FINSEC
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SECURITIES AND INVESTMENT REGULATIONS

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Foreign Direct Investment Policy 2015

The Consolidated Foreign Direct Investment Policy Circular of 2015 became effective from May 12, 2015. Some of the key features and changes therein are highlighted here.

The Government has relaxed norms in several sectors, including railways, defence, pharmaceutical and insurance. In ***defence***, permissible investment under the automatic route has been increased from 26% to 49%. FDI beyond 49% with proposed inflow of more than Rs. 2000 crores (formerly Rs. 1200 crores), which are to be approved by Cabinet Committee on Security, will not require further approval of the Cabinet Committee on Economic Affairs. Further, portfolio investment by FPIs/FIIs/NRIs/QFIs and by FVCIs together cannot be over 24% of the total equity of the investee/joint venture company. Furthermore, the Chief Security Officer of the investee/joint venture company should be a resident Indian citizen. The three-year lock-in requirement for transfer of equity from a non-resident to another non-resident has been removed. In ***railways***, 100% FDI is allowed under the automatic route for construction, operation and maintenance of, inter alia, suburban corridor projects through PPP, high speed train projects and freight terminals. The CCS will consider on a case-to-case basis, proposals involving FDI beyond 49% insensitive areas from security point of view. In ***insurance***, the sectoral cap has been raised from 26% to 49% and upto 26% is under the automatic route. Other Insurance Intermediaries appointed under the Insurance Regulatory and Development Authority Act, 1999 can also bring FDI. In ***pharmaceutical***, FDI up to 100%, under the automatic route is permitted for manufacturing of medical devices. Further, the definition of "Holding Company" and "Indian Company" has been aligned with the Companies Act, 2013.

The FDI Policy 2015, recognizes fully, compulsorily and mandatorily convertible debentures and preference shares as eligible instruments. Further, it has been now clarified that shares and convertible debentures can be transferred from one non-resident to another without prior approval of the Government in sectors which are under the automatic route, however Government's approval will be required for the same in sectors which are under Government approval route. The Policy clarified that if a non-resident (including an NRI) acquires shares on the stock exchanges under the FDI scheme, the obligation to file FC-TRS with the AD Category-I bank would be on the investee company. Further, an investment now can be made on all types of Depository Receipts as permissible under the Depositories Receipts Scheme, 2014.

In relation to pricing of instruments to be issued or transferred to non-residents, it has been clarified that the pricing be based on a fair valuation methodology done by a SEBI registered Merchant Banker or a Chartered Accountant *as per any internationally accepted pricing methodology on arm's length basis*, where the shares of the company are not listed on any recognised stock exchange in India. Further, no FIPB approval would be required for mergers and acquisitions happening in sectors under the automatic route. In addition, no fresh approval will be required for any additional foreign investment into the same entity within an approved foreign equity percentage/or into a wholly owned subsidiary. In a move to provide Person of Indian Origin and Overseas Citizenship of India parity with NRIs, the Cabinet has reportedly decided that NRIs would now include OCI and PIO cardholders.

The FDI Policy, 2015 essentially consolidates the changes made to the policy in the previous year and clarifies the extant policy in many aspects. At the same time, the Government has relaxed norms in several sectors and taken measures to attract greater funds, such as liberalizing FDI norms for NRIs and OCIs. Given the importance of FDI for economic development, further certainty is required in a few respects such as FDI in e-commerce.

Factorial Master Fund's Aggressive Short Position

In October 2014, SEBI passed an order restraining Factorial Master Fund from accessing the securities market and prohibited the Fund from buying, selling or dealing in securities on the grounds of alleged insider trading in the scrip of L&T Financial Holding Limited (LTFH).

In the said order, SEBI had alleged that the Fund created an unusual and aggressive short position on the derivative contracts of LTFH on March 13, 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 SEBI Order was based on correspondence between two employees of Credit Suisse, wherein they discussed the likelihood of L&T offering a steep discount in relation LTFH's shares. Since the Fund was involved as a potential investor in the market gauging exercise undertaken by Credit Suisse for the proposed offer for sale of LTFH shares, it had access to the communication between the two employees. The SEBI order was based on the assumption that L&T had fixed the floor price for the proposed offer for sale on March 13, 2014 even before the close of trading hours and the Fund had the UPSI on the steep discount to be offered therein. SEBI observed that it is highly unlikely and contrary to the market behaviour that the 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 Fund had filed an appeal against the said order before SAT. SAT in

its ruling dated May 8, 2015 held that the floor price for offer for sale cannot be fixed in advance and has to be fixed with reference to the price prevailing at the end of trading hours on the previous day. According to SAT, therefore the presumption drawn by SEBI that L&T had fixed the floor price beforehand is unlikely. SAT observed that the SEBI's claim that the Fund was in possession of UPSI was primarily based on the correspondence between the two employees of Credit Suisse. However, SAT observed that from perusal of the transcript of the correspondence, it can neither be inferred that Credit Suisse had recommended nor L&T had finalized the floor price of the LTFH shares. Further, SAT held that there was nothing on record to suggest, as to how the Fund had access to the information, therefore the presumption of SEBI that the Fund was privy to UPSI was hypothetical and there was no rational basis for the same. However, since SEBI claimed that the investigation in relation to the alleged misconduct by the Fund is still to be complete and is at a crucial stage, SAT allowed the restraint to continue. However SAT directed SEBI to conclude the investigation within two months, failing which the restraint order would come to an end.

Co-location or Proximity Hosting by Stock Exchanges

Time is a crucial factor for those trading in the securities markets. Every millisecond counts in the world of financial transactions. In order to minimise or eliminate delay in the execution of trade orders, stock exchanges offer co-location or proximity hosting services. Through this, a broker or a data-vendor is permitted to be located within or at close proximity with the stock exchange and can connect to the trading platform through a direct and private network.

In light of the recent rise in such practices, SEBI, based on the recommendations of the Technical Advisory Committee, issued guidelines on May 13, 2015. The guidelines focus on two major aspects. The first concern is ensuring fair and equitable access to the co-location/proximity hosting facility. The guidelines stipulate that the provision of the co-location/proximity hosting must be in a fair, transparent and equitable manner, and stock exchanges must ensure that the space available for these facilities is sufficient to accommodate all stock brokers who are desirous of availing the facility. Stock exchanges are required to specify the eligibility requirements on their websites, and on receipt of applications, must expeditiously decide on the request.

The second concern is ensuring that the facility of co-location/proximity hosting does not compromise the integrity and security of the data and trading systems. The guidelines mandate that stock exchanges must implement safeguards and other suitable mechanisms to protect their systems from unauthorized access, create guidelines on access and conduct of personnel of stock brokers in the co-located space and ensure that these personnel have no access to the stock exchange's trading platform and databases. Stock exchanges are required to take necessary steps to implement the guidelines, including making amendments to existing bye-laws and rules, within a period of three months.

While this circular gives legitimacy to the provision of co-location/proximity hosting facilities by stock exchanges, it stops short of providing clarity on the eligibility criteria. Hence, there is a risk that stock exchanges may set a high threshold and effectively limit the benefit of low delay trading to a small section of securities market participants. It remains unclear whether this will act as an unfair advantage for only those who can afford the facility.

Government NBFCs are now Eligible Participants for Repo Transactions in Corporate Debt Securities

With the objective of developing the corporate debt market, RBI replaced the existing norms governing forward contracts in corporate debt securities with the new Repo in Corporate Debt Securities (Amendment) Directions, 2015 on February 03, 2015. Under a *repo transaction* or a *ready forward transaction*, a holder of securities sells them to an investor with an agreement to repurchase them at a predetermined date and rate. A repo is a means of funding by selling a security held on a spot/ready basis and repurchasing the same on a forward basis. Under the new directions, RBI has introduced several changes, including mandatory settlement through the clearing houses of NSE, BSE and MCX-SX; which was hitherto OTC. In addition, it has expanded the list of eligible underlying collateral in repo transactions and replaced the minimum haircut standard with a rating-linked haircut for determining the percentage value to be deducted from an asset while being used as collateral.

Recently, on May 14, 2015, RBI has expanded the list of eligible participants who are eligible to undertake repo transactions in corporate debt securities. Previously, government companies, as defined in Section 2 (45) of the Companies Act, 2013, registered as NBFCs were not permitted to undertake repo transactions in corporate debt securities. The notification has now permitted such NBFCs to undertake repo transactions, subject to compliance with prudential norms for NBFCs prescribed by the Department of Non-Banking Regulation.

Since the 1990s, the Government and RBI have been excessively cautious about freeing of repos because of numerous instances of misuse of repos. Since then, every step has been taken as an exception to the general overarching ban on forward contracts. Although the current developments are welcome, there is further scope for expanding the list of eligible participants as well as eligible underlying securities, in order to provide the necessary depth and liquidity to repos in the corporate debt market.

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