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Effectiveness of Green Shoe Option as a Technique of Price Stabilization in India

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Abstract: The primary market of shares and securities where Initial public offerings (IPO) of securities are issued contributes a vital role in the financial development of an economy by means of mobilizing financial resources from the public and investing these resources in various developmental projects of the economy. Investors would undoubtedly be worried if the price of the shares in the secondary market is gradually declining or highly unpredictable in the period immediately following the listing date. The Green Shoe Option (GSO) is one of the price stabilization mechanisms newly came into force since 2003 by which such situation should be managed. This study attempts to assess the effectiveness of Green Shoe Option (GSO) as a technique of price stabilization in India by means of analyzing the mechanism through which GSO works.

Keywords: Green Shoe Option, India, IPO, Primary market.

1. Introduction

The primary market of shares and securities where Initial public offerings (IPO) of securities are issued, contributes a vital role in the financial development of an economy by means of mobilizing financial resources from the public and investing these resources in various developmental projects of the economy. In reality, IPO is the canal for new capital inflow to hatchling companies, and simultaneously it is the mechanism for the existing owners to realize a return for their efforts. The Investors generally invest in shares of companies through initial public offering (IPO) with the optimism that the shares would be traded in the secondary market at a price higher than the original selling price in order to have greater accessibility of growth. Investors would undoubtedly be worried if the price of the shares in the secondary market is gradually declining or highly unpredictable in the period immediately following the listing date. Such unpredictability will surely damage the investor's self-belief, the image of the issuer company and the issue managers in particular, and the image of capital markets in general. The Green Shoe Option (GSO) is one of the price stabilization mechanisms newly came into force since 2003 by which such situation should be managed. The term comes from a company, Green Shoe Manufacturing Company, founded in 1919 which made Wellington boots, now called Stride Rite Corporation, which was the first company to permit underwriters to use this practice in its offering in US. In a company prospectus, the legal term for the greenshoe is "over-allotment option", because in addition to the shares originally offered, shares are set aside for underwriters. The Securities and Exchange Commission (SEC) introduced this option in order to enhance the efficiency and competitiveness of the fund raising process for IPOs.

A greenshoe is a clause contained in the underwriting agreement of an initial public offering (IPO) that allows underwriters to buy up to an additional 15% of company shares at the offering price. The investment banks and brokerage agencies (the underwriters) that take part in the greenshoe process have the ability to exercise this option if public demand for the shares exceeds expectations and the stock trades above the offering price. This mechanism guarantees small investors ,specially retail individual investors (RIIs), that they would have an exit route during the first 30 days after the listing of shares (called the GSO window period) at a price close to the issue price, due to the price stabilizing activity of the merchant banks. The issuer company also gets advantage from this mechanism, as enhanced investor confidence will result in more bids from investors at better prices.SEBI introduced this option with a view to improve investor's confidence by arresting the speculative force, which works immediately after listing and thus result in short term volatility in post listing price. This type of option is the only means permitted by the Securities and Exchange Commission (SEC) for an underwriter to legally stabilize the price of a new issue after the offering price has been determined. The SEC introduced this option in order to enhance the efficiency and competitiveness of the fund raising process for IPOs.

In India, the SEBI is in favour 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 minimum investment limit for RIIs has been raised to INR 2 lakh [Regulation 2(ze) of the SEBI (ICDR) Regulations, 2009].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. The Securities and Exchange Board of India (SEBI) has introduced Green Shoe Option (GSO) on 12 Aug 2003, in order to bring the Indian Primary Markets on par with global markets such as US, Canada and others where over 90 percent of the primary issues is through the Book-Building route having the GSO. Moreover, 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.

2. Green Shoe Option: Meaning of

Green Shoe Option is a mechanism used by companies to provide price support to investors for shares procured by them in the public offering, in the event that the prices of equity shares witness a drop immediately after listing. A Green Shoe, also known by its legal title as an “over-allotment option” (the only way it can be referred to in a prospectus), gives underwriters the right to sell additional shares in a registered securities offering if demand for the securities is in excess of the original amount offered. The Green Shoe can vary in size up to 15% of the original number of shares offered. This option is also called the over-allotment option. A green shoe option means that an underwriter of a security can choose to sell more stocks of the company going for IPO if the demand of the stocks exceeds the number of stocks made available for the offering. One of the major beneficiaries of the GSO happens to be the investor as this option helps to preserve his capital as buying of excess shares limits panic selling in the market, as and when the stock gets listed on the bourses.

Green Shoe Option is a commonly used tool in international capital market transactions which is used by investment bankers, acting as stabilizing agents, to provide share price support to companies for a certain small period after their public offering. Basically, it is a price stabilization mechanism whereby a company over-allots shares to investors participating in the issue, with a view to have the merchant banker buy them back from the open market after listing, in order to arrest any fall in the share prices below the issue price.

This term has been derived from the name of a company that first implemented this mechanism in its public offering in 1960 – the Green Shoe Manufacturing Company, USA. SEBI introduced the Green Shoe mechanism in Indian capital markets in 2003 vide a circular SEBI/CFD/DIL/ DIP/Circular No. 11 dated 14th August, 2003. Since then, a number of companies have implemented the Green Shoe Option in their initial public offerings, e.g. Electrosteel Integrated Ltd., India bulls Power Ltd., Housing Development & Infrastructure Ltd., etc.

Full, Partial and Reverse Greenshoes

The number of shares the underwriter buys back determines whether they will exercise a partial greenshoe or a full greenshoe. A partial greenshoe is adopted when underwriters are only able to buy back some shares before the price of the shares increases. A full greenshoe occurs when they are unable to buy back any shares before the price goes higher. At this point, the underwriter needs to exercise the full option and buy at the offering price. The option can be exercised any time throughout the first 30 days of IPO trading. There is also the reverse greenshoe option. This option has the same effect on the price of the shares as the regular greenshoe option, but instead of buying the shares, the underwriter is allowed to sell shares back to the issuer. Under the Reverse Option, in the event that there is a fall in the share prices during the stabilization period, the stabilizing agent would procure shares from the open market at the depressed prices, and sell them back to the issuer at the (higher) issue price. Procurement of large blocks of shares from the open market while exercising Reverse Green Shoe would assist in stabilizing the falling share prices.

3. Why GSO?

One of the advantages of using the greenshoe option is that it has the capability to ease risk for the company issuing the shares because price volatility is likely to be even greater in the case of an Initial Public Offering (IPO) since there is no established Secondary Market for the securities. It enables the underwriter to have buying power in order to cover their short position when a stock price falls, without the risk of having to buy stock if the price rises. In return, this facilitates to maintain the share price stable, which positively affects both the issuers and investors. It is an Investor Protection measure especially for the small investors during post-listing period. The purpose of an issuer and/or a selling security holder in providing an underwriter with an over-allotment is to allow the underwriter to stabilize the after-market for the issuer's securities in the period immediately after the public offering begins. By permitting an underwriter to obtain additional securities covering an over-allotment and to sell these securities to the public, an underwriter can maintain a balance between the demand for an issuer's securities and the supply of securities available to satisfy market demand .It benefits the Underwriters in both bullish and bearish conditions. In bull market, underwriters will opt for additional allotment of 15% due to index riding high. In a bearish market, the underwriting option may not be exercised or the underwriters may buy upto 15% at prices lower than the issue price from the market.

The insertion of GSOs in the IPO programme of an issuer company can be acceptable on the following ground:

(i)Getting rid of fear of small investors

In India, the SEBI is in favour of encouraging the participation of retail investors in the primary market for securities. Small investors become afraid when the price of the shares which they bought through an IPO is falling instantaneously after listing. Flipping is the practice of immediately liquidating shares in the initial after market. The price may fall in the immediate aftermarket because of the activities of flippers .As a result, they may try to sell their shares at low prices, and may exit the capital markets altogether in some cases. As a result of this, SEBI introduced GSOs to protect RIIs that their interests would be protected by the issuer company, the merchant bankers, and the regulator.

(ii).Merchant bank's reputation

The merchant bank plays an important role in arriving at the price band or the floor price. The reputation of a merchant bank may be affected if an issue managed by them has a awful opening. Merchant banks can prevent such a loss of reputation by availing of the GSO mechanism, and trying to sustain the price of the share if it were to fall below the issue price in the immediate aftermarket.

(iii)Signaling confidence

By means of GSO mechanism, the issuer company and the merchant bank can signal confidence in the issue. 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. Many small investors are by and large 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 out to be untenable.

(iv).Favouring preferred investors

During the planning phase of IPOs, merchant banks go on a road show, meeting institutional investors and other sophisticated investors, in order to measure the potential demand for the IPO and the price at which the shares could be sold. The merchant bank then makes a favourable allotment to such institutional investors.

(v) Liquidity

Green shoe options 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 there 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 would buy shares from the market, thereby enhancing liquidity.

4. Mechanism for Stabilization of Share Price

The Securities and Exchange Board of India (SEBI) has introduced GSO facility in India on August 14, 2003. This facility was anticipated to be a key policy initiative to bolster investors, especially the RIIs. The rationale for the introduction of GSOs was stated as follows:
Unexpected developments may have an unfavorable impact on price of newly listed securities. The facility of green shoe option 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. [SEBI Annual Report 2003–04, p. 9.]
The mechanism by which the greenshoe option 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 Green Shoe Option in public offerings.
Three parties are involved in implementing this mechanism:
I. Issuer company, being the company proposing to undertake the public offering.
II. Stabilizing Agent, one of the merchant bankers, who would be in charge of stabilization process;
III. Lender-Shareholders, one of pre-issue shareholders, holding a significant portion of shares of the issuer company.

4.1. Mechanism during pre-issue period

(i)Issuer Company obtains approval from shareholders for over-allotment through the Green Shoe Option.
(ii) Issuer company selects and recruits one of its investment bankers to act as the stabilizing agent.
(iii) Stabilizing Agent enters into agreements with the issuer company and lender shareholders-an initial public offering (IPO), and in case of a follow-on public offering (FPO), being any of the pre-issue shareholders holding more than five per cent of the share capital – detailing key terms, *inter alia*, the maximum number of shares that may be borrowed for over-allotment. The details of such an agreement have to be disclosed in the offer document. The extent of borrowed shares is restricted to 15% of the issue size.[Regulation 45(1)(d) of the SEBI (ICDR) Regulations, 2009]

(iv) A special escrow account has to be opened with one of the banks, where funds from the over-allotment would be credited. These funds would later form the 'war chest' which would be used to acquire shares from the market during the price stabilization period. A special depository account also would be opened with the depository in order to credit any shares that may be bought back during the stabilization period.

4.2. Mechanism during issue period

(i) Company over allots shares to investors(the base IPO shares plus the shares borrowed by the Stabilizing Agent).

(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 over-allotment component is parked in the special escrow account.

(iii) Allotment procedure is completed by the issuing company and the equity shares are listed on the stock exchanges within the T+12 days timeline as prescribed by SEBI.Lastly, shares commence trading on exchanges.

4.3. 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. [Regulation 45(3) of the SEBI (ICDR) Regulations, 2009. 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 the stabilizing agent initiates when the share prices of the issuer company begin to fall.

Where there is a fall in share price:

(i) The stabilizing agent (using 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 credited to 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 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 the total 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 the 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 the escrow account.

(iii) The shares are then returned by the Stabilizing Agent to the Lender-Shareholder. The issuer company would require to make a separate application with the exchanges to list all shares issued as a result of exercise of Green Shoe Option.

A distinguished facet of the regulation of GSOs in India is the *mantra* of the doctrine of unjust enrichment. According to this doctrine, neither the issuer company nor the promoters or pre-issue shareholders can gain any profit from the stabilizing activity. The profits, if any, would be used for protecting and educating investors. Another noteworthy attribute of the regulation of GSOs in India is that it is discretionary in the manner that it is left to the discretion of the issuer-company. Apart from GSOs, the SEBI Regulations also include an enabling provision for issuer companies to afford a safety-net arrangement. The idea of a safety net is as follows: if the shares trade at a price below the issue price in the period immediately following the listing date, a specially designated entity would buy the shares from the investors. The issuer company and the merchant bank are required to ascertain the financial capacity of the designated entity, and make requisite disclosures in the offer document [Regulation 44 of the SEBI (ICDR) Regulations, 2009]. The safety-net arrangement is exclusively planned to shield the interests of small investors. Thus, the regulations offer to purchase up to a maximum of 1000 shares from the "original resident retail individual allottees at the issue price within a period of six months from the last date of dispatch of security certificates or credit of demat account."[Proviso to Regulation 44 of the SEBI (ICDR) Regulations, 2009].

Table 1: Features of GSOs in India

Regulatory Authority	**GSO Window Period**	**Naked short position**	**Penalty bids**	**Extent of Over allotment**	**Retention of Profits**
Securities Exchange Board of India (SEBI	Mandatorily, 30 calendar days from the listing day[Regulation 45(3) of SEBI (ICDR)	Not allowed	Not allowed	15% of the issue size	Not allowed

	regulations, 2009]				

A list of companies that included GSOs in their IPO programmes is given in Table 2.

Table 2: Companies that included GSOs in their IPO programmes

No	Issuer company	Opening date	Listing date
1.	Tata Consultancy Services Ltd.	29 Jul 2004	25 Aug 2004
2.	Deccan Chronicle Holdings Ltd.	25 Nov 2004	22 Dec 2004
3.	3I Infotech Ltd.	30 Mar 2005	22 Apr 2005
4.	HT Media Ltd.	4 Aug 2005	1 Sep 2005
5.	Shree Renuka Sugars Ltd	7 Oct 2005	1 Sep 2005
6.	Entertainment Network (India) Ltd.	23 Jan 2006	15 Feb 2006
7.	Jagran Prakashan Ltd.	25 Jan 2006	22 Feb 2006
8.	B. L. Kashyap & Sons Ltd.	20 Feb 2006	17 Mar 2006
9.	Prime Focus Ltd.	25 May 2006	20 Jun 2006
10.	Parsvnath Developers Ltd.	6 Nov 2006	30 Nov 2006
11.	Cairn India Ltd	11 Dec 2006	9 Jan 2007
12.	House of Pearl Fashions Ltd.	16 Jan 2007	19 Feb 2007
13.	Idea Cellular Ltd	12 Feb 2007	9 Mar 2007
14.	Housing Development & Infrastructure Ltd.	28 Jun 2007	24 Jul 2007
15.	Omaxe Ltd	17 Jul 2007	9 Aug 2007
16.	Brigade Enterprises Ltd	10 Dec 2007	31 Dec 2007
17.	India bulls Power Ltd.	12 Oct 2009	30 Oct 2009
18.	Electrosteel Steels Ltd	21 Sep 2010	8 Oct 2010

Source: www.nseindia.com

Table 3: Number of Companies that Opted for GSOs in their IPOs in India from August 14, 2003 to December 31, 2011

Year	No of IPOs	Number of companies opting 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%
Total	365	18	4.93%

Source: www.nseindia.com

Out of the 365 companies that made an IPO from August 2003 (when GSOs were introduced in India) to December 31, 2011, only 18 companies availed of the GSO facility in their IPO programmes [Table 3]. From August 24, 2003 (the day GSOs were introduced in India) to December 31, 2011, 365 companies made IPOs in India. Of these companies, only 18 companies (4.93%) had included GSOs in their IPO program.

5. Conclusion:

The greenshoe option is popular because it is one of a few security and exchange commission -permitted, risk-free avenues for an underwriter to stabilize the price of a new issue post-pricing. But, it has been found that the majority of the issuer companies and merchant banks are unresponsive to GSOs, and consequently such options were seldom availed. A variety of reasons for this indifference sought out to be the vagueness about the effects of GSOs, the reluctance to bear added responsibility, the lack of incentives, the absence of market discipline and so on. A very few companies as shown above have opted for GSO and reaped the benefit of price stabilization. Nevertheless, one of the advantages of using the greenshoe is its capability to reduce risk for the company issuing the shares. It enables the underwriter to have buying power in order to cover their short position when a stock price falls, without the risk of having to buy stock if the price rises. In return, this facilitates to maintain the share price stable which positively affects both the issuers and investors.

In conclusion, it can be suggested that GSOs should be made obligatory in stabilizing prices of shares going for initial public offerring and alertness programs should be conducted to instruct the companies about the significance of GSO. Merchant bankers should unveil their track record and the IPO rules would have to be restricted in case of small issues. Some penalties would require to be imposed on Qualified Institutional Buyer (QIBs) selling in the immediate aftermarket which is deemed financially sophisticated and is legally recognized by security market regulators.

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