SELF-DEALING IN SECURITIES ISSUANCE

Evidence from U.S. State Bonds

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Abstract

Self-dealing in securities issuance can be characterized by an issuing manager who gains at the expense of the other existing stakeholders in the issue. The current system of public securities issuance for U.S. states potentially allows for conflict of interest through campaign contributions that benefit issuing officials. This paper shows that selecting a contributing underwriter through negotiation results in underpricing compared to a non-contributing underwriter. It also shows that an increase in the amount of campaign contributions by an underwriter results in an increase in the likelihood of selection. This result is mainly driven by lower-ranked underwriters. The pricing result is robust to endogeneity of the selection of a contributing underwriter. First-stage results of instrumental variable regression methods indicate that a large margin of victory for the political official is associated with a larger proportion of potentially conflicted deals. In addition, out of all the issues done through negotiation by underwriters who contributed, the issues that went to market in the year immediately after an election are the most underpriced.

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By hiring an intermediary to price and distribute its securities, an issuer pays not only fees, but also costs due to misaligned incentives. These costs include a low issue price and possibly a hasty sale. The situation is more complicated for entities with an internal agency problem, and involves three types of parties: the issuing stakeholder (the principal), the issuing manager (issuing agent), and the underwriter (underwriting agent). If the incentives are not perfectly aligned internally, there is the potential for self-dealing.

Self-dealing in securities issuance can be characterized by an issuing manager who gains at the expense of the other existing stakeholders in the issue. By offering side payments to the manager, the underwriter may gain a competitive advantage and realign incentives so that the manager is more willing to accept underpricing. Is there self-dealing in securities issuance? Do side payments to the issuing manager result in underpricing if selected? Do side payments by the underwriter increase the likelihood of selection? I use a state bond sample to answer these questions.

The primary market for state government bonds is an excellent setting to investigate this topic for three reasons. The electoral process for government representatives is susceptible to potential conflict of interest given the campaign finance system. There is an internal political agency problem involving the voter-taxpayer (the principal) and the political representative (the agent), where the voter-taxpayer requires that the political representative receive the highest possible price for public securities. In many instances, the political representative may be influenced by campaign contributions to serve narrow interests. Self-dealing in securities issuance occurs when contributions that benefit the political representative cause a dereliction of duty in the area of public finance. Given this general agency problem, the primary benefit of this sample as opposed to a corporate finance sample is that information regarding these side payments is publicly available. Second, in terms of estimating the pricing effects due to self-dealing, many government bonds carry third-party insurance which minimizes credit risk (Thakor (1982)). This feature somewhat obviates asymmetric information explanations that rely heavily on credit risk: Rock (1986). Finally, key institutional issuance characteristics and the set of potential underwriters for municipal bonds are not wholly unique to the public sector. Hence, some of the results from this type of analysis have implications for a wide variety of securities issuance settings. Given the focus of this paper, one important feature of the sample is the issuer's choice of underwriter selection method. A state security issuer can choose to commit to

an underwriter through the negotiated method, or allow the underwriters to compete for the issue in an auction. The negotiated method allows for self-dealing, whereas the competitive method should mitigate the effects of self-dealing.[1] Therefore the main focus of this study uses bonds issued through the negotiated method. In addition, pricing analysis uses insured bonds with minimal credit risk.

How effective are side payments to the issuing agent in the selection of the lead underwriter? Specifically, do campaign contributions increase the likelihood of being selected through the negotiated method? Analysis of the data shows that an underwriter is more likely to be selected through the negotiated method for an issue if a contribution was made. By investigating the relative amount contributed, I show that there is a non-monotonic effect of contributions on the likelihood of selection; contributing too much may reduce the likelihood of being chosen. This result is mainly driven by lower-ranked underwriters. This is consistent with explicit and implicit campaign contribution limits having an effect on this potentially conflicted exchange. What are the pricing and performance effects of contributions for issuers that use the negotiated method? I show that selecting a contributing underwriter results in underpricing for the issuer, and no difference in long-term post-sale date performance compared to a non-contributing underwriter. Therefore underpricing due to the selection of a contributing underwriter is not due to long-lasting demand-side effects. These results are robust controlling for underwriter prestige, funding source, year effects, state effects, and state clustering for standard errors. Pricing results also are robust to endogeneity of the selection of a contributing underwriter. Using a robust Ordinary Least Squares (OLS) specification, the abnormal first-day return is approximately 2.807 percent higher for a bond associated with a contributing underwriter compared to a bond associated with a non-contributing underwriter. First-stage results for instrumental variables (IV) methods show that the likelihood of selecting a contributing underwriter increases with the politician's margin of victory. This result is consistent with the relationship between broad voter support and abuse of power by the political official. Consistent with the literature on political business cycles with government officials avoiding costly actions before an election, an examination of issuer behavior shows that none of the contributed issues went to market in the year before an election. In addition, out of all the

[1] Even though it is not the focus of this particular paper, a discussion on negotiated versus competitive underwritings is provided in Section VIII.

issues done by underwriters who contributed, the issues that went to market in the year immediately after an election are the most underpriced. Consistent with the results of the underwriter choice analysis, the effect is stronger for lower-ranked underwriters. To the best of my knowledge, this is the first finance paper to find support for self-dealing by estimating the market pricing effect due to payments to the issuer by the selected underwriter.

This paper is organized as follows. Section II provides a brief literature review of related areas of research. Section III presents information on the background on municipal bond issuance and regulation. Section IV presents the sample construction and description. Section V presents results on campaign contributions and underwriter choice. Section VI presents the methodology for abnormal bond return calculation for pricing analysis. Section VII shows the results of the empirical analysis of pricing. Section VIII provides the reader with robustness considerations and results. Section IX discusses the implications for corporate finance, and Section X concludes.

II. Related Literature

In answering these research questions, this paper builds on the literature on agency and securities issuance. External agency conflict has been theoretically linked to securities underpricing. In many cases the issuer delegates the pricing decision to the underwriter. This is done in order to take advantage of the underwriter's information about demand conditions. The underwriter self-selects a contract that optimizes the underwriter's unobservable selling effort. Given that effort is costly to the underwriter, there is underpricing in equilibrium as a result of the informational advantage (Baron (1982), Baron and Holmstrom (1980)). McAfee and McMillan (1987) introduce a market for agent services, which is more applicable for securities issuance in the presence of underwriter competition. Potential agents of different types compete with each other. The principal does not observe these types, and there is adverse selection in the market. The contract design exploits agent competition, and instead of the risk-sharing moral hazard tradeoff, the contract exhibits an adverse selection moral hazard tradeoff. The contract screens agents according to their abilities, and a more efficient agent is induced to work at a rate closer to the first best (less underpricing) than in the usual principal-agent model. In modeling

the relationship between external agency and the pricing of securities, one typically makes assumptions about the underwriter's intrinsic ability and cost of effort. By providing results that show that underpricing varies over the election cycle, this paper contributes to the theoretical literature on external agency and underpricing by suggesting that underwriters may not underprice because of intrinsic quality; they can vary the amount of underpricing depending on the incentives involved. Ljungqvist (2003) uses UK data where there is sufficient heterogeneity in commission costs to show that by making the underwriter's compensation optimally sensitive to the offer price, efficient contracting between the issuer and the underwriter reduces the amount of underpricing. Levitt and Syverson (2005) compare home sales in which real estate agents are hired by others to sell a home to instances in which a real estate agent sells his or her own home. They show that homes owned by real estate agents attract higher prices than those not owned by real estate agents. These results provide support for external agency theories of securities issuance.

In addition to external agency, there may be an internal agency problem involving three types of parties: the issuing stakeholder (the principal), the issuing manager (issuing agent), and the underwriter (underwriting agent). Ljungqvist and Wilhelm (2003) show that higher pre-issue ownership of issuing managers results in less underpricing. Therefore monitoring by the issuer can reduce the amount of underpricing, thus highlighting the importance of internal and external agency theories. In the presence of internal and external agency, there is the potential for self-dealing. Even though it is the duty of the issuing manager to get the highest possible price for the issue, the underwriter may be successful at motivating this agent to accept a lower than fair price by offering side payments. Anecdotal evidence of self-dealing in the form of 'spinning,[2]' along with a vigorous regulatory response that came out of behavior in the late 1990s, has engendered an interest in this problem. Moreover, Loughran and Ritter (2004) put forward indirect self-dealing explanations of this type for the magnitude of equilibrium equity IPO underpricing in the late 1990s.[3] Direct analysis of self-dealing and its effect on pricing requires the use of a potentially conflicted payment variable. Given the data limitations regarding transfers between underwriters and corporate executives (Ljungqvist (2004)), I use a state government bond

[2] The co-opting of executives of issuing firms by setting up personal brokerage accounts and allocating profits from buying and selling hot IPOs.

[3] See "Underwriters Set Aside IPO Stock for Officials of Potential Customers," *The Wall Street Journal*, November 12, 1997, for a representative article in the popular press.

sample, where side payments are campaign contributions, the U.S. taxpayers represent the stakeholders, and issuing political officials are the issuing management.[4] By finding evidence consistent with self-dealing, this paper provides support for internal and external agency theories of securities issuance.

By providing evidence on campaign contributions and self-dealing, this paper also adds to the political economy literature on interest groups and campaign finance. There are two schools of thought on equilibrium contribution effects and contributor motives. One school supports position-induced contributions, where contributions are made to candidates who have a pre-existing policy position favorable to the contributor (Baron (1994), Bronars and Lott (1997)). The other school promotes the notion of service-induced contributions; contributors will contribute in order to influence the behavior of political officials (Baron (1989) and Coate (2004)). In the presence of self-dealing, contributions are not made to promote particular policies; hence, the evidence in this paper provides support for the service-induced campaign contribution assumption. One interesting result of the paper is that the incidence of potential self-dealing increases in the margin of victory for the politician. I interpret this result as reflecting a positive relationship between broad voter support and abuse of power. However, there is a competing hypothesis in that contributions may be more important to the politician in close elections and may result in more potentially conflicted exchanges. Given the results of the choice model where there is a non-monotonic effect of contributions on the likelihood of being selected, the former explanation has relatively more support in the data. The first-stage results also suggest that the effectiveness of service-induced campaign contributions may be related to the margin of victory. This notion would have implications for the impact of close elections on the incentives to contribute when voters are not swayed by special interest money. The results for the underwriter choice model where there is a non-monotonic effect of contributions for lower-ranked underwriters suggest that contributions are not hugely pivotal. Therefore, in close elections voters may not be influenced by campaign contributions from special interest groups. Hence, in the case of service-induced campaign contributions, close elections should result in fewer contributions by special interests when voters are not influenced by candidates who receive large amounts in contributions from special interests.

[4] Conflict of interest in municipal bond issuance has been documented in the public financial management literature (Hildreth (1993, 1994), Filling (1996), and SEC (1994)). This research though has not focused on first-day returns. Instead it has mostly focused on general issue costs.

III. Municipal Bond Issuance and Regulation

The municipal bond market provides the state and local governments the ability to borrow money for projects that have a substantial impact on the general citizenry. Projects funded include schools, highways, hospitals, housing, sewer systems, etc. Given that a decision has been made to issue debt, the first stage of the issuance process is one of security structuring and general financial advice. Typically, the issuer's bond counsel and financial advisor play key roles in the first stage. Large issuers with sufficient knowledge of financial markets and local laws, in most cases, do not utilize the services of a financial advisor. The second stage is one of underwriter selection and bond sale. An issuer can choose to commit to an underwriter through the negotiated method, or allow the underwriters to compete for the issue in an auction. In both negotiated and competitive sales, underwriters assume complete risk and responsibility for selling the bonds. For a competitive issue, the underwriter is committed to the price upon the end of the auction. In a negotiated sale, the underwriter decides on the price when the deal is underwritten based on discussions with the issuer and issue demand, not on a specific time schedule.

In the 1980s underwriters started to give large amounts of money to politicians in the form of campaign contributions. This event coincided with increased use of the negotiated method (Cross (1993)). Concerned about conflict of interest problems, the Municipal Securities Rulemaking Board (MSRB) enacted Rule G-37[5] on April 7 1994, prohibiting a broker, dealer, or municipal professional of the broker from engaging in negotiated municipal securities business with an issuer if political contributions have been made to officials of the issuers by the finance agent in the previous two years. After the enactment of Rule G-37, underwriters began to employ consultants as middlemen to lobby on their behalf in order to promote negotiated issuance business.

On January 17, 1996, the MSRB adopted Rule G-38 which required underwriters to disclose information about consultant arrangements. Rule G-38 defines consultants as any person used by a broker, dealer, or municipal securities dealer to obtain or retain municipal securities business through direct or indirect communication by such person with an issuer on behalf of such broker, dealer, municipal securities dealer, or any other person. It goes on to state that the

[5] The Municipal Securities Rulemaking Board, http://www.msrb.org

following persons shall not be considered consultants for the purposes of this rule: (a) a municipal finance professional of the broker, dealer, or municipal securities dealer; and (b) any person whose sole basis of compensation from the broker, dealer, or municipal securities dealer is the actual provision of legal, accounting, or engineering advice, services, or assistance in connection with the municipal securities business that the broker, dealer, or municipal securities dealer is seeking to obtain or retain. Concerned about underwriters avoiding regulatory monitoring through the use of consultants, Rule G-38 was amended in 1999 by the MSRB to require dealers to list not only their campaign contributions, but the contributions of their consultants.

IV. Data and Sample Construction

A. Bonds

This paper uses a sample of U.S. state-level municipal straight bond offerings in the years 1998 to 2004. The search set of municipal bond issuers includes all 50 states and excludes Puerto Rico and other U.S. territories not subject to sample political conventions. The sample used for underwriter choice analysis consists of 797 insured and uninsured bonds issued by underwriters selected through the negotiated method. The sample used for return analysis is limited to insured offerings.[6] The insured sample consists of 248 bonds. All offer information including price data is obtained from the *Bloomberg* database. The main bond data items used in this paper are insurance classification, time to maturity upon issue, bond size in U.S. dollars, issue size of the serial collection of bonds in U.S. dollars, information on whether a bond is taxable by the issuing state, and funding source type; an underlying quality score for each bond is recorded based on ratings by third-party agencies using a system consistent with Nanda and Singh (2004) (see Appendix for details). Daily bond returns are subsequently calculated using the price and coupon data. Benchmark return data for the Lehman Brothers Municipal Bond Index are collected from the *Datastream* database.

[6] This study recognizes four primary insurance entities: the Municipal Bond Investors Assurance Corporation (MBIA Corporation), successor to the Municipal Bond Insurance Association, founded in 1974; the Ambac Financial group (AMBAC), founded in 1971; the Financial Guaranty Insurance Company (FGIC), founded in 1983; and the Financial Security Assurance Inc. (FSA).

Table I shows the sample characteristics of insured bonds. Ninety-one percent of the insured sample consists of bonds secured by the taxing authority of the state, whereas the remainder consists of bonds that use project revenue as the funding source. Eighty-three percent of the insured sample consists of issues that are state tax-exempt. Table I also shows that none of the insured bonds trade on the sale date and all of the bonds trade within the first five days of issuance. In addition to the lack of liquidity, the municipal bond market lacks transparency and trading costs are large (Green et al. (2005) and Harris and Piwowar (2004)). But Harris and Piwowar (2004) show that insured bonds and straight bonds are likely to have smaller than average trading costs. They show that the maximum effective spread for straight bonds in their sample is one percent. Hence large spreads are less of a problem for this sample as opposed to the general municipal bond market.

B. Campaign Contributions

The main analysis for this study uses campaign contributions from the previous two years to the sitting elected governor at the time of sale[7] as the set of potentially conflicted payments.[8] In order to determine the governor in power for each state in the sample, election results for governors for the sample period are sourced from various state election Web sites and the *CQ Voting and Elections Collection*. Campaign contribution data--payment date, amount, and contributor information--for the identified governors are sourced from state election and online campaign finance databases (see Appendix for the list). Only database records kept in spreadsheet format with employer and/or corporate contribution data are used. This restriction ultimately limits the initial set of states to California, New Jersey, Michigan, Ohio, Massachusetts, Hawaii, New York, Rhode Island, and Wisconsin. The insured sample consists of data from the following states: California, Massachusetts, Hawaii, Ohio, Rhode Island, and Wisconsin. Contributions are grouped by gubernatorial candidate and filtered for underwriters ranked in the top 100. Table I shows that based on the potentially conflicted payment classification, roughly 27 percent of the insured bonds are associated with prior campaign contributions.

[7] This limits the set to initial governors and excludes politicians who come to power due to the departure of elected officials.
[8] Campaign contributions are initially recorded a year into the start of the contribution series for each state.

C. Underwriters

In order to focus on underwriters that could be reasonably chosen by each issuer, each candidate file is filtered for employees and related entities of top-ranked municipal bond underwriters based on total dollar amount of issues. An underwriter is classified as such if it appears on the list of top 100 underwriters for short-term or long-term issues in any of the fall editions of the *Bond Buyer's Municipal Marketplace Directory* for the years 1997 to 2004. All mergers and acquisitions involving these underwriters are recorded with relevant dates to identify the correct entities through the sample period. Both long-term issue and short-term issue rankings for each underwriter are recorded for the years 1997 to 2004. The average underwriter ranking is subsequently calculated and recorded. Underwriter prestige scores are used as a robustness control variable in this study. These data are sourced from Loughran and Ritter (2004) who use an expanded version of the dataset created by Carter and Manaster (1990). These prestige scores are highly correlated with the average underwriter rankings based on municipal bond issuance. For insured and uninsured issues done through the negotiated method, the set of chosen underwriters consists of 20 underwriters.

V. Contributions and Underwriter Choice

Logit analysis is used to explain underwriter choice and test the hypothesis that a campaign contribution made in the previous two years is more likely to result in being chosen through the negotiated method. The model assumes the following distribution for underwriter choice.

$$\Pr_j = \exp(x_j\beta) / \left[1 + \exp(x_j\beta)\right] \tag{1}$$

Logit analysis of underwriter choice uses different sub-specifications of the following general model specification, where the dependent variable set for each year includes all underwriters with a market share of 90 percent in the year prior to the sale date in addition to the underwriters chosen in the year of sale.

$$\begin{aligned}\Pr(underwriter) = \Pr(&\beta_1 CONTUWDUM_{ki} + \beta_2 CONTUW_{ki} + \beta_3 CONTUW^2{}_{ki} \\ &+ \beta_4 RANK_k + \beta_5 RANK_k * CONTUWDUM_{ki} + \beta_6 RANK_k * CONTUW_{ki} \\ &+ \beta_7 RANK_k * CONTUW^2{}_{ki} + \delta' BANK_k + \mu' MAT *_i + \kappa' BSIZE *_i \\ &+ \gamma' T_i + \lambda' S_i)\end{aligned} \tag{2}$$

$CONTUWDUM_{ki}$ is a dummy variable equal to 1 if underwriter (k) contributed to the political campaign of the sitting elected governor of the issuing state for bond (i) in the previous two years, and equal to 0 otherwise.

$CONTUW_{ki}$ is the amount contributed by underwriter (k) to the political campaign of the sitting elected governor of the issuing state for bond (i) in the previous two years divided by the total amount of contributions for the campaign per year of fund-raising.

$RANK_k$ is the rank of underwriter (k) in the year prior to the sale date for bond (i) based on long term issues.

$BANK_k$ is a vector of underwriter specific dummy variables.

$MAT *_i$ is the set of interaction variables of length of maturity of bond (i) with each underwriter (k).

$BSIZE *_i$ is the set of interaction variables of the size of bond (i) with each underwriter (k).

S_i and T_i denote issuing state and year dummy vectors respectively.

Null Hypothesis I: $\beta_1 = 0$

There is NO difference in the likelihood that an underwriter is selected for an issue done through the negotiated method between the cases of contribution and cases of no contribution.

Null Hypothesis IIa: $\beta_2 = 0$

The relative amount contributed has NO effect on the likelihood that an underwriter is selected for an issue done through the negotiated method.

Null Hypothesis IIb: $\beta_6 = 0$

For lower-ranked underwriters, the relative amount contributed has NO effect on the likelihood that an underwriter is selected for an issue done through the negotiated method.

Table II shows the results of this operation for insured and uninsured bonds. The total number of bonds is 797. All baseline regressions use year and state dummy interaction variables and heteroskedasticity-robust standard errors that cluster at the state level. In the absence of the baseline control variables, contributing to the campaign of an official increases the likelihood of being selected. The coefficient for the contribution dummy variable is positive and statistically significant at the five percent level (Hypothesis I). When all control variables are included, the coefficient for the contribution dummy variable is negative and not statistically significant at the five percent level.

Table II shows the results of the choice model using the relative amount contributed by underwriters in the previous two years. The relative amount contributed is the actual campaign contributions in US dollars normalized by the total amount of contributions for the campaign per year of fund-raising, and then multiplied by 100 for scale. Given implicit and explicit contribution limits involved in campaign finance, one would expect a non-monotonic effect of the relative amount contributed on the likelihood of being selected. I therefore include a squared term for the contribution variable to capture this effect. The data on underwriter rank allow for an analysis of this effect for different classes. One would expect that lower-ranked underwriters would be more likely to resort to campaign contributions in order to generate bond issuance business. This in turn would result in higher-ranked underwriters contributing to compete. The effect of contributions by rank should depend on the total benefit in terms of generating issuance business. If it is the case that contributing by itself is not enough for an underwriter to systematically gain market share, then in equilibrium, there should be an effect for lower ranked underwriters in the presence of contributions from all underwriters. Without interaction terms for underwriter rank, the results in column 4 show that an increase in the relative amount contributed results in an increased likelihood of selection once the squared term is included in the specification. The coefficient for the relative amount contributed is statistically significant at the five percent level (Hypothesis IIa). The results in column 6 of Table II show that a lower ranked underwriter is more likely to be selected the higher the relative amount of contribution, but only

up to a point; there are decreasing marginal benefits with respect to likelihood of being chosen. For lower-ranked underwriters, the coefficient for the contribution-rank interaction variable is positive and statistically significant at the one percent level (Hypothesis IIb). The coefficient for the squared term is negative, but not statistically significant at the five percent level, but is statistically significant at the 10 percent level. Panel B of Table II shows the coefficients from this estimation procedure and the impact of changes in the independent variables on the change in the probability of being chosen. For a lower-ranked underwriter, the change in probability of being chosen versus not being chosen is percent for a unit change 1.46 percent for the contribution-interaction variable, and -1.21 percent for the squared contribution-interaction variable. For a unit standard deviation change, the change in probability is 22.12 percent for the contribution-interaction variable, and -30.87 percent for the squared contribution-interaction variable. Hence the net effect goes from positive to negative with increasing contributions.

VI. Abnormal Bond Return Calculation

In order to investigate the impact of selecting a contributing underwriter on pricing and performance, I calculate abnormal returns over the first 60 days on and after the sale date for each issue. The methodology used to calculate returns for bonds is similar to that of Datta et al. (1997). It utilizes mean adjusted returns in an event study format. This methodology was originally adapted for bonds by Handjinicolau and Kalay (1984). Bonds pose two problems in a mean adjusted model: They are traded infrequently and their returns have to account for term structure changes. In order to address infrequent trading, all multi-period bond returns are calculated using the logarithmic function and transformed into single-day returns. In order to address the term structure problem, each municipal bond is adjusted with a matching bond index to adjust for term structure changes. The result is the adjusted bond return. It is calculated as the holding period return for each municipal bond minus the return over the same period for the index return. I assume that these adjusted returns follow a stationary process. Handjinicolau and Kalay (1984) show that this methodology produces unbiased estimates of single-day holding period returns in an environment with infrequent trading.

This study utilizes two types of day calculations of abnormal returns: calendar day returns and trading day returns. The sale date of the offering is identified as CDAY in the case of calendar day returns, and the first day of trading is TDAY. Given a relative lack of liquidity in the municipal bond market compared to other major U.S. financial markets, non-trading over the initial period on and after the sale date is a concern. Hence, TDAY is used to analyze initial daily period abnormal returns, whereas CDAY representation is used to analyze cumulative day returns. A 71-day post-offering interval is used to estimate normal returns; the normal return used for each bond is the mean of the adjusted returns for the period CDAY + 60 to CDAY + 130. The daily abnormal return for each bond is calculated as the daily adjusted bond return of the relevant day in the announcement period (CDAY to CDAY + 59) minus the normal return.

Trading-day returns are calculated based on the first day of trading TDAY, which is not necessarily the same as CDAY. For the initial trading period, TDAY to TDAY + 9 are reported. For cumulative holding period returns, the actual CDAY + 5 to CDAY + 59 returns are used. Trading day and cumulative return testing operations are performed on these abnormal returns. (For further details, see Datta et al. (1997) and Handjinicolau and Kalay (1984)).

VII. Sample Statistics and Empirical Analysis

To investigate the pricing effects due to self-dealing, I use only insured bonds. Given the focus of this paper, one important feature of the sample is the issuer's choice of underwriter selection method. A state security issuer can choose to commit to an underwriter through the negotiated method, or allow the underwriters to compete for the issue in an auction. The negotiated method allows for self-dealing, whereas the competitive method should mitigate the pricing effects of self-dealing. I provide a discussion along with supporting results to show that my assumption maintains. I show that by accounting for sample selection, the pricing effect due to selecting a contributing underwriter is only existent in the negotiated sample and non-existent when using the competitive sample (see Section VIII and Appendix for further details).

Table III provides basic sample statistics for insured state bonds. I investigate differences in means for the basic covariates of interest. Issues done by underwriters that contributed to the campaign of the governor are, on average, longer in maturity than non-contribution issues. This

difference is statistically significant at the one percent level. Given that the issuing manager decides whether a contributing underwriter is selected or not, he or she will want to avoid taxpayer scrutiny in the presence of conflict of interest. Hence, there should be a lower proportion of general obligation bonds in the contributed sample. Indeed, issues done by underwriters that contributed to the campaign of the governor are more likely to be revenue bonds as opposed to issues secured by the taxing authority of the state, with 18 percent of contributed issues being revenue bonds compared to six percent for other issues. This difference is statistically significant at the one percent level. The 18 percent figure is twice as high as the mean value of nine percent for the insured sample.

Table IV shows the mean daily abnormal returns for days on and following the first day of trading (henceforth referred to as the first-day return) and holding period abnormal returns following the sale date of the bond. Simple mean analysis of first-day returns shows that this insured sample of bonds is underpriced on average by 9.9 basis points. This figure is not statistically significant at the five percent level, and not large enough to claim that the bonds are not priced well in aggregate. If the conflict of interest hypothesis holds in the univariate case, issues done by contributing underwriters should carry a larger first-day return than that for non-contributing underwriters. This is indeed the case; along the contribution dimension, the mean first-day return for issues done by a contributing underwriter is 28 basis points and is statistically significant at the five percent level. The mean first-day return for issues done by a non-contributing underwriter is 3.3 basis points, and not statistically significant at the 10 percent level. The difference in means between the two figures is statistically different at the 10 percent level. Hence, issues done by contributing underwriters are underpriced compared to issues done by non-contributing underwriters.

If issuers select underwriters that contribute and these underwriters are of high quality and typically issue securities that outperform, then the first day return difference may be related to this factor. To address concerns of possible demand-side superiority for contributed issues, I investigate post-sale date long-term performance. For long-term performance outcomes, the mean cumulative 60-day return for issues done by a contributing underwriter is 1.13 percent, while the mean cumulative 60-day return for issues done by a non-contributing underwriter is 1.68 percent. Both figures are statistically significant at the one percent level, but the difference

between the two is not statistically significant at the 10 percent level. Hence, issues done by contributing underwriters do not outperform issues done by non-contributing underwriters.

Regression analysis is used to verify that the economic and statistical significance of differences in means maintain controlling for other factors. Regression analysis of first-day returns and cumulative returns uses the different sub-specifications of the following general model specification.

$$BER_i = \beta_0 + \beta_1 CON_i + \beta_2 MAT_i + \beta_3 MAT_i^2 + \beta_4 BSIZE_i + \beta_5 STAX_i + \beta_6 GOL_i + \beta_7 GOU_i + \beta_8 UWP_i + \gamma' T_i + \lambda' S_i + \varepsilon_i \quad (3)$$

where

BER_i is the first trading day abnormal rate of return of bond (i) for pricing regressions or the cumulative return for performance regressions.

CON_i is a dummy variable equal to 1 if bond (i) if the selected underwriter did contribute to the political campaign of the sitting governor of the issuing state and equal to 0 otherwise.

MAT_i is the length of maturity of bond (i).

$BSIZE_i$ is the log of the size of bond (i).

$STAX_i$ is a dummy variable equal to 1 if bond (i) is taxable by the state of issuance.

UWP is the score of the underwriter prestige for bond (i).

GOL_i is a dummy variable equal to 1 if bond (i) is funded by tax receipts with a limit.

GOU_i is a dummy variable equal to 1 if bond (i) is funded by tax receipts with no limit.

ε_i is the random error term for bond (i).

S_i and T_i denote issuing state and year dummy vectors respectively.

Null Hypothesis III: $\beta_1 = 0$

There is NO difference in pricing or performance between insured municipal bonds issued through contributing underwriters and insured municipal bonds issued through non contributing underwriters.

Table VI shows the results of the regressions using Ordinary Least Squares (OLS), where the dependent variable is the first-day return. All baseline regressions use year and state dummy variables and heteroskedasticity-robust standard errors that cluster at the state level. The basic control variables are length, bond size and state tax status (for demand effects due to liquidity). Given the lack of credit risk associated with this sample of state bonds, effects due to basic controls are unclear. In fact, one can argue that in the absence of credit risk, none of the basic control variables should have a strong influence on pricing. This conjecture is somewhat supported in the baseline regression in the absence of the contributed variable in that none of the coefficients for basic control variables are statistically significant at the one percent level. Once the contributed variable is included in the baseline regression, there is a significant and positive effect. Out of all the control variables, tax status is shown to be a significant component of the specification with a 2.843 percent effect. This coefficient is statistically significant at the one percent level. Hence variation in liquidity is important once we account for contributions. Using all control variables, the coefficient for the contribution dummy variable shows that the choice of negotiating with an underwriter that contributed to the campaign results in a first-day return of 2.807 percentage points when compared with the option of negotiating with a non-contributing underwriter, and Hypothesis III is rejected at the one percent level.

Given large trading costs associated with the municipal bond market, the economic significance of this estimate is a concern. But Harris and Piwowar (2005) show that the maximum effective spread for straight bonds in their sample is one percent. Moreover, the average daily return for straight municipal bonds is approximately two basis points, whereas the abnormal return effect is in excess of 100 times this amount. Hence the effect is economically significant.

VIII. Robustness

The baseline results show that selecting a contributing underwriter results in underpricing, but further analysis is needed in order to interpret this result as supporting the conflict of interest claim. This section addresses the conflict of interest interpretation of these results accounting for unobserved demand-side effects, top contributors, and differential effects based on the point in time over the electoral cycle. A discussion of negotiated versus competitive underwritings also is provided in this section. In addition to questions of interpretation, OLS baseline estimates may be biased due to a number of factors. In this section, I present results of tests that attempt to address the most important factors that may bias the basic coefficient estimates: lack of proper control variables, and endogeneity due to the selection of issuance method.

A. Underwriter Prestige

Underwriter prestige has been shown to affect first-day returns of equity IPOs. Carter and Manasater (1990) argue that highly prestigious underwriters may provide certification services that reduce underpricing, but recent evidence is at conflict with this prediction and interpretation (Beatty and Welch (1996), Loughran and Ritter (2004), and Cooney, Singh, Carter, and Dark (2001)). This insured bond sample comes with minimal credit risk; the certification hypothesis is not likely to be supported. Loughran and Ritter (2004) argue that the positive effect of prestige on underpricing may be partly due to conflict of interest with underwriters requiring favorable analyst coverage. Again, with this sample, it is not clear that issuers will benefit from favorable analyst coverage. In any case, underwriter prestige is used in order to control for a potential conflict of interest factor in that prestigious underwriters may offer other services to issuing managers and stakeholders that may not be interpreted as an internal agency problem.[9] Table VI gives the results of the pricing regression controlling for underwriter prestige. The coefficient for the contribution dummy variable remains statistically significant at the one percent level when the underwriter prestige variable is included in the regression. The coefficient for the prestige

[9] Prestige scores are highly correlated with average rankings based on municipal bond issuance. Similar results are obtained with the rank measure.

variable is 8.2 basis points and not statistically significant for the full baseline specification. This result by itself does not support either certification or conflict of interest.[10]

B. Funding Source

I also include funding source dummies as controls. There are three potential sources recognized in the data: revenue, general obligation (unlimited), and general obligation (limited). Project funds are used to pay the holders of revenue bonds. General obligation (limited) bonds are bonds secured by the limited taxing authority of the state. General obligation (unlimited) bonds are bonds secured by the unlimited taxing authority of the state. General obligation issues are typically subject to voter support, whereas revenue bonds are not and thus are not tied to a host of political economy voting factors. General obligation (limited) bonds should be relatively risky compared to general obligation (unlimited) bonds and revenue bonds. In the absence of credit risk, the relative pricing effects should be less significant or nonexistent. Table VI provides the results of the pricing regression controlling for funding source. The coefficient for the contribution dummy variable remains statistically significant at the one percent level when funding source dummy variables are included. The coefficient for the limited general obligation dummy variable is 81.2 basis points and statistically significant at the five percent level in the full baseline specification, while the coefficient for the unlimited is -43 basis points and not statistically significant at the five percent level. This result supports the hypothesis that general obligation bonds supported by the limited taxing authority of the state may carry a voter risk factor that carries a discount for initial investors

C. Endogeneity

Endogeneity becomes a concern when the issuer chooses whether the underwriter is one that contributed. There may be omitted variables correlated with the underwriter selection variable and the first-day return. For instance, I expect that an issuing manager may act in line with an agreement between the elected official and the underwriter, given that many appointees and employees are dependent on the elected official for continued benefits. Therefore in the expectation of underpricing, the issuing manager will select a contributing underwriter, leading

[10] I provide results in the electoral cycle subsection to show a positive effect of underwriter prestige on first-day returns in line with most recent studies of underwriter prestige and pricing.

to a positive correlation between this unobserved agreement and the contributed variable. This omitted variables problem would result in an upward biased coefficient for the contributed variable. In order to address this problem, I use an instrumental variables approach using Heckman treatment effects and two-stage least squares (2SLS) regression methods. Table VIII reports the results of this operation where the choice of selecting a contributing underwriter is endogenised. I use the margin of victory of the sitting governor as the identifying instrument. Specifically, this variable is the percentage vote for the governor minus the vote percentage for the runner-up in the most recent election, and is coded in percentage points. Political officials may feel they have broad voter support with a large margin of victory and should be more likely to abuse power in the absence of political competition. Hence a larger margin of victory should result in a larger proportion of contributed issues. A competing hypothesis involves pivotal campaign contributions, where contributions have a more important effect on the margin; hence, there may be a negative relationship in the presence of conflict of interest. The results reported for underwriter choice suggest that contributions may not be pivotal; therefore, the abuse of power explanation is more applicable. In addition, the margin of victory should be uncorrelated with first-day abnormal returns. As predicted, the margin of victory has the expected effect on the binary endogenous variables; an increase in the margin of victory results in an increase in the proportion of contributed issues. In addition, first-stage IV results show that consistent with the underwriter choice results, an increase in underwriter prestige is associated with a lower proportion of contributed issues. Second-stage results maintain the baseline conclusion. Using the Heckman treatment effects method, the choice of negotiating with a contributing underwriter results in a first-day return of 2.159 percent when compared with the option of negotiating with a non-contributing underwriter. The coefficient is statistically significant at the one percent level. The comparable coefficient in the baseline regression is 2.807 percent. Hence the OLS coefficient is upward biased. To formally test the hypothesis of an endogenous system, I implement a Wald test with the null hypothesis that there is no correlation between the first- and second-stage model errors. This hypothesis is rejected at the one percent level.

D. Contribution Magnitude

The link between the pricing effects on campaign contributions and the conflict of interest interpretation may not be strong given only one point of reference. If the self-dealing

interpretation is correct, then choosing an underwriter that contributed a relatively large amount to the campaign should result in a higher first-day return. To address this point, I use a more restrictive payment indicator in the top three contributor variable which is equal to 1 if the underwriter of the issue is one of the top three contributors out of all underwriters that contribute to the campaign for the governor in office. Given the expected increase in magnitude, there should be an increase in the coefficient. Table IX shows the results of the OLS estimation method using this variable. Using the full baseline specification, the choice of negotiating with a top three contributing underwriter results in a first day return of 4.147 percent when compared with the option of negotiating with a non-top three contributing underwriter. This pricing difference is statistically significant at the one percent level. This result provides support for the conflict of interest interpretation.

E. Market Efficiency and Long-Term Performance

The municipal bond market is relatively inefficient compared to corporate equity markets. Hence the true price impact may not be observed on the first day; a wider event window may be needed. In addition, there may be demand-side effects that may be correlated with campaign contributions. If in order to observe the true price impact one has to observe abnormal returns over a wider event time period, then the result should not be overturned for short-term cumulative returns. In addition, if issuers select underwriters that contribute, and issues by these underwriters tend to outperform given the distribution quality of underwriter and demand-side pressure from investors, then the pricing difference may be related to this factor. If there is a fixed benefit from investing in contributed issues, then it should be observed when analyzing long-term performance. If there is no fixed demand-side effect, then short-term effects should dissipate as we use longer time periods. Table VII provides the results of the cumulative returns regressions using the full baseline specification. For the day 6 to day 10 (CDAY + 5 to CDAY + 9) cumulative return, the coefficient for the contribution dummy variable is positive but not statistically significant at the five percent level. Hence the original result of underpricing is not overturned. For all remaining cumulative return dependent variables, the coefficient for the contribution dummy variable is never positive and statistically significant.

F. Election Cycle

The relationship between the issuing stakeholders and the issuing agent has implications for the conflict of interest interpretation. The political economy literature on political business cycles provides a prediction of what to expect in regard to this relationship over the election cycle. Political officials favor signals of competence in the immediate period before an election (Rogoff and Sibert (1988), Blais and Nadeau (1992), Veiga and Veiga (2004)). They avoid costly actions in the immediate period before the election, and prefer to carry out such actions immediately after the election date.[11] Underlying this signaling argument is the notion that the politician's concern for voters changes over the election cycles. By extension, the issuing manager's concern for the voter-taxpayer also changes over the election cycle. In essence, the election cycle provides variation in the issuing official's sensitivity to the costs to the issuing stakeholders. If conflict of interest exists, political officials should be more inclined to select a contributing underwriter in the immediate period after the election, and should be more willing to accept underpricing. Figure I shows the average first-day return and the contributed coefficient for deals where a contributing underwriter is selected through the negotiated method. Consistent with the political economy conflict of interest interpretation, none of these issues occur in the year before an election. In the year after an election, the average first-day return is 1.63 percent and is statistically different from zero at the one percent level. The average first-day return for the intermediate period in the election cycle is -4.5 basis points. This estimate is not statistically different from zero at the 10 percent level. In order to formally test the hypothesis that negotiating with a contributing underwriter results in more underpricing in the year after an election than in other periods, I use the full baseline specification incorporating an after-election dummy variable, the contributed dummy variable, and the interaction between the two. Table IX shows the results of this operation. Consistent with the conflict of interest prediction, the choice of negotiating with a contributing underwriter results in a first day return of 5.01 percent when compared with the option of negotiating with a non-contributing underwriter in the year after an election. The comparable figure for the other period in the election cycle is 1.52 percent. The coefficient for the contribution dummy variable is statistically significant at the one percent

[11] See Brown and Dinc (2005) for evidence of this type of behavior in the finance literature with an application to bank failure resolution.

level, whereas the coefficient for the interaction between the dummy variables for contribution and the year after an election is statistically significant at the five percent level.

G. Rank

The results of the underwriter choice model show that the benefit of contributions goes mainly to lower-ranked underwriters. This result is consistent with the notion that lower-ranked underwriters in the absence of campaign contributions probably would not generate as much issuance business, but do not gain market share since higher-ranked underwriters also contribute. If lower-ranked underwriters are more likely to engage and benefit in a conflicted exchange, then, presumably, they will underprice contributed issues even more so than higher-ranked underwriters. Hence the pricing effect should be stronger for lower-ranked underwriters. I formally test this hypothesis by using a rank variable, the contributed dummy variable, and an interaction term. A higher-rank score represents a lower-ranked underwriter. Table IX shows the results. Consistent with the prediction, the lower the rank of the underwriter, the higher is the underpricing due to contributions. The interaction coefficient is 10.3 and statistically significant at the one percent level. The result supports the hypothesis that the pricing effect of selecting a contributing underwriter is stronger for lower-ranked underwriters. Another noteworthy result is that in the absence of contributions, the higher-ranked underwriters underprice compared to lower-ranked underwriters, consistent with recent results in the IPO literature using the underwriter prestige variable. The coefficient for rank is -0.016 and statistically significant at the one percent level.

H. Non-Normality, Extreme Observations, and State Dependency

First- day returns have been known to exhibit non-normal behavior. As a result of this phenomenon, OLS will not produce correct estimates given the normality assumption. The technically superior way to estimate central tendency differences in the presence of non-normality is to use quantile regression. Using a quantile regression method with bootstrapped standard errors, I find a difference in first-day returns on the order of 2.33 percent. This difference is statistically significant at the one percent level. In addition to the distribution concern, another potential data problem involves extreme observations. In order to address this issue, I estimate coefficients using Iterated Reweighted Least Squares (IRLS), which effectively

downweights extreme observations. The coefficient for the contribution dummy variable is 1.794 percent and statistically significant at the one percent level.

Are the results being driven by particular states? In order to answer this question, I run regressions excluding one state at a time (results not reported in the set of tables). The coefficient for the contribution dummy variable is at least 1.8 percent for each regression and always statistically significant at the five percent level or better.

I. Negotiated versus Competitive Underwritings

A state security issuer can choose to commit to an underwriter through the negotiated method or allow the underwriters to compete for the issue in an auction. The literature on negotiated versus competitive underwritings has focused on relative issue costs. Ederington (1976), Sorenson (1979), and Bhagat and Frost (1986) show that negotiated offers are costlier to the issuer than competitive offers. In acknowledging the agency problem in securities issuance, Smith (1986) suggests that there may be less monitoring involved in a competitive offer and this factor should be taken into account when comparing negotiated offers with competitive offers. To provide an explanation as to the popularity of negotiated underwritings, Logue and Tinic (1999) provide evidence that there may be no intrinsic difference between the two methods with respect to an issuer with good credit quality; market conditions and bid preparation costs influence relative issue costs. Their results support the view widely held by market professionals that the competitive method is costlier to the issuer than the negotiated method when there is a relative lack of bidders in the market. Bhagat and Frost (1986) suggest that the higher costs associated with negotiated underwritings is due to conflict of interest given their popularity. They claim that managers choose negotiation over competition at the expense of issuing stakeholders because they receive side payments from underwriters. This line of argument is not necessarily inconsistent with the results of Logue and Tinic (1999), but does beg for an account of stakeholder-manager conflict and bid preparation costs in comparing negotiated versus competitive underwritings.

The results presented in this paper provide evidence that the negotiated method allows for self-dealing. By focusing on bonds issued through the negotiated method, the assumption made is that the competitive method should mitigate the effects of self-dealing. This conjecture is investigated further with respect to pricing. In addition, one may argue that choosing an

underwriter is a two-stage decision-making process. This factor is taken into consideration with respect to underwriter choice.

Pricing of Negotiated versus Competitive Issues

In order to confirm the difference in the self-dealing effect on pricing, I use the full OLS baseline specification, and apply it to all insured bonds (negotiated and competitive). I then use the specification for the two subsamples of interest, while addressing the problem of sample selection. Results of this operation are provided in the Appendix.

Table A.III shows that the coefficient for contribution dummy variable is not statistically significant in the full insured sample. In analyzing the effect for both subsamples, I use a simple Probit model to estimate the predicted probability of each bond being done through the negotiated method. Two types of specifications are used: a selection of observables specification and a selection of unobservables specification. The first specification uses maturity, size, tax status, and funding source variables. The second specification uses the covariates in the first specification in addition to a dummy variable equal to one if the bond issued within a year before an election. The inverse Mill's ratio (IMR) is then calculated for each specification-sample pair. The second stage of estimation uses the baseline pricing specification with the IMR as a control variable. For both first-stage specification types, Table A.III shows that the coefficient for the contribution dummy variable is not statistically significant in the competitive subsample but obviously statistically significant for the negotiated sample. These results confirm the assumption that the negotiated method allows for a pricing effect due to contributions, while the competitive method does not allow for a pricing effect.

Negotiated versus Competitive and Underwriter Choice

Presumably, the choice of an underwriter can be understood as a two-stage process. In this case, the nested logit becomes an appropriate framework to explain underwriter choice and test the hypothesis that a campaign contribution made in the previous two years is more likely to result in being chosen through the negotiated method.[12] The model assumes a decision process made in stages in which the decisions made in the later stages are dependent on the decisions made in the earlier stages. In this case, issuers first decide to select an underwriter through the

[12] The advantages of this approach for bond underwriter choice are highlighted in Yasuda (2005).

negotiated method or the competitive method. Once the decision is made, the issuer then chooses a particular underwriter in the case of the negotiated method and allows underwriters to compete in the case of the competitive method. Formally this is a two-level nested logit model where the first-stage alternative (negotiated versus competitive) is indexed as i and the last-stage alternative as j (underwriter choice). I denote x_{ij} and y_i as vectors of explanatory variables specific to categories (i, j) and (i) respectively. The following conditional probability will involve only the parameters of the second stage.

$$\Pr_{j|i} = \exp(x_{ij}\beta) / \sum_n \exp(x_{in}\beta) \tag{4}$$

Inclusive values for each category in the first stage and unconditional probabilities are defined in the following way;

$$I_i = \ln\left[\sum_k \exp(x_{ik}\beta)\right] \tag{5}$$

$$\Pr_i = \exp(y_i\alpha + \tau_i I_i) / \sum_m \exp(y_i\alpha + \tau_m) \tag{6}$$

Nested logit analysis of underwriter choice uses different sub-specifications of the following general model specification, where the dependent variable set for negotiated underwritings includes all underwriters that were chosen through the negotiated method, and the dependent variable set for competitive underwritings includes all underwriters that were chosen through the competitive method.

$$\Pr(\textit{underwriter} \mid \textit{selection method}) = \Pr(\beta_1 CONTUWDUM_{ki}) \tag{7}$$

$$\Pr(\textit{selection method}) = \Pr(y_i\alpha + \tau_i I_i) \tag{8}$$

$CONTUWDUM_{ki}$ is a dummy variable equal to 1 if underwriter (k) contributed to the political campaign of the sitting elected governor of the issuing state for bond (i) in the previous two years, and equal to 0 otherwise.

y_i includes baseline control variables, year and state dummy variables interacted with the negotiated method dummy variable.

Null Hypothesis IV: $\beta_1 = 0$

There is NO difference in the likelihood that an underwriter is selected for an issue done through the negotiated method between the cases of contribution and cases of no contribution.

Table A.IV shows the results of this operation. Year and state dummy variables explain variation in the choice of underwriter selection method; once year and state dummy variables are included, maturity, size, and underlying quality have no effect on the type of underwriter selection method you choose. For all types of bonds the coefficient for the contributed dummy variable is positive and statistically significant at the one percent level, thus rejecting Hypothesis IV. The result of the LR test supports the use of this nested structure versus a non-nested conditional logit model for each group; thus, the independence of irrelevant alternatives assumption (IIA) does not hold for the non-nested model.

IX. Implications

For corporate finance, Ljungqvist and Wilhelm (2003) show that issuers can mitigate agency conflict by providing incentives for issuing managers to monitor underwriters. Monitoring incentives are shown to increase in the issuing manager's equity stake. Monitoring alone may not be sufficient in the presence of self-dealing if the amount needed to cover the issuing manager's loss is less than the underwriter's cost savings by underpricing. In addition, Ljungqvist (2003) shows that issuers should directly address conflict of interest through efficient contracting by making the underwriter's compensation an increasing function of the offer price. By linking the loss directly to the underwriter, this option becomes a superior policy solution in the case of self-dealing. Given this potentially beneficial policy solution, contract restrictions and collusion reinforce the self-dealing effect. For instance, in the case of initial equity in the U.S., underwriter's fees cluster around 7 percent, and limit the feasibility of the flexible compensation

option to some extent in this market. Debt may prove to be less costly in this setting given recent evidence on the variation in underwriting fees (Yasuda (2005)).

The results in this paper suggest there also may be a role for corporate governance in that more powerful issuing managers may be more likely to engage in this costly practice. In addition, results in this paper suggest that there may be potential conflicts of interest when financial intermediaries influence outcomes without direct ownership. Hence, strategies designed to limit managerial power and potentially conflicted financial intermediary influence may help to reduce issuance costs associated with self-dealing. For stakeholder expropriation in corporate finance, the role of law is determinative in this regard. Djankov et al. (2005) highlight the importance of the legal framework in addressing the problem of self-dealing in corporate finance across countries. They show that laws that require full disclosure and disinterested stakeholder approval for potentially conflicted transactions are associated with a higher level of financial development and smaller block premiums.

The results in this paper also suggest that prestigious underwriters are less likely to benefit from self-dealing, and issuers that hire prestigious underwriters are subject to less underpricing due to self-dealing compared to issuers that hire lower-ranked underwriters. The third column in Table IX shows that the coefficient for rank in the absence of self-dealing is -.016, whereas the coefficient for rank in the presence of self-dealing is .087 (= -.016 + .103). This is not a trivial consideration. Even though the result in the absence of self-dealing is consistent with recent evidence showing that underwriter prestige is associated with IPO underpricing, the opposite effect on first-day returns due to high-ranked or high-prestige underwriters in the presence of self-dealing is shown to be roughly nine times the comparable effect in the absence of self-dealing.

X. Conclusion

This paper addresses self-dealing of interest in securities issuance, the existence of which fractures the integrity of the securities issuance process and is costly to the stakeholders of an issue. An analysis within this context requires the use of a potentially conflicted payment variable. I use a government bond sample matched with campaign contributions to elected

officials which serve as a potentially conflicted payment variable. In addition, pricing outcomes due to selecting contributors require some treatment of asymmetric information explanations of mispricing that rely heavily on credit risk. To address the pricing component, I use insured bonds that carry minimal credit risk so as to somewhat obviate these asymmetric information theories of mispricing.

I investigate underwriter choice in order to determine whether incentives to contribute for negotiated issuance business exist. This paper shows that an increase in the amount of campaign contributions by an underwriter results in an increase in the likelihood of selection. This result is mainly driven by lower-ranked underwriters. Hence, underwriters in many cases are rewarded for having contributed to an elected official's campaign. This result is consistent with the notion that lower-ranked underwriters in the absence of campaign contributions probably would not generate as much issuance business, but do not gain market share since higher-ranked underwriters also contribute. Consistent with the result that it is the lower-ranked underwriters that benefit from contributions, the first-stage regression result of the contributed variable shows that an increase in the underwriter prestige score reduces the likelihood of a contributed issue. By using the contribution amounts normalized by campaign size, I show that there is a non-monotonic effect of contributions on the likelihood of selection; lower-ranked underwriters may not be rewarded for contributing too much to a political candidate. This is consistent with implicit and explicit campaign contribution limits having an effect on this potentially conflicted exchange. Moreover, the result suggests that campaign contributions mat not be hugely pivotal so as to outweigh concerns about contribution limits.

I then examine pricing and performance differences along the dimension of self-dealing. In doing this, I estimate the effects due to contributions. Sample means for deals characterized by self-dealing show support for the prediction. On average, issues done through non-contributing underwriters are priced well in comparison to those deals done through contributing underwriters, which are slightly underpriced. Using an OLS regression framework to sharpen difference in mean estimates confirms this result. The abnormal first-day return is approximately 2.807 percent higher for a bond associated with a contributing underwriter compared to a bond associated with a non-contributing underwriter. This loss to the voter-taxpayer does not result in superior performance after the first day of trading; there is no difference in cumulative 60-day returns between deals with a contributing underwriter compared to deals with a non-contributing

underwriter. Hence, results do not seem to be driven by factors that would generate superior performance: demand-side effects from investors and underwriter distribution quality.

Given evidence on underwriter selection and pricing, the question then becomes one of interpretation. In order to support the conflict of interest claim, I show that the first-day return increases to 4.147 percent if the issuer selects a top-three contributing underwriter. Hence, an increase in magnitude of potential conflict results in a higher first-day return. An examination of issuer behavior also supports the existence of conflict of interest in that none of the contributed issues went to the market in the year before an election. This is consistent with arguments in the literature on electioneering: government officials avoiding costly actions prior to an election. With respect to pricing of bonds in the three years following an election, of all the contributed issues, those that went to market in the year immediately after the election are the most underpriced.

Using the instrumental variables approach to address potential endogeneity of the contribution dummy variable, I show that an increase in the margin of victory for the sitting elected governor results in a higher proportion of contributor issues. In light of this evidence, voters, regulators, and policymakers should be cognizant of the potential abuse by politicians who have broad voter support. Given the potential for self-dealing, regulators should seriously consider applying Rule G-37 to all underwriter employees including consultants. The general conclusion of the paper and the aforementioned policy considerations beg for a rigorous treatment of the following questions: What can issuers do to address agency conflicts in the presence of self-dealing and contract design restrictions? What are the relative costs of debt versus equity issuance in the presence of self-dealing? Future research should address these and other related questions.

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Table I: Sample Characteristics of Municipal Bonds

The table provides the list of state level municipal straight bond offerings. This full sample includes insured and uninsured bonds issued without competitive bidding. The insured sample is limited to insured bonds. Both samples are grouped by section categories. For the contributions category, *Contributed* represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *No Contribution* represents bonds issued by an underwriter that did not contribute to the gubernatorial campaign of the governor in office in the previous 2 years. For trading categories, *Trade* represents a bond that trades on the sale date or within the first five calendar days of trading, *No Trade* otherwise. For state tax status, *Taxable* represents a bond taxable by the issuing state, *Tax Exempt* otherwise. *General Obligation Limited* represents a bond that is secured by the limited taxing authority of the issuer. *General Obligation Unlimited* represents a bond that is secured by the unlimited taxing authority of the issuer. *Revenue* represents a bond that is secured by a specific project.

Panel A

	Full Sample		**Insured Sample**	
State	**Number of Offers**	**Percentage**	**Number of Offers**	**Percentage**
California	53	6.65	7	2.82
Hawaii	129	16.19	128	51.61
Massachusetts	75	9.41	20	8.06
Michigan	38	4.77	0	0
New Jersey	33	4.14	0	0
New York	14	1.76	0	0
Ohio	361	45.29	27	10.89
Rhode Island	25	3.14	25	10.08
Wisconsin	69	8.66	41	16.53
Total	797	100	248	100
Year	**Number of Offers**	**Percentage**	**Number of Offers**	**Percentage**
1998	37	4.64	14	5.65
1999	31	3.89	16	6.45
2000	25	3.14	5	2.02
2001	117	14.68	23	9.27
2002	127	15.93	21	8.47
2003	194	24.34	38	15.32
2004	266	33.38	131	52.82
Total	797	100	248	100

Panel B

	Insured Sample	
Contribution	**Number of Offers**	**Percentage**
No Contribution	181	72.98
Contributed	67	27.02
Total	248	100
Sale Date	**Number of Offers**	**Percentage**
No Trade	248	100
Trade	0	0
Total	248	100
First 5 Calendar Days	**Number of Offers**	**Percentage**
No Trade	0	0
Trade	248	100
Total	248	100
State Tax Status	**Number of Offers**	**Percentage**
Tax Exempt	207	83.47
Taxable	41	16.53
Total	248	100
Issue Type	**Number of Offers**	**Percentage**
General Obligation Limited	3	1.21
General Obligation Unlimited	222	89.52
Revenue	23	9.27
Total	248	100

Table II. Campaign Contributions and Underwriter Choice

The table provides summary results of a logit model where the dependent variable is equal to 1 if the underwriter is selected. Control variables are maturity and bond size, both interacted with each underwriter in the dependent variable set. *Contributed* is equal to 1 if an underwriter contributed to the gubernatorial campaign of the governor in office in the previous 2 years, and 0 otherwise. *Contribution* is equal to the amount contributed by an underwriter to the gubernatorial campaign of the governor in office in the previous 2 years normalized by the size of the campaign. *Rank* is the ranking of the underwriter in the year prior to issue based on the amount issued for long term bonds. Heteroskedasticity-robust standard errors are provided in parentheses. Columns 3 and 4 of Panel B show the change in probability associated with a -1/2 to +1/2 unit shift and a -1/2 SD to +1/2 SD shift around the mean of variables of interest holding all other variables constant at their mean. *, ** denote statistical significance at the 5% and 1% levels, respectively.

Total Number of Bonds = 797

Panel A: Choice Regressions

Dependent Variable: 1 if the Underwriter is Chosen, 0 Otherwise

Contributed	0.554	-0.248				
	(0.282)*	(0.450)				
Contribution			-0.095	6.270	-2.788	-3.787
			(0.211)	(2.513)*	(5.135)	(5.387)
Contribution^2				-7.889	-12.894	-4.910
				(3.382)*	(21.060)	(8.597)
Rank					-0.057	-0.113
					(0.021)**	(0.046)*
Contribution*Rank					1.006	0.942
					(0.331)**	(0.293)**
Contribution^2*Rank					-0.737	-0.789
					(0.487)	(0.407)
Control Variables	No	Yes	No	No	Yes	Yes
Cluster on State	Yes	Yes	Yes	Yes	Yes	Yes
Year Dummies	Yes	Yes	Yes	Yes	Yes	Yes
State Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Bank Dummies	No	No	No	No	No	Yes
Number of Observations	14728	14709	14728	14728	14006	14006
Pseudo R-sq	0.007	0.125	0.001	0.001	0.145	0.179

Panel B: Impact of Changes in Independent Variables

Variable	Coefficient	Change in Probability for a +/- 1/2 Unit Change	Change in Probability for a +/- ½ SD Change	Standard Deviation
Contribution	-3.787	-0.091	-0.009	0.154
Contribution^2	-4.910	-0.151	-0.016	0.213
Rank	-0.113	-0.002	-0.024	13.267
Contribution*Rank	0.942	0.015	0.221	6.198
Contribution^2*Rank	-0.789	-0.012	-0.309	8.545

Table III. Sample Statistics

The table provides sample statistics for the bonds in the sample. The sample consists of bonds issued through the negotiated method and packaged with third-party insurance from one of the four major insurance entities: Municipal Bond Investors Assurance Corporation (MBIA Corporation), the Ambac Financial group (AMBAC), the Financial Guaranty Insurance Company (FGIC), and Financial Security Assurance Inc. (FSA). *Contributed* represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *No Contribution* represents bonds issued by an underwriter that did not contribute to the gubernatorial campaign of the governor in office in the previous 2 years. *Maturity* is measured in number of calendar years and is the difference between the dated date and the maturity date of the bond. *Bond Size* is the size of the bond issue measured in million U.S. dollars. *Issue Size* is the size of the bond serial issue measured in million U.S. dollars. *State Tax* is a dummy variable with 1 representing a bond that is state-taxable. *General Obligation* is a dummy variable with 1 representing a bond secured by the taxing authority of the issuer, and 0 representing a bond secured by revenue from a specific project source. *, ** denote statistical significance at the 5% and 1% levels, respectively, in a two-sided test of the mean with respect to the relevant categories.

Panel A

Variable Name		Contributed	No Contribution	All
Maturity	Mean	9.050**	7.097	7.624
	sd.	5.197	3.088	3.862
	N	67	181	248
Bond Size (in $M)	Mean	19.600**	10.400	12.900
	sd.	24.800	13.700	17.800
	N	66	181	247
Issue Size (in $M)	Mean	295.000*	209.000	232.000
	sd.	250.000	322.000	306.000
	N	67	181	248
State Tax Status	Mean	0.090*	0.193	0.165
	sd.	0.288	0.396	0.372
	N	67	181	248
General Obligation	Mean	0.821**	0.939	0.907
	sd.	0.386	0.240	0.291
	N	67	181	248

Table IV. Initial Daily and Holding Period Returns

The table provides sample statistics for the daily and holding period returns along with positive-negative odds and positive group odds ratios following the day of issue. Returns are measured in percentage points. The sample consists of bonds packaged with third-party insurance from one of the four major insurance entities: Municipal Bond Investors Assurance Corporation (MBIA Corporation), the Ambac Financial group (AMBAC), the Financial Guaranty Insurance Company (FGIC), and Financial Security Assurance Inc. (FSA). *Contributed* represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *No Contribution* represents bonds issued by an underwriter that did not contribute to the gubernatorial campaign of the governor in office in the previous 2 years. *, ** denote statistical significance at the 5% and 1% levels, respectively, in a two-sided test with the null hypothesis that the mean is equal to zero.

Panel A

	CONTRIBUTED		NO CONTRIBUTION			ALL	
Trading Day	**Return**	**Odds**	**Return**	**Odds**	**Odds Ratio**	**Return**	**Odds**
1	0.280*	1.577	0.033	1.011	1.560	0.099	1.138
2	0.020	2.190	0.025**	1.479	1.481	0.024**	1.638
3	0.005	1.913	0.098**	1.828	1.046	0.073**	1.851
4	0.022**	1.913	0.078**	1.321	1.449	0.063**	1.455
5	0.010	1.310	0.070**	1.291	1.015	0.054**	1.296
6	0.078**	1.680	0.003	0.885	1.897	0.023**	1.050
7	-0.076**	0.367	0.043**	3.415	0.108	0.011	1.756
8	0.085**	2.350	-0.029	0.547	4.296	0.001	0.810
9	0.078**	2.941	0.011	0.946	3.108	0.029**	1.255
10	-0.039**	0.634	-0.005	0.828	0.766	-0.014*	0.771
	CONTRIBUTED		**NO CONTRIBUTION**			**ALL**	
Holding Period	**Return**	**Odds**	**Return**	**Odds**	**Odds Ratio**	**Return**	**Odds**
6 to10	0.075*	1.792	0.245**	1.662	1.078	0.199**	1.696
6 to 20	0.098	1.792	0.442**	1.321	1.357	0.349**	1.431
6 to 30	0.998**	2.941	0.993**	2.549	1.154	0.995**	2.647
6 to 40	1.080**	2.526	1.394**	2.415	1.046	1.309**	2.444
6 to 50	1.455**	2.526	1.462**	1.873	1.349	1.460**	2.024
6 to 60	1.127**	2.722	1.680**	3.310	0.823	1.530**	3.133

Table V. Initial Daily and Holding Period Return Statistics

The table provides sample statistics for the bonds in the sample. The sample consists of bonds packaged with third-party insurance from one of the four major insurance entities: Municipal Bond Investors Assurance Corporation (MBIA Corporation), the Ambac Financial group (AMBAC), the Financial Guaranty Insurance Company (FGIC), and Financial Security Assurance Inc. (FSA). *Contributed* is a dummy variable that represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *, ** denote statistical significance at the 5% and 1% levels, respectively, in a two-sided test of the mean differences.

Variable Name		Contributed	No Contribution	All
First-Day Return	Mean	0.280	0.033	0.099
	sd.	1.168	0.794	0.915
	N	67	181	248
60 Day Cumulative Return	Mean	1.127	1.680	1.530
	sd.	2.804	2.520	2.605
	N	67	181	248

Table VI. OLS Regressions Using the Initial Trading Day Return

The table presents the results of regression analysis using ordinary least squares (OLS) where the dependent variable is the daily return on the first day of trading in percentage points. *Contributed* is a dummy variable that represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *Maturity* is measured in number of calendar years and is the difference between the dated date and the maturity date of the bond. *Bond Size* is the log of size of the bond. *State Tax* is a dummy variable with 1 representing a bond that is state-taxable. *General Obligation Limited* is a dummy variable with 1 representing a bond secured by the limited taxing authority of the issuer, and 0 otherwise. *General Obligation Unlimited* is a dummy variable with 1 representing a bond secured by the unlimited taxing authority of the issuer, and 0 otherwise. A bond that is neither general obligation type is a revenue bond secured by a specific project source. *Underwriter Prestige* represents the Carter and Manaster score of underwriter prestige. *, ** denote statistical significance at the 5% and 1% levels, respectively.

Panel A
Dependent Variable: First Trading Day Return

Maturity	0.084	0.105	0.094	0.119
	(0.067)	(0.071)	(0.065)	(0.071)
Maturity^2	-0.007	-0.008	-0.008	-0.009
	(0.004)	(0.004)	(0.004)	(0.004)*
Bond Size	1.655	2.038	1.665	2.129
	(1.321)	(1.173)	(1.238)	(1.132)
Tax Status	1.095	0.106	0.818	0.021
	(0.166)**	(0.332)	(0.528)	(0.266)
Underwriter Prestige		-0.196		-0.204
		(0.231)		(0.227)
General Obligation			1.696	1.328
Limited			(0.393)**	(0.533)*
General Obligation			0.335	-0.099
Unlimited			(0.544)	(0.699)
Constant	-5.186	-3.665	-5.296	-3.700
	(3.175)	(4.233)	(2.965)	(4.619)
Year Dummies	Yes	Yes	Yes	Yes
State Dummies	Yes	Yes	Yes	Yes
Cluster on State	Yes	Yes	Yes	Yes
Number of Bonds	247	245	247	245
Adjusted R-sq	0.308	0.344	0.327	0.366

Panel B
Dependent Variable: First Trading Day Return

Contributed	2.753	2.814	2.776	2.807
	(0.515)**	(0.595)**	(0.493)**	(0.582)**
Maturity	0.066	0.065	0.079	0.080
	(0.053)	(0.054)	(0.048)	(0.051)
Maturity^2	-0.006	-0.005	-0.006	-0.006
	(0.003)	(0.003)	(0.003)*	(0.003)*
Bond Size	1.129	0.840	1.228	0.969
	(0.736)	(0.625)	(0.690)	(0.592)
Tax Status	2.843	-0.257	2.893	2.859
	(0.427)**	(0.266)	(0.503)**	(0.592)**
Underwriter Prestige		0.082		0.072
		(0.077)		(0.068)
General Obligation			0.812	0.770
Limited			(0.324)*	(0.311)*
General Obligation			-0.430	-0.458
Unlimited			(0.304)	(0.294)
Constant	-5.809	-2.648	-5.747	-5.619
	(1.976)*	(1.428)	(1.710)**	(1.644)**
Year Dummies	Yes	Yes	Yes	Yes
State Dummies	Yes	Yes	Yes	Yes
Cluster on State	Yes	Yes	Yes	Yes
Number of Bonds	247	245	247	245
Adjusted R-sq	0.665	0.644	0.684	0.664

Table VII. Performance

The table presents the results of regression analysis using ordinary least squares (OLS) where the dependent variables are the cumulative day returns for the relevant time period in the column heading in percentage points. Both regressions use all controls in the baseline specification. *Contributed* is a dummy variable that represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *Maturity* is measured in number of calendar years and is the difference between the dated date and the maturity date of the bond. *Bond Size* is the log of size of the bond. *State Tax* is a dummy variable with 1 representing a bond that is state-taxable. *General Obligation Limited* is a dummy variable with 1 representing a bond secured by the limited taxing authority of the issuer, and 0 otherwise. *General Obligation Unlimited* is a dummy variable with 1 representing a bond secured by the unlimited taxing authority of the issuer, and 0 otherwise. A bond that is neither general obligation type is a revenue bond secured by a specific project source. *Underwriter Prestige* represents the Carter and Manaster score of underwriter prestige. *, ** denote statistical significance at the 5% and 1% levels, respectively.

	(1) 10 Day Return	(2) 20 Day Return	(3) 30 Day Return	(4) 50 Day Return	(5) 60 Day Return
Contributed	0.940	1.262	-1.066	-1.478	-0.845
	(0.659)	(1.162)	(0.869)	(1.199)	(1.363)
Maturity	0.020	-0.032	0.062	0.140	0.090
	(0.016)	(0.088)	(0.111)	(0.185)	(0.200)
Maturity^2	0.001	0.006	0.004	0.003	0.004
	(0.001)	(0.006)	(0.007)	(0.011)	(0.014)
Bond Size	0.282	1.109	1.321	1.295	1.901
	(0.423)	(1.061)	(1.005)	(1.511)	(1.890)
Tax Status	1.318	2.980	1.341	3.260	4.297
	(0.655)*	(1.167)*	(0.929)	(1.134)**	(1.291)**
Underwriter Prestige	-0.068	-0.216	-0.746	-0.586	-0.460
	(0.141)	(0.399)	(0.336)*	(0.505)	(0.549)
General Obligation	0.657	-0.328	1.600	-2.971	-3.098
Limited	(0.299)*	(0.666)	(0.681)*	(1.005)**	(1.217)**
General Obligation	0.289	-0.473	0.494	-2.284	-2.358
Unlimited	(0.296)	(0.510)	(0.441)	(0.475)**	(0.508)**
Constant	-1.741	-3.247	2.477	2.559	-0.404
	(1.780)	(3.703)	(3.186)	(4.614)	(6.078)
Year Dummies	Yes	Yes	Yes	Yes	Yes
State Dummies	Yes	Yes	Yes	Yes	Yes
Cluster on State	Yes	Yes	Yes	Yes	Yes
Number of Bonds	245	245	245	245	245
Adjusted R-sq	0.563	0.433	0.612	0.608	0.564

Table VIII. Instrumental Variable Regressions

The table presents the results of instrumental variables regression analysis using two stage least squares (2SLS) and a Heckman-type treatment effects model where the dependent variable is the daily return on the first day of trading in percentage points. Both sets of regressions include year dummies in the specification. The identification instrument used in the first stage is *Margin of Victory*, the percentage of votes received by the sitting governor minus the percentage of votes received by the runner-up in the most recent election (coded in percentage points). *Contributed* is a dummy variable that represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *Maturity* is measured in number of calendar years and is the difference between the dated date and the maturity date of the bond. *Bond Size* is the log of size of the bond. *State Tax* is a dummy variable with 1 representing a bond that is state-taxable. *General Obligation Limited* is a dummy variable with 1 representing a bond secured by the limited taxing authority of the issuer, and 0 otherwise. *General Obligation Unlimited* is a dummy variable with 1 representing a bond secured by the unlimited taxing authority of the issuer, and 0 otherwise. A bond that is neither general obligation type is a revenue bond secured by a specific project source. *Underwriter Prestige* represents the Carter and Manaster score of underwriter prestige. *, ** denote statistical significance at the 5% and 1% levels, respectively.

Dependent Variables: Contributed & First Trading Day Return

First Stage	Heckman	2SLS	Second Stage	Heckman	2SLS
Margin of Victory	0.184	0.047	Contributed	2.159	1.526
	(0.041)**	(0.004)**		(0.000)**	(0.344)**
Maturity	0.042	-0.001	Maturity	0.110	0.098
	(0.092)	(0.008)		(0.000)**	(0.035)**
Maturity^2	0.003	0.0005	Maturity^2	-0.007	-0.007
	(0.004)	(0.0004)		(0.000)**	(0.002)**
Bond Size	0.155	0.013	Bond Size	0.101	0.100
	(0.097)	(0.008)		(0.000)**	(0.032)**
Tax Status	0.231	0.796	Tax Status	3.224	-0.152
	(0.283)	(0.088)**		(0.000)**	(0.263)
Underwriter Prestige	-0.558	-0.085	Underwriter Prestige	0.055	-0.054
	(0.149)**	(0.015)**		(0.000)	(0.086)
General Obligation	5.601	0.675	General Obligation	0.526	1.019
Limited	(0.000)**	(0.128)**	Limited	(0.000)**	(0.617)
General Obligation	-0.926	0.676	General Obligation	-1.261	-0.300
Unlimited	(0.512)	(0.096)**	Unlimited	(0.000)	(0.196)
			Inverse Mill's Ratio	0.875	
				(0.273)**	
			Year Dummies	Yes	Yes
			State Dummies	Yes	Yes
Number of Bonds	245	245	Number of Bonds	245	245
F Stat (Prob >F)		30.020	Prob > Chi2	0.000	.
Test for excl instruments	.	(0.000)	Prob > F	.	0.000

Table IX. Top Three Contributors, Election Cycle, and Rank

The table presents the results of regression analysis using ordinary least squares (OLS) for negotiated bonds where the dependent variable is the daily return on the first day of trading in percentage points. All regressions use all controls in the baseline specification. *Contributed* is a dummy variable that represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *Top Three Contributed* is a dummy variable that represents bonds issued by a top 3 contributing underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *After Election* is a dummy variable that is equal to 1 if the bond is issued in the year following a gubernatorial election for the issuing state. *Rank* is the ranking of the underwriter in the year prior to issue based on the amount issued for long term bonds. *Maturity* is measured in number of calendar years and is the difference between the dated date and the maturity date of the bond. *Bond Size* is the log of size of the bond. *State Tax* is a dummy variable with 1 representing a bond that is state-taxable. *General Obligation Limited* is a dummy variable with 1 representing a bond secured by the limited taxing authority of the issuer, and 0 otherwise. *General Obligation Unlimited* is a dummy variable with 1 representing a bond secured by the unlimited taxing authority of the issuer, and 0 otherwise. A bond that is neither general obligation type is a revenue bond secured by a specific project source. *Underwriter Prestige* represents the Carter and Manaster score of underwriter prestige. *, ** denote statistical significance at the 5% and 1% levels, respectively.

Dependent Variable: First Trading Day Return

Top Three Contributed	4.147	Contributed	1.517	Contributed	1.193
	(0.124)**		(0.066)**		(0.058)**
		After Election	2.260	Rank	-0.016
			(0.539)**		(0.006)**
		Contributed*After Election	1.226	Contributed*Rank	0.103
			(0.555)*		(0.003)**
Underwriter Prestige	0.125	Underwriter Prestige	0.140		
	(0.063)*		(0.045)**		
General Obligation	1.686	General Obligation	0.334	General Obligation	1.322
Limited	(0.260)**	Limited	(0.276)	Limited	(0.158)**
General Obligation	0.526	General Obligation	-0.971	General Obligation	0.020
Unlimited	(0.220)**	Unlimited	(0.411)**	Unlimited	(0.061)
Constant	-3.541	Constant	-4.161	Constant	-2.879
	(0.330)**		(0.539)**		(0.635)**
Year Dummies	Yes	Year Dummies	Yes	Year Dummies	Yes
State Dummies	Yes	State Dummies	Yes	State Dummies	Yes
Cluster on State	Yes	Cluster on State	Yes	Cluster on State	Yes
Number of Bonds	245	Number of Bonds	245	Number of Bonds	245
Adjusted R-sq	0.679	Adjusted R-sq	0.690	Adjusted R-sq	0.711

Table X. Quantile and Iterated Reweighted Least Squares (IRLS) Regression

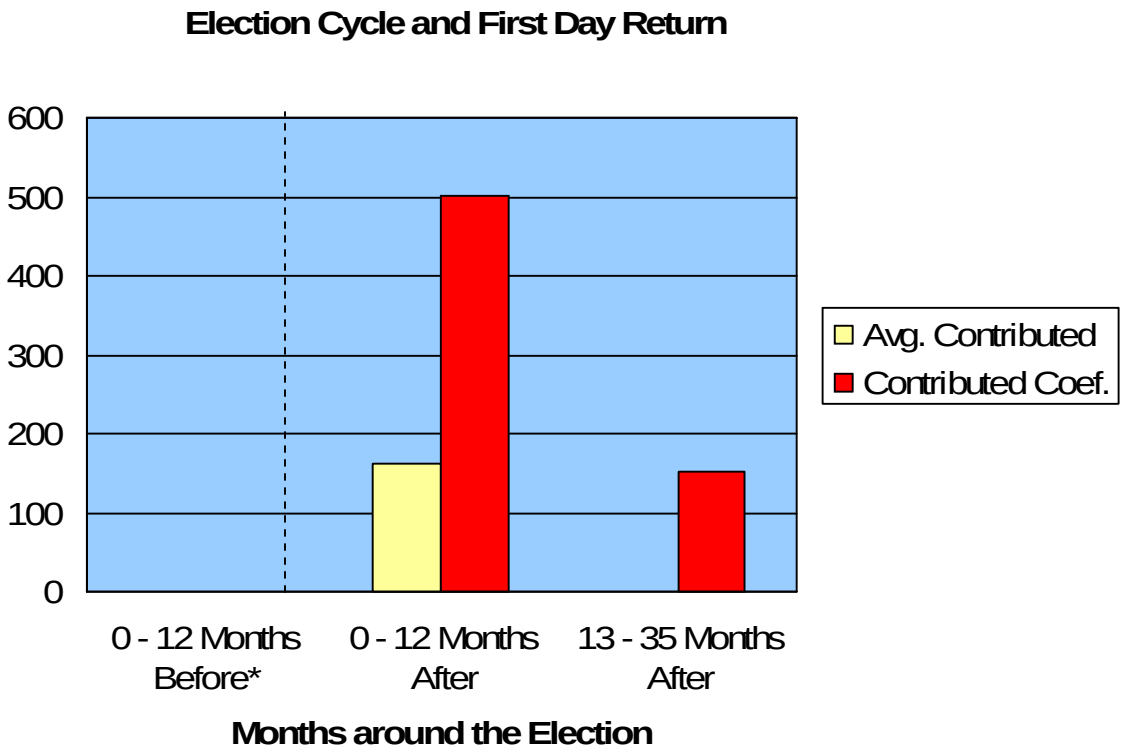
The table presents the results of regression analysis where the dependent variable is the daily return on the first day of trading in percentage points. Quantile regression is used for column 1 with bootstrapped standard errors. Iterated Reweighted Least Squares (IRLS) regression is used for column 2 where extreme observations are given less weight than other observations. For columns 1 and 2, *Contributed* is a dummy variable that represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous two years. *Maturity* is measured in number of calendar years and is the difference between the dated date and the maturity date of the bond. *Bond Size* is the log of size of the bond. *State Tax* is a dummy variable with 1 representing a bond that is state-taxable. *General Obligation Limited* is a dummy variable with 1 representing a bond secured by the limited taxing authority of the issuer, and 0 otherwise. *General Obligation Unlimited* is a dummy variable with 1 representing a bond secured by the unlimited taxing authority of the issuer, and 0 otherwise. A bond that is neither general obligation type is a revenue bond secured by a specific project source. *Underwriter Prestige* represents the Carter and Manaster score of underwriter prestige. *, ** denote statistical significance at the 5% and 1% levels, respectively.

Dependent Variable: First-Day Return

	(1) Quantile	(2) IRLS
Contributed	2.332	1.794
	(0.412)**	(0.138)**
Maturity	0.085	0.069
	(0.035)**	(0.019)**
Maturity^2	-0.007	-0.007
	(0.002)**	(0.001)**
Bond Size	0.040	0.098
	(0.038)	(0.022)**
Tax Status	2.223	1.715
	(0.563)**	(0.224)**
Underwriter Prestige	-0.022	-0.080
	(0.092)	(0.041)*
General Obligation	0.455	0.633
Limited	(0.924)	(0.314)*
General Obligation	-0.329	0.059
Unlimited	(0.435)	(0.214)
Constant	-2.423	-2.519
	(0.871)**	(0.369)**
Year Dummies	Yes	Yes
State Dummies	Yes	Yes
Cluster on State	No	No
Number of Bonds	245	245
Adjusted R-sq	.	0.693

Figure I. Electoral Cycle and First Day Return

The figure presents the distribution of offers where on the sale date the lead underwriter contributed to the sitting elected governor's campaign in the previous two years and was selected through the negotiated method. The first day return is shown on the y-axis in terms of basis points. *Avg. Contributed* represents the simple mean of the first day return for the relevant time period. *Contributed Coefficient* represents the coefficient for contributed issued from the OLS regression model using the *After Election* dummy variable. * denotes no observations for the time period.



Appendix

Table A.I. State Election and Campaign Contribution Web sites and Bond Quality Scoring

The table provides the list of state level municipal straight bond offerings. This sample is grouped by section categories

State Election Web sites

State	Homepage
Alabama	http://www.sos.state.al.us/sosinfo/inquiry.cfm?area=Elections
Alaska	http://www.state.ak.us/apoc/campaign.htm
Arizona	http://www.azsos.gov/cfs/
Arkansas	.
California	http://cal-access.ss.ca.gov/Campaign/
Colorado	http://www.sos.state.co.us/pubs/elections/main.htm
Connecticut	http://www.sots.state.ct.us/ElectionsDivision/CampaignFinance.html
Delaware	http://www.state.de.us/election/
Florida	http://election.dos.state.fl.us/campfin/cfindb.shtml
Georgia	http://www.sos.state.ga.us/elections/campaign_disclosures/default.htm
Hawaii	http://www.hawaii.gov/campaign/index.html
Idaho	http://www.idsos.state.id.us/elect/finance.htm
Illinois	http://www.elections.state.il.us/
Indiana	http://www.state.in.us/sos/elections/
Iowa	http://www.sos.state.ia.us/elections/
Kansas	http://www.accesskansas.org/ethics/
Kentucky	http://www.state.ky.us/agencies/kref/krefhome.htm
Louisiana	http://www.ethics.state.la.us/general/index.html
Maine	http://www.maine.gov/ethics/
Maryland	http://www.elections.state.md.us/
Massachusetts	http://www.mass.gov/ocpf/
Michigan	http://www.michigan.gov/sos/0,1607,7-127-1633_8723---,00.html
Minnesota	http://www.cfboard.state.mn.us/
Mississippi	http://www.sos.state.ms.us/elections/CampFinc/
Missouri	http://www.moethics.state.mo.us/Ethics/Generalinfo/Generalinfo.aspx
Montana	.
Nebraska	.
Nevada	http://sos.state.nv.us/nvelection/
New Hampshire	http://www.sos.nh.gov/political%20page.htm
New Jersey	http://www.elec.state.nj.us/index.html
New Mexico	http://www.sos.state.nm.us/ethics.htm
New York	http://www.elections.state.ny.us
North Carolina	http://www.app.sboe.state.nc.us/
North Dakota	http://www.state.nd.us/sec/campfinance/
Ohio	http://www.sos.state.oh.us/sos//
Oklahoma	www.ok.gov/okcids/search/search.php
Oregon	http://www.sos.state.or.us/elections/other.info/ce.htm
Pennsylvania	http://www.dos.state.pa.us/bcel/cwp/view.asp?a=1099&Q=431609&bcelNav=|&dosNav=|

Rhode Island	http://www.ricampaignfinance.com/RIPublic/Contributions.aspx
South Carolina	.
South Dakota	http://www.sdsos.gov/elections/
Tennessee	http://www.state.tn.us/tref/
Texas	http://www.ethics.state.tx.us/
Utah	http://elections.utah.gov/
Vermont	http://vermont-elections.org/elections1/campaign_finance.html
Virginia	http://www.sbe.state.va.us/Campaign_Finance/Default.html
Washington	http://www.pdc.wa.gov/
West Virginia	http://www.wvsos.com/elections/cfreports/
Wisconsin	http://www.wisdc.org/wdc.php
Wyoming	.

Underlying Quality Rating

Bond ratings are converted to a consistent numerical score consistent with Nanda and Singh (2004)

Quality	S&P Ratings	Moodys Ratings
1	Not Rated	Not Rated
2	Below BBB+	Below Baa1
3	A-, BBB+	Baa1, A3
4	A+, A	A, A1, A2
5	AA, AA-	Aa2, Aa3
6	AA+, AAA	Aa, Aa1, Aaa

Table A.II. Initial Daily and Holding Period Return Statistics

The table provides sample statistics for bonds issued through the negotiated and competitive methods. The sample consists of bonds packaged with third-party insurance from one of the four major insurance entities: Municipal Bond Investors Assurance Corporation (MBIA Corporation), the Ambac Financial group (AMBAC), the Financial Guaranty Insurance Company (FGIC), and Financial Security Assurance Inc. (FSA). *Negotiated* represents bonds issued on the basis of an issuer committing to an underwriter. *Competitive* represents bonds issued under a sealed bid auction. *Contributed* is a dummy variable that represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *, ** denote statistical significance at the 5% and 1% levels, respectively, in a two-sided test of the mean differences.

Variable Name		**Contributed**	**No Contribution**	**All**
First Day Return	Mean	0.142	0.168	0.161
	sd.	0.087	0.746	0.038
	N	116	332	448
60 Day Cumulative Return	Mean	0.864**	1.498	1.335
	sd.	2.404	1.991	2.121
	N	116	334	450
Variable Name		**Contributed**	**No Contribution**	**Negotiated**
First Day Return	Mean	0.280	0.033	0.099
	sd.	1.168	0.794	0.915
	N	67	181	248
60 Day Cumulative Return	Mean	1.127	1.680	1.530
	sd.	2.804	2.520	2.605
	N	67	181	248
Variable Name		**Contributed**	**No Contribution**	**Competitive**
First Day Return	Mean	-0.048**	0.331	0.237
	sd.	0.423	0.649	0.622
	N	49	151	200
60 Day Cumulative Return	Mean	0.504**	1.284	1.095
	sd.	1.677	1.039	1.265
	N	49	153	202

Table A.III. OLS Regressions Using the Initial Trading Day Return

The table presents the results of regression analysis of insured bonds issued through the negotiated and competitive methods using ordinary least squares (OLS) where the dependent variable is the daily return on the first day of trading in percentage points. *Contributed* is a dummy variable that represents bonds issued by an underwriter that contributed to the gubernatorial campaign of the governor in office in the previous 2 years. *Maturity* is measured in number of calendar years and is the difference between the dated date and the maturity date of the bond. *Bond Size* is the log of size of the bond. *State Tax* is a dummy variable with 1 representing a bond that is state-taxable. *General Obligation Limited* is a dummy variable with 1 representing a bond secured by the limited taxing authority of the issuer, and 0 otherwise. *General Obligation Unlimited* is a dummy variable with 1 representing a bond secured by the unlimited taxing authority of the issuer, and 0 otherwise. A bond that is neither general obligation type is a revenue bond secured by a specific project source. *, ** denote statistical significance at the 5% and 1% levels, respectively.

	(1) All	(2) Competitive	(3) Negotiated	(4) Competitive	(5) Negotiated
Contributed	0.571	0.147	2.752	0.229	2.768
	(0.578)	(0.097)	(0.517)**	(0.118)	(0.497)**
Maturity	0.095	0.285	0.021	0.204	-0.041
	(0.044)*	(0.017)**	(0.105)	(0.083)**	(0.059)
Maturity^2	-0.006	-0.001	-0.006	-0.004	-0.005
	(0.003)**	(0.002)	(0.003)*	(0.003)	(0.002)*
Bond Size	0.059	-0.328	0.152	-0.129	0.201
	(0.074)	(0.015)**	(0.089)	(0.083)	(0.052)**
Tax Status	0.581	-1.311	-0.415	-0.321	-0.431
	(0.673)	(0.478)**	(0.175)**	(1.656)	(0.159)**
General Obligation	1.187		1.524		2.290
Limited	(0.241)**		(1.331)		(0.692)**
General Obligation	0.042	0.569	-0.188	-0.074	0.067
Unlimited	(0.302)	(0.213)**	(0.625)	(0.774)	(0.366)
Constant	-1.416	7.144	-0.974	3.020	-1.252
	(1.296)	(0.603)**	(0.753)	(2.455)	(0.408)**
Stage 1: Before Election		No	No	Yes	Yes
Year Dummies	Yes	Yes	Yes	Yes	Yes
State Dummies	Yes	Yes	Yes	Yes	Yes
Cluster on State	Yes	Yes	Yes	Yes	Yes
Number of Bonds	447	200	247	200	247
Adjusted R-sq	0.369	0.603	0.683	0.573	0.686

Table A.IV. Campaign Contributions and Underwriter Choice

The table provides results of nested logit regressions where the last-stage dependent variable is the equal to 1 if the underwriter is selected. *Negotiated* represents bonds issued on the basis of an issuer` committing to an underwriter. *Competitive* represents bonds issued under a sealed bid auction. Control variables are maturity, bond size, and quality all interacted with *Negotiated*. *Contributed* is equal to 1 if an underwriter contributed to the gubernatorial campaign of the governor in office in the previous 2 years, and 0 otherwise. Heteroskedasticity-robust standard errors are provided in parentheses. The LR test is of the null hypothesis of a non-nested model.*, ** denote statistical significance at the 5% and 1% levels, respectively.

Dependent Variable: 1 if the Underwriter is Chosen, 0 Otherwise

	(1) **Nested Full**	**(2)** **Nested Full**
Contributed	0.390	0.390
	(0.133)**	(0.132)**
Type		
Bond Size * Negotiated	-0.129	-0.128
	(1.260)	(1.277)
Maturity * Negotiated	0.103	0.103
	(0.103)	(0.107)
Quality * Negotiated	0.029	0.030
	(0.498)	(0.521)
Before Election * Negotiated		0.086
		(1.581)
Inclusive Parameters		
Negotiated	7.121	7.049
	(9.364)	(10.537)
Competitive	8.124	8.043
	(5.144)	(5.976)
Stage 1: Before Election	No	Yes
Year Interaction Dummies	Yes	Yes
State Interaction Dummies	Yes	Yes
Number of Observations	74888	74888
Number of Groups	1702	1702
LR Test: Prob > Chi2	0.000	0.000