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RETAIL INVESTOR - A LOST SPECIES

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ABSTRACT

Everybody in India seems to be looking for the retail investor to come back to the market. He is badly needed because he is the major (rather only) source of providing risk capital. Portfolio managers (including FFIs) only shuffle around the holdings in existing scrips, but do not inject much needed risk capital to upcoming enterprises to undertake new industrial activity. It is the retail investor who provides this capital either directly by investing in equity market or participating through institutions (i.e. mutual funds).

Since the advent of SEBI, regulatory philosophy has changed from merit (administered) to disclosure (marked based). Since there is asymmetry of information between issuers and investors, disclosure philosophy presuppose existence of a matured and vibrant financial analyst industry. Professional analysts help the investor to decode corporate information and investigate beyond stated information, particularly in the absence of uniform accounting standards.

Since institutional investors and retail investors do not have expertise and resources to fully understand the information, retail investors in a market-based system generally participate through mutual funds. In India, institutional accountability to investors has been dismal and the regulatory framework has repeatedly failed to provide effective and timely remedies. Retail investors, though enthusiastic in the beginning, have lost faith in mutual funds for equity investment because of many ugly episodes.

The evolving regulatory framework in India is serving mainly institutional interests, sometime even at the cost of retail investors. To win the retail investor's confidence, the style and functioning of SEBI will have to change. The interests of the retail investor must get primary in SEBI's rule making processes.

RETAIL INVESTOR- A LOST SPECIES

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The finance ministry, SEBI, capital market reformists, seminar/conference speakers, media commentators - all are looking for the retail investor to come back to the market. He is badly needed because he is the major (rather only) source of providing risk capital. Portfolio managers only shuffle around the holdings in existing scrips in their basket based on their subjective evaluation of relative valuation of various scrips, but do not inject much needed risk capital to upcoming enterprises to undertake new industrial activity. Even foreign institutional investors (FIIs) generally bring capital in the country to acquire shares in existing profitable companies but do not provide risk capital to the corporate world. That task is left to the retail investor i.e., the household sector.

There are two ways through which household savings get converted into risk capital which funnels the industrial growth. One, the households invest in fixed income deposits/instruments and somebody else who has access to these funds (financial intermediaries like banks or non-banking financial companies) takes the risk by contributing to the equity capital of new enterprises. The other is where households themselves take the risk either by participating directly (holding shares in individual names) or through collective schemes (popularly known as mutual funds) by pooling their resources.

In the first three decades of India's independence, household savings were mostly mobilized by the banking network throughout the country. The government

gave complete assurance to depositors about safety and liquidity. Returns were guaranteed and known in advance. Banks acted as intermediaries which in turn provided funds to the developmental financial institutions to subscribe to the risk capital.

A major break came in 1977 when FERA companies were asked to dilute their shareholding at prices determined by the Controller of Capital Issues (CCI). Household savers particularly those belonging to enterprising communities, directly participated in equity markets. This was followed by successive equity issues of Reliance and other bluechip companies where again investors made sizable profits. However, there were also issues (particularly those of lease companies and others) where investors lost money. On balance, investors were still making the money. It is a universally recognized phenomenon that when access to capital market is not adequately regulated, good issues do get underpriced to make up for lemons, as the investor is unable to differentiate good from bad at the time of subscription. With an administered price regime, return vis-a-vis risk in the primary market was still in favour of the investor.

In 1992, CCI was abolished and SEBI was created. As part of the liberalization process and setting the tone for rest of the economy, emphasis was put on market forces. Anybody could enter the market and sell shares at prevailing market prices; sometimes even at higher prices, if promoters could sell the dream. Prices went dizzy high because of manipulation (funds provided by the bank scam), everybody was in a mood to make money. Greed became the norm. SEBI also

wanted to accumulate funds so that it could be free from governmental budgetary support. Without exercising due diligence it gave licenses to anybody who could satisfy capital norms and wanted to become merchant banker, underwriters, registrars etc. It also collected a hefty fee on prospectuses. Anybody could style himself a promoter, file a prospectus, and collect the money from the public. Financial journalists were busy collecting their gifts during roadshows and merchant bankers their fees. Stock exchanges collected listing fees without worrying about the bonafides of the company. Emphasis was not on the project, but on rosy projections.

Investors were also happy. With rising stock prices, they were making huge paper profits, and there was all around prosperity. The only difference was that all other players in the market were taking out the money from the market to buy goodies for themselves (promoters buying bungalows and cars for their use, fat salary and bonus for employees of the merchant bankers and other intermediaries); while investors were putting the money in the market.

The merry making party could not have lasted long. So when bubble bursted, it was the investor who was the real loser-and not the promoters or middlemen. The whole episode affected the investment climate, repercussions of which are still being felt.

NEW REGULATORY SYSTEM

Before 1992, retail investors were familiar with the rules of the investment game. However, with the advent of SEBI, entire investment game got changed. Field became global, new players with enormous resources and superior (manipulative) skills entered the field, and the game became fiercely competitive with no holds barred. There are two important issues which must be discussed in detail for comprehending the implications of the changeover.

1. *Changeover from Merit (Administered) to Disclosure (Market Based) Regulatory System*

Before 1992, the Controller of Capital Issues (CCI) used to regulate entry and fix the price for a new issue. In essence CCI was asked to act as an investment advisor to the public. This was changed to free pricing where the emphasis is on 'disclosure'. Full disclosure in free pricing regime becomes necessary because there is asymmetry of information and bargaining power between issuers and subscribers. This is a common mode of issuing securities in the developed countries.

However, all securities markets are not the same. They vary depending upon their location and stage of development. A country's securities market regulator, like its market, should reflect its history, culture, and customs. Institutional and legal infrastructure affects the design, construction and role of the regulator. Terms like 'full disclosure' and 'due diligence' sound progressive and modern, but how they works in a given set-up is equally important.

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The basic simplicity of the disclosure philosophy hodes several complications that arise in practice. First, the regulations must clearly spell out what type and in what format the required information is to be disclosed. Second, investors must have the ability to understand the disclosed information, draw conclusions from it, and identify higher quality and lower risk securities. Third, issuers must be careful to disclose fairly all the risks inherent in a particularly security while preserving the attractiveness of the offering.

There are a few essential developments that should precede or occur in conjunction with a transition from merit to disclosure regulation of securities. The most important one is a fully developed financial analyst industry to decode corporate information. Those needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them. The financial analyst should not only reproduce and/or reformat the given corporate information but also investigate beyond the given figures.

Further, full disclosure does not only mean itemize the prescribed information, but also implies high quality of information. Sometimes, one cannot be sure of the quality of audited accounting data if management have considerable leeway in choosing accounting policies and mode of recording the transactions in the absence of widely accepted accounting standards. Institutes of accounting profession have to act as responsible self-regulatory organizations (SROs) to enforce standard accounting practices and discipline among its members. The prescribed accounting

standards have to be such that they minimize management choices or creativity. Companies should be required to present their financial information in a consistent manner that facilitates comparison across firms.

2. *Institutionalization of Retail Savings : Providing Risk Capital through Intermediaries*

Reliance on market forces and free pricing are more suited to large investors because they have resources and expertise to fully understand the implications of disclosures made by issuing companies and have better bargaining powers. In India, the new system was introduced in all sincerity and hope that the small investor would participate in the market through intermediaries (that is mutual funds). Retail investors were also amenable to this suggestion, but again there were regulatory failures in the absence of institutional accountability to its members and public at large. Nobody knew what to do with phenomena like Canstar, Morgan Stanley, CRB Capital, etc. SEBI tried to salvage its prestige by making government owned Canara Bank to honour Canstar promises, Morgan Stanley was termed as a case of market failure, and the CRB case is still being tossed around between RBI and SEBI.

The Indian small investor knows from experience that whenever there is an institutional failure, he does not get help from any quarter and has to accept it as a bad luck. Economic scams perpetually remain under investigation as far as the small investor is concerned and the therefore accepts the scams as part of investment risk.

What to do in such a market scenario ? Isn't it natural for an investor to withdraw from the market? Investor who brings new money to the capital market is

not to be seen anywhere. We have to do something to bring him back in the market. Cosmetic changes in regulations are not going to alter the retail investor's perception. Most of the changes suggested and/or done so far are to facilitate intermediaries' task, increase their operating flexibility, or provide incentives to lure the investor, but the retail investor is not accepting the bait.

Regulators and financial intermediaries (including stock exchange) only highlight the value addition of new services, new instruments, and new system of trading, but nobody discloses (or even willing to discuss) the inherent risk in changeover. Risk-return parameters in the changed system for all investors have to be the same. For retail investor to come back to the market, the game has to be fair and there should be a level playing field. To illustrate my point let me give a few examples where the investor feels that the system is loaded against him.

A. Dematerialized Trading

Nobody can question that dematerialized trading is a convenient and cost effective system compared to the present system of trading and settlement. Efficiency gains accrue to everybody, but only retail investors have been asked to bear the so called `agency risk'. Institutional and high net worth investors can hold shares in their own name with depositories while the small investor can hold and transfer shares only through a depository participant which acts as his agent.

Regulators and depository chiefs are minimizing or ignoring this risk. But as far as the retail investor is concerned, the risk perception in the new system is no

less (if not more) than what it is in the present system. In fact, right now his risk is diversified among various players (brokers, registrars, postal system, etc.) and limited in scope, while in the proposed system all eggs would be in one basket, i.e. depository participant. Even if the depository participant is a reputed bank, the retail investor does not feel confident until adequate and effective insurance coverage is provided (indemnity guarantee is not enough). The participation of reputed Indian and foreign banks in the security scam is still fresh in the investor's mind. He fully well knows that, when institutional failure takes place, nobody takes the responsibility and nobody is there to adequately compensate him immediately. 'Agency risk' cannot be ignored or minimized.

What the investor is looking for is a level playing field. Since everybody is making efficiency gains, the cost associated with eliminating the risk in the new system should also be shared by everybody. To provide a level playing field, there are two options for regulators:

a) Ask depositories to enroll all investors as account holders. There would be millions of accounts spread all over the country. This would be prohibitively expensive and almost impossible to administer nationally for one central agency.

b) Provide insurance for the holdings of all investors. The insurance costs must be shared by all including institutional holders. This should not be considered as a favour or subsidy to the retail investor. It is the cost associated with the new game and all players must pay a fee to enjoy efficiency gains.

B. New Issues

It has been observed that all blue chip companies are raising equity capital through GDRs/ADRs abroad. No company worth the name has approached the Indian investor with a primary issue. Even public sector companies want to issue only GDRs. Policy makers expect that the Indian investor should take the risk by investing in unknown companies or greenfield projects and thus provide venture capital. Once these greenfield projects become profitable, institutional investors want to become the equity holder through the secondary market. This attitude has to change.

Institutional investors should be providing venture capital (through IPOs, private placement, book building, etc). If you can not coax or attract institutional investors to participate in primary issues, one should not presume that retail investors will step in. And please do not expect government agencies like public provident funds to provide risk capital. The contributing employees are happy to receive 12 per cent tax free return. If they intend to have higher return they on their own can invest in the equity market, or do so through mutual funds which in essence can act like private pension funds. The only difference is that it would be through voluntary contribution. But for this again they will have to earn the investor's confidence.

SOME SUGGESTIONS TO BRING BACK RETAIL INVESTOR

1. *Induce Blue Chip Companies to Issue New Equity to the Investors at Reasonably Fair Price*

In order to give all those involved time to learn and adjust, merit regulation should be practised simultaneously with the new disclosure system during a transitory period. You would be surprised to know that in the United States, 35 states still practise this dual system. (Securities regulation in the USA is a federal as well as state subject).

During last five years, it is the investors who have lost heavily. Preferential allotment under section 81 of the Companies Act was done at prices much lower than prevailing market prices (even lower than 1977 CCI prices if adjusted for inflation) by promoters of blue chip companies (including multinationals). This dilution of equity was at the cost of the retail investor. Media commentators even today remember the Janta government forcing FERA dilution in 1977 but today nobody mentions multinationals milking the companies at the cost of retail investors only about five years ago. It is not easy for investors to forget what has happened in the past.

Free pricing has taken its toll. Now let the investor make some money. This can be done only by inducing blue chip companies and PSUs to make fresh issues at lower premium than current prevailing market prices. Investors would retain confidence in the system during the changeover from the merit to full disclosure regulatory system.

2. *Provide Exit Route to Small Investors of Defunct Companies*

Bombay and Delhi Stock Exchanges are thinking of delisting thousands of companies for not paying listing fee. Some of these companies do not even exist. Addresses do not exist, promoters have abandoned the companies. There are many others which probably are sick and badly managed. Why not pass appropriate legislation to make them private companies, or hand over to some body which would provide exit route to small investors? Recently, there was a news item that financial institutions have started exploring this possibility of unloading their untraded shares by selling their stakes to promoters and other buyers. Why not have this scheme for small investors also? SEBI should conceptualize it and make it workable. This would cleanup the mess.

3. *Do Not Rush for Index Futures Trading*

Index futures trading does not provide portfolio hedging. It only facilitates a kind of programme trading with high leverage which would create extra risk in the market. The Indian speculators are slightly different. In a well developed market, a speculator does not create extra risk: he plays on the risk inherent in the market. Indian speculators tend to create risk in the market and then indulge in arbitrage to make gains. One has to just look at the volume of intra-valan and inter-exchange trade with insignificant percentage of deliveries. These transactions do not help in price discovery processes, they only help big boys with large amounts of money and inventory of securities to swing the prices. Introduction of index futures with high leveraged trading is going to accentuate this problem and it is the retail investor who would be the loser. I have covered this point extensively in my other writings.

4. *Change in the Structure and Style of SEBI's Functioning*

One had thought that, with the establishment of SEBI, there will be some conceptual thinking, some kind of vision before enacting laws to regulate capital markets. But lately, SEBI has turned itself into more of an administrative wing only, doing a firefighting job. For every single issue, a number of study groups and/or committees are constituted. In these committees, every interest group except the retail investor is represented to protect its immediate interests. Chosen members are very knowledgeable and articulate but have a narrow and focused interest. A perceived neutral expert is made chairman to facilitate arbitration among various conflicting interest groups. A compromise solution is evolved, a report is produced, and suitable changes in regulations are announced. Soon ground realities change, a new committee is appointed and fresh bargaining among members representing various interest groups begins. A new acceptable solution is arrived and changes are announced. And the show goes on. For SEBI, regulations framing has become a political process. The emphasis is on seeking immediate consensus rather than developing a long term development plan and/or regulatory framework for capital markets.

SEBI must have a thinktank with experts from relevant fields and not merely an assembly of successful bureaucrats on deputation from various government agencies. The thinktank should help SEBI Board to conceptualize a problem and help to find a long term workable solution. SEBI officials instead of looking for solutions in New York, Singapore, and Hongkong should more often visit investment centres in India and listen to domestic investors' concerns and suggestions. Small investors

certainly deserve to be heard, and not just lectured in meetings organized by interest groups. After all, they contribute more than 95 percent of total investment made in India. Foreign practices would not provide solutions to Indian problems. The battle between the among *Pandavas* and *Kauravas* required different approach and solution to the battle in Waterloo. Understanding the Indian psyche, traditions, and system is equally important in finding solutions to investment problems in India.

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