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Misuse of Stock Exchanges to Avoid Taxes

Since December, 2014, SEBI has passed four orders restricting over 300 entities from accessing the capital markets. SEBI has found these entities to have misused the stock exchange system to generate fictitious long term capital gains in order to convert their unaccounted income into accounted income and avail of a tax exemption. Under the existing tax laws, if the equity shares of a listed company are held for more than twelve months, the long term gain arising from the sale of such equity shares is exempt from income tax. To avail of this exemption and evade tax, the entities employed a scheme, plan, device and/or artifice which resulted in the creation of artificial volume and manipulation of the price of the scrip.

The companies involved in the said scheme allegedly allotted equity shares to certain known entities on preferential basis with a lock in period of one year in accordance with the ICDR Regulations. SEBI examined the financial history of the said companies and noted that the companies garnered large investments through preferential allotment, despite their unimpressive track record. SEBI held that such investments would not have been made unless there was prior arrangement between the management of the company and the allottees.

SEBI observed that two groups of entities were involved in the execution of the scheme. One group increased the price of the scrip during the lock in period and the other acted as buyers after the expiry of the lock in period to provide exit to the allottees. It was also observed that the funds bought in by way of preferential allotment were utilized for purposes other than those disclosed and, in some cases, were forwarded to various connected entities through informal arrangements. Funds were also provided to entities who acted as buyers for purchasing the shares from the allottees through layering of fund transfers. This resulted in the creation of artificial volume and considerable increase in the price of the scrip. For instance, the price of one of the scrips involved jumped from Rs. 5/- to Rs. 263/- within 115 trading days.

After the examination of the schemes, SEBI observed that there was no change in the beneficial ownership of the traded shares as the buyers and sellers were both part of a common group. The schemes were employed to avoid taxes and to legitimize the sources of income. The allottees allegedly made large gains (for instance, in one case, the allottees made a collective profit of over Rs. 3 billion on their investment of Rs. 130 million). SEBI held that the schemes were fraudulent in nature and thereby in violation of PFUTP Regulations and had the potential to harm gullible and genuine investors.

Relaxed norms for private placement of NCDs by NBFCs

RBI had issued circulars dated 27 June, 2013, and July 02, 2013, to regulate NBFCs which had been raising considerable resources from the retail public through private placement of debentures. RBI has issued a circular dated February 20, 2015, revising the norms on private placement of NCDs (having maturity more than 1 year) by NBFCs, to align them with the provisions of the Companies Act, 2013, to the extent possible, and wherever required, to override the same.

The minimum subscription per investor has been decreased from Rs. 2.5 million and multiples of Rs. 1 million thereafter to Rs. 20,000. This would attract smaller investors who have an investible surplus of Rs. 20,000. The issuance shall be in two separate categories: those with a maximum subscription of less than Rs. 10 million, and those with a minimum subscription of Rs. 10 million and above per investor. In the first route, there shall be a maximum of 200 subscribers in a financial year and the subscription shall be fully secured. However, there will be no limit on the number of subscribers under the second category and issuers will have the option to create security in favour of the subscribers.

Further, it has been clarified that unsecured debentures shall not tantamount to public deposits under the NBFCs Acceptance of Public Deposits (Reserve Bank) Directions, 1998. Under the existing regime, unsecured bonds are treated as public deposits and hence, debentures issued by NBFCs had to necessarily be secured and issued as per section 71 of the Companies Act, 2013 and rules made thereunder. This caused significant hardships for NBFCs as the security has to be “tangible” and by way of “specific” assets.

The restriction on NBFCs (excluding core investment companies) to issue debentures only for deployment of funds on its own balance sheet and not to facilitate resource requests of group entities/ parent company/ associates, has been retained from the earlier guidelines. Similarly, the requirement for NBFCs to put in place a Board approved policy for resource planning that should cover the planning horizon and periodicity of private placement, continues to be in place under the revised guidelines. The revised guidelines are not applicable to tax exempt bonds offered by NBFCs. The revised guidelines will facilitate in the development of the corporate bond market and help meet the long-term financing needs of companies.

Rs. 860 million Penalty against DLF and others

An adjudicating officer of SEBI recently passed two orders in the matter of DLF Limited and Sudipti Estates Limited pursuant to an investigation that was initiated in response to a FIR against Sudipti. The AO found that during the Rs. 90 billion IPO undertaken by DLF in 2007, DLF had actively and knowingly suppressed information in the offer document. Particularly, the AO noted that DLF had camouflaged its association with Sudipti (found to be a subsidiary of DLF) and had subsequently failed to make necessary disclosures pertaining to the subsidiary in the offer documents.

In a DRHP filed by DLF initially, Sudipti had been disclosed as a subsidiary. However, this document was withdrawn and subsequent filings contained no such disclosure. On investigation, SEBI found that DLF had transferred Sudipti to the spouses of three of its KMPs through a set of complex transfers. The primary issue decided by the AO was in relation to whether Sudipti continued to be a subsidiary even after DLF had sold its shareholding. Based on the following findings, SEBI concluded that the transfers were nothing but a sham transaction and that Sudipti continues to be a subsidiary as DLF never lost control over it:

(1) The new shareholders of Sudipti were the spouses of KMPs. The employee employer relationship between DLF and the KMPs ensured that DLF still exerted influence over Sudipti.

(2) The new shareholders were inexperienced traders who had never traded in securities previously or had minimal experience in the same. They had no income of their own and funding for the investments came from their husbands, i.e., the KMPs of DLF.

(3) Not only were the complex set of transfers undertaken in 2 days, but the funds for the payments were sourced from the sellers. Further, in one case, there was no evidence of any consideration at all.

(4) The new shareholders of Sudipti never exercised their powers to change the composition of the board, the signatories to the bank accounts, the statutory auditors or the registered office.

(5) The members of the board and the signatories to the bank accounts were the original appointees of DLF and were all either KMPs of DLF, directors in subsidiaries of DLF or employees of DLF. The employee employer relationship between DLF and these directors ensured that DLF still exerted influence over Sudipti.

(6) Subsequent to the initial transfer, the shareholding in Sudipti was further distributed among the spouses of 10KMPs. SEBI noted that the spouses retained shareholding only as long as their husbands were KMPs of DLF. In two cases, when the KMPs left their position in DLF, the spouses sold their shareholding to another spouse of a KMP or to a subsidiary of DLF.

The AO observed that these sham transactions were undertaken wilfully and deliberately by all parties involved to suppress material information pertaining to RPTs entered into between DLF and Sudipti, financial information pertaining to Sudipti and an FIR lodged against Sudipti, resulting in misstatements in the offer documents.

SEBI found DLF and its Directors to be in violation of the DIP Guidelines, the SEBI Act and the PFUTP Regulations and imposed penalties of Rs. 260 million each on the Company and against its directors. Additionally, the other companies, their directors, the KMPs and their respective spouses were found to have aided and abetted DLF in the whole sham transaction and violated the PFUTP Regulations and the SEBI Act. Penalties of Rs. 10 million were imposed on each of the companies involved and Rs. 30 million on their directors. Each of the KMPs, their spouses and other related individuals were penalised in the Rs. 0.5 to 1.5 million range.

New Norms for FPI Investments in Corporate Bonds and G-Secs

In the Sixth Bi-monthly Monetary Policy Statement, 2014-15, released on February 3, 2015, by the RBI in consultation with the Government, the RBI communicated its decision to incentivise long term foreign investors. Pursuant to this, SEBI has issued two circulars dated February 3 and February 5, 2015, making suitable changes to the norms governing investments by FPIs in corporate bonds and G-Secs.

Currently, FPIs are permitted to invest in G-Secs with a minimum residual maturity of three years. However, there is no such condition for investments in corporate bonds by FPIs. The February 3, 2015, circular harmonises the residual maturity requirement between corporate bonds and G-Secs. The circular requires that all future investments by FPIs, within the overall corporate debt limit (USD 51 billion), including the limits vacated when the current investment by an FPI runs off either through sale or redemption, shall be required to be made only in corporate bonds with a minimum residual maturity of three years. However, there is no lock-in restriction for such investments and FPIs would be free to sell such securities (including those that are presently held with less than three years residual maturity) to domestic investors. Furthermore, FPIs will not be allowed to invest in liquid and money market mutual fund schemes which have a short maturity period.

As regards G-Secs, FPI investments are currently capped at USD 30 billion, of which USD 5 billion is reserved for long term investors. Keeping in mind that the said limit is now fully utilised, it was decided to permit the reinvestment of coupons received from existing G-Secs into further G-Secs, even when the existing limits are fully utilised. FPIs will have an investment period of five working days from the date of receipt of the coupon and coupons invested in purchasing G-Secs would be classified into a separate investment category, which would be over and above the existing government debt limit of USD 30 billion. This reinvestment facility would also be available on any further coupons that may be generated by such reinvestment of coupons.

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