Vyapak Desai Anil Choudhary
Nishith Desai Associates

Reforms in Indian Capital Markets

Ever since the Indian economy was liberalized in the early '90s, India has seen a tremendous growth of its capital markets with close to 5,000 Initial Public Offerings (IPOs), second only to the United States. Although the amount of capital raised during the period may have been lower as compared to that of the developed world and other BRIC nations, Indian companies have still managed to attract capital from the world over.

In the financial year of 2008, India saw the greatest year in Indian capital markets when the total capital raised went northwards of US$9 billion. However, the following years have not been very promising. Notwithstanding the impact of the global financial crisis, Indian capital markets have not been able to match the growth story witnessed ever since the liberalization of the economy till 2008. In the preceding financial year 2010, while India ranked 4th with respect to the amount of capital raised, contributing to 3.7% of global IPO share, China (which also includes Hong Kong) contributed to almost 47% of the global capital raised in IPOs. (Source: Global IPO Trends 2011, published by Ernst and Young) The above statistics provide an interesting insight into the growth trajectory of the Indian capital markets and its future role in the financial world. From 2008 to 2010, the amount raised by IPOs in China increased by 250%, but in India, there was no substantial increase. (Source: Global IPO Trends 2011, published by Ernst and Young). The writing on the wall seems to indicate that the Indian capital markets is losing its growth momentum in the post-crisis financial world and that China is increasingly becoming popular with respect to attracting foreign capital.

Possible Reasons for Loss in Momentum Pricing:
Many capital market experts have blamed the aggressive pricing of IPOs as a major reason for the loss in momentum in the primary market space. The Indian primary market has not yielded favorable returns for investors over the last few years compared to the listing premium they enjoyed before. Out of the close to 50 public issues that came out between January 2010 and March 31, 2011, securities of almost 3/4th of such companies are currently trading below their issue price. Some critics blame the moral hazard problem of investment bank's fees being linked to the issue price as a reason for such high pricing while others attribute it to the performance and fluctuations of the secondary market. While there would never be a consensus on reasons for bad performance of the recently listed companies, the issue of pricing still looms large over the Indian capital market, which needs to be addressed sooner than later.

Pricing of securities should follow the basic model of demand and supply, but there are various factors which may distort the efficient functioning of the model. Firstly, there is the issue of promoters and private equity players exiting via public offers demanding higher price for the securities offered. Secondly, there is the issue of investments bankers' fee being linked to the pricing of securities which may cause some distortions to the effective pricing of securities.

An aggressive pricing model may be helpful for short-term gains but is not advisable for the sustenance of investment appetite for a long run in the primary market. There is need for change not only in the mindset of promoters and private equity players towards a more market efficient pricing model but also in the regulatory framework providing more flexibility to issuers in pricing their securities.

The existing book-building system is only a relative price discovery model since the floor and cap price of securities is determined by the issuers and underwriters and the issue price determined is within a set price band and time period, which may not lead to a true price discovery. This may be the reason why we have seen high amount of fluctuations on the day of listing of securities, when the market participants are not restricted by a set price band. The Indian regulators may think of introducing the Dutch auction method wherein the issuer is allowed to freely price its securities and is allowed to lower the fixed price till all the securities offered by it are subscribed. The issue price would be the price at which the last subscriber purchases the securities. This method may be a more effective pricing model as there would be a much longer time period for determination of price and as it would be more aligned to the demand supply system of pricing.

In addition, for better price discovery of securities offered in public offer, Indian regulations should lay down clear and liberal rules governing distribution of research reports and road shows, which play a crucial role in the determination of price bands of public offers. As per the extant regulations, issuers are not allowed to share any additional information on road shows other than the disclosures made in draft prospectus, which restrict issuers in effectively communicating with prospective investors. A more liberal regime of road shows must be adopted by Indian laws wherein presentations made to prospective investors in road shows could have information extraneous to the draft prospectus if they are made available to the public at large by posting them on the issuers' websites. However, such presentations would have to be subjected to the liability on mis-statements and other appropriate strictures as may be provided by the regulators. Further, as is the case in the US, all oral communications made to a live audience in a road show should not be subjected to any restrictions.

Opening up of Indian capital markets, a case for development:
Both academics and skeptics would agree that the health of an economy is reflected in the performance of its capital market. Currently, India's economic growth is second only to China but unfortunately the phenomenal growth rate has not reflected in the performance of its capital market. Performance of a nation's capital market is not merely reflected by the performance of its secondary market and indices of stock exchanges, but also by the positioning of the market in the global financial circle in terms of reputation and presence of foreign companies.

If we take the example of developed nations, all of them have a robust capital market with the presence of international companies and a high reputation. The major financial hubs over the past two decades have been cities from developed nations - New York, London and Tokyo - and in the recent past, Hong Kong and Shanghai are fast emerging as the next financial centers. To take the argument further, while the Indian economy has been growing at a rate higher than most of the other economies, India still has a long way to go before attaining the status of an attractive financial hub in the world. This poses one of the major hurdles for India to progress from a developing economy to a developed economy.

China has developed its markets to make them more accessible to foreign capital. This is well illustrated by the fact that well known international companies like Glencore, Samsonite, Prada, to name a few, have approached the Hong Kong exchange for listing. As per current news reports, global conglomerates l ke Coca Cola, HSBC, Unilever and Standard Chartered are eyeing the Shanghai Stock Exchange. On the other hand, Indian exchanges are way behind to join this bandwagon. The question that begs asking is whether we would l ke these companies to come to India for listing? And if the answer is yes, are we providing a platform for international listings in India?

The current legal framework in India with respect to listing of foreign companies in India is rather onerous and since the introduction of Indian Depositary Receipts (“IDRs”) in 2000, there has been only one foreign company i.e. Standard Chartered Plc, which got listed in India. It was almost 11 years back that the concept of IDR was floated in India by way of insertion of Section 605A of the Companies Act, 1956. But even after several rounds of amendments to l beralise and lay down a detailed framework of rules to govern the issue of IDRs, Indian exchanges have not been able to attract foreign companies. There are onerous restrictions on foreign companies requiring them to have minimum pre-issue paidup capital and free reserves of USD 50 million and a minimum average market capitalization (during the preceding 3 years) in its parent country of USD 100 million, for them to be eligible to list their IDRs in India. In addition, the regulations require such foreign companies to be listed in their home jurisdictions for a minimum period of three preceding years and a track record of profitability in at least 3 years out of the preceding 5 years. These restrictions would allow only large listed foreign companies to be able to list in India, for which India has not yet evolved into an attractive dual-listing venue. India should either relax these rather onerous restrictions for listing of IDRs or set-up an alternate exchange on lines of the Alternate Investment Market of the London Stock Exchange and the Growth Enterprise Market of the Hong Kong Stock Exchange, which allows for smaller foreign companies to get listed on their exchanges with no requirement of prior listing on home exchanges.

India should also provide a forum for listing of common shares of foreign companies in India. Currently, only common shares of Indian companies can be listed on Indian exchanges. In an increasingly globalized world where most multinational foreign companies have business presence in India, they should also have the opportunity to be listed on Indian exchanges and thereby assist in increasing India’s competitiveness in the global securities market. There are two major schools of thought with respect to increasing the competitiveness of a securities market, the proponents of the ‘issuer choice’ approach and advocates of the existing legal regime where foreign issuers would be subject to the local laws. While the current Indian legal framework subject foreign issuers to local Indian laws, it is argued here that an issuer choice regime would be more beneficial to develop the struggling Indian capital market.

Why Issuer Choice?

Under the system of ’issuer choice’, a foreign issuer could choose the regulatory regime under which its securities would trade, which may be their home country laws or any other recognized system of securities laws. There are two major variance in this broad proposition; (a) foreign issuers have complete freedom to choose the regulatory regime they prefer and would just be required to disclose their choice and (b) foreign issuers do not have complete freedom to select the regime they prefer, but would be offered ‘portable or selective mobility’ whereby host countries may require issuers to select from a menu of approved regimes. India should move towards a ‘selective mobility’ route as there may be less developed capital markets regimes in certain countries which may not be fully efficient. Under complete mobility, issuers may have an incentive to choose a low disclosure regime of its home country to reduce its cost of compliance and to reduce its potential liability. Therefore, India should allow foreign issuers to choose selective regulatory regimes l ke that of U.S., U.K, EU, from a menu of choices. This would not only reduce the cost of compliances of multiple regulatory regimes with respect to disclosures and adaption of accounting standards but also help in attracting more foreign companies in India.

Regulatory hurdles

The regulations governing public offers have recently witnessed an overhaul by the introduction of Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009. However there still remain a plethora of disclosure requirements and restrictions on issuers, which at times make it difficult for them in their decision to go public.

Some of the regulations which demands immediate attention are (a) extensive disclosure of information on promoter group of issuers, which are onerous and time consuming (b) lock-up of bonus shares or equity shares arising out of conversion of convert ble instruments issued to existing shareholders one year prior to the filing of the draft prospectus (c) rather broad definition of ‘promoter’, which does not explicitly exclude private equity players.

Relaxation of these norms would provide access to a lot more companies to get themselves listed on the Indian exchanges, especially to companies that have got private equity investments. The regulator, in a welcome move, has conceptualized a framework for listing of small and medium scale enterprises and thus, as a corollary should also further liberalize norms for funds raising by large listed companies by providing a higher time frame, like for a year, for the validity of the their prospectus - similar to the WKSI model of the US.

Corruption and scams:

There would be a universal consensus amongst all players in the capital market that the outlook of India has taken a severe blow due to outbreak of corruption cases against Indian public officials and more so because of the involvement of corporate leaders in such corruption scandals. With the recent scams of Satyam and 2G, there is a growing lack of confidence of global investors in the Indian securities market due to the fear of potential liability under their local anti-corruption legislations.

The Foreign Corrupt Practices Act of the U.S. and the Bribery Act of 2010 of the U.K. (which is to come into effect on July 1, 2011) have far reaching territorial scope and may be invoked even if the corrupt practices take place outside their home jurisdictions. The provisions of the U.K. Bribery Act impose strict liability on companies with UK "connections" for lack of adequate procedures to prevent bribery. In backdrop of the above, there has been high skepticism amongst the foreign investors about the safety of their capital in India and about the possible cause for the recent drop of foreign participation in Indian capital. The issue of tackling corruption is more of a cultural problem associated with India and probably a phase which should hopefully take a backseat once corrective actions in form of prosecution and stricter anti-corruption legal framework are adopted by the Indian legislature in the form of the Lokpal Act.

Closing remarks

Reforms of the Indian capital markets have long been overdue; l beralization of onerous disclosure requirements, better price discovery mechanism and entry of foreign companies in Indian markets would provide the necessary fillip for overall growth of the economy. An active market for foreign companies in India is likely to attract investment from wider avenues, both domestic and foreign and consequently be beneficial to domestic companies already listed or waiting to be listed on Indian bourses. Greater participation from global institutional investors also assures greater liquidity and enhanced reputation of the market, leading to better valuations for companies listed on Indian exchanges. In addition, such reforms would also have ancillary benefits l ke job creation in financial cities of India and exposure to global best practices in corporate-securities law.