NSE Indices' consultation on treatment of merger/demerger in Nifty equity indices

NSE Indices Limited seeks market feedback through public consultation on:

A. Treatment of merger in Nifty equity indices
B. Treatment of demerger in Nifty equity indices

Background

Currently, additional event-based index reconstitution is undertaken in case of scheme of arrangement for merger/ demerger of any of the index constituents, where equity shareholders' approval is considered as a trigger to initiate the replacement of such stock. Exclusion of such stock is done much ahead of its ex-date of merger/ demerger.

More specifically, in case of event-based reconstitution on account of merger, index reconstitution takes place at the time of exclusion of the transferor company and subsequently weight rebalancing of the stocks in the index takes place when the shareholders of transferor company are allotted shares of merged entity & they are available for trading at NSE (in case the merged entity is constituent of the same index). This results into churning of stocks twice in case passive funds (ETF/Index funds) are tracking such index.

Further, in case of event-based reconstitution on account of demerger, index reconstitution and weight rebalancing take place at the time exclusion of the demerged company (irrespective of its size in terms of market capitalization or demerged business).

NSE Indices is proposing revision in treatment of merger and demerger of index constituents for equity indices. Accordingly, NSE Indices is conducting consultation with market participants to take their feedback on the same.

A. Treatment of merger in Nifty equity indices

A.1. Current treatment of merger in Nifty equity indices:

In case of scheme of arrangement for merger of any of the index constituents (transferor company) with another constituent of the same index or with a company which is not a constituent of the index or constituent of another index (merged entity), NSE Indices currently follows the below approach:

➢ **Step 1: Exclusion of transferor company from index:**

- Equity shareholders' approval to the scheme of arrangement for merger of a company is considered as a trigger for making the index reconstitution and weight rebalancing as given below
- Soon after the equity shareholders' approval, exclusion of transferor company which is involved in scheme of arrangement for merger is initiated from respective indices

- In case transferor company is a constituent of indices on which Futures and Options are traded at NSE, changes are announced to the market participants four weeks prior to the index reconstitution date. As on October 17, 2022, Nifty 50, Nifty Bank, Nifty Financial Services and Nifty Midcap Select are the indices on which Futures and Options are traded at NSE
- Transferor company is excluded from the index and the same is replaced with another eligible stock (in case of indices with fixed number of constituents). This results into reconstitution and weight rebalancing of the index

➢ **Step 2: Increasing the number of equity shares of the merged entity:**

Following steps are currently followed whenever equity shares of merged entity are allotted to the shareholder of transferor company and these shares are granted permission to trade at NSE:

- If the equity shares of merged entity which are allotted to the shareholders of transferor company (post-merger) account for more than or equal to 5% of the current equity of the merged entity, these shares are updated for calculation of market capitalization with effect from the last trading day (T Day) of the calendar month of listing of these shares
- In case, equity shares of merged entity which are allotted to the shareholders of transferor company (post-merger) account for less than 5% of the current equity of the merged entity, these shares are updated for calculation of market capitalization with effect from the last trading day of corresponding calendar quarter (March, June, September and December)

Challenges in the current approach:

A. In case, a transferor company is a constituent of an index and is merged into another company which is also constituent of the same index, index reconstitution and weight rebalancing get triggered on two instances as explained hereunder:
    - First, during the index reconstitution, exclusion of the transferor company (and including another company as replacement) is done. On this instance, funds tracking the index will be required to sell the shares of transferor company and rebalance the weights of the index constituents
    - Second, weight rebalancing is done when the shareholders of transferor company are allotted shares of merged entity & they are available for trading at NSE. On this instance, funds tracking the index will be required to again buy shares of merged entity which are allotted to the shareholders of transferor company (post-merger)

    For funds tracking the index, both the above instances will result into additional buying and selling transactions in relevant companies (all constituents) in a short span of time

B. The transferor company is excluded from the index much ahead of its ex-date of merger

A.2. Proposed treatment of merger in Nifty equity indices:

Transferor Company

- Transferor company shall be excluded from index on the ex-date (T Day) of merger i.e. closing of T-1 day

Merged Entity

- Equity shares, investible weight factor and capping factor (if applicable) of merged entity shall be updated based on the terms of merger on the ex-date of merger i.e. closing of T-1 day

Replacement in indices

- Indices with fixed number of constituents - On ex-date, a replacement of company will be made based on the eligibility criteria of respective indices in place of transferor company which is being excluded
- Indices with variable number of constituents - On ex-date, no replacement will be made in place of the transferor company which is being excluded
- Announcement of the above changes shall be made minimum 3 working days in advance for change in the constituents of indices including the indices on which Futures and Options are traded at NSE

B. Treatment of demerger in Nifty equity indices

B.1. Current treatment of demerger in Nifty equity indices:
In case of scheme of arrangement for demerger of any of the index constituents, NSE Indices currently follows the below approach:

➢ **Exclusion of demerged company from index:**

1. Equity shareholders' approval to the scheme of arrangement for demerger of a company is considered as a trigger for making the index reconstitution and weight rebalancing as given below
2. Soon after the equity shareholders' approval, exclusion of demerged company, which is involved in scheme of arrangement for demerger is initiated from respective indices
3. In case demerged company is a constituent of indices on which Futures and Options are traded at NSE, changes are announced to the market participants four weeks prior to the index reconstitution date. As on October 17, 2022, Nifty 50, Nifty Bank, Nifty Financial Services and Nifty Midcap Select are the indices on which Futures and Options are traded at NSE
4. Demerged company is excluded from the respective indices and the same is replaced with another eligible stock (in case of indices with fixed number of constituents). This results into reconstitution and weight rebalancing of the index

Challenges in the existing approach:

- The demerged company is excluded from the index much ahead of its ex-date of demerger
- Companies with large market capitalisation may get excluded and may again become eligible for inclusion in subsequent reviews thereby increasing churn in the index and consequently in funds tracking such index

B.2. Proposed treatment of demerger in Nifty equity indices

Demerged Company

- In case a special trading of the demerged company is conducted by the stock exchanges for price discovery, such demerged entity would be retained in the index and the index divisor would be adjusted before the market opening of ex-date of demerger based on the price discovered during the special trading session for the demerged company
- The demerged company which is retained in the index shall be screened for its continued eligibility, considering data for the period starting the ex-date till the last trading day of the next calendar month. Such demerged company shall be replaced, in case a suitable replacement is available
- In case a special trading session is not conducted by the stock exchanges, after the shareholders' approval, such demerged company shall be excluded from the index on the ex-date of demerger or the next scheduled review effective date of Nifty 500 and Nifty Microcap 250 indices (after such shareholders' approval) whichever is earlier

Replacement in indices in case of exclusion

- Indices with fixed number of constituents - On ex-date, a replacement of company will be made based on the eligibility criteria of respective indices in place of transferor company which is being excluded
- Indices with variable number of constituents - On ex-date, no replacement will be made in place of the transferor company which is being excluded
- Announcement of the above changes shall be made minimum 3 working days in advance for change in the constituents of indices including the indices on which Futures and Options are traded at NSE

Feedback for proposed treatment of merger/demerger in Nifty equity indices

Name of the respondent	Organization name	Email ID	Phone number

Sr. No.	Consultation Point	Agree/ Disagree	Rationale	Suggestions (if any)
1	Proposed treatment of merger in Nifty equity indices			
2	Proposed treatment of demerger in Nifty equity indices			

Feedback from market participant is invited on the proposal contained in this paper. The feedback should reach NSE Indices latest by November 2, 2022, in any of the following manner:

a) By participating through '**Online Survey**'; or
b) By email: **index-consultation@nse.co.in**

Feedback received from this consultation will be reviewed and considered by the Index Maintenance Sub-Committee (Equity) of NSE Indices Limited. In case of any revision, formal announcement shall be made through a press release. The consultation may or may not lead to the implementation of any or all of the proposed changes in Nifty equity indices

NSE Indices Limited

Exchange Plaza, C-1, Block G,

Bandra Kurla Complex,

Bandra (East),

Mumbai 400 051 (India).

Date: October 18, 2022

Glossary

Merger is a corporate event in which company/companies are combined into another company to operate as a single entity where the merging entity (transferor company) ceases to exist.

Transferor Company means a company which is merged into another company

Merged Entity is the resultant company that is formed post-merger

Demerger is the transfer of a company's business undertaking/division to another company/ companies

Demerged company means a company from which business undertaking/ division have been transferred to another company/ companies