FINSEC
Law Advisors

SECURITIES AND INVESTMENT REGULATIONS

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Newsletter

Monitoring compliance with listing agreement

Listed companies are required to make a number of disclosures under the equity listing agreement pertaining to corporate actions like financial results, corporate governance. SEBI has issued a circular dated 18 November, 2013 on "Compliance with Provision of Equity Listing Agreement by Listed Companies- Monitoring by Stock Exchanges" ("**Circular**"), as there are concerns that even though listed companies make disclosures to the stock exchanges the contents of such disclosures are not adequate and accurate. The Circular has made it mandatory for stock exchanges to put in place monitoring mechanisms to ensure adequacy and accuracy of disclosures made by companies through a separate monitoring cell with identifiable personnel.

SEBI, through this Circular has advised the stock exchanges, inter alia, to put in place a monitoring framework in a manner that detects non-compliance with applicable laws such as the SEBI Act, 1992 and the Securities Contract Regulation Act, 1956 and also provide for appropriate mechanisms for handling complaints related to inadequate and inaccurate disclosures. Stock exchanges are expected to submit to SEBI an "Exception Report" with the details of companies which do not respond to clarifications sought by them and/or where the response submitted is not satisfactory, in their opinion.

Initially, it is proposed that the top 500 listed companies (by market cap as on 31 March 2013) will be scrutinized for compliance with Clauses 35, 36, 41 and 49 of the listing agreement for the quarter ending 31 December 2013. However, no specific timeline has been given for stock exchanges to comply with the Circular. The Circular highlights the increasing significance and responsibilities of stock exchanges in ensuring compliance of securities laws by listed companies.

The stock exchanges have also been given the power to seek more information from companies in cases of deficiency in the information provided to them. However, the stock exchanges have only been given a period 2 working days from the date of disclosure to seek clarifications from the company and companies have been given a period of 5 working days to provide information / clarification to the stock exchanges. If the reply provided by a company is not found satisfactory, the stock exchanges have been directed to treat inadequate and inaccurate disclosures as non-compliance and proceed as per the standard operating procedure laid down by SEBI circular dated 30 September 2013. The deadline mandated by SEBI is rather aggressive and only time will tell whether the stock exchanges will be able to carry out their duties under this Circular effectively. In addition, this will require the stock exchanges to substantially boost their compliance and supervision role in both quality and the number of personnel employed.

A shot in the arm for SEBI - Draft search and seizure regulations

SEBI, in exercise of its powers under the Securities Laws (Amendment) Ordinance, 2013 ("**Ordinance**"), has recently framed draft SEBI (Procedure for Search and Seizure) Regulations, 2013 ("**Regulations**"), laying down the procedure to be followed during different stages of search and seizure while conducting investigations, in addition to providing certain safeguards to the persons subjected to search.

As per the draft Regulations, if the investigating authority has reason to believe that any or all of the grounds under Section 11C of SEBI Act, 1992 exists, he may approach the SEBI Chairman, who after satisfying himself that it is necessary to do so, may issue a warrant of authority under which the investigating authority can enter and search any place, building, vessel, vehicle, computer etc. and proceed to seize such materials as he may be authorized to. The power of the SEBI Chairman to authorize search and seizure under the Ordinance, as has been reaffirmed in the draft Regulations is highly controversial, as other regulators such as the RBI and FMC are required to take prior approval of a judicial magistrate while exercising similar powers of search and seizure. Although the Regulations provide a list of rights for persons under search, such rights are illusory and provide very little substantive protection to persons under search.

The draft Regulations also lays down the procedure to be followed by the investigating authority while conducting search and seizure operations. Elaborate guidelines have been provided for the investigating authority to record the documents seized. It would be equally important for SEBI to train their investigating authorities to comply with the Regulations down to the last letter while undertaking a search operation under these Regulations, as any lapse in the procedure required to be followed may dilute the value of the evidence collected.

The draft Regulations require that an investigating authority has "reason to believe" or a "reason to suspect" before approaching the SEBI Chairman for issuance of a warrant under Section 11 C and under the draft Regulations. This is a subjective test and introducing such subjective elements may affect the investigation process and upset the overall outcome of a particular investigation. Therefore, it would be prudent to juxtapose SEBI's position as a regulator and purpose behind the investigations conducted by SEBI before the final nature and extent of SEBI's powers is crystallized, to prevent excessive concentration of regulatory power.

The Gordian knot of employee benefit schemes

Employee benefit schemes, including employee stock options ('**ESOPs**') and employee stock purchase schemes ('**ESPS**'), are used by companies to incentivize employees with a view to attract and retain talent by organizations. As per the SEBI (ESOP & ESPS) Guidelines, 1999 ('**Guidelines**'), an ESOP/ ESPS may be administered directly by the company or through a trust mechanism. SEBI has issued a discussion paper on 'review of guidelines governing stock related employee benefit schemes' in light of certain practices that have been brought to its notice.

SEBI has been concerned for some time now about ESOS / ESPS trusts of certain listed companies that deal in their own securities in the secondary market, which is outside the purview of SEBI Guidelines. A circular dated 17 January 2013 was issued by SEBI amending the equity listing agreement and the SEBI Guidelines to restrict this practice, as it apprehended that some companies may frame such schemes to deal in their own securities to inflate, depress, maintain or cause fluctuation in the price by engaging in fraudulent and unfair trade practices. The amendment required that all employee benefit schemes already framed and implemented by companies involving dealing in securities before 17 January 2013 be aligned with and made to comply with SEBI Guidelines on or before 30 June 2013. A circular dated 13 May 2013 was issued by SEBI which gave companies time till December 2013 to bring their employee benefit schemes in line with SEBI Guidelines. In light of the discussion paper to review the stock related employee benefit schemes, SEBI has issued a circular dated 29 November 2013 extending the deadline further to 30 June 2014.

The Primary Market Advisory Committee ('**PMAC**') has also recommended that the functioning of employee benefit trusts be regulated by imposing certain restrictions such as: permitting only schemes set up as trusts to undertake acquisition of shares from secondary market; minimum share holding period of six months (except when the shares are handed over to the employee in accordance with the scheme); disclosure of the shares held by the trust under a separate head under promoter/promoter group category under clause 35 of the listing agreement; limit on such acquisition of shares (percentage of total share capital); treatment as insider including requirement to make all necessary disclosures; and appointment of an independent trustee to manage the affairs of the such trusts.

Another important recommendation envisages expansion of the regulatory ambit to include all non ESOS / ESPS employee benefit schemes which are either set up, managed or financed by the company directly or through a trust and deal in securities. They also recommend framing regulations to deal with Stock Appreciation Right Schemes, General Employee Benefit Schemes and Retirement Schemes dealing in securities. While these recommendations are in the right spirit, it is yet to be seen whether SEBI can effectively regulate the myriad employee benefit schemes.

One circular to rule them all: Circular on System Audit of Brokers

SEBI passed a circular on Annual System Audit of Stock Brokers / Trading Members on 6 November 2013 ('**Circular**'), which seems to be modelled on the SEBI circular dated 29 November 2011 on Annual System Audit Framework for exchanges and depositories.

The system audit framework for stock brokers is required to be conducted with differing periodicities. Those stock brokers who use Computer-to-Computer Link ('**CTCL**') or Intermediate Messaging Layer ('**IML**') / Internet Based Trading ('**IBT**') / Direct Market Access ('**DMA**') / Securities Trading using Wireless Technology ('**STWT**') / Smart Order Routing ('**SOR**') and have a presence in more than 10 locations or more than 50 terminals and those stock brokers who are depository participants or are involved in offering any other financial services have to conduct an annual system audit Stock brokers who use Algorithmic Trading or provide their clients with the facility of Algorithmic Trading are required to conduct a half-yearly audit. All other stock brokers have to conduct a system audit once in every two years.

The Circular provides for a system audit framework for stock brokers / trading members of stock exchanges including the system audit process, auditor selection norms and terms of reference. Stock brokers have been categorized into the following different categories: (a) Type I Brokers - those stock brokers who trade through exchange provided terminals such as NSE's NEAT, BSE's BOLT, MCX-SX's TWS, etc.; (b) Type II Brokers - those stock brokers who trade through API based trading terminals like [CTCL or IML] or IBT/DMA/STWT or SOR facility and who may also be Type I Brokers; and (c) Type III Brokers - those stock brokers who use Algorithmic Trading facility to trade and who may also be Type II Brokers. Separate terms of reference have been provided for all the three categories of stock brokers.

The Circular requires the stock exchanges to keep track of findings of system audits of all brokers on a quarterly basis and ensure that all major audit findings especially with respect to critical areas have been rectified / complied with in a time bound manner and also obligates stock exchanges to report all major non-compliances / observations of system auditors, broker wise, on a quarterly basis to SEBI.

Hitherto, the system audit framework was prescribed by the stock exchanges through their bye-laws and it varied from exchange to exchange. This Circular provides a uniform framework to be followed by all stock exchanges for system audit for stock brokers. However, it may result in an increase in the cost of compliance for stock brokers, who are already reeling under falling revenues because of low retail participation and high compliance costs.

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