

Regulations

Cracking the whip

Levelling the field for retail and institutional investors was the most notable achievement of Sebi in 2010



Standard Chartered Plc of UK launched the first-ever issue of Indian Depository Receipts

2010 was an eventful year for investors, with many scrips crossing peak prices reached during the boom of 2007. The year witnessed the beginning of a new chapter in the primary market, with Standard Chartered Plc of UK launching the first-ever issue of Indian Depository Receipts. This issue marked the reversal of the last decade's trend when several Indian companies had raised funds through American Depository Receipt offerings on the New York Stock Exchange and Nasdaq. The year was also noteworthy for the host of changes introduced by market regulator Securities and Exchange Board of India (Sebi) to protect the interests of the investors.

Addressing complaints of investors in the primary market, Sebi mooted the idea of application supported by blocked amount (Asba) in 2008. Investors can now apply for initial public offers (IPOs), follow-on public offers (FPOs) and rights issues of shares without upfront payment. Instead, the application amount is blocked in the investors' bank account. An amount proportionate to the shares is released and the balance is unblocked. Despite its potential, Asba did not

become popular in the initial phase. However, Asba gained popularity in 2010 as, from 1 May 2010, the Asba facility was extended to all kinds of investors including qualified institutional buyers (QIBs).

Another major risk associated with investments in the primary market is the time gap between the closure of the issue and the listing of shares on the stock exchanges. There may be considerable fluctuation in the market in the interim period. Extension of Asba for QIBs enabled Sebi to close the time gap between the closure of a public issue and the listing of shares from the average period of 22 days to just 12 days. Around 15 years ago, this gap was about three months. The new process became applicable to all public issues that opened after 3 May 2010. Thus, Asba has not only saved investors from the risk of loss of refund orders but also from market associated risk.

The Asba facility has also been made applicable to new fund offers (NFOs) of mutual funds from 1 July 2010 to reduce the period between close of subscription and opening of the scheme for purchase and sale transaction to just 15 days instead of 30 days

for open ended schemes and 45 days for close ended schemes. Mutual funds have to allot units or refund the money and dispatch statement of accounts within five business days from the closure of the NFO and all the schemes (except equity-linked saving scheme) have to be made available for on-going repurchase, sale or trading within five business days of allotment.

Sebi (Issue of Capital & Disclosure Requirements) Regulations, 2009, were amended on 11 December 2009 to allow companies to adopt the French auction method (also known as multiple price auction method) for FPOs. This method operates on the principle that highest bidder wins. Companies fix only the floor price or the reserve price, and there is no ceiling on price or upper limit for bidding. QIBs submit their bids above the floor price, specifying the quantity and the price at which they want to purchase the desired quantity of shares. Allocation of shares is done on the basis of top-down approach, with maximum allocation to the highest bidder. However, the issuer can put a cap on allotting shares to a single bidder to prevent concentration of shareholding with few institutional investors. The French auction method is for institutional investors only. Retail investors can bid at the floor price.

In February 2010, the government used the French auction method for disinvestment of shares of power sector PSUs NTPC and REC. The rationale was that competition among institutional investors might lead to better price discovery and, thus, enable the government to raise larger sums from disinvestment to reduce the fiscal deficit.

However, the government's experiment with the French auction method was not successful. The floor price of the NTPC issue that closed on 5 February 2010 was set at Rs 201 per share even as the market price was hovering between Rs 205 to Rs 208. SBI and LIC had to bail out the issue by placing bids for a large portion at Rs. 209 per share on the very first day. As a result, there was no incentive for other institutional investors to bid at Rs 210 or at a price higher to obtain allotment because they could have very well purchased the shares from the market at a lower price. Moreover, there was no option available to SBI and LIC to revise their bids downwards because the French auction norms do not allow downward revision of bids. Perhaps the department of disinvestment and the merchant

bankers to the issue had never thought that such a peculiar situation could emerge.

In view of these developments, the department of disinvestment requested Sebi to change the auction norms for FPO of REC, which opened for subscription on 19 February 2010, so as to allow institutional investors to revise their bids downward. The government altogether dumped the French auction method for the NMDC issue that closed on 12 March 2010 in favour of the conventional book-building method, also known as the Dutch auction method. Thereafter, the French auction method has not been used for any of the PSU FPOs.

At its meeting held on 6 March 2010, Sebi decided that from 1 May 2010 all types of investors would be required to pay 100% of application money as margin along with application for securities. Till April 2010, institutional investors enjoyed the privilege of paying just 10% of the total value of the shares at the time of submitting their bids or applications in an IPO or FPO. The balance amount had to be paid on allotment of shares.

The rationale behind Sebi's move was not only to provide a level-playing field to retail individual investors, who have to pay the entire subscription amount at the time of making the application but also to curtail the tendency of institutional investors to submit bids for around 10 to 20 times their actual requirement of shares. Heavy over-subscription in the QIB category of IPOs created an impression on retail investors that



SBI and LIC had to bid to save the NTPC FPO

the issue is not only of very high quality but also reasonably priced. After this amendment, the artificial oversubscription levels in the QIB category have come down drastically. Thus, investors are in a position to see clear trends. To give more room to retail investors, the maximum application size for retail individual investors in IPOs and FPOs has been increased from Rs 1 lakh to Rs 2 lakh per application.

To reduce volatility in various scrips at the opening of the market and to arrive at the ideal opening price of scrips, Sebi mandated stock exchanges to introduce a call auction process in the pre-open session from 18 October 2010. Under this arrangement,

the stock exchanges collect orders for the first few minutes of the session. On the basis of the orders received, the system arrives at the opening price and matches the tradable orders with that price.

The 15-minutes pre-open session is divided into three phases: ● Order entry period from 9.00 am to 9.08 am, when fresh orders can be placed, modified or deleted. ● Order matching and confirmation or the price discovery period from 9.08 am to 9.12 am for the stock exchange to arrive at the opening price. Matching orders are converted into trades at the opening price. The client cannot modify or delete the orders during this period. ● Buffer period from 9.12 am to 9.15 am used as transition period between pre-open and continuous trading sessions.

Regular trading begins at 9.15 am and continues till 3:30 pm. The orders that have not been executed are carried over to the normal trading session. If the opening price is not discovered during the pre-open session, market orders are shifted to the normal trading session at the previous day's closing price.

On 4 May 2010, Sebi permitted stock exchanges to introduce option contracts on the Sensex and the Nifty with tenure of up to five years subject to the condition that there are eight semi-annual contracts of the cycle June-December in sequence to three serial monthly contracts and three quarterly contracts of the cycle March-June-September-December. The stock exchanges would have to put in place appropriate risk management framework before commencement of trading in such derivatives contracts. Time will tell

Staying afloat

Some PSUs came out with FPOs in 2010 to increase public float and many more are in the pipeline

In his budget speech delivered on 6 July 2009, the finance minister had proposed to raise the public float in listed companies to 25%. On 4 June 2010, the ministry of finance amended the Securities Contracts Regulation Rules, 1957, making it mandatory for all listed companies to increase the public shareholding to at least 25% in a phased manner. Large public shareholding reduces volatility, improves liquidity, increases floating stock, prevents market manipulation, widens the ownership base, ensuring greater investor participation and wealth creation. Last, but not the least, it helps in better price discovery.

After years of debate, the ministry brought out the amendment that would have far reaching implications for the stock market since there are a number of private and public sector companies with promoter shareholding exceeding 75%. Some PSUs have already come out with FPOs in 2010 to increase the public float and many more are in the pipeline. This would provide decent opportunity to retail investors to invest in well managed PSUs at reasonable price as retail investors are also offered discount of 5% on the cut-off price determined through book building.

about investors' enthusiasm to enter into such long-term option contracts.

To encourage investment of surplus funds in mutual funds (MFs), Sebi has permitted transactions in units of mutual fund schemes through clearing members of registered stock exchanges. Depository participants (DPs) have been allowed to process redemption requests of units held in demat form.

Investors receive redemption amount or units purchased through the broker's or clearing member's pool account. The MF or the asset management company (AMC) pays redemption proceeds to the broker or clearing member and the broker or clearing member in turn pays to the investor. Similarly, units are credited by MF or AMC into the broker's or clearing member's pool account on purchase and the broker or clearing member in turn credits the units in the demat account of the investor.

Payment of redemption proceeds to the broker or clearing members by MF or AMC discharges MF or AMC of its obligation to pay the investor. Similarly, for purchase of units, crediting the units in the broker's or clearing member's pool account discharges the MF or AMC of its obligation to allot the units to the investor.

Sebi had made income tax permanent account number (Pan) mandatory for all transactions in the securities market a few years ago. There are still a large number of demat accounts where the account holders have not yet furnished their PAN despite repeated reminders by DPs. These demat accounts were made inactive in 2008 under the category, 'Suspended for debits' so that the account holder cannot transfer the securities to any other demat account. To ensure better compliance with the know-your-client norms, from 16 August 2010 such Pan non-compliant demat accounts were 'Suspended for credit' other than credits arising out of automatic corporate actions. All credits from IPOs or FPOs or rights issues also are not allowed into such demat accounts.

Even the DPs have also not been spared by Sebi. Most of the DPs follow the system of collecting annual account maintenance charges upfront from their clients for maintaining the demat account. Sebi has directed that on closure of the demat account, the amount collected on annual or half yearly basis is to be refunded by the DP to the client for the balance of the quarter(s). For instance, if full amount has been charged upfront and the demat account is closed in the first quar-



Call auction process in the pre-open session to reduce volatility

ter, then the proportionate amount for the balance three quarters, i.e., 3/4th of the total amount, is to be refunded to the client. If a client closes his demat account in the third quarter, he will get refund for the last quarter, i.e., 1/4th of the amount.

Sebi continued with its drive to tighten norms for preferential allotment of shares and convertible warrants to promoters. If a promoter fails to exercise the convertible warrants, then he would not be eligible for issue of equity shares or convertible securities or warrants for further one year. The intention is to stop the misuse of preferential warrants. During the last downturn, promoters not only declined to exercise the preferential warrants but also attempted to obtain the shareholders' approval for issue of new preferential warrants at lower prices. During the boom period, some promoters sold their existing shares in the market and replenished them through preferential allotment of shares or convertible warrants. To stop this practice, Sebi mandated that if any member of the promoters or promoter group has sold shares in the previous six months, then the promoters or promoter group would not be eligible for preferential allotment of shares.

Although these steps are welcome, a lot needs to be done on the issue of preferential allotment of convertible warrants. Sebi must appreciate the fact that if promoters want to increase their controlling stake in the company to avoid takeover threats, they can easily do so by directly subscribing to the equity shares through preferential allotment route instead of adopting the preferential warrants route. A benefit of preferential allotment is that it helps

in garnering quick money needed by the company without much expenditure compared with FPOs and rights issues, which involve numerous formalities and high costs. Moreover, if the company is not doing well financially, then public and institutional investors would be reluctant to risk their money by subscribing to the equity shares. On the other hand, promoters always come forward to subscribe to the shares of their company as they are committed to support the company even in adverse circumstances.

These arguments hold good for preferential allotment of shares. But promoters pay only 25% of the total amount for preferential warrants and there is no certainty when they would exercise the conversion option and pay the balance 75%. If the company needs the remaining amount, say, within the next six months, but the promoters do not have surplus funds, they would opt for conversion of warrants at their own sweet will. Thus, the company is not in a position to plan its cash flow. If a company has good prospects, then all the existing shareholders would be interested to subscribe to the new shares. In other words, issue of preferential warrants to promoters blocks rights issues, thereby denying opportunity to retail investors to increase their shareholding in well managed companies at an attractive price. Hence, there is need to set these issues right in 2011.

The initiatives taken by Sebi in 2010 are laudable. But a lot needs to be done to make stock markets investor-friendly and free from rampant insider trading, which can shake the confidence of investors.

— *Rajesh Relan*