Mutually beneficial move

Sebi is considering doubling the mutual funds quota in IPOs to 10 per cent. Great, but why stop at 10 per cent? Increase it to 25 per cent

It will give small investors a greater exposure to IPOs -- and lead to an increase in household savings in equities

Prithvi Haldea

Reports suggest that Sebi (Securities and Exchange Board of India) is planning to double the quota for mutual funds in IPOs to 10 per cent. Excellent move, I think. The world over, mutual funds are the investment vehicles of choice for small investors, as they are professionally managed, and they save investors from paperwork and complex decision-making.

The proposal

At present, in IPOs, a quota of 35 per cent is kept for retail investors, and 15 per cent for high net worth individuals and companies. The balance 50 per cent is for qualified institutional buyers (QIBs), within which, domestic mutual funds have a quota of 5 per cent. The current arrangement is the result of several modifications through the years.

Until August 2005, 50 per cent of an issue was reserved for QIBs, but issuers/investment bankers had the freedom to allot shares to QIBs of their choice. When it was found that this facility was being misused and mutual funds were being left out, Sebi banned discretionary allotments and introduced proportionate allotments in the QIB portion, similar to the system followed for the retail portion. Guided by the larger objective of promoting investments by small investors through mutual funds, it also introduced a 5 per cent quota for mutual funds, who could also compete for allocations in the remaining 45 per cent of the QIB category.

A study by PRIME Database of all 40 IPOs between April and December 2006 shows that mutual funds have demonstrated a healthy appetite for IPOs. In 32 issues, they maxed their 5 per cent quota, as well as got a significant allocation from the balance QIB quota, courtesy the proportionate allotment system. I think, therefore, the time is right to increase their quota in IPOs, which should be at the expense of the QIB portion.

Here's what I suggest. Increase the mutual fund quota not just to 10 per cent, but to 25 per cent, with the provision that this would be the quota not just for mutual funds, but for all domestic QIBs. This remaining 25 per cent would be for foreign QIBs (read FIIs). For PSU IPOs, the entire QIB quota should be for domestic QIBs.

The ultimate beneficiary of this recalibration would be small investors, who miss out in oversubscribed issues, who give IPOs a miss because of operational hassles and uncertainty on allotments. Indirectly, more household savings will find their way into equities.

The defence

There are many sections in the market that are opposed to such a move. Free-market exponents argue that a market is most efficient when it is left to itself. They say there is no economic logic for quotas in IPOs and that reservations don't lead to an efficient market system. All investors should have the same degree of access to the market, they add. My point, exactly. How can small investors or even domestic mutual funds be considered at par with trillion-dollar FIIs? There isn't a level-playing field, and that's why reservations are needed.

Worse, the anti-reservation believers wrongly compare the primary market with the secondary market stating the latter has no reservations. What they miss out is that, prices in the secondary market are not set by the issuer, but by the market. Secondly, there is no limitation on the number of shares available. Third, the price discovery is impacted by millions of investors at the same time.

Going further, the anti-reservation lobby argues that quotas lead to unfair gains to the beneficiaries. I would like to present two rejoinders to that view. First, reservation in IPOs was, in fact, introduced for QIBs. Till 1999, there was no classification of investors in IPOs. All applications were clubbed together, and a proportionate system of allotment was followed. It's the FIIs who pushed for a 50 per cent reservation for themselves, which led to the evolution of an investor classification system in IPOs. Two, the benefits of reservation don't just go to small investors or mutual funds. These go equally to FIIs. By demanding a ban on reservations, aren't they trying to corner all the gains?

The other argument given is that the mutual fund industry is now strong and therefore does not need reservations. Even this view is ill-founded. The industry mutual funds is still small. Its assets under management might be around Rs 3,20,000 crore, but just 35 per cent of this is in equity funds, a lot of which is corporate money. Also, in a pro-rata allotment system, mutual funds get sidelined due to the sheer number of FIIs -- there are about 1,000 FIIs, but just 30 mutual funds.

There's another view that some mutual funds have been an easy target for subscribing to bad IPOs and, therefore, increasing their allocation would actually harm the interests of retail investors. Some PSU fund houses were guilty of this practice in the 90s, but I feel this is not happening anymore. Such funds, if any, would be punished by investors in the new market environment. In any case, for the misdeeds of one or two, the entire mutual fund industry cannot be punished.

Experience and logic favour a move to substantially increase the quota for domestic QIBs and small investors, and one way to do that is by increasing the quota for mutual funds. We need to act fast as the improving health of our economy, combined with a continuing bull run in the secondary market, will ensure a continuing floatation of IPOs. Simultaneously, we need to continuously improve the functioning and transparency of mutual funds so that they truly become the preferred vehicle for our large base of small investors.