The small squeeze

The Economic Survey proposal to move to price auctions and scrap reservations will nudge the small investor out of IPOs

The auction system will sound the death knell for small investors, who can't work out issue pricing

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This is déjà vu. Rarely have scams been nipped in the bud. When these assumed large proportions, instead of addressing the root causes, we will killed the activity itself. Regulatory responses, actual and suggested, to the recent IPO demat scam reflect that classic sequence of inaction and wrong action.

Good, but...

The IPO demat scam was about the absence of a unique identification number (UIN) for investors, because of which a handful of fraudsters abused the system. It was not about malpractice by millions of retail investors. Still, instead of addressing the UIN issue, the recent Economic Survey talks of completely doing away with reservation for small investors in IPOs. It proposes to shift all IPOs to a unified auction system, which effectively means making them the preserve of moneybag investors.

This proposal can't be based in the belief that retail interest in IPOs is inadequate; past oversubscriptions prove otherwise. A public market is now sought to be converted into a private market. Our secondary market has already been taken over by foreigners; now, it appears to be the turn of the primary market.

I am all for the auction system. In our book-building system, price discovery is a farce. Book-built issues, in fact, work like fixed price issues -- the price is decided by the issuer. The only difference is that instead of a single price, there is a price band. The auction system helps issuers get the best price for their shares from qualified institutional buyers, who too are happy as they get the desired quantity of shares at prices they are willing to bid at.

What I am not for is the entire IPO being sold through auction. Such a move would sound the death knell for the small investor, who is not equipped to work out issue pricing. This move might have been good if we had a responsible mutual funds industry, through which small investors could have invested. IPOs have always expanded the investor base, as these are typically the best entry points. Almost half of the present eight million demat accounts were opened in the past three years, courtesy new IPO investors (large, even after ignoring the multiple accounts). If the objective of the proposed policy is to nudge investors towards mutual funds, it is ill-timed, as mutual funds have neither built confidence among investors nor do they have any reasonable level of market penetration. It would just mean a further drop in household savings moving into the capital market.

Up, not down

My suggestion is to reserve only half of the IPO for QIBs through the auction system. The balance should be reserved for retail. For QIBs, there should be no price indication, though a floor price should be submitted by the issuer to Sebi in a sealed envelope. In order to avoid concentration of shares, a cap can be prescribed on the maximum a QIB/group can bid for. Allotment should be made on a top-down bid price basis. If there are not enough QIB bids above the floor price, the issuer would have the option to reset the floor price or withdraw the IPO.

After completing the QIB portion, the balance IPO should be sold through the fixed price route to the retail segment. This fixed price can be the floor price, or the lowest of the QIB allotment price, or an average of the bottom five QIB allotment prices, or the average price at which the bottom 25 per cent of the issue was sold to QIBs. Even in the present sense, the retail segment doesn't do any price discovery -- about over 97 per cent of retail applications have been at cut-off price. Hence, only a fixed price offering for them makes sense.

In fact, if we are serious about enlarging the investor base, the retail portion should be raised to 75 per cent of the issue size. One of the reasons why reservations were introduced for QIBs was that it would validate the issue for retail investors. True, but even a 25 per cent reservation will ensure that objective. Another reason given was that small investors might not bring in the numbers, which has been proven wrong. Another argument given is that if QIB reservation is lowered, it will push them away from our market. Not true -- if an issue is good, QIBs will subscribe, as they do in the secondary market.

If lower reservation for QIBs is not acceptable, another alternative is to increase the share of mutual funds from 5 per cent of the QIB portion to, say, 50 per cent. It will encourage small investors to go to mutual funds.

For the misdeeds of a few, millions of genuine retail investors should not be punished. Any new policy should be fair, equitable and transparent, and its objective should primarily be to enlarge the investor base.