SECURITIES LAWS

MINIMUM PUBLIC FLOAT NORM – BITTER PILL FOR STOCK MARKET'S AILMENTS

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This article deals with the amendment brought about by the Ministry of Finance on June 4, 2010 in the Securities Contracts (Regulation) Rules, 1957 thereby mandating the listed companies to increase the public float to minimum level of 25 per cent in a phased manner by increasing the public shareholding by at least 5 per cent every year till the public shareholding reaches the minimum prescribed level of 25 per cent. The author explains the procedure for increasing the public float and outlines some pitfalls in the new Rules. He suggests that it would have been appropriate if the threshold limit for public shareholding has been linked to market capitalisation rather than having an uniform threshold limit of 25 per cent for all the companies.

Introduction

1. On June 4, 2010, the Ministry of Finance amended the Securities Contracts Regulation Rules, 1957 thereby making it mandatory for all the listed companies to increase the public shareholding to at least 25 per cent in a phased manner. The Finance Minister in his Budget Speech delivered on July 6, 2009 had proposed to raise the public float in listed companies in order to increase the market depth and to check the price manipulations. At last, the Ministry has brought out this amendment which would have far-reaching implications for the stock market since there are a number of private and public sector companies which have promoters' shareholding exceeding 75 per cent. In other words, the public shareholding is less than 25 per cent.

Public shareholding in a listed company comprises of aggregate of the shareholding of Retail Investors, Financial Institutions, Banks, Mutual Funds, Foreign Institutional Investors (FIIs), Body Corporates and NRIs/ OCBs. Since the definition of 'Public shareholding' includes the shares held by all the non-promoter entities, virtually the shareholding of the retail investors in most of the blue chip companies is minuscule. That's why there is a need to increase the public float in listed companies.

Basic reason for low public float

2. The erstwhile rule 19(2)(*b*) of the Securities Contracts Regulation Rules, 1957 provided that a company must offer at least 25 per cent shares to the

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public for getting listed. However, the aforesaid rule was relaxed by the SEBI in the year 1999 to enable the companies in information technology sector to come with IPOs with only 10 per cent public float. The justification given by the SEBI was that neither the Indian market had the appetite for such large IPOs nor the companies needed so much of funds. The rule was further relaxed in April 2000 to accommodate media and telecom companies as well. The said Rule was once again amended by the SEBI in the year 2001 to provide that all the companies proposing to issue at least 20 lakh shares aggregating to Rs. 100 crore or more through book building could list with 10 per cent public float.

After IPO every company has to comply with the listing agreement entered into with the stock exchanges. Clause 40A of the listing agreement provides that a company shall maintain on a continuous basis at least 25 per cent public shareholding. However, a company can continue to be listed with only 10 per cent public float if :—

- the original offer to the public was of only 10 per cent of the total capital; or
- the number of listed shares are more than 2 crore and the market capitalisation exceeds Rs. 1,000 crore.

The Government companies, infrastructure companies and the sick industrial companies referred to the Board for Industrial and Financial Reconstruction (BIFR) were so far exempt from the applicability of the aforesaid clause. This is the reason as to why so many PSUs continue to be listed at the stock exchanges with not even 10 per cent public float. Thus, the combined effect of rule 19(2)(*b*) of SCRA and clause 40A of the listing agreement is that there are many companies with public float less than 25 per cent.

Advantages of large public float

3. Large public shareholding is advantageous from the point of view of investors since it reduces volatility, improves liquidity, increases floating stock, prevents market manipulation and widens the ownership base that ensures greater investor participation and wealth creation. Last, but not the least, it helps in better price discovery. There are a number of PSU shares which are quoting at very high valuations just because of meagre floating stock in the market.

For example, NMDC Limited had public shareholding of just 1.62 per cent (*Source: Shareholding Pattern* – December 31, 2009 at BSE website). The share was commanding price of Rs. 458 as on February 19, 2010. Subsequently, it came out with a Follow-on Public Offer (FPO), in the price band of Rs. 300 to Rs. 350 per share, as part of the Government's disinvestment programme. The issue opened for subscription on March 10, 2010. After the allotment of shares the public shareholding increased to 10 per cent but the share price fell below the cut-off price of Rs. 300 fixed for FPO.

Thus, increase in public shareholding wrecked the NMDC's share price. From the above example, it can be observed that the presence of public float is utmost necessary for true and fair price discovery.

Salient Features of the new Rule

4. The salient features of the new rule are as follows :—

- Minimum threshold level of public shareholding will be 25 per cent, which would be uniformly applicable to all the listed companies, whether private sector or public sector. Hence, the PSUs would no more enjoy the privilege granted to them by clause 40A of the listing agreement.
- Existing listed companies which have less than 25 per cent public float would have to reach the minimum level of 25 per cent by annual addition of not less than 5 per cent.
- For Initial Public Offerings (IPOs), if the post-issue capital of the company calculated at offer price is more than Rs. 4,000 crore, the company may be allowed to go public with just 10 per cent public shareholding and comply with the 25 per cent public shareholding requirement later on by increasing its public shareholding by at least 5 per cent per annum.
- Companies seeking fresh listing through IPO would have to dilute 25 per cent in one go in case their market capitalisation is less than Rs. 4,000 crore. However, the companies in the process of going public that have already filed draft prospectus with the SEBI could divest the decided quantity and later on meet the 25 per cent public shareholding requirement.
- A company may increase its public shareholding by less than 5 per cent in a particular year if such increase results in its public shareholding reaching the level of 25 per cent during that year.
- Every listed company must maintain public shareholding of at least 25 per cent. If the public shareholding in a listed company falls below 25 per cent at any time, such company shall reinstate the public shareholding to 25 per cent within a maximum period of 12 months from the date of such fall. This sub-rule would substitute the existing clause 40A of the listing agreement. Since, the violation of this sub-rule would be deemed to be a violation of the provisions of Securities Contracts Regulation Act, 1956 and the Rules framed thereunder, it would be easier for the SEBI and the stock exchanges to take suitable penal action against the defaulting companies, which may include levy of penalty up to Rs. 25 crore on such companies.

Methods for increasing the public float

5. The public shareholding can be increased through combination of any of the following ways :—

- Follow-on public offer or Public Issue of shares.
- Private placement with Qualified Institutional Buyers (QIBs).
- Offer for sale to public by the promoters.
- Sale of shares by promoters in the stock market.
- ESOPs to employees since the employees and independent directors are not treated as part of the promoter group.

There is a saying, 'Necessity is the mother of invention'. Similarly, when new rules and regulations are made by the Government, the entrepreneurs find innovative ways of complying with the same. Recently, Kwality Dairy issued bonus shares in the ratio of 5:7 only to its non-promoter shareholders. This resulted in increase in public shareholding from 16 per cent to 25 per cent. Thus, as on date, the company is fully compliant with the new rule. In fact, Reliance Power Ltd. pioneered the concept of issue of bonus shares only to the non-promoter shareholders, when the shares issued in its IPO at Rs. 450 per share were trading in the market at considerable discount to the issue price.

Major concerns

6. Although the new rule is a welcome move on the part of the Finance Ministry, but it is not free from pitfalls. Some of the major areas of concern have been highlighted below :—

(*a*) *Flooding of Primary markets* - All the companies having public float less than the threshold limit of 25 per cent would be constrained to come out with FPOs in a time bound manner as they have to dilute their promoter shareholding by at least 5 per cent every year till the promoter's shareholding falls to 75 per cent. Consequently, the primary market is likely to be flooded with public issues, which may suck the liquidity from the system.

(*b*) *Lack of participation by investors* - The investors would be reluctant to subscribe to so many public issues since they know in advance that the companies would be coming out with series of FPOs to raise their public shareholding every year by at least 5 per cent. For example, if a company has public shareholding of 12 per cent in 2010, then it would have to come out with FPO of 5 per cent in 2011, another 5 per cent in 2012 and finally 3 per cent in 2013 so that the public shareholding reaches 25 per cent. Now when investors know that they can subscribe to FPOs in the years 2012 and 2013 as well then what is the incentive for investing in 2011, until and unless the offer price is substantially lower than the prevailing market price. If the shares are issued at a discount to the market price the company runs the risk that the market price may fall further after the allotment of new shares which would not only affect the company's market capitalisation but would also be prejudicial to the interests of the promoter group.

(c) *Under-utilization of funds raised* - The new rule would compel the companies to come out with FPOs irrespective of the fact whether they require funds or not. The increase in number of shares coupled with the under-utilization of funds raised through FPOs may lead to decline in EPS and consequently the share price.

(d) *Sale of shares by promoters not in their interest* - In case the promoters don't wish to come out with FPOs or privately place the shares with QIBs, the other option left with them is to off load their shares in the stock market. This may put some temporary pressure on the stock price; with the result the promoters may not get the right price.

(e) *It may impact insurance joint ventures* - Listing of shares is mandatory for life and general insurance companies after 10 years of inception. At present the Indian promoters of most of the insurance joint ventures are holding 74 per cent shareholding while the balance 26 per cent is held by their foreign counterpart. In order to get the shares listed at the stock exchanges, the Indian JV partners may have to dilute their stake from the present 74 per cent to 49 per cent so as to give room to the public shareholders since the foreign JV partners may not agree to dilute their stake below 26 per cent. This is due to the simple reason that if any strategic investor holds 26 per cent stake, he can easily block the special resolutions proposed by the company for approval of the shareholders.

Whether the new norm can trigger delisting of shares?

7. The promoters may also consider the option of increasing their shareholding beyond 90 per cent and get the shares voluntarily delisted from the stock exchanges. Already various MNCs like Cadbury, Reckitt Benckiser, Philips, MICO, Wartsila India, Otis Elevator, Carrier Aircon, Sandvik Asia etc., have got their shares voluntarily delisted from the Indian stock exchanges during the past few years. It is quite possible that the new rule may compel some more MNCs to opt for voluntary delisting of shares.

Immediately after the announcement of this amendment, there was sharp rise in the market price of MNC shares like BOC India, Oracle Financials, Astra Zeneca Pharma etc., all of which have very high promoters' shareholding. Market players are expecting that the promoters of MNCs would not dilute their shareholding under any circumstance rather they would opt for delisting of shares to escape from the new provision. The expectation of these market players may come true but one should not forget that voluntary delisting of shares from stock exchanges is no more a simple task after the introduction of the SEBI (Delisting of Equity Shares) Regulations, 2009 with effect from June, 10 2009.

The erstwhile SEBI (Delisting of Securities) Guidelines, 2003 were very handy for the promoters to get rid of the minority shareholders and get the

shares delisted from the stock exchanges. However, the position has changed considerably after coming into force of the SEBI (Delisting of Equity Shares) Regulations, 2009. The new Regulations have put various hurdles in the path of promoters, thus, making delisting an uphill task for them. These hurdles are:—

(*a*) Earlier, the company had to obtain the approval of its shareholders for delisting, through a special resolution passed at a general meeting. All of us know that if the promoters have sufficient shareholding/ voting power in their hands, then it is just a child's play to get a special resolution passed because only a handful of shareholders attend the general meetings. In order to remedy the situation the SEBI has provided that the said special resolution has to be passed through postal ballot, wherein even the shareholders residing at far off places can participate through voting by post. Not only this, the SEBI has gone a step further by debarring the promoters from voting on such resolutions. Thus, even if the promoters have substantial shareholding, say, 85 per cent, they still can't influence the decision of the minority shareholders.

(*b*) Another safeguard introduced by the new Regulations is that the companies seeking delisting would have to submit an application to the stock exchanges for their in-principle approval. Only after obtaining the in-principle approval of the stock exchange(s), the promoters can proceed with the open offer to the public shareholders. No doubt the stock exchanges can't unduly hold or refuse to give the in-principle approval but still it would help a lot in ensuring that the promoters don't resort to foul play.

(*c*) Under the erstwhile SEBI Guidelines, the companies were permitted to delist in case the level of public shareholding after the delisting offer declined below the minimum level of public shareholding required as per clause 40A of the listing agreement, which is either 10 per cent or 25 per cent of the equity capital. Under the new Regulations, a delisting offer would be deemed to be successful if post-open offer, the shareholding of the promoter group reaches the higher of the following –

- 90 per cent of the total issued shares of that class.
- Aggregate of (pre-offer promoters' shareholding + 50 per cent of the offer size).

Thus, earlier the promoters could increase their shareholding to above 75 per cent and thereafter apply for delisting (in case the level of minimum public shareholding for the company was 25 per cent) but under the new Regulations, they would have to increase their shareholding to at least 90 per cent. Moreover, at least 50 per cent of the public shareholders must accept the exit offer and tender their shares to the promoters. The promoters of Goodyear India Limited, *vide* their public announcement

dated June 15, 2010, have informed that their delisting offer has failed since the promoters' shareholding even after taking into account the shares tendered by the public shareholders under the exit offer (through reverse book building method) could not reach the minimum prescribed level of 90 per cent under the SEBI's Delisting Regulations. Thus, it seems that the delisting of shares may not be a workable solution to deal with the issue of minimum public float.

Conclusion

8. The basic objective of the new rule is to increase the market depth and thereby prevent market manipulation. Although the amendment is a step in right direction but whether it would yield the desired results is doubtful. This is because having the uniform threshold limit of 25 per cent for all the listed companies irrespective of the size of their paid-up capital and market capitalisation does not make much sense. In case of small companies even 25 per cent public float may not be sufficient to prevent price manipulation whereas in case of large cap companies even 5 per cent free float may make the market operators sweat while manipulating the share price. Thus, it would have been appropriate if the threshold limit for public shareholding has been linked to market capitalisation rather than having an uniform threshold limit of 25 per cent for all the companies.