FINSEC Law Advisors

SECURITIES AND INVESTMENT REGULATIONS

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SEBI has Powers to Regulate GDRs

SEBI, through its order dated June 20, 2013, had barred *Pan Asia Advisors* and one *Mr. Arun Panchariya* from rendering services in connection with securities, dealing in securities and accessing the capital market for 10 years, for having manipulated the securities market by issuing global depository receipts. This order was challenged before the Securities Appellate Tribunal, wherein SEBI's jurisdiction on GDRs was examined. SAT ruled that SEBI does not have jurisdiction to issue orders in transactions in GDRs as they fall within the exclusive jurisdiction of the Ministry of Finance. SEBI's jurisdiction is limited to regulating *"securities"* as defined under Section 2(h) of the Securities Contracts (Regulation) Act, 1956. Although, SAT did not decide on whether GDRs would be *"securities"* under the SCRA, consequent to SAT's judgment, GDRs got carved out from the purview of the SCRA; and hence out of SEBI's regulatory domain. Significantly, the dissenting view in the order held that SEBI *has* powers to regulate and adjudicate on transactions in GDRs.

The majority ruling of SAT was the leading law regarding SEBI's jurisdiction on depository receipts until December 2013; when the Supreme Court stayed the SAT order, pending the final decision in an appeal by SEBI against the SAT decision. The Supreme Court, on July 06, 2015 ruled in favour of SEBI. The Supreme Court held that SEBI had jurisdiction while passing the order dated June 20, 2013, and that a GDR is a form of *"security"* as defined under Section 2(h) of the SCRA. Further, relying on constitutional principles of extra-territorial jurisdiction and SEBI's powers under the SEBI Act, 1992, the apex court held that, the allegations leveled against *Pan Asia* may have far reaching consequences for the Indian securities market and Indian investors, and consequently, SEBI's duty of investor protection would automatically come into play.

This settles a long standing confusion regarding SEBI's jurisdiction over ADRs and GDRs. SAT's decision was criticized since the definition of *"securities"* under the SCRA clearly includes *"rights and interest in securities"* within its ambit. This should have perceptively led to classifying depository receipts, which are instruments representing rights and interests in Indian equity shares, as *"securities"*. The Supreme Court's verdict has now provided the much needed clarity on the matter.

Issue and Listing of Debt Securities by Municipalities

A municipality is a self-government institution constituted under Article 243Q of the Constitution of India and includes a municipal corporation, a municipal council and a nagar panchayat. To facilitate funding mechanisms for municipalities, SEBI notified the SEBI (Issue and Listing of Debt Securities by Municipalities) Regulations, 2015, on July 15, 2015. The regulations permit municipalities to issue: (i) revenue bonds, which are serviced by revenues from one or more projects, and (ii) general obligation bonds, which are not backed by revenues from any particular project, but are serviced through tax proceeds of the municipality. However, municipalities which have had a negative net-worth or have previously defaulted in their repayment obligations are not eligible to raise funds under these regulations.

Only revenue bonds may be issued to the public. These bonds have to be compulsorily listed on a stock exchange. Further, municipalities have to obtain a minimum credit rating of A+ from a recognized credit rating agency. However, both revenue bonds and general obligation bonds may be issued on a private placement basis. These may be listed provided certain conditions are met, such as, minimum subscription amount per investor must not be less than Rs. 25,000.

The regulations provide a clear mechanism for issuing municipal bonds and will help develop India's municipal bond market. However, unlike government securities, these are not risk free and may not be suited for retail or unsophisticated participants. Another point of concern pertains to the applicability of the SCRA, 1956 which governs all dealing in securities and empowers SEBI and stock exchanges in this regard. Section 28(1)(a) states that the SCRA shall not apply to the government or any local authorities, and hence, to municipal bonds. This provision may be amended to better enable SEBI to govern issuance of debt securities by municipalities.

Prohibition on Capital Raising by Suspended Companies

SEBI issued the SEBI (Prohibition on Raising Further Capital From Public and Transfer of Securities of Suspended Companies) Order, 2015, on July 20, 2015, to be made effective immediately. The General Order defines *"suspended company"* to mean a listed company in whose shares trading is suspended by the recognized stock exchange due to non-compliance with listing requirements. Firstly, the General Order prohibits a suspended company, its holding and/or subsidiary, its promoters and directors from issuing prospectus, offer document or advertisement soliciting money from the public for issuing securities. This is not a blanket ban, but a restriction which would remain till the concerned exchange revokes the suspension, or securities of the company are delisted, whichever is earlier. Further, SEBI may grant relaxations from strict enforcement of this restriction if the stock exchange so recommends, for companies other than the suspended company, its holding and/or subsidiary, wherein such promoters are also promoters/directors. Secondly, pursuant to the General Order, the suspended company and the depositories cannot effect transfer, through sale, pledge and so on, of shares of a suspended company held by promoters/promoter group and directors, till three months after revocation of suspension by the concerned exchange or till securities of such company are delisted, whichever is earlier. The stock exchange may remove this restriction if such promoter/director files objection and provides satisfactory reasons.

Mere suspension of listed companies harmed minority shareholders more than promoters since it closed the exit route. Accordingly, SEBI had, on September 30, 2013 prescribed a Standard Operating Procedure whereby stock exchanges were directed to take action against promoters of non-compliant companies (such as imposition of fines, freezing of shares of promoter group) before suspending their share trading. The General Order is a step further towards enhancing the compliance environment, and creating necessary deterrence for companies that fail to comply with the listing agreement and treat money raised through public offers as free money. Further, it would disable promoters/directors, who are responsible for such defaults from using undisclosed information about the company and disposing of their shareholding. While the General Order may affect capital raising initiatives of suspended companies, it does not close the possibility of revival of such companies. The General Order would help check market manipulation pertaining to such suspended stocks and thereby prevent losses to the public shareholders of these suspended companies.

Composite Caps for Foreign Investment

The Government of India, through a press release dated July 16, 2015, has introduced composite caps for simplification of FDI policy. These changes were alluded to by the finance minister during the presentation of the union budget in February 2015. Consequent to the change, foreign investors can invest in Indian companies till the applicable sectoral cap, irrespective of whether the investments are made by an FDI entity or by an FPI or an NRI, QFI, LLPs or through depository receipts, *unless provided otherwise.* However, the last three words of the previous sentence have created tremendous confusion, with experts claiming that the press release does not introduce any change at all. For instance, the composite sectoral cap for foreign investment in the defence sector has been limited to 49% within which, there is a maximum sub-limit of 24% for portfolio investments by FPI/FIIs/NRIs/QFIs/FVCIs under the automatic route. Such sub-limits have also been prescribed for the banking sector, commodity exchanges, infrastructure companies in securities markets, etc. and if one were to take a conservative view of the press release, existing position is maintained in the aforementioned sectors. However, in sectors having no sub-limits, portfolio investment upto 49% is allowed, without any requirement of seeking government approval or compliance with sectoral conditions, if such investment does not result in transfer of ownership and/or control to non-resident entities. This would benefit sectors like pharmaceuticals and multi-brand retail where FDI investors need to comply with stringent conditions.

The press release also clarifies that FCCBs and DRs having underlying instruments, being in the nature of debt, issued under Schedule 5 of FEMA 20, shall not be treated as foreign investment. Earlier, FCCB holdings were also considered for calculating total foreign investment in the company. However, FCCBs will now be counted towards calculating foreign investment only at the time of their conversion into equity, not at the time of issuance of FCCBs. This will give companies more headroom for attracting foreign investment.

Policy on Annulment of Trades

Under the existing framework on annulment of trades executed on stock exchanges, dealings on an exchange are treated as inviolable and the exchange may annul trades only on grounds of fraud, willful misrepresentation or material mistake in the trade. SAT has held that negligence and execution of erroneous trades do not qualify for annulment.

SEBI, with an objective to provide transparency and uniformity in the trade annulment process, issued a circular on July 16, 2015 prescribing a policy for annulment of trades, resulting from material mistake or erroneous orders. As per the Circular, exchanges can consider annulment of trades on their own or on a stock broker's request. Exchanges have to define suitable criteria to discourage frivolous requests and implement a framework to penalize brokers who place erroneous orders. A broker has to submit the request to the exchange within 30 minutes of the execution of the particular trade. The exchange is required to inform the details of the said request to all its brokers in a time bound manner. The exchange has to consider the potential effect of such annulment on the trades of other stock brokers/investors across all segments and decide upon the request before the start of next trading day. The policy provides an alternate mechanism whereby exchanges can reset the price of the trade, if price reset is less disruptive than annulment of the trade. The exchange needs to convey its reasoned decision to all counter parties. The policy also allows an aggrieved party to submit a request to the stock exchange for review of the decision taken by the exchange. Further, the Circular allows exchanges to annul trades resulting from willful misrepresentation, manipulation or fraud, as provided in their extant bye-laws.

Stock exchanges need to implement the changes within a month from the date of the Circular. The modified policy will provide more clarity on the issue of annulment of 'fat finger trades', i.e., trades containing a mistyped order. The famous erroneous trade entered by Emkay in 2012 (and several other prior instances) highlighted the need for a specific policy which would be fair to the one committing the error, to the counterparty to such a trade and to the market which is impacted by the price movement. While basic principles of contract law do not recognize a contract without meeting of minds, the anonymous and large secondary markets require a more nuanced approach to the problem - which will now be available. Globally most regulators or exchanges provide for such a framework.

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