Growth Pangs of the IPO Market

ONGC's recent Initial Public Offering (IPO) mis-allotment has brought into focus many issues that surround the primary market. Investors are cynical about the efficiency of Indian markets in handling large IPO issues. Moreover, it is felt that the registrar to the issue forms the weakest link in the IPO chain. This debate tries to focus on the problems and potential solutions that would remove the likely bottlenecks in the growth of primary markets.

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❑ Indian Capital Market Lacking Proper Infrastructure

Sundar Sankaran: In the last few years, emphasis has been more on secondary markets, where infrastructure and performance match global standards. Lack of investment in the primary market is understandable, given that the market itself has been oscillating between vibrancy and despondency.

Earlier, the banking system had a more direct role in accepting application forms for primary issues. With book building, the role of banks has declined. Incidentally, if any segment of the financial market has invested aggressively in technology in the last few years, it is the banks. Thus, primary market activities have migrated from a segment that has invested in technology (albeit for their core banking activities), to a segment that has found it difficult to justify such investments!

S Manikutty: It was not really the infrastructure that was at fault, but the ability or the willingness of the managers to the issue to do what they were supposed to do.

Deepak Pareek: The fiasco in the ONGC allotment seems to be fading off, as in the most past cases. The attitude of the regulator, and therefore the government, does little to improve the confidence of the investor, the government is least serious about the white-collar criminals. The Harshad Mehta scam was explained as a structural error. Even before the investigation started, the regulator stated that the fiasco is due to human error. Therefore, the Indian financial market can expect to attract the wrong type of investor, foreign or otherwise, and keep out genuine investors.

India is a power in the software world. Software has to be designed to detect and correct human error. The good old term GIGO (Garbage In, Garbage Out) was a warning to the programmer and system designer, and not the user. That a wrong tape was put in by mistake, says much about the quality of management, not only of the software agency but all those involved in choosing to work with it. It's hard to believe that the management of ONGC and the merchant bankers are that incompetent. Then, the conclusion is that the error was either mala fide or due to gross incompetence.

The views expressed by the participants are their own and do not necessarily reflect those of the organizations they represent.

Unless the government holds managements responsible for these errors, then, we will have to live with the fact that our money is not safe because the managements are not accountable for human error. It is essential that investigations be expeditious. Stringent punishment, jail terms rather than fines, should be the punishment when the stakes are so high.

G Sethu: Like any other business, a registrar too would create capacity in such a way that he does not have to carry idle capacity too frequently. Therefore, when issues are few and small or when issues are many and large, registrars face problems. Besides this, I think the quality of infrastructure needs to be enhanced. IPOs involve a number of tasks that need to be performed in a given span of time. It is debatable if all registrars have the process quality in place. It appears that Sebi has appointed a committee to assess the quality of capital market infrastructure. This step is in the right direction.

❑ Lukewarm Participation by Retail Investors in IPO Market

Sundar Sankaran: Structurally, I would be quite happy to see retail participation routed through the mutual fund and pension fund route—at least until investors are prepared to take greater responsibility for their actions, and the political class gets comfortable with the paradigm of investors having to bear the consequences of their greed.

For a long time, the interest rate structure was such that investors did not need to invest in equities. With the realignment of interest rates, and greater recognition of risk-reward relationships by investors, retail participation in equities will go up.

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S Manikutty: I do not know, perhaps they are wary of the issues themselves; perhaps they have no means of arriving at their own judgment on whether the pricing is reasonable.

Deepak Pareek: Stock investments make only 4 to 5% of the Indian household savings while around Rs. 18,00,000 cr are tied up in bank savings deposits—that is almost twice the total market capitalization of the Bombay Stock Exchange. Globally, there are increased evidences to suggest that investor confidence has assumed an important role in the economic development of a country. Lack of the same in India is the prime reason for the lukewarm response in the retail segment unlike in the West. Some key pointers are:

- Scams, scams and more scams without a single high profile indictment for white-collar crime have made people lose their confidence in the system.
- Regulators are acting more as a deterrent and putting more barriers for retail investment than safeguarding them.
- Lack of corporate transparency and good governance.
- Lack of safe investment opportunities in primary markets due to various unwarranted restrictions on IPO/Listings.

G Sethu: Indians have relatively lower investible surplus. Anyone with small investible surplus might first look at safe investment avenues and then move towards risky avenues. There is no organized social security for most citizens in India. These factors might explain why Indians have been comfortable with traditional avenues such as banks, post offices, gold etc. US and some other nations have had market orientation for many years, while India has begun to think of liberalization just two decades back. Quality investment opportunities in the Indian corporate sector are limited, though there are a number of listed companies. A few select communities have dominated the equity markets till the 1970s. The regulatory framework in the capital markets is gradually beginning to fall in place unlike in the US and UK. The market failures of 1990s and experiences of early 2000 are still fresh in the minds of investors. Intermediaries have shown little professional approach in guiding investors. All these are factors why retail Indian investors are fewer in the capital market in general, and primary markets in particular.

❑ Ways to Increase Retail Investor Participation

Sundar Sankaran: Investors need to be better educated on the financial markets and financial planning. This would be a good starting point. Further, income tax policies as well as primary allotment policies could be biased in favor of retail investors.

As mentioned earlier, mutual funds would still be a better route for most retail investors. It may be a good idea for income tax and other regulatory authorities to differentiate between retail-oriented mutual fund schemes and wholesale mutual fund schemes based on transparent parameters.

S Manikutty: There should be more stringent controls on the manipulators who collect money from the investors and disappear. Better analysis by different agencies on the prospects and pricing may help.

Deepak Pareek: Measures to increase retail participation include:

- Latest and easy availability of information, like information related to promoters' background.
- Transparency in the system and operations.
- Sensitive information should be made available to everyone at the same time.
- Action against issue managers, analysts and companies for providing overoptimistic and wrong information.
- Regulation to control scandals, prevention of corporate frauds, and bogus companies not to be allowed to raise funds.
- Tighter regulations and strict action against cheaters.
- More liquidity in primary market investment and operations.
- Investor-friendly enactments are necessary.

G Sethu: It is whether we should increase the direct retail participation in the capital market. If the investor is not sophisticated enough, it is better to consider dedicated vehicles through which retail investors can seek access to the capital markets. Regulators, however, should have a substantial oversight on these vehicles.

❑ Affect of the Increasing Foreign Participation in the IPO Market

Sundar Sankaran: In the days of free competition, we cannot afford to be too fearful of foreigners. The only answer is to let the domestic companies and institutions grow through mergers and acquisitions, and in general, give them the same freedom that the foreigners enjoy in their domicile.

S Manikutty: Foreign investors are no different from Indian investors. They are there for the money. There is no dependence on increased participation of foreign investors or the possibility of markets getting affected adversely.

Deepak Pareek: Yes, too much dependence on foreign investors would adversely affect the market. Indian domestic investors must have sizable share in primary market investment, especially, till the time indirect methods of foreign investment are not plugged.

G Sethu: Foreign investors would shift their investments to the most attractive destination. That is the mandate of those fund managers. Sometimes, this is interpreted as FII induced volatility. We have seen this when Indian corporates and banks move into and out of the market. I think, it is the size of the investor and the alternative investment opportunities faced by them that make the difference. If we have domestic institutions and MFs who are large and who can garner high levels of retail money, it is possible for them to equilibrate the market.

❑ On how the Investors Should be Compensated for Mis-allotment in Case of ONGC Issue and who Should Take Action for the Same

Sundar Sankaran: ONGC had the benefit of some shrewd drafting of the offer document. Otherwise, the Government of India would not have gained access to the issue proceeds until the allotment was completed truly and fairly.

As a general policy, responsibility is that of the registrar. It should be made mandatory for the registrar to take insurance policies to cover such risks. The claims on behalf of the investors could be made by the stock exchanges, which have an interest in safeguarding the investors' interests. The issuer too could be a facilitator in such claims, given that it has appointed the registrar.

S Manikutty: The actual losses suffered, if any, are due to the selling of wrongly credited shares, that will have to be made up by the managers to the issue. If this has been done intentionally, criminal cases must be launched against the culprits. Sebi, and the police must get into the act.

Deepak Pareek: It should be simple—people who have lost money must be paid the equivalent amount of loss incurred. Both ONGC and its registrars are responsible. Sebi should ensure that investors are properly compensated.

G Sethu: I think there are examples that we can learn from. Recently, Securities and Exchange Commission (SEC) has fined large players in the mutual fund industry in the US and has used the proceeds to compensate the investors. Sebi can consider such steps.

❑ Increasing the Efficiency of Registrar and Other Gray Areas to be Tackled in the Primary Market

Sundar Sankaran: There are two things that Sebi needs to insist on, as a precondition to maintaining the authorization of the registrars. One is the insurance policy mentioned earlier; the other is that every registrar has to be audited by a Certified Information Systems Auditor. This audit of the processes and systems would be different from the normal financial audit.

Recently, we had a stock exchange admitting a flaw in its bid acceptance program. An independent systems audit would have highlighted the bug much earlier. In this case, investment bankers too should have been attentive to the differences between the bids reported by the exchange and the applications reported by the registrar on earlier issues.

I hope all the agencies that are concerned with the financial markets are conscious of their roles and responsibilities. There is perhaps a need to move from technical performance of duties to realistic performance of responsibilities.

An area that needs to be pondered over is the competency and organization structure of investment bankers/lead managers. They perform a key role in coordinating the entire issue. Lead managers have obvious strengths in the areas of security valuation and investor relationships. Unfortunately, the same people are not necessarily strong in systems and processes. May be investment banks need to have process-oriented professionals to coordinate issues.

Deepak Pareek: In fact, not just registrars, but also all market intermediaries need improvement. Sebi needs to be proactive in screening, vigilance, regulation, benchmarking, training, auditing and penalizing culprits.

G Sethu: We need to tell the registrars (and other intermediaries) to make their processes quality compliant. This will cost money and eventually the investors have to bear it in one form or the other.♦

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