FINSEC
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SECURITIES AND INVESTMENT REGULATIONS

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Newsletter

From FIIS and QFIS to FPIs

Based on the K. M. Chandrasekhar Committee Report, SEBI has instituted a new class of foreign investors to put in place an easier registration process and operating framework for overseas entities seeking to invest in Indian capital markets. The SEBI (Foreign Portfolio Investors) Regulations, 2014 notified on 7 January, 2014, replaces the existing regulations on FIIs and provides that erstwhile portfolio investment categories FIIs, sub-accounts and QFIs would now be categorised as a single investor class i.e. FPIs.

An applicant is now required to approach designated depository participants, not SEBI, for being registered as an FPI. Existing custodians of securities and qualified depositary participants will be deemed to be DDPs subject to payment of fees to SEBI. SEBI has also laid down eligibility criteria for registration as a DDP which requires an applicant to be a registered depositary participant, registered custodian of securities, and a bank. In addition, a global bank regulated in its home jurisdiction may also apply for registration as a DDP. The DDPs will have extensive responsibilities of ensuring compliance by FPIs, determining the eligibility of FPI applicants, adequate and timely disclosures to the SEBI, determining beneficial ownership of FPIs, etc.

Existing FIIs and QFIs may continue to buy, sell or otherwise deal in securities until the respective deadlines mentioned in the Regulations. However, such FIIs and QFIs have to acquire FPI certification to continue their operations beyond the deadlines mentioned.

Under the new regulations, FPIs have been divided into three categories based on their risk profile. Category I would comprise of low risk entities including government and government related investors, Category II would comprise of appropriately regulated broad-based funds, other appropriately regulated entities, broad-based funds which are not appropriately regulated but whose investment manager is appropriately regulated, university funds, university related endowments, pension funds etc. Category III would be a residual category for investors who do not fall under Categories I and II.

Upon the receipt of a certificate of registration, the FPI can deal in all securities in which FIIs had previously traded. Further, the Regulations also provide that FPIs shall only invest in listed or to be listed securities.

FPIs will be permanently registered unless suspended or cancelled by SEBI or surrendered by the FPI.

The investment limit of FPIs has been capped at ten percent of the total issued capital of an investee company and if the ultimate beneficial owner(s) invest through multiple entities, these entities would be treated as part of the same investor group and their combined shareholding is considered for determining compliance with the investment limit.

Furthermore, the Regulations have tightened the conditions for the issuance of offshore derivatives instruments by foreign units. Category III and broad-based funds under Category II, which are not appropriately regulated but whose investment manager is appropriately regulated, are not permitted to issue offshore derivatives instruments. This has raised a concern that, investment through P-Notes, which until now was the preferred route for overseas HNIs and hedge funds for taking exposure to Indian securities, may get bottlenecked.

Optionality Clauses in FDI Instruments

The Reserve Bank of India has finally cleared the dust and permitted optionality clauses in equity shares and compulsorily and mandatorily convertible preference shares/debentures issued to a person resident outside India under the Foreign Direct Investment Scheme. An optionality clause will oblige the buy-back of securities from the foreign investor by Indian promoters/residents at the price prevailing/value determined at the time of exercise of the put option by such foreign investor, provided the put option is exercised without *assuring any fixed return* to the foreign investor.

Put options in favour of foreign investors will be valid and enforceable under the exchange control laws if:

- They are exercised after a minimum lock-in period of one year from the date of allotment of securities to foreign investors or any other lock-in period as may be specified under the FDI Policy, whichever is higher;
- The exit price should be as follows: (i) In case of listed company, at the market price determined on the floor of the recognized stock exchanges; (ii) In case of unlisted equity shares, at a price not exceeding that arrived on the basis of Return on Equity (RoE) as per latest audited balance sheet. RoE is defined as the profit after tax divided by the net worth (defined to include all free reserves and paid up capital); and (iii) In case of preference shares or debentures, at a price determined by a Chartered Accountant or a SEBI registered Merchant Banker.

While this move from RBI will help in regaining the confidence of foreign investors, the differentiation in valuation methodology for calculating exit price of equity shares and convertible securities requires some explanation from the regulator. Further, the ROE formula prescribed for calculating maximum exit price of foreign investors is not in line with standard market practice to value securities of a company. While the FDI Policy prescribes fair value/DCF methodology, which is forward looking, for calculating the minimum floor price for FDI in Indian securities, the maximum exit price, through exercise of put options, is now capped at a valuation arrived at using ROE methodology, which is based on past performance of the company. This move may lead to lower returns for the foreign investors as they would be required to purchase Indian securities at a price taking into account the company's future performance, but exit only at a price derived from performance of the company during the course of such foreign investment.

Informal Guidance in the matter of R Systems

M/s R Systems International Limited, a listed entity, received an interpretative letter from SEBI on 8 January, 2014 under the Informal Guidance Scheme on the issue of whether Mr. Bhavook Tripathi would be classified as a public shareholder for the purpose of computing the Minimum Public Shareholding (MPS) requirements. Indian listed companies are required to have a minimum public float of 25% of their issued capital.

Mr. Tripathi, who is not a promoter of R Systems or a PAC with the promoters, had made an open offer on 15 December, 2011 for acquiring 26% of the share capital of R Systems. Post open offer and some later acquisitions, Mr. Tripathi held 34.82% of R Systems while the promoter entities held 50.17%.

Informal Guidance was sought on Regulation 7(4) of Takeover Regulations, 2011 which requires an acquirer to bring down the non-public shareholding in the event that the open offer results in an increase of non-public shareholding beyond 75% of the share capital of the target company. The application letter stated that the shareholding of Mr. Tripathi should be treated as non-public shareholding since he held a substantial stake of approximately 35% in the company and would be in a position to exercise significant influence over the affairs of the company. Since the promoter entities already held over 50% of share capital of the company, it was represented that the aggregate public shareholding in the company had been reduced to approximately 15%, lower than the minimum prescribed limit of 25%. Therefore, the application letter stated, in terms of Regulation 7(4), Mr. Tripathi ought to bring down his shareholding so that the public holding in the company is restored at a level above the statutory limit of 25%.

SEBI clarified that as per the Takeover Regulations, the term '*acquirer*' did not make any distinction between promoter and public shareholding. An acquirer of substantial number of shares can either be a member of a promoter group or belong to the public category. Further, SEBI noted that the term '*public*', as per the Securities Contracts (Regulation) Rules, 1957, referred to any persons other than '*promoter or promoter group*' and '*subsidiaries and associates of the company*' and since Mr. Tripathi was neither the promoter nor a part of the promoter group, he qualified as a '*public shareholder*'. This determination led SEBI to conclude that Mr. Tripathi's shareholding should be construed as 'public' for the purpose of MPS requirements and he would not be required to bring down its shareholding in furtherance of Regulation 7(4).

A determination that the largest public shareholder's holdings could be lumped with the promoter's holdings to ascertain '*non-public*' holding would open a Pandora's Box, particularly where financial institutions hold large stakes in listed entities.

If the understanding that an 'acquirer's' holdings, by default, are '*non-public*' found credence with SEBI, it would lead to absurdities in situations where the acquisition of a company would *not* at all be possible when the promoter entities hold 74% of the shareholding of such company, since all acquirer holdings would be treated as '*non-public*' which will lead to a breach of MPS requirements.

This is therefore the correct and sensible legal view of the regulator.

SEBI (Settlement of Administrative and Civil Proceedings) Regulations, 2014

SEBI has recently issued the SEBI (Settlement of Administrative and Civil Proceedings) Regulations, 2014 with retrospective effect from April 20, 2007 rescinding the earlier circulars on the same issue.

The Regulations lay down the substantive procedure for settlement of administrative and civil proceedings. It provides for settlement in monetary as well as non-monetary terms or a combination of both, in accordance with the guidelines issued thereunder to arrive at settlement terms. It also lays down factors which shall be considered to arrive at the settlement terms. Serious offenses like insider trading and fraudulent and unfair trade practices, including front running, which could potentially affect the whole market or cause substantial losses to or affect the rights of retail and small investors cannot be settled under the Regulations. However, a small window has been left open for settlement with applicants who intend to make good the losses caused to the investors. Other offenses like failure to make open offer, defaults or manipulative trade practices by mutual funds, AIFs, CISs and their sponsors or AMCs, managers, trustees are also not consentable unless the applicant makes good the losses suffered by investors.

Securities Laws (Amendment) Second Ordinance, 2013 Lapses

The Securities Laws (Amendment) Second Ordinance, 2013 was promulgated in July 2013 and re-promulgated in September 2013, to give additional powers to SEBI. However, it lapsed on 15 January, 2014. Consequently, some of the provisions that had been newly framed under the Ordinance have become ineffective. For instance, the Ordinance empowered the Chairman of SEBI to authorize an investigating authority or any other officer of the regulator to conduct search and seizure. Further, it provided for establishment of special courts for speedy trials, modes for recovery of amounts like attachment orders, arrest of person and appointment of receiver. These powers were not there with SEBI earlier and with the lapse of the Ordinance, SEBI has lost them. However, there are certain implied powers under the SEBI Act, 1992 and the Ordinance had merely inserted provisions clarifying or expanding the same. Prior to the Ordinance SEBI had the implicit power to pass a direction of disgorgement which was explicitly provided for in the Ordinance. Similarly, SEBI had implied powers to pass consent orders. Therefore, despite the lapse of the Ordinance, SEBI is still empowered to pass a disgorgement order or a consent order.

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