No controls on day one

Sebi's move to put a 20 per cent price band on IPO listing day is regressive. It will scuttle true price discovery and manipulators will still be on the prowl

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Price bands are a tool to contain volatility in a stock. Indian stock exchanges apply daily price bands on stocks in a varying manner: mostly 20 per cent; 2-10 per cent in some stocks. However, there are three categories of stocks that don't have limits on intra-day movement: stocks that are also traded in the derivatives segment, stocks that are in indices on which derivative products are available and new listings (on their first day only).

Of late, the need for price bands in this last category -- IPOs and stocks that are newly listed or relisted because of a financial restructuring exercise like demerger or capital reduction -- has become a subject for debate. After seeing significant spikes in new listings, Sebi, suspecting manipulation, is thinking of defining a 20 per cent band for the first day of such non-IPO stocks. The regulator has suggested that the company should get a valuation certificate from a merchant banker, which will be considered as the base price for applying bands on commencement of trading. This move itself has several deficiencies. Now it's plan to extend this rule to IPOs of less than Rs 200 crore also, which is also regressive.

Price discovery

Several IPOs have seen dramatic listing gains on their first day of trading. Of the 110 IPOs floated between January 2006 and April 2007, 104 recorded listing gains. In 70 of them, the listing day gain exceeded 20 per cent, which is the proposed price band.

The reason is simple: most of our IPOs are underpriced. For three reasons. One, 50 per cent of an issue is assigned to qualified institutional buyers (QIBs), who use their clout to force companies to lower the issue price. Second, because of underpricing, demand exceeds supply. Third, since companies now have to offload only 10 per cent of their equity to go public, the float is limited. Manipulation by some entities, as Sebi discovered while investigating trading patterns in six IPOs, might also be a reason, but probably less so and restricted to select stocks only.

If it was rampant, prices of these new listings wouldn't have kept rising. Tech Mahindra hit a high of Rs 569 on listing day, a gain of 55 per cent on its issue price of Rs 365. Nine months on, it quotes at Rs 1,372. That's not manipulation, that's price discovery. In fact, for 39 of the 110 IPOs, their price is higher than their listing day high.

Without limits

Any move to impose price bands on IPOs will tamper with the natural price discovery mechanism. In our IPO system, it is a myth that book-building leads to price discovery. Our book-built IPOs are akin to fixed price issues, except that instead of one price, it is in a 20 per cent band. The issuer fixes the price, and the market, at best, discovers it only within the price band.

Real price discovery would take place only when there is no price indication from the issuer, and the price is freely determined through an auction system. In such an auction system, a price band on the first day of listing would still make some sense. Until then, the real price discovery should take place on the listing day -- without any limits.

In fact, a price band could lead to more manipulations. A few operators could trade in the first minute at the upper end of the price band and, even on small volumes, prevent trading in the scrip for the rest of the day. They could repeat this exercise for several days. Having taken the price to a high level, they can start liquidating their positions. Price bands are anti-small investors. On listing day, a large number of small investors exit. With a 20 per cent band, they may be denied the opportunity to do so, not just on listing day, but also in subsequent days. It might even lead to a drop in small investor interest in IPOs.

It is being said that Sebi's worries also stem from the fact that the volume of trade on day one is huge, but deliveries are small; and those large volumes create artificial demand. But that's true of our secondary market, where day traders account for 75 per cent of daily turnover. If it's acceptable in a secondary market stock, it should be acceptable in an IPO also, which, when it lists, also becomes a secondary market stock.

Singling out smaller IPOs for price bands is a reflection of the bias against SMEs. It's a myth that only small IPOs attract price riggers. In the recent investigation, it was established that manipulators were active even in the large-sized MindTree issue. Sebi shouldn't be concerned with price movement, it should focus on manipulation and insider trading. And in doing so, it shouldn't kill the process of natural price discovery.

Manipulation or price discovery?

The 20 per cent price band on listing day is uncalled for. There have been crash lands after a heady start, suggesting manipulation – for instance, Nissan Copper, Lokesh Machines, Pochiraju Industries and Lumax Auto. But as the price patterns of the top 15 listing day gainers between January 2006 and April 2007 shows, these are the exception, not the norm.

	Issue price	Listing day high	Listing gain (%)	Current price	Net gain

					(%)
Nissan Copper	39	137	251.0	30	-6.6
Cambridge Technology	38	110	188.7	60	20.1
Icra	330	880	166.7	900	64.8
Lokesh Machines	140	300	114.3	130	-3.3
Pochiraju Industries	30	64	113.3	27	-4.7
Kamdhenu Ispat	25	53	110.0	31	11.4
Global Broadcast News	250	524	109.6	854	115.3
Sobha Developers	640	1,248	95.0	914	22.0
Info Edge	320	624	94.9	800	76.9
Parsvnath Developers	300	579	93.0	314	2.4
Indo Tech Transformers	130	248	90.8	352	89.5
Lumax Auto	75	143	90.7	73	-1.4
Development Credit Bank	26	49	87.3	102	156.1
Gujarat State Petronet	27	50	85.2	59	64.0
Sadbhav Engineering	185	338	82.9	519	98.7
Entertainment Network	162	288	77.6	381	76.1
Sunil Hitech Engineers	100	177	76.9	131	17.5
Plethico Pharmaceuticals	300	525	75.0	344	8.4
Reliance Petroleum	60	105	75.0	99	37.1
Sun TV	875	1,503	71.8	1400	34.9