

## **More hits than misses**

***Sebi's order on the IPO demat fraud may seem harsh and rushed, but deserves praise for the issues it raises***

***Sebi has shown it is serious about punishing the guilty and restoring small investor confidence***

### **Prithvi Haldea**

The media has been inundating us with stories on the IPO demat scam for over a week now. I would not call it a scam in the first place – 'fraud' is a more appropriate term. Scams assume gigantic proportions and hurt many people. In this case, a hundred-odd people got undue allotments worth Rs. 146 crore, on which they made a profit of Rs. 72 crore. Moreover, unlike previous transgressions, investors did not lose money this time around; they only lost an opportunity.

Remember the abuse of the IPO route that Sebi stopped last year? Now that was a primary market scam, as allotments worth Rs 26,000 crore (from issues worth Rs 50,000 crore) were made on a discretionary basis to select institutional investors who went on to make a staggering profit of Rs 18,000 crore. Surprisingly, most of the media ignored it.

It is amusing that a lobby is now arguing that multiple applications stem from the incentives offered by underpriced IPOs, and is demanding the abolition of the retail quota to obviate this problem. Its stance is untenable, as QIBs and HNIs also get these incentives. Besides, isn't a paradox that concerns about aggressive IPO pricing existing simultaneously?

The lobby is making irrelevant comparisons with quotas in other sectors to garner support for the removal of retail reservation in IPOs. The quota for small investors only ensures that the moneybags don't edge them out in the system of proportionate allotment. The idea is to allow them to participate in the capital market. If the retail quota has to go, so must the 50 per cent reservation for FIIs – they too have been bidding within price bands (and not in an open auction) and are getting shares at low prices. In any case, unlike in other reservations where there is an opportunity to favour specific investors, the IPO retail quota is used for allotments on an anonymous basis.

The solution offered by the lobby – IPO actions – is weak and wouldn't find favour even with the QIBs, as it might result in a handful of allottees with the highest bid. What happens to the after-market?

### **The real solution**

A better way would be to auction 50 per cent of an IPO to QIBs and reserve the rest for small investors, at the lowest QIB allotment price or the average price at which the bottom 25 per cent was sold to QIBs. Everyone would be happy – the QIBs would get the number of shares they want at the prices they are willing to pay, the issuer would maximize his inflows and retail investors would get allotments at a good price. This would help move household savings into the capital market. IPOs have always helped augment the investor base, as they are typically the best entry points for a segment that is showing interest in equities after considerable abstinence.

The root of the present problem is the lack of an investor identification system and insufficient due diligence by banks and DPs that allowed a handful of fraudsters to create thousands of fictitious identities. The solution to this lies in installing entry stage systems and creating a unique identification – like the permanent account number. All the bank accounts of an investor should bear his PAN. Besides, no investor should be allowed to have more than one demat account. Requisite software can be developed to provide for joint names and for special requirements like creating a lien. A system to help establish linkages among investors should also be designed. The entire procedure, from application to allotment, also needs to be reviewed urgently.

### **Looking beyond**

There may be many benami/fraudulent operations in the much larger secondary market. The banking system too is infested with benami and multiple accounts, and unaccounted cash in lockers. Beyond that, a big fraud possibly lies in the sub-accounts of FIIs.

If Sebi really wants to ensure a proper KYC (know your client) for every domestic investor, let the norm be extended to foreign sub-accounts too. Otherwise, the system of registering FIIs itself might just as well be done away with, if half the FII inflows can't be assigned to specific names and their sources of funding cannot be ascertained.

### **The Sebi order**

While the present Sebi order is path-breaking for the concerns it addresses, it is quite harsh in some ways. An ex-parte interim order in the form of a show-cause notice, it has not only banned some DPs from undertaking fresh business (which is fine), but has also asked clients of two DPs to shift their accounts within 15 days. Moving 750,000 accounts in such a short span of time is a Herculean task. Existing DPs will exercise greater due diligence before accepting accounts from a 'tainted' DP and may charge investors more for accepting them as clients. There's another problem: all new accounts now require PANs. If clients shifting from a tainted DP are treated as new accounts, the workload on the PAN issuance system will increase manifold. So a step that has been conceived to protect the investor might just cause him greater hardship instead.

Regrettably, the media has dwelt on some omissions in Sebi's order instead of focusing on the issues it raises. The omissions,

though unjustifiable, were unintentional, as Sebi clearly wants to punish the scamsters and not the investors. Its drive to clean up the market is praiseworthy. Its worry on the declining participation of households in the capital market is evident and the need to restore their confidence, visible.