

ANNEXURE NO. 9

LEGALISING GRAY MARKET⁴

Tradeable card :-

We can best describe a system with tradeable cards by showing public issue process as it would then operate

(1) When an application form is submitted for the public issue, there would be no name or address attached. Application money would be paid and the applicant would be issued one credit-card style plastic card for each 1000 shares applied for. The card would merely be proof of having applied for 1000 shares of a given public issue, the applicant's name would be the only proof of having applied for a thousand shares.

(2) The card would be fully and legally tradeable. The issuing company would not make any attempt at tracking how the card changes hands. Tradeable cards would give investors an exit route after the public issue but before listing. This would eliminate liquidity premium components of IPO underpricing. Organisations like the OTCEI could offer two way quotes on these cards, thus creating publicly available price quotes.

(3) At some point in time, which we shall call "redemption date", the company would announce the allotment for this public issue. Under proportional allotment, it would per force have to be an allotment rule of the form "n" shares for each card with probability "y". Regardless of the degree of oversubscription, we can find probability "y" which makes "n" trading lot. The merchant bankers would be required to give out the list of cards which won allotment in electronic form to any one who asks for it (eg. the OTCEI and similar gray market participants, electronic

informations companies, newspapers etc) The moment this advertisement appears, the market value of the cards which got no allotment would drop to the refund they are entitled to, and the cards that have got allotment would start trading at the price of "n" shares

(4) Once the card has appeared, the person who holds the cards would walk up to a publicly accessible machine, which is like an ATM machine, where he inserts the card, type in his name and address, and (on the spot) is issued share certificates. A less high tech-way of implementing this same step would be to have human operator at a window who would take the card, type in the name and address of the customer, and issue share certificates

This style of share allotment eliminates the entire difficulty of the postal system, where by shares often get listed before all applicants have got share certificates. In this system, SEBI could ensure that these machines are giving out share certificates a full week before the listing date. The cards which have no allotment would be accepted by this machine, and a refund cheque would be given to the customers.

This system achieves a "full legal" gray market for trading in these cards, price discovery could easily coalesce around institutions like the OTCEI who would offer two way quotes on these cards

Price Discovery:

The market price of tradeable cards at a time 't' would be 'P_t'. How does this connect with price at first listing ? The financial contract here can be represented as follows 'T' days from now, at redemption date, a lottery will be drawn and with probability 'y', the card will become worth the refund money 'R', with probability '1-y', it will become worth 'n' shares of the company

Using informations available at time 't', including the market price of the card at time 't', we would like to estimate the price at first listing. This problem appears to be well-posed once the allotment rule is made public, so that 'y' and 'n' would also

be known. Unanticipated delays in allotment, would be a complication. However, it does appear that pricing algorithms could be constructed which infer the price at first listing as a function of the market price of the cards. Thus, there appears to be a clear connection between price discovery as applied to the cards and price discovery at first listing. The policy implications of this reasoning are:

(a) Knowing y and n is absolutely crucial for mapping the card price to the listing price. A very short time after the issue, the firm should announce the allotment rule, i.e. the probability that a given card would win allotment, and the number of shares that successful cards will get.

(b) Uncertainty in T is also a hurdle, though not an insurmountable one. As early as possible the firm should announce the redemption date (the date at which the advertisement showing the list of successful cards appears and when the machines start accepting cards and issuing shares).

Difficulties of these system:-

- 1 Such cards would not be legally tradeable under the present legal system.
- 2 Merchant bankers would have to install the ATM like machines, which accept the cards and print out share certificates. It is not possible to predict where a given customer will go to present his cards, so the unique identifying numbers on the share certificates must be chosen only at the instant the card appears before the machine. These machines would need reasonable computer networking nationwide.
- 3 This system is biased against gray market participants in small towns, who would have to travel to a larger city to use the certificate-issuing machine.
- 4 There is a real risk of monopoly controlling the network, that network would then earn monopoly rents.

5 This system does not allow small investors to participate. Cards worth an application of 100 shares could easily be cumbersome and application of 1000 shares may be out of reach for many investors.

6 The cards are like money, with problems like theft, loss or destruction and counterfeiting. If a criminal could manufacture these cards, then the counterfeit cards could be a serious problem. The best line of attack in deterring this seems to be to define specifications for the cards which makes the manufacturing process for these cards relatively convoluted. This would make it difficult to set up small scale counterfeiting operations.

Authentication procedures have a role here. With authentication procedures, the criminal would not be able to read the list of cards which won allotment and mass-produce the winning numbers. The only recourse he would have is to buy a card from the market, read the (encrypted) number on it, and replicate it. This is slower and more difficult, and hence reduces the rate of return in the forgery business.

Initialisation:-

Thus tradeable cards appear to be a useful idea “once well established”. It may not be difficult for such a system to come about on its own, once legal impediments are removed. From the view point of an investor, a public issue which works with tradeable cards is more attractive because of the liquidity obtained.

From the viewpoint of firms competing for resources in the primary market, tradeable cards are attractive because they would help attract investors. By eliminating the liquidity premium, they would reduce underpricing (the issuer would obtain a better price). By improving price discovery, tradeable cards reduce price volatility of the stock price upon first listing.