FINANCIAL SERVICES

On offer but underpriced?

Should directors be liable for significantly underpricing initial public offerings in Hong Kong, asks *Chee Keong Low*?

Why are initial public offerings (IPOs) in Hong Kong substantially underpriced? Two reasons are traditionally given: investment bankers find it less costly to market IPOs that are underpriced, and underwriters receive certain quid pro quos from buy-side clients in return for allocating such issues to them.

Recent research has sought to document the exploitation of this 'information asymmetry' by owners to increase their own private wealth. However, this research fails to discuss whether directors ought to assume some liability for such underpricing.

The need to raise capital is not the only reason companies issue shares, but in any case, directors have a common law duty to attain the best value for such assets.

This paper examined the duties of directors in respect to issuing shares in 190 IPOs over four years on the Stock Exchange of Hong Kong (SEHK) and argues that directors have possibly breached such duties where the IPO is significantly underpriced.

While it may be unfair for courts to 'second guess' what the fair price of an IPO should be ex post given the uncertainties associated with the length of the offering process, there is nonetheless a need to close the expectation gap in terms of the increasing degree of underpricing if the capital market is to maintain its competitiveness.

A BOOM YEAR IN 2006

In 2006, strong retail demand led to around US$42.5 billion being raised from IPOs on the Main Board of the SEHK, placing it second globally after the London Stock Exchange. Such was the exuberance of the retail demand that the 53 IPOs in 2006 were, on average, over-subscribed by about 250 times presenting those fortunate enough to be allotted the shares with an average premium of approximately 25 per cent. This, however, represents an aggregate 'loss' of some US$7.3 billion to the companies involved as a consequence of their IPOs being underpriced, and this doesn't include further losses arising from the exercise of greenshoe over-allotment options by the underwriters.

DUTY OF DIRECTORS

The need to raise capital is not the only reason why companies issue shares, but in any case, directors have a common law duty to attain the best value for such assets. In the context of an IPO, the central question should focus on whether the directors breached this duty in setting an IPO price significantly below that which the market eventually was prepared to pay. Thus, rather than being viewed as a 'success', the excessive rates of oversubscription for shares during an IPO and the associated short-run underpricing thereof, should more appropriately be viewed as a loss to the company.

BREACH OF DUTY

Acknowledging that markets are subject to fluctuations, the following – which is based on the average underpricing of IPOs in Hong Kong from 1980 – is proposed as an objective benchmark to determine whether directors ought to be held accountable.

Extent of Underpricing	Liability of Directors
Less than 35%	No breach of duty
Between 35 and 85%	Rebuttal presumption of breach of duty by directors
More than 85%	Prima facie breach of duty established

WHO MONITORS THIS?

Given the obstacles posed by *Foss v Harbottle* and the reality that directors are unlikely to initiate actions against themselves, the most appropriate plaintiff may be the Securities and Futures Commission of Hong Kong as it has a statutory duty to ensure that the regulatory framework facilitates the establishment of a quality market.

As the complexity of securities regulation is compounded by the fundamental mismatch of applying domestic laws to increasingly globalised markets without national boundaries, it is proposed that a specialised Securities Court with an exclusive mandate to hear and adjudicate securities laws cases be established.

The rules of this court ought to be sufficiently proactive and flexible to meet the demands of the constantly changing securities markets and it must be empowered with a comprehensive range of legal and administrative orders. To prevent possible abuses of process, restrictions must be imposed on the use of damages that are awarded against directors as these would facilitate a better alignment of the interests of independent shareholders and the company.

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LIGHT RELIEF By Steven Moore

" Aren't the poor supposed to be the most generous Miss Smith? "

ACCOUNTING

A capital decision

A recent case study on three foreign direct investment (FDI) projects in the 1990s by leading Greek ice cream maker Delta has endorsed previous findings on the role of information in the capital budgeting process. Results showed that financial analysis in FDI decision-making had limited influence. As Delta's treasurer says, "The financing study takes place at the implementation stage..."

Delta's enormous growth in a few short years meant it had to split its functions into operational and corporate activities. However, this decentralisation negatively impacted on intra-company relations.

A new reporting system provided more precise estimates on future sales and proved more useful in investment decision-making, budgeting and reporting.

Basically, Delta's FDI decision-making information is strategic, qualitative and informal, focusing on the macro-environment. Delta's mission was to build a high market share, allowing at least five years for a return. A break-even was considered essential for arguing the commercial viability of projects.

Financial analysis deviated from both the normative theory where discounted cash flow (DCF) would be expected to feature and from survey findings. Sales volume estimates and the average selling price of ice cream were the basic indicators of its project analyses.

Another use the capital budgeting system serves is management control. In FDI decisions, capital budgeting and business planning systems provide reassurance that important issues have been considered.

Cash flows are used to guarantee that whoever proposes a capital investment project has taken into account its most important elements and financial impact.

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