

# ***The Strategic Role of Investment Banks in Initial Public Offerings: Pricing, Underwriting, and Market Signaling***

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**Abstract.** IPOs are an essential stage in the corporate life cycle whereby private firms transform themselves into publicly held companies that gain access to finance, regulation, and oversight. In such a scenario, it is imperative to consider the strategic importance of investment banks in the IPO process. Investment banks are not just intermediaries; they play almost all roles in the IPO process including valuation, due diligence, book building, underwriting, investor relations, and stabilization after listing. This study aims to investigate the strategic importance of investment banks in the IPO process based on three major themes: pricing, underwriting, and signaling. This paper will focus on the role played by the investment bank in the IPO valuation process and the issue of striking a balance between issuer and investor interests. In addition, this paper will consider the role of investment banks in IPO underwriting in terms of risk transfer, credibility, and execution. Finally, this study will analyze how investment banks add value to the IPO process in terms of reputation, road shows, research coverage, and stabilization against various challenges including conflict of interest, investor psychology, direct listings, SPACs, and regulatory developments.

**Keywords:** Investment Banks, Initial Public Offerings, IPO Pricing, Underwriting, Market Signaling.

## **1. Introduction**

The global market for initial public offerings (IPOs) has undergone a great deal of evolution over time due to macroeconomic factors, regulation, technological development, and investor sentiment. Generally, IPOs happen in waves rather than continuously as companies float on the stock market when the circumstances, profit potential, and values are favorable [1]. The aftermath of the coronavirus pandemic has made IPO markets very complex as there are now differences in the levels of investors' protection, risk, and environmental, social, and corporate governance (ESG) reporting across countries [2]. Besides, direct listings and special purpose acquisition companies (SPACs) pose difficulties to traditional IPOs and question the changing nature of banks' involvement.

Though the process of IPOs underwent structural changes, banks continue playing key roles in many IPO deals as they no longer act as intermediaries but also as strategic partners. The whole IPO process is highly complicated and cannot be considered merely a mechanical exercise due to the

information asymmetry that exists since insiders are better informed than outsiders. There are many strategic roles of banks such as valuation, coordination of book-building, underwriting, investor relations, and provision of reputational capital. For instance, the research shows that investment banks play a role in issuers' certifiers while incentivizing investors to reveal their private information during the period of pricing.

Although the public market infrastructure has been changing significantly, the importance of the investment bank's role in many IPOs remains vital.

### **1.1. Research purpose and research questions**

The aim of this study is to explore how investment banks maintain an optimal trade-off between value creation and risk-taking in three dimensions – pricing, underwriting, and signaling. The difference with many other studies is that this study assumes the active role of investment banks in valuation, risk management, and signaling processes.

In order to answer this question, this study examines the following issues:

(1) How do investment banks promote efficient pricing and prevent underpricing via valuation methods, book building, and organizational changes?

(2) What role do various types of underwriting contracts and syndicate structures play in spreading risks and achieving better results from issuances?

(3) What is the role of investment bank reputation in reducing information asymmetry, and what functions does communication during roadshows and post-IPO share stabilization have as credible signals?

(4) How are new listing methods (direct listing, SPAC) and new regulatory frameworks changing the traditional role of investment banks in IPOs?

The answers to these questions will be given further in the corresponding chapters.

### **1.2. Significance of the study**

This research holds both theoretical and practical significance. From a theoretical perspective, it contributes to the IPO intermediation literature by demonstrating that pricing, underwriting, and signaling cannot be analyzed in isolation. On the contrary, they constitute an integrated strategic system that investment banks employ to help companies access public capital markets under uncertainty.

From a practical perspective, this research explains why companies continue to rely on investment banks for accessing public markets despite the growing availability of alternative listing strategies. For issuers, it informs decisions regarding the timing and structure of their offering, and the selection of underwriters. For investors, it helps them understand how underwriter selection shapes market perception of IPO firms [3]. For regulators, it underscores the continued significance of investment banks in maintaining fair and efficient capital markets [2].

## **2. Theoretical background of initial public offerings and investment banking**

### **2.1. Definition of initial public offerings and their basic process**

Initial Public Offering (IPO) refers to the process through which the first public sale of shares takes place. This event marks the shift from private to public ownership status. As a result, companies raise funds from the general public in stock markets. There are several motives behind the decision to conduct an IPO including raising capital, expanding the business, providing exit opportunities for

early investors, image building, and using equity financing for acquisitions. Nevertheless, going public has some associated costs such as disclosures, regulatory constraints, underwriting, and market-related costs [1].

There are four main stages in the IPO process. Firstly, the company evaluates itself for IPO listings considering capital needs, governance issues, and timing. Secondly, the company gathers the assistance of advisors, auditors, and legal experts. Thirdly, the company hires one or several investment banks which offer valuation, structure, and sales of shares. Finally, the company conducts book-building processes and then sells its shares and trades on a stock market. From this point forward, the performance of the firm is publicly assessed [1].

It should be acknowledged that the IPO process is dynamic. To put it differently, the stages of IPO cannot be strictly delineated from each other. This happens due to the fact that all IPO process elements involve some information gathering process before marketing and roadshow.

## 2.2. Definition and general functions of investment banks

An investment bank is a financial institution that offers special services. An investment bank differs from a commercial bank by the absence of the main activities related to taking deposits and giving loans. Investment banks deal with security underwriting, mergers and acquisitions of advisory services, capital raising, research production, and security distribution.

There are five basic activities that an investment bank conducts within the IPO framework. Firstly, it provides advisory services to make sure the going-public decision is reasonable. Secondly, it deals with valuation and pricing of shares, based on financial analysis, comparison with the same companies, and evaluation from investors. Thirdly, it becomes the underwriter, bearing either full or partial responsibility for the risks of issuing the shares depending on the agreement with the issuer. Fourthly, it conducts marketing and distribution services including road shows, meetings with institutional investors, and book building. Finally, it performs the function of certification, because an investor evaluates the IPO based on the reputation of the investment bank, certifying that the issuer was evaluated appropriately [3].

Two major roles of an investment bank in IPOs have been formulated in the literature. The first one is the information production role, which has been explained by Benveniste and Spindt when studying the use of indications of interest in order to estimate the share pricing during an IPO under asymmetric information [4]. The second role performed by the investment banks during IPO is certification, described in detail by Booth and Smith [5].

## 2.3. The importance of investment banks in IPOs

The roles of investment banks in assisting IPOs include reducing uncertainty, dealing with complicated transactions, and transforming private information into market trustworthiness. Applying information production and certification theories, they satisfy issuers' concerns via three channels: improving valuation credibility, facilitating information exchange between issuers and investors, and providing strategic partnership in complex situations.

First, they improve valuation credibility. Research demonstrates that final IPO prices are affected by valuation procedures as well as by investors' information, with information formation and reduction of underpricing partially facilitated by the relationships between bankers and fund managers [6]. Second, they assist in the exchange of information between issuers and investors. For example, underpricing was negatively associated with the reputation of underwriters in China's Growth Enterprise Market due to higher levels of uncertainty [3]. Third, they maintain their

importance when IPOs become increasingly complex. Underpricing increased during Covid-19 and ESG development, making the special knowledge of banks crucial [6,7]. Other methods such as direct listing and SPACs are possible for certain types of issuers only, and even then, banks are essential in both [8,9].

Cross-border and growth-oriented issuers are characterized by more complexity and uncertainty. For them, banks provide strategic partnerships in addition to deal management.

### 3. Pricing mechanisms and valuation

#### 3.1. Valuation of the issuing firm

Valuation is another important, but difficult task that occurs during an IPO. Valuation requires significant experience and is complicated due to the absence of price history before the IPO. Investment banks try to evaluate the intrinsic value of companies and make their presentations publicly.

Discounted cash flow method, comparable company valuation approach, and earnings multiples are used in practice by banks for this purpose. However, the valuation of the IPO is much more than mere numbers. Market situation, industry peculiarities, timing of the issue, and the story that the issuer has can influence IPO valuations [1]. The bank should consider the issuer's expectations, investor demand, and the IPO itself.

Valuation of mistakes can have negative consequences for the deal. Overvaluation leads to poor demand and low performance after the IPO. Undervaluation implies losing opportunities for a company. According to Ritter and Welch, the successful IPO valuation requires market dynamics consideration and undervaluation [1]. Therefore, valuation and IPO stock allocation become strategic, and not just financial.

Experience, market understanding, and feedback from investors are necessary when the issuing company operates in non-comparable and/or fast-growing or risky markets. As a result, valuation is one of the most difficult tasks performed by banks.

#### 3.2. Setting the offer price range

After the valuation of the issuing firm is completed, investment banks usually recommend a price range for the initial public offering. Such a range can serve several important purposes: it sets up a comparison point for investors, shows how the issuer positions itself on the market, and allows for possible changes throughout the process of promotion and order bookbuilding. In this regard, the price range is not just a number but also a communication tool used strategically.

While based on financial analysis, the price range is often influenced by external market conditions. Investment banks should consider the level of performance of competitors, current investor preferences, valuation levels within the sector, and the expected level of demand. According to Benveniste and Spindt, price settings in IPO are strongly related to the information collected during the process and cannot be based solely on the results of valuation [4]. As such, the price range should be treated as a starting point for testing on the market.

Another function of an appropriate price range is the mediation of issuer and investor needs and interests. Usually, issuers want to receive higher proceeds from their stock issue; meanwhile, investors expect favorable conditions and high profits from purchasing newly issued shares. Therefore, investment banks should develop a price range that would be ambitious but believable

enough to attract many investors. It can be stated that this function is one of the most visible ways to show the value provided by investment banks to the IPO.

According to recent research, the interests and incentives of underwriters affect the quality of price setting in IPOs. For instance, Espenlaub, Mohamed, and Saadouni have found that better price informativeness and information production is associated with increased underwriter incentives [10]. Thus, the results of setting a price range may reflect underwriter incentives besides issuers' financial characteristics and fundamentals.

### **3.3. Bookbuilding and price discovery**

Bookbuilding involves the gathering of indications of interest from investors before setting up the final issue of price. It is a key feature of the modern IPO process and one of the main reasons why investment banks play an important role in the issuing of securities.

According to the conventional theory of Benveniste & Spindt, bookbuilding allows for the use of incentives by the underwriter to get privately held information about the value of the issue from informed investors. Given the fact that informed investors reveal their information only if they receive a sufficient incentive, this aspect provides one of the possible explanations of underpricing. Simply put, the process of bookbuilding is not just marketing but a particular information gathering activity.

The underwriter evaluates various assessments made by different investors with respect to the issuer through roadshow presentations, meetings, and discussions. These evaluations determine adjustments to both the final price of the stock and the method of allocation. As such, the investment bank acts as a mediator between issuers and investors, additionally, between private information and pricing.

Recent literature adds another element to the above process. According to Brockman et al., social relations between the members of the banking industry and the participants of the bid may contribute to the information sharing among investors, and, therefore, reduce the level of underpricing in some cases. As follows, price discovery includes both formal aspects of the procedure and trustful relations with repeat business.

Therefore, bookbuilding improves the position of investment banks as it allows for integrating analysis-based valuation with real-time information about the demand.

## **4. Underwriting, risk bearing and syndication**

### **4.1. Meaning and types of underwriting**

Underwriting represents the legal basis of the IPO process. Underwriting stands for the agreement according to which the investment bank is responsible for ensuring the company's entrance to the market via offering of shares and based on the type of the agreement, bears part of the risk related to the offering.

There are two classical forms of underwriting – firm commitment underwriting and best efforts underwriting. Firm commitment means that the investment bank is obliged to purchase the shares offered and to resell them on the stock market, thus bearing more financial risk. Best efforts stand for the agreement according to which the investment bank undertakes to promote shares without making any commitments regarding the sale of all of them. Hence, these forms of underwriting imply different risks for issuers and underwriters as well as different investor confidence levels.

According to Booth and Smith, underwriting represents an important certificate as the underwriter is responsible for putting their name at stake to assure investors about thorough screening and pricing of the issue [5]. In this case, underwriting implies much more than distribution services as a tool that reduces information asymmetries. The chosen model of underwriting can have an impact both on risk distribution and on investors' perception of the IPO.

#### **4.2. Risk allocation in the IPO process**

IPOs come with several dimensions of risk. For the issuer, there is a possibility of low demand, insufficient returns from the offering, or damage to reputation in case of poor performance. For investors, there are concerns about overvalued offers or information asymmetries. Finally, investment banks face reputational risk; in addition, depending on the type of underwriting, there may be a financial risk involved.

Through underwriting, risk is distributed between all major parties of the transaction. A strong underwriting arrangement implies that banks take up most of the risks in the process and provide additional security for the issuer. In exchange, they charge high commissions and have more influence on how the transaction takes place. Thus, underwriting cannot be viewed merely as an agreement but as an instrument that enables efficient risk management by distributing it to different parties.

This feature is especially important in volatile conditions. At times when the sentiment of investors is weak, issuers depend more on the help of reputable banks capable of managing expectations and prices and controlling the whole transaction process. This is shown by Zhang's findings regarding greater underpricing of IPOs during the period of the coronavirus pandemic [2].

#### **4.3. The role of syndicates in IPO underwriting**

Large-scale IPOs frequently exceed the scope of a single underwriter due to their magnitude or high-risk nature. In this instance, underwriting syndicates are employed rather than relying on an underwriter. Typically, an underwriting syndicate involves a lead bank in addition to other participating banks that contribute to allocation of expertise, investor relations experience, and industry understanding.

Syndication has several advantages. For starters, syndication offers risk sharing between different firms. Second, it expands the potential of the issuer to reach diverse investment circles. Third, it broadens the reputational and market knowledge base of the issue. Consequently, syndication generally boosts the likelihood of success.

Conversely, syndication poses coordination issues. The lead bank must coordinate all communications, allocation, and decisions that require to be undertaken. If handled properly, this can aid in improving execution and coverage. Poor coordination might result in inefficiency in pricing and market communication.

Hence, the syndicate arrangement affects both execution and strategy. Syndication will affect marketing efficiency, risk distribution, and issue perceptions.

#### **4.4. Underwriting as a strategic function**

Understanding underwriting should not be seen in terms of being purely a technical function; it impacts risk sharing, the perception of quality of the issue in the marketplace, and the effective completion of the deal.

The certification hypothesis by Booth and Smith argues that a part of the strategic significance of underwriting lies in the transfer of reputation from the underwriter to the issuer [5]. Recent research findings suggest that the success of underwriting can be explained based on the internal incentives of the investment bank doing the underwriting. According to Espenlaub, Mohamed, and Saadouni, stronger incentives at the underwriter side mean that the range of prices is more informative. There is more effort made during the roadshow, and the initial return is lower [10]. This suggests that, apart from the formality of the contract used, the effectiveness of underwriting also relies on how much effort is put into the work and information provided.

For the issuer, underwriting provides assurance. For the investor, it means screening and certification. For the underwriter, it helps to extract value from their reputation.

## **5. Reputation, signaling and post-IPO dynamics**

### **5.1. Information asymmetry in IPO markets**

The informational asymmetry between insiders and outside investors forms an essential feature of IPO markets. Managers know much more about the real quality of their business, its strategies, and possible risks than the public investor who looks to assess the new stock. As a result, there will be uncertainty and caution on the part of public investors due to the information problem.

Hence, IPO markets operate based on a great number of signals. It is crucial for investors to assess the issuing company as well as those people who work as intermediaries in the transaction. It explains the strong role played by investment banks in such transactions since they assist in translating information from inside companies into the signal.

The more complex valuation of the issuer is, the greater the role of signaling becomes. High-growth or innovation-based companies may have difficulty obtaining recognition from investors because of the increased skepticism of outside investors, which results in increased attention paid to signals coming from outside parties. Therefore, an investment bank does not limit itself to organizing the deal; it helps shape its meaning in the market.

### **5.2. Investment bank reputation as a market signal**

In the context of IPO markets, among many signaling factors available, the reputation of the underwriter ranks among the most important and powerful. Having a prestigious underwriter means that sufficient due diligence was conducted, that proper pricing of the stock was established, and that the issuer is likely to be of good quality.

This logic coincides with the certification hypothesis that argues that the underwriter's reputation is instrumental in certifying quality of an issue and minimizing informational problems in IPO markets [5]. Later research provides evidence in favor of this theory. In a study, Hu et al. find that having reputable underwriters in the Chinese Growth Enterprise Market leads to lower IPO underpricing because they alleviate informational problems and instill confidence among investors [3].

Reputation gains increased importance amid heightened uncertainty. If the uncertainty about the fundamental quality of an issuer is great, investors might use an underwriter's reputation as a proxy measure of quality. In this context, the reputation capital provided by an underwriter plays an essential role before the transaction takes place.

### 5.3. Investor communication and roadshows

One of the ways through which investment banks can make a positive contribution to IPOs is through investor communication. Investor communication involves roadshows, analyst presentations, pre-marketing conferences, as well as meetings between banks and institutional investors.

Of all these modes of communication, roadshows stand out in terms of importance because they allow both the issuer and the investment bank to communicate their strategic vision and growth stories, while addressing the questions of the investors and generating an interest in the issuance. The importance of roadshows lies not only in the provision of information, but also in demonstrating preparation, confidence, and credibility of the issuing firm and its sponsors. According to empirical studies, social ties between investment bankers and institutional investors may result in better information flow and effective pricing [6].

Therefore, investment bankers can improve the effectiveness of their communications due to the quality of information that they provide and the trust that they build during the process. This, in turn, allows roadshows to increase the signaling effect of investment banks by lowering uncertainty and creating a demand for the IPO.

### 5.4. Post-ipo stabilization and market support

However, the activities of the investment bank can extend well beyond the primary trading of security. Indeed, in many IPO transactions, the underwriter continues to offer support for the issue in the form of stabilization activities, research analysis, and investor relations services.

Stabilization after an IPO is an important task because new issues are vulnerable to price fluctuations during the early stages of their life cycle. Through organized trading activity when permitted, the underwriter will be able to smooth out any sudden price changes and build market confidence. Furthermore, continued analyst coverage and regular communication can also sustain interest from investors after an IPO.

On the other hand, post-IPO support can also raise conflict-of-interest issues because the same firm that prices and markets the IPO can also affect its reputation in the secondary market.

### 5.5. IPO underpricing and strategic pricing decisions

IPO underpricing refers to the practice of pricing below the observed market price right after trading begins. It is one of the most studied aspects of IPOs, indicating both market inefficiencies and deliberate actions.

Benveniste and Spindt argue that underpricing may be viewed as a signal revealing private information from informed investors [4]. Consequently, underpricing does not always occur due to a mistake, but in some cases, it is an integral part of the IPO itself.

At the same time, underpricing may pursue different strategic aims. Slight underpricing can help gather more investments, increase the probability of fully subscribing to the deal, gain positive first-day media attention, and protect the underwriter's reputation from the possibility of a failed deal. However, excessive underpricing incurs costs directly on the issuer in the form of reduced funds raised.

The results of recent studies show that underpricing depends on several variables, such as the underwriter's reputation, banker-investor networks, underwriter motivations, and institutional

environments that IPO underpricing should not be considered only as an error in pricing but rather because of strategic decisions made in uncertain conditions [3,6,10,11].

## **6. Contemporary challenges and regulatory evolution**

### **6.1. Conflicts of interest**

One main criticism of the conventional IPO process has to do with the number of interests that investment banks have. They are involved in advising the issuing companies, distributing stocks to buyers, protecting their reputation, and maintaining connections with their institutional customers. It is not always assured that there is some sort of alignment in their interests, which leads to the problem of conflict of interest.

Issuing companies would prefer an increase in the offer price and amount of money raised, while the stock buyers will be more inclined toward having low-priced entry points and high gains. Placed between them, the investment bank might be compelled to balance both sides' demands. This issue could equally apply to other factors like research coverage and analyst behavior.

### **6.2. Market volatility and uncertain investor sentiment**

However, even the most experienced investment banks cannot exercise full control over the conditions in the markets. IPO success is largely determined by the market sentiment, uncertainties, and cycles within the market. In times of volatility, even well-thought-out issues might be associated with lower demand, prices, or delays in their implementation.

As Zhang argues, IPO underpricing increased significantly in the context of the coronavirus period, which means that uncertainties can exacerbate pricing disparities despite the ongoing activity of financial intermediaries [2]. Therefore, it is clear that investment banks can control uncertainty but not eliminate it.

Market sentiment plays an important role regarding IPOs because these securities tend to depend strongly on their timing. An IPO that will receive great demand in one situation can face problems in another market situation. Hence, along with assessing the value of the company, banks should also evaluate the conditions in the market to see if it is appropriate to make the issue.

### **6.3. Regulatory pressure and competitive environment**

It is worth noting that the regulatory and competitive environment within which IPOs operate is becoming tougher in today's world. In terms of regulation, there are increased disclosure requirements, enhanced governance scrutiny, and growing concerns about sustainability and ESG factors. Baker et al. point out that high ESG-related governance environments are linked to lower IPO underpricing [7]. Furthermore, according to Boulton, mandatory ESG disclosure decreases IPO underpricing, especially in poor information environments [12]. Taken together, the above results show that regulatory quality may have a significant impact on the efficiency of IPO pricing.

From the competitive side, traditional IPOs find themselves competing against alternative listing mechanisms such as direct listings and SPAC listings. Brown et al. have found that companies choosing to undertake direct listings have greater size, profitability, and low debt ratios compared to average IPO firms; therefore, direct listing is suitable only for some firms [9]. Additionally, Gahng et al. have shown that the merger with SPAC may come at a higher cost than the traditional IPO approach and lead to worse outcomes for public investors [8]. The results imply that innovation has not made the intermediation of the offering redundant but changed its nature.

Overall, the regulatory pressure and competitive environment should not make investment banks obsolete but force them to evolve. Moving forward, the intermediation process may become less dependent on transactional tasks and depend more on advisory skills, reputational capital, and experience in handling challenging situations related to disclosure and pricing.

## 7. Conclusion

This paper demonstrates how investment banks influence IPOs through three channels: pricing, underwriting, and signaling.

Pricing: involvement in valuation, offer range specifications, and price discovery using book-building.

Underwriting: risk sharing, syndication, and security distribution.

Signaling: uncertainty reduction through reputation, investor information, and IPO follow-up.

Consequently, investment banks do both facilitate IPOs and guide the way for firms' entrance into the public market and investors' perception of them through financial expertise, market connections, and reputation under uncertainty.

However, this study limited to the classical IPO process and lack of a comprehensive comparison between various pathways of IPOs; more emphasis on theoretical perspectives rather than practical aspects; although some recent developments such as environmental, social, and governance considerations, direct listing, and SPACs are mentioned, further examination is needed.

Thus, the future research would focus on cross-country IPO comparison with direct listing and SPACs; effect of ESG reporting, governance, and digitalization on IPO intermediation; whether bank reputation still matters in other institutional environments and industries.

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