Steps Required to Foster Growth of Retail Individual Investors

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According to Indian Shareholders - A Survey by the renowned stock market expert, L.C. Gupta, there were 9 million individuals owning shares in India in 1990. The growth of the shareholding population has been tardy not commensurate with the growth of the market.

As on March 31, 2010, the number of Beneficial Owners (BO's) holding demat accounts was 17.2 million. Taking duly into account the number of BOs holding undemated shares at about 3 million and ignoring the multiple BO accounts, the number of shareholders in India may be about 20 million which is less than one percent of the population. As against this, China with a population of about 1.25 billion has 124 million brokerage accounts, i.e about 10 percent of the population. More of the developed markets of the world have 20 to 25 percent of the population holding shares.

Growth of the Market:

As against this, the market as a whole has grown by leaps and bounds. For example, capital raised from the primary market zoomed from Rs. 7,817 crores in 1900-00 to Rs. 87,029 crore in 2007-08 while in 2009-10, it was Rs.57,555 crore.

Turnover at the National Stock Exchange and Bombay Stock Exchanges put together rose steeply from Rs. 13.25 lakh crore in 1990-10 to Rs.55.17 lakh crore in 2009-10, a rise of 316 percent. Trading in derivatives commenced at both BSE and NSE in June 2000 with negligible turnover. At NSE, trading in derivatives has been a fantastic success. In 2009-10, the turnover was as much as Rs. 176.64 lakh crore. In fact, in stock futures, the turnover was Rs. 51.95 lakh crore, being the second highest in the world. At BSE, however, trading in derivatives could not make any significant headway, resulting virtually in zero levels presently.

Market Capitalisation at BSE, which was Rs. 9.12 lakh crore as on March 31, 2000, catapulted to Rs. 51.3 lakh crore as on March 31, 2008 before declining to Rs. 30.86 lakh crore on March 31, 2009 which however rose to Rs. 61.66 lakh crore on March 31, 2010. At NSE, market capitalisation rose from Rs. 10.20 lakh crore as on March 31, 2000 to Rs. 48.58 lakh crore on March 31, 2008. It was much lower at Rs, 28.96 lakh crore on March 31, 2009, while on March 31, 2010, it rose steeply to Rs. 60.09 lakh crore.

The bell weather index, SENSEX, shot up from 781.05 on March 30, 1990 to 17,527.77 on March 31, 2010, thereby registering a rise of 22.4 times over the decade.

Disproportionate Growth of the shareholding population

The disproportionate growth of the shareholding population compared to the market as a whole can be attributed to some extent to the restrictive policies followed by the regulating authorities with regard to participation by Retail Individual Investors (RIIs) in acquiring shares. Some of these policies are mentioned below.

Shrinkage in Public Offer:

Rule 19(2)(b) of the Securities Contracts (Regulation) Act, 1957 (SC(R) Rules), provided, with effect from 1st 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 the 60 per cent, 11 per cent taken up 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 percent. 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 guideline 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, the Securities and Exchange Board of India (SEBI) in its draft Disclosure & Investor 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 of RIIs. While amending the SC(R)

Rules in September 1993, Government provided for 25 per cent minimum public offer. In May 1995, however, SEBI directed that out of the public offer, 50 per cent should be reserved for 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 (QIBs) and 10 per cent to Non-Institutional Investors (NIIs) and 30 per cent to RIIs. SEBI amended the guidelines further providing for allocation of 50 per cent to QIBs, 15 percent to Non-Institutional Investors (NIIs) 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 ie 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.

Continous Listing Requirement:

The listing agreement as amended in May 2006 provides for a continuous maintenance of at least 25 per cent of the shareholding with the public. However, if a company had offered shares to the extent of at least 10 per cent of the capital, public share holding would 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 public through prospectus, or offer for sale of shares held by the promoters, or sale of shares by the promoters. Unfortunately, these requirements have not been implemented and have remained only on paper.

Announcement in the 2009-10 Budget:

In the 2009-10 budget, the Finance Minister had observed that the average public float in Indian listed companies is less than 15 per cent and that he proposed to raise in a phased manner the threshold for non-promoter public shareholding in companies in the private sector as well as unlisted public sector companies, presumably to 25 per cent as per the proposal made earlier by the Ministry of Finance.

As per the Discussion Paper published by the Ministry of Finance, as on June 30, 2007, shareholding pattern indicated that while promoters held as much 48.35 per cent of the shareholding, Indian public held only 13.35 per cent with FIIs holding 10.53 per cent and Mutual Funds and other Domestic FIIs holding 9.14 per cent. Ministry of Finance announced subsequently that listed companies would be permitted to raise the public shareholding by five percentage points each year till they reach 25 per cent. No guidelines to were issued, presumably due to pressure from the corporate sector.

As per a recent study, as many as 180 leading companies, including several public sector listed companies, need to raise as much as Rs. 2.1 lakh crore to reach 25 percent of public share holding if promoters decide to dilute through fresh issues. The amount can be reduced to Rs. 1.6 lakh crore, if promoters choose to opt to sell their existing shares by an offer for sale. It is surprising how a company like MMTC was allowed to be listed with a public shareholding of just 0.67 per cent of its capital.

Dominance by the FIIs:

In the absence of any worthwhile growth of RIIs, FIIs continue to dominate the market. With an aggregate holding of over $ 89 billion as on March 31, 2010 and accounting for nearly 30 per cent of the floating stocks and 25 per cent of the deliveries, FIIs dominate the Indian market. Purchases and sales by FIIs virtually determine the movement of prices due to any effective contrarian move by others. For example, the net disinvestment of $ 11.785 billiion by FIIs from January 2008 to March 2009 led to decline of 54.16 per cent in SENSEX while in 2000-10, net investment of $ 30.252 billion resulted a rise in of 83.49 per cent in SENSEX.

Beneficial effects of Raising Strength of RIIs:

Raising the strength of RIIs to at least 25 percent will have the following beneficial effects.

Lack of liquidity is a major concern of the Indian stock markets. As on March 31, 2010, out to 8,072 listed scrips on BSE, only 2,963 securities were traded. Out of this, the number of scrip traded continuously will be about 60 per cent to 70 per cent. In fact, top 100 scrips account for about 60 to 70 per cent of the trading.

In 2007-08, out of 7,681 scrips listed on the Bombay Stock Exchange (BSE), only 2,709 companies 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.

Manipulation of Prices:

Indian stock markets are subject to manipulation of prices, rigging up of prices, creating a false market, etc. due to low holding of shares by RIIs.

Manipulation of prices by interested parties continues to be a common feature despite the strict penal action taken by SEBI under the SEBI (Prohibition of Fraudulent and unfair Trade Practices) Regulations, 1995. Large-scale manipulation of prices of FIIs acting together is also a major problem.

Volatility:

Indian stock markets are among the most volatile in the world. During 2009, average daily volatility of Sensex and Nifty was 2.11 and 2.14 respectively as against 1.52 of Dow Jones, 1.47 of FTSE and 1.76 of Nikkei. Comparing with emerging markets, volatility of all the major markets viz., 1.93 of IBOV of Brazil, 1.70 of MEXBOL of Mexico and 1.54 of JALSA of South Africa were lower than that of Sensex and Nifty during the same period.

A single point solution to curb all these malpractices is to increase the strength of RIIs.

Amendments to Securities Contracts (Regulation) Rules, 1957:

It is comforting to note that after a lot of hesitation, Ministry of Finance amended on June 4, 2010 the Securities Contracts (Regulation) Rules raising the minimum threshold level of public shareholding to 25 per cent for all listed companies and requiring existing listed companies having less than 25 percent public holding to reach the minimum 25 percent level by an annual addition of not less than 5 percent to public holding.

In order to allay fears of large companies not wanting additional capital immediately, the amendment includes a significant provision which stipulates that "if the post issue capital of the company calculated at the offer price is more than Rs.4,000 crore the company may be allowed to go public with a minimum of 10 per cent public holding and employ with the 25 per cent shareholding required by increasing its shareholding by at least five per cent a year.

What is equally significant is that if the public shareholding falls below 25 per cent, the company will have to step up the public shareholding up to 25 per cent within 12 months.

Apprehensions that the market will not be able to absorb such a large amount of capital are misplaced. The Indian investing public have a tremendous appetite for new issues provided issues are attractive and leave scope for appreciation after listing. With gross domestic savings of over Rs. 20 lakh crore, absorption of Rs. 2 lakh crore in a year or two, in addition to an annual offtake of Rs. 50,000 crore is a feasible proposition.

It is crucial to note that performance of the primary market is related to the level of offer price. The extent of oversubscription is almost directly linked to the extent of higher post-listing price, irrespective of the fundamentals of the company.

There is no need whatever for the Government to have any "modification, correction, amendment or may be amplification," as reportedly stated by the Finance Secretary on June 9, 2010.

Book-building:

Book –building has not proved to be a proper price discovery mechanism. Besides, RIIs have virtually no role to play in book building. Since book building has come to stay, it is desirable at least to rationalise the IPO/FPO pre-issue announcements.

A serious lacuna in the procedure laid down for IPO's and FPO's , which has acted as a major hurdle in participation by the RIIs is the ununderstandable proximity in the timing of the announcement relating to price band and the minimum bid lot size, to the issue opening date. In the case of IPOs, it is two working days while it is just one working day in the case of FPOs.

Abridged prospectus, which becomes generally available about seven days prior to the issue opening date, does not contain the price bands and the minimum lot size. As a result, in the portion relating to the "basis for issue price", figures relating to price earnings ratios, etc. are answered with a dot.

The most crucial issue in any IPO is the issue price and in the absence of the same, all comparisons with the industry peers is, to say the last, meaningless. Moreover, the format of an abridged prospectus is such that it is difficult to locate the portion relating to "Basis for issue price".

Grey Market:

As an ordinary investor is thus not able to apprise the merits of an issue, he willy nilly consults his broker. Brokers are generally influenced by the premium quoted in the unofficial grey market located mostly in Bombay, Ahmedabad, Jaipur, Rajkot, etc. The organisers of the grey market are in touch with the stock brokers and merchant bankers who in turn influence the grey market quotations.

While an alert investor located in metropolitan cities keeps himself informed of the quotations in the grey market and the price band, most of the investors located in semi-urban and rural areas just grope in the dark. This is a major reason why subscription to any issue from semi-urban and rural areas is minimal, just not more than say 10 percent of the issue. No wonder, growth of shareholding population in India is affected.

Answer:

What then is the answer? All work relating to fixation of the price band must be done by the issuer in consultation with the Book Running Lead Managers prior to the publication of the abridged prospectus. The abridged prospectus containing this information must be made available to the investors at least ten working

days prior to the opening of the issue. Besides this, the announcement in news papers relating to opening of the IPO issue needs to be made at least seven working days before the date of opening and not just 3 or 4 days, as is being done at present by most of the companies. Giving an extra day for closure of the issue for non-institutional investors, as announced recently by the SEBI Chairman is welcome, as it grants some leeway to the non-institutional investors but is hardly the solution to attract the RIIs, located particularly in semi-urban and rural areas.

Not only the announcement be made seven working days in advance but also, a summary of the basis for issue price needs to be given in the announcement, as is being done recently by a few companies like Tarapur Transformers Ltd., JSW Energy ltd. etc. This will help the ordinary investor to make a quick assessment of the merits of the issue.

As the announcement is made in several cases only in a newspaper like The Financial Express, circulation of which is rather limited, even most of the regular investors, do not have access to this valuable information.

Rank of the IPO grading done by Credit Rating Agencies is given in a remote corner of the abridged prospectus. In order that the eye of the investor catches easily the IPO grading, it should be given in bold letters not only on the first page of the abridged prospectus but also displayed prominently in the application form itself.

The format of the abridged prospectus needs also to be recast in a booklet form on the basis of the offer document of mutual funds with a proper contents page. The perforated application form can be attached to the offer document.

Issue Pricing Key to attract RIIs:

Key to the success of the primary market, mainly subscription by RIIs, lies in the pricing of the issue. The parameters prescribed by SEBI like the EPS for the last three year, P/E pre-issue and comparison with the industry P/E, average return on the networth in the last three years, latest net asset value per share, net asset value after issue and comparison with the issue price, etc. have failed in checking the issues from being fixed at unrealistic levels. What needs to be realized is that any price that is fixed should ensure that post- listing price normally does not fall below the offer price so that investors, particularly RIIs, get attracted to subscribe to new issues. Stricter parameters for issue pricing are, therefore, needed.

It is worth noting in this connected that in the US, a free market economy, issue of securities is also governed by separate securities laws of individual states in addition to the Federal Securities Act, 1933. The common denominations of all these state level legislations specify minimum promoters contribution, maximum expenses of public offerings, the price insiders must pay for their stocks related to the proposal price for public investors, offer prices to be related to earnings ratios or other benchmarks, interest and dividend coverage with regard to senior securities, minimal shareholder voting rights, etc. In order to harmonize State Securities Regulations, the US Congress has enacted the Uniform Securities Act in 1985 which has been adopted by almost all the States.

The question of revision of norms relating to basis of issue price in order to render issue price more realistic needs, therefore, to be considered.

PSU Disinvestment:

At least with regard to disinvestment by Public Sector Undertakings, it is desirable that instead of book building method for fixing the offer price, fixed price route is availed off to attract RIIs. Share of the RIIs may also be raised to say 50 per cent of the offer and a discount of say 10 per cent in offer price may be given to the RIIs as has been done recently by some of the PSUs. This is a surer method of strengthening the RIIs.

Conclusion:

Enhancing the strength of RIIs will ensure that the fruits of growth are shared by the common man. This will be in accordance with clauses (b) and (c) Article 39 of the Constitution of India which ordains “that the ownership and control of the market resources of the community are so distributed as best subscribe the common good” and “that the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment.”