

THE RESEARCH OF *IPO* INQUIRY SYSTEM - BASED ON INSTITUTIONAL INVESTORS' LACK OF INTEGRITY

LI LIU*

Abstract: IPOs have been issued in China formally for nine years. Although both the efficiency and marketization level have improved, it still has many shortcomings. Especially, institutional investors who often lack integrity have led to inquiry results that are not meaningful for pricing. This work studies the institutional investors' lack of integrity and its impact on the current IPO system in China. The goal is to begin a discussion of potential problems and possibly to suggest a few solutions.

Keywords: institutional investors, integrity, IPO (Initial Public Offering), inquiry

On January 1st, 2005, the IPO inquiry system officially started in China, indicating an important step of the securities market in the development towards the marketization reform.

IPO (Initial Public Offering) refers to listed companies selling shares to the public for the first time. It is also referred to as new issues in the primary market. In other words, it is the first time a company will publicly sell shares to investors and institutions through intermediaries such as securities companies, to raise the funds required.

The American standard inquiry system is called the accumulated bidding inquiry system. The idea is that the investors announce how many shares will be demanded at each price. Issuers and lead underwriters will decide the quantity and price for the issuance of new shares using the aggregate demand information provided by the investors.

THE CHARACTERISTICS OF *IPO* INQUIRY SYSTEM IN CHINA

On January 1st, 2005, SEC of China issued "The notice on issues concerning IPO trial inquiry system" and supporting documents. From

* Li Liu (✉)

School of Economics, Northwest University for Nationalities, Lanzhou, Gansu, P.R. China – 730124

e-mail: 362057647@qq.com

then on, China began to implement IPO inquiry system for the first time. The system stipulates that the company and its sponsor should determine the price of share issuance through inquiring information from institutional investors. After the application of share issuance is approved by SEC, the issuers must present a letter of intent including the prospectus publicly to introduce itself and inquire about the price. The issuing price will be determined in two stages. One is the preliminary inquiry, and the other is the accumulated bidding inquiry. There are big differences between the inquiry system in China and the standard American accumulated bidding system. In essence, the inquiry system in China is a combination of an accumulated bidding inquiry system and fixed price system. Specifically, the characteristics of IPO inquiry system in China are:

1. In terms of rights of placement, the same proportion of placement is applied to all investors in China. But in American inquiry system, the underwriters can allocate more new shares to investors who can provide true information when the investors quote prices. So in American, the underwriters have more flexible “rights of placement” and they do not need to use the same proportion for placement to all investors.

2. In terms of the quantity of issuance of the inquiry system in China, the number of new issues has been identified in advance and only the price can be inquired. But in the American standard inquiry system, not only price but also issue number is uncertain in advance. Both will be determined in the process of inquiry.

LACK OF INTEGRITY OF INSTITUTIONAL INVESTORS AND THE IPO INQUIRY SYSTEM OF CHINA

The new inquiry system gives rights of pricing new shares to institutional investors for the first time. But because of some reasons, institutional investors behave dishonestly in the quotation process. The main appearance is that institutional investors give the quotation arbitrarily in the preliminary inquiry with obvious bargaining or bounty intentions. That is to say, for the same new stock which sponsors provided the same issuer pricing valuation report, different institutions will quote differently and the difference was up to more than a factor of two. Obviously, this kind of arbitrary quotations lack practical significance and reference value for the determination of the final price. This phenomenon is still widespread currently.

There are other indications of institutional investors' lack of integrity. For example, institutional investors sometimes assist the issuer to disclose false information in the process of information disclosure. Or, institutional investors intentionally do nothing even when they discover false information in the process of disclosure.

In addition, the inquiry system is introduced as a new method of new share pricing method from abroad. Although this method intends to respect the will of the market, we have met a lot of problems in the implementation, or, the "localization" process in China. Examples include: the stock inquiry price range of the initial inquiry is usually too low, which leads to the price of subsequent accumulated inquiry being close to the upper limit of the initial inquiry; when the stocks are in the circulating market, the oversubscribed quantity is very large because of the seriously deviated low issuing price from reality. One of the reasons is the lack of integrity of institutional investors.

After some analysis, it is concluded that there are two main reasons for institutional investors giving dishonest, false quotations, as described below.

1. The preliminary inquiry and the accumulated bidding process are separated. In terms of system design of new stock inquiry system in China, the preliminary inquiry and the accumulated bidding process are separated processes. At first, the price of range is determined at the preliminary inquiry stage. Then the purchase quantity for each inquiry institution is determined at the accumulated bidding process. Therefore, it is possible that some participating institutions in the preliminary inquiry process do not participate in the formal accumulated bidding process. These institutions accept benefits from the issuer so that they give higher offers to raise the price of new shares in preliminary inquiry process. But in the accumulated bidding process, these same institutions choose not to participate in formal bid. Because of this kind of behavior, the issue price range is not reasonable and the authenticity and rationality of the price range will be inevitably questioned by the public.

2. The rights and obligations of institutional investors who participate in the book-building allotment are inconsistent. Under the current distribution mechanism, some institutional investors as the object of inquiry, who faced the huge risk-free interest temptation of the primary market, often collude with each other regardless of the interests of medium and small investors and the stability of the securities market. They would collectively offer lower price range to

obtain more new shares allotment for profiting more in the secondary market. Obviously, this kind of behavior not only can be misleading for the quotation of other investors, but also causes the new share price seriously deviate from its intrinsic value. It also leads to serious imbalance in the distribution of interests between the primary market and the secondary market and violates the market fairness.

In fact, whether the inquiry institutions give high price for the issuer, or collude to get a low price, or both exist at the same time, institutional investors will mostly make a choice according to their own interests. They will try to make maximum profits for themselves, even though the result of the game finally may not be the same as they wish for.

ESTABLISHING AND IMPROVING THE INCENTIVE AND CONSTRAINED MECHANISMS FOR INSTITUTIONAL INVESTORS TO MAKE THEM PROVIDE QUOTATION WITH INTEGRITY AND PERFECT OUR *IPO* INQUIRY SYSTEM

1. We will establish margin system in the process of preliminary inquiry.

By system design, institutional investors who want to participate in the inquiry must pay an amount of margin so that it can help inquiry objects to combine the bidding behavior in the preliminary inquiry stage with the actual purchase behavior in accumulated bidding phase. At the same time, as auxiliary and support, we should set up a corresponding credit evaluation system to track and monitor the whole process of institutions quotation and issuer. If the institutions are found and confirmed that they have done dishonest inquiry, the deposit will be confiscated. On this way the cost for the institutions to be dishonest is higher, so that the inquiry institutions will give the quotation more objectively and truthfully.

2. Using the experience of other countries as reference, a good method is to increase the penalties of institutional investors who lack integrity.

We can draw lessons from the American system in which the American underwriters have flexible “overallotment right” if the issuing is oversubscribed. In the American system, if oversubscription occurs, the underwriters have the “overallotment right” for the new shares. For example, they have the rights to decide who can purchase new shares when demand exceeds supply. The key factor is that weather or not the underwriters have “overallotment rights”. Actually

the “overallotment rights” represent a “punishing” measure. By this deterrence of punishment, the inquiry institutions will try their best to disclose the real demand of information so that the quotation will be more accurate. If the punishment power is used after oversubscription, meaning that the underwriters have the right to decide which inquiry institution can subscribe the new shares after oversubscription, the inquiry institutions who knowingly quote lower will realize that if it is found by the underwriters they will not get the valuable new shares any more. In this way, the function of penalties will be stronger. This should be the most effective solution to restrain institutional investors from giving dishonest quotation.

In summary, strengthening the integrity of institutional investors is important for consummating the IPO inquiry system of China, systematically studying and exploring how to reform the IPO pricing of China, as well as a key factor in improving the security market in China.

ACKNOWLEDGEMENT: Financed by the Science and Technology Plan of Gansu Province, Program “Financial support policy research about which encourage SMS of Gansu province to improve the ability of independent innovation”. Project number: 1207ZCRA204.

REFERENCES:

- Chen You (2009). “How to improve our new inquiry system”. *Journal of Accounting* [J], 2.
- Dong Xiuliang, Xue Fenghui (2008). “The empirical analysis of the effect of China’s IPO pricing system reform”. *Journal of Changchun University of Technology*, [J], (social science edition).
- Li Jing (2008). “IPO inquiry system effect”. *Journal of Renmin University of China*, [J], 11.
- Wang Xiaofang, Xie Jinjing (2008). “Empirical study on the performance of book-building regime in China”. *Journal of Shanxi University of Finance and Economics*, [J], 2.
- Zhang Zhiyuan (2009). “Investment banking”. Beijing: Mechanical Industry Publishing Firm, [M], March.