FINSEC
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SECURITIES AND INVESTMENT REGULATIONS

September 2014 Newsletter

From the founder's desk

We are proud to announce that this is the first anniversary edition of our newsletter. We have received wonderful feedback from our readers over the 12 editions. We hope to reach more decision making desks across India and the world in the years to come.

Please continue writing to us with your feedback.

Sandeep Parekh

The Securities Laws (Amendment) Act, 2014

After being successively promulgated as an ordinance thrice, provisions enhancing the regulatory powers of the securities regulator have finally been etched in stone as the Securities Laws (Amendment) Act, 2014 which came into force on the August 25, 2014. The Act strengthens the investigative and enforcement powers of SEBI to crack down on illegal ponzi schemes and seeks to ensure that ample avenues are available with the regulator to recover funds raised by these entities. In brief, the powers regarding calling of information, modes of recovery of amounts upon the failure of a person to pay any penalty, fees or the failure to comply with a disgorgement order etc. are in line with the previous ordinances. However, the Act has omitted the elaborate powers that were previously given to the chairman regarding the authorisations of search and seizure operations under the ordinances. Now, authorisation has to be taken from a magistrate or judge of a central government designated court for search and seizure operations. This entails that the SEBI (Procedure for Search and Seizure) Regulations, 2014 which were framed on the basis of the powers granted under the ordinances would now be rendered redundant.

Although the effort is laudable on a broader level, concerns have been raised regarding an overtly paternalistic attitude towards regulating every activity which involves collective investment. For instance, as it stands today, any pooling of funds with a corpus of Rs. 100 crores (Rs 1 billion) or more would be deemed to a collective investment scheme and will attract the onerous registration and disclosure requirements under the SEBI CIS Regulations, 1999. Such a requirement would unnecessarily hinder genuine commercial activity such as construction of real estate projects etc. which inevitably require the pooling of money over the specified threshold of Rs. 100 Crores. It is important to establish checks and balances to restrict the scope of Section 11AA of the SEBI Act, 1992 in order to avoid an overly broad interpretation of the provision.

Rupee Denominated Bonds - A New Source of Funding

The Central Government acting through the Ministry of Finance, on August 01, 2014, has issued a notification declaring 'onshore rupee bonds' issued by multilateral institutions like the Asian Development Bank (ADB) and the International Finance Corporation (IFC) as 'securities' within the meaning of sub-section (h) of Section 2 of the Securities Contracts (Regulation) Act, 1956.

The notification assumes significance in the backdrop of internationalisation of the Indian Rupee. Last year, with an aim of attracting greater foreign capital flows into India, the government approved a proposal from IFC to launch its US$ 1 billion Offshore Rupee Bond Program. Under this program, international savings have been channelized towards development of capital markets in India by broadening the international investor base for investments in India.

Offshore rupee bonds, typically, are financial instruments issued by foreign multilateral institutions, such as ADB and IFC, which allow foreign investors to take exposure to Indian currency. These bonds are denominated in rupees but settled in a foreign currency i.e. the investment is made in the foreign currency which is then converted into Indian rupees and invested in India. These offshore rupee bond programmes are intended to provide an alternative source of funding for Indian companies. Previous rupee bond issues made by IFC have met with overwhelming responses from a diverse range of foreign investors. This is reflective of the growing confidence of international investors in the Indian economy. In addition to attracting foreign capital, the success of offshore rupee bonds signifies India's economic strengths in comparison to foreign capital markets.

Simultaneously with the development of the offshore rupee market, the August 1st notification indicates the intention of the government to develop the onshore market for rupee denominated bonds issued by developmental institutions such as ADB and IFC. Allowing multilateral institutions to offer onshore rupee bonds in India would ensure that new investors such as pension and insurance funds, which can only invest in quality paper, are encouraged to make investments in the infrastructure sector without being apprehensive about the fears ordinarily associated with debt funding of infrastructure.

The specific inclusion of "onshore rupee bonds" within the meaning of "Securities" under Section 2(h) of the SCRA appears to be the groundwork for facilitating future listing and trading of such onshore rupee bonds on an institutional platform. However, as opposed to offshore rupee bonds, which fall within the regulatory purview of a foreign regulator, onshore rupee bonds would have to be regulated by a domestic regulator. In this light, several questions regarding the issuance and listing requirements, eligibility of investors, regulatory oversight etc. remain unanswered and further clarity is required.

Acquirers cannot run away from Golden Tobacco Ltd.

The Securities Appellate Tribunal, in a recent decision, considered whether certain acquirers who made a hostile takeover bid for a stake in Golden Tobacco Ltd. could withdraw their open offer. The withdrawal was sought on 2 grounds: (1) SEBI delayed the granting of approval for the open offer by 2 years; (2) the promoters of the company have encumbered the assets and siphoned funds of the target company, leaving only a shell company.

On the first ground, the Tribunal was critical of the time taken by SEBI in permitting the public offer. However, the Supreme Court has often taken the view that delay by SEBI, though undesirable, is not fatal. Despite SEBI's delay the Tribunal struck down this ground by citing the Supreme Court.

On the second ground, the majority of the Tribunal took a narrow view and stated that the discretion of SEBI in allowing withdrawal is limited to those circumstances wherein it is impossible for the acquirer to go through with the public offer (e.g., when requisite statutory approvals are denied or when the sole acquirer expires). Therefore, the withdrawal sought in the present case was rejected.

This narrow view restricts SEBI's ability to protect acquirers in circumstances where they are being taken for a ride by unruly promoters. The minority view rightly highlights this gap. The target company has been reduced to a sick company since the public announcement and this can be noted by observing the drops in profitability, book value and earnings per share. Further, an Adjudicating Officer of SEBI, in his decision from February, 2014, notes that the modus operandi of the promoters of the target company was to encumber the valuable assets without taking the risk of getting the statutorily mandated shareholder's approval.

These actions were clearly unforeseeable despite the exercise of due skill and care by the acquirers. There is a clear need for reconsidering the interpretation of Regulation 27 of the takeover code which would allow SEBI to exercise its discretion and allow withdrawal in such circumstances.

CBDT Clarification on Tax Treatment of Alternative Investment Funds

The Central Board of Direct Taxes issued a clarification on 28 July, 2014 dealing with taxation of Alternative Investment Funds (AIFs) registered with SEBI. The circular notes that AIFs have been accorded tax pass-through status under the Income Tax Act, 1961.

The tax department has now clarified, through the circular, that in a scenario where the trust deed of an AIF, when set up as non-charitable trust,does not set out the names of the investors or their respective beneficial interests as on the date of creation of trust, tax pass through will not be available for the fund. This clarification will lead to the entire income of the Fund to be taxed at the 'Maximum Marginal Rate', in the hands of the AIF Trustees, in their capacity as 'Representative Assessee'. Therefore, such income shall not be assessed in the hands of the investors.

The position taken in the circular is at variance from that taken by the Authority for Advanced Rulings in the AIG case (In Re: Advance Ruling P. No. 10 of 1996), wherein it was held that it is not required for the trust deed to state the exact names or shares of all beneficiaries for a trust to be considered a determinate trust. The primary issue that arises is that AIFs almost never have a ready set of investors at the time of fund formation and various investors enter at the subsequent or final closings. This circular differs from the entire edifice of AIF taxation built upon the AIG ruling, based on which merely class of beneficiaries and formula/methodology for calculation of shares/distributions were sufficient to make the trust determinate.

Further, the circular inflicts more pain on the bruised AIF industry, by imposing tax at the Maximum Marginal Rate on the Trustees of the AIF, i.e., the rate applicable to highest slab of income for individuals, should the income of the AIF be ascertained to be earned through profits, income or other gains of business, even where the AIF is determinate. The circular may have been issued with the objective of clarifying the tax position for onshore funds established as AIFs, however it has the potential of having a detrimental effect on a sunrise source of capital for cash-strapped enterprises, jeopardizing the commercial viability of AIFs in the first place.

New Changes to Related Party Transaction Norms

The Ministry of Corporate Affairs, on 14th August, 2014, issued a notification relating to amendment of the Companies (Meetings of Board and its Powers) Rules, 2014. Prior to the amendment, companies having paid-up share capital of Rs 10 crores (Rs. 100 million) or more were required to obtain prior shareholder approval for all related party transactions that were neither in the ordinary course of business or at an arm's length basis irrespective of the amount involved. This resulted in onerous obligation on companies to take approval of their shareholders for even trivial and routine related party transactions which may have potentially impacted the efficiency of their business.

The amendment made to Company Rules liberalizes the above restrictions by imposing monetary thresholds on related party transactions which would require prior shareholder approval. The amendment also removes the Rs. 10 crore threshold and make the rules applicable to all companies, irrespective of their paid-up share capital.

Post amendment, related party transactions would require prior approval only in the following circumstances:
(1) When the RPT relates to sale, purchase or supply of goods or materials, if the transaction exceeds 10% of the turnover of the company or Rs. 100 Crores, whichever is lower;
(2) When the RPT relates to sale, purchase or lease of property, if the transaction exceeds 10% of the net worth of the company or Rs. 100 Crores, whichever is lower; and
(3) When the RPT relates to offering or receiving services, if the transaction exceeds 10% of the turnover or Rs. 50 Crores, whichever is lower.

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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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