Chapter 2
Public Issue Market in India
2.1 Evolution of Indian Capital Market

The origin and growth of capital market activities in India can be traced back to the eighteenth century. It all started with the trading in shares of banks initially by six persons who called themselves as share brokers during the 1830s. In addition to the shares of banks, these brokers were also dealing in the securities of East India Company under a banyan tree in front of the town hall in Mumbai till 1850. In the year 1850, the Companies Act was enacted which introduced limited liability on the part of owners leading to the era of modern joint stock companies. This had further propelled trading volumes in securities. After India became the full-fledged colony of the U.K. in 1858, capital and entrepreneurship started flowing from the U.K. into the country without any restriction on them by the East India Company. This resulted in the growth of coffee and tea plantations, jute mills, and coal mines. Further, with the outbreak of the civil war in America in 1861, the supply of cotton from America to Lancashire (Great Britain) and to other European countries was interrupted. This had led to an increased demand for cotton from India resulting in a sharp increase in the price for Indian cotton in the European market. This had resulted in inflow of funds towards Bombay cotton dealers and a part of this flowed into the shares of many joint stock companies which were floated in Bombay because of the prevailing boom conditions. Between the period 1863 and 1865, new companies in Bombay raised around Rs 30 crore in the form of paid-up capital and around Rs 38 crore as premium. The share of Back Bay Reclamation with Rs 5,000 paid up was at a premium of Rs 50,000, the share of Port Canning with Rs 1,000 paid up was at a premium of Rs 11,000 were some of the examples for the boom prevailing (source: Bajpai (2004)).

However, the boom ended in 1865 with the civil war in America coming to an end resulting in the failure of several companies and a depression to follow. Nevertheless, a regular market in securities was already a well-observed phenomenon by then. The depression following the end of the civil war in America was so severe that it led to the formation of a formal market in India; the number of brokers which had increased during the boom period of 1861-65, started declining. Because of the benefits they enjoyed out of their trading during the sixties, these brokers started to organise themselves for the safety of themselves and the public. A Brokers’ Association, with a membership of 300, was formed in 1875 with its head office in the present Dalal Street. By an indenture dated 3rd of December 1887, the ‘Native Share and Stock Brokers’ Association of Bombay’ was formally set up. This association later came to be called Bombay Stock Exchange,
the oldest stock exchange in the entire Asia, and it was set up with the objective “to support and protect the character and status of brokers and to further the interests of both brokers and public dealing in Bombay in stocks, shares and like securities and in exchange, to promote honourable practices, to discourage and supress malpractices” etc. Seth Chumilal Motichand was its first president and by 1909, it had a membership of 361. Apart from government securities, the dealings on this exchange were limited to a few textile shares and the trading pattern was not properly organised till 1914.

Almost at the same time when Bombay witnessed boom in its trading activities e.g. during the 1860s, Calcutta also witnessed a major boost in economic activity. The number of tea and jute companies and the dealings in their shares had increased. In 1864, the daily market reports of Roussac and Co gave quotations for as many as 91 joint stock companies, tea being the largest group with 38 companies (source Thomas (1948)). However, the trading was carried on in an unorganised manner under a neem tree. Later, as a result of collective efforts of European and Indian brokers, a private association called ‘Calcutta Stock Exchange Association’ was started on 15th of June 1908 with an initial membership of 150. After 1880, another trading centre, Ahmedabad forged ahead with a growing textile industry under indigenous joint stock companies. Here also, a need for security dealings was felt, and as a result of this in 1894, the ‘Ahmedabad Share and Stock Brokers’ Association’ was set up which later became Ahmedabad Stock Exchange. In 1914-15, there were 2,545 joint stock companies in India with a total paid up capital of Rs 81 crore, by 1939-40, the number of companies rose to 11,372 and the paid-up capital to Rs 303.7 crore, and by 1944-45, the number of companies was 14,859 and the total paid-up capital was Rs 388.9 crore (sources Atlay (1924), Bajpai (2004), and Thomas (1948)).

Next came a series of legislations to regulate the activities in the stock exchanges or in the capital market. To begin with, during World War II, Control of capital issues was introduced by the British regime through the Defence of India Rules in 1943 under the Defence of India Act, 1939 to divert the resources to support the war effort. Such control over the raising of capital remained in force with some modifications even after the war in order to ensure that the national resources were available to fulfil the goals and priorities of the government and also to safeguard the investors. The relevant provisions in the Defence of India Rules were replaced by the Capital Issues (Continuance of Control) Act in April, 1947. Though there were many stock exchanges functioning in the pre-independence period, there were no proper regulations regulating their functioning.
till Bombay Securities Contracts Control Act was passed in 1925. After India got independence, under the constitution which was set up in 1950, stock exchanges and forward markets came under the exclusive control of central government. Owing to Gorwala Committee recommendations in 1951, the Securities Contracts (Regulations) Act, 1956 was passed to provide direct and indirect control of every aspect of securities trading, to administer the functioning of stock exchanges and to monitor possible undesirable transactions in securities (source Bapai (2004)).

During the decades of 1980s and 1990s, the governments and the policy makers felt the need for an efficient and well-developed capital market in order to accelerate the economic growth. During the entire post-independent era of Indian capital market, the decade of 1990s will stand apart and will be recognised as the most important decade. In 1991, as soon as the Congress led coalition government came to power, it initiated the famous LPG (liberalisation, privatisation, and globalisation) in every sector of the economy. As part of the financial liberalisation initiated in the capital market, several changes took place in the capital market as well. These reforms in the capital market that kicked off were, in fact, preceded by a regime which ensured almost complete control of the state over the financial markets. Public issues were subject to control under the Capital Issues (Control) Act, 1947 with Controller of Capital Issue (CCI) controlling the issue price as well as the volume of public issues. Also, there was lack of transparency in the trading practices. The banking sector was also subject to rigorous control by the government. After the two phases of nationalisation of major banks in 1969 and 1980, respectively, the role of private sector banks was very much limited in the economy. Lack of competition, low capital base, low productivity, high intermediation costs were some of the common features of Indian banking sector. The UTI, which was set up in 1964, was the only mutual fund which virtually enjoyed monopoly till 1988, government owned LIC and GIC were the only players in life insurance and general insurance sectors, respectively which continued till late 1990s when insurance sector was privatised in 1998 (source PWC (2010)). With this backdrop, the major reforms that shook the Indian capital market can be listed as under:

- The Capital Issues (Control) Act, 1947 was repealed putting an end to the regime of CCI and allowing free pricing of public issues.
• Establishment of market regulator In the place of CCI, Securities and Exchange Board of India (SEBI) was set up in 1992 and entrusted with the responsibility of regulating the capital market activities.

• Screen based trading a nation-wide on-line fully automated screen-based trading system (SBTS) was introduced where a member can punch into the computer quantities of securities and the prices at which he likes to transact. The transaction in such a case is executed as soon as it finds a matching sale or buy order from a counter party.

• Risk management several measures were introduced to handle the risk in the market so as to ensure the safety of market participants and the integrity of the market. Some of such measures undertaken included:

  1) Trading cycle – earlier trading cycle used to vary from 14 to 30 days and settlement used to take another fortnight. In order to reduce large open position, because of which there might be defaults and risks in settlement, trading cycle was reduced over a period of time.

  2) Dematerialisation – passing of the Depositories Act, 1996 provided for the dematerialisation of securities in the depository mode, and establishment of depositories in securities in order to facilitate free transferability of securities with speed, accuracy and safety.

  3) Derivatives – the Securities Contracts (Regulations) Act was amended in 1995 to lift the ban on options in securities and thus to help the market participants to manage their risks better through hedging, speculation and arbitrage.

  4) Settlement guarantee – clearing corporations were set up to assume counter party risk. In case there is default by the brokers, to guarantee the settlement of trades, trade and settlement guarantee funds were set up.

Thus, the decade of 1990s witnessed a paradigm shift in the Indian capital market. It was characterised by a new industrial policy, abolition of CCI, free pricing of public issues, emergence of SEBI as the market regulator, on-line trading replacing the traditional outcry system on the floor of stock exchanges, new stock exchanges, and entry of new players like private sector mutual funds, private sector banks, and private sector insurance companies (source: Bajpai (2004)).

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The post-2000 period also witnessed several milestones in the Indian capital market. The book-building method of issue became increasingly popular among issuers. As part of the disinvestment strategy of the government, several PSUs including nationalised banks came out with IPOs and FPOs. Because of the encouragement given by the government for infrastructural development during the eleventh five-year plan, many companies from the infrastructure sector, especially power, housing development, or telecommunication came out with public issues. Of late, SEBI has introduced several revolutionary concepts in the Indian capital market like application supported by blocked amount (ASBA), grading of IPOs for the first time in the entire world, or the concept of anchor investors for IPOs. Very recently, SEBI has proposed the introduction of safety net for investments in IPOs. All these developments are expected to change the outlook of investors, especially retail investors, who have stayed away from the capital market activities after their bitter experiences during the 1990s.

Overall, the Indian capital market has undergone significant changes in the last two decades. It is on the path of becoming efficient through the use of modern technology and proactive legislations. It has attracted significant global interest and has managed to establish confidence of both global and local investors. The abolition of CCI and the setting up of SEBI as the market regulator is a landmark development of this period. Basically, SEBI is the regulatory authority established under the SEBI Act, 1992, in order to protect the interests of the investors in securities and also to promote the development of capital market in the country. This involves regulating the operations of stock exchanges, supervising the working of stock brokers, share transfer agents, merchant bankers, underwriters, etc., as well as prohibiting unfair trade practices in the securities market.

2.2 Roles and Responsibilities of SEBI

The SEBI was established on April 12, 1992 in accordance with the provisions of the SEBI Act, 1992. Initially, when set up, it was a non-statutory body without any statutory power. The preamble of SEBI describes the basic functions of the SEBI as

"An Act to provide for the establishment of a board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto." In 1995, SEBI was given additional statutory power by the GOI through an amendment to the SEBI Act, 1992.
April 1998, SEBI was constituted as the capital market regulator in India under the resolution of the GOI (Ahuja (2012)). The basic objectives of SEBI are identified as under:

- To protect the interest of investors in securities
- To promote the development of securities market in India
- To regulate the functioning of securities market
- To consider matters connected therewith or incidental thereto

As far as responsibilities are concerned, SEBI has to be responsive to the needs of three main groups constituting the capital market which are as follows:

- The issuers of securities
- The investors
- The market intermediaries

The Roles or Functions of SEBI may be listed as under:

- Investor Education and Protection: SEBI aims at providing education and guidance to investors, especially retail investors, with respect to the safety of their investments in capital market. It issues booklets and handbooks for the guidance and protection of small investors. It also frames various rules and regulations/amendments to the existing rules and regulations to be followed by financial intermediaries to ensure the safety of investments. Also, it receives complaints from investors and looks into their settlement ensuring justice to the aggrieved investors.

- SEBI keeps a close watch on the functioning of various financial intermediaries on the stock exchanges. It has made the registration of brokers and sub-brokers compulsory for trading on the stock exchanges, and they are expected to follow certain rules and regulations. Just as it provides education and awareness to the investors, it also provides suitable training to the intermediaries. Overall, it regulates and controls the functioning of stock exchanges and other security markets.

- To ensure the safety of investments made by investors in various mutual funds including UTI, SEBI has come out with several rules and regulations to be followed by mutual funds in India. The objective behind the framing of such rules and regulations is to ensure transparency in the dealings of various fund houses and to ensure safety and fair return to the investors.
• Self-regulation is better than external regulation, SEBI is given wide statutory powers to promote self-regulatory organisations by the intermediaries. It encourages the formation of professional associations by various financial intermediaries in order to control undesirable activities of their members by having their own bye-laws to be followed by their members.

• Next, SEBI issues separate guidelines, makes amendments to these guidelines from time to time, to be followed by companies approaching capital market. It has separate set of guidelines for companies which are going public for the first time i.e., companies issuing IPOs or for public issues by listed companies i.e. for the issuance of FPOs.

• SEBI conducts research on various developments in the capital market from time to time and publishes its findings for the benefit of various market participants – both buyers and sellers. Also, it regulates and controls fraudulent and unfair practices of various forms by the intermediaries which may harm the investors and healthy growth of capital market.

• SEBI is authorised to conduct inspection, inquiries and regular audit of various stock exchanges operating in the country, intermediaries, and self-regulating organisations. It also has the power to take punitive action or remedial measures if found necessary. Thus, SEBI ensures orderly and transparent functioning of various stock exchanges and other intermediaries.

• SEBI also keeps a close watch on the trading pattern or activities by brokers and top executives of companies just before the announcement of major corporate events in order to restrict insider trading activity by these executives or brokers.

Powers vested with SEBI:
In order to effectively regulate the functioning of capital markets and its various participants, SEBI is given vast power. Some of these important powers are

• To approve the bye-laws of various stock exchanges.
• To recommend the amendments in the bye-laws of stock exchanges.
• To inspect the books of accounts periodically and to call for periodical returns from stock exchanges.
• To inspect the books of accounts of various financial intermediaries.
• To levy fees and other charges on the intermediaries for performing their functions.
• To further delegate powers exercisable by it
• To prosecute and judge directly in the event of violation of various laws by the market participants

(source SEBI (1992))

2.3 Pricing of Public Issues in India

2.3.1 The Regime of Controller of Capital Issue

Prior to the economic reforms initiated in the early nineties, the process of new issue in the Indian primary market was time consuming and was highly regulated. All public issues were required to obtain the approval from the office of Controller of Capital Issues (CCI), Government of India. The approval covered all aspects of an issue, including the price at which the securities were proposed to be offered. Market regulators in different countries of the world exercise substantial control over the issuance activities in order to avoid clustering of issues and second, to protect the interest of investors against manipulation by fraudulent promoters. But, however, the story seemed to be different on Indian capital market. The regulatory agencies in India did not seem to be assigning top priority to the above-mentioned two objectives, in fact, they seemed to be more concerned about ensuring a fair price to investors prior to 1992. The flood of new issues in the second half of 1989 and the virtual drought of issues in the first half of 1990 were sufficient indicators of regulatory failure as regards the first objective. There had also been a serious failure in respect of investor protection against misrepresentation, suppression of vital information and rampant insider trading indulged in by unprincipled company managements. While in other developed countries, quarterly reporting and link-of-business profitability statements were already considered minimum information requirements, of late, the Government of India had taken the reversing step of abridging the annual reports. In the name of saving on stationery costs, companies were being allowed to eliminate even the elementary accounting information which they were providing earlier.

When sufficient information is made available to the prospective investors by the issuer and when the issue price is based on the free play of market forces of demand and supply, investors may not have serious complaints against the issue price so determined. In a prudent, matured, and healthy capital market, the role of regulatory agency is very much limited as far as pricing of securities is concerned. The mechanism prevailing would
automatically protect against either overpricing or underpricing of issues. The role of the regulator is limited just to facilitate the smooth functioning of such a mechanism by making sure adequate disclosure of the information by the issuer and safeguarding against any unhealthy practices which might result in price manipulation. In India, however, it was widely believed that managements indulge in massive insider trading and price rigging especially around the time of a new issue. This was a major structural deficiency in the Indian Capital Market. The plethora of regulatory agencies had taken very little remedial action in this regard. Instead, it appeared that the regulatory process was designed to cure the symptoms rather than the disease. The premium fixation by the Controller of Capital Issues (CCI) was one such measure (Varma and Venkiteswaran (1990)).

2.3.2 Guidelines for Share Valuation by the Controller of Capital Issue

Earlier in India, the Capital Issues (Control) Act, 1947, and the Capital Issues (Exemption) Order, 1969, defined the terms and conditions for issuance of securities by the corporate sector. Under these, while certain security issues were exempt from prior governmental authorisation, no issues could be made without such approval if they were to be priced higher or lower than the face (par) value. Thus, for every share issue which was proposed to be made at a premium, companies had to seek the approval of the CCI, the governmental agency responsible for administering the securities regulation in the country. One of the major functions of the CCI was to determine the price at which a share issue had to be made. The office of the CCI had prepared for this purpose detailed guidelines for valuation of shares. The share valuation process proposed by the CCI guidelines was as follows:

- The ‘Fair Value’ (FV) of a company’s shares had to be computed by averaging the values obtained under the ‘Net Asset Value’ (NAV) method and the ‘Profit Earning Capacity Value’ (PECV) method. These computations had to be largely based on audited accounts of the recent past.

- The market price of the company’s share based on the previous three years’ high-low would only be kept ‘in the background’ and had to be largely used for fine-tuning the FV.

- The NAV was nothing but the traditional book value per share computed on the basis of the latest published annual accounts.
• The PECV had to be calculated in the normal course by capitalising the average of the after tax profits for the preceding three years at specified capitalisation rates and dividing the resultant figure by the number of equity shares.

• The capitalisation rates were different for trading, manufacturing and 'intermediate' companies. The PECV had to be recomputed by using lower capitalisation rates in the case of shares which were highly regarded by the market. Similarly, there were specific suggestions for computing the average in cases of high variability of profits.

• There were also definitions specifying in detail the various inclusions and exclusions in computing NAV, PECV and average market price.

Varma and Venkiteswaran (1990) made a critical evaluation of the various guidelines of CCI with respect to capital issues. In their evaluation, they have listed out the major limitations of these guidelines. According to them, there were some basic flaws in the CCI guidelines in sharp contrast with the market valuation process. The market values a security essentially by discounting future cash flow streams at a discount rate which reflects the degree of risk of these cash flows. As against this, the CCI guidelines relied exclusively on past accounting data, and used a capitalisation rate which was unadjusted for degree of risk. They note that while the market captures all available information in its valuation, the guidelines did make use of only outdated historical data.

As stated in the guidelines, the fair value of the company's share had to be computed by averaging values obtained under 'Net Asset Value' method and 'Profit Earning Capacity Value' method. According to CCI guidelines, the computation of these two values, in turn, had to be done subject to following guidelines:

2.3.3 Computation of Net Asset Value (NAV)

• Adjustment for the Proposed Issue

The guidelines required that in computing the book value or NAV, the effect of the proposed issue of capital should be taken into account by adding the face value of the fresh issue of capital to the net worth as at the latest balance sheet date and by dividing the resulting net worth by the enlarged capital base including the fresh issue. However, Varma and Venkiteswaran argued that the very notion of adjusting the book value to reflect the dilution caused by a fresh issue was based on a total misconception, if the fresh issue were to be made at a premium, the net worth after the issue should include the...
proposed premium in addition to the face value, and there is no reason to exclude the proposed premium while adjusting the book value

- **Revaluation of Assets**

  The guidelines did not recognise revaluation of fixed assets unless this had taken place “long ago, say nearly 15 years ago”. However, Varma and Venkiteswaran were of the opinion that in the absence of revaluation, the balance sheet values of assets would be far divorced from the current market price, especially when the assets include large blocks of land and buildings acquired decades ago, any ‘fair’ valuation should reflect the current market values of these old assets

- **Depreciation**

  The guidelines recognised straight line method (SLM) or written down value (WDV) method of depreciation provided the company had consistently followed that method. Varma and Venkiteswaran criticised this guideline of CCI on the ground that for any fair valuation, it is more appropriate to use SLM depreciation on replacement cost as this is most likely to reflect the true economic value of the assets. Failure to insist on a uniform depreciation policy can lead to an anomalous situation where a company which follows WDV depreciation is valued lower than a comparable company which follows SLM depreciation. The guidelines also disallowed any changeover from WDV to SLM unless the changeover had taken place before five years. In other words, where there had been a change in the depreciation policy from WDV to SLM within the last five years, the guideline expected to rework the depreciation on WDV basis and ignore the SLM depreciation provided in the books. For this purpose, the companies were required to furnish the depreciation claims for income tax purposes to enable the CCI to determine the WDV depreciation. Under the Companies Amendment Act, 1988, the rates of SLM and WDV depreciation to be provided in the books have been specified in Schedule XIV, these rates were totally delinked from the income tax rates. As such, according to Varma and Venkiteswaran, recomputing depreciation on the basis of income tax claims was anomalous

2.3.4 **Computation of Profit Earning Capacity Value (PECV)**

- **Capitalisation Rate**

  As per the guidelines of CCI, ‘The Profit Earning Capacity Value’ (PECV) had to be calculated by capitalising the average of the after tax profits at the following rates

  (i) 15 percent in the case of manufacturing companies,
(ii) 20 percent in the case of trading companies, and
(iii) 17.5 percent in the case of ‘intermediate’ companies that is to say, companies whose turnover from trading activities was more than 40 percent, but less than 60 percent of their total turnover.

Varma and Venkiteswaran observe that CCI’s method of determining capitalisation rate was peculiar. Finance theory suggests that the capitalisation rate is a function principally of the degree of risk of the profit stream, i.e., the more risky business should be capitalised at a higher rate. On the other hand, the factor to which the CCI attached greatest importance was whether the company was in trading or manufacturing. The implicit suggestion that trading companies were more risky than manufacturing companies was devoid of theoretical or empirical support. Very often, an established trading company carries far less risk than a relatively new manufacturing company. Again, the CCI’s demarcation of intermediate companies in terms of percentage of sales from trading activity was also unsound. Percentage of profits would be obviously the more relevant criterion. Further, Finance theory asserts that companies with substantial leverage (high debt/equity ratio) should be capitalised at higher rates reflecting higher degree of risk. The CCI’s formula, however, did not explicitly consider leverage at all in determining the capitalisation rate. It was also not at all clear how finance, leasing, and investment companies would be fitted into the valuation scheme. Moreover, within manufacturing or trading, different lines of business have totally different risk profiles, the CCI used omnibus rates of capitalisation, ignoring these variations completely.

The guidelines provided for relaxation of the normal capitalisation rate only for a manufacturing company under the following circumstances:

❖ When the market price of its share was substantially above the average of NAV and PECV at 15 percent capitalisation
❖ Where a company had a ‘high profitability rate as revealed by the percentage of after tax profits to the equity capital of the company’
❖ Where the company had diversified its activities and was a multi-unit company because of which it would be in a position to sustain its overall profits even if any one part of its operations runs into difficulties.

Varma and Venkiteswaran note that the CCI’s proposal to measure the profitability rate in terms of return on equity capital instead of the widely used return on net worth was erroneous. Furthermore, since for a profitable company, high leverage has the effect of magnifying the profitability rate, the CCI formula would have ended up granting a lower
capitalisation rate to highly levered companies. In fact, a higher capitalisation rate would have been appropriate for such companies consistent with their higher risk proneness. Varma and Venkiteswaran further note that the assumption in the guidelines that diversified and multi-unit companies have greater capacity to sustain overall profits was not borne out by empirical work. It was fairly well established that companies which stuck to their knitting or undertake only related diversification show greater consistency in long-term performance. Moreover, finance theory also tells that if the relevant measure of risk is systematic (non-diversifiable) risk, then diversification should not make a difference, as shareholders themselves have the freedom to diversify their respective portfolios.

- **Computation of Average Profits**

The CCI guidelines stated that “The crux of estimating the PECV lies in the assessment of the future maintainable earnings of the business. While the past trends in profits and profitability would serve as a guide, it should not be overlooked that valuation is for the future and that it is the future maintainable stream of earnings that is of great significance in the process of valuation. All relevant factors that have a bearing on the future maintainable earnings of the business must, therefore, be given due consideration.”

However, Varma and Venkiteswaran observed that the operative part of the guidelines largely confined itself to the average of the last three to five years profits as per audited accounts. There was an implied assumption that the recent past would replicate itself into perpetuity. The guidelines also proposed greater weightage for the most recent year’s performance when past profits showed a steadily increasing or decreasing trend. The guidelines also asserted that “If a business has sustained losses in all the three years or even in the latest two years, the PECV will have to be regarded as nil because it would not then be realistic to assume that the business would earn profits in the near future.”

Varma and Venkiteswaran, however, document that this assertion was outrageous. Indeed, if it were true that the business would earn no profits in the near future, there would be no justification for allowing it to raise scarce capital, and perhaps, there is every justification for winding up the company under the just and equitable clause (Section 433(1)(f) of the Companies Act, 1956). Unlike the CCI, the stock market values a company realistically on the basis of its future prospects despite past losses.
• **Taxation**

CCI guidelines provided that in computing the average profits, provision for taxation, with some exceptions, had to be assumed at the prevailing statutory rate under the Income Tax. Varma and Venkiteswaran, however, noted that this assumption ignored the actual tax position of a given company which may be considerably lower for the foreseeable future due to unabsorbed capital allowances or losses or various reliefs and concessions. In the case of export-oriented units, and investment/leasing companies, the tax benefits could be indeed significant, and to ignore them would be grossly unfair.

**2.3.5 Other Adjustments**

While, in computing the NAV, adjustments were required to be made in respect of depreciation changes and gratuity and other liabilities not provided for in the books, no such adjustments were prescribed for computing the average profits. In addition to these adjustments, it was also necessary to restate, at least for this purpose, the profit and loss account by incorporating various items charged directly to reserves by creative accountants.

**2.3.6 Profitability of Fresh Issue**

The CCI guidelines proposed to estimate the profitability of fresh issue of capital as follows:

- "Where the fresh issue of capital is for the purpose of financing expansion or new projects, it could be assumed that the fresh capital would contribute to the profits up to a maximum of 50 percent of the existing rate of profitability. This will be added to the existing profits after tax and the total will be divided by the enlarged capital base to arrive at the future maintainable earnings per share."

- "Where the fresh capital is sought to be raised for general reasons like modernisation and replacement of assets, it would not be advisable to assume that the fresh capital will contribute to the profitability of the business in any tangible manner in the near future. In such cases, while the fresh issue of capital will be taken into account, no additional profits will be assumed."

**2.3.7 Market Price**

The guidelines stated that in the case of subsequent issues, the average market price (based on high-low of previous three years) would be kept in the background as a relevant factor while setting the fair value (FV) unless there were reasons to believe that the market price was vitiated by speculative transactions and manipulative practices.
guidelines also seek to revise the FV by recomputing the PECV at a lower capitalisation rate whenever the original FV was significantly below the average market price.

2.3.8 Liquidity

The guidelines also provided that "where the PECV is nil or negligible, the FV should be limited to half of the NAV. If, however, the net assets comprise mostly of liquid assets, the FV may be fixed up to two-thirds of NAV or up to the actual cash and bank balances, if the latter is even higher." However, Varma and Venkiteswaran criticise this guideline on the ground that equity is a long-term investment, and the liquidity of the assets comprising its book value is not a very significant consideration in valuing it.

Overall, the most tangible achievement of the CCI’s pricing policy had been the systematic underpricing of new issues. While this had, no doubt, helped in creating a substantial body of small investors, this creation of the equity cult had been achieved at a substantial cost in terms of massive oversubscriptions, dominance of stag operators, and other undesirable side effects. Moreover, one of the effects of this policy had been to increase the effective cost of equity capital to the corporate sector. This is because a company was forced to issue a larger number of shares to raise the same amount of money when the issue price was lowered. Another major distortion was the transfer of wealth from existing shareholders to a new set of shareholders whenever the companies made issues otherwise than on rights basis. Finally, thanks to the financial liberalisation (1991), the new issue market was at last freed from the grips of CCI that enjoyed pervasive power over new issues, especially IPOs, during the control regime. To keep pace with the globalisation and liberalisation process, the Government of India was very keen to bring the Indian capital market in line with international practices through gradual deregulation of the economy. In 1992, the office of CCI was abolished and the newly created securities market regulator, Securities and Exchange Board of India (SEBI) was entrusted with the task of regulating all aspects of Capital Markets. Further, as an essential step of financial liberalisation, free pricing of new issue was allowed.

2.4 The Post-CCI Era

During the pre-liberalisation era, the CCI did not freely allow companies in ‘unproductive’ areas such as finance, leasing, and entertainment activities to make public issues. Thus, most companies making public issues were essentially from industrial companies. However, in the post-CCI period, the number of finance companies approaching the capital market with their IPOs has gone up. In 1992-1993, finance
companies approaching the primary market with their public issues accounted for only 6 percent of the total number of public issues made. In 1994-1995, this share went up to 33 percent. Prior to the reforms, IPOs were characterised by heavy underpricing, and it was often alleged that the conservative policies of CCI was responsible for such a phenomenon. There was a feeling that free pricing, if allowed, would improve efficiency of new issue market and relieve the corporate sector from the adverse effects of underpricing (Karmakar (2002)). When the CCI was in force, any company going for a public issue at a premium had to get the approval of the CCI and the premium allowed was generally lower than the market price at that point of time (Narasimhan and Ramana (1995)). However, studies conducted after the abolition of CCI have also shown that underpricing of IPOs was still a significant phenomenon in the Indian IPO market (For example, Narasimhan and Ramana (1995), Karmakar (2002), and Chaturvedi et al (2006) to mention a few). In fact, even after the abolition of CCI, the method of public issue that was available to the issuers in the Indian capital market was confined only to fixed-price mechanism.

2.4.1 Need for Book-Building

During the CCI regime, new companies were allowed to issue securities only at par value. Only the existing companies with good profit record and sufficient reserves were allowed to issue at premium. Even in the case of such companies, the issue price had to be calculated according to the guidelines or norms of CCI. With the abolition of the Capital Issue (Control) Act, 1947 and scrapping of the CCI in 1992, things had changed with the emergence of free pricing of public issues in India. Under the new regime, the market regulator SEBI, which was set up in 1992, had no role to play in the pricing of securities. The issuing companies, in consultation with their lead managers, were deciding issue price/premium for their securities. All they had to do was giving proper justification for the premium by disclosing relevant information to the investors so that investors can make an informed decision. The issue mechanism followed during this period was fixed-price method. The major limitations of this method were, the issue price was decided by the issuers and the lead managers well in advance, at least 60 to 90 days prior to the issue opening and as a result it was difficult for them to take into account market clearing price at the time of setting the issue price. In case the issue price was below the market clearing price, this would have resulted in oversubscription in which case a large portion of funds had to be refunded, if the issue price was above the market clearing price, this would have resulted in undersubscription in which case issues might
failure (Kumar (2007)). Also, in developed capital markets studies have found that bookbuilding method results in lower underpricing (Benvensite and Spindt (1989), Ljungqvist et al (2003), Sherman (2005) etc). Because of all these, there was a vital need to strengthen the capital market which, the government felt, could only be achieved through structural modifications, by introducing new mechanism and instruments, and by taking steps for safeguarding the interest of the investors through more disclosures and transparency. Therefore, in 1995, SEBI had set up a committee under the chairmanship of Y H Malegam to recommend changes in the issue method as also in disclosure requirements in offer documents.

2.4.2 Introduction of Book-Building in India

The introduction of book-building method of public issues in India by SEBI, in 1995, can be attributed to the recommendations of the committee under the chairmanship of Y H Malegam which was appointed by SEBI to review the (then) existing disclosure requirements in offer documents. In addition, two of the tasks assigned to the committee to look into were firstly, ‘the basis of pricing the issue’, and secondly, ‘whether substantial reduction was possible in the time taken for processing applications by SEBI’.

The committee submitted its report with several recommendations in November 1995. As a result of these recommendations, book-building was introduced in the Indian capital market subject to certain terms and conditions which were as follows:

- The option of book-building was to be made available only to issues exceeding Rs 100 crore.
- The book-building issuer companies could either reserve the securities for firm allotment or avail themselves of the book-building process.
- Draft prospectus to be submitted to SEBI could exclude information about the offer price.
- A book runner to be nominated from among the lead merchant bankers, charged with specific responsibilities and the name had to be submitted to the SEBI for its approval.
- The requirement of 25 percent of the securities to be offered to the public would be continued.

There have been several amendments/revisions made to the above guidelines from time to time. For example, in December 1996, the option of book-building was made available to all corporate bodies, which were otherwise eligible to make an issue of capital to the
public, and in case of undersubscription, the spill-over from the public portion could be permitted to the placement arena and vice-versa. In 1997, the restriction of the facility to 75 percent of the issue was thought that it would severely constrain the benefits arising out of price and demand discovery, and the facility was extended to 100 percent of the issue, available only if the issue amount was Rs 100 crore and above, compulsorily offering an additional 10 percent of the issue to the public through prospectus, and reserving at least 15 percent of the issue size to individual investors applying up to ten tradable lots (The Hindu 22/03/2004)

Basically, book-building is the process by which an underwriter attempts to determine at what price to offer an IPO based on demand from institutional investors. It is a method of marketing the shares of a company whereby the quantum and the price of the securities to be issued will be decided on the basis of the bids received from the prospective investors by the lead merchant bankers. According to this method, share prices are determined on the basis of real demand for the shares at various price levels in the market. As per SEBI guidelines, book-building means “a process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for the securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document” (source SEBI (2000)). Book-building process is a common practice used in most developed countries for marketing a public offer of equity shares of a company. It is a transparent and flexible price discovery method of IPOs in which price of securities is fixed by the issuer company along with the Book Running Lead Manager (BRLM) on the basis of feedback received from investors as well as market intermediaries during the period when the issue is open. Price discovery is basically a function of the demand for the stock at various prices. A weighted average of all the bids received is calculated to arrive at the final price. Though India has adopted the U.S. book-building procedure, there are certain differences between the book-building procedure followed in the two countries. In the U.S., the underwriter has the discretion when it comes to the allocation of shares to the investors (Benveniste and Spundt (1989) for e.g.) However, in India, retail investors and non-institutional investors are to be allocated on a pro-rata basis out of their respective quotas of 35 percent and 15 percent, respectively in the event of oversubscription while allocation to institutional investors was initially done at the discretion of the BRLM. However, with effect from
November 2005, SEBI has made it mandatory to allocate all types of investors on a pro-rata basis in the event of oversubscription (Bora et al (2012))

2.4.3 Process of Book-Building in India

The main parties who are directly associated with book-building process are the issuer company, the Book Running Lead Manager (BRLM) and the syndicate members. The BRLM (i.e., merchant banker) and the syndicate members who are the intermediaries are both eligible to act as underwriters. The steps that are usually followed in the case of book-building process in India are as under:

- The company intending to go public has to appoint a lead merchant banker as the BRLM. A merchant banker possessing a valid SEBI registration in accordance with the SEBI (Merchant Bankers) Regulations, 1992, is eligible to act as a BRLM.
- The issuer and the BRLM together draw a draft prospectus or offer document. This draft prospectus does not mention the price at which the issue will be made, but instead includes other issue-related details like the issue volume, background of the company, price band etc. In this offer document, the number of shares meant for the public is to be separately identified as “net offer to the public”.
- Next, the draft prospectus so prepared is filed with SEBI and this gives the prospectus a legal standing.
- A definite time period is fixed which is called the bid period. During this, the BRLM is expected to conduct awareness campaigns like advertisement, road shows etc.
- The BRLM appoints syndicate member(s), who should be a SEBI registered intermediary, to underwrite the issues to the extent of “net offer to the public.” The lead book runner and co-book runners shall compulsorily underwrite the issue and the syndicate members shall sub-underwrite with the lead book runner /co-book runners.
- The lead book runners/syndicate members shall enter into underwriting/sub-underwriting agreement on the date of allocation and furnish details forthwith to the Board.
- The details of final underwriting arrangement indicating actual numbers of shares underwritten shall be disclosed and printed in the prospectus before it is registered with the Registrar of Companies.
In case of undersubscription in an issue, the shortfall shall have to be made good by the book runner(s) to the issue.

The issuer shall enter into an agreement with one or more of the stock exchange(s) which have the system of on-line offer of securities.

The book runner(s)/syndicate members shall appoint stock brokers who are members of the recognised stock exchange and registered with the Board, for the purpose of accepting bids, applications and placing orders with the issuer and ensure that the stock brokers so appointed are financially capable of honouring their commitments arising out of defaults of their clients/investors, if any.

Provided that in case of Application Supported by Blocked Amount, Self Certified Syndicate Banks shall also accept and upload the details of such applications in electronic bidding system of the stock exchange(s). The stock brokers and Self Certified Syndicate Bank accepting applications and application monies shall be deemed as ‘bidding/collection centres’.

The issuer shall pay the book runners/syndicate members/stock brokers/Self Certified Syndicate Banks a commission/fee for the services rendered by them.

The issuer may mention the floor price or price band in the red herring prospectus.

The cap of the price band should not be more than 20 percent of the floor of the band, i.e., cap of the price band shall be less than or equal to 120 percent of the floor of the price band.

The price band can be revised during the bidding period in which case the maximum revision on either side shall not exceed 20 percent, i.e., floor of price band can move up or down to the extent of 20 percent of floor of the price band disclosed in the red herring prospectus and the cap of the revised price band will be fixed accordingly.

Any revision in the price band shall be widely disseminated by informing the stock exchanges, by issuing a press release and also indicating the change on the relevant website and the terminals of the syndicate members.

The copy of the draft prospectus may be circulated by the BRLM to the institutional investors as well as to the syndicate members.

The syndicate members create demand and ask each investor for the number of shares and the offer price.
- The issuer shall provide the application-cum-bidding forms to the syndicate members and Self Certified Syndicate Banks. The issuer shall also make arrangement for collection of the applications-cum-bidding forms from mandatory collection centres.

- For the purpose of 'bidding', the document should be printed and circulated as “Red Herring Prospectus”. The same nomenclature shall be used throughout the document. Bid should be defined as 'indication to make an offer' and not as 'an offer'.

- The application-cum-bidding form for Applications Supported by Blocked Amount shall contain all the relevant details and shall be uniform for all ASBA investors.

- In the case of anchor investor, an anchor investor shall make an application of a value of at least Rs 10 crore in the public issue. Allocation to anchor investors shall be on a discretionary basis and subject to a minimum number of 2 such investors for allocation of up to Rs 250 crore and 5 such investors for allocation of more than Rs 250 crore. The anchor investor, who cannot be a promoter of the issuer company, can be allocated as much as 30 percent of the portion reserved for qualified institutional buyers (usually 50 percent) in an issue, through a bidding process. One-third of the anchor investor portion shall be reserved for domestic mutual funds. The bidding for anchor investors shall open one day before the issue opening date and shall complete on the same day.

- If the price determined by the book-building process is higher than the price at which allocation is made to anchor investor, the anchor investor shall have to bring in the differential amount. However, if the price determined by the book-building process is lower than the price at which allocation is made to anchor investors, the surplus amount shall not be refunded to them, these investors shall take allotment at the price at which shares were originally allotted to them. There shall be a lock-in period of 30 days on the shares allotted to the anchor investors from the date of allotment in the public issue.

- The number of shares allocated to the anchor investors along with the price at which the allocation is made shall be made available in the public domain by the merchant banker before the opening of the issue.
Margin money collected shall be uniform across all categories of investors. An amount to the extent of entire application money as margin money may be collected from the applicants before they place an order on their behalf. The payment accompanied with any revision of bid, shall be adjusted against the payment made at the time of the original bid or the previously revised bid.

The BRLM shall receive the feedback about the investors’ bids through syndicate members. Bidding process shall be only through an electronically linked transparent bidding facility provided by recognised stock exchange(s).

The lead book runner shall ensure the availability of adequate infrastructure with syndicate members for data entry of bids in a timely manner.

The syndicate members shall be present at the bidding centres in order to make sure that minimum one electronically linked computer terminal at all the bidding centres is available for the purpose of bidding.

When the issue is open for public bidding, the prospective investors may approach the stock brokers of the exchanges through which the securities are offered under on-line system, or shall approach the Self Certified Syndicate Banks, as the case may be, so as to place their order for the said securities.

Every stock broker shall accept orders from all clients/investors who place orders through him and every Self Certified Syndicate Bank shall accept Applications Supported by Blocked Amount from ASBA investors.

The prospective investors may revise their bids at any time during the bid period.

Qualified institutional buyers shall place their bids only through the stock brokers who have the right to scrutinise the bids. These investors shall not withdraw their bids after the closure of bidding and that their identity shall not be made public.

The bidding terminal shall contain an on-line graphical display of demand and bid prices updated at periodical intervals, not exceeding thirty minutes.

The stock exchanges shall continue displaying on their website data pertaining to book-built issues, both overall and category-wise details of bids received for a period of at least three days after the closure of bids.

The BRLM on receipt of the feedback from the syndicate members about the bid price and the quantity of shares applied has to build up an order book showing the demand for the shares of the company at various prices. The syndicate members...
must also maintain a record book for orders received from institutional investors for subscribing to the issue out of the placement portion

- On receipts of the above information, the BRLM and the issuer company together shall determine the issue price. This is known as the market-clearing price.

- On finalising the issue price, the number of securities to be offered shall be determined which will be issue size divided by the issue price.

- Once the final price (cut-off price) is determined, all those successful bidders i.e. those who had bid at and above the final price or cut-off price shall be entitled for allotment of securities.

- Only the retail individual investors have the right to bid at cut-off price instead of mentioning their specific bid price in the bid forms.

- Allotment to retail individual investors, non-institutional investors, and qualified institutional buyers other than anchor investors shall be made proportionately in the event of oversubscription.

- The Final prospectus is filed with the registrar of companies within 2 days of determination of issue price including the issue price and the number of specified securities proposed to be issued.

- The issuer may apply for listing of specified securities on a stock exchange other than the one through which it offers its securities to the public through the online system.

- A final book of demand indicating the result of the allocation process shall be maintained by the lead book runner.

- The book runner(s) and other intermediaries associated with the book-building process shall maintain the record of the book-building prices.

- Finally, the SEBI has the right to inspect such records and books which are maintained by the BRLM and other intermediaries involved in the book-building process.

(source SEBI (2009))

The entire process of book-building can be briefly shown in the following figure.
2.4.4 Advantages of Book-Building Process

- The price of an issue is set in a realistic fashion
- The primary aim of book-building process is to fix the highest market price for shares and securities
- As investors have a voice in the pricing of the issue, they have a greater certainty of being allotted what they demand
- The issue price is determined by the market. As there is a distant possibility of the market price of share falling lower than issue price, investor is less likely to suffer from erosion of his investment on listing
- Well-organised capital raising mechanism with enhanced issue procedures, which leads to a reduction in (a) issue costs (b) paper work and (c) lead times
- Flexibility to increase/decrease price and/or size of offering the issues is possible
- There is transparency of allocations to investors
- Instant allotment and listing of placement portion of securities
2.4.5 Limitations of Book-Building Process

- Book-building is suitable only for mega issues
- The issuer firm must be fundamentally strong and well known to the investors
- The book-building system functions very well in matured market conditions where the investors are knowledgeable of the various parameters influencing the market price of the securities. But, such conditions are generally not seen in practice.
- There is a chance of price rigging on listing as promoters shall try to bail out syndicate members.

Finally, a comparison between book-building method and the traditional fixed-price method can be summarized as under:

**Figure 2.2 Differences between Fixed-Priced and Book-Built Issues**

<table>
<thead>
<tr>
<th>Issue Type</th>
<th>Offer Price</th>
<th>Demand</th>
<th>Payment</th>
<th>Reservations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed Price Issues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Price at which the securities are offered and would be allotted is made known in advance to the investors</td>
<td>Demand for the securities offered is known only after the closure of the issue</td>
<td>100% advance payment is required to be made by the investors at the time of application</td>
<td>50% of the shares offered are reserved for applications below Rs 1 lakh and the balance for higher amount applications</td>
</tr>
<tr>
<td><strong>Book Building Issues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>A 20% price band is offered by the issuer within which investors are allowed to bid and the final price is determined by the issuer only after closure of the bidding</td>
<td>Demand for the securities offered, and at various prices, is available on a real time basis on the BSE website during the bidding period</td>
<td>10% advance payment is required to be made by the QIBs along with the application, while other categories of investors have to pay 100% advance along with the application</td>
<td>50% of shares offered are reserved for QIBS, 35% for small investors and the balance for all other investors</td>
</tr>
</tbody>
</table>

*Source: BSE India (2013a)*

2.4.6 Reverse Book-Building Process

SEBI (Delisting of Equity Shares) Regulations, 2009 provides for voluntary delisting of equity shares of a listed company by the promoters or acquirer through a process called reverse book-building. The promoter or the acquirer who intends to delist the company has to first appoint a merchant banker and a trading member for placing bids on the on-
The merchant banker and the promoter shall together make a public announcement to the effect and shall make arrangements for the dispatch of letter of offer to the public shareholders along with a bidding form. The shareholders desirous of availing the exit opportunity may approach the trading member with the bidding form for placing offers on the on-line trading system. The final offer price shall be determined as the price at which the maximum number of shares has been offered. The promoter shall have the option of either accepting or rejecting the offer price. In case the price is accepted, the promoter shall be required to accept all valid offers up to and including the final offer price. However, if the quantity eligible for acquiring securities at the final price offered does not result in promoter holding crossing the limits specified in the Regulations, the offer shall be deemed to have failed and the company shall remain listed.

At the end of the offer, the merchant banker to the reverse book-building process shall announce the final price and the acceptance or rejection of the price by the promoter. Any remaining public shareholders may tender shares to the promoter at the same final price within a period of one year from the date of delisting. However, special provisions have been made for the voluntary delisting of small companies. Equity shares of such companies may be delisted without following the above-mentioned reverse book-building process, separate procedure is to be followed in the case of such companies (source: BSE India (2013b)).

The first ever book-built public issue on Indian capital market was from ICICI for its Rs 1,000 crore bond issue in April 1996 which was followed by Larson and Toubro FPO for Rs 4,323 crore and Rs 5,878 crore bond issue of TISCO (Bora et al (2012)). It was in September 1999, the first ever book-built IPO was experimented in the Indian IPO market. Hughes Software Systems (HSS) was the maiden IPO company that followed the book-building procedure while going public in India. Some of the salient features of the company and its issue are as follows (source: Capital Market (1999)).

- Besides the MNC tag, the company was in the software field. However, it differed from the other red-hot software stocks in its area of operations, its software was exclusively used for the telecom sector. Hughes Network Systems (HNS), the 100 percent subsidiary of the U.S.-based General Motors-promoted Hughes Electronics (HE), had 76 percent stake in the company. The rest of the Rs 15.75 crore pre-issue paid-up capital was held by Digital Networks India Private Limited (10 percent), and Indus East Holding Limited, a Mauritius-based holding company (14 percent).
• According to the then Vice President, Finance, and Chief Finance Officer of the company, the company had outperformed Infosys and Wipro on many productivity and R and D benchmarks. For instance, according to them, the company had been apportioning up to 12 percent of its revenues for R and D, which no other Indian software company was doing at that point of time.

• This first ever book-built issue was a roaring success, it garnered a whopping Rs 6,000 crore subscription for an issue that was less than twentieth in size, that is, the size of the issue on offer was Rs 250 crore. The Rs 6,000 crore subscription was the largest amount ever received for an Indian issue. The applications that had poured in from all over the world would have required the company to allot 97.5 million shares to satiate the demand instead of the 3.9 million shares on offer.

• Only Rs 27 crore of the Rs 275-crore issue (20 percent dilution by promoters of their stake and 10 percent issue of new equity) was offered to the public via the fixed price (the cut-off price arrived at in the book-building process) route.

• Another notable feature of the issue was that all the promoters who had diluted their stake to 20 percent in equal measure had given an undertaking not to offload their shares for 180 days from listing so as not to adversely affect the pricing in the secondary market with oversupply.

• 98 percent of the applications that were received were for the upper price band of Rs 630. Only 9 applications were for the floor price of Rs 480. According to the then President and MD of the company, the company had conducted road shows in the US, Europe, and the Far East in order to test the depth of the market and to attract a wide basket of investors.

• According to the then President of the company, the company had attracted a lot of FII interest which would not have been possible without book-building, and consequently, holding road shows abroad. Seventy-five percent of the applicants through the book-building process were institutional investors. A major chunk of them, at 21 percent, were Foreign Institutional Investors, with mutual funds comprising 13 percent, domestic institutions 5 percent, corporates 7 percent, and high net worth individuals 25 percent. Only 15 percent were small investors.

• According to Kotak Mahindra Capital Company, which was the book-running lead manager to the issue, the price band, as per SEBI stipulation for issues
adopting the book-building, was fixed after extensive pre-marketing research and survey between September 6 and 17, 1999 (the book-building portion of the issue was conducted between September 22 and 28, 1999), which included feedback from more than 50 institutional and high net worth investors, both in India and abroad. The price range was based on the analysis of the feedback and taking into account other quantitative factors.

After the grand success of the first book-built issue in the Indian IPO market, soon after book-building method of IPO became popular in India as well as in most of the other capital markets. However, side by side the traditional fixed-price public offer also exists. Today, one can find companies going public in India following either fixed-price method or the book-building procedure. In spite of the availability of both these methods, book-building procedure dominates the fixed-price method of IPO issuance in India.

2.5 Some Recent Reforms in Indian Capital Market

During the post-2000 decade, the market regulator SEBI has been introducing several revolutionary new concepts, some of which are for the first time among all the capital markets in the world, to boost confidence among the investors, especially the retail investors. These changes brought about by SEBI are expected to change the outlook of investors towards investments in capital market activities. Some of such developments initiated by SEBI in the Indian capital market may be listed as under.

2.5.1 Application Supported by Blocked Amount (ASBA)

One of the blockbuster IPOs on the Indian Capital Market in the year 2008, Reliance Power, was subscribed about 73 times of its issue size. Against an issue size of Rs 11,560 crore, the issue could manage to attract a total of Rs 8 lakh crore. This total collected amount through oversubscription was more than that of the combined market capitalisation of companies listed in Portugal and Czech Republic (source Newstrack India (2008)). However, soon after the issue was closed and share allotment was finalised, the unsuccessful applicants in the issue started complaining about the non-refund or delayed refund of their application money. In a written reply, the then Minister of State for Finance, Mr P K Bansal, told the Lok Sabha that the market regulator SEBI, as on April 10, 2008, had received 8,362 grievances from the retail investors regarding non-receipt of refunds from Reliance Power IPO (BL, 26/04/2008). Following these complaints from retail investors, SEBI had called a meeting of personnel of Reliance
Power, Registrar and all merchant-bankers. Post-issue, the merchant banker was advised to monitor and resolve all pending cases. Apart from Reliance Power IPO, a large number of IPOs was subscribed many times their issue size, some even up to 100 times, especially, in the year 2007 and in January 2008. To mention a few, Religare Enterprises (November 2007) was subscribed 153 times, BGR Energy Systems (December 2007) was subscribed 119 times, and Future Capital Holdings (January 2008) was subscribed 133 times. In all these cases, a large number of unsuccessful IPO applicants had to be refunded their application money. Not only there were delays in the refund of their application money, also these investors lost interest on their money for the period of application and the refund of their application money.

To overcome this problem, the market regulator SEBI has introduced a new mechanism of applying for shares in public issues, especially for the benefit of retail investors, called 'Application Supported by Blocked Amount', (ASBA). In May 2008, the Board of SEBI had “approved in principle, the concept of making lien on bank account as an alternative mode of payment in public/right issues”, thus, addressing a long-standing demand of retail investors whose IPO application money was often blocked for weeks even when they were not allotted shares. The proposed system was also supposed to do away with the refund process and also shorten the time between a public issue and its listing, since listing happens only after refunds are done (BL, 31/07/2008). With the introduction of ASBA, an investor can apply for an IPO directly through his bank account and consequently earn interest on the money so invested. ASBA carries the advantage of applying for an IPO without having to pay for it in advance or without waiting many weeks for a refund. What is more attractive for the investor is that he has to pay only that amount which is due for the shares allotted to him in case of pro-rata allotment, unlike having to pay a wholesome amount for the total number of shares applied irrespective of the allotment made to him. Such a system has been made effective from September 1, 2008 through the amendment to SEBI (DIP) Guidelines, 2000, to make this a part of the existing mode for IPO applications. Through this process, any person can apply for any public issue which is through a book-building process and as per the SEBI circular, this process co-exists with the traditional cheque payment mode.

This new mode of applying for IPO shares is expected to be of great benefit to the investors, especially to the retail investors. The biggest advantage is that the investors shall have to make payment to the issuer only in the event of allotment of shares. As a result of this, there is no loss of interest to the investors and there shall be no further
problem of refunds. However, because of this new mode, the issuers stand to lose because they now cannot earn interest on investors' funds lying at their disposal, at least for a few days, in the event of oversubscription of issues. One can imagine the quantum of funds lying in the bank account of the issuers of public issues which are oversubscribed several times. Reliance Power, for example, whose issue size was around Rs 11,500 crore, had garnered an amount of around Rs 8 lakh crore through oversubscription.

The Procedure

The investor has to apply for the public issue through ASBA through which an authorisation has to be given to block the application money in a bank account. This account facility will be provided through SEBI-notified banks called Self Certified Syndicate Banks (SCSBs) and SEBI will, from time to time, update the name of these banks through its website. To begin with, SEBI had given permission to Corporation Bank, Union Bank of India, HDFC Bank, State Bank of India, and ICICI Bank Limited. A bank selected for this process shall provide this facility to all its account holders and enter into the required arrangement with any company issuing an IPO. An investor who wants to apply through ASBA has to make a request to the notified SCSB, which, in turn, gives them an ASBA facility. After receiving the application from the investors, the SCSB through its controlling branches, communicates the details of all the ASBA investors to the issuers for the purpose of allotment of shares. In this process, the issuer shall ensure that adequate arrangements are made by the registrar of the IPO to obtain information about all ASBAs and to treat these applications similar to non-ASBA applications while finalising the basis of allotment. Initially, this ASBA process was applicable to all book-built public issues which provided for not more than one payment option to the retail individual investors, though this restriction was relaxed later. The first ever IPO in the Indian IPO market to follow this route was '20 Microns' in September 2008. Of the total issue size, 10 percent was subscribed through ASBA process. Further, out of the SCSBs, ICICI bank accounted for the largest number of ASBA applications applied for the issue. The other SCSBs for the issue were SBI, Corporation Bank, HDFC Bank, and Union Bank of India (BL, 13/09/2008).

ASBA - How Does it Work

All the eligible investors can submit their application to the notified branches of SCSBs physically or through internet banking. After receiving the applications, the SCSB blocks the amount in the specified account authorised by the investor for the said issue.
application money will then remain blocked in the account till the finalisation of the basis of the allotment of the shares. The application data shall thereafter be uploaded by the SCSB into the electronic bidding system through the internet into the database of the stock exchange. On the finalisation of the allotment basis, the registrar to the issue shall send an appropriate request to the SCSB for unblocking the aforesaid bank accounts and for transferring the requisite amount to the issuer’s (company that has launched the IPO) account. Another important fact is that in the process, if the issuer withdraws or fails to complete its issue, the SCSB will unblock the relevant account on the receipt of information from the pre-issue merchant bankers and the investor can take the amount back. In the entire process, the biggest benefit is that the investor does not lose interest since the funds lie in his or her bank account for the time it takes for the final allotment of the shares. The problem of refunds is also taken care of. The system really looks to be a good step in favour of the investors, many of whom often complained of how their refund orders were delayed or even lost, thereby requiring additional and frustrating documentation. In 2009, SEBI has clarified payment of commission to brokers through ASBA, which is the same as for applications made through the non-ASBA process meaning that banks can charge commission for their services. Earlier, while commission was being paid for non-ASBA applications, none was being paid for ASBA applications. Though the ASBA process became applicable to all book-built issues opening on or after September 1, 2008, initially, the response in the public issues was very poor. According to SEBI observations, one main reason for the poor response to ASBA was that there was lack of incentive for SCSBs to accept ASBA (BL, 06/08/2009).

**Eligibility Factor**

Initially, when ASBA was introduced on July 30, 2008, it was restricted only for retail individual investors who could make applications in book-built public issues (both IPOs and FPOs) by blocking the bid amount in their bank account, with the restriction that these investors bid only at cut-off price without revision facility. Later, the facility was extended to right issues on August 20, 2009. Owing to the inherent benefits associated with ASBA and also based on the market response, ASBA facility was later extended to other investor categories also, the facility was extended to Non-institutional Investors and Qualified Institutional Buyers (QIBs) with effect from January 1, 2010 and May 1, 2010, respectively. When SEBI had extended ASBA facility to investor categories except QIBs in January 2010, QIBs at that time were required to bring in only 10 percent of the application money at the time of placing the bids. Later, when the facility was extended
to QIBs, they were made to bring in 100 percent of application money as margin along with the application for securities in public issues with effect from May 1, 2010. Under the ASBA facility, the bank account of the QIBs would be blocked to the extent of the application money and the application money would get debited from the account only if the application is selected for allotment after the basis of allotment is finalised. At present, ASBA investors can make multiple price bids (up to three bids) and can undertake revision of bids. Also at present, ASBA facility has become effective for all public issues (book-built and fixed-priced) and right issues. In October 2010, SEBI has authorised syndicate/sub-syndicate members to collect ASBA forms from the investors and to submit it to the SCSBs. Earlier, only SCSBs were allowed to collect ASBA forms, while syndicate/sub-syndicate members used to collect non-ASBA forms. Under the new scheme, syndicate/sub-syndicate members would be required to upload the bid and other relevant details of such ASBA forms in the bidding platform provided by the stock exchanges and forward the same to the respective SCSBs. SCSBs should carry out further action for such ASBA forms such as signature verification, blocking of funds etc. and forward these forms to the registrar to the issue (sources: SEBI (2013a), SEBI Updates (2009a), SEBI Updates (2009b), SEBI Updates (2010a), SEBI Updates (2010b), and SEBI Updates (2010c)).

**ASBA Process: A Graphical Representation**

- An ASBA investor shall submit a completed ASBA form to an SCSB with whom the bank account to be blocked, is maintained.
- Submit the form physically with the designated branch or electronically through internet banking.
- The SCSB shall give an acknowledgment specifying the application number to the ASBA investor.
- If the bank account specified in the ASBA does not have sufficient credit balance to meet the application money, the ASBA shall be rejected by the SCSB.
- In case of physical ASBA, the SCSB shall block funds available in the bank account to the extent of the application money specified in the ASBA.
- The SCSB shall then upload the details in the electronic system provided by the stock exchange(s) for the particular public issue, which includes:
  1) Application Number.
  2) DP ID, Client ID.
m) Bid Quantity
iv) PAN

- In case of electronic ASBA, the ASBA investor himself will fill in all the above-mentioned details, except the application number which shall be system-generated. The SCSB shall thereafter upload all the above-mentioned details in the electronic bidding system provided by the stock exchange(s).
- The SCSB (Controlling Branch or Designated Branch) shall generate a Transaction Registration Slip/Order Number, confirming upload of ASBA details in the electronic bidding system of the stock exchange(s).
- The Transaction Registration Slip/Order Number shall be given to the ASBA investor as proof of uploading the details of ASBA only on demand.
- In case an ASBA investor wants to withdraw his ASBA during the bidding period, he/she can submit his/her withdrawal request to the SCSB, which, in turn, takes the necessary action, including deletion of details of the withdrawn ASBA from the electronic bidding system of the stock exchange(s) and unblocking of funds in the relevant bank account.
- SCSB shall send the aggregate information to the registrar to the issue after closure of the bidding period, which includes total number of ASBAs uploaded by the SCSB, the total number of shares, and the total amount blocked against the uploaded ASBAs.
- The registrar to the issue will reconcile the compiled data received from the stock exchange(s) and all SCSBs and reject the application in which any discrepancy is noticed.
- In case an ASBA investor wants to withdraw his ASBA after the bid closing date, he or she can submit a withdrawal request to the registrar to the issue. The registrar shall delete the withdrawn bid from the bid file.
- The registrar to the issue will reject multiple ASBAs determined as such, based on common PAN.
- The registrar to the issue shall finalise the basis of allotment and submit it to the designated stock exchange for approval.
- Once the basis of allotment is approved by the designated stock exchange, the registrar to the issue shall provide the following details to the controlling branch of each SCSB.
i) Number of shares to be allotted against each valid ASBA

ii) Amount to be transferred from the relevant bank account to the issuer’s account for each valid ASBA.

iii) The date by which the funds shall be transferred to the issuer’s account

iv) Details of rejected ASBAs, if any, along with reason for rejection and details of withdrawn/ unsuccessful ASBAs

- Along with this, the registrar instructs the SCSB to unblock the relevant bank accounts and transfer the requisite money to the issuer’s account

- SCSBs will unblock the relevant bank accounts for

  i) Transfer of requisite money to the issuer’s account against each valid ASBA

  ii) Withdrawn/rejected/unsuccesful ASBAs

- The controlling branch of each SCSB shall confirm the transfer of requisite money against each successful ASBA to the registrar to the issue

- The issuer shall make the allotment.

- The registrar to the issue shall credit the shares to the demat account of the successful ASBA investors

(source Dalal Street Investment Journal (2008b))

Advantages of ASBA

After its introduction, ASBA has resulted in some major advantages to investors, issuers, intermediaries, and to the capital market as a whole. Some of the notable advantages are as follows:

- Interest earning for investors One of the major advantages of the introduction of ASBA is its interest earning capability for the investors. On an average, application money in the case of unsuccessful applicants is blocked for about 20 days, from the date of application till the credit of refund in bank account of the investors. In ASBA, money is only blocked in the account of the investors, while they continue to earn interest on the blocked amount. Only in the event of allotment of shares, the blocked amount will be debited to the investors’ accounts.

- Savings in refund expenses The introduction of ASBA has also resulted in huge savings for the issuers on account of reduction in refund expense in the event of oversubscription.
• Unclogging the payment system ASBA has helped in reducing pressure on fund payment and clearing mechanism in the absence of movement of funds/payment instruments.

• Reduction in work load ASBA has also brought about reduction in the work load of various intermediaries/entities associated with the issue process. This is especially material when the issue is oversubscribed several times, and the refund orders have to be sent through registered post requiring rigorous handling mechanism.

• Reduction in refund related concerns Earlier, in public issues the entire application money used to move from the investors’ accounts to the escrow accounts maintained by the bankers to the issue. Upon allotment, excess money was refunded to the applicants. This process was associated with delays in dispatch of refund orders, loss of refund orders in transit, wrong credit of refunds etc. The introduction of ASBA overcomes all these hassles as the application money is only blocked in the applicant’s account and does not go out till the allotment of shares to the investors. (source SEBI (2013a))

2.5.2 IPO Grading
To instill investor confidence, especially among retail investors, and to attract them to the primary market, the market regulator SEBI has undertaken many landmark initiatives in the last one decade. A major development that has taken place in the Indian IPO market in the second half of last decade was the introduction of grading of IPOs. What had always troubled the IPO market in India, especially during the decade of 1990s, was the predominance of poor quality IPOs and their mixing up with the good ones. Especially, after the abolition of CCI and the introduction of free pricing, there was no check on the pricing of IPOs in India. The subscribers to IPOs had suffered huge losses in those cases where they unknowingly purchased poor quality, bogus or even fraudulent issues. There was no action preventing the fraudsters from approaching the capital market, given the weak legal system prevailing in the country, particularly before the setting up of SEBI (BL, 14/06/2007). Therefore, there has been a necessity to segregate good quality issues from the bad ones which would help investors while making their investment decisions. The market regulator, SEBI was thinking seriously in this regard and consequently, it had decided to experiment with grading of IPOs, initially on optional basis.
SEBI started negotiating with various credit rating agencies in the country way back in 2005 for the introduction of grading of IPOs. The aim of the introduction of such rating system for IPOs was to enable more realistic pricing of shares and help investors make an informed decision (BL, 22/10/2005). The concept of IPO grading was intended to provide investors with an independent, reliable and consistent assessment of the fundamentals of new public issues. Such an assessment of company fundamentals is supposed to consider five parameters – EPS, financial risks, accounting quality, corporate governance, and management quality. Thus, the grading awarded to an IPO is expected to reflect the general health of the company in terms of both quantitative and qualitative factors (BL, 15/04/2007). The introduction of grading of IPOs was intended to assist investors, especially the retail investors, who are planning to invest in the securities of companies that are unknown in the equity markets, and thus helping them in making sound decisions regarding their investment in IPOs. Investors are expected to have an independent opinion from credible rating agencies on the fundamental business strengths of the company (BL, 19/02/2006).

**IPO Grading and the Legal Framework**

Finally, after detailed discussions with rating agencies, SEBI has introduced the concept of IPO grading in India in January 2006. Initially, SEBI had permitted grading of IPOs by four of the rating agencies in India – CRISIL, ICRA, Fitch Ratings India (P) Ltd, and CARE (BL, 19/02/2006). Later, in addition to these four, Brickwork Ratings India (P) Ltd was also authorised to award the IPO grading. The introduction of IPO grading in India was the first such effort anywhere in the world. The first-ever graded IPO in India was that of SRS Entertainment. ICRA had awarded grade 2 (below average fundamentals) to this IPO (BL, 14/04/2006). Soon after the rating system was introduced to provide investors with additional information and investment guidance tool, CRISIL and ICRA were the first rating agencies to initiate the grading of IPOs. However, such grading did not get good response in the initial stage. Of the more than forty IPOs that were expected to hit the market in the first half of 2006-07, after the introduction of grading, only four companies had approached the agencies approved by SEBI for rating of their issues. Incidentally, they too did not accept the ratings awarded to them because they did not match up to their expectations (BL, 20/03/2006). However, the rating agencies were confident that the grading of IPOs would become popular once the issuers and its users understand the benefits derived from such gradings. Many merchant bankers believed that through the introduction of IPO grading, SEBI can have a check on the fly-by-night and
bogus operators, while many others were not sure whether grading of IPOs would reflect the ‘true value’ of issuing companies. Some merchant bankers feared that as grading is done at the draft prospectus stage, there is a ‘disconnect’ between the grade and the price of the issue (BL, 14/09/2006).

Basically, IPO grade is the grade assigned by any of the SEBI recognised Credit Rating Agencies (CRAs) for the IPO of equity shares or any other security which may be later converted into or exchanged for equity shares at a future date. An IPO grade is not the same as an investment recommendation. Investment recommendations by their very nature are expressed as ‘buy’, ‘hold’ or ‘sell’ which are based on the assessment of fundamental factors, current pricing of the instrument, and the likely appreciation in its price in the definite future. Therefore, investment recommendations are based on an appraisal of various market factors like demand and supply, liquidity, valuation etc. whereas grading of an IPO is based on relative assessment of the fundamentals of the issuing company in relation to other listed equity securities in the country. It does not consider the cognizance of the price of the security or the possible appreciation in the market value the security can achieve over a specified time period. Since the grading of IPOs does not take into account the issue price, SEBI has made it very clear that such a grading of IPOs is not an investment recommendation or suggestion by itself. In fact, it is one of the inputs for the investors in deciding whether to make investment in an IPO or not.

Other things remaining equal, an IPO company with stronger fundamentals, which is reflected in better IPO grade, is expected to command higher market price post-listing. SEBI, by itself, does not play any direct role in the assessment made by the CRA. It only facilitates grading of IPOs by CRAs, and the awarding of grading is expected to be an independent and unbiased opinion of the CRAs. Also, SEBI does not make any comment or pass any judgement about the quality of issuer company on the basis of IPO grade. SEBI’s observations on the IPO of a company would be totally independent of the grading process or the grade awarded by the CRA. The intention behind the introduction of such a grading of IPOs was to make additional information available for the investors in order to facilitate their assessment of equity shares offered through an IPO and to make sound investment decision. The company desirous of making the IPO itself is expected to bear the expenses incurred for grading the IPO. The IPO grading can be obtained by the issuing company either before filing draft offer document with SEBI or thereafter. An issuer cannot reject the grading awarded by a CRA. In case the issuer is not happy with the grading of one CRA, he can approach another CRA. Also, an issuer can get his IPO
graded by more than one CRA. However, in both these cases, the grading awarded by all the CRAs must be displayed in the prospectus. This grading is generally assigned on a five-point scale with a higher score indicating stronger fundamentals and vice versa as shown below:

IPO Grade 1 – Poor Fundamentals
IPO Grade 2 – Below-Average Fundamentals
IPO Grade 3 – Average Fundamentals
IPO Grade 4 – Above-Average Fundamentals
IPO Grade 5 – Strong Fundamentals

The specific factors considered by the rating agencies while grading the IPOs may not be identical or limited to a narrow line of variables. Nevertheless, the broader areas listed below may be generally considered by the rating agencies while arriving at the IPO grade:

I Business Prospects and Competitive Position
   • Industry Prospects
   • Company Prospects

II Financial Position

III Management Quality

IV Corporate Governance Practices

V Compliance and Litigation History

VI New Projects – Risks and Prospects

Further, it may be noted that the above list of variables is only indicative of some of the important factors considered in the IPO grading process and may vary on a case to case basis. While growth prospects of the industry, financial strength and operating performance of the issuer are some of the quantitative parameters analysed for IPO grading, qualitative parameters such as management capability, promoter evaluation, accounting policies, corporate governance practices, although subjective, provide a critical input in determining an issuer’s fundamentals.

(sources: Haldea (2010), SEBI (2013b), and ICRA (2013))

In the process of rating fixed deposit schemes of corporate entities and their debt instruments, the rating agencies in India have acquired a lot of industry-specific expertise and knowledge which would help them in grading the IPOs as well. However, one has to notice that there are fundamental differences between equity and debt. Safety of the principal money invested in a particular scheme and the company’s ability to repay the
rated debt are the key factors the rating agencies have to consider in rating the debt instrument. As a rule, the rating on fixed deposit schemes may not change very quickly nor often in the case of debt instruments. No doubt, in the case of equities too, business fundamentals underlying may not change too often, but valuation of equity may be influenced by both investor expectations about future earnings of the company and their assessment of how other investors would look at this prospect. As a result, assessment of the attractiveness of equity investments is liable to change. In fact, equities by definition are risk capital. An investor seeks not just regular dividend from his investment in equities, but capital appreciation too. Therefore, in addition to mere safety of the funds invested, it is the attractiveness of the price of a particular stock that would guide the investment decision in equities. However, the problem with the grading of IPOs is that it will not comment anything about the issue price, and there will be no straight advice on whether the stock is worth investing in. Further, there is no empirical evidence, even from the developed markets, about the effectiveness of IPO grading (BL, 28/03/2007).

The success of this move would depend on the rating agencies and the ways investors interpret the ratings. Jacob and Agarwalla (2012) note that the grading of IPOs, which was expected to improve the pricing efficiency of IPOs in India by way of providing comprehensive issue related information to the market, especially to the retail investors, has only limited influence on the IPO demand of retail and institutional investors. They note that low grade issues have weaker demand from investors relative to the ungraded IPOs. However, they did not find any evidence supporting IPO pricing improvement after the introduction of IPO grading suggesting the failure of grading as an IPO certification. They note that underpricing for graded issues, which are supposed to have lower degree of information asymmetry, was not less than the underpricing for ungraded issues which are expected to have high degree of information asymmetry as they are not graded, or underpricing for high grade issues was not less than underpricing for low grade issues. Such finding was consistent with Khurshed et al (2011) who report that IPO grading has done little in reducing ex-ante uncertainty of IPO firms and, therefore, there is no significant drop in the first day returns of Indian IPOs after the introduction of grading of IPOs.

Criticisms against IPO Grading

When grading of IPOs was introduced in India, there was criticism against it arguing that grading of IPOs could be a tricky affair and this could give a false sense of security to the investing public. It was thought that the responsibility of promoting and marketing an IPO
could shift from merchant bankers to the rating agencies by way of awarding high grade. The IPO companies were also worried about the possible impact of poor grading of their issues on the pricing of their issues. According to Haldea of Prime Database, “there are no incentives for the companies to rate their IPOs. First, there are no ratings of IPOs anywhere in the world and thus, there are no models. If a company accepts a particular rating, the concerned agency would have to report it to the SEBI and stock exchanges within the same month, which makes it public information. In such a case, a good company would not go for rating fearing that if it gets a bad rating its issue may suffer despite strong fundamentals. Similarly, a bad company too would not go for rating fearing that its cover-ups might get exposed with a poor rating.” (BL, 20/03/2006)

Another argument against grading of IPOs of equity shares was the difficulty associated with rating of equity issues. The argument was equity shares, by their very nature, are different from debentures or fixed deposits. Equity shares are more risk-prone because their market prices are mostly driven by investor-sentiment and therefore are not compatible for credit rating while debt or fixed-deposits are more compatible for credit rating as their prices are not driven by market sentiment. As a result of this, a particular grade awarded to the equity issue of a particular company at the time of going public may not be indicative of its future market performance. Also, there is a great deal of subjectivity involved in rating an IPO so much so that rating by two different accredited agencies could well differ from each other. Further, the long-run outlook for the industry, the global market and the players therein, the nature of consumers and change in their preferences, taxation policy of the government and a whole lot of other factors might make the initial rating of the IPO less relevant in the distant future. Some critics of the IPO grading were of the opinion that in the absence of safety net wherein the promoters and merchant bankers are ready to buy back the shares from the public if the post-listing market prices go below the offer price during the statutory period, grading of IPOs may not serve the purpose of protecting the interest of the investors. (BL, 20/04/2006)

Above all, the most critical argument against the concept of IPO grading is that it doesn’t consider the issue price. The credit rating agencies do not comment on the issue price/price band or the valuations of the company. But the fact of the matter is pricing is an important aspect in IPOs because everything is relative to price. What good is a company with strong fundamentals, if its IPO is overpriced? Many companies that come out with IPOs are not leaving anything on the table for investors making the price aspect even more important. And the reality is, grading of IPO will not determine its value in real
sense On a relative basis, what it will do is give a sense of what the company and its management are all about. Thus, it will establish parameters over a period of time, which will be a good indicator for investors. That means, one cannot take a look at the IPO grading alone and make a decision to buy. If the company has poor fundamentals or below average fundamentals, then the investor can decide not to participate in the IPO, but he/she cannot take a decision to buy based on the grading alone. However, an IPO with a grading of 5 which means strong fundamentals, does not tell whether the company is going to leave anything on the table for the investors or not, and therefore investor may not be in a position to decide whether the issue is worth subscribing or not. 

IPO of Reliance Power, for example, was graded 4 by two of the rating agencies – CRISIL and ICRA, but post-listing, the IPO proved to be overpriced. Thus, grading will not give any indication of whether the issue is fairly priced or not which is a critical issue in an IPO today.

However, the counterargument in this regard is that the reasonableness of the price itself depends on the IPO's fundamental quality. Determining the quality is a very complex job which is beyond the competence of most investors. Grading of IPOs in terms of their fundamental quality will enable investors to steer clear of unsound and fraudulent IPOs. Such IPOs are likely to be restrained by the grading system as they will be in the bottom grades of 1 or 2.

Credit rating agencies like CRISIL and CARE also have justified grading of IPOs on the basis of fundamentals instead of pricing. These agencies are of the opinion that different classes of investors have different risk appetites and it is the investors themselves who have to decide the reasonableness of the pricing of the issues based on their risk appetites. “An analysis of fundamentals does not change from investor to investor, but investor needs that is, investment horizons, return expectations and risk thresholds do. What may be a ‘buy’ for a 25 year old who has just begun his working career might not be so for a 57 year old individual retiring next year. Recommending an all-encompassing buy (or not) opinion can, in fact, be misleading”, was the comment made by a senior director of CRISIL in an interview to Dalal Street. Similar opinion was expressed by the Deputy MD of CARE when he said, “It could very well be a prudent investment decision to invest in a high risk business for one set of investors if such investments carry a low price tag, while for other set of investors, risky business may be a straight no-no as far as betting money on such business goes.” Overall, while pricing the issues, especially equity issues, the issuer has to consider not only the financial aspects, but also non-financial aspects like...
growth potential of the industry, competitiveness in the industry, entry barriers and availability of substitute products or services. All such factors get embedded in the issue price, especially of equity issues. Thus, taking a view purely on past financial information could result in investors making incorrect conclusion on valuations (*source Dalal Street Investment Journal (2008a)*)

After having experimented with IPO grading as an optional exercise, with effect from May 1, 2007, SEBI made grading of IPOs compulsory, thus setting an international standard among capital markets worldwide. The then chairman of SEBI, Damodaran M., said in an interview, “There is no international experience on the basis of which you can formulate a policy, but what has been taken into account is ground realities” (*BL, 23/03/2007*). According to him, such compulsory rating was meant to discourage people who are less than serious in the market, and SEBI intended to build disincentives (to such people) through the process of engagement for the grading exercise itself. Rating agencies had welcomed SEBI's move to make IPO grading compulsory. The then MD and CEO of CRISIL said that such compulsory rating would be beneficial for the investors, especially the retail investors. According to him, when a company with strong fundamentals lists at a time when the market is volatile, initially investors might lose out on money. However, in the long run such investors can be benefited, if they hold on to the stock, they can enhance their wealth in the long run. According to him, even an IPO which has got poor grading could well be an attractive investment at a particular price (*BL, 24/03/2007*).

### 2.5.3 Anchor Investors

In June 2009, SEBI has introduced the concept of anchor investor for public issues in India. Anchor investors are entities which are offered, and subscribed to, shares in an IPO before the offer opens to the public. The idea behind the introduction of this category of investors is, first, to help investors in setting a rough benchmark for issue pricing, and two, to attract investors by infusing a measure of confidence, especially retail investors, to public offers before they hit the market. Thus, an anchor investor in a public issue is the first investor in any round that provides subsequent investors a degree of confidence. These investors belong to the Qualified Institutional Buyers (QIBs) category, which include mutual funds, foreign institutional investors, banks, and venture capital funds - domestic and international, provident and pension funds. These QIBs are expected to be in a better position than regular investors, especially retail investors, to judge the fundamentals and future prospects of the issuing company. Therefore, typically an anchor investor will know the issuing company and have a high degree of confidence in the
The anchor investor may even have invested in other projects with the company. An anchor investor will apply for the shares of a public issue just like a regular investor, at the prices it deems the best fit.

The anchor investor, who cannot be a promoter of the issuer company, can be allocated as much as 30 percent of the portion reserved for qualified institutional buyers (usually 50 percent) in an issue, through a bidding process. One-third of the anchor investor portion shall be reserved for domestic mutual funds. The bidding for anchor investors opens one day before the issue opens and is completed on the same day. Allocation to anchor investors is on a discretionary basis subject to a minimum number of two investors for allocation of up to Rs 250 crore and five investors for allocation of more than Rs 250 crore. Once the entire issue, i.e., to the anchor investors and to the public as well, is over and the issue price is fixed according to the book-building process, anchor investors have to make up the difference if the price paid by them is lower than what has been fixed. However, if the price fixed for the issue is lower than their price, they have to forego their cash. The minimum application size for each anchor investor should be Rs 10 crore. Anchor investors also have to make available a margin of 25 percent of their application and part with the balance within two days from the close of the issue.

The number of shares allocated to anchor investors and the price at which the allocation is made, is made available in public domain by the merchant banker before opening of the issue. The IPO of Adani Power was the first in India to use anchor investors. Adani Power IPO had a total of six anchor investors (sources IEPF (2012) and BL, 27/08/2009).

However, the concept of anchor investor was also criticised by many. In an interview to Business Line, the MD and CEO of an investment banking firm told that, the introduction of anchor investor offers opportunity for merchant bankers who have affiliated mutual funds to make money, since the lock-in period is just a month, these anchor investors can exit much before promoters and other insiders do, who have a lock-in period of six months, and can make substantial gain in the aftermarket. This can bring the aftermarket price of the IPO securities down and can be injurious to the investments of retail investors (BL, 19/06/2009). However, contrary to this, there are also evidences where anchor investors have purchased shares of IPO companies post-listing. Three of the IPOs in 2010 – Cox and Kings, Jubilant Food Works and Infinite Computer Solutions – saw their anchor investors picking up additional shares in the secondary market on the listing day. Interestingly, these post-listing purchase of shares were made at a price higher than
the issue price (BL, 20/02/2010) Finally, there are also instances where issuers dared to go public without opting for anchor investors. In 2010, the Government of India had decided not to go in for anchor investors for its IPOs of MOIL and Coal India, and for FPO of Power Grid Corporation (BL, 25/11/2010).

2.5.4 Safety Net for IPOs (proposed)

A study by SEBI, of companies listed on Indian stock exchanges between 2008 and 2011, revealed that over 60 percent of the listings were trading below their issue price six months after the IPO. Further, a large proportion of listings (almost 50 percent) had registered falls in value of greater than 20 percent. Because of such a trend in the secondary market, the market regulator SEBI felt that the sentiments of investors may be negatively impacted, and as a result, the investors might lose confidence in the capital market activities. Accordingly, in September 2012, SEBI had issued a discussion paper for public comment on 'Mandatory Safety Net Mechanism.' Basically, safety net mechanism provides for downside protection (a fall in value of shares) for a specified period of time after the IPO event. If the safety net provisions are triggered, the provider of the safety net (such as the promoter or issuer) must buy back the shares at the issue (or the specified) price. The objective of SEBI behind mootng the concept of safety net mechanism was to instill confidence and encourage participation in the capital market by retail/small investors. However, the concept of safety net arrangements in public issues on voluntary basis by the issuers had already been previously addressed by SEBI as per Regulation 44 of ICDR Regulations (2009).

The proposed mandatory SEBI requirements, as per the discussion paper, is that the safety net provisions will trigger only in cases where the prices of shares being issued fall in value by more than 20 percent from the issue price. The price is calculated as the volume-weighted average market price of such shares for a period of three months from the date of listing. Further, the triggering of the safety net provisions shall take into consideration the movement in the market index. As per SEBI proposals, the eligibility of the safety net facility are only for original resident retail individual allottees for up to Rs 50,000 in the issue, not applicable for secondary purchases after the IPO. Further, the regulations propose to cap the total obligation on the safety net provider at 5 percent of the issue size. Even though, the SEBI safety net requirements are not yet mandatory, after the discussion paper was issued, a number of companies have started including some form of safety nets for retail investors in their prospectus. IPO prospectus of Sai Silk (Kalamandir) contained safety net provisions, but the company was unsuccessful in
raising the requisite capital. After Sai Silk, IPO of Justdial contained safety net provisions for retail investors. Earlier in 2006, Usher Agro had offered safety net to its investors.

(sources: SEBI (2012) and BL, 09/06/2013)