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# **IMPACT OF REGULATORY FRAMEWORK ON INITIAL PUBLIC OFFERING (IPO) UNDERPRICING IN INDIA**

AUTHORED BY - AAYUSHI AGRAWAL

## **Introduction**

A new company's decision to go public is a significant turning point in its history. It makes public equity capital accessible, which could reduce the cost of financing the business's operations and investments. Additionally, it offers a platform for the company's share trading, which helps current investors diversify their portfolios and capture the cash gains they have made from supporting the business—a crucial factor for venture capitalists. The simple process of going public draws attention to the business, and the associated publicity may have unintended consequences like drawing in managers of a higher level. Simultaneously, the business takes on additional responsibilities in the shape of disclosure and transparency laws, and it is held responsible for a bigger number of mostly anonymous shareholders who will tend to “vote with their feet (by selling the shares) rather than assist the company’s decision-makers in the way a venture capitalist might<sup>1</sup>”

The initial public offer, or IPO as it is more often known, is the formal term for the company's initial public offering of its shares to the general public. Either young businesses seeking to raise funds to grow, or established major partnerships or private limited companies wishing to become public limited companies, issue the IPOs. The most well-known anomaly connected to this going public procedure is the underpricing of initial public offerings (IPOs). The degree of underpricing differs between markets, with emerging capital markets exhibiting higher levels of underpricing. In a market like India where businesses go public to finance their expansion despite paradoxical underpricing in the IPO, it is a riddle that continues to be difficult to solve.

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<sup>1</sup> Eckbo BE, ‘IPO Underpricing’, *Handbook of Corporate Finance: Empirical Corporate Finance. Volume 1* (Elsevier 2008)

Underpricing is defined as “the percentage difference between the price at which the IPO shares were sold to investors (the offer price) and the price at which the shares subsequently trade in the market<sup>2</sup>”. When an issue is priced below its actual value, this is known as underpricing. The extent of underpricing differs between nations and within a single nation for different issues. An undervalued initial public offering (IPO) results in money left on the table for the company, which is a loss of capital. However, this money also benefits the investors by providing them with positive early returns on their undervalued shares. “Though underpricing is a cost for the issuing company, the issuing company underprices the issue.<sup>3</sup>”

Specifically, it is expected that the undervaluing of IPOs would gradually diminish as the vast majority of investors identify and take advantage of the associated profit opportunities. Nevertheless, it appears that most markets will always undervalue first public offerings. These abnormalities are particularly harder to explain because they are present in both industrialized and developing markets.

One important factor that can either raise or decrease IPO underpricing is the regulatory framework that oversees the offerings. In addition to exerting stringent control over the issuing company, the regulatory framework serves as a guide for investors in making just decisions. One of the primary regulatory guidelines influencing the underpricing of the initial public offering (IPO) is the pricing mechanism used to issue the shares. The two most popular pricing strategies for IPOs are fixed price and book building. Although it is only available in some countries, auction pricing is another option for issuing shares. It is not often used. This paper aims to identify any significant modifications to the regulatory framework pertaining to the issue of an IPO and study the impact of legal framework on IPO underpricing.

### **Literature Review**

Initial Public Offerings (IPOs) underpricing has drawn more attention than other financial market irregularities. Without coming to a consensus, researchers have provided a range of explanations as well as theoretical and empirical support. The empirical literature that has grown over time demonstrates how difficult it is for the market to value initial public offerings (IPOs) fairly. To

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<sup>2</sup> *Ibid.*

<sup>3</sup> Jain N, ‘Underpricing of Initial Public Offerings in the Indian Capital Market’ [2009] SSRN Electronic Journal

be more precise, the main characteristic of initial public offerings (IPOs) is their systematic pricing at a lower price than their eventual market price. Five primary theories can be used to classify the various conflicting hypotheses and models put out to explain IPO underpricing:

1. Theories of asymmetric information are seen to be the most applicable in explaining IPO underpricing. According to the notion, one party to an IPO is presumed to know more than the rest. According to Rock (1986)<sup>4</sup>, there are two types of investors: informed and ignorant. Only the informed investor is aware of the actual worth of the share that is being offered. Because of this imbalance, knowledgeable investors only place bids on IPOs with appealing prices, while ignorant investors placed bids on any IPO. Due to this, there is a significant risk of adverse selection where shares in "bad" issues are distributed to ignorant investors. Another name for this theory is "the winner's curse."
2. Three factors—legal culpability, price stabilization, and taxation—are the foundation of the three institutionally connected explanations for IPO underpricing. Companies purposefully sell their stock at a discount, according to Ibbotson (1975)<sup>5</sup>, to lessen the possibility of lawsuits in the future from shareholders dissatisfied with the performance of their shares after the first public offering. Price stabilization is referred to by Benveniste and Busaba<sup>6</sup> (1997) as "a mechanism that bonds underwriters and investors" since the underwriter's dollar fees are based on the total amount raised. Additionally, this naturally encourages the underwriter to increase the bid price.
3. The division of ownership and control is the foundation of the third group of theories. According to Brennan and Franks<sup>7</sup> (1997), underpricing enables managers to maintain control over their operations and the associated agency costs by evading scrutiny from a sizable number of external shareholders. They speculate that in order to lessen the possibility of being watched, IPO managers would like to discourage new block holdings. According to this theory, initial public offerings (IPOs) are underpriced to encourage ownership dispersion, which boosts the IPO stocks' aftermarket liquidity. Many scholars look at behavioural explanations for IPO underpricing because they are dissatisfied with the rational theories' explanations, which do not support underpricing on large scale.

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<sup>4</sup> Rock K, 'Why New Issues Are Underpriced' (1986) 15 *Journal of Financial Economics* 187

<sup>5</sup> Ibbotson RG and Jaffe JF, "'hot Issue' Markets' (1975) 30 *The Journal of Finance* 1027

<sup>6</sup> Benveniste LM and Busaba WY, 'Bookbuilding vs. Fixed Price: An Analysis of Competing Strategies for Marketing Ipos' (1997) 32 *The Journal of Financial and Quantitative Analysis* 383

<sup>7</sup> Brennan MJ and Franks J, 'Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the UK' (1997) 45 *Journal of Financial Economics* 391

4. Behavioural theories presuppose that issuers are prone to behavioural biases or that there exist "irrational" investors that drive up the price of IPO shares above their genuine value. Ljungqvist, Nanda, and Singh<sup>8</sup> (2003) make the assumption that sentimental investors have high hopes for the IPO Company's future. The issuer wants to seize as much of the excess as it can from the downward-sloping demand curve caused by sentimental investors. This analysis is improved by taking into account both hot and cold markets. They discover that only in a thriving market do IPO firms trade at a greater valuation.
5. Signalling theory provides an explanation for the extent of IPO underpricing. According to this hypothesis, the issuer wants to induce a certain level of IPO underpricing in order to "leave good taste" in the minds of investors and guarantee the success of subsequent public offerings. Welch<sup>9</sup> (1992) replicated the signalling theory argument, which states that companies purposefully undervalue the issue in order to ensure a positive response and raise money through future seasoned equity offerings. According to the model, high-quality firms indicate their firm quality by inducing a certain degree of underpricing.

### **Regulatory Framework In India**

1992 was a pivotal year for the Indian economy, both historically and economically. The federal government initiated the reform process, which served as the foundation for all policy matters and established India's economy as one of the fastest-growing in the world. The process began with the Securities and Exchange Board of India (SEBI) being incorporated and the Capital Issues (Control) Act being repealed. The Controller of Capital offerings (CCI) had complete control over the price of new offerings under the Capital Issue (Control) Act of 1947, and the disclosure standards were appalling. Issuers have the freedom to choose the issue price in accordance with SEBI regulations. Prior to 1995, the fixed price system was the only allowed method of pricing. Protecting investor interests and growing and regulating the primary and secondary markets were SEBI's principal goals upon incorporation. SEBI streamlined the share issuance process and instituted stricter disclosure guidelines and prudential standards. Many regulations have been developed, and further laws have been passed (such as the Prevention of Money Laundering Act of 2002, the Securities Contracts (Regulation) Act of 1956, and the Depositories Act of 1996). SEBI imposed further rules on IPO pricing and other limitations on promoters, like a lock-in

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<sup>8</sup> Ljungqvist A, Nanda V and Singh R, 'Hot Markets, Investor Sentiment, and IPO Pricing' (2003) SSRN Electronic Journal

<sup>9</sup> WELCH I, 'Sequential Sales, Learning, and Cascades' (1992) 47 The Journal of Finance 695

period for their ownership, between 1995 and 1996. By corporatizing and demutualizing stock exchanges, the government made the historic decision in 2001 to separate ownership and operation of stock exchanges from trading rights.

The Securities and Exchange Board of India and other regulatory bodies have focused on protecting investors and increasing market competitiveness in the global marketplace over the last few years. The employment of different pricing systems to issue shares in the primary market has been one of the main regulatory challenges. The three different pricing strategies that are utilized globally are (a) auction pricing, (b) book building, and (c) fixed price. There have been three distinct regimes, with respect to regulatory framework, in the Indian market namely the immediate post-liberalization regime (1992-1995), the initial regulated regime (1996-2000), and the reformed regulated regime (2001 onwards).

Following the economy's opening up, there was a sharp spike in demand for shares, which raised their underpricing. Throughout the various regimes, the average underpricing for fixed priced issues has been declining. The average underpricing for fixed priced initial public offerings (IPOs) was cut in half during the first regulated regime, and it was further decreased during the reformed regulated.

Considering the two distinct pricing methods, the impact of regulatory changes can be examined. In the first mechanism (fixed pricing), the issue price and total number of shares that the company can issue are strictly regulated. In contrast, in the second mechanism (book building), companies are more free to choose how much to charge for their initial public offerings (IPOs), can provide investors with variable pricing, and can even change the total number of shares that are sold to investors. Allowing the issuance of shares through the book building process was one of the main modifications made to the primary market's regulatory framework in 1998. In 2004, the corporations began using this procedure to issue shares. The primary benefit of the book-building method over the fixed price mechanism for pricing initial public offerings (IPOs) is that it incorporates market perception of the firm value into the pricing process. Thus, the book-building process of pricing is used to issue initial public offerings (IPOs) in the majority of countries. "Through book-building, the IPOs are issued in a price band of not more than 20 per cent (as per SEBI guidelines) and for a period (maximum 13 days) in which the applicants bid for the issue and after closing of the issue, a final price (called as the market clearing price) is determined on

the basis of the demand received through the applicants' bids.<sup>10</sup> The issue's offer price is represented by this ultimate cost.

As per a research conducted by Bhalla and Kaushal<sup>11</sup> (2014) average underpricing of all the issues through fixed pricing mechanism was way less than shares issued through book building process. The results are in conformity with the literature that fixed price offer can lead to higher underpricing as compared to book building offer as the market perception and mood of the investors will be considered while fixing the final issue price.

In comparison to fixed pricing and the auction method, the book building process is thought to be a superior share issuance mechanism. When using the auction pricing method, investors may experience the winner's curse because they won't know the share price that is fair. In contrast, when using fixed pricing, issuers will typically price the share at a lower value in order to attract buyers and increase demand for the shares. Investors will have more information by setting a price range for the shares through the book building process, and the company will also be able to set a price by assessing the investor base's sentiment. When determining the price range, consideration is given to the price range of shares held by rival firms as well as the anticipated value based on investor expectations of what the company can sell for. Because they are more adaptable, issuers and intermediaries are better equipped to meet individual demands. Additionally, they are able to distinguish between investors, forging a lasting relationship in the process.

“Maximum underpricing has been 1620.50 per cent for fixed priced IPO in 1999 whereas in case of IPOs issued through book building process, the maximum underpricing has been found to be relatively very less at 230.26 per cent in 2006”<sup>12</sup>. The fact that some of the largest initial public offerings (IPOs) to date have only been made through the book building method indicates that this IPO process has become more popular in India.

Underpricing in initial public offerings (IPOs) can be caused by or reduced by the regulatory framework. Due to increased government intervention, a stringent and restricted regulatory framework will cause more underpricing, whereas a reformed and free regulatory regime will

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<sup>10</sup> Bhalla, Lalit, and Vijay K. 'IPO Underpricing.' (2014) *Sch. J. Econ. Bus. Manag* 1, no. 4.

<sup>11</sup> *ibid*

<sup>12</sup> *ibid*

assist issuers in pricing their initial public offerings (IPOs) fairly, resulting in less underpricing. The aforementioned data unequivocally demonstrates that underpricing has decreased over time in India as well, as the country's securities market transitioned from a post-liberalization one to an initial regulated one and then to a reformed one. In addition, IPOs issued through the book building process often have far lower average underpricing than IPOs issued under the fixed pricing method. Since over 80% of IPOs since 2001 have been issued through the book building process<sup>13</sup>, this is the reason why more businesses have begun to choose it as their preferred IPO issuance technique since 2004.

### Conclusion

A nation's regulatory framework has a big impact on how much underpricing occurs in initial public offerings (IPOs). Issuers, investors, and intermediaries have better opportunity to capitalize on market conditions in a more reformed market. By lowering information asymmetry, the regulatory framework aids investors in making well-informed decisions. Since 1992, there have been significant modifications to India's primary market regulatory framework. The primary market in India has been able to develop and become more competitive with other developed markets worldwide because to the reform process. The aforementioned study unequivocally demonstrates that underpricing is a widespread occurrence in IPOs across nearly every nation. There are several reasons why initial public offerings (IPOs) are underpriced. To lessen underpricing in initial public offerings (IPOs), SEBI and other regulatory organizations have implemented a number of initiatives, some of which have also produced the expected outcomes.

It has also been noted that regulatory actions taken by SEBI to protect the interests of retail investors, such as IPO grading and the anchor investor, are not very successful. In the Indian IPO market, investor sentiment is a significant factor, as seen by variations in initial returns based on market phases and IPO pricing at higher or lower price points.

Although the number of companies going public in India has increased recently, we are still far behind other developed economies in this regard. As a result, IPOs are sometimes viewed more as opportunities for speculation than as ways to diversify portfolios. Furthermore, the efficiency of the Indian IPO market has not increased with the transition of the putting process from fixed

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<sup>13</sup> Bhalla, Lalit, and Vijay K. 'IPO Underpricing.' (2014) *Sch. J. Econ. Bus. Manag* 1, no. 4.

price offerings to book building. It is unfortunate that intermediaries' activism in India lacks transparency following listing. A list of comprehensive details that the intermediaries must furnish and publicize when trading shares following listing should be arranged by SEBI as soon as practicable.

The correct actions being taken by SEBI to uphold and sustain investor confidence and enhance corporate governance standards in companies will play a crucial role in the future in lowering IPO underpricing.

