FINSEC Law Advisors

Securities and Investment Regulations

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SEBI (Research Analysts) Regulations, 2014

SEBI has notified Regulations for research analysts on 1 September 2014, but the same will come into effect three months from its publication in the official gazette. These Regulations provide for the mandatory registration of research analysts and regulation of their activities. The focus of these Regulations is on minimizing potential and actual conflicts of interests in research reports issued by research analysts by imposing measures like trading restrictions on research analysts and placing limitations on public appearances by them. These Regulations also seek to regulate the activities of proxy advisors by imposing mandatory registration, trading restrictions and disclosure requirements. It also tries to bring within its scope the activities of foreign based research analysts who publish research reports on securities listed or proposed to be listed in India by requiring them to enter into an agreement with a domestic research analyst for distributing a research report. The domestic research analyst is then required to review the report for any untrue statement or false or misleading information.

There are a few areas of concern that need to be addressed in the Regulations, going forward. Firstly, the capital adequacy requirements for research analysts should be removed, atleast for individual research analysts as it is not clear how net worth is related to the ability of the research analysts to make stock recommendations. Secondly, the disclosure obligations placed on research analysts appear to be very onerous as they are also required to make disclosures on behalf of their relatives. Thirdly, the Regulations should provide for the liability of research analysts in case of non-compliance with the decisions or directions of the body corporate or the self-regulatory organization (SRO) which may be recognized by SEBI to regulate the activities of research analysts. This step will ensure the enforceability of the decisions of the SRO.

Self-trading and Manipulation

The Securities Appellate Tribunal recently dismissed an appeal regarding the trading activities of Angel Broking Private Limited in the scrip of Sterling Green Wood Limited. Angel Broking had acted as the broker and the counter party broker in certain circumstances. The Tribunal held that the trades, while manipulating the stock price and giving a false appearance of trading, were undertaken without the intent to effect any change in beneficial ownership.

It was alleged that Angel Broking undertook self-trades on two occasions in 2009. The first instance involved 323 shares and was priced lower than the prevalent average traded price. The second instance, effected on the following day, involved 9350 shares and was priced higher than the prevalent average traded price. While in one, a small portion of the earlier sell order matched a subsequent buy order, the second involved a sell order matching a small portion of a large buy order placed subsequently. In both situations, the buy and sell orders were placed over 12 minutes apart and were about 20 paise away from the average traded price (the stock price at the time was around Rs. 40). Angel Broking argued that the trades were executed independent of each other by separate dealers and were mere jobbing transactions.

The question of how strong an effect these trades had on the market remains as the number of shares traded and the difference between price of trades and average traded price was relatively low. However, while observing that it is not logical to place large buy orders at a higher price when a sell order at a lower price is pending, the Tribunal found no merit in the appeal and upheld the order imposing a penalty of Rs. 30 lakhs. Brokers might need to improve mechanisms to prevent self-trades as they may result in hefty penalties, however small the quantum of trade and however little its effect on the stock.

RBI and Wilful Defaulters: impact on access to capital markets

According to RBI's 'Master Circular on Wilful Defaulters', dated 1 July, 2014, an entity is termed as a wilful defaulter if it does not meet its payment/ repayment obligations despite having the capacity to repay or when it uses the loan amount for purposes other than specified ones. Further, the minimum outstanding amount should be Rs. 25 lakhs and the actions should be shown as intentional, deliberate and calculated. The wilful defaulter tag is not a mere naming and shaming exercise but entails severe implications for entities so labeled.

The RBI has proposed to SEBI to bar wilful defaulters from raising funds through issuance of any securities. Currently there are no restrictions on such entities raising money from the capital market. To prevent access to capital markets, SEBI receives a list of wilful defaulters (suit-filed accounts) and wilful defaulters (where no suit has been filed) from the RBI and Credit Information Bureau (India) Limited (CIBIL) respectively, on a quarterly basis. However, in the absence of specific norms, it is difficult to actually debar such entities.

Under the existing norms, where guarantees furnished by companies within the group on behalf of the willfully defaulting entity are not honoured, such group companies could also be classified as wilful defaulters. However, on 9 September, 2014 the RBI issued clarifications to the Circular that the existing provision is applicable to individuals and non-group corporates. It was stated that the liability of the guarantor is co-terminus with that of the principal debtor and thus banks could proceed against the guarantors simultaneously. Such an expansion will have significant implications, given the harsh consequences of being declared as a wilful defaulter. There will be no access to institutional finance and no access to capital markets. It may spread to individuals and non-group companies, thereby having an unreasonable cascading effect.

The issue has come to the forefront again after Kingfisher Airlines and its chairman Vijay Mallya were tagged as wilful defaulters by United Bank of India. The Circular and Companies Act, 2013 may indicate that a wilful defaulter tag will not mean automatic disqualification in the absence of criminal conviction. Nevertheless, shareholders can demand such removal on the basis of its negative ramifications such as the entities becoming ineligible for bank finance. Therefore, given that if a person on a company's board is declared as a 'wilful defaulter', its funding avenues will be narrowed, companies facing growth challenges and in need of greater resources may suffer.

SEBI is in the process of finalizing guidelines in relation to wilful defaulters. SEBI may consider the entity classified as wilful defaulter as not being 'fit and proper' for accessing the capital market. The release of the new framework could affect transactions that are awaiting regulatory clearances. It will trigger a list that may blacklist many companies from issuing securities in the market and raising funds.

Aggressive short position leads to market ban for Hedge Fund

In June, 2014, SEBI had issued an ad interim ex-parte order restraining Factorial Master Fund from accessing the securities market and prohibited the fund from buying, selling or dealing in securities, till further directions. FM fund challenged the directions issued under the interim order by submitting that the facts and circumstances do not warrant an intervention. The issue before the whole time member was that whether the directions issued under the interim order needed to be confirmed, vacated or modified during the pendency of the investigation. The member after examining the facts and circumstances, passed an order confirming the directions issued under the interim order.

The member observed that FM fund created an unusual and aggressive short position on the derivative contracts of LTFH on 13 March, 2014 ahead of the LTFH offer for sale and asserted that the short position was taken based on the UPSI available with the fund. The member held that FM fund was involved as a potential investor in the market gauging exercise undertaken by Credit Suisse, therefore this strengthens the *prima facie* finding that FM fund was in possession of UPSI about the discounted floor price of the LTFH offer for sale. The member further observed that it is highly unlikely that FM fund, which previously did not have any exposure to the scrip of LTFH, took an aggressive short position without being in possession of UPSI. The member further opined that it was highly unlikely that the FM fund would have taken a reverse position of the same number of shares in the cash segment by subscribing to LTFH offer for sale, unless it was in possession of the UPSI.

The above order is solely based on mere suspicion that FM fund which did not have any exposure in the scrip took an aggressive short position. Since it was contrary to market behaviour, therefore FM fund took such a position as it was in possession of UPSI. The directions issued under the order appears to be harsh, as the same has been passed on mere presumption that the fund was in possession of UPSI and the fund's attempt to rebut the presumption was ignored by the member by reasserting the conclusion reached in the ad interim ex-parte order.

Issue Equity Shares to Non-Residents for Legitimate Dues

In another move to facilitate FDI investments, RBI has relaxed the norms for the issuance of equity shares by Indian companies to non-residents against funds payable by the Indian company to such non-residents. Hitherto, Indian companies were permitted to issue shares and convertible debentures to a person resident outside India against lumpsum technical know-how fees, royalty, External Commercial Borrowing (ECB) and import payables of capital goods by SEZ units.

RBI through its circular dated September 17, 2014, has further permitted Indian companies to issue equity shares against *any funds payable* by the Indian company, remittance of which does not require prior permission of the Government of India or RBI under FEMA, 1999. However, issuance of preference shares or convertible debentures by the Indian company for such funds payable is not permitted. This facility is only available to Indian companies that can accept FDI under the automatic route and all guidelines relating to sectoral caps, pricing guidelines etc. would be applicable.

In relation to pricing of the equity shares issued in lieu of funds payable, an unlisted issuer would have to comply with any internationally accepted pricing methodology. Whereas, listed issuers would have to comply with the requirements under the SEBI ICDR Regulations, 2009.

In effect, Indian companies would now be able to issue equity shares, in lieu of cash, for any amounts payable for all current account and capital account transactions which are within the permissible remittance limit and do not require prior approval of RBI or the Government of India. These may include payments for goods imported, services availed, salaries payable etc.

Keeping in line with the primary objectives behind the FDI policy i.e. to accelerate economic growth, providing the option to offer equity participation to foreign suppliers and service providers would definitely help domestic companies in conserving their cash resources for their operational activities in India and this would be beneficial especially for early stage companies.

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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