e-IPO – The next step in the Evolution of IPOs

Ashishkumar Chauhan
Interim Chief Executive Officer
BSE Ltd.

Introduction

Primary equity markets are one of the most efficient methods of raising capital for many firms. The relative cost and ease of raising capital make the primary market a very attractive choice for firms looking for capital and Initial Public Offering (IPO) mechanism is the preferred way of raising significant amount for a Company. In this paper, we try and give a global perspective of IPO processes and propose introduction of the e-IPO process, which would make the offering's mechanism far more efficient. The goal is to reduce the time gap between application closure and listing of the issue without losing the procedural rigour or compromising on risk management, at the same time adhering to the regulatory and legal framework. There are clear benefits to achieving this goal as it would reduce various inefficiencies in the system including discouraging grey market activities.

Evolution of IPOs in India

In the Capital Control of India (CCI) days, companies would appoint designated banks to which prospective investors would submit their duly filled-in application form along with application fee cheque for the amount aggregating to their desired subscription of the issue. The pricing would be "fixed price", a set price as determined by the Company within the stringent set of regulations provided by CCI. The Bank on encashing the cheque, would forward the successful applications to the Registrar to the Issue (RTI) for the allotment of shares. In case of over-subscription, the shares would be allotted on a pro-rata basis. The process could take 1-2 months from the date of application to the date of allotment and allotment to listing could take even longer, while the refunds could take upto 6 months.

With the establishment of the Securities and Exchange Board of India (SEBI), the issuance process for raising capital underwent significant changes. The Disclosure and Investor Protection (DIP) Guidelines by SEBI issued under the Section 11 of the SEBI Act led to the removal of control on capital issuance and companies more than 12 months old were allowed to issue capital at price higher than the par value.

The Book Building process was introduced for certain categories in 1994. This process was broken into multiple stages. In the pre-offer marketing stage, the underwriter performed an exhaustive survey of the market to determine the appropriate price and interest in the investors for the firm's stock. This was usually done through road shows and other avenues available to the underwriter. Using these methods the underwriter used to come up with their estimate of the IPO price. For the first time in India, a Crunch Time limit of one month was introduced for the listing of shares from the date of closure of issue. The Crunch Time was later revised to 24 days post closure date, 15 days for allotment and 7 working days (+2 weekend days) for the listing. Other significant changes empowered due to technology like downloading and printing IPO application forms from the website significantly enhanced the reach of IPO. Earlier there used to be a dedicated printer responsible for printing and distributing the IPO application and at times there would be a shortage of physical application forms restricting people from participating in the process.

Underwriting of issues was made optional by SEBI in 1994 thereby reducing the cost of the issue under the condition that if the issue was not underwritten, and was not able to collect 90% of the amount offered to the public, the entire amount collected would be refunded to the investors.

Working towards making investing more transparent, SEBI introduced Application Supported by Blocked Amount (ASBA) in September, 2008. According to SEBI, "ASBA is an application containing an authorization to block the application money in the bank account, for subscribing to an issue. If an investor is applying through ASBA, his application money shall be debited from the bank account only if his/her application is selected for allotment after the basis of allotment is finalized, or the issue is withdrawn/failed". The investors are spared from paying the application amount at the time of applying for the IPO and later wait for a refund of the unutilized amount, which was later returned through cheques resulting in a delay of upto 45 days. Moreover, since the amount is not debited from the account of the investor, the investor continues to earn interest on the amount blocked under ASBA.

In April 2010, SEBI further revised the timeline between issue closure and listing of shares to 12 days which led to reduction in market risk for investors, and also freed-up their funds faster. It also benefitted the companies, as they received and were able to use the IPO funds in their account, sooner. Furthermore, due to the reduction in timeline, the gray market operations were curtailed and the investors' exposure to market risk was reduced as well. The timeline for "Fixed Price" issues, however, was revised to 15 days between issue closure and listing of shares.

SEBI made applying through ASBA compulsory for all non-retail investors, High Net-worth Individuals (HNIs – subscription size more than Rs. 2 Lakh) and Qualified Institutional Buyers (QIBs) in April 2011.

e-IPO Process

The current IPO process can be modified by adding features or options to make it more akin to secondary market trading to stocks. While the legal framework makes a distinction between primary and secondary market transactions – for example, requiring the submission of an application form in the case of a primary market purchase – there is now broad consensus questioning the basis for the legal provisions.

Given ongoing developments in technology and processes, including the experiences gained from other initiatives like the processing of mutual fund transactions, a framework maybe developed wherein investments in IPOs can be processed with the same level of investor protection safeguards as the current process, but with substantially lower levels of operational risk from the perspectives of an investor as well as systemic risk.

The IPO process can potentially be modified through any of the following methods (and perhaps more) that will essentially allow an investor to submit "applications" or purchase instructions electronically:-

1. A mechanism similar to Secondary Market – The investor will invest through a trading member of the exchange as his client, like he would do for any secondary market transaction. The payment could be processed as any current secondary market buy transaction in the cash segment of the exchange – transactions will be guaranteed by the clearing house, and appropriate margins levied on the member (who in turn will collect it from the investor). A similar process is currently being employed for the Offer For Sale (OFS) sub-segment of equity. Timeline between issue closure and listing of shares expected to be 1-2 working days.

2. A Separate Mechanism mimicking the current process with some modifications – There are two sub-methods through which the process can be improved without making any major changes from the system in vogue. Timeline between issue closure and listing of shares expected to be 4-5 working days.

i) *Direct application* – The investor will be able to submit an application or instruction directly via electronic connectivity provided by the stock exchange. This will require pre-registration wherein the investor submits demat and ASBA account details. Acceptance of the application by the exchange platform will involve validation of the demat account and verification and blocking of the appropriate amount in the bank account.

ii) *Indirect application* – The investor will submit an application or instruction through a member of the exchange. The payment could be through the ASBA facility, or through the trading member; in case of failure by the investor or the member to make payments to settle the transaction, the underwriter shall step in as is the case in the current process.

The actual process to be adapted could be a variant of the methods discussed above or something similar to the above discussed methods. Currently, the process is being discussed and debated at various levels.

Advantages of e-IPO Process

1. With e-IPO, the timeline between issue closure and listing of shares can be further cut down to 2-4 days bringing much needed efficiency.
2. Faster refunds of the money in case of over-subscription or failed issue will help improve the liquidity of the investor for entering into other primary or secondary market transactions as well as improving general utilization of funds.
3. The accessibility to IPO subscription will be significantly improved since the IPOs will be able to piggyback on the reach of the stock exchanges having nationwide terminals and many other innovation methods, for instance, in Singapore, investors can use e-IPO facility through ATMs; banks in India can provide similar facilities by tying up with their subsidiary security arms or through other trading members which will open the market to a whole new set of investors.
4. With a 2-4 day cycle between issue closure and listing of shares, there will be a significant reduction in market risk between IPO closure and listing
5. Companies get to utilize the raised funds stated purposes earlier since companies cannot use the raised funds till the listing.
6. Usage of paper will be greatly minimized thereby creating an environmental friendly IPO process.
7. The cost to both the issuer and the investor will come down with increased efficiency and transparency.
8. The investor will get delivery of his stocks much faster after the closure of issue.
9. Post issue compliances will become easier to handle due to a paperless or near paperless system based on the final method selected for the execution of e-IPO.