FINSEC
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SECURITIES AND INVESTMENT REGULATIONS

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Disclosure of 'otherwise encumbered' shares

The Securities Appellate Tribunal passed an order on 30 October, 2013, setting aside the penalties imposed by SEBI on Golden Tobacco Ltd. and GHCL Ltd., for violating Clause 35 of the Listing Agreement and Regulations 3(d) and 4(2)(f) of the SEBI (PFUTP) Regulations, 2003. Golden Tobacco had not disclosed to the stock exchange that, an arbitration order had restrained certain promoter entities from transferring or creating third party interest in the company's shares, which had created an encumbrance on such shares otherwise than by way of a pledge. The issue was whether a listed company needs to disclose to the stock exchange, details of 'otherwise encumbered' shares of the company held by the promoter/promoter group, although the promoters are not obligated to make such disclosures to the company under Clause 35 of the Listing Agreement.

SAT held that the press releases issued by SEBI on 21 January, 2009, and Regulation 8A of Takeover Regulations, 1997 envisage listed companies to disclose to the stock exchanges only such information as is received by the company from the promoter/promoter group. Regulation 8A(1)/8A(2) of the Takeover Regulations and the two SEBI circulars dated 3 February, 2009, obligate the promoter/promoter group to disclose to the listed company only details of shares that are pledged/revoked/invoked and not shares that are 'otherwise encumbered'. SAT, while ruling in favour of the appellant companies, observed that, in the absence of any corresponding obligation upon the promoter/promoter group to make disclosures to the company regarding shares that are 'otherwise encumbered', it would be unjustified and anomalous to mandate listed companies to make such disclosures to the stock exchanges.

Beware algo traders

The Whole Time Member, SEBI passed an order dated 13 November, 2014, in respect of Crosseas Capital Services Private Ltd., a registered stock broker for engaging in self trades. SEBI had alleged that Crosseas conducted self trades in the BGIL-scrip on the listing day and contravened the provisions of the SEBI Act, 1992, PFUTP Regulations and the provisions and Code of Conduct under the Stock Brokers and Sub-Brokers Regulations, 1992. The Adjudicating Officer on 30 April, 2014, found that Crosseas undertook jobbing activities/proprietary trading and the self trades were a mere technological by-product of high-speed trading. Despite the AO having disposed of the case without any penalty, the matter was called for re-examination in terms of Section 15-I(3) of the SEBI Act. This is one of the first cases where SEBI exercised its powers under the newly inserted Section 15-I(3) as it considered the AO's observations to be erroneous, and imposed penalty.

The WTM stated that self trades are fictitious and reprehensible, and a stock broker could adopt any business model so long as it complied with the regulatory framework. The WTM observed that all prohibitions governing order placement through manual means would equally apply to algo trading also. The algo trading software utilised by Crosseas should have been written in a manner such that it ensured compliance with the law, including the avoidance of self trades. The WTM found that Crosseas had not exercised due care and diligence in the conduct of its business and its inability to prevent self trades while using its algo trading system, meant that it had contravened the provisions of the PFUTP Regulations. The WTM directed Crosseas to take appropriate measures to avoid trades that are prohibited under SEBI guidelines/regulations and imposed a penalty Rs. 5,00,000.

The WTM order did not recognize the inherent difference between self trades happening manually and self trades happening under the algo trading software, wherein the orders are generated using pre-programmed computer software systems. The order found Crosseas in violation of the provisions of the PFUTP Regulations without proving its intention to manipulate, which should trigger alarm bells for algo traders. Most algo trading transactions will result numerous self trades due to the inherent nature of high-speed multiple trading software. Therefore it would be more prudent for SEBI to build a separate regulatory mechanism for algo trading to protect the industry from future censures.

PFIs to disclose invocation of pledge

SICOM, a public financial institution, during the course of its regular business provided financial assistance to Raj Oil Mills whose promoters pledged their shares in the company as collateral. When Raj Oil Mills failed to repay, SICOM invoked the pledge and became the beneficial owner of the shares. The acquisition of shares through invocation of pledge triggered disclosure requirements under Regulations 29(1) and 29(2) of the Takeover Regulations, 2011 and Regulations 13(1) and 13(3) read with 13(5) of the SEBI (PIT) Regulations, 1992. However, SICOM did not make the disclosures. In its response to SEBI's show cause notice, SICOM submitted that Regulation 29(4) exempted a PFI holding shares under pledge in its ordinary course of business from making disclosures under Regulation 29(1) and 29(2). The issue pertained to the scope and application of the exemption under Regulation 29(4) of the Takeover Regulations: whether PFIs are exempted from making disclosures, in case of acquisition pursuant to invocation of pledge, i.e., actual acquisition of shares, or whether the exemption is limited to cases of creation and release of pledge, i.e., deemed acquisition of shares.

SAT by its order dated 28 October, 2014, observed that Regulation 29(4) creates a deeming fiction, wherein the acquisition of shares by way of encumbrance is treated as deemed acquisition and the giving back of shares upon release of encumbrance is deemed disposal. Therefore, the exemption provided to PFIs from making disclosures is only limited to cases of deemed acquisition of shares by way of creation, or deemed disposal through release of shares, in course of their business, for securing indebtedness. SAT held that the ambit of exemption under Regulation 29(4) only covers deemed acquisitions and cannot be extended to the actual acquisition of shares. SAT concluded that, since, SICOM actually acquired the shares by way of invocation of pledge, it had to make disclosures under Regulations 29(1) and 29(2) of the Takeover Regulations and Regulations 13(1) and 13(3) read with 13(5) of the PIT Regulations.

FPIs and Offshore Derivative Instruments

Until now only certain categories of FPIs under the SEBI (FPI) Regulations, 2014, were permitted to subscribe to, or otherwise deal in, offshore derivative instruments if, the counter party in such transactions was regulated by an appropriate foreign regulatory authority. However, the meaning of the phrase '*regulated by an appropriate foreign regulatory authority*' was ambiguous. Although 'appropriately regulated' under the FPI Regulations generally meant that, such a body is '*regulated or supervised by the securities market regulator or the banking regulator of the concerned foreign jurisdiction*', there were no specific criteria for determining the eligibility of an ODI subscriber (not being an FPI) as a counter party in an ODI transaction involving an FPI.

SEBI, by its Circular dated 24 November, 2014, has prescribed conditions for the issuance of ODIs by FPIs, including the criteria for determining the eligibility of ODI subscribers. ODIs are used by foreign investors, as a means to retain economic interest over an asset without changing the legal ownership of the underlying asset, such as, Indian listed equity shares. To prevent the layering of investments through the ODI route, the Circular imposes the eligibility criteria for FPIs under Regulation 4 of the FPI Regulations on prospective subscribers of ODIs issued by FPIs. As per the Circular, in addition to the requirements under Regulation 22, ODIs can only be subscribed by entities which meet the eligibility criteria under Regulation 4 of the FPI Regulations. Regulation 4 prescribes certain requirements such as the entity is resident of a country whose securities market regulator is a signatory to the IOSCO's Multilateral MoU or a signatory to bilateral MoU with SEBI; the entity is legally permitted to invest in securities outside the country of its incorporation or establishment or place of business.

Moreover, the ODI subscriber should not have an 'opaque structure', such as a protected/ segregated cell company, as understood under Explanation 1 of Regulation 32(1)(f) of the FPI Regulations. The investment restriction of 10% applicable to FPIs under Regulation 21(7) of the FPI Regulations would also be applicable to ODI subscribers. Thus, ODI subscribers with the same beneficial owner, can take a maximum exposure of 10% of the total issued capital of a company. If FPIs hold investments through the FPI route along with ODI positions, their ODI positions would be clubbed with the FPI investments for determining investment limits under the FPI Regulations. The requirements under the Circular would be applicable prospectively and all existing ODI positions would be legally valid until their expiry. The Circular seeks to align the eligibility and investment norms between the FPI regime and the ODI structure.

New Depository Receipts Scheme

A committee headed by M. S. Sahoo submitted its report on restructuring of the provisions on the issuance of depository receipts in November, 2013. The Ministry of Finance, in light of the recommendations of the Sahoo Committee, has repealed the archaic scheme of 1993 to the extent that it was applicable to DRs. The new scheme governing the issuance of DRs will be effective from 15 December, 2014, and regulators such as SEBI and RBI need to implement the same.

A DR is an instrument issued by a foreign depository, through public offering or private placement, with Indian permissible securities being the underlying securities. DRs may be issued in any of the 34 permissible jurisdictions listed under the scheme and may be listed on an international stock exchange. The new scheme widens the ambit of permissible securities and extends it beyond securities as defined under the SCRA, 1956 to include other similar instruments issued by private companies. Further, the scheme permits the issuance of unsponsored DRs wherein the issuance can be undertaken without the specific approval of the issuer of the underlying securities. Such DRs must grant the holder the right to issue voting instructions and must be listed on an international exchange.

To streamline the process, all approvals necessary for issuance or transfer of securities to a foreign entity will be applicable only at the stage when the underlying securities are being issued or transferred to the foreign depository, without further approvals at the time of issuance of DRs. The Ministry of Finance has incorporated safeguards for preventing abuse, such as, the prohibition on issuers from undertaking the issue at a price lower than the price applicable to the corresponding mode of issuance under Indian laws. Additionally, DRs may be categorized as public shareholding for the purposes of the SCRA only if the DRs are listed on an international stock exchange and the holder has the right to issue voting instructions.

The old scheme was not in line with the recent significant legal and regulatory changes. The overhaul is a welcome measure as it enhances procedural clarity, improves the viability of issuing DRs for attracting investment and for providing private companies with a new avenue for raising capital.

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