FINSEC
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SECURITIES AND INVESTMENT REGULATIONS

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Newsletter

Sahoo Committee Report

The Central Government has recently accepted the Sahoo Committee Report which recommends review of the existing regulatory regime relating to the issuance of ADR/GDRs by Indian companies. The Report proposes certain major regulatory changes, although it does not discuss the FCCB regime. The Committee has recommended that all kinds of issuers of securities, whether private or public, listed or unlisted companies, mutual funds or investment trusts, be allowed to access the DR market. DRs will be allowed to be issued on all kinds of securities as opposed to the earlier condition of DRs being permissible only for listed shares of public companies. While the move is laudable, DRs are often listed abroad and a free access to all kinds of issuers without any Indian regulatory interference would increase risks of fraud, thereby endangering the reputation of the Indian capital market. Further, the Committee has recommended allowing both sponsored DR programs where issuer companies sponsor the issue and raise fresh capital through the issuance, and unsponsored DR programs where a security holder, without any formal arrangement with the issuer company, may sponsor a DR programme for the securities held by the holder. The Committee recommends that securities issued to foreign depository for creation of DRs shall have the same pricing restrictions that may be applicable to a domestic investor. This would imply that pricing restrictions applicable under the current FDI policy will not be applicable to DR programs and issuers would be free to price their securities for issuances of DRs. Under the current FDI policy, investment through ADR/GDR is treated as FDI and is subject to pricing restrictions. DRs should be subject to FDI restrictions in case of acquisition of DRs representing more than 10% of equity capital of issuer companies. Pricing flexibility should only be accorded for portfolio investments constituting not over 10%, and any larger or strategic investment made through DRs should be subject to pricing norms. The Committee opined that SEBI, being the securities market regulator, is the appropriate authority to investigate market abuse related to DRs on the back of securities, as defined in the Securities Contracts (Regulation) Act, 1956. The view of the Committee is contrary to the ruling of Securities Appellate Tribunal in Pan Asia Advisors Limited case of 2013 where SAT found that DRs are governed by rules framed by Ministry of Finance and SEBI does not have jurisdiction over market abuse in DRs. Mr. S. Ravindran, representative of SEBI on the Committee has also dissented in the Report and observed that SEBI has jurisdiction only over companies whose securities are listed or are proposed to be listed on Indian stock exchanges.

New Norms on Offer For Sale Mechanism

SEBI in its Board Meeting held on 19 June, 2014, cleared new norms relating to offer for sale mechanism, as a part of its measures aimed at revitalizing the primary market. The modifications seek to enhance retail participation and enable large shareholders including non-promoters to use the route to exit. SEBI has mandated that minimum 10% of the offer size shall be reserved for retail investors i.e. for investors bidding for amounts below Rs. 2 lakh. Further the seller of shares may offer a discount to retail investors as per the framework specified from time to time. Non-promoter shareholders holding over 10% or such percentage as specified by SEBI shall be eligible to utilize OFS. The range of companies to whom the OFS mechanism is available has also been broadened. Such OFS mechanism shall be made available for shareholders of top 200 companies by market capitalization, instead of the earlier mandate of top 100 companies. Though allowing the top-200 companies and including non-promoters are commendable measures so far as changes in the OFS rules are concerned, the requirement of 10% shareholding of a non-promoter seller may limit this to only a few situations. A lower holding limit (like 5%) would have enabled more number of investors to resort to the route. Overall, the relaxations in the share-sale norms and increase in their scope will enable companies to sell their shares with greater ease and raise money from the public, enhance liquidity in the market and bring in more transparency. Further, the Board approved the proposal to allow bonus shares issued a year before filing of the draft offer document to be offloaded through OFS, provided that such shares were issued out of the free reserves or share premium of a company.

First Informal Guidance on the SEBI (AIF) Regulations, 2012

SEBI issued its first informal guidance dated 28 February, 2014, on the SEBI (Alternative Investment Funds) Regulations, 2012, in response to queries raised by Motilal Oswal Real Estate Investment Advisors Private Limited. Motilal Oswal Real Estate sought interpretative guidance on four crucial points under the AIF Regulations which required clarity. In relation to the question, whether the investment limit of 25% (in one investee company) of the investible funds is to be complied with at the time of final close of the Fund or at the time of each investment by the Fund, SEBI clarified that this restriction must be complied with throughout the life cycle of the Fund or the scheme. In addition, SEBI clarified that the phrase “Category II Alternative Investment Funds shall invest primarily in unlisted investee companies or in units of other Alternative Investment Funds”, in Regulation 17(a) is indicative of where the “main thrust” of a Category II Fund ought to be. In other words, the requirement is to ensure that investments in unlisted securities or units of other AIF are more than other investments i.e. greater than 50% of the funds invested at all times. Further, even this requirement ought to be complied with throughout the life cycle of the Fund or the scheme. Another query raised by Motilal Oswal Real Estate was in relation to the understanding of the phrase "investible funds" SEBI clarified that the amount of investible funds is to be computed on the basis of commitment made by the sponsor inclusive of green shoe option, as may be exercised, as on the date of computation. These are welcome clarifications which would facilitate continual compliance by fund managers and thereby avoid the issue of infringement of investment limits. In the current market practice, managers seek to comply with investment limits only towards subsequent closings. Moreover, the informal guidance has provided clarity regarding what constitutes "primary investment".

Crowd-Funding: An Innovative Way to Raise Capital

SEBI issued a Consultative Paper on Crowd-funding on 17 June, 2014. Crowd-funding involves raising capital from multiple investors through a web based platform or social networking website. Though there are various kinds of crowd-funding like donation crowd-funding, reward crowd-funding, peer-to-peer lending, only securities crowd-funding falls within SEBI's regulatory domain. The three categories are Equity based Crowd-funding, Debt based Crowd-funding and Fund based Crowd-funding. Further, crowd-funding platforms are categorized into Class-I entities like stock exchanges with nationwide terminals and depositories, and Class-II entities like government promoted technology business incubators. Given that there is no need to list or file a prospectus with SEBI nor any requirement to pay fees to intermediaries, advertising or marketing fees, crowd-funding is less costly and cumbersome as compared to an IPO and is an innovative way to raise capital for start-ups and SMEs. To ensure that retail investors are not over-exposed to the risks of start-up ventures, participation in crowd-funding is restricted to accredited investors like Qualified Institutional Buyers, High Net-worth Individuals and retail investors who have access to investment advice and resources. However, the exit from crowd-funded securities is also restricted as there is no secondary market for investors to sell their investments. Consequently, crowd-funding securities can only be transferred to a few persons like the issuer, another accredited investor, a family member or relative or friend of the accredited investor. The restricted participation in crowd funding is primarily due to the shift in investor risk from institutional investors to retailer investors; indirect solicitation of funds by the issuer; and illiquidity due to lack of secondary markets. To check the high possibility of money-laundering, cyber-crimes and fraud, issuers are allowed to raise funds through crowd-funding only through a recognized crowd-funding platform, with the approval of a screening committee, in accordance with the prescribed disclosure and due-diligence requirements. The Paper recognizes that a regulatory framework is required in India for crowd-funding, an emerging alternative funding avenue for projects which banks are reluctant to finance. However, such a framework can only be effectively implemented if punitive measures like fines or prohibition on accessing crowd-funding platforms, loss of accreditation etc. can be imposed on participants who violate the prescribed norms.

Test for Transfer of Management

The Supreme Court, in the matter of Bhushan Energy Limited v. Orissa Sponge Iron and Steel Limited, had directed SEBI to decide on the point of whether conversion of 35,00,000 warrants of Orissa Sponge Iron and Steel held by Bhushan Energy could result in a transfer of management. The initial issue had arisen when OSIL refused to convert the warrants on the ground that the transfer of 'management' due to conversion in favour of Bhushan Energy was against the terms of issuance of the warrants. The concept of 'control' is widely used in statutes and regulations such as the takeover code and has been interpreted repeatedly by various judicial pronouncements. However, there has been no clear threshold by which it can be concluded that a person has control over 'management' or when there is a transfer of 'management'. SEBI's Whole Time Member distinguished the terms 'control' and 'management' and observed that the incumbent management could continue to be in control even if it lost the largest shareholder status, if a sufficient number of the remaining shareholders was not disinclined towards them. In light of this, the WTM set out two considerations that would be relevant in determining whether there was a transfer of management: (i) the management would have been transferred to any person if that person's shareholding exceeds 50% or, (ii) there is a clear indication that a segment of the remaining shareholders are likely to support the person in forcing the incumbent to quit. It is unclear how voting rights alone can be used to determine if a person has control over the management of a company. However, based on his findings, the WTM went into the factual consideration of whether the conversion would result in Bhushan Energy exercising greater than 50% of the voting rights in the Target. As there was no evidence in support of the same, it was concluded that the conversion of warrants cannot result in a transfer of management to Bhushan Energy.

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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