Dr. M. Venkataramana Reddy. (2010). Green Shoe Options in Indian Primary Market.
International Journal of Economic Perspectives, 4(1), 18-31.
Retrieved from: https://ijeponline.org/index.php/journal/article

Green Shoe Options in Indian Primary Market

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Introduction:

The primary market for securities plays an important role in economic development of a country, by enabling companies to mobilize financial resources from the public for undertaking various projects. The primary market also enables members of the public to invest their savings in gainful investment and allows investors to participate directly in the profits of the corporate sector.

Investors buy shares of companies in an Initial Public Offer (IPO) with the hope that the shares would trade in the secondary market at higher price. Investors would certainly be anxious if the price of the shares in the secondary market is highly volatile in the period immediately following the listing date. Such volatility is determined to invest confidence, to the image of the issuer company and the issue managers, and to capital markets at large. This necessitates some sort of price stabilizationmechanism. One such price stabilization mechanism is the Green Shoe Option (GSO).

Green Shoe Options or over allotment options were introduced by the Securities and Exchange Board of India (SEBI), the Indian market regulator, in 2003 to stabilize the aftermarket price of shares issued in IPOs. A GSO provides the option of allotting equity shares in excess of the shares issued in the offered in the public issue as a post-listing price stabilizing mechanism.

The objective of this mechanism is to reassure investors, especially small investors who are known as retail individual investors (RIIs), that they would have an exit route during first 30 days after the listing of shares (GSO window period) at a price close to the issue price due to the price sub listing activity of the merchant banks. The issuer company also benefits with this mechanism as enhanced investor confidence will result in more bids from investors at better prices.

Objectives: 1. To analyze the Green Shoe Options in India

2. To examine the Green Shoe Option mechanism

3. To bring out the recent developments of Green Shoe Option in India

4. To critically evaluate and suggest ways to make the Green Shoe Option mechanism more effective

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Submitted: 27 Oct 2010, Revised: 09 November 2010, Accepted: 18 November 2010

Review of Literature:

There has been a lot of research on IPO pricing. However very little has focused on the inclusion of GSOs in IPO programs. The underpricing of IPOs seems to have received greater attention than the phenomenon of overpricing. Aggarwal et al. (2002), Su and Fleisher (1997), and Hunger (2003) found that underpricing was rampant in the US during 1981-2000, reaching its peak during the dot-com bubble. Chowdhury and Nanda (1996) provided a justification for the aftermarket stabilization of IPOs by underwriting syndicates, and showed that stabilization dominates underwriting as a means of compensating uniformed investors of the adverse selection that they face. Lewellen (2003) studied the price effectsand crosssectional determinants of price support, and found price stabilization to be extensive in the US, inducing significant price rigidity at and below the offer price. The pricing mechanism and the phenomenon of underpricing in Indian IPOs were analyzed by Madhusudanan and Thiripalraju (1997) and Jagadeesh et al. (1993).

Green Shoe Options:

The term “green shoe” came from the Green Shoe Manufacturing Company (now called Stride Rite Corporation), founded in 1919. It was the first company to implement the green shoe clause into their underwriting agreement.

To understand the GPO mechanism, one needs to understand the IPO process. When a company decides to launch an IPO, it hires a merchant bank to help it assess the number of shares that it can offer and at what price. Based on this advice, the company fixex a price band (or a floor price) within which the investors bid for the shares.

An IPO can be made through the fixed price method, the book building method, or a combination of both. When the issuer decides the issue price at the outset and mentions it in the offer document, it is commonly known as a fixed price issue. When the price of an issue is discovered based on the demand received from the prospective investors at various price levels, it is called book built issue.

In a book built issue, the issuer company and the merchant bank solicit indications of interest from institutional investors in order to construct a demand curve. Book building is a process of price discovery. The issuer discloses a price band or floor price before the opening of the issue of the securities offered. It is at this stage the issuer company and the merchant bank decide whether to avail of the GSO. This decision is taken after considering various factors such as the level of confidence of the issuer company and the merchant bank about the price band determined by them, the expectation regarding investors’response, the market sentiment, and so on.

In order to manage the book building process, the issuer company designates one merchant bank as the book running lead manager (BRLM) or book runner. Once the issue is declared open, the

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BRLM accepts bids from investors. On the closing of the issue, the company, in consultation with the merchant bank, decides the cut off price, or the price at which shares will be allotted to the investors. The issue price is not set to any explicit rule, it is based on the interpretation of the investor' indications of interest that is made by the Issuer Company and merchant bank. The price is set at a level which demand exceeds supply, and the shares are allocated to the bidders at this price. Thus, the book building procedure resembles an auction, with some important differences. The most important difference is that the pricing and allocation rules are not announced early on, but are left to the discretion of the issuer company and the merchant bank. As the issue price is determined based on the bids received from the investors, it is fair to expect that the aftermarket price of the shares will hover around this price, at least in the short run. In practice, it is observed that the aftermarket price is often significantly higher (underpricing) or significantly lower than the issue price (overpricing). This indicates a miscalculation in the pricing of the issue. However, research supports the claim that book building helps companies to reduce underpricing.

Rationale for including GSOs in IPO programs:

Investors in an IPO could be anxious about various things: before the allotment of shares, they are generally anxious whether they will get the shares; after they get the shares, they worry about how the secondary market will react in the period immediately following the day of listing. Will the market open above the issue price or will it open below? If the market price immediately following the listing day is higher than the issue price, it implies that the issue price was under estimated, a phenomenon known as underpricing. On the other hand, if the market price immediately following the listing day is lower than the issue price, it implies that the issue price was over estimated, a phenomenon known as overpricing. IPO underpricing as well as overpricing are annoying from the investor perspective. Underpricing may appear beneficial to those investors who were actually allocated shares in an IPO. However, Jenkinson and Ljungqvist (2001) reveal that such shares perform badly in the long run, after initial positive returns. Overpricing, which results in the shares selling at a price lower than the issue price may cause panic among the most vulnerable investors, the retail individual investors. The inclusion of GSOs in the IPO program of an issuer company can be justified on five grounds: avoiding price among RIIs, signaling confidence in the IPO price, protecting the reputation of merchant banks, enhancing liquidity in the aftermarket, and favoring preferred clients.

Avoiding panic among small investors

Small investor anywhere is likely to panic if the price of the shares they received in an IPO wereto fall immediately after the listing. In their panic, they may try to sell their shares at low prices, and may exit the capital market altogether in some cases. The price may fall in the immediate

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aftermarket because of the activities of flippers. Flippers, also known as stags in stock market jargon, are investors who bid for shares only to sell them on the listing day, hoping to make a huge profit in a short period.

In India, the SEBI is in favor of encouraging the participation of retail investors in the primary market for securities. Towards this end, it has taken various measures over the last few years. The maximum investment limit for RIIs has been raised to INR 2 lakhs. The minimum offer to public has been hiked to 25% of the issue; in an issue made through the book building process, a minimum of 35% of the net offer to public category is required to be made to RIIs.it is in this context that the SEBI introduced GSOs to protect RIIs, and to reassure them that their interests would be taken care of by the issuer company, the merchant bankers, and the regulator.

Signaling confidence

The price at which the shares are issued in a book-built IPO is determined in two stages. In the first stage, the issuer company and the merchant banker decide the price band within which investors can bid or the floor price above which the investors are required to bid. This price band or floor price is decided based on various qualitative and quantitative factors. In the second stage the issuer company and the merchant bank that are designated as the book running lead manager (BRLM) decide the issue price after receiving bids from the investors. Thus, there is lot of subjectivity in the IPO pricing. Many investor, especially small investors are usually unable to make up their minds whether to bid or not to bid for the shares at the stated price band, as they stand to lose if the price turns to be unsustainable. In this context, the issuer company and the merchant bank can signal confidence in te issue by availing of the GSO mechanism. By doing so,the merchant banks back up their claims of the price being fair by proposing to buy shares from the secondary market if their claims were to be disproved and the aftermarket price were to fall below the issue price.

Merchant bank reputation

Merchant bank may prevail upon the issuers to avail of GSOs in their IPO programs ro retain or enhance their reputation. Given that the merchant bank plays an important role in arriving at the price band or the floor price; they risk facing the ire of the investors if the share trades at a price below the issue price in the immediate aftermarket. Thus, the reputation of a merchant bank may be affected if an issue managed by them has a bad opening. In US, Beatty and Ritter (1986) found that the market share of merchant banks (underwriters) fell significantly after the issues managed by them fared poorly in the aftermarket. Merchant banks can prevent such a loss of reputation by availing of the GSO mechanism, and trying to prop up the price of the share if it were to fall below the issue price in the immediate after market.

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Liquidity

GSOs help improve the liquidity of markets. Due to the over-allotment of shares, more shares would go to the investors than it would have if GSOs were not present. The larger the number of shares in the hands of the investors, the greater the possibility these shares will be traded in the secondary market. Secondly, if the aftermarket prices of the shares were to go below the issue price during the GSO window period, the stabilizing agent buy shares from the market, thereby enhancing liquidity.

Favoring preferred investors

In some jurisdictions, especially in US merchant banks avail of the GSO so that they can issue shares to some of their preferred client, who often happen to be institutional investors. During the planning phase of IPOs, merchant banks go on a road show, meeting institutional investors and other sophisticated investors, in order to guage the potential demand for the IPO and the price at which the shares could be sold. The merchant bank then makes a favorable allotment to such institutional investors.

Mechanism for stabilization of share price

The SEBI has introduced GSO facility in India on August 14, 2003.This facility was anticipated to be a key policy initiative to boost investors, especially the RIIs. The rationale for the introduction of GSOs was stated as follows:

Unexpected development may have an unfavorable impact on price of newly listed swcurities. The facility of GSO introduced by SEBI facilitates the investment bankers to stabilize the post listing price of the security. This measure is expected to mitigate volatility and enhance investor confidence. The mechanism by which the GSO operates to ensure stability and liquidity to a public offering is depicted in the following manner:

Regulation 45 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (ICDR Regulations) lays down the provisions regarding implementation of GSO in public offerings. Three parties are involved in implementing this mechanism;

1. Issuer company, being the company proposing to undertake the public offering.
2. Stabilizing agent, one of the merchant bankers, who would be in charge of stabilization process
3. Lender-Shareholders, one of pre-issue shareholders, holding a significant portion of shares of the issuer company

- **Mechanism during issue period**

i. Company over allots shares investors

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ii. Proceeds received from the shares forming part of the base case IPO are credited to the public issue account, while the proceeds from the overallotment component is parked in the special escrow account

iii. Allotment procedure is completed by the issuing company and the equityshares are listed on the stock exchanges within the T+12 days' timeline as prescribed by SEBI. Lastly shares commence trading on exchanges.

- **Mechanism during post-issue period**

The price stabilization period can last up to a maximum of 30 days after the issuer company receives listing and trading permission from the stock exchanges for its shares. The SEBI may permit the extension of the GSO window period, as was done in the case of India Bulls Power Ltd., where the period was extended by one week. The role of stabilizing agent initiates when the share prices of the issuer company being to fall.

Where there is a fall in share price:

i. The stabilizing agent, using the funds lying in the special escrow account, acquires the equity shares at the prevalent market prices from the open market.

ii. Shares procured by the Stabilizing Agent are creditedto the special depository account.

iii. All shares lying in the special depository account are then returned to the lender-shareholders, thereby closing the loop.

iv. The stabilizing agent is required to return all shares to the then lender-shareholders within a maximum period of two working days from the end of the stabilization period.

v. In order to bridge the gap between all shares borrowed by the stabilizing agent and the shares that have been bought back, the issuer company would issue such number of shares comprising the shortfall to the special depository account at issue price, which would then be returned by the stabilizing agent to the lender-shareholders.

vi. Any excess amount that remains in escrow account after remittance of the proceeds is subsequently transferred to the SEBI's Investors' Protection and Education Fund.

Where there is no fall in share price:

i. There would be no necessity for the stabilizing agent to conduct any share purchases.

ii. At the end of the stabilization period, the issuer company allots shares to the extent borrowed from the Lender-shareholder to the Special Depository Account, consideration being the amount in escrow account.

iii. The shares are then returned to the stabilizing agent to the Lender-Shareholder. The issuer company would require making a separate application with the exchanges to list all shares issued as a result of exercise of GSD.

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Analysis of GSOs in India

Data and methodology

The current study focuses on the IPOs made in India from the time the first IPO was made on March 26, 2004 after the GSO mechanism was introduced by SEBI, up to and including the IPOs made until October 2013 saw 382 IPOs being made. The data relating to IPOs was gathered from the commercial database, prime database, the prospectus issued by the respective companies, and the SEBI bulletins and press releases. The information relating to whether or not the issuer company had opted for the GSO was gathered from the offer documents filed by the companies with the SEBI. The price data was obtained from the Website of the National Stock Exchange of India Limited (NSE).

Companies that included GSOs in their IPO programmers			
No	**Issuer company**	**Opening date**	**Listing date**
1	Tata consultancy services Ltd.	29-Jul-04	25-Aug-04
2	Deccan chronicle	25-Nov-04	22-Dec-04
3	3I Infotech Ltd.	30-Mar-05	22-Apr-05
4	Ht media Ltd.	04-Aug-05	01-Sep-05
5	Shree Renuka sugars	07-Oct-05	01-Sep-05
6	Entertainment Network Ltd.	23-Jan-06	15-Feb-06
7	JagranPrakashan Ltd.	25-Jan-06	22-Feb-06
8	BL Kashyap& Sons Ltd.	20-Feb-06	17-Mar-06
9	Prime Focus Ltd.	25-May-06	20-Jun-06
10	Parsnathdevelpoers Ltd.	06-Nov-06	30-Nov-06
11	Carin India Ltd.	11-Dec-06	09-Jan-07
12	House of Pearl Gashion Ltd.	16-Feb-07	19-Feb-07
13	Idea Cellular Ltd.	12-Feb-07	09-Mar-07
14	Housing Development &Infrastucture Ltd.	28-Jun-07	24-Jul-07
15	Omaxe Ltd.	17-Jul-07	09-Aug-07
16	Brigade Enterprises Ltd.	10-Dec-07	31-Dec-07
17	Indian Bulls Power Ltd.	12-Oct-09	30-Oct-09
18	Electrosteel Steels Ltd.	21-Sep-10	08-Oct-10

From August 24, 2003 (the day GSOs were introduced in India) to October 2013, 382 companies made IPOs in India. Of these companies, only 18 companies (4.93%) had included GSOs in their IPO program.

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List of companies that included GSOs			
Year	Number of IPOs	Number of Campanies option for GSOs	Percentage of Companies Opting for GSOs
2003	3	0	0%
2004	21	2	9.52%
2005	43	3	6.98%
2006	60	6	10%
2007	86	5	5.81%
2008	30	0	0%
2009	17	1	5.88%
2010	66	1	1.51%
2011	39	0	0%
2012	12	0	0%
2013	05	0	0%
	382	18	4.93%

Source: www.nesindia.com

Out of the 382 companies that made an IPO from August 2003 (when GSOs were introduced in India) to October 2013, only 18 companies availed of the GSO facility in their IPO programmes. From August 24, 2003 (the day GSOs were introduced in India) to October 2013, 382 companies made IPOs in India. Of these companies, only 18 companies (4.93%)had included GSOs in their IPO program.

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Performance of Companies that Opted For GSOs in India From August 14, 2003 to October 2013						
No	Issuer comapny	Issue Price	Days when closing price was below issue price during GSO Window period	Trading days during GSO window period	Percentage of days when closing price was below issue price during GSO window period(%)	Last transaction Price.(04/11/2013)
1	Tata consultancy services Ltd.	850	0	23	0%	2099
2	Deccan chronicle	162	17	22	77.27	2.5
3	3I Infotech Ltd.	100	20	21	95.24	8.5
4	Ht media Ltd.	530	19	21	90.48	83.95
5	Shree Renuka sugars	285	0	21	0	22.5
6	EntertainmentNetworkLtd.	162	0	21	0	335.35
7	JagranPrakashan Ltd.	320	19	20	100	88.55
8	BL Kashyap& Sons Ltd.	685	0	19	0	6.25
9	Prime Focus Ltd.	417	23	18	100	33.85
10	Parsnathdevelpoers Ltd.	300	0	23	0	26.95
11	Carin India Ltd.	160	21	21	100	322.5
12	House of Pearl Gashion Ltd.	550	20	21	100	157.05
13	Idea Cellular Ltd.	75	0	20	0	170.7
14	HousingDevelopment&Infrastucture Ltd.	500	4	19	18.18	46.5
15	Omaxe Ltd.	310	4	21	19.05	140.2
16	Brigade Enterprises Ltd.	390	21	23	91.3	57.3
17	Indian bulls Power Ltd.	45	20	20	100	8.5
18	Electrosteel Steels Ltd.	11	18	21	85.71	3.95

The aftermarket price of six of these companies never fell below the issue price during the GSO window period, and therefore, the SAs of these companies were inactive during the GSO window period. Surprisingly, the SAs of four companies remained inactive even though the aftermarket shares of their respective companies fell below the issue price during GSO window period. This highlights the fact that the SEBI Regulations do not compel the SAs to intervene in the aftermarket even when the market price falls below the issue price. The Sas are granted complete discretion when and to what extent to intervene in the aftermarket.

The market price of the remaining eight companies fell below the issue price, and their SAs did

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intervene in the aftermarket. However, only two of these companies purchased the full extent of the shares that had been over-allotted. Five of the 12 companies (41.66) actually posted a listed day gain before the market price fell below the issue price. Only two of the 12 companies (16.67%) showed positive, during the GSO window period.

Performance of Companies that did not include GSOs

In this section, we study the aftermarket performance of the companies that made IPOs in India from 2009 to 2013 without availing of GSO mechanism. One possible reason for the companies not including GSOs is that they were confident their shares would trade in the immediate aftermarket at or above at the issue price. The purpose of this analysis is to evaluate the aftermarket performance of this companies during GSO window period, in terms of listing day returns, mean daily returns during the GSO window period, and market-adjusted mean daily returns during the GSO window period.

Reasons for indifference towards GSOs

The data reveals that there is a case for issuer companies and merchant banks to avail the facility of GSOs to reassure investors, especially RIIs, and to discourage them from exiting the capital markets. Then what is the reason for this indifference to GSOs on the part of issuer companies and merchant banks? With market participants and merchant banks, various reasons emerged, such as

- The uncertainty about the effects of GSOs, the interference with market forces,
- The unfair advantages to merchant banks,
- The merchant bank's unwillingness to bear additional responsibility, the lack of incentives,
- The absence of market discipline, and so on.

Challenges

A. Uncertainty about impact of GSOs

Merchant bankers revealed that many issuer companies and quite a few merchant banks were unsure of the effects of GSOs. There was a feeling that the GSOs facility was highly constrained by the limit of 15% over-allotment and the 30-day stabilization period. The general opinion was that there was no guarantee that the stabilization programme would in fact be successful. In this scenario, these issuer companies and merchant banks felt that the panic and fear of the retail individual investors (RIIs) would only increase.

B. Interference with free play of market forces

Some investors felt that the practice of GSOs was questionable as it artificially propped up share prices, thereby interfering with the free play of market forces. It was suggested that starting from the pre-SEBI days, RIIs were led to believe that investing in an IPO would guarantee them positive initial returns. The GSO would merely reinforce these attitudes. Further, any aftermarket price stabilization

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would deprive "value investors" from purchasing shares from native investors when the price falls in the immediate aftermarket.

C. Unfair advantage for merchant banks

Merchant banks that are designated as stabilizing agents get high fees for availing of the GSOs. Such high fees for merchant banks were felt to be unjust as they face limited risk in implementing GSOs.

D. **Unwillingness of merchant banks to accept additional responsibility**.

The issuer companies and merchant banks that we interacted with felt the legal and regulatory compliances were cumbersome, and that the consequent risks had increased manifold. In this scenario, they were not prepared to take any additional responsibility for a facility that was optional to begin with.

E. Lack of incentives

According to the GSO regulations, merchant bankers are not allowed to earn a profit from the aftermarket price stabilizing activity. This was one of the major concerns highlighted by merchant bankers in a survey conducted by The Economic Times; a typical response was "Unlike in the US, SEBI does not permit merchant bankers to make money in trading. They will have to buy the stock if the price falls below the offer price, but they are not allowed to sell even if the stock value goes up. We are required to stabilize the price around the offer price for which we get a fixed fee" (Anand, 2002). Any profits arising from the price stabilization activity need to be transferred to the Investor Protection and Education Fund (IPEF) established by the SEBI. In this scenario, issuer companies, promoters and pre-listing shareholders, and merchant banks did not see any incentive to opt for GSOs.

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F. Absence of market discipline

In a mature market, if the aftermarket price of the shares falls significantly, the investors would hold the merchant banks responsible for the same. In such an event, the credibility of the merchant banks would take a hit. This would adversely affect their chances of getting further business because investors would keep away from the issues managed by them. However, investors in India, especially the RIIs, appear to be indifferent to ascribing responsibility. In the face of this lack of market discipline, merchant banks in India have no reason to shirk the additional responsibilities associated with GSOs and talk about the lack of incentives.

Suggestions

The GSOs provisions was introduced by the SEBI in 2003 as a mechanism for reassuring RIIs that the aftermarket price of the shares they were allotted in an IPO would be maintained at least in the first month of listing. However, we found that most issuer companies and merchant banks were indifferent to GSOs, and such options were rarely availed. Various reasons for this indifferent emerged, such as the uncertainty about the effects of GSOs, the unwillingness to bear additional responsibility, the lack of incentives, the absence of market discipline, and so on. The suggestions are -Make GSOs mandatory; control flipping by Qualified Institutional Buyers (QIBs); disclose the track record of merchant banks; and tighten IPO norms, especially for small IPOs.

A. Make GSOs mandatory

On the face of it, the suggestion to make GSOs mandatory may sound preposterous to many people. Currently, GSO s are not mandatory in any country.However, given the SEBI's objective of increasing the participation of RIIs, and the peculiar nature of the capital markets in India, we feel that the suggestion to make GSOs mandatory is reasonable.

B. Control QIB flips

When an issuer company is unable to satisfy the eligibility criteria related to past track records, they are allowed to mate an IPO if they are able to get qualified institutional buyers (QIBs)to make a significant investment. The implicit assumption is that the QIBs are sophisticated investors who would take a long-term investment.

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C. Disclose track record of merchant banks

Merchant banks seemed to be indifferent to the aftermarket price movement. They claimed this indifference was justified because the compliance work IPOs was already voluminous, and they were not in any position to assume additional responsibilities and risks. Merchant banks in India are able to get away with this attitude because the investors do not show any interest in

Disciplining them, for instance, by the boycotting the issues managed by them. In order to facilitate such market discipline, the regulator may need to mandate an additional disclosures requirement regarding the aftermarket returns for each merchant bank.

D. Tighten norms for small IPOs

The performance of small IPOs (with an issue size less than INR 100 crore) has been dismal. There is a definite need to re-examine the IPO norms for such small issues. The implicit assumptions and expectations from QIBs and project appraisal in such small issues also need to be re-examined. Further, this issue needs to be studied in detail by independent researches.

Conclusion: -

Based on the analysis of the aftermarket price performance of the companies that availed of the GSO facility IPO programmes, it could be concluded that GSOs were not effective in stabilizing the prices in the period immediately following the listing date. However, broad generalization cannot be made due to the small size of the companies, both in absolute terms and as a proportion of the companies making IPOs. Of the companies that did not include the GSO facility in their IPO Programmers, a disproportionately large number of companies performed poorly. This led us to propose that GSOs be made mandatory; some penalties would need to be imposed on QIBs who sell in the immediate aftermarket; merchant bankers would need to disclose their track record; and the IPO norms would have to be tightened, especially for small issues

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Submitted: 27 Oct 2010, Revised: 09 November 2010, Accepted: 18 November 2010