Capital Markets - India

Going public: think twice (25% public float mandatory)

Contributed by **PSA, Legal Counsellors**

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Introduction

The Securities Contracts (Regulation) Act 1956 is the principal governing law of securities trading in India and regulates the various stock exchanges to prevent detrimental transactions in securities. It is not a very lengthy piece of legislation,(1) and while it was initially administered by the central government, the Securities and Exchange Board of India (SEBI) has concurrent powers to administer almost all its provisions.

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 the issue size, the number or value of the securities or any combination thereof. Given the volatility of the global market since 2008, in his Budget speech for 2009-10 the Indian finance minister proposed to raise the threshold for non-promoter, public shareholdings for all listed companies. Clearly, the rationale was that where there is a large number of shareholders, 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, which were notified through a Ministry of Finance press release. The amendment rules also prescribe the requirements for continuous listing and provide intermediary provisions for companies with a public shareholding below 25%. On August 9 2010 the Ministry of Finance further amended these rules by enacting the Securities Contracts (Regulation) (Second Amendment) Rules 2010. This update discusses the amendment rules and their implications.

Changes

Position before June 4 2010
While the prevailing rules(2) established the minimum float at 25%,(3) both the stock exchanges and SEBI had ample discretionary power to waive or adapt this criterion for public sector undertakings, IT companies and those in the media, entertainment and telecommunications industries. At the time of an initial public offering (IPO), the percentage could be reduced to 10%, provided that three conditions were met:

- The minimum offer was for 2 million securities;
- The size of the offer was a minimum of Rs1 billion (approximately $21.5 million); and
- The issue was undertaken through the book-building process with allocation of 60% of the issue to qualified institutional buyers.

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 also requires that listed companies maintain the 25% public float threshold. As with an IPO, the rules for continuous listing allowed room for bending and this percentage could be reduced to 10% if: (i) a company had offered between 10% and 25% of its shares to the public; or (ii) a company had more than 20 million shares outstanding or its market capitalisation was at least Rs10 billion (approximately $215 million).

New changes
The flexibility available under the rules before June 4 and August 9 2010 has now been removed. The principal features of the amendment rules are as follows:

- All listed companies (other than public sector companies) must have a 25% minimum threshold level of public holding. If the percentage falls below the stipulated figure, the company will have to ensure that the shareholding is increased to 25% within 12 months of the date of such reduction.
- Listed companies other than public sector companies with a public holding of less than 25% must reach the prescribed minimum level within three years.
- A public sector company must offer and allot at least 10% of each class or kind of equity share to the public in terms of an offer document.
- Every listed public sector company must maintain a public shareholding of at least 10%. Where a listed public sector company has a public shareholding of less than 10% on the date of the commencement of the amended rules, it must increase its public shareholding to 10% within three years. If the percentage falls below the stipulated figure, the company will have to ensure that the public shareholding is increased to 10% within 12 months of the date of such reduction.
- 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 Rs40 billion (approximately $860 million), the company may be allowed to go public with 10% public shareholding and comply with the 25% rule within three years of the date of listing the securities in the manner specified by SEBI.
- Companies which satisfied the requirements of Rule 19(2)(b) before the amendment and had a pending draft offer document with SEBI on or before June 4 2010 will be required to comply with the 25% public shareholding requirement by increasing their public shareholding by at least 5% annually, regardless of the company's post-issue capital amount calculated at offer price.
- The requirement for continuous listing will be the same as the conditions for initial listing.

The penalties for non-compliance are severe. Those that fail to adhere with the minimum public float requirement within the stipulated timeframe could face compulsory delisting, suspension of trading or a fine in excess of $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.

Impact

According to the amendment rules, 'public'(4) excludes a company's promoter, promoter group, subsidiaries and associates. 'Public shareholding'(5) means equity shares of the company held by the public and not the shares held by the custodian against depositary receipts issued overseas. 'Public sector company' means a body corporate constituted by an act of Parliament or any state legislature, and includes a government company. These changes show that a key objective is to prevent the concentration of wealth in the hands of the promoters and the promoter group, which can expose the securities to price manipulation. Clearly, this has an inherent risk of prejudicing the interest(s) of the public investors and is contrary to the principal purpose of the act. By stipulating a minimum public float, the general public is given an opportunity to share in the increased wealth generated by an increasingly competitive private sector.

The flipside of a higher public shareholding is that it acts as a deterrent and prevents companies from going public. As in other parts of the world, the promoters want the benefits of listing, but are often loath to give 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 on the one hand to juggle the needs of the promoters, who want to retain a reasonable minimum stake while looking for more money from the market, while, on the other hand to strike a balance to prevent accumulation of wealth for a select few.

Based on media reports, it is anticipated that over 175 listed companies will need to disinvest an astronomical sum of approximately Rs1.6 trillion (approximately $3.4 billion). These include some of India's top blue-chip companies, such as Reliance Power, Wipro, Indian Oil Corporation, Tata Communications, Steel Authority of India and National Thermal Power Corporation.

However, the amendment rules already seem to have met with some troubles within the first month. The Department of Disinvestment takes an opposing view in light of the government's disinvestment policy,(6) which envisages a 10% stake sale in listed government companies. Consequently, the August 9 2010 amendment has kept public sector companies out of the 25% minimum public float requirement. Accordingly, now public sector companies are required to achieve minimum public shareholdings of merely 10%.

Whether private companies will willingly accept this discrimination in the threshold norms with regard to government companies remains to be seen. However, the future of the Indian capital markets promises to be exciting in the months to come.

For further information on this topic please contact Priti Suri at PSA, Legal Counsellors by telephone (+91 11 4350 0500), fax (+ 91 11 4350 0502) or email (p.suri@psalegal.com).

Endnotes

(1) It has only 31 sections.

(2) See Securities Contracts (Regulation) Rules 1957. These rules provide for requirements which must be satisfied by companies in order to have their securities listed on Indian stock exchanges.

(3) See Rule 19(2(b). The percentages of shares are those to be 'offered' to be public - how many shares are actually taken up and allotted is immaterial.

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

(5) In Rule 2, the new sub-clause (e) defines 'public shareholding'.

(6) This policy was approved at the end of 2009.