SEBI's Discussion Paper on Mandatory Safety Net Mechanism for IPOs

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SEBI has recently issued the "***Discussion Paper on Mandatory Safety Net Mechanism***" for IPOs which addresses the mandatory safety net for initial public issues and obligation on public issuers. The discussion paper was made available for public comments till October 31, 2012. The mandatory safety net mechanism has been envisaged considering the recent post-listing price performance of IPOs in India and to reinforce investor confidence in capital markets as well to discipline issuers and market intermediaries in public issues. Although the intent of SEBI to protect investor confidence and rationalize IPO pricing is appreciable, it is our belief that the concept of a mandatory safety net mechanism is completely misplaced and should never be implemented.

The reasons for not having a mandatory safety net mechanism are listed below:

1. ***Reasons for Review*****:** SEBI has given its reasons for such a mechanism based on its analysis of price performance of scrips listed during 2008 to 2011 and its observations that around 55 of the 117 scrips during this period were trading below 20% after six months of listing. However, the proposal for the safety net to trigger has been fixed at 20% over and above the fall in overall market index in the same discussion paper. If SEBI has based its proposal solely on such a simple analysis without any proper consideration for overall market factors or industry and company specific risks during the same period (2008 – 2011), the reason for such a review itself is questionable. The overall market index itself has seen a substantial dip during the time period taken for the analysis. Although, it is agreeable that the price performance of IPOs has been a major concern for investors, the data SEBI has used in its analysis to arrive at such a proposal looks completely misguided. SEBI should back-test its data for a larger time period while comparing it with overall market performance to ascertain if we there is need for such a review.

2. ***Concept of Safety Net against Capital Market Ethos:*** The proposal to compel issuers to provide a safety net mechanism would be against the fundamental ethos of capital markets, viz. equity risk taking. The proposal is equivalent to enforcing a warranty on a contractual agreement otherwise entered wilfully between two parties. If a manufacturing company were to sell its product on warranty, the risk cover it is giving its consumer is solely based on its manufacturing efficiency, the risk of which is completely under the control of that company. Can that same logic be applied to a stock market investment? By such a proposal, SEBI is trying to define the sole risk of a stock market investment as mispricing of security (which is again based on incorrect statistics taken during a downturn) and to an extent overall market factors. What about all the other risk factors affecting a company, which is beyond the control of the issuer or its promoter? If there was death of key management personnel post listing or if there was a major fire in one of the key factories or a labour strike, which lead to the fall in stock price, is the promoter liable to provide a warranty to the investor for suck risks? All risks inherent in a stock market investment, including mispricing by the issuer, are solely the responsibility of the investor, as long as investors are taking informed decisions. Mispricing of securities by some issuers cannot be the logic to compel all issuers in providing warranties for their issuances. Introducing more checks and balances on the promoters and the intermediaries, the due diligence process and rationalizing the pricing methodology and book build process etc., will be far more beneficial in reducing risks of IPO mispricing.

3. ***Incorrect Methodology for Calculating Safety Net Trigger:*** The discussion paper proposes that the mandatory safety net shall trigger when the price of shares depreciate more than 20% of the issue price. Further, the 20% depreciation shall be considered over and above the fall in the market index (BSE500 or S&P500). The fundamental mistake with such a proposal is to consider that the risks inherent in all scrips are the same vis-à-vis the overall market. Such an otiose proposal again reinforces the fact that SEBI is considering mispricing and overall market fall as the only risks affecting an issue. Industry specific or company specific risks are completely ignored. The second error is in its heads I win tails you lose philosophy of selectively choosing absolute fall when overall markets are up and relative fall when overall markets are down. A better way of calculating the safety net trigger would be to take a reasonable relative fall over and above the overall market multiplied by the industry or company specific beta factor.

4. ***Effect of Sub-Classification of RIIs for Eligibility Criteria:*** The current proposal makes the safety net facility available to resident retail individual investors (RIIs) who have made an application for up to Rs 50,000, while SEBI generally classifies RIIs as investors who can make an application for up to Rs 200,000. By providing such a sub-classification, it incentivizes retail investors to invest in multiple issues (regardless of the quality if the issues) than into a single public issue. For example, a retail investor with Rs 200,000 investable surplus would rather invest Rs 50,000 each in four IPOs than invest Rs 200,000 in a single IPO (regardless of the quality of these four public issues), since the safety net mechanism ensures price safety on all four issues for the investor. Such sub-classifications will indirectly trigger more poor quality issues in the market negating the original intent of SEBI to improve the IPO market.

5. ***Short-Lived Safety Net Period:*** The safety net period under the current proposal triggers three months post the listing date, which seems to be too short-lived and does not serve the purpose of protecting retail investors. If the intent of the issuer/promoter were to misprice the security wilfully, then nothing stops them from rigging their prices and holding on to the issue price levels for another three months. In the event SEBI goes ahead with the proposal, the safety net trigger period should be at least more than a year, so as the issuer gets sufficient time to utilize the proceeds of the issue and that there is proper price discovery in the market. This would also ensure that good quality issues are not penalized for external risks if it were to occur during first few months of their listing.

6. ***Primary Safety Net Obligation Provider:*** The current proposal puts the primary obligation for providing the mandatory safety net on the promoters of the issuing company regardless of the fact whether the promoter has benefited from the issue (through an offer for sale of his shares) or not. Even if were to assume that there was mispricing, to put the obligation on the promoter even though he has not directly benefited from the mispricing would be completely one-sided. If the public issues involves only a issue of fresh shares by the issuer without an offer for sale from the promoter and there are no immediate corporate actions where promoters have taken cash out of the company, then in such instances the mandatory safety net mechanism should not be applicable. Also, there could be price manipulation actions due to corporate rivalry that could unduly put the onus on the promoter of a good company.

SEBI should relook at the need for such a safety net mechanism and whether the objectives can be achieved by such a proposal. The current proposal gives much scope to disrupt SEBI's intent of a achieving a better IPO market. SEBI as a market regulator overseeing regulatory and development functions should focus more on ensuring market integrity by proper checks and balances on issuers and the intermediaries. It is the responsibility of SEBI and other regulators to ensure that information dissemination is symmetric and market participants make better disclosures, and swift penal actions for insider trading or broker price manipulations should be the basis. Investors should take informed decisions and it is also the responsibility of SEBI to enhance its investor education programs.