FINSEC Law Advisors

Securities and Investment Regulations

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Highlights of Budget in Relation to Securities Market

The Finance Minister has brought some sunlight for capital markets in India. For players in the securities market, the highlights of the Finance Bill, 2014 are as follows:

Characterisation of income of fund managers of FPIs: One of the major issues plaguing investments into India was tax uncertainty in relation to characterisation of income for managers of FPIs residing in India. Despite huge investments being made, fund managers preferred residing overseas due to the question whether double taxation treaty benefits would be accorded to such entities.

This led to substantial tax leakages from investments made in Indian securities and loss of employment opportunities. However, from now on, securities held by an FPI will be considered "capital assets", and gains derived from their transfer will be considered capital gains and thus the income arising out of such transfers will be eligible for treaty benefits. This would incentivise fund managers to shift to India, which in turn is expected to increase inflows of investments along with additional improvements in employment opportunities and reduction of tax disputes.

Depository Receipts: It has been seen that capital raising through IDRs has been abysmally low. In order to revamp the regulatory framework for IDRs and based on the recommendations of the Sahoo Committee Report, the government has proposed to launch a more liberal regime - Bharat Depository Receipt (BhDR). BhDRs would have a wider range of securities such as debentures, bonds and mutual funds as underlying securities as opposed to equity alone. In addition, requirements in relation to taxation have been simplified to facilitate fund raising. In addition, it has been proposed to liberalize the norms for ADRs and GDRs by expanding the list of underlying securities to include all securities of public and private companies.

Mutual funds: The mutual fund industry is one which has been adversely affected. Fixed Maturity Plans (especially those with a tenor of 1-3 years) and debt funds would become less lucrative owing to higher taxes on all non-equity linked mutual funds. Presently, for the units of mutual funds with the exemption of equity oriented funds, the capital gains arising on transfer of units held for over a year are taxed at a rate of 10%. This rate is proposed to be increased to 20%. Additionally, until now 12 months was the threshold for categorising an asset as a long term asset however this has been stretched to 36 months. Although, some relief comes in the form of retirement mutual funds being afforded a tax treatment similar to regular pension funds, that might not be sufficient to undo the damage.

Tax Pass Through for REITS and InvITs: The Finance Bill has proposed a tax pass-through regime for real estate investment trusts (REITs) and infrastructure investment trusts (InvITs). This means that income received by the REIT would be exempt from taxation. Tax clarity has made these new investment vehicles lucrative investment options while ensuring that funds are directed towards infrastructural growth in the country. However, a much awaited and a logically consistent announcement regarding a pass-through status for all categories of alternative investment funds, which have already raised substantial amounts of funds, was missing from the budget. On the contrary, a CBDT circular on the nature of a fund being closed to new investors to avail of pass through benefits has wreaked havoc in the beneficial alternate fund industry.

Regulation of InvITs

SEBI released the Draft SEBI (Infrastructure Investment Trusts) Regulations, 2014 on 17 July, 2014. This follows the consultation paper on InvITs which SEBI had released on 20 December, 2013, and incorporates the provisions delineated under the Finance Bill 2014-15, which confers pass-through taxation status on InvITs. The Draft Regulations provide for two broad categories of InvITs: those that seek to invest at least 80% of the value of the assets in completed and revenue generating projects, and those that propose to invest over 10% of the value of their assets in under construction projects. In the former route, money can be raised only through public issue of units with minimum trading lot of Rs. 5 lakhs. In the latter route, funds can be raised only through private placement from Qualified Institutional Buyers and body corporate, and the trading lot shall be Rs. 1 crore. Such InvITs shall invest in not less than one completed and revenue generating project and not less than one pre-Commercial Operations Date project. While the Draft Regulations have provided for an elaborate framework that would help attract long-term investment for the infrastructure sector, there are certain issues that warrant attention. A very wide definition of "associate" may have the unintended consequence of precluding certain otherwise eligible entities from becoming trustees of the InvIT, given that a trustee cannot be an "associate" of the sponsor or investment manager. Similarly, the prescribed net worth requirement of Rs. 10 crore for a sponsor appears to be disproportionately high and would hinder entities from becoming sponsors of the InvIT. Further, listing has been made mandatory for both publicly offered and privately placed InvITs. However, there is a one-year lock-in requirement with respect to units held by non-sponsors. This may hinder free transferability of the units and impact market liquidity. The use of this as a separate set of regulations instead of as a sub-category in alternative investment fund regulations is not clear.

Clarification on Related Party Transactions

Section 188 of the Companies Act, 2013 discusses related party transactions and the requirement to seek approval of the shareholders by way of a special resolution. The provision specifically restricts members from casting their vote on such special resolutions if such member is a related party. As the definition of a 'related party' within the Companies Act is very wide, a blanket ban on all such persons would be unfair as they might not be a related party with reference to the contract or arrangement for which the said special resolution is being passed.

The Ministry of Corporate Affairs issued General Circular 30/2014 on 17th July 2014 which provides some clarity in this regard. 'Related party' has to be construed with reference only to the contract or arrangement for which the said special resolution is being passed.

Though the intent of the clarification seems to be to cover only those related parties who are involved in the relevant contract or transaction, the language of the Circular can lead to further confusion. Firstly, there is no definition for related party with reference to a contract or arrangement. The Act merely contains a general definition with reference to the company. Secondly, the circular does not envisage a situation where the majority shareholder of a company can enter into contracts with the company after diluting his shareholding to other related parties. This will make it easier for him to ensure a successful special resolution as he will only be barred from exercising voting rights to the extent of his diluted shareholding.

The circular provides further clarifications on two other matters. Firstly, it is now established that the requirement of obtaining approval through special resolution is not applicable to compromises, arrangements and corporate amalgamations. Secondly, contracts which have already come into effect prior to the enactment of Section 188 will not require fresh approval till the expiry of the original term of such contracts. However, any further modification in such contracts should fulfil the requirement of Section 188.

New Pricing Guidelines for FDI

The Reserve Bank of India recently revised the pricing guidelines with respect to issue and transfer of shares under the FDI Policy. Earlier, in unlisted companies, the floor price was computed on the basis of valuation done as per Discounted Free Cash Flow method by a merchant banker or a chartered accountant. This requirement has now been done away with. Now, in case of issue of shares to non-resident by unlisted company, transfer of shares by an unlisted resident company to a non-resident or in transfer of shares by a non-resident to a resident unlisted company, the issue or the transfer price must be based on *fair valuation of shares computed in accordance with any internationally accepted pricing methodology on arm's length basis.* The price calculated must be duly certified by a chartered accountant or a merchant banker. The non-resident investor at time of their exit may sell their securities at a fair price computed as above.

In listed companies, the transfer or issues of shares, including CCPS and CCDs, shall be as per SEBI guidelines. Also, in shares with optionality clauses, the non-resident investor can exit at the market price prevailing on the recognised stock exchanges subject to the stipulated lock-in period.

This is a positive shift, moving away from a strict and often rigid formula which at times restricted genuine commercial activity. Instead the new norm allows a more flexible and business friendly principles based valuation methodology.

Foreign Investment in Partly Paid-up Equity Shares and Warrants

RBI, through a recent notification, reviewed what instruments would be permissible means of foreign investment. FIIs and Registered FPIs can now invest in partly paid-up equity shares and warrants as part of FDI and FPI, subject to applicable sectoral caps.

Partly paid-up Equity shares: The pricing is required to be determined upfront and 25% of the total consideration is to be received by the issuer upfront. The balance consideration is required to be received within a period of 12 months. In case of listed companies, if the issue size exceeds five hundred crores and the issuer complies with Regulation 17 of the ICDR Regulations, the 12 month requirement will not be insisted upon.

In case of unlisted companies, if the consideration amount exceeds five hundred crores (Rs. 5 billion), the 12 month requirement will not be attracted as long as issuer appoints a monitoring agency on similar lines as required by ICDR Regulations of SEBI for listed companies.

Partly paid-up Warrants: The pricing or the price/conversion formula of the warrants shall be determined upfront and 25% of the consideration amount shall be received upfront. The balance consideration shall be received within a period of 18 months. It is also necessary to ensure that the price of the warrants at the time of conversion shall not be less than the fair value computed at the time of issuance in accordance with the extant FEMA Regulations and pricing guidelines stipulated by RBI.

These measures provide additional flexibility and options to Indian companies in raising foreign capital.

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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