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SECURITIES AND INVESTMENT REGULATIONS

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Discussion Paper on Clause 36

SEBI recently released a discussion paper on review of clause 36 of the equity listing agreement. Presently, Clause 36 imposes an obligation on listed companies to make prompt disclosures to the stock exchanges of any price sensitive information or events which may have an impact on the performance or operations of the company. Companies currently enjoy discretion on deciding which events are material or price sensitive based on a broad and indicative list of material events provided under the Listing Agreement. SEBI felt that such discretion led to voluntary and inadequate disclosures by the listed companies in the securities market.

SEBI, by way of this discussion paper, proposes to introduce stringent laws on the requirement of issuer companies in relation to immediate disclosures of price sensitive information. It proposes to practically take away the discretionary powers from the management of the companies in making such disclosures and replacing it with a long list of events and tests based on which disclosures will be required to be made within a short span of one day. Additionally, it has suggested qualitative criteria or quantitative criteria for determining whether a specific event/ information would be considered material for disclosures.

Further, the Discussion Paper provides three parameters to ascertain the price sensitivity of a particular information: (i) price impact test which covers information regarding the listed entity, which if published is likely to materially affect the share price of the listed entity, (ii) reasonable investor test which refers to information which is likely to be used by a reasonable investor for making investment decisions and thus which is likely to impact the share price, and (iii) information/event which the Board of Directors considers price sensitive.

This proposal, if implemented, will result in disclosures of a lot of unnecessary information which may not be material, relevant or required for public dissemination. Such disclosures may at times result in loss of trade secrets and interference with confidentiality. Further, companies may find it difficult to ascertain within one day whether an event or information is required to be disclosed under the vague tests of materiality proposed to be introduced by SEBI.

SEBI would be better advised to remove the long list of events and information to be disclosed and instead replace it with broad standards coupled with enhanced liabilities on defaulting companies.

The Fat Finger Syndrome

The Securities Appellate Tribunal recently passed an order in relation to an erroneous order which was placed by a dealer at Emkay Global Financial Services Limited. The dealer placed an order to sell 17 lakh NIFTY 50 units, worth Rs. 980 crores, instead of an order worth Rs. 17 lakhs. Before the error was noticed, the order had entered NSE's trading system and a substantial portion of it was executed resulting in the fall of the NIFTY index by 15.5% on 05 October, 2012. While rejecting the request of Emkay Global for annulment of the trade, NSE's Disciplinary Action Committee imposed a penalty of Rs. 25 lakh on Emkay Global.

On appeal before SAT, it was argued that the trade must be annulled on the grounds that the erroneous sell order constitutes a 'material mistake in trade' under the NSE Byelaws. Clause 5 of the NSE Byelaws states that dealings in securities on the exchange are inviolable and may only be annulled there has been a 'material mistake in trade'. The Tribunal observed that the object of clause 5 is to ensure sanctity of the dealings on the exchange by making the trades inviolable and not to give relief to a trader who didn't exercise due care and caution. They strictly interpreted the clause to mean that annulment may only be permitted in case of certain unforeseen circumstances, not merely when the trade was executed by mistake or merely because it led to huge financial loses.

This strict interpretation places an onerous obligation on traders and sets a penalty for a mistake far higher than what is allowed in the international markets. Further, international markets allow easy reversal of erroneous trades.

PACL Limited - SEBI's Expansive Jurisdiction

In an order dated August 22, 2014, a whole time member of SEBI found the business activities of PACL Limited to be in the nature of a Collective Investment Scheme and ordered the refund of all the money it had received and the 'returns' it had promised to its customers.

Under the SEBI Act, a CIS is any scheme that involves the pooling of money from investors for the purposes of the scheme and which attracts investments through assured profits or returns. The scheme involves management of the funds collected on behalf of its investors who do not have day to day control in the scheme. In order to run a CIS, entities need to be registered under the SEBI (CIS) Regulations, 1999.

PACL offered customers the opportunity to purchase small parcels of barren land and provided the service of developing the said parcel into fertile agricultural land. Customers paid for the land and the development services either at the outset or in instalments. At the time of purchase, while PACL provided an estimated value that could be realised post the development activity, it did not promise any fixed return to its customers. It merely offered to provide marketing services to those customers who intended to sell the land at the end of the development period.

By concluding that the aforesaid activities of PACL amounted to be in the nature of a CIS, SEBI has substantially expanded the scope of its jurisdiction to include land sale-purchase transactions. For instance, it is unreasonable to consider that SEBI is empowered to regulate any builder who may collect money while constructing a commercial or residential building in a city, thereby engaging in an activity which is not too different from the activities of PACL.

Disclosure: Finsec Law Advisors appeared for PACL Limited in the aforementioned proceedings.

New Norms for Risk Management in Clearing Corporations

SEBI has issued new norms, vide circular dated August 27, 2014, relating to core settlement guarantee fund (CSGF), stress testing and default procedures for risk management in clearing corporations. In 1997, SEBI issued the Guidelines for Settlement Guarantee Fund (SGF) at Stock Exchanges, which was a rudimentary set of guidelines which laid down the composition and mode of utilisation for a Settlement Guarantee Fund. Additional requirements were then prescribed under the SCR (SECC) Regulations, 2012 and an amendment to the same was made on September 02, 2013 to adapt with the structural changes in the Indian securities market since 1997.

SEBI under the new risk management norms has introduced the concept of a Core Settlement Guarantee Fund (CSGF). Broadly, 50% of minimum required corpus for the CSGF would be contributed by clearing corporations, atleast 25% by stock exchange and upto 25% by the clearing members. The CSGF would have no exposure and would be readily and unconditionally available to meet settlement obligations in case any clearing member fails to honour its settlement obligations.

The norms also prescribe that clearing corporations would be required to conduct stress tests on a daily basis. Stress tests are measures adopted to measure, monitor, and manage a clearing corporation's credit exposure and to ensure adequate availability of liquid resources. These tests provide a basis for ascertaining the minimum corpus required to be maintained in the CSGF.

In addition, the norms prescribe a detailed default waterfall which is essentially a list of monies, in an order of priority, utilised to meet liabilities in the case of default, CGSF being one of them. This has been the most laudable development as it seeks not only to ring-fence each segment of clearing corporation from defaults in other segments but also addresses the current issue of losses being attributed to non-defaulting clearing members as these new norms lay down the manner for limiting the liability of non-defaulting members.

It may be recalled that the legal sanctity of the priority of the clearing corporation's (then exchange's) rights were ensured by the Supreme Court's ruling in Vinay Bubna v. Stock Exchange, Mumbai.

Amendment to Corporate Governance Requirements under Clause 49

In April 2014, SEBI had amended Clause 49 of the listing agreement imposing stricter corporate governance standards on all listed companies with effect from 1 October, 2014. However, it was found that not all the companies were prepared and they faced practical roadblocks in ensuring compliance with the amended provisions by the initial stipulated deadline. Therefore, as a breather to such companies, SEBI by its circular dated 15 September, 2014, has further amended Clause 49 with effect from 1 October, 2014 and diluted the stringent conditions imposed under the original rule.

For example, SEBI had originally imposed stringent norms regarding related party transactions, such as imposing 'majority of minority' approval for material RPTs. Earlier a transaction was material if the transaction together with previous transactions in a financial year, exceeded 5% of the annual turnover or 20% of the net worth of the company. The revised clause has relaxed the materiality threshold by setting the limit at 10% of the annual consolidated turnover, so as to provide more flexibility to companies. Further, the definition of 'related party' under the original rule was found to be very broad which imposed undue operational hardships on the companies. Under the amended rule, the definition of a 'related party' has now been made consistent in terms of the Companies Act, so that companies are required to follow uniform standards for disclosure of RPTs. Further, the Audit Committee has been empowered to grant omnibus approvals for RPTs which would make it less burdensome for the Committee and the companies. The amendments also revise the definition of independent directors. Unlike the earlier clause, the new definition refers to 'materiality' of pecuniary relationship.

While targeted measures may address problems specific to the Indian corporate governance model, excessive regulation will impose significant constraints on listed companies. Given that substantive regulation is merely as good as the effectiveness of its enforcement, well-intended but radical norms may affect effective implementation. Through these amendments SEBI has sought to offer the potential for more effective implementation of governance practices by making them more acceptable to companies. However, discrepancies remain in certain aspects which require further clarification for smooth compliance.

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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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