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IPOs In Compulsory Demat Mode

How Fair For The Small Investors?

Sachin Agarwal *

Abstract

The SEBI ruling requiring issue houses to issue public offerings (IPO's, new issues, etc.) in compulsory demat mode has created an anomaly which keeps the small and long-term investor out of the game. The benefits that would have accrued to small investors are snatched away by the larger & powerful players. The IPOs of banks and companies like Maruti Udyog, NTPC and TV Today etc. had claimed to target the small investor, but the small investor had in fact been a mere conduit to channel the holdings to larger players. This defeated the objective of creating wide-spread public participation and holding in the disinvestment of profitable stocks.

Based on actual market study and observations of the author, this case study raises vital and provocative policy issues such as: Who is the beneficiary of IPOs in compulsory dematerialised mode? It also highlights the failure of SEBI (the Securities Exchange Board of India), depositories and the major stock exchanges in addressing the cause of the small and marginal investors beyond lip-service and cosmetic efforts like framing rules for orderly 'development' and 'regulation' of the capital market. This study suggests some practical solutions to correct the anomaly.

INTRODUCTION

Since the Initial Public Offerings (IPO) period boomed in the nineties, "the retail investor has long been a creature in whose name countless laws, rules, regulations and articles have been written." The dematerialisation of share which started in 1996 has been one such area. It has always hogged the limelight. Having provided respite from some of the perennial, investor strangulating worries of the stock market, this phenomenon is largely touted as a god-send panacea for investors. On the flip side, dematerialisation brings along a host of problems: High cost

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of operations and transactions, poor service quality and non-delivery of the promised benefits are the commonly alleged accuses.

In India, dematerialisation grew on the fertile turf of commercially favourable regulation. While being touted by the regulator (SEBI) and the principal player NSDL2 as a phenomenon being promoted for the benefit of the small investors; in reality investors were caught unaware when, within a year of inception of dematerialization, SEBI issued orders for compulsory trading and settlement in demat mode. Investors were left bleeding and coerced into accepting the switch-over3. No doubt, cosmetic efforts have been made by the market regulator to wipe a few tears of the small investors. One such example is the setting up of a separate window on stock exchanges for trading in small quantities of physical shares4. But, for all practical purposes this facility does not hold any relevance as neither stock exchange nor their brokers prefer to trade on that window. As a result investors are forced to incur high costs for availing the demat services even for mundane stocks.

SEBI rules now require issue houses (companies issuing securities like shares, debentures etc.) to issue their securities in demat mode. This means that there will be no primary issue of securities in the physical format. As a consequence, the Initial Public Offerings (IPO's) of shares of banks and companies like Maruti Udyog, NTPC and TV today etc. (to name a few) were ab-initio issued in demat mode. The application forms of these IPO's required the applicant to quote his demat account number, failing which the application would be rejected.

This requirement creates a serious anomaly that keeps the small investor in a disadvantageous position. The practices adopted by the Depository Participants (DPs) and by extension, also by the Depositories are such that the small investor largely remains away from the game. Even if an investor joins the fray he is merely used as a conduit for channelling the allotted stocks to larger players. Larger players actually make more money without even investing in the initial stage. As a consequence a number of anomalies are created which harm the small investors. To cite a few:

a) A new investor has to shell out money for opening a demat account even with no certainty of ever holding any security.

b) Small investors lose their money if no allotment is received by them and also any prospects of future gains.

c) The very purpose of creating widespread public holdings of shares of profitable companies put on the block in the disinvestment process get[5] defeated.

d) The practice also keeps the marginal investor away from sharing in the prosperity of these stocks as most remain fence sitters.

e) The extent and reach of depository participants being limited to big and metro cities largely leaves out the investors from small town5 from participating in the IPO.

THE PRACTICE ADOPTED BY DEPOSITORY PARTICIPANTS

The primary market has been lack-lustre for the last few years. Therefore, at the time of initial public offering (IPO) of banks or PSU stocks like Maruti Udyog and NTPC or of leading companies like TV Today of Aaj Tak fame, there are a large number of investors who wish to apply. As SEBI's rules now essentially require the quoting of a demat account number in the Share Application Form, investors who do not have a demat account and wish to apply in the IPO market are solicited by DPs who design a 'special scheme' for the purpose of tapping this lucrative business opportunity. Table 1, gives an actual profile of this 'special scheme' and its charges as compared to the regular schemes of demat accounts as offered by two DPs. For the purpose of this study one DP of National Securities Depositories Limited (NSDL) and another of Central Depository Services Limited (CDSL) operating from Lucknow were considered. As the validity of the accounts in this 'special scheme' is only for three months, this 'special scheme' is popularly known as 'short term

Table1 : Comparison of Charges of Depository Participants

Panel A: Sykes & Ray Equities Ltd., Lucknow (A DP of CDSL)			
S.No.	Particulars	Charges in Special Scheme (Rs.)	Charges in Regular Scheme (Rs.)
1.	Cost of form and Stamp Paper	30	30
2.	Account Opening Charges	50	100
3.	Annual / Maintenance Charges	100	300
4.	Sub Total (1+2+3) =	180	430
5.	Service Tax @ 10.2% (On item number 2 & 3 only)	15.3	40.8
	Total (4+5) =	195.3	470.8
	Custody Charges	Nil	Nil
	Validity	3 Months but extendable	12 Months (Renewable)
Panel B: Karvy Consultants Ltd., Lucknow. (A DP of NSDL)			
S.No.	Particulars	Charges in Special Scheme (Rs.)	Charges in Regular Scheme (Rs.)
1.	Cost of form & Stamp Paper	105	105
2.	Account Opening Charges	100	100
3.	Annual / Maintenance Charges	125	300
4.	Sub Total (1+2+3) =	330	505
5.	Service Tax @ 10.2% (On item number 2 & 3 only)	22.95	40.8
	Total (4+5) =	352.95	545.8
	Custody Charges	Rs. 1 per ISINi per month	Rs. 1 per ISIN* per month
	Validity	3 Months but extendable	12 Months (Renewable)

account' amongst the investors and market players.

Source: Market Survey by the author.

ANALYSIS

Pre-issue position

The data in Table 1, shows that any person who does not have a demat account and wishes to apply in an IPO has to immediately spend at least Rs. 195 if he wishes to open demat account with a DP of DSL, and at least Rs. 352 if he decides to open a demat account with a DP of NSDL. It is clear that merely having a demat account does not guarantee allotment in an IPO. Thus, if the investor does not get any allotment in the IPO, the money thus spent on opening a demat account is wasted. The average profile of investors is that he is cost averse and stays in for long term. Therefore paying the charges for opening a demat account is against the normal behaviour of the investors.

According to a survey conducted by the Society for Capital Market Research and Development (SCMRD) authored by Prof. LC Gupta and Naveen Jain, published in the Economic and Political Weekly (EPW) dated 17 May 2003, as large as 36% of the investing population does not have a demat account. As a natural consequence, these investors are either left out of enjoying the benefits of investing in IPO or they are an easy market for the DPs and the depositories, every time an IPO is floated. Talks with the DPs under study reveal that there is a spate of investors who queue into their offices to open these short term accounts, as getting shares of that 'good company' or bank is the immediate objective of these unsuspecting investors. The regular account is generally ruled out as most of them are occasional investors who wish to take part in IPOs6 . The habit of retail investors to prefer to apply for shares in small quantity but in different names also means that the coffers of the demat service providers swell manifold for each application a new demat account has to be opened.

In view of the large oversubscriptions to the IPOs it is also a logical conclusion that a huge amount of money is drained out from the pockets of the small and marginal investor. For example in the light that the IPO of TV Today Media Ltd (AAJ TAK) which was oversubscribed by 36 times, consider the following statistics.

1. The issue size was: 14,500,000 shares
2. 30 percent of it is reserved for the small investors[7].
3. Therefore the number of shares available to the small investors

- (14,500,000*0.3) = 43, 50,000 shares

4. The issue was oversubscribed by 36 times.
5. Therefore total shares applied by the small investors is
   - (43,50,000 * 36) = 156,600,000 shares
6. Assuming that the average size of application by small investor is for 200 shares[8].
7. Therefore 156,600,000 / 200 = 7, 83,000 small investors have applied for the shares.
8. If the findings of the study of Prof. LC Gupta and Naveen Jain are considered then a large number of people are left out of participating in the likely fortunes of the capital markets or else they go on to open the short term account with a DP.
9. 36 percent of 7, 83,000 = 2, 81,880 people opened the short term DP account.
10. Average of charges for short term account with the two DPs under study is (353+195)/2 = 274. Let's take it to Rs. 250, on a conservative estimate.
11. Therefore the two depositories and their DP collectively make (250 * 2,81,880) Rs. 704,70,000 even when the investor has not made a single rupee[9].

The above statistics may be based on some (not all) hypothetical assumptions but they reflect the plight of the common investor. The reality is bleaker, as this is a statistical presentation for only one IPO. Many IPOs have hit the market since the compulsory demat mode was prescribed for them and a good number of them are in the pipeline. As the feel-good factor engulfs the economy there is all likeli-hood of many hitting the market in the near future10. Each time the investor will loose money, while the depositories and their participants will get richer as the number of refund orders received is going to be higher than the number of allotments in the IPOs.

Post-issue position

The small and occasional investors' worries are yet not over. Those who are not able to secure allotment lose the money they paid to the DP for account opening and it's the end of the game for them. For those who are able to secure allotment: if applying for shares was a costly option then holding is even more costly, thanks to high custody charges of NSDL and the stipulation of three months for the demat account comes trailing to its end. If an investor decides to hold the securities for a duration exceeding three months, he has to pay additional Maintenance and Custody Charges (Refer to Table 1). As a result, a large number of investors exit from the scrip as soon as they receive the allotment or within a very small time of receiving the allotment.

If stock exchanges function on the principles of demand and supply then this mass exodus of the small and marginal investors is bound to leave its impact on the price of the scrip. By extension it means that the exit from the scrip is actually loss of money because in most cases the prices of shares in the IPO firm up after some period. In this catch 22 situation the investor is perplexed. If he holds the shares he pays much in custody charges and increased maintenance charges of DP, and if he sells them he looses prospects of future growth and participation in growth.

The SCMRD survey also shows that between one-half to two-third shareholders across all income and age groups are long-term investors. So if the investors in IPO are forced to exit prematurely it is against their normal behaviour. This means that given a chance these small investors will emerge as long-term and loyal shareholders.

ANOMALIES CREATED BECAUSE OF THE IPOs IN COMPULSORY DEMAT MODE

- Many prospective investors thus remain out of the primary market. They have thus been deprived of the opportunity of investing and gaining by participating in the IPOs in recent times. This raises doubts about the so-called 'revival' of the primary market. The revival of primary market as projected by the SEBI and the government is actually partial revival and not a complete revival, as a larger number of prospective investors are excluded in the process and only the enterprising kind who are willing to take chances by opening a demat account, are able to participate in the game. "For the majority of retail investors, the demat system is a white elephant."11

- Those who wish to participate only in the IPO generally go for a short-term demat account valid for three months. They end up paying charges as enumerated above. There is always an uncertainty of getting allotment in the PO. Those who do not wish to risk their hard-earned money due to this uncertainty stay out. The cost of demat account opening has to be borne even if there is no allotment of shares.
- Small investors are being fleeced and the coffers of NSDL, CDSL and their DPs swell beyond proportions. Investors shell out money at the time of applying in the IPO even though there is no certainty of allotments.
- Due to the short validity of the demat account, many investors who are able to secure allotment in the issue are forced to exit early. Immediately after the confirmation of allotment and the listing of the security on offer, small and marginal investors rush to the broker to sell their newly acquired assets. This wide-spread exodus creates a selling pressure on the market and the security price is likely to be suppressed. So the small investor is not able to reap full or matured benefits out of his investment as the exit is neither voluntary nor an informed decision. Rather, it is dictated by the chasing deadline of three months.
- Should anyone decide to hold the security for a longer duration (exceeding three months) then he has to pay the additional

Maintenance and Custody Charges.

- In the process the scrip generally gets accumulated by the large and institutional players. They actually acquire shares from the small investors who have got the allotment after incurring substantial cost but were forced to exit early from the scrip due faulty regulation of SEBI.
- The promised public benefit in the disinvestment of shares offered in recent times is nowhere in sight. At all stages the small investor is in a disadvantageous position. He cannot apply, get or hold shares without incurring a considerable cost just for opening and maintaining a demat account. The much hyped profit of the small investor is taken away by the depository system and more so by the SEBI diktat that requires issue houses to issue new securities only in demat mode.
- To quote from the cited article in EPW:

  "The whole depository system in India seems to have been designed mainly keeping in view the needs of frequent trader and speculator rather than the needs of the long term investor who may trade only once in a while."

  In this case also the benefits of changes and new technology in financial markets are restricted to a select few12. The larger population of investors remains sitting on the fence and if it decides to join it has to suffer.
- Investors in remote and far-flung areas who wish to participate in the IPO will find it difficult to do so, because the coverage of the depository system is only limited to metros and major towns. According to the findings of a survey conducted for SEBI by the Consumer Education and Research Centre (CERC), Ahemdabad, it is now a known fact that DP facility is not available in many small towns. A case in point is the city of Jaunpur, which is just 55 km

from the legendary city of Varanasi. Jaunpur town has a University but no DP. Any investor wishing to deal with a DP either has to go to Varanasi or the state capital at Lucknow, which is 230 km away. The situation means incurring extra cost by the investor. One goes to Varanasi or to Lucknow or deals through post. Either way it is a frustrating exercise and the best option is to forget investing in the IPO.

WHO BENEFITS FROM IT?

Bound by the demat account rules the small and marginal shareholder (allotees in the IPOs) are forced to exit the scrip at low levels and are not able to reap the benefits of long term investing. So the vital question is who gets benefited? A popular maxim of the market is: 'somebody's loss is somebody's profit'. As small investors lose their holding, the bigger ones start accumulating the scrip. They buy from investors and hold. After most small investors have moved out and eventually when the supply of such scrip gets controlled, the 'dealers' get out to take charge and the price movement benefits them the most.

The shares of small investors actually get channelled to larger players, who have not even borne the initial risk of investing. Small investors get only a very nominal part of the gains. The small investor thus, becomes a conduit for funnelling the equity to big players. The bigger ones get the shares without bearing the risk in making the original investment, the cost involved and the wait period before allotment.

COSMETIC EFFORTS BY SEBI AND EXCHANGES TO WIPE INVESTOR TEARS

There is a SEBI ruling on allowing small investors, who hold less than 500 shares of a company in physical mode, to trade on a separate window at Stock Exchanges. But, in this case the SEBI has actually closed all chances of ever holding the scrip in physical mode.

(If shares are originally issued in demat mode, how can the small investor take advantage of the SEBI ruling allowing trade of small quantities in physical mode). Understandably, this rule was a cosmetic effort to wipe a few investor tears which started to fall unabated in the initial stages of the securities depository system in India. In practice neither the brokers nor the exchange take any interest in trading on this 'separate window'. If at all the brokers do so, they charge exorbitant prices. Investors complain of having been asked to pay as high as 7 to 10 per cent of the trade value if transaction is made on this window. This forces investors to go for the next best option and open a demat account. Either way there is no respite to the small investor who continues to be extorted inside plush offices.

On the other hand, brokers fear Bad Delivery 13 that may arise in case of physical shares and thus restrain from transacting in that window. When questioned, the regulator safely takes refuge behind the ruling document and blames others for its own failures. This is a perfectly fit case of cosmetic regulation, i.e., having a ruling and still not being able to deliver the intended benefit to the target audience.

The SEBI and the Stock Exchanges hardly did anything to redeem this anomaly. What actually transpires at the ground level is quite different from what is envisaged at the planning level. Our market regulator entrusted with the responsibility of "regulating and developing the capital market" has paid little attention to this area. From the beginning, by making the trade and settlement of transactions in demat mode compulsory, SEBI has actually created a commercially favourable regulatory environment for the depository system to flourish in India. The coffers of depositories and DPs swelled while the small investor got crushed. This diktat of issuing securities in IPO compulsorily in demat form is an extension of the commercially favourable regulatory regime.

In this case it has failed on many counts. The failure to regulate the near monopoly actions of the depositories and their DPs, the erring brokers, from allowing the legitimate trade of small quantities of shares in physical mode and the exchanges being a mute spectator to the plight of the investor, is now more than exposed. For SEBI, development of the capital market actually means the development and prosperity of bigger players and fleecing small and marginal investors. If while framing the law, the regulator itself is not keeping the larger interest of small investors in mind, then who else is expected to listen to their already subdued cries?14

SUGGESTIONS

1. As the present system of compulsory issue of securities in demat mode is disadvantageous to the small investor, SEBI should immediately do away with this stipulation and allow issue houses to issue securities in physical mode, specially for very small and marginal investors.
2. The stipulation may be made on investors who apply for more than a certain quantity of shares. Say, for example the investors applying for more than 500 shares may be asked to compulsorily quote their demat account number. Small investors (say, below 500 shares) should be allowed to apply, hold and transact shares in physical mode.
3. A study be conducted at The Stock Exchange, Mumbai and National Stock Exchange of trades executed in the special window (for trade in physical shares). The study should cover the transactions made through this window in the past 6 years. Data from this study be compared with the number of demat accounts with NSDL or CDSL in which small holdings of shares (between 1 to 500 shares) were dematerialised in the same period. This will actually bring out the truth that how effective is/was this cosmetic facility which was seemingly provided to the small investor for his benefit. The value and volume of shares traded on this window when compared with

the value and volume of shares dematerialised will actually leave no scope for speculation.

4. This study also explains one of the reasons as to why shareholding is becoming the prerogative of the people living in metros and large cities. Why don't the benefits of capital market reach small and sub-urban areas? Small cities have a lot of investible surplus, which can be channelled into the capital market, but the strangulating rules actually curtail their participation. To ensure that people from small towns also participate in the profitable IPOs the SEBI should immediately do away with this draconian requirement of IPOs in compulsory demat mode.
5. A study of the beneficiary account holders of the depositories must be conducted to find out how many have sold their shares within 3 months of allotment and closed their account. The study must also question the abnormally large number of demat accounts being opened at the time of IPOs in recent times and the causes behind these accounts disappearing soon after the issue be also investigated.
6. SEBI should be more sensitive to the needs of the small investors and restrain itself from indulging in cosmetic regulation of the market. SEBI's practices are like the companies who fill their Annual Reports with glossy pages and use phrases such as "your company" to address the shareholders but actually no part of the company belongs to the investor or to quote Prof. LC Gupta, "The apathetic attitude of the Indian Stock Market authorities towards the large mass of small investors reminds me of the French Queen Marie Antoninette who, on being told that the people could not afford bread, is reported to have asked why don't they eat cakes."
7. Stock exchanges should also share their responsibility in the process of development of financial markets. How can the market develop if its backbone the small investor is driven away? Stock exchanges would do well on their part if they conducted investor surveys at

regular intervals and got to know about the problems faced by them in trading and from the brokers etc. Loosing the small and long term investor shall be detrimental to the market as they are the permanent strengths of the market.

CONCLUSION

The cited problem being caused collectively due to high charges of depositories and the skewed regulation of SEBI leaves the small investors in a sorry state. It is sad and disturbing to see the fleecing of small investors in the market of securities. Everyone seems to have forgotten the small investor who is an integral part of the capital market. The regulator's very existence was to focus on this segment. But the focus is lost and nobody cares for them. The SCMRD survey reveals that the shareholding population in India is on the decline. Due to the excessive focus on big operators, small investors feel let down on all fronts. Be it the sensitivity of market players like exchanges, brokers and issue houses, or the lack of orientation of the regulator.

Regulation should aim at making the target audience better-off but in the cited case it makes the small investor worse-off. Unless this anomaly is corrected, marginal investors will stay away from the market. A strong and vibrant investing population can make the market robust. Market players and regulators fail to understand this ground rule.

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Notes :

[1] Dhirendra Kumar, CEO, Value Research, writes in the Economic Times dated January 06, 2004 on a debate entitled "Is the retail investor driving the stock markets?"

[2] National Securities Depositories Limited, the leading depository of the country. For all practical purposes NSDL is the only player in the market as its competitor Central Depository Services Limited (CDSL) is a mere follower. CDSL lags far behind in number of client accounts and reach and as such it is NSDL who dictates the terms in the demat market.

[3] From the survey conducted by the Society for Capital Markets, as published in EPW, Volume XXXVIII Number 20, May 17, 2003 apart from other things the startling fact that is brought to light is that majority (56.6%) of the shareholders who responded still preferred to hold shares in physical form. Thus, belying SEBI and NSDL claims that dematerialization is the panacea for small investors.

[4] Small quantities as per SEBI guidelines are 500 shares per investor.

[5] International Security Index Number: The unique code allotted to each security which distinguishes it from any other security. For understanding, it can be equated to a folio in a ledger.

[6] To quote Prithvi Haldea from the debate in Economic Times, "One area where retail (investor) is definitely participating in a big way is the primary markets"

[7] Initially the offer document said that 25% of the issue shall be reserved for the retail investors but keeping in view the massive oversubscription

the share of retail investors in the entire issue was increased by 5% reducing the share of Qualified Institutional Bidders (QIBs) by a similar percentage.

[8] Range of small investor is assumed to be being between 100 500 shares. A minimum lot of 100 shares can be applied for and then in multiples of 100 thereof.

[9] In the debate cited above, Prithi Haldea, Managing Director of Prime Database writes that the increase in depository accounts to 48 Lakhs now (January 2004) up from 40 Lakhs in March 20003 is largely ascribable to the large number of IPO applicants between April 2003 and October 2003. IPOs of three banks and Maruti Udyog opened between this period, garnering a mind boggling 22.78 Lakhs applications.

[10] As per the information available from www.moneycontrol.com , the IPOs of Gas Authority of India, Oil and Natural Gas Commission, NDTV, Patni Computers are a few to name.

[11] Prof. LC Gupta writes in the above mentioned debate.

[12] As the SEBI-NCAER survey of Indian investors has shown that the number of individual shareholders has decreased from 23 million in 1998-99 to 19.5 million in 2000-2001. It can be an indication that the depository system has started the process of exit of the small investor from the capital market.

[13] Bad Delivery refers to the state when the securities (in the physical form) are sold and offered to the buyer (either through the Stock Exchanges or otherwise) could not transferable to the name of buyer due to some technical reasons like signature difference or old / date expired Share Transfer Form or forged or stolen shares. In fact this was one of the major problems and the principle reason because of which the depository system was started in India.

[14] "The small investor now accepts that he neither understands the corporate sector or the economy and that it is unwise to be in such a place, more so when the regulatory redressal is slow or inadequate."