FINSEC
Law Advisors

Securities and Investment Regulations

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Newsletter

Securities Laws Amendment Ordinance, 2014

In the midst of several securities laws violations that have been unearthed in the recent past, the Securities Laws (Amendment) Ordinances, which have been successively re-promulgated, have equipped SEBI with the regulatory ammunition that is required to deal with several securities laws violations such as illegal pooling of funds and other frauds on the market. An ordinance is in effect for a period of six months and the Securities Laws (Amendment) Second Ordinance, 2013 promulgated on September 16, 2013 lapsed in January this year. In the interest of maintaining continuity and considering the implication on an ongoing investigation in case of a sudden regulatory vacuum where action is initiated based on the enhanced powers, but could not have continued because of the lapse, the President has re-promulgated the ordinance on March 28, 2014.

More importantly, it must be pointed out that the current ordinance stands modified in respect of certain issues. First, a new Section 11C (8A) has been introduced which allows an authorised officer to requisition the services of a police officer or any central government officer while conducting search and seizure. Second, the ordinance envisioned a mechanism where the requirement to approach a judicial magistrate to before conducting a search and seizure operation was removed. Concerns were raised regarding the possibility of arbitrary action on the part of the regulator. However, the current ordinance has addressed this concern to a large extent by imposing an obligation on the Chairman of SEBI to record his reasons in writing for authorizing a search and seizure operation.

Although the above moves are laudable, there is another addition which has managed to raise some eyebrows. The ordinance has introduced a new sub-Section 15 I (3) which authorises the Board to call for and examine an order passed by an adjudicating officer and if the Board is of the opinion that such an order is erroneous and not in the interest of the securities market, the Board may enhance the quantum of penalty imposed under such an order. There is a clear demarcation of jurisdiction between the AO and the Board. Such a provision would result in unnecessary encroachment into the independent jurisdiction of an AO by the Board and hence lead to unwanted confusion and delays.

Public Sector Banks as 'public shareholders' in stock exchanges

SEBI has suggested that public sector banks and financial institutions be considered as 'public shareholders' in stock exchanges. SEBI opined that imposing limitations on shareholding of banks and financial institutions by allowing them to hold shares in stock exchanges only as 'public shareholders' would adversely affect their levels of market participation. Three national stock exchanges namely, BSE, MCX-SX and United Stock Exchange will need to enhance their public shareholding while the public shareholding at NSE stands at 57.48% which is beyond the required level of 51%. However, the Finance Ministry has rejected the proposal on the ground that it would violate statutory provisions. Section 4B of the Securities and Contracts Regulation Act, 1956 mandates a recognized stock exchange to ensure that at least 51% of its equity share capital is held, within 12 months from the date of publication of the order approving the scheme of corporatization or demutualization, by the public excluding shareholders having trading rights. Therefore, banks could come in the public shareholding category if they did not have trading rights on the bourse. However, under the currency derivatives segment, trading members have to be banks and hence as per the existing rules banks cannot be included as public shareholders.

According to SEBI, the SCRA provisions intended to keep trading members separate from the management and ownership of the exchange to enhance transparency. Institutional investors such as banks and financial institutions are managed by independent professionals and are 'informed investors' who can help bring in good governance norms in the functioning of an exchange. The effect of the Finance Ministry's refusal of the suggestion is yet to be known.

Developments in relation to FPI

The SEBI notified the FPI Regulations in January, 2013, to subsume the FII and the QFI routes of foreign investment into India to form a new category of investment into India termed as the 'foreign portfolio investment' or FPI route.

Recently, in March 2014, the FPI scheme also received the blessings of RBI, which issued a circular under the FEMA Regulations, replacing the Portfolio Investment Scheme for FIIs and QFIs with the 'Foreign Portfolio Investment' scheme, for those entities registered as FPIs in accordance with the SEBI FPI Regulations. However, there appear to be significant differences between the SEBI FPI Regulations and the RBI notification with respect to investment restrictions. While the SEBI Regulations provides that an FPI can invest in securities in both primary and secondary markets in listed and to be listed companies, the RBI notification seems to suggest that FPIs can purchase shares and convertible debentures which are only *"offered to the public in terms of relevant SEBI guidelines/ regulations."* The language used in the RBI notification clouds investments by FPIs in preferential allotment and QIPs of listed companies, which under existing laws are technically not 'offers to public.' One hopes that these differences will be ironed out sooner rather than later, as uncertainties may affect foreign investments.

The FPI Regulations has shifted the onus of registering FPIs from SEBI to Designated Depository Participants (DDPs) and operational guidelines have been notified to facilitate registration of FPIs by DDPs. However, SEBI has recently issued a notification specifying that the FPI regime shall commence from June 1, 2014 and that SEBI would continue accepting all applications for registration of FIIs and sub-accounts till May 31, 2014. Interestingly, the 1995 SEBI FII Regulations have been repealed by the FPI Regulations and all investments by FIIs and sub-accounts will now be governed by the FPI Regulations even though the FPI regime will only commence from June 1, 2014. This will cause some confusion.

Disclosure of Price Sensitive Information - A stitch in time saves nine

The Code of Corporate Disclosure Practices provided within schedule II of the SEBI (Prohibition of Insider Trading) Regulations, 1992, provides various requirements that are to be adhered to by all listed companies. One such requirement is that all listed companies must disseminate all price sensitive information to stock exchanges on a continuous and immediate basis. In order to decide what information can be termed as price sensitive, it must be considered whether the information is directly or indirectly related to the company and whether the publication of the information is likely to materially affect the price of the securities of the company.

In a recent order in the matter of MAN Industries, an Adjudicating Officer decided that delays in disclosing certain price sensitive information warranted a penalty of Rs. 25 lakh. The company had bagged two major orders that would earn it revenue in the range of a 100 million Euros each. However, the stock exchanges were informed of one of these orders nearly 60 days after the contract was signed, while the other was 7 days late.

The company had contended that there was a strong likelihood of the order being amended and might have required additional confirmations. They also argued that they were waiting for the payment of the advance in order to ensure the commitment of the clients. In their view, disclosure of the information without being certain of the finality of the contract would be premature, misleading and result in greater harm to investors.

By taking note of the clause within the contract clearly stating that the contract shall come into effect and become binding on the parties upon it being duly signed, the adjudicating officer held that the signing of the contract would constitute reasonable crystallization of the order and warrant dissemination of the information. Payment of advance is merely a discharge of an obligation arising out of a valid and binding contract and waiting for the same is not an acceptable defence. Additionally, any future amendments would simply require a separate disclosure under the same disclosure requirements.

Executives Beware

The adjudicating officer of SEBI recently penalized directors and promoters of Falcon Tyres Ltd. on their failure to create a Code of Internal Procedures and Conduct as required under the Insider Trading Regulations for all listed companies in India. A hefty penalty of Rs. 1 crore was imposed on the promoter director, the managing director and the non-executive director and the company secretary cum compliance officer of the Company, each of them being jointly and severally liable to pay the entire penalty amount. The company secretary cum compliance officer was held liable because he was considered as a professional whose core competency was corporate governance and compliances. The promoter director and the managing director were held liable as they were in charge of the day to day management of the company and the non-executive director was liable on the ground that he was considered to be the custodian of corporate governance and had the responsibility to monitor executive activity. The penalty appears to be disproportionate to the offence.

RBI plans to remove FDI Pricing Guidelines

In its first Bi-monthly Monetary Policy Statement, 2014-15, the RBI has expressed its intention to remove all applicable pricing guidelines that were hitherto applicable to acquisition and sale of shares by foreign investors. The RBI until 2010 had prescribed pricing guidelines for acquisition and sale of shares by foreign investors in unlisted India companies based on the formula prescribed by the erstwhile Controller of Capital Issues. Subsequently, in 2010, the RBI introduced the DCF Method i.e. the discounted cash flow valuation method which took into account the future performance potential of a particular company. Recently, the RBI prescribed the RoE (Return on Equity) based pricing method for options.

However, in a rather unexpected move, the RBI has decided to shift from the existing model to a model where under the pricing in relation to transactions of acquisition and sale would be based on acceptable market practices. This change is a part of several other changes that the central bank seeks to implement in the interest of attracting long term investors.

The move has been a pleasant surprise for a lot of investors and is expected to give the required impetus to inbound investment. However, the RBI has informed that operating guidelines will be notified separately and one would have to wait until such guidelines are notified in order to evaluate the actual implication of this decision. On a broader level, the inclination of the regulator to move towards a more liberalised regime has brought a sigh of relief to most and hopefully this attitude would be reflected in other changes in relation to foreign investments that may be seen in the near future.

709 Raheja Centre, Free Press Journal Road, Nariman Point, Mumbai 400 021, India. Tel : +91 22 43470750 info@finseclaw.com