

Going Public – Think Twice (25% Public Float Mandatory)

Introduction

The Securities Contracts (Regulation) Act, 1956 (“**SCRA**”) is the principal law which governs the trading of securities in India and keeps a close watch over the various stock exchanges to prevent detrimental transactions in securities. It is not a very lengthy legislation¹ and while initially it was administered by the Central Government, but Securities and Exchange Board of India (“**SEBI**”) has concurrent powers to administer almost all the provisions of the SCRA.

At the time of an initial listing of shares a minimum offer is generally prescribed while a minimum public float is prescribed for continued listing based on the listing agreement. These are prescribed in terms of a *percentage of issue size, number or value of securities* or any combination thereof. Given the volatility of the global market since 2008, the Indian Finance Minister in his Budget speech for 2009-10 proposed to raise the threshold for non-promoter, public shareholding for all listed companies. Clearly, the rationale was that when the number of shareholders is large, monitoring is stringent and there is less scope for price manipulation.

On June 4, 2010 steps were taken to implement this initiative by means of the Securities Contracts (Regulation) (Amendment) Rules, 2010 (“**SCRA Amendment**”) which was notified through a Ministry of Finance press release. The SCRA Amendment also prescribes the requirements for continuous listing and provides intermediary provisions for companies with a public shareholding below 25%. This Bulletin discusses the amendments and their implications.

The Changes

Position before June 4, 2010

While the prevailing rules² did establish the minimum float at 25%,³ but both the stock exchanges and SEBI had ample discretionary power to waive or adapt this criterion for public-sector undertakings, information technology companies and those in the media, entertainment and telecommunications. At the time of an IPO, the number could be reduced to 10% provided 3 conditions were met, *viz.* **(i)** minimum offer is for 2 million securities, **(ii)** size of the offer is a minimum of INR 100 crores (approximately US\$ 21.5 million) and **(iii)** the issue is undertaken through the book-building process with allocation of 60% of the issue to qualified institutional buyers.

¹ It has only 31 sections.

² See Securities Contracts (Regulation) Rules 1957. The SCR Rules provide for the requirements which have to be satisfied by companies for the purpose of getting their securities listed on Indian stock exchanges.

³ See Rule 19(2(b) of the SCR Rules. The percentages of shares are those to be “offered” to be public – how many shares are actually taken up and allotted is not material.

Once listed, companies were required to maintain a minimum public float during the period of listing in accordance with Clause 40A of the listing agreement which too provides that listed companies maintain the 25% public float threshold. As with an IPO, the rules for continuous listing allowed room for bending and this number could be reduced to 10% in two circumstances, *viz.* (i) a company has offered between 10-25% shares to the public, or (ii) a company has more than 20 million shares outstanding or its market capitalization is at least INR 10 billion (approximately US\$ 215 million).

The June 4, 2010 changes

The flexibility possible under the rules prior to June 4 has now been taken away. The principal features of the SCRA Amendment are as follows:

- All listed companies must have 25% minimum threshold level of public holding. If the percentage reduces below the stipulated figure, then the company will have to ensure that the shareholding is enhanced to 25% within a maximum period of 12 months from the date of such reduction
- Existing listed companies below 25% public holding have to reach the prescribed minimum level by ensuring an annual addition of at least 5%
- The offer documents of all IPOs are now required to offer and allot to the public at least 25% of each class or kind of securities
- However, for any new IPO if the post-issue capital of the company calculated at offer price is more than INR 40 billion (approximately US\$ 860 million) the company may be allowed to go public with 10% public shareholding and comply with the 25% rule by increasing its public shareholding by, at least, 5% annually
- Companies which satisfied the requirements of Rule 19(2)(b) of the SCR Rules prior to the SCRA Amendment and who had a pending draft offer document with SEBI on or before June 4, 2010 will be required to comply with 25% public shareholding requirement by increasing their public shareholding by at least 5% annually, regardless of the amount of the post-issue capital of the company calculated at offer price
- A company may increase its public shareholding by less than 5% in a year if such increase brings its public shareholding to the level of 25% in that year
- The requirement for continuous listing will be the same as the conditions for initial listing.

Penalties for non-compliance are stringent. Those who fail to adhere with the minimum public float within the stipulated time period could face compulsory delisting, suspension of trading or a fine in excess of US\$ 5 million and/or prosecution. This is merely the start; going forward, SEBI will have to notify the process of the mandatory increase in public shareholding and issue detailed clarifications to plug the gaps.

The Impact and the Great Debate

According to the SCRA Amendment, *public*⁴ excludes the promoter, promoter group, subsidiaries and associates of a company. *Public shareholding*⁵ means equity shares of the company held by the public and not the shares held by the custodian against depository receipts issued overseas. These changes show that a significant objective is to prevent concentration of wealth in the hands of the promoters and the promoter group, which can expose the securities to price manipulation. Clearly, that has an inherent risk of prejudicing the interest(s) of the public investors and is, anyway, contrary to the principal purpose of the SCRA. By stipulating a minimum public float, the general public gets an opportunity to share in the increased wealth generated by an increasingly competitive private sector.

The flip side of a higher public shareholding is that it acts as a deterrent and prevents upcoming companies from going public. As in other parts of the world, the promoters want the benefits of listing, but are often loathe to giving a large share in the capital as well as control to the public. Company management usually wants to be in control over the timing of dilution of its stocks based on its needs for funds, rather than forcing an annual 5% dilution. The policy needs to juggle the needs of the promoters - on one hand - who want to retain a reasonable minimum stake while looking for more money from the market, yet – on the other hand - strike a balance to prevent accumulation of wealth only for a select few.

Based on media reports, the anticipation is that over 175 listed companies will need to disinvest an astronomical sum of about INR 1.6 trillion (approximately US\$ 3.4 billion). These include some of India's blue-chip companies like Reliance Power, Wipro, Indian Oil Corporation, Tata Communications, Steel Authority of India, and National Thermal Power Corporation, amongst others.

However, the SCRA Amendment seems to have confronted some troubles within the first month itself. The Department of Disinvestment has a contrarian view in view of the government's disinvestment policy⁶ which envisages 10% stake sale in listed, government companies. The dichotomy between two different positions needs to be settled, and as a consequence, the Department of Economic Affairs has agreed to defer the 25% norm for state-owned enterprises until a common position is attained between the different government departments.

Whether the private companies will easily and silently accept any discrimination in the threshold norms *vis. a. vis.* the government companies remains to be seen. The future, however, promises to be exciting in the Indian capital markets in the months to come.

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⁴ See SCR Rules 1957. In Rule 2, two new provision rules have been inserted. The new sub-clause (d) defines what constitutes public.

⁵ See SCR Rules 1957. In Rule 2, the new sub-clause (e) defines public shareholding.

⁶ This policy was approved end of 2009.