Stock splits – Theoretical and Legal framework

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Abstract:
Theoretically stock splits do not result in a change in market capitalization but still literature review puts forth several interesting effects of stock splits. Most of the past literature uses event study methodology and findings of research tend to be mixed, and sometimes contradictory. Very few studies considered long term effects of stock-splits. In India before 1999 stocks splits was an occasional phenomenon and companies restrained themselves from splitting their shares because of mandatory minimum par values. Securities and Exchange Board of India (SEBI) by circular SMDRP/ Policy/ Cir-16/ 99 in 1999 allowed companies to set face value of their equity shares as long as it was not fractional. The discussion below focuses on different aspects of stock splits both legal and procedural.

Keywords: *Stock splits, Market capitalization, SEBI*

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1. Introduction

Share prices of a company are affected by different types of events broadly categorised as exogenous and endogenous events. Exogenous events are the events result of external factors. They are unpredictable and in no way result of management decisions.According to Lo and Mc Kinlay (2004) changes in regulations or law, financial crisis, terrorism or natural disasters etc. are examples of exogenous events, which affects all companies at the same time and have same event day.These events are industry wide or affect the entire economy. Endogenous events are the events that are initiated by management of the company. They are also termed as self-selected news events. Dividend announcements, stock splits and initial public offer are examples of such events.These events are different for different companies and have different event days. Thus stock splits are endogenous events.

2. Stock splits - meaning

Stock split is a corporate decision in which company divides face value of the equity share into more than one unit. Stock splits add no value but increases number of shares. A stock split is a decision by company's board of directors to increase number of outstanding shares of the company without changing shareholders equity but by changing face value of equity shares.

In the current study stock split is defined as a corporate action wherein face value of the equity shares is reduced to a lower face value.

According to Sharpe, Alexander, Bailey (1995) a stock split entails reduction of par value or face value of the corporation's shares and simultaneous exchange of multiple number of new shares for each existing share. For example in a 2:1 stock split, every share holder with one share is given an additional share. As a result after a stock split there will be two shares for each one pre-split share. So if a company has 10 lakh shares outstanding before the split, it will now have 20 lakh shares outstanding in case of a two for one stock split.

3. Stock splits - reasons and advantages

Fama (1969) has defined market efficiency in terms of how quickly stock market reacts to information. All markets are neither fully efficient nor fully inefficient but level of efficiency varies in between. Fama (1970) provided different forms of market efficiency:-

- Market is considered as weak if share prices react to all past information so fast that no investor can earn abnormal returns.
- The market is regarded as semi-strong if share prices react to all public information so fast that no investor can earn above normal returns by acting on it.
- Market is regarded as strong and efficient if share prices react so fast to all information both public and private that no investor can earn abnormal returns by acting on it.

Thus according to efficient market hypothesis (EMH) information is quickly absorbed and reflected in the share prices. The past prices cannot be used to forecast future prices. Stock split is defined as a corporate announcement which simply results in reduction of face value of equity shares and increase in number of shares outstanding. In a perfect capital market in theory stock splits should not have any impact on share prices since it does not contain any information. But impact on share prices, returns and liquidity has been observed in past empirical studies. Companies decide to undertake stock splits for a number of reasons and advantages which are:

a) A stock split is done to improve liquidity of the shares. There is an increase in number of shares as a result of stock splits which increases supply of equity shares and investors are willing to buy or sell (Angel, 1997; Lin, Singh, and Yu, 2009).
b) It is a tool used by managers to convey positive information about the company. The positive information is better performance and growth in future (Brennan and Copeland, 1988; Byun and Rozeff, 2003).A stock split can be announced if a company wants to communicate about its confidence in future positive dividend and earnings according to Fama et al. (1969), Grinblatt et al. (1984); and McNichols and Dravid (1990).
c) If the share prices are too high, stock splits are done to ensure that share prices reduce and equity shares become affordable for small investors (Copeland, 1979).
d) Stock splits are done to bring down share prices in a price range which is preferred by the company due to high liquidity associated with that price range (Baker and Gallagher, 1980; Easley et al., 2001). According to Copeland (1979) companies consistently measure their share prices against companies of similar standing and decide to split when they find their share prices are higher than industry standards to maintain liquidity of their shares.
e) Stock splits may be undertaken to ensure wider distribution of shares by increasing proportion of small investors in total shareholding of the company. Splits result in decrease in market value per share, increase in volume of shares traded and increase in liquidity (Dolley, 1933).
f) Stock split is used by companies who perceive them to be undervalued due to neglect of market investors. A stock split is used, to attract attention of investors (Arbel and Swanson, 1993).
g) Companies may undertake stock splits to stabilize share prices. The institutional investors buy and sell more frequently as compared to individual investors. Investment by individual investors will broaden shareholders base. The stock split is used to lower the fraction of institutional investor (Kothare, 1997) stabilize share prices and increase stake of individual investors.
h) Managers announce stock splits for positive effect on share prices since positive abnormal returns are present around stock splits according to Grinblatt, Masulis and Titman (1984); and McNichols and Dravid (1990).
i) Stock splits can be done with an intention to boost demand and drive up share prices. A stock split will lower share prices and shares will become more affordable for small investors. Demand for shares which are split if increases more than proportionate increase in supply, then it may result in an increase in share prices (Datta and Banerjee, 2012).

4. Stock splits - disadvantages

According to Mc Gough (1993) some academics and researchers warn that stock splits may not result in an increase in value for following reasons:

a) The cost of conducting stock splits is considerably high.
b) The current share price may be insufficient to carry out a stock split decision.
c) After a stock split the resulting share prices may position the company at a lower level in the industry.
d) After a stock split, increase in number of shareholders may increase the expenses.
e) The future share price range has to be decided with caution so that the company does not become an acquisition target.

5. Stock Splits in India: Introduction

In Indian stock market 'Stock split' is also termed as subdivision of shares. With boom in share prices[1] of giants like Wipro, Zee and Infosys there was an increase in number of stock splits and an era of stock splits started. This popularity was further enhanced because of the changes in legal framework in relation to stock splits.

Before 1999, stock splits were an occasional feature in Indian capital market. It was mandatory for equity share to be of denomination of Rs.10 or Rs.100 on or before December 31, 1983[2].This concept of fixed par value was changed by Securities Exchange Board of India (SEBI) in 1999[3]. As a result companies were able to split their shares into shares of any denomination other than fraction of a rupee. Information technology companies were among the first to split their shares after this legal change. Dematerialization of shares acted as added facilitators for stock splits. The companies are now permitted to issue shares in any denomination other than in decimal of a rupee.

After circular of 1999 it was observed that many companies resorted to consolidation and splitting quite often. Such frequent changes in face value can confuse investors in relation to share prices, while calculation of return/payment from the company. Also it becomes difficult to compare share price movement of companies which have split with other companies of similar sector. In India many times dividend is declared as a percentage of face value of shares of the company. Frequent changes in face value through split or consolidation may mislead investors and investors may assume a higher dividend rate in relation to the company.

6. Stock Splits - Legal framework

- According to Section 4(1) of Companies Act 2013[4] Memorandum of Association (MOA) every company shall state in case of company having share capital, the amount of share capital with which company is to be registered and division thereof into shares of a fixed amount. Listed companies which have issued shares in denomination of Rs.10 or Rs.100 may change the standard denomination of shares by splitting or consolidating existing shares. An eligible company is free to make public offer of its equity shares in any denomination determined in accordance with Section 4(1) of the Act and in compliance with SEBI (Disclosure & Investors Protection)

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[1] In 1999 equity share prices of Information technology companies were comparatively high due to boom of dot-com.This suit was followed by others.In 2005 again bull phase in Indian stock market resulted in an increase in the share prices far beyond the normal trading range.

[2] Ministry of Finance, vide Circular No.1/7/SE/81 dated January 22, 1983 had restricted change of face value at denomination lower than Rs.10 keeping them fixed at Rs.10 or Rs.100.

[3] SMDRP/ Policy/ Cir-16/ 99 dated June 14, 1999 provided companies freedom to issue shares in any denomination to be determined by them as long as it is not fractional by amending their Memorandum and Articles of Associations.

[4] Herein after referred to as "Act"

Guidelines 2000 (hereinafter referred to as DIP Guidelines).Clause 3.7 of DIP Guidelines provides as under:

1. In case of initial public offer by an unlisted company, if issue price is Rs.500 or more, Issuer company shall have discretion to fix face value below Rs.10 per share subject to condition that face value shall in no case be less than Rs.1 per share.If issue price is less than Rs.500 per share, face value shall be Rs.10 per share.
2. The disclosure about face value of shares (including the statement about issue price being "x" times of the face value) shall be made in the advertisement, offer documents and in application forms in identical font size as that of issue price or price band.
3. The companies proposing to issue shares in any denomination or changing standard denomination shall comply with following according to DIP Guidelines:

(a) Shares shall not be issued in denomination of decimal of a rupee.
(b) The denomination of existing shares shall not be altered to a denomination of decimal of a r upee.
(c) At any given time there shall be only one denomination for shares of the company.
(d) The companies seeking to change the standard denomination may do so after amending MOA and Articles of Association (AOA) if required.
(e) The company shall adhere to disclosure and accounting norms specified by SEBI from time to time.

In India, it is the limited companies which are permitted to announce stock splits and reduce face value, after making an amendment in MOA as per section 61(1) (d)[5] of the Companies Act 2013.According to sec 61(1) (d) of Companies Act 2013 every limited company having share capital if authorised by its articles is permitted to subdivide its shares, or any of them, into shares of smaller amount than is fixed by the MOA by alteration in MOA. However, after split proportion between the amount paid and amount, if any, unpaid on each reduced share shall be same as it was in case of the share from which reduced share is derived.

- According to sec 61(2) powers conferred by the section 61(1)(d) shall be exercised by the company in general meeting and not required to be confirmed by the Court. The alteration can be done by an ordinary resolution passed in General meeting.
- If a company has split its shares then it shall within 30 days after doing so, give notice thereof in prescribed form of return (From 5) to Registrar of Companies specifying shares so split.
- The Listing agreement restricts company from charging any fees for sub division and consolidation of shares.
- After a stock split shareholders need to recalculate their cost price for every share obtained after stock split. Recalculating cost price is usually trivial. In case of split shareholder's cost does not change at all. It is the same amount of money paid for original block of shares including commission paid. The new cost per share changes and is the total cost of shares that are split divided by total number of shares.

[5] The section replaces sec 94(1) (d) of the Companies Act 1956.According to sec 94(1) (d) of the Companies Act 1956 every limited company is permitted to subdivide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum. However in sub-division proportion between amount paid and amount, if any, unpaid on each reduced share shall be same as it was in case of the share from which reduced share is derived. The powers conferred by this section shall be exercised by company in general meeting and need not be confirmed by the Court. Cancellation of shares in pursuance of this section shall not be deemed to be reduction of share capital within the meaning of this Act.

- Stock splits are not subject to any tax. When an investor sells the new shares obtained after the split, he or she must adjust the cost as discussed above in order to determine capital gain or loss incurred on sale of shares.

7. Stock Splits -Procedure

If a company in India decides to undertake a stock split, it has to do so by getting the decision approved in a meeting of Board of Directors. The date of the board meeting and outcome of the board meeting need to be intimated immediately by the company to the Stock exchanges where company is listed.

The MOA and AOA of the company are required to be altered for the same. For this resolution has to be passed in Annual General Meeting/Extraordinary General Meeting (AGM/EGM) or through postal ballot. Company must fix the record date for the stock split and intimate the same to Stock exchanges and National Securities Depository Limited /Central Depository Securities Limited (NSDL/CDSL). Corporate action forms need to be sent to the NSDL or CDSL well in advance before the record date for obtaining new ISIN and activation thereof.

Once the legal and procedural formalities are through, company declaring a stock split must inform the Stock exchanges about the record date. Consequently, the Stock exchanges finalize ex-dates which are usually a few days prior to record date. The shares are traded as post split shares, on ex-date and after that in Stock exchanges. On the record date, the shareholders who are holding their shares in electronic form get their accounts credited with shares split automatically. Company can dispatch on request physical share certificates to shareholders against exchange /cancellation of old share certificates as the case may be.

8. Stock Splits - Procedural Check List

1. Company must check if stock split is permitted by AOA.
2. Company then has to all a board meeting to consider split of shares and to fix the date, time and place for calling general meeting.
3. Company will then send intimation about stock split and holding of general meeting to Stock exchanges immediately after board meeting.
4. Company has to issue notice at least twenty-one days before the date of general meeting with suitable explanatory statement to all share holders and Stock exchanges.
5. At least twenty-one days before general meeting company must publish a notice in leading news papers.
6. The company has to hold general meeting and pass the required resolution.
7. Copy of proceedings of the general meeting to Stock exchanges must be sent by the company.
8. Company has to file resolution with concerned Registrar of Companies in prescribed form along with amended copy of MOA and AOA.
9. Company will then call a board meeting to fix record date for purpose of sub-division.
10. Company will send advance intimation to Stock exchanges for holding board meeting to fix a record date for purpose of stock split.
11. Company has to obtain Stock exchange approval for printing of new share certificate consequent to stock split. It is advisable to differentiate old and new share certificates by adopting different colour combinations.
12. In case shares are in physical form and company decides to dispatch new share certificate without surrender of old share certificate, then intimation to that effect must be given to the Stock exchange.
13. Company must hold a board meeting and fix a record date in consultation with Stock exchange(s) for the purpose of stock splits.

14. Company must send intimation to Stock exchange(s), Depositories (NSDL/CDSL) about record date for the purpose of stock splits.
15. Based on the record date Stock exchange(s) fixes a 'No Delivery period' and accordingly issue a notice to its members. A copy of notice fixing no delivery period must be submitted to depository by the company.
16. In terms of Depository Business Rules, company has to provide an option to shareholders to hold securities either in physical or electronic form.
17. Company must download data on any given date prior to record date to ascertain shareholders eligible to receive shares in DEMAT form.
18. Corporate Action of stock split will result in creation of new ISIN for which request letter to NSDL must be given by the company.
19. Company then has to send request letter to Depositories for ISIN deactivation/activation as on record date.
20. If shares are partly paid up shares then company must ensure that after stock split proportion between amount paid and amount, if any, unpaid on each reduced share shall be same as it was in case of shares from which reduced share is derived.
21. Company must reconcile capital held in DEMAT and physical form as on record date.
22. Company has to file Corporate action form with respective depository and pay requisite charges based on number of records along with a copy of notice published by exchange for "No Delivery Period"
23. Stock splits of shares is defined as system built corporate action and hence on compliance of all the formalities pertaining to the corporate action, Depository shall automatically debit account of respective beneficiary with shares of face value of Rs.10 (value assumed) and credit the account with the face value of Rs.2 (value assumed) under new ISIN at the end of day (being the day subsequent to record date).
24. Company must review all 'Stop Transfer' cases prior to printing of new share certificates.
25. Company has to generate fresh distinctive numbers consequent to stock split. It is advisable to create a range of distinctive numbers for the shares held in DEMAT and physical form.
26. Company will issue printed share certificates in physical mode and maintain a register with cross reference of new/old folio/certificate/distinctive number.
27. No stamp duty is payable on stock splits. It is advisable that company must make a cross reference of old share certificate on new share certificates, e.g.

"ISSUED IN LIEU OF SHARE CERTIFICATE NO……"

or

"ISSUED CONSEQUENT TO SUBDIVISION OF SHARES"

9. Conclusion

Stock split is a corporate announcement which results in decrease in face value of equity share and increase in number of shares outstanding, but no change in share capital of the company. Stock splits are also termed as stock sub-division. Besides certain differences in legal procedures, concept of stock splits is same in India also. The discussion in this chapter has given conceptual clarity in relation to stock splits. The scope of present study is limited to analysing impact of stock splits on share prices and liquidity in short-term.

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