FINSEC
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SECURITIES AND INVESTMENT REGULATIONS

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Newsletter

From the founder's desk

This is the inaugural issue of our firm's newsletter. We intend to make our newsletter more than a mere summary of events and hope to share our views and opinions on how things could be improved from a policy perspective. We would like your feedback. Please do write to us at info@finseclaw.com

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Sandeep Parekh

The Securities Laws (Amendment) Bill, 2013

The Government of India, in its attempt to bolster the securities regulation regime, has affirmed that fraudulent investment schemes would be dealt with an iron hand. The proposed Bill has adopted a three-pronged approach to target Ponzi schemes and other fraudulent practices. First, it expands the jurisdictional expanse of the SEBI Act, 1992. Second, it provides additional powers of enforcement to SEBI, and third, it facilitates the speedy disposal of cases. The Bill has provided sweeping powers to SEBI, in relation to calling for information, regulating collective investment schemes, disgorgement, search and seizure, settlement of administrative and civil proceedings and recovery of penalties.

Although the Bill has addressed certain uncertainties that existed regarding the scope of SEBI's enforcement powers such as those questioned in *Karvy Stock Broking Ltd. v. SEBI,* there are several concerns that are yet to be addressed in relation to the new powers that have been vested in SEBI.

The broad and inclusive meaning given to *Collective Investment Schemes* has resulted in some confusion regarding the scope of the term. Further, the Bill proposes a mechanism which is heavily dependent on delegated legislation which should be passed promptly to avoid uncertainty.

The Bill proposes to insert a new provision which provides that any amount disgorged be credited to the SEBI Investor Protection and Education Fund. SEBI should now clearly provide that the disgorged amount be made available to victims of the fraud/insider trading violations. Merely taking away ill-gotten gains is not sufficient to redress the grievance of investors who must be made whole where possible.

While providing extensive powers of investigation to SEBI, the Bill has removed certain checks and balances that were hitherto in effect. For instance, the requirement to approach a judicial magistrate in relation to search and seizure has been removed. Further, to recover penalties, the Bill proposes to empower SEBI with unfettered powers of attachment and sale of a person's movable/immovable property, attachment of a person's bank accounts and even arrest and imprisonment. There is a need for some internal checks and balances to be put in place by SEBI.

Foreign Portfolio Investors (FPIs) under the Chandrashekhar Committee Report

In an attempt to further simplify the foreign investment regulatory regime in India, the *K B Chandrasekhar Committee* has, inter alia, suggested the clubbing of Foreign Institutional Investors (FIIs), sub-accounts and Qualified Financial Investors (QFIs) into a single investor class called "Foreign Portfolio Investors" (FPIs). The Non-Resident Indian (NRI) and the Foreign Venture Capital Investor (FVCI) categories have been retained due to the special nature of these investments.

An investor must be free to come from any jurisdiction which has reasonable standards against money laundering. Inflows from both institutional and retail investors must be encouraged alike. A laudable departure under the report is that the SEBI registration requirement for making portfolio investments has been removed and private sector KYC, though graded based on risk posed, would suffice.

Another obstruction to the inflow of foreign investments is the uncertainty related to taxation and efforts must therefore be made towards ensuring certainty as far as taxation is concerned.

Self-Regulatory Organisations ("SRO") Another step towards compliance

It has taken close to a decade for SEBI to make operational the SEBI (Self-Regulatory Organizations) Regulations, 2004. SEBI's recent notice (March 2013), inviting applications from entities desirous of being registered as an SRO for distributors of mutual funds and portfolio managers, would mark the beginning of a new era of securities regulation in India.

IOSCO, an international group of national securities regulators, has recognised the importance of SROs in emerging markets as a part of an important strategy to enhance the effectiveness of securities regulation and market integrity. The effectiveness of the traditional exchange-based SRO model is increasingly being questioned in the background of commercialization of exchanges, inability of statutory regulatory authorities to cover new areas of regulations, and globalization of capital markets.

Post the international financial crisis of 2008-09, a general shift has been observed towards a more powerful statutory securities regulator supplemented by an independent SRO. However, countries have differed on the role of an SRO. For instance, most European countries minimise the use of SROs and the statutory regulator reserves most regulatory functions, whereas, the

US has preferred a more dominant role for an independent SRO. This was done in light of the increasing complexity of the marketplace, greater conflicts of interest and the fragmented structure of an exchange-based SRO model.

An independent SRO can tap the expertise of practitioners and pay them market compensation to enhance the quality of surveillance. This will allow the statutory regulator to address priority sectors and major systemic risks rather than routine supervision.

Although, at present, the scope of the proposed SRO under SEBI is restricted to mutual fund distributors and it does not have extensive rule making powers, it is worth noting that several full-fledged SROs evolved from industry association with limited legislative and enforcement power *viz.* the NASD in the US and the IDA in Canada.

It would therefore be interesting to observe how SEBI facilitates the development of SROs or a single SRO and thus pushes for more effective regulation.

SEBI (Buy-back of Securities) (Amendment) Regulations, 2013

In January 2013, SEBI released a discussion paper suggesting extensive changes to the SEBI (Buy-back of Securities) Regulations, 1998. SEBI recently came out with an amendment to the regulations, which is a lenient version of the discussion paper. However, SEBI has failed to address underlying issues with the regulation of buy-backs.

The key developments include, an increase in the minimum mandatory buyback requirement from 25% to 50%, mandatory opening of buyback offer within seven working days from the date of public announcement and mandatory completion within six months, mandatory requirement to submit buyback information to stock exchanges on a daily basis, a new escrow mechanism which would hold 25% of the buyback amount, a cooling period of one year from the closure of the buyback for further capital raising or another buy-back offer and an increase in the restrictions on the promoters of the company in relation to on or off market transactions.

It may be emphasised here that two classes of shareholders are impacted by buybacks a) shareholders who sell back their shares and b) the surviving shareholders of the company. Thus, any gain offered to exiting shareholders is automatically a loss to the surviving shareholders.

Buy-back under the Companies Act, 1956, is a tool in the hands of the company to support the share price during periods of temporary weaknesses. Therefore, the size of the buyback should be dependent on the needs of a company and not a mechanical statutory percentage. In fact, if the market price is above the book value of the company, every purchase it makes will be detrimental for the existing shareholders. A mandatory minimum purchase is unnecessarily restrictive and such a requirement must be removed completely as it would harm surviving shareholders whose interest should be key.

Spot Delivery Contracts and Applicability of the Securities Contracts Regulation Act, 1956 to *Public Unlisted Companies*

Courts have been divided in their views on the applicability of the Securities Contract (Regulations) Act, 1956 to transactions involving shares of *unlisted public* companies. Two significant issues relating to this were decided by the Supreme Court of India recently, and the ruling could have a significantly adverse result on commercial contracts of share purchases. The apex court in *Bhagwati* v. *Peerless Gen. Finance*, ruled that the term 'marketability' must be widely interpreted to mean 'saleability'. Therefore, as shares of an unlisted public company are saleable, though outside a stock exchange, they would fall within the definition of "securities" [Section 2(h)].

The Act prohibits forward contracts in securities i.e. where the delivery occurs after the contract has been entered into. Since securities are now widely defined, a shareholder agreement in an unlisted public company may be unenforceable as it could be in violation of the forward contract prohibition contained in the Act and enforced by a circular. This would be the result unless the shareholder or share purchase agreement is promptly followed by delivery.

Another finding by the court on spot delivery also finds later delivery would result in the prohibition against off-exchange non-spot delivery contracts. While the original intent of the prohibition, introduced in 1969, was to curb speculation, the effect of the restriction after this ruling would be to damage non-speculative commercial contracts. The prohibition drafted in a different era of suspicion towards speculation needs to be repealed. This can be done without statutory amendment as SEBI and the government have been given powers to specify the classes and persons to whom the prohibition applies. This needs to be done on an urgent basis as investor confidence does not require another jolt of pointless uncertainty.

Investment Advisers

With the deadline for registration under the SEBI (Investment Advisers) Regulations, 2013 looming in October 2013, Investment Advisers are gearing up to meet the registration, enhanced qualification and certification requirements prescribed by SEBI. However, the array of exemptions provided under the regulations has given space to various distributors who also provide investment advice to weigh the pros and cons before registering as investment advisers.

The regulations mark a key departure from a present commission-cum-fee based structure to an investor centric model. Regulation 15(2) prohibits an investment adviser from charging any consideration from any person other than a client of the investment adviser. This would ensure that investment advice is not marred by vested interests or conflicts of interest of selling the most profitable product rather than the most suitable one.

About Us

Finsec Law Advisors is a financial sector law firm which provides regulatory advice and assistance focusing on the securities, investments and banking industry.

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