Analysing The Legal Framework: The Influence and Requirement for Fractional Share Trading /(Investing) in India[1]

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Abstract

This essay explores the concept of fractional share trading, which enables investors to trade less than a whole share, thereby promoting financial inclusivity and allowing retail investors to invest in blue chip and highly priced shares in price denomination of their choice. It delves into the legal aspects in India, considering the Third Company Law report and potential regulatory obstacles. Additionally, the essay presents and evaluates two models, namely the Inventory Model and Market Linked Model, along with their adaptable regulatory frameworks, addressing concerns related to voting rights, share transferability, valuation, and dividend rights, offering potential solutions. The empirical assessment of stakeholders such as retail investors, brokers, secondary market participants, and listed entities examines the demand and impact of fractional share trading, as well as its market necessity. Also, the essay compares the concept of Marginal Trading Facility which currently mimics aspects of fracitional share trading (rather fractional payment for share trading) with the analysis of reduction in costs dor similar facilitation uniformly across the market. Furthermore, the essay suggests a path forward for the adoption of fractional share trading, while considering the current regulatory ambiguity. It explores options like the SEBI Regulatory Sandbox and the Informal Guidance Scheme, and also compares a similar idea proposed by a broker under the sandbox regime.

Introduction

Fractional Share Trading (or Fractional Share Investment) is a type of trading that allows investors to purchase a fraction of a share instead of a full share. This makes it possible for individuals with limited funds to invest in high-priced stocks that would otherwise be inaccessible to them, thereby democratizing finance and making it more inclusive. In India, law does not specifically prohibit (except for subscribers to memorandum) fractional trading, but neither does the same has an operational regulatory framework, lately, the Company Law Board raised the issue proposing amendments for operationalizing fractional share trading[2].

This essay proposes and analyses two models through which the same can be operationalized by broker(s) i.e., Market Linked Model or Inventory Model and analyses the cross section of this grey area with possible issues, their solutions, and to determine market landscape, need and impact of the same.

Current Position of Law in India

The Third Company Law Report, vide its report[3] made first ever legislative mention of "Fractional Share Trading" in India. Majorly, the report had been in favour of fractional share trading, and proposed two amendments to current hurdles in fractional share trading;

1. Section 4 (1) of Companies Act, 2013[4] restricts the subscribers of Memorandum to subscribe to less than one share.
2. Para 4 of Table F- Schedule I of Companies Act, 2013[5] restricts holding of any fractional part of share.

On a cross-sectional analysis along it can be said that, though, aforesaid mentioned reasons are hurdle to fractional trading, but it does not impact the operations of fractional trading except for a set of person(s), i.e. subscribers to memorandum, and neither these subscribers have intent lined with that of fractional trading. For other shareholders/investors, in effective operation of fractional share trading, investing in part of share does anyways not hold for himself that part, rather through custodian that is usually his broker.

Therefore, summarily Indian legal provisions do not rule out the concept of fractional share trading completely in its operation or explicitly. But in 2021, Zeroda & StockHissa applied to

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[2] Company Law Committee, *REPORT OF THE COMPANY LAW COMMITTEE* (2022), para 3
[3] Ibid
[4] Companies Act 2013, s 4(1)
[5] Companies Act 2013, Sch. I Table F para 4

SEBI Regulatory sandbox for fractional trading, which got rejected[6], therefore currently in essence SEBI has not permitted the model.

Dynamics of Fractional Share Trading

Globally, the practice of Fractional Share Trading is broker oriented whereby the broker, in selected scrips pools the fractional orders of investors to purchase one whole share. We propose/note and analyse two models for Fractional Share Trading from Indian perspective:

Inventory Model

Inventory model would refer to a structure where the broker would hold suitable inventory of shares through which it enables its customers to trade fractionally in, and further, on a buy order, the broker to notionally sell from his own inventory (but keep the actual possession) and in case of customer to sell the share, broker to buy back the part.

This model involves broker to bear the fluctuation(s), and such fluctuations would affect the Stock in Trade[7] in broker's balance sheet and may show untrue positions.

Furthermore, another innovation to the model to resolve the cash liquidity issue and blockage of broker fund is, broker takes the delivery of shares at a fair price, and further pledges the share to have cash in circulation for other margin and intra-day purposes, where broker earns an interest higher than that of bank rate.[8]

In conclusion, this is the model in which windfall gains and market turmoil is borne by the broker. In Indian context, the question would arise whether the retail traders would trust or should trust the broker as safe keeper of their shares especially in light of scams to the like of Karvy[9].

The model may not be very sustainable or lucrative for brokers, but, practically looked at, the fluctuations should not be a core issue, since shares like MRF, Page Industries or Honeywell

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[6] SEBI Regulatory Sandbox, 'Status of application received under Regulatory Sandbox' (SEBI, 21 January 2021) < https://www.sebi.gov.in/sebiweb/other/RegulatorySandbox.jsp> accessed 12 February 2023

[7] Ministry of Corporate Affairs, 'Indian Accounting Standard (Ind AS) 2' <https://www.mca.gov.in/Ministry/pdf/IndAS2_2019.pdf> accessed 12 February 2023

[8] Editorial T, 'Loan against Shares - Get Loan against Shares Online in India | ...' (Loan Against Shares) <https://www.sbi.co.in/web/personal-banking/loans/loans-against-securities/loan-against-shares> accessed 28 January 2024

[9] Confirmatory Order in the matter of M/s. Karvy Stock Broking Limited 2020, WTM/AB/SEBI/MIRSD/HO/17/2020

show lesser fluctuations. Furthermore, for this model's sustainability, when it is discussed the need of fractional trading for democratizing, the very model brings to centre the broker, and autonomy of transaction and holding of securities finally lies in the hands of broker over the beneficial owner. The same would be an issue in taxation and further to know beneficial ownership in companies as discussed forward.

Market Pooling Mechanism

Market Pooling refers to mechanism in which the orders of retail traders are pooled, and whilst the order(s) of multiple retail traders total for one whole part, the orders are kept in spool. The regulatory prerogative in this scenario involves a vigil on broker who is the custodian of the share and its accruing benefits (holding and enforcement of associated rights), allowing only Qualified Stock Brokers[10] to provide this facility, transparency and frequent audits to ensure right valuation and mechanism to ensure fractional share trading only in scrips where adequate liquidity can be ensured.

In this model, broker would not bear the market fluctuations, and would act as a manager and intermediary to execute transactions. The current regime operational modus operandi can consist of broker creating an escrow account holding entity which shall in its own demat. Account holds whole shares and the same be internally distributed by the broker.

For simplified understanding, the following example can be referred:

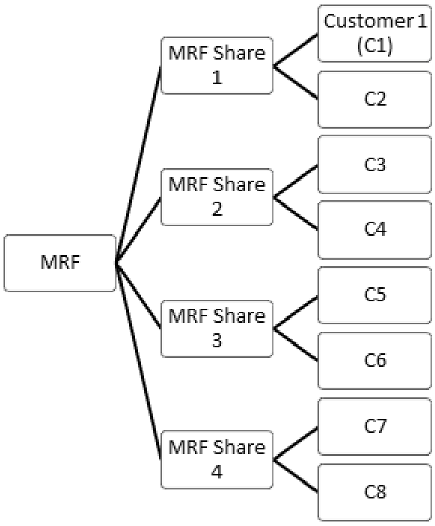

Figure (i)

[10] Enhanced obligations and responsibilities on Qualified Stock Brokers (QSBs) 2023, SEBI/HO/MIRSD/MIRSD-PoD-1/P/CIR/2023/24

i. Customers place order for fractional shares of MRF which is pooled by the broker.
ii. Delivery of MRF Share 1 is taken by the broker's escrow account, and proportionate fictitious amount is reflected in client terminal.
iii. Fractional pooling, as in Figure 1 is maintained by the broker.
iv. In case of "Sell", in a scenario where diverse set of customers wish to sell their holdings, for instance C1, C8, C5, C3, in accordance with proportionate mapping, indicatively 2 shares can be sold in pairs of C1 & C8 and Pair 2 of C3 & C5, respectively the gap shall be filled by mapping single holders to the newly vacated positions.

In this way, no person is effectively holding fractional shares which is prohibited rather it is just indicative convenience provided by broker to his clients. The mere issue is that in any circumstances since the actual owner/holder is the broker, the profits or losses must not accrue for taxation purpose on the broker rather the same should be mapped to the actual beneficial owner, and thereby this specific hurdle would require regulations specific to taxation of fractional trading.

"True Market Reflection" is a key element in this case, since the interaction of spooled set of customers is directly integrating with market forces and broker is acting merely like broker to collect its client for execution, this would also result in volume trade changes of the shares, further decentralize the process away from broker and bring it to open markets. In essence, the market operations and individual fractional trades would be in universal set unlike a small subset as in latter case which would not impact market.

Further, expanding Market Pooling, over a common interface of the bourses itself would be scalable, if a few brokers in cohort or agreement have a common trustee and the matching of orders of multiple brokers together matches, it would make trading faster and more efficient. Furthermore, a common interface in future could have ability to pool all common trades, with common trusteeship of NSDL or CDSL to in effective operation make possible trading of any value.

Issues pertaining to Fractional Trading

1. **Voting:**

   In any matter of shareholder's interest, voting is a binary concept in terms of accepting or rejecting the proposal. In case of fractional shareholders, the proportionate voting within the pool of shareholders of one whole share would be insignificant because in a scenario where majority of the pool votes for accepting a proposal, the count of that share would go towards an affirmative vote without accounting for the contrary votes at all.

   In United States, Robinhood- a broker offering fractional share trading has a mechanism to aggregate the votes and finalise the majority voting.

   Also, the concept of shares with Differential Voting Rights (DVRs) has had limited success in India with merely four scrips of DVR shares. In fractional share trading having DVR scrips can be a solution to the aforesaid mentioned issue since there would be no voting and in return of which the price of the share would be lower but this seems a far-fetched idea since it would involve a lot of intermediary work which the Indian markets might not be ready for.

   Another practice to ensure proper voting enforcement can be delegation of voting rights via proxy mechanism by engaging proxy advisory firms for better corporate governance related decision making.

2. **Dividend:**

   Since the holder of the share which accrues the dividend is the stock broker, the same shall be custodian of the dividend received. A regulatory framework to ensure that such dividend is in safe keeping is required and further the same should be proportionately deposited in client's account. Further, since the dividend distribution tax (DDT) is now abolished in favour of the beneficial owner of the accrued dividend paying the tax, therefore regulatory changes in Income Tax Act along with mapping of beneficial owner is essential.

3. **Valuation:**

   Only in an idealistic perfect market with a utopian timing perfection, the purchase order and delivery of one whole share vis-à-vis multiple fractional orders for completing the whole shall match else each fractional shareholder would have a different quoted/buying price. Similarly, broker holds one share having multiple vested rights, when a portion of these beneficial owners intend to sell and the other half doesn't, in practicality, the broker covers for the marginal disparity so as to affect the real price of each beneficial owner.

4. **Inter-Broker Transfer:**

   While the owners of fractional shares have beneficial interest in the whole of a share which is held by the broker, this interest is fictitious one and therefore, transferability inter-broker shall not be possible since it is the broker who owns the tangible share with multiple vested rights of other shareholders as well.

Assessing the Need of Fractional Trading

Utility of fractional trading over mutual funds:

The MCA report of the Company Law Committee (March, 2022) which was one of the first official documents introducing fractional share trading stated that a reason to propound this idea in market is that the retail investors may not have the purchasing power to buy a whole share due to high price of a single unit and that fractional share trading would allow retail investors to purchase shares which were otherwise inaccessible due to high prices.

The measure of introducing Fractional Share Trading to achieve this purpose seems a mere unnecessary solution, for the very purpose of retail investors to invest in good quality companies and for pooling of resources we have into existence the concept of Collective Investment Schemes (CIS) or Mutual Funds. This article began with the example of buying a MRF share as a fractional bit but to achieve the same objective, an investor intending to invest can route the investment through a mutual fund which would have a small value NAV thereby, proceeding towards the same goal at the same time by passing much of the hurdles listed above. In conclusion, there seems to be no purposive reason to achieve the objective that is laid by the CLC by operation of fractional shares over investing through mutual funds.

Are the Indian investors ready for Fractional Share Trading?

India has witnessed an exponential boom in demat and trading account opening, the number of accounts surpassed the 10-crore mark[11] in December, 2022 with more than 8 crores[12] active demat. accounts. This shows the exponential increase in interest of investors. To begin with, it may be presumed that the new account openings would have a subset of people investing for the first time with a smaller pocket.

To compare this traction, with new investors getting into derivative segment, SEBI has studied the market participation and tracked investor activity which suggests that 9 out of 10 investors loose money in derivatives, even in some of the safest and stable options like that of index only 8 per cent of investors could actually make money.

The inference can be not to take markets as get rich quick scheme rather to invest in quality stocks for long terms and that the experience of investors with innovative products of finance has not been very successful.

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[11] Team MintGenie, Demat accounts rise 34% to 10.8 crore in December; Here are key reasons (mintgenie, 16 January 2023) < https://mintgenie.livemint.com/news/personal-finance/demat-accounts-rise-34-to-108-crore-in-december-here-are-key-reasons-151673837294631> accessed 29 January 2024

[12] Ibid.

Assessing the Impact of Fractional Share Trading on Stakeholders

The industry prima-facie contains a subset of customer/retail investor, broker, the person(s) in secondary market and the listed company. This section, analyses whether such actual demand for fractional trading exists, and if so, the same shall benefit whom the most and in what manner?

Retail Investor

The underlying principle of democratizing financial markets with inclusion of all pocket sizes into the market, seems the fundamental ground for a reason of existence of fractional share trading, so as to achieve the objective of small investors' ability to purchase shares of high value.

Should such investors even trade? On analysis of 66,545 households for 6 years, it was analysed and found that an average household underperformed a value-weighted market index[13], which exhibits that "Trading is hazardous to wealth" if the decision maker is uninformed.

On a further empirical analysis of why retail investors would be more prone to losses[14], an ascertainable reason of many would be, investment in penny stocks, which catch the eyes of investors. Democratizing finance, and markets, in true sense would be to bring choice vide purchasing power of penny stocks vis-à-vis blue-chip stocks. With fractional share trading, this democratization is brought to the customers, but achieving this is no different from the concept of **collectively** investing, since retail traders are clubbed to make transaction for one whole part, which is prima facie the same concept of Mutual Funds, where people collectively pool their funds, therefore with complexities in fractional trading, investment of time, knowledge and expertise it would be better for an investor to invest through ETFs and Mutual Funds.

Secondary Market; its impact

Retail traction towards stock, and collective buying, as a phenomenon intertwined with fractional trading when measured using volume index spikes shows the price hike comparison[15] to that of stock split in traditional market, through which it can be inferred that the theory of higher activity leading to fluctuation holds true. In essence, fractional share trading would lead to higher fluctuations in market, furthermore, a spike in volumes due to fractional trading

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[13] Dyakov T, Jiang H and Verbeek M, "Trading Is Hazardous to Your Wealth: Evidence from Mutual Funds around the World" [2017] SSRN Electronic Journal

[14] Kumar, A. (2009). Who gambles in the stock market? Journal of Finance, 64(4):1889–1933

[15] Da Z, Fang VW and Lin W, "Fractional Trading" [2021] SSRN Electronic Journal

would lead to domino effect to bring in volume changes per se due to further momentum traction from other investors[16].

To study this effect in empirical study, we chose **Berkshire Hathaway, Inc. (BRK.A)** share(s), reason it being one of the costliest but value investment across markets. We compared the Beta[17] value of the scrip from 2014 onwards (i.e. base year index when Fractional Trading commenced).

The Beta performance of the stock[18] was as follows:

2013[19]	2014[20]	2015	2016	2017
-0.52	0	-0.02	0.03	0.08

(Table 1.1)

Similar analysis was conducted for scrip of **Apple, Inc. (AAPL)** – it being one of the right fit of a consumer stock with high pricing.

The Beta performance of the stock[21] was as follows:

2013	2014	2015	2016	2017
-0.56	-0.23	0.00	0.40	0.35

(Table 1.2)

Tesla (TSLA)

2013	2014	2015	2016	2017
-0.77	0.48	0.06	0.33	0.37

(Table 1.3)

[16] Ibid.
[17] Kenton W, "Beta: Definition, Calculation, and Explanation for Investors" (Investopedia January 10, 2023) <https://www.investopedia.com/terms/b/beta> accessed February 12, 2023
[18] "CRSP ISS ESG Indexes" (CRSP) <http://crsp.org/> accessed February 12, 2023
[19] Year of Pre-Fractional Trading Beta
[20] Year of Commencement of Fractional Trading
[21] Supra pt. 17

On analysing Beta values of these three prominent valuable stocks on NASDAQ and NYSE, we found a positive correlation between adoption of fractional share trading by retail traders and Beta index of a particular scrip.

(Limitation of this hypothetical empirical study shall be lack of detailed yearly analysis of multiple events that may have occurred, but the same shall have a contra effect on trading of fractional shares. Prima facie intention is to analyse the overall volume spikes, the marginal volume increase would be needed to be calculated by analysing overall growth in volume trading and comparision with increase in fractional share trading data which may be acquired from broker(s) enabling this option, which may be open for a future academic study.)

In conclusion, it can be inferred that with advent of fractional share trading, the volumes shall spike which would lead to increase in liquidity of market and beta indexes.

Listed Entity

Capital appreciation is a primary financial motive of the entity towards its shareholders. Retail investors are one of the fundamental forces for driving up to price but more importantly they are also long-kuterm positive investors and seldom take negative positions[22], which make them at the core of fair valuation and pricing objectives for the stock of the company. To have retail traders as catalyst for price discovery, once the stock of the company has priced at marginally high value, to bring back the stock in "optimal trading range"[23] companies can adopt either of these two:

Stock Split

A stock split can reduce the nominal price of the share, thereby increase in marketability leads to increased liquidity. In promoter-less companies, this may also be a good mechanism to diversify shareholding patterns, and also whilst the liquidity and shareholding is more diversified a company may have better moat at times of hostile takeover since a lot of market activity would be required for such a successful attempt.

Fractional Share Trading

Fractional Share trading can act as an independent market force/mechanism for a company to achieve this objective since now the price of individual share is itself not a matter of consideration.

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[22] Supra pt.13

[23] Dyl EA and Elliott WB, "The Share Price Puzzle*" (2006) 79 The Journal of Business 2045

In an empirical study analysing the effect of stock split vis-à-vis fractional trading and price momentum for objective of stabilizing price of a single share it was found, that post analysis 50 stock splits that took place post-fractional trading, it was observed that there was an average increase in the stock price of 9.8% starting from one day before the announcement and peaking on the split date.

However, this increase appeared to be temporary as it decreased by 3.0% within ten days. In contrast, during the pre-FT period (2015-2019), the average price increase for stock splits over a similar time frame was only 2.8%, but this increase was permanent and due to increased liquidity and marketability.[24]

Impact assessed for a company, it can be said that fractional share trading brings price discovery and free market determination of nominal value easily for the company, and that less corporate action involvement would be so required. Furthermore, as earlier stated the positive correlation of retail investor sub-set vis-à-vis price valuations, fractional trading would add a more positive subset to investor table.

Materialising Fractional Share Trading in India

In India, whilst the regulatory regime on fractional share trading is silent, which i.e. means that there is no restriction on such trading per se (except for subscribers to memorandum). For this, a multi-faceted approach should be undertaken from regulators as well as industry's part.

a. SEBI Regulatory Sandbox[25]: Market participants can apply to SEBI for regulatory relaxations in a sandbox environment for testing innovative financial products. Since there is no regulations with regards to fractional trading, SEBI can grant relaxations under the ambit of sandbox provisions. Interestingly, Zerodha and Stock Hissa had applied to SEBI much before the Company Law Report regarding a similar idea which was rejected[26] but with recent traction, SEBI may permit such innovation.

b. SEBI Informal Guidance Scheme: Since Fractional Trading would not constitute any offence prima facie, a company intending to enter into the said business can take a no action or interpretative letter regarding SEBI's stance.

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[24] Supra pt. 14

[25] "Framework for Regulatory Sandbox - an Innovation Sandbox" <https://www.innovation-sandbox.in/downloads/Framework_for_Regulatory_Sandbox.pdf> accessed February 12, 2023

[26] Supra pt. 5

Furthermore, SEBI should, in light of report of company law board, release consultation paper for analysing fractional share trading and invite public comments, furthermore this would help analyse issues to be faced and whether industry demand(s) the same.

Conclusion

This paper analyses and proposes models for fractional trading, the concerned issues, its possible solutions and its impact on various stakeholders. In conclusion, the concept of fractional share trading has been introduced with the aim of democratizing the financial markets and enabling small investors to purchase shares of high value that were otherwise inaccessible. However, the utility of fractional trading over collective investment schemes and other methods of investment(s) remains questionable, as they already offer the opportunity for pooling of resources for investment in good quality companies. Moreover, the Indian market has yet to show significant success in investor activity with innovative financial products, as seen in the 9 out of 10 investors losing money in derivatives. As for the stakeholders involved in fractional trading, retail investors may benefit from the opportunity to invest in high value shares, but the actual demand for such trading remains to be seen. It is further important for regulatory frameworks to be in place to ensure the proper protection of fractional shareholders' interests, such as proper voting enforcement, dividend distribution, and valuation mechanisms. Along with these, it becomes essential to ascertain the beneficial ownership to prevent market abuse or fractional trading mechanism to be used as a veil to coverup the actual owners.