

# **POLICY AND PRACTICES OF INITIAL PUBLIC OFFERING SHARE PRICING IN NEPAL**

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## **Abstract**

*This paper aimed at swotting policies and practices of initial public offering share pricing in Nepal. The paper employed the data from both primary and secondary sources like policy documents issued by SEBON related to the pricing of IPO shares and opinion surveys with the market participants about whether existing pricing policies are appropriate to adopt new pricing of IPO like book building. Data has been analyzed using descriptive statistics. Review of various policy documents like Companies Act 2006, Securities Act 2006, and Securities Registration and Issue Regulation 2016 revealed that IPO pricing prevailing in Nepal are related to the fixed price public offer mechanism. Issuance of IPO shares in premium is occasionally found in practice while there is a restriction of IPO of shares at discount under fixed-price public offer. There is high initial returns or deeper underpricing of IPOs under fixed-price public offer. The provision of free pricing like auction pricing of IPO shares is not found in the regulations. In this regard, market participants opined that the existing regulatory provisions are insufficient and supposed to not appropriate for launching the book building pricing method of IPO share in Nepal. In later period, it is found that SEBON initiated amendment of Securities Registration and Issue Regulation 2016 with provisions of book building pricing on February 13, 2020, and also brought about Book Building Directives 2020, aiming to implement book building pricing of IPOs. However, no companies are yet to go public through book-building pricing so far.*

**Keywords:** *policy reviews, policy amendment, fixed price, book building, IPOs*

## **Introduction**

Initial public offering (IPO) is a course of public offering in which it sold shares of a company to both institutional and retail investors (Hirst & Kastiel, 2019). IPOs are traded through the intermediation

of investment banks or merchant banks in the primary market. Investment banks typically underwrite it and they also arrange for the shares to be listed on the stock exchanges. Through this process, a privately held company is transformed into a public company. IPO enables easy

trading of existing holdings and future capital raising by becoming publicly traded. Company can use the capital raised from IPO for working capital, expansion of its activities, research and development, retiring existing indebtedness, and acquiring other companies, which may have significant implications on performing the company (Allison et al., 2008).

The earliest form of a company that issued public shares was the case of the *publicani*, legal bodies like modern joint-stock companies, during the Roman Republic. These shares were sold to public investors and traded in a type of over-the-counter market in the forum, near the Temple of Castor and Pollux, Rome. The first modern IPO occurred in March 1602 when the Dutch East India Company offered shares of the company to the public to raise capital. In the United States, the first IPO was the public offering of Bank of North America around 1783. Likewise, the public issuance of shares of Biratnagar Jute Mills Limited in 1936 was the primary experience of initial public offering in the context of Nepal.

Pricing of a public offering of shares is a crucial part of issuing companies. Before public issuance of stock, an investment bank determines the value of the company and then its shares. Fixed price public offer and free pricing like book building and auctions are the basic pricing

mechanisms of IPO. Historically, the fixed price method of IPO pricing has been the dominant approach in the UK and its former colonies, i.e. India and Singapore, and in most of Europe (Benveniste & Busaba, 1997). Under this, the price and allocation rules are set before information on demand is received and they allocate shares according to the rules announced earlier (Jagannathan et al., 2010). The trends towards issuing extremely large public companies and the wave of privatizations led to experimentation first with auctions pricing and then with the US book building method. Auction pricing is generally based on investor bids. Under this, a minimum acceptable price is set by the underwriter and issuer, generally, one week before the IPO date and investors make price/quantity bids, just as in a sealed-bid auction (Derrien & Womack, 2003). As the auction price is based on investor bids, auction allocations are usually determined by rules that are set and publicly announced before bidding (Jagannathan et al., 2010). The public offering vis-à-vis book building typically arranges for investors to attend a roadshow and then collects indications of interest to build the order book. Under this, the offering price is set only after the order book is full, giving the underwriter some idea of demand. It is, thus, a process of discovering the price of shares through the demand of market shares. The underwriter has substantial

discretion over allocations with those investors who helped in pricing the issue and those with long term relationships (Jagannathan et al., 2010). Nowadays, many countries have used hybrids of book building especially, book building/public offer in which the underwriter sets the price based on the indications of interest during roadshows and allocate shares to the institutional and foreign investors. Benveniste and Busaba (1997) stated that the book-building procedure generates higher expected proceeds than that of the fixed price method is used.

A debate extensively soars regarding the best way to price and place IPOs in the international market. Price-performance, thus, of IPO shares in the developed and emerging markets incessantly attracts the attention of many researchers in finance. An empirical study by Loughran et al. (1994) noted that, in all 25 countries (including seven Asian countries), the average initial returns tend to be higher when a fixed offering price is set, and very low initial returns exist when auctions are used. Shengfeng (2010) also found that fixed-price public offer has a deeper underpricing of IPOs i.e. the first-day trading price highly exceeds the offer price, while the auction price has the lowest underpricing among three pricing alternatives. Book building pricing has fairly priced relative to the first day trading of IPOs in the stock exchange. However,

the ongoing quest for the reasons of IPO pricing and performance both short and long run, has generated various conflicting evidence resulting in the development of numerous hypotheses/theories such as the winner's curse, the certification, the signalling, the market feedback, the lawsuit avoidance, the fads hypothesis (Durukan, 2002), among others.

Policy issues are crucial regarding IPO and the embracing of various methods of their pricing. Moreover, it also affects short-run and long-run performance of IPOs. Regulatory issues are more critical and challenging in the least developing countries like Nepal where so much is expected from the government in regulating the market. IPO policy is one of the public policies that aim to attract the public for holding ownership in the corporate sectors of the economy. They are also designed to respond to perceived public problems and challenges requiring government action for their solution (Anyebe, 2018). It may be seen as a political system's response to demands arising from its environment, which is recognized as a system theory (Obi et al., 2008). Braybrooke and Lindblom (1964) contends that policymakers examine a limited number of policy alternatives and implement change in a series of small steps which is only a small change in the status quo.

In regard to laws and their enforcement on the performance of IPOs

Laughran et al. (1994) reported that the average initial returns tend to be higher when the degree of government interference is higher. Change in regulation towards a market-based pricing mechanism in 1996 has an adverse effect on underpricing in case of Malaysia (Saadouni et al., 2005) indicating IPO underpricing significantly increase after the change in regulatory environment. After the 1988 liberalization of Korean IPO pricing, financial variables significantly affect on the market price of an IPO (Kim et al., 1995b). Moshirian et al. (2010) found an average initial return of China IPO with 118.4 percent covering the period from 1990 to 2013 with a sample size of 2512 firms. They argued that the high initial return in China was due to the distinctive corporate governance system, security laws, and lack of law enforcement. Jelic et al. (2001) concluded that in immature IPO markets the initial returns were high due to weak regulatory environment and the failue of investment bankers to adequately manage the process of new listing. Liu et al. (2014) concluded that firms from a province with more developed legal framework experienced less underpricing after controlling for time-invariant, province-fixed effect especially after the introduction of a book building system in China. Xu et al. (2017) found that private firms with top-level political connections and family involvement had lower IPO underpricing.

IPO price restrictions reduces the power of negotiations but not the influence of cultural factors contributing to the understanding of price formation process (Hu et al., 2019). Further, there is a significant impact of changing economic and regulatory environment in Turkey IPO underpricing and deal terms (Tanyeri et al., 2022). These evidences suggest that IPO price is influenced by the regulatory framework of the market. Overall, it is concluded that strict restrictions in pricing results deeper underpricing of IPOs in most cases.

The foregoing literature demonstrates that the fixed price, book building and auction pricing are the various methods of IPO pricing. Pricing of IPO is guided by the certain theories/ approaches and they challenge to solve public/investor interests. Evidences revealed that regulatory frameworks also affect IPO performance in terms of returns like underpricing to the investors. Thus, the major quest of this paper is to assess the existing policies and practices of fixed price method of IPOs under the given regulatory framework experienced so far. The benefits and demerits of fixed price method of IPO shares and its regulations have been less talked both in the stock market and academic community, which, in essence, a less applicable model worldwide. Further, it attempst to present and examine the recently formulated book building pricing regulations to be implemented in Nepal.

Thus, this paper will serve a milestone in promoting modern pricing of IPOs along with overall development of the primary market.

### **Data and Methodology**

This paper is descriptive one. It reviewed various IPO policy provisions formulated in the past as well as in recent years along with their practices in the primary market of Nepal. The data used in the study was quantitative and sources of data were both primary and secondary. Secondary data were collected from the policies formulated by the Securities Board of Nepal (SEBON) in different time-period related to the IPO pricing of shares. Companies Act 2006, Securities Act 2006, Securities Registration and Issuance Regulation 2016 (3<sup>rd</sup> Amendment 2020), SEBON's policies and programs related to securities and commodities exchange for the fiscal year 2019/20, and Book Building Directives, 2020 were the major sources of secondary data. Moreover, the prospectuses of corporate bodies have been widely used to collect data related to the premium and few of IPO auction pricing.

Researcher also conducted the opinion survey using Likert scale items in a well-structured questionnaire for the two months of January and February 2020. The survey aims to record the views, perceptions, and characteristics of market participants like issue managers, portfolio managers, share registrars, mutual funds, stockbrokers and professional investors

to measure the capacity of the existing regulatory framework for adopting market-based pricing. It is assumed that market participants are well-informed about the existing regulatory framework because they are the major players of the primary market. Since Securities Board of Nepal is planning to adopt book building pricing, it is expected that examining existing capacity of stock market regulations becomes eventually essential. It helps identifying policy gaps and shortcomings in existing practices, which guides in necessary amendments in the existing regulations to make it market-friendly. Altogether, seventy-one respondents were selected as a sample under judgmental sampling. The selected respondents were assumed to be the experts of the primary market and expected their correct response to the questions. Researcher analyzed the primary data based on mean, standard deviation, and range to understand the capacity of existing regulations for implementing the book building pricing method in Nepal.

The study has some limitations. The study was confined to the review of IPO pricing policies formulated in the past and new initiatives in this area as well. The data on pricing practices were collected from various secondary sources especially from the prospectuses of the companies. Primary data were collected from the capital market participants; no general/retail investors were participated during the questionnaire administration.

**Pricing Policies and Practices of Initial Public Offering Shares**  
**Existing Pricing Policies**

The history of the capital market in Nepal dates back to 1936, whereby the shares of Biratnagar Jute Mills Ltd. were issued. The first Company Act came into effect in 1964. The first issuance of government bonds was made in the year 1964 through Nepal Rastra Bank to raise development funds of the government (Shrestha, 1981). Regarding the pricing of IPO shares, the regulatory body fixed the price whereby companies cannot offer shares at price more than par value (Vaidya, 2012). Therefore, since the beginning only the fixed pricing mechanism is prevailing in the capital market, which is completely regulated in the context of Nepal.

With regard to reviewing Companies Act 2006 clause 27 (1) and (2), the face value/par value of shares of a private company shall be as specified in its Articles of Association whereas the face/par value of shares of a public company shall be Rs.50/- per share or shall be equivalent to such amount exceeding Rs.50/- as is divisible by the figure 10 as provided in the memorandum of association and articles of association. Clause 29 of Companies Act 2006 also states that a company can issue shares at a premium upon fulfilling the conditions like (a) the company has been making profits and distributing dividends for three consecutive years; (b) the company's net worth exceeds its total liabilities, and (c) the company's general

meeting has issued shares at a premium. However, clause 64 of the Act restricts a company from issuing or sell its shares at a discount (below the par value).

Further, the Securities Act 2006 clause 29 states that the provisions relating to the value of securities for which public issue has to be made shall be as prescribed. Rule 42 of Securities Registration and Issue Regulation 2016 states that the face value of securities shall, generally, be Rs.100/- per unit, if share, Rs.1000/- per unit, if debenture, and Rs.10/- per unit, if mutual fund scheme. Similarly, rule 25 of the Regulation states that a corporate body upon fulfilling the provisions of issuing securities can issue at a premium like, (i) shall have to fulfil the conditions prescribed by the prevailing company-related law, (ii) outside expert or expert institution shall be required to have carried out due diligence audit about the methodology, rationale and justification of fixation of premium, and (iii) comply with the provisions regarding the determination of premium in the Directives. The provision related to issuing shares at discount has not been covered by the Regulation.

Auction pricing has been widely used, especially in issuing government bonds and treasury bills in Nepal, but we do not find such provisions in IPOs of equity shares. Securities Registration and Issue Regulation 2016 rule 20 has made a provision of the auction only in case of right share issue/sell as "If any number of share remained unsold during the sale of the right

share period, the body corporate shall be required to sale by auction method through publishing the information publicly". All these pieces of evidence are attributed to the fact that there is a strict restriction on IPO equity share pricing in Nepal. Public companies are not free to determine the price of their IPO shares, which results in suffering the wealth loss of shareholders due to deeper underpricing (Welch, 1989).

### **Opinion on Existing Capacity of Pricing Regulations**

Researcher has administered the questionnaire through a personal visit to the market participants to collect their

opinion, especially on whether the existing regulations of the IPO market suffices to launch free pricing, such as book building IPO pricing method, in Nepal. Because appropriate policies/regulations are essential for implementing the new pricing mechanism. The Likert scale items included in the study as variables measure the applicability of prevailing regulatory framework in adopting book building pricing of IPOs in Nepal. Table 1 presents the status of existing regulatory capacity, that whether they suffice for adopting book building pricing of IPOs in the primary market of Nepal.

**Table 1**

*Status of Existing Regulatory Capacity and Its Capacity to Promote Book Building*

Items	Mean	Std Dev	Range
The existing regulations are sufficient to lead the stock market with the coherent effort to initiate book building pricing of IPOs	2.39	0.82	1-5
The existing regulation ensures that the issuing company has disclosed all the required information to facilitate investment decisions	3.15	1.14	1-5
The existing regulations can promote new initiatives like private equity funds, hedge funds, endowment funds, etc. that required under book building pricing of IPOs	2.55	1.17	1-5
The existing regulations can protect investors' sentiments against undue practices of market players under book building pricing	2.76	0.92	1-5
The existing regulations would allow divestment of existing shares to attract private companies in the capital market under book building pricing	2.90	0.78	2-4
The existing regulations can promote an environment of a public issue that can be a mechanism for an exit strategy	2.72	0.86	1-4
Average	2.75	0.72	

*Source: Questionnaire survey 2020*

Table 1 displays the weighted mean score and standard deviation of existing regulatory capacity of the primary market as to whether it is appropriate to implement book building pricing. Referring to scale items of Table 1, the overall mean score and the mean of all individual Likert items except the second one are below three, showing relatively a poor regulatory capacity, indicating that the existing regulatory capacity is not appropriate to promote and implement book building pricing in Nepal. Categorically, market participants disagreed regarding existing regulations of IPO pricing, support of private equity and hedge funds, fairness in protecting investors, divestment of existing shares and exit policy from the company. This suggests that the regulatory provisions necessary for implementing book building pricing need to be duly amended and develop a conducive environment aiming to receive supports from different stakeholders. The results also suggest that SEBON should also formulate necessary bylaws that will help effective implementation of book building in the primary market of Nepal.

### **Recent Initiatives to Pricing IPO Shares**

Book building, a widely popular mechanism of IPO pricing mechanism practised already even in our neighbouring countries, has now becoming an issue of discussion in the primary market of Nepal.

In this connection, SEBON initiated a study of book-building pricing methods by visiting neighboring countries in 2019. Similarly, SEBON's policies and programs for the fiscal year 2019/20 asserted to implement book building pricing on an experimental basis in Nepal. They made the third amendment of "Securities Registration and Issuance Regulation 2016" on February 13, 2020, with the provision of implementing book-building pricing of IPO of shares in Nepal. One more separate rule, i.e. Rule No. 25 'Ga', is added in the Regulation, which states the provisions related to initial public offerings of shares through book building pricing. The major provisions included in the Rule No. 25 'Ga' are:

1. A body corporate fulfilling the following conditions shall go through public issues under the book building mechanism.
  - a. Require having a track record of net profits for the last three consecutive years.
  - b. Require having a resolution related to public issues through book building mechanism passed by the annual general meeting.
  - c. Require having net worth per share at least 150 percent of paid-up value (per share).
  - d. Required to have to get an average or above-average rate of credit rating.

2. A body corporate requires getting indications of interest of price from qualified institutional investors (QIIs) in public issues under the book building mechanism.
  3. It required a body corporate to determine the price band of securities based on the indications of interest of price and set aside 40 percent of offerings to QIIs and 60 percent to the general investors.
  4. A body corporate allocated security to the QIIs shall not allow selling or transfer of securities until the six months of listed in the stock exchange.
  5. The following institutional investors licensed from SEBON, can take part as QIIs under book building mechanism: a) listed corporate bodies, b) financial institutions established under the special act, c) mutual fund managers, d) mutual fund schemes, e) merchant bankers, f) eligible retirement funds, and g) other funds or company or organization as prescribed by the board.
- from the QIIs, a body corporate should first determine the base rate of an IPO share. Similarly, rules 9 (2) and (3) state that the price range can then be determined within 20 percent upper and lower limit of the base rate. The QIIs will then be asked to submit their bids with the bid amount not exceeding the 20 percent upper limit mark. Rule 13 (1) and (2) state that when the deadline of application is over then the cut-off price is determined and those who apply for the price above the cut-off price will be offered shares as per their demand and allotted proportionately to those who will demand shares at the cut-off price. Rule 14 (1) of the Directives states that general/retail investors will receive a 10 percent discount on the cut-off price and can apply for minimum 50 unit shares.

SEBON has also brought “Book Building Directives 2020” which states that companies can issue shares at a price in access to the par value of an IPO. Rule 8 (1) of Directives states that a body corporate should demand a minimum number of shares, expected price, and its method of valuation from the QIIs through the help of merchant bankers. Rule 9 (1) of the Directives further states that based on a thorough study of expected price collected

In the same way, “Mutual Fund Regulation 2010” has been amended on February 13 2020 with the provision of allowing insurance companies and non-banking financial institutions established with special Act can operate mutual investment fund plans. Since the recent amendment in Securities Regulation and Issue Regulation allows mutual funds to undertake the role of institutional investors, the amendment in Mutual Funds Regulation, as such, helps to extend the number of institutional investors in the market. The role of institutional investors in terms of QIIs regarding pricing and also in the allocation of IPO shares is crucial

while implementing book building pricing (Jagannathan et al., 2010). Similarly, the existing “Specialized Investment Fund Regulation 2019”, which includes various new initiatives like private equity funds, hedge funds, endowment funds, etc. was amended on July 16 2020. The amended provision mainly allows registering foreign funds or fund managers to register in Nepal. This provision provides an opportunity to attract foreign institutional investors in the country, consequently it help internationalization of the capital market of Nepal. It adds significant impetus in the implementation of book building pricing of new issues in the market.

The major aim of these new policy initiatives is to bring a structural change in the existing primary market environment by attracting large and family-owned real sector enterprises into the mainstream of the capital market (SEBON, 2020).

### **IPO Pricing Practices**

In Nepal, the regulatory regime fixes the price of a public offering of shares, whereby companies cannot offer shares at price more than par value or face value. To date, a body corporate issued their IPO of shares at the par value as per Companies Act 2006, Securities Act 2006 and Securities Registration and Issue Regulation 2016. The fixed price method of IPO pricing is dominant which results deeper underpricing in the primary market

of Nepal.

In this connection, Dahal (2007) conducted a study on the performance of Nepalese IPOs of total 107 IPOs from 1993/94 to 2005/06 and found that the Nepalese IPOs are highly oversubscribed and underpriced by 53.25 percent. Another study by Pradhan and Shrestha (2016) found an 200.16 percent average initial return of 61 IPOs during 2005 to 2011. Similarly, Gurung (2020) documented the underpricing of Nepalese IPOs of 276.87 percent for the period of 2009/10 through 2018/19. These results are consistent with the findings of Loughran et al. (1994) and Shengfeng (2010) where they found that underpricing of IPOs are higher under fixed price method. Moreover, the deeper underpricing of IPOs apparently is due to the fixed price methods with excessive regulatory control which is consistent with the findings of Moshirian et al. (2010) and Jelic et al. (2001).

Issue of IPO shares at a premium, the price above the par, are rarely found in practice. The first hydropower company viz. Arun Valley Hydropower Development Company Ltd. has offered IPOs at a premium of Rs.184/- per share in 2008. Similarly, Nepal Telecom (2008), Chilime Hydropower Company Ltd. (2011), Rural Microfinance Development Center Ltd., and Shivam Cements (2019) have issued their IPOs at a premium of Rs.601/-, Rs.408/36, Rs.180/-, and

Rs.300/- (Rs.200/- for locals) respectively. Most recently, Ruru Hydropower Project Ltd. (2021) issued its IPOs at Rs.120/- per share, respectively. However, these issues had not been made any attempt to understand the market for determining the offer price of IPOs.

Nepal does not have a real experience of IPO common stock pricing under an auction mechanism. Even no provisions are made in the Regulations as well. But occasionally, some corporate bodies have undergone different forms of auction pricing practices in Nepal. In this connection, the ordinary shares of Standard Chartered Bank Nepal Ltd. under the ownership of Nepal Bank Ltd. were offered to the public, under closed bid auction in which the floor price is set at the prevailing market price of Rs.1500/- per share in 2004 (Vaidya, 2012). Similarly, Nepal Telecom offered its IPO of 15 million shares under closed bid auction with a premium price of Rs.601/- per share as the floor price. Further, the secondary offerings of Nabil Bank Ltd., and Nepal Investment Bank Ltd. were made using a discriminatory auction. Moreover, unsubscribed right offerings of shares of corporate bodies have been widely sold under discriminatory auction methods, as per Securities Registration and Issuance Regulation 2016.

On behalf of the Nepal government, Nepal Rastra Bank issued IPO of treasury bills for short-run, and development bonds

for long-run capital on an auction basis regularly. The price of the treasury bills is determined in the multi-bid price method, known as discriminatory auction while the interest rate of the development bonds depends on a uniform bidding system, commonly known as Dutch auction mechanism (NRB, 2016). In this way, the practice of auction pricing of IPO securities has not found systematic and regular except government's debt instruments, in the primary market of Nepal.

Regarding book building, SEBON has been binding to liftoff price discovery method of IPO shares of public companies. The regulatory body initiated to come up with adequate pre-requisites since it fairly priced IPOs relative to the first day trading in the stock exchange (Shengfeng, 2010). But no attempt has been made to employ book building pricing of IPOs by any of the corporate bodies in the market to date. It raises a number of questions and also implies that there are still serious gaps in regulatory interest and the overall market structure in the primary market of Nepal.

### **Conclusion**

An efficient pricing mechanism is important to both issuers and investors because it ensures fair price discovery of IPO securities. Over- and underpricing of IPO shares, in effect, is the cost to the issuing firm and investors, respectively. The study shows that the fixed price public

offer, which results in deeper underpricing of IPO shares is the dominant pricing method in Nepal. Review of various policy documents like Companies Act 2006, Securities Act 2006 and Securities Registration and Issue Regulation 2016 revealed that the fixed pricing method is dominant since the dawn of the stock market in Nepal indicating deeper underpricing of IPOs, which is consistent with the findings of Jelic et al. (2001), Moshirian et al. (2010) and Tanyeri et al. (2022). Issuance of IPO shares in premium is occasionally found in practice while there is a restriction of IPO equity issue at discount in Nepal. These findings are supported by the opinion of market participants which suggests that the existing regulations are not effective and they cannot be applicable to launch book building pricing, implying they need to be amended rigorously. Some practices of auction pricing of cross-holding shares of commercial banks is also occasionally

experienced in Nepal.

Regarding book building, SEBON initiated amendments in Securities Registration and Issue Regulation 2016 to implement the price discovery method. Book Building Directives 2020 has also come into effect to support the amendments made in the Regulation. Mutual Fund Regulation 2010 and Specialized Investment fund Regulation 2019 have also been duly amended. However, no companies are interested to go for book-building pricing of IPOs in the market to date. Since the neighbouring countries like India (1999), China (2005), Pakistan (2008), Bangladesh (2009), Sri Lanka (2015), etc. have already adopted the book building mechanism of IPO pricing, SEBON should take due initiation to bring book building pricing in practice as possible.

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**134** *The Journal of Madhyabindu Multiple Campus, Vol. 8, No. 1, 2023*

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