Requirement of Minimum Public Share Holding for Initial and Continuous Listing

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Ministry of Finance needs to be warmly congratulated for its proposal to amend Rule 19(2)(b) of the Securities Contracts (Regulation) Act, 1957 to provide for a public shareholding of 25 per cent of each and every class of issued capital of a company, both initial and continuous, seeking listing on a stock exchange.

Background

The proposal has to be considered in the background of Rule 19(2)(b) of the Securities Contracts (Regulation) Act, 1957 (SC(R) Rules) – which provided with effect from 1 st June, 1972 that at least 60 per cent of each class or kind of securities was required to be offered to the public to be eligible for listing on a stock exchange. Out of 60 per cent, 11 per cent taken by the Central Government, State Government and some notified public institutions like Industrial Development Bank of India, Industrial Finance Corporation of India, ICICI LIC, UTI, development / investment agency of a State Government, etc. was considered to be part of the public offer. Comprehensive guidelines issued by the Government provided for relaxation only in the case of companies with foreign equity participation or joint sector companies, with the minimum public offer pegged at 33 1/3 per cent.

In the case of FERA companies, the minimum public offer that was required to be offered was the issued capital of the company minus the permissible level of foreign equity and the existing level of Indian shareholders subject to a minimum of 20 per cent. If the foreign equity was say 40 per cent and the Indian promoters held 20 per cent, then the public offer should be 40 per cent.

Reduction to 40 per cent in two stages was allowed vide March 18, 1985 guidelines of the Government subject to the condition that the company has been in existence for at least 10 years and making profits for at least 4 out of 5 years, prior to the date of listing application. Further reduction was allowed, if the shares held by non-management (including officials) were widely spread for at least three years.

In June 1992, Securities and Exchange Board of India (SEBI) in its draft Disclosure & Investors Protection Guidelines came out with a proposal of minimum 20 per cent public offer for listing. This was a big climbdown from the point of view if Retail Individual Investors (RIIs). While amending the SC(R) Rules in September 1993, Government provided for 25 per cent minimum public offer. It was only from May 1995 that SEBI directed that out of the public offer, 50 per cent should be reserved to RIIs.

After a series of alterations, Government amended SC(R) Rules in 2001 providing for a minimum public offer of 25 percent for all companies except Government companies where stock exchanges could relax the requirement, and further provided for a public offer of 10 per cent subject to a minimum of public offer of Rs.100 crore and 20 lakh shares and through book building with 60 per cent being allotted to Qualified Institutional Buyers (QIB)s and 10 per cent to Non-Institutional Investors (NNIs) and 30 per cent to RIIs. SEBI amended the guidelines further providing for allocation of 50 per cent to QIBs, 15 per cent to Non-Institutional Investors (NNIs) and 35 per cent to RIIs in some cases. This meant that a company with a capital of Rs.1,000 crore could offer only Rs.100 crore and RIIs would get 30 or 35 per cent of the same i.e. Rs.30 crore or Rs.35 crore. In other words, a company with a capital of Rs.1,000 crore would offer only 3 or 3.5 per cent of the public offer of the issued capital to the RIIs. Needless to say that this mutilated against the concept of spreading equity cult in the country preached by all.

Continuous Listing Requirement

The listing agreement as amended in May 2006 provides for a continuous maintenance of at least 25 per cent.

However, if a company had offered shares to the extent of at least 10 per cent of the capital, public shareholding should be maintained at 10 per cent on a continuous basis. Also, if the outstanding listed shares of the company are two crore or more and the market capitalization of such company is Rs.1,000 crore or more, continuous public shareholding should be at least 10 per cent of the total of issued shares.

Besides, where as on may 1, 2006, the shares of a company are listed and the public shareholding is less than 25 per cent or 10 per cent as the case may be, the company has to increase the minimum public shareholding to at least 25 per cent or 10 per cent, as the case may be.

In case of shortfall of public shareholding to the minimum level as stated above, a period of two years is given to increase the shareholding to the relevant level. The company can increase the public shareholding by issue of shares to the pubic through prospectus, or offer for sale of shares held by the promoters, or sale of shares by promoters.

Implementation of Ministry of Finances proposal is a single point answer to a significant extent to the four major problems affecting adversely the smooth and orderly functioning of the stock exchanges in the country.

Lack of Liquidty

While the most popular scrips get traded heavily, often a sizeable portion of the issued capital in a single day, the less popular ones do not get adequately traded to provide for easy entry or exit with the gap between the bids and offers being quite wide, not to speak of a majority of listed scrips either being thinly traded or not being traded at all, all because of low floating stocks.

In 2007-08, out of 7,681 scrips listed on the Bombay Stock Exchange (BSE), only 2,709 i.e 35.27 per cent of the listed scrips were traded. Number of scrips traded for more than 100 days was much less, being about 2,400.

With the National Stock Exchange listing mostly large cap companies, and trading on all the regional stock exchanges having ground to a halt, BSE is the only stock exchange today where trading in mid cap and small cap stocks are taking place.

Volatility

Indian stock markets are among the most volatile in the world. During 2007-08, average daily volatility of Sensex and Nifty was 1.93 and 2.03 respectively as against 1.10 of Dow Jones, 1.37 of FTSE and 1.56 of Nikkei. Comparing with emerging markets, volatility of all the major markets viz, 1.88 of IBOV of Brazil, 1.55 of MEXBOL of Mexico and 1.45 of JALSA of South Africa were lower than that of Sensex and Nifty during the same period.

Sensex fluctuated by 28.4 per cent from a high of 21,113 on 9th January to a low 15,332 on 22nd January, 2008. Overnight fall of Sensex on 22nd January 2008 was by 13.8 per cent from 17,605 to 15,332.

A major cause of volatility is the operations of Foreign Institutional Institutions (FIIs) who with over $ 68 billion net investment (as on March 31, 2008) amounting to about 4 per cent of market capitalization account for about 30 per cent of the floating stocks and 30 per cent of the deliveries. As against this, although domestic mutual funds had as on March 31, 2008 assets of about Rs.5.05 lakh crore i.e. about Rs.125 billion, their operations were hardly 50 per cent of those of FIIs.

The overall fall in Sensex by 16.9 per cent from 20,728 on January 14 to 17,222 on January 24, 2008 was mainly due to net disinvestment of Rs.12,735.5 crore by FIIs while mutual funds had a net investment of Rs.9.686.80 crore.

Low shareholdings by Resident Individual Investors (RIIs)

Despite the growth of the market several fold with market capitalization of nearly $ 2 trillion, shareholding population has not grown. In fact, according to SEBI – NCAER study, the number of equity investor households halved from 12.1 million in 1998-99 to 6.1 million in 2000-01, representing just 3.7 per cent of Indian households. As on 31-3.2005, 20.1 million had invested in equities, debentures and mutual funds representing a meagre 2 per cent of the population. Number of demat beneficial owner accounts as on April 30, 2008 was about 14 million.

There are several companies where holdings by RIIs are less than 10 per cent, and out of them a lot of them less than even 5 per cent. As per the Ministry of Finance, Indian public held in NSE as on June 30, 2007, 13.35 per cent out of which share of RIIs may be 7 to 8 per cent or even less, while those of Indian promoters and FIIs were 48.35 per cent and 10.53 per cent respectively.

Manipulation of Prices

Indian stock markets are also subject to manipulation of prices, rigging up of prices, creating a false market, etc. Prior to the abolition of wealth tax, to see the prices of SME shares hammered by interested parties to pay less tax was a common feature. However, stock exchanges took no effective action, although they had ample powers to do so under their bye-laws.

Manipulation of prices by interested parties continued to be a common feature till SEBI started taking penal action in 1996 under the SEBI (Prohibition of Fraudulent and Unfair Trade Practices) Regulations, 1995. Relatively, instances of manipulation of prices have come down mainly due to close surveillance by both stock exchanges and SEBI.

Manipulation of prices on a large scale by FIIs, however continues as most of them act in concert Scale of operations are so widespread that it has become virtually impossible to track them down.

Concerns Answered

A major concern of Corporate India is that large listed companies need not have a minimum public float of 25 per cent while the same can be applicable to small companies.

The answer to this is that companies, small or big, need to have the same percentage of float as wider issues of spreading the equity cult, reducing unequal distribution of wealth, etc are concerned.

Another concern of Corporate India is that all companies may not need all the cash that would be raised by the public offer of 25 per cent. The answer is that a company should weigh the pros and corns of going for listing. Companies already listed can very well utilize the excess funds for expansion, diversification, modernization, etc. and try to give better returns to the shareholders. Problem of excess cash, barring a few companies, is more a mirage than a reality.

Fears of market depression is exaggerated as offer of shares by the large holders to meet the minimum 25 per cent float, does not in any way reduce the earning per share.

The proposal not to grant any concession to government companies is indeed welcome. How can one justify a company like MMTC with a market capitalization of over Rs.1,20,000 crore and a turnover of over Rs.20,000 crore in FY 2008 currently trading at Rs.20,000 having a public float of a meagre 0.67 per cent with government holding 99.33 per cent of the capital.

Recommendations

Minimum Public Offer

The minimum public offer and float may be raised from 25 per cent to 40 per cent with the power to SEBI to reduce subject to a minimum of 25 per cent in respect of companies with foreign equity participation, joint sector undertakings and Government companies.

Share of RIIs

The share of RIIs in the public offer needs to be raised to 40 per cent as against 30 / 35 per cent at present, with the share of QIBs and NIIs being pegged at 45 per cent and 15 per cent respectively.

If initially there is an allotment of less than 40 per cent to RIIs, there can then be an interchange among the three groups and also vice versa. Once the listing is over, while QIBs and NIIs holdings may be reduced to 45 per cent and 15 per cent respectively, RIIs holdings may be permitted to be raised to 40 per cent. This ratio among the RIIs, QIBs and NNIs need to be maintained continuously with some flexibility so as not to affect adversely liquidity. The onus of maintaining this ratio should be put on the promoters and management.

It is not as though this is an unique experiment. New York Stock Exchange, London Stock Exchange and Hong Kong Stock Exchange have 25 per cent as the requirement both for initial and continuous listing while NASDAQ has 1.1 million publicly held shares for initial listing and 0.75 million publicly held shares for continuous listing.

Period for Compliance

In case of a shortfall below 25 per cent at present, the company may be permitted to bring about the public shareholding to 25 per cent within a period of one year as against the period of three months as proposed by the Ministry of Finance. According to one estimate, 1,200 companies would be required to offer shares worth Rs.10 trillion as against the market capitalization of about Rs.60 trillion as on April 31, 2008 i.e. 16.7 per cent of market capitalization.

Offer to RIIs at a Discount

At present, on a voluntary basis, companies can offer a discount upto 10 per cent to the offer prices to RIIs. It is worth considering making the discount of say 5 per cent on a mandatory basis to RIIs.

Fixed Price Offer

Instead of having book-building method with a band of prices, it is better to have a fixed price, as not all RIIs understand phrases like option I, option II, cut off price, etc.

Definition of Public

At present there is no definition of the word “public”

The definition of “public” can be as under :

Persons eligible to apply for securities offered by a company applying for listing its securities on a recognized stock exchange shall constitute the public. Securities allotted initially and held subsequently continuously shall be in the proportion of 45:15:40 among the Qualified Institutional Buyers, Non-Institutional Investors and Retail Individual Investors, respectively.

Conclusion

Implementation of the proposals incorporating the suggestions mentioned above will usher in a new era for the RIIs. Let the stock exchanges and stock brokers celebrate the year 2009 as the Year of RIIs.