SECURITIES AND FINANCIAL REGULATIONS ROUNDTABLE
MAY 07, 2015

APPROACH PAPER

INTRODUCTION

Finsec Law Advisors and the *Securities Markets Association of India*, supported by the US India Business Council, successfully conducted the Securities and Financial Regulations Roundtable on May 07, 2015. The Roundtable sought to provide a platform to examine some of the critical issues in securities law, which affect industry, intermediaries and investors in India. The round table is a part of our continuing efforts to engage with financial market experts and key decision makers within regulators, academia and industry to produce both debate and recommended outcomes.

In furtherance of the discussions made during the first Securities Market and Investment Regulations Roundtable, this approach paper captures key recommendations put forth by various attendees.

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THE NEW INSIDER TRADING REGULATIONS, 2015

Justice N.K Sodhi Committee was set-up to revisit and restructure the existing legal regime on insider trading in India. Based on the recommendation of the Committee, SEBI overhauled the existing insider trading norms and notified the ***SEBI (Prohibition of Insider Trading) Regulation, 2015***. The regulations are scheduled to come into force on **May 15, 2015**. The change was long overdue in order to protect legitimate commercial transactions which could potentially be seen as illegal if a pedantic view of the law was taken, however several changes in the new regulations appear to be half baked.

KEY CHANGES

The following table highlights some of the significant changes in the insider trading regulations: -

PIT Regulations, 1992	PIT Regulations, 2015
Definition of "Connected Person" broadened	
The determination of "connected persons" was mainly relationship based. There was no provision which considered persons who frequently communicate with the company officials as "connected persons".	Persons who frequently communicate with the company officials having access to Unpublished Price Sensitive Information will be included in the definition of "connected persons".
Communication of UPSI	
Communication without trading in securities was not punishable.	Mere communication of UPSI is an offence, even in the absence of any trading in securities. The regulations prohibit communication, providing or allowing access to any UPSI in relation to a company and/or securities listed or proposed to be listed.
Unpublished Price Sensitive Information	
The regulations defined price sensitive information as any information which relates directly or indirectly to a company and which if "published" is likely to materially affect the price of the securities.	Under the new regulations, there is a shift from "published" to the threshold of "generally available information". When an information is accessible to the public on non-discriminatory basis, it is generally available information. However, any information which is not generally available

	becomes UPSI.
Dealing v. Trading	
Regulations governed all dealing in securities, including subscribing, buying selling or agreeing to subscribe, buy, sell or deal in securities.	The regulations replace the word 'dealing" with "trading" with an intention to widen the term. The definition of trading includes subscribing, buying, selling of securities or dealing in securities.
Defences	
The regulations provided defences for dealing in securities of one company by another company which in possession of UPSI in certain circumstances.	The new regulations provide certain defences which may be adopted by any insider who has either communicated UPSI or has traded while in possession of UPSI.
Trading Plan	
No concept of trading plan was provided.	Insiders can use pre-disclosed trading plans to carry out trades.
Due Diligence	
Permissibility of conducting due diligence prior to an investment was unclear.	Due diligence is permissible if the board of the company believes that is in the best interest of the company. In cases where open offer is not triggered by the proposed transaction, an additional obligation to disclose all UPSI at least 2 days prior to the proposed transaction.

ISSUES AND CHALLENGES

1. ***Who is an insider?***

The new regulations define "insider" as any person who is a connected person or any person in possession of or having access to UPSI. Both the new and the erstwhile regulations defined the term connected persons. Under the erstwhile regulations directors, officers, employees or persons who have professional or business relation with the company which may give them access to UPSI were considered as "connected persons". The new regulations define the term *"connected persons" as any person who is associated with the company, directly or indirectly, in any capacity including by reason of frequent communication with its officers or by being in any contractual, fiduciary or employment relationship or by being a director, officer or an employee of the company or holds any position including a professional or business relationship between himself and the company.*

Under the new regulations, the addition of persons associated with the company by reason of frequent communications with the officers of the company has expanded the scope of the term “connected persons”. Under the erstwhile regulations the scope of connected persons was mainly relationship based, whereas under the new regulations it is more access based. The new definition would consider any person who is completely unconnected with the company as a connected person if such person has frequent communications with the officers of the company. This may include communications with friends, vendors, suppliers etc. Also the burden is on the connected person to prove that he is not connected with the company and also does not have access to the UPSI. Therefore, the question is whether the regulator is right in expanding such scope of “connected persons”? Does this reversal of burden of proof makes it difficult for such persons to defend themselves? Also, would it be just to subject persons who inadvertently become “connected persons” to such standards of proof?

Moreover, the new regulations tend to carry forward some of the flaws of its predecessor. The new regulations still consider members of board of trustees of a mutual fund or a members of the board of directors of the asset management company of a mutual fund or employees of a mutual fund as “connected persons”. A mutual fund generally invests on the basis of its investment objectives. So, would it be reasonable to assume the said persons as “connected persons”?

Summary of discussion held at the Round Table

- Concerns regarding the widened scope of the expression “connected persons” and the shift from a relationship based threshold to an access based threshold were discussed. The change may greatly impact private equity players as it will make it difficult for them to take up board seats and/or invest in Indian listed companies.
- Another point discussed was in relation to the addition of “frequent communication” as a basis for determination of “connected person”. This is a concern as, merely by virtue of their communication with their friends, batch-mates etc., who were officers in listed companies, they will be considered as “connected persons”. Another example where this may be a concern is when the company asks one of its suppliers to increase the supply of raw materials, making the supplier a “connected person”.
- There is need for further clarification by SEBI on questions such as – what would be the scope of “frequent communication”? How can one ensure that there is no frequent communication? And whether there is any structure that they can be adopted to avoid frequent communication?
- Concerns regarding the impact of the new regulations have on the research analyst sector was discussed. Many opined that this provision will restrict the scope of research and limit it to merely collating publicly available information.

2. ***Is mere communication of UPSI punishable? Will negligence amount to communication?***

Insider trading must involve actual trading of securities when in possession of UPSI. Imposition of sanctions on mere communication in absence of any trade is improper and unjust. The new regulations state that *no insider shall communicate, provide, or allow access to any UPSI, relating to a company or securities listed or proposed to be listed, to any persons including other insiders*. Therefore under the new regulations, communication or providing or allowing access to UPSI is actionable i.e. communication without dealing will attract sanctions. This is not a great development because innocuous talk between people has been criminalised, rather than substantive action or harm.

There is uncertainty in relation to communicating or permitting access to UPSI inadvertently or because of negligence. For instance, if couple of pages containing UPSI blew away from office's window or if someone accidentally forgets papers containing UPSI in a taxi. Keeping in mind such circumstances, the questions which arise are what constitutes communication? Will negligence amount to communication? If yes, will it attract sanctions? Can a person use the defence of innocence? While not clear, it is hoped that this would be seen more as a violation of best practices of corporate governance rather than a substantive violation.

Summary of discussion held at the Round Table

- The consequences of making communication actionable under the new regulations on Indian listed companies which are subsidiaries of the offshore companies was discussed. For instance, for the purpose of consolidation, these subsidiaries are often required to share information with their offshore parents on a monthly basis. As communication of information will attract sanctions under the new regulations, the Indian listed subsidiaries may face challenges in this regard.
- Another concern is the scope of the expression "legitimate purpose". While the new regulations permit sharing of information for a legitimate purpose or for compliance with law, the expression "legitimate purpose" is vague. Attendees hoped that SEBI would clarify that the scope of legitimate purpose goes beyond 'legal purpose'.

3. ***When does the information become "generally available"?***

The new regulations state that any information which is not generally available and materially affect the price of the securities will be considered as UPSI. However, it is unclear whether unconfirmed information that is generally available would be seen as a UPSI. Therefore, the questions which arises are what is the scope of "generally available information"? Does it depends upon the person disclosing the information or the platform on which the information is disclosed? Will dissemination of information through print media or electronic media be considered as generally available or it is only restricted to dissemination of information through stock exchange? Where does one draw a line?

4. ***When can one avail defences under the regulations? Is intention relevant to prove innocence?***

The new regulations allow communication in furtherance of legitimate purpose, performance of duty or discharge of legal obligation. The list of defences provided in the regulations is merely an indication and not an exhaustive list. The underlying principle is the absence of intention to commit fraud. This aligns the definition more closely to the American definition of insider trading which is a derivative of the anti-fraud rule. There has been a shift from strict liability to providing an option to prove absence of intention to commit fraud. The question which arises is whether this is a jumbo defence which is available with an "insider"? Does this defence dilutes the effectiveness of the new regulations?

5. ***What are the issues relating to exemption provided for due diligence? Would they have any impact on carrying out transactions?***

The new regulations state that *UPSI may be communicated, provided, allowed access to or procured, in connection with a transaction*. Therefore, it provides exemption to the communication of information pursuant to due diligence, provided that access to information must be authorized by the Board of the company based on its informed opinion. This means that the management of the company will have to go to the board twice i.e. firstly for pre-authorization of due diligence process and later at the time of conclusion of the transaction. This might be onerous on the management and may raise various issues relating to confidentiality of the transaction.

The new regulations state that the Board must conclude that transaction is in the best interest of the company. This may prompt superfluous interference of the Board in every transaction. Why should the Board take a view whether selling of shares by a promoter or a majority shareholder is or isn't in the best interest of the company?

In cases where open offer is not triggered, the regulations make it mandatory to disclose findings containing UPSI at least 2 days prior to the proposed transaction. However, SEBI will have to relook at the impact of advance disclosure requirement on proprietary and confidential information which may become available to competitors and would thus harm the company.

The new regulations do not extend this exemption to various institutionalised fund raising modes like follow on public offering, preferential allotment, rights issue and qualified institutional placement which requires substantial due diligence.

Further, there is uncertainty in relation to what will happen in situations where UPSI is communicated to prospective investors but the transactions is not undertaken or is put on hold for an indefinite period of time? Can the recipient of the information participate in the trading of the securities of the company? If no, till when will the restrictions be placed?

Summary of discussion held at the Round Table

- Concerns regarding various challenges that boards of companies will face in relation to the obligation placed on them to allow due diligence were discussed. For instance, in cases where the deal does not fructify, the board will be exposing itself by having to decide that the transaction is in the best interests of the company.
- The new regulations place a high burden on the board in deciding whether to allow the entry of a potential investor to examine information which is far more internal to the company than what is published outside. Given the way these regulations have been drafted, the board may be wary of allowing due diligence. They may insist that the potential investor reviews the company's publicly available information initially to make their decision to invest before granting further access. Even qualitative explanation, by the company, of the publicly available information would amount to sharing of information under the new regulations.
- The new regulations mandate the disclosure of the shared information two days prior to a transactions. Such disclosure may affect the transactional economics and the information shared with the potential investor will also be available to competitors, post the publication.

6. ***Do these regulations intend to provide wider meaning to the expression "trading"? What will be its impact on transactions?***

The new regulations state that *"trading" means and includes subscribing, buying, selling, dealing or agreeing to subscribe, buy, sell deal in any securities, and "trade" shall be construed accordingly*. The interpretative notes to the definition of "trading" state that the meaning of the term "trading" must be broadly construed because the intention is to curb the activities based on UPSI which are strictly not buying, selling or subscribing, such as pledging etc. when in possession of UPSI. This wide expansion to include pledging might significantly impact financing transactions. For instance, a financial institution before lending money to a company for a project will perform diligence. In course of that diligence they will have admittance to UPSI. Therefore, a loan against the pledge of promoters' shares might fall under the ambit of the regulations and would attract sanctions. So the questions are, what purpose will this broad definition of "trading" serve? What will be its impact on transactions? Has the broad construction made it difficult to undertake financing transactions?

7. ***Who can use trading plans? What are the issues related with its implementation?***

SEBI introduced the concept of "trading plans" under the new regulations in order to bring the insider trading regulations in line with other jurisdictions. Under the new regulations, the "insiders" will have an option to execute trades in accordance with a pre-determined "trading plan". Once commenced, the trading plan cannot be revoked and would have to be mandatorily implemented even if such execution result in losses to the "insider".

The objective of “trading plans” was to provide persons who are perpetually in possession of UPSI, an avenue to trade without attracting sanctions under the regulations. The new regulations express that if an individual has UPSI, he would be disentitled to execute the “trading plan”. Hence, the new regulations are asking “insiders” to implement “trading plans”, however they can't execute them if they have access to UPSI. So will it be possible for a person who is perpetually in possession of UPSI to implement “trading plans”?

Further, since the “trading plan” would be disclosed to the public in advance, it would be easy for the investors to front run the “insider” and artificially increase or decrease the price of the scrip before the expected date of trading. So the questions are, is it impractical for “insiders” to formulate “trading plans”? What is the way forward?

Summary of discussion held at the Round Table

- A major concern is the code of conduct prescribed under the new regulations. While the erstwhile regulations contained separate codes for listed companies and intermediaries, the new regulations provides only one model code of conduct which is applicable to both listed companies as well as the intermediaries. There is a lack of clarity on how to draft the code of conduct and how to determine what provisions will be applicable to listed companies and what will be applicable to intermediaries. This may lead to certain awkward situations such as applying the six months contra trade rule to mutual funds although they have no access to inside information.

DIFFERENTIATED BANKS AND PAYMENT SYSTEMS

INTRODUCTION

The primary barriers to financial inclusion in India are the poor accessibility to banking services and, where accessible, the high cost of accessing such services. Reserve Bank of India has, in the recent past, come up with three kinds of niche banks and/or financial institutions to further financial inclusion. These are: - Non Banking Financial Company-Micro Finance Institutions (NBFC-MFIs), Small Finance Banks and Payments Banks.

Before such new categories of banks were formulated, Prepaid Payment Instruments had come into being. PPI are instruments that facilitate purchase of goods and services against the value stored on such instruments. Such value is the amount paid for by the holders by cash, by debit to a bank account, or by credit card.

RBI introduced NBFC-MFIs in December 2011, in order to address the issues and concerns in the MFI sector. NBFC-MFIs are non-deposit taking NBFCs (other than companies licensed under Section 25 of the Indian Companies Act, 1956), that focus on granting low-interest rate loans to rural households, self-help groups, joint-liability groups.

Small Banks seek to extend provision of savings vehicles to under-served and un-served sections of the population, supply of credit to small business units, small and marginal farmers, micro and small industries, and other unorganised sector entities through high technology-low cost operations.

Payment Banks are meant to provide small savings accounts, payment/remittance services to migrant labour, low income households, small businesses, other unorganised sector entities and other users by enabling high volume-low value transactions in deposits and payments/remittance services in a secured technology-driven environment.

NBFC-MFIs might have helped rural households get loans at transparent interest rates and without meeting the stringent requirements of commercial bank loans. However, these institutions did not provide the complete range of banking services, including acceptance of deposits. Small Finance Banks would fill this gap to an extent, given that they would be providing saving facilities to the underserved segment and extending loans to small business units, which hitherto had been neglected by large commercial banks. Payments Banks will help facilitate transactions at low costs. This would benefit a considerable section of the Indian migrant population.

SPECIFIC PROVISIONS IN THE DIRECTIONS/ GUIDELINES IN RELATION TO DIFFERENTIATED BANKS/ FINANCIAL INSTITUTIONS AND PAYMENT SYSTEMS

1. ***Pre-paid Payment Instruments in India*** *- Master Circular on Policy Guidelines on Issuance and Operation of PPIs*

(i) PPIs can be issued as smart cards, internet accounts, mobile accounts, mobile wallets and any such instrument which can be used to access the pre-paid amount.

(ii) There are three categories of payment instruments:

a. **Closed**: Issued by a person for facilitating the purchase of goods and services from him. No cash withdrawal, redemption or payment to third parties;

b. **Semi-closed**: Can be used for purchase of goods and services, including financial services at a group of clearly identified merchant locations/ establishments which have a specific contract with the issuer to accept the payment instruments;

c. **Open**: Payment instruments which can be used for purchase of goods and services, including financial services like funds transfer at any card accepting merchant locations (point of sale terminals) and also permit cash withdrawal at ATMs/ BCs.

(iii) **Eligibility**: Banks who comply with the eligibility criteria can issue all three categories of PPIs. NBFCs and other persons are only eligible to issue closed and semi-closed categories of PPIs.

(iv) **Capital Requirements**: Banks and NBFCs have to comply with capital requirements as prescribed by RBI. Other persons need to have a minimum paid up capital of Rs. 5 crore and net worth of Rs. 1 crore.

(v) **KYC requirements**: Varies based on the category of the PPI.

a. Banks issuing open PPIs – The Full KYC requirements as required of banks.

b. Other Semi-closed PPIs – varying degrees of KYC obligations based on the amount in the PPI instrument.

(vi) Restrictions on **deployment of money** collected:

a. Restrictions on Banks: The outstanding balance to be considered a part of 'net demand and time liabilities' for maintenance of reserve requirements.

b. Restrictions on Other entities: The outstanding balance to be maintained in escrow with a scheduled commercial bank. The amount in escrow is charged unto the holders of PPIs and Merchants. No interest is payable on the amount in the escrow by the bank.

(vii) **Validity**: The minimum validity of PPIs prescribed under the guidelines is 6 months.

(viii) **Consumer protection**: Apart from the requirement of making mandatory disclosure of all important terms and conditions, charges and fees, expiry period, customer service numbers, etc., the issuer must also establish a grievance redressal mechanism.

2. ***Micro Finance Institutions*** - *Master Circular on 'Non-Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs)*

(i) Minimum Net Owned Funds of Rs.5 crores.

(ii) Not less than 85% of its net assets are in the nature of "qualifying assets". "Qualifying asset means a loan fulfilling the following criteria:

  a. loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs. 60,000 or urban and semi-urban household income not exceeding Rs. 1,20,000;

  b. loan amount does not exceed Rs. 35,000 in the first cycle and Rs. 50,000 in subsequent cycles;

  c. total indebtedness of the borrower does not exceed Rs. 50,000;

  d. tenure of the loan not to be less than 24 months for loan amount in excess of Rs. 15,000 with prepayment without penalty;

  e. loan to be extended without collateral;

  f. aggregate amount of loans, given for income generation, is not less than 70 % of the total loans given by the MFIs

  g. loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower.

(iii) All new NBFC-MFIs shall maintain a capital adequacy ratio consisting of Tier I and Tier II Capital which shall not be less than 15 % of its aggregate risk weighted assets.

(iv) There shall be only three components in the pricing of the loan, namely, the interest charge, the processing charge and the insurance premium (which includes the administrative charges in respect thereof).

(v) Non- Coercive Methods of Recovery.

3. ***Small Finance Banks and Payment Banks*** - *Guidelines for Licensing*

(i) The following are some of the conditions applicable to both kinds of banks:-

  a. The bank shall be registered as a public limited company under the Companies Act, 2013 and licensed under Section 22 of the Banking Regulation Act, 1949

  b. Minimum paid-up equity capital requirement is Rs 100 crores.

  c. Promoter contribution of at least 40 % for the first five years.

  d. Operations of the bank to be fully networked and technology driven from the beginning.

  e. Other financial and non-financial services activities of the promoters should be ring-fenced.

(ii) The following are the salient features of Small Finance Banks:-

a. Resident individuals with 10 years of experience in banking and finance, companies and societies owned and controlled by residents will be eligible as promoters to set up small banks. NFBCs, MFIs, and Local Area Banks (LABs) can convert their operations into those of a Small Bank.

b. Different promoter groups cannot form joint ventures for setting up small banks. Proposals from large public sector entities and industrial and business houses, including from NBFCs promoted by them, will not be entertained.

c. Purpose will be to provide a whole suite of basic banking products such as deposits and supply of credit, but in a limited area of operation.

d. Can undertake other non-risk sharing simple financial services activities, not requiring any commitment of own fund such as distribution of mutual fund units, insurance products, pension products, etc. with the prior approval of the RBI and after complying with the requirements of the sectoral regulator for such products.

e. For branch expansion prior RBI approval will be required for initial three years and at least 25% of branches are required to be opened in unbanked rural centres.

f. A robust risk management framework is required and the banks would be subject to all prudential norms and RBI regulations that apply to existing commercial banks, including maintenance of CRR and SLR.

g. The maximum loan size and investment limit exposure to single and group borrowers would be restricted to 10% and 15% of capital funds, respectively. Loans and advances of up to Rs 25 lakhs, primarily to micro enterprises, should constitute at least 50% of the loan portfolio.

(iii) The following are the salient features of Payments Banks:-

a. Can be promoted by a non-bank PPI Issuers, NBFCs, corporates, mobile telephone companies, super market chains, real sector cooperatives companies and public sector entities. Even banks can take equity in Payments Banks.

b. A promoter/promoter group can have a joint venture with an existing scheduled commercial bank to set up a payments bank, subject to compliance with the stake holding permitted under the Banking Regulation Act, 1949.

c. Payments Banks can accept demand deposits to the extent of Rs 1,00,000 per customer initially.

d. Can issue ATM/debit cards, however a Payments Bank cannot issue credit cards.

e. Issuance of PPI (e.g., mobile wallets) under the Payment and Settlement Systems Act, 2007.

f. The RBI is also open to payments bank offering Internet banking services, though RBI does not envisage Payments Banks to be "virtual" banks or branchless banks.

g. Payments Banks will be permitted to handle cross border remittance transactions in the nature of personal payments/remittances on the current account. All facilities/approvals incidental to undertaking such transactions in foreign exchange will be enabled by RBI on an application made to it.

h. Payments Banks can undertake other non-risk sharing simple financial services activities, not requiring any commitment of their own funds, such as distribution of mutual fund units, insurance products, pension products etc. with the prior approval of the RBI and after complying with the requirements of the sectoral regulator for such products.
i. No credit lending is allowed for Payments Banks.
j. Payments Bank will not have loans and advances in its portfolio, the prudential norms and regulations of RBI as applicable to loans and advances, will therefore, not apply to it. However, the Payments Bank will be exposed to operational risk and should establish a robust operational risk management system.
k. Payments Bank shall operate in remote areas mostly through Business Correspondents, ATMs and other networks. Therefore, the requirement of opening at least 25% of branches in unbanked rural centres, is not stipulated for them. However, the Payments Bank will be required to have at least 25% of physical access points including Business Correspondents in rural centres.
l. The operations of the Payments Bank should be fully networked and technology driven from the beginning, conforming to generally accepted standards and norms. While the new approaches (such as data storage, security and real time data updation) are encouraged, a detailed technology plan for the same should be furnished to RBI.
m. Deposits will be covered under India’s Deposit Insurance Corporation and accounts will be eligible for the RBI’s simplified KYC norms.

4. *Peer-to-Peer Lending*

Peer to peer lending is carried out through online lending ‘platforms’ which charge a relatively small commission for matching lenders/investors with borrowers in order to provide unsecured loans. The platform may provide support services like verification of identity and financial details of the borrowers.

P2P is quickly catching up with traditional banking abroad and is now making its way into India. Its success may be attributed to the frustration that borrowers face with regard to the lending practices of banks.

While investors may be able to earn much better returns by buying the safest loans from P2P platforms, there is no investor protection by way of a compensation scheme to cover defaults. Retail investors, who do not have the capacity to absorb defaults, may lose significant proportions of their investments, if there are any defaults

While there is no element of securities involved in P2P lending, there are discussions about developing a secondary market for such loans and their securitised products.

Jurisdictions around the world have treated these platforms differently, such as:

a. In the extremes, there are countries that either completely prohibit the model or those that leave it unregulated. India currently does not have any regulatory framework for P2P lending.

b. Some jurisdictions treat these platforms as intermediaries and require them to obtain a registration to continue functioning.

c. Some jurisdictions require these platforms to adhere to banking regulations.

d. The US model has a two tier system wherein the intermediary is required to register with the SEC while a separate license is also required at the state level for functioning in a particular state.

ISSUES AND CHALLENGES

1. ***No open PPIs by non-banks:*** Given that open PPIs can be issued only by banks permitted by the RBI to provide mobile banking services, mobile wallets etc. cannot be used in India as a universal mode of payments by mobile users who lack access to bank accounts.
2. ***Non-NBFC MFIs***: While NBFCs dominate the total loan portfolio through the microfinance channel, other MFIs such as societies, trusts, Section 25 companies and cooperative societies fall outside the purview of RBI. Thus, the 2014 directions cover only a section of MFIs, i.e. NBFCs and there is still no proper regulatory body for supervision of MFIs.
3. ***Nature of Guidelines***: Keeping in view the relative ingenuousness of the section of the population Small Finance Banks and Payments Banks are meant to cater to, the Guidelines framed by RBI have strict requirements for entities seeking to set up Small Finance and Payments Banks. However these requirements may hinder new players from setting up such banks.
4. ***Clarity in objectives***: The definition of “small” in Small Finance Banks must also be linked to the transaction size and not only the geographical coverage. An institution may have achieved scale while serving microfinance clients. Definitions of underserved and un-served may be mentioned in the Guidelines.
5. ***Urban financial inclusion*****:** Currently the Guidelines are biased towards rural geographies. Small customers in urban locations also need inclusion. Institutions that seek to serve urban and semi-urban customers should also be allowed to apply for a license.
6. ***High minimum paid-up equity capital***: The stipulated capital of Rs. 100 crore is in excess and would deny small and new players from entering the space. Capital requirement should be consistent with risk profile. The envisaged structure for Payments Bank has significantly lower risk (maximum deposits of Rs. 1 lakh, no lending).

7. ***Eligible promoters***: For a group of individual promoters, 10 years of financial sector experience is too high a requirement to be insisted for all promoters. Clarity is required in this regard.
8. ***Area of operations***: Instead of strictly limiting area of operations to contiguous districts, guidelines may be made flexible to allow Small Finance Banks to operate across non-contiguous areas based on clear evidence of their '*experience, and commitment*' in all the proposed geographies.
9. ***Capital adequacy ratio***: Given the limited area of operation and the lower frequency of equity infusion in small banks, they do not need to have 15% CAR. This would help enhance return to the stakeholders and attract aspirants.
10. ***Prudential Norms/ Loan size***: Rs 25 lakhs is too high a range in view of the financial inclusion objective and is likely to result insignificant portion of the portfolio of the Small Finance Banks catering to larger loan sizes, thereby excluding clients with small credit needs. A broad range may be prescribed. Similarly the limit of 15% of capital funds is excessive from the inclusion perspective.
11. ***Foreign Investment limit***: The Guidelines stipulate that the foreign shareholding in a Payments Banks and Small Banks should be as per the foreign direct investment policy applicable for private sector banks. Accordingly, the aggregate foreign investment in a Payments Bank will be capped at 74% (automatic route up to 49%). This is at variance with the corresponding policy on foreign investment in the telecom services sector, which now permits foreign investment up to 100% in a telecom services provider. Thus, for instance, mobile phone operators will, should they choose to set up a payment bank, have to incorporate a new joint venture entity for this purpose, with at least 26% being held by Indian residents. Unless such a restriction on foreign investment is addressed, large foreign-owned mobile phone operators may find it hard to enter this sector.
12. ***Ring-fencing of other services***: The Guidelines stipulate that a Payments Bank can only undertake certain permitted activities, which must be distinctly ring fenced from the other activities of the promoter and not co-mingled with the banking services/ payments bank products. Therefore, a telecom operator seeking to enter the Payments Bank business will need to set up a separate entity for this purpose. This new entity must have an initial paid-up capital of at least Rs. 100 crore. This rule would hinder such operators from leveraging their nationwide retailer networks and existing distribution and technological infrastructure and compel operators planning to set up Payments Banks to invest afresh in retailer and distribution networks purely to support banking operations.
13. ***Overregulation of e-money***: Non-banks in India can issue only semi-closed prepaid instruments, which do not provide for cash withdrawals. It needs to be considered whether KYC requirement is justified in such cases, when any usage of the card will only result in credits to the bank accounts of the merchants. Whilst KYC requirements are, in some form necessary, consideration should be given to whether or not their current application is appropriate.

14. ***Revenue and Profitability***- Payments Banks cannot give loans and thereby earn any revenue from the interest. They have to rely mostly on fees from remittances and services such as utility payments or mobile top-ups. Volume will be critical to their survival. They need to identify the right regions to expand- such as areas with limited access to mainstream banks and where a large chunk of money is coming from urban remittances.
15. ***Complex new regulatory regime***: The question remains whether the RBI could not have implemented a simpler regulatory fix, so as to allow non-bank entities (such as mobile operators) to issue open PPIs/enable licensed non-bank prepaid issuers to allow their customers to cash-out. RBI could have perhaps addressed related regulatory concerns through tougher compliance requirements for this purpose within the PPI Guidelines.
16. ***Unregulated Peer to Peer lending*** – There is no clarity in relation to the rules and regulations that govern peer to peer lending. In fact, in a discussion paper released by SEBI on 'crowd funding', SEBI opines that P2P lending may fall under the regulatory purview of the RBI. The RBI has not accepted this view by issuing any guidelines or press releases. In such a scenario, there is a risk that some might use the platform and the prevalent regulatory arbitrage to the detriment of innocent investors.

WAY FORWARD

While such differentiated banks would make it convenient for unbanked segments of India's population to transfer money, access loans and participate in the financial economy of the country, the regulatory framework should be such that niche banks remain commercially viable for providing significant boost to digital financial inclusion. For instance, appropriate incentives for achieving specific inclusion indicators may be created that would encourage small banks to lend to micro-borrowers. Inclusion incentives such as access to refinance, exemption from SLR on refinance and may be provided.

Summary of discussion held at the Round Table

Payment Banks

- While in most cases, innovation comes from the market, payment banking is a rare example of innovation coming from regulator. This model is the first of its kind in the world and envisages bringing in non-banking entities into banking. It is a disruptive element in the market and has the potential to revolutionize the manner in which banking services are provided. Other payment networks, such as Visa, MasterCard, and Rupay, may be affected. Another example of a disruptive element could be the Apple Pay system in the US.
- However, there are certain challenges to the effective functioning of Payments Banks, for instance, how will the process of settlement take place, how will it actually benefit rural households and how will it help financial inclusion. Further,

- Payment Banks entail a transaction-based revenue model, not a balance-based model. So if transactions fail are not sufficient to support operations, Payments Banks may not be viable.
- Payments Banks will be technology-driven from the outset. The operations are proposed to be well-integrated with mobile applications. There is concern that, while such a framework will facilitate big players such as Vodafone and Airtel to enter the banking space, these market players would merely be lending their platforms to enhance their own scope of business and would not be motivated by the need to deepen the banking system. This would not help achieve the objectives of the regulator.
- Some concerns were raised about whether revenue generation will consume a lot of time and there will not be enough room for the numerous market players who have applied. Countering this, it was pointed out that limiting registrations does not help and merely affects competition. The example of SEBI was sited which regularly gives registration to all who apply as long as the eligibility criteria is satisfied.
- Further, amongst the benefits of payment banks, it was noted that NPCI is coming up with a system for payment of utilities bills online. This, coupled with other transactions which can be undertaken without a POS device, may result in immense revenues. The cost of set up will be low, whereas the output would be high.

Small Finance Banks

- Small Finance Banks are similar to other banks, however, they have certain special features such as size of loans, area of operation etc. These banks may pose considerable risk to microfinance banks which do not get license.
- The challenges that Small Finance Banks may face, inter alia, pertain to the liabilities they may incur. Small Finance Banks may not be profitable as collection of deposits will take time. This is especially so in the rural markets that are the main target regions of these banks. Another issue with regard to the viability of delivering the technology required to technology low rural areas.

Micro-Finance Institutions

- Concerns were expressed regarding the present MFI model. They presently face challenges due to inefficiency, especially due to the absence of minimum technology. Even if they chose to migrate to a small bank license which depends on revenues from deposits, it remains to be seen how they will successfully shift from a lending based model to a deposit taking model.

IMPLICATIONS OF RESEARCH ANALYST AND INVESTMENT ADVISORS REGULATIONS

SEBI notified the Investment Advisers Regulations in 2013 and the Research Analyst Regulations in 2014, compelling firms in the financial sector to re-think the manner in which their organizations are structured and managed, in order to comply with these regulations. From our experience, firms have not found it easy to re-organize or re-structure their operations to comply with these regulations. Their problem is also compounded by the fact that these are not the most well drafted regulations that SEBI has introduced. Often times, the regulations are over broad and vague and lack the nuance that is required to regulate the complex financial services sector, where the law is always playing catch-up. These regulations were also introduced at a time when the financial services sector in India was in the middle of a slowdown and their revenues and profitability had hit all-time lows. Many firms in the business feared that these regulations would increase their compliance costs and reduce their profitability. This note seeks to briefly highlight some of the sticky issues under these regulations.

ISSUES AND CHALLENGES

I. Key Issues under the Investment Adviser Regulations

1. *Scope of the "incidental activity" exemption for mutual fund distributors*

The Investment Adviser Regulations exempt those mutual fund distributors who provide investment advice that is incidental to their primary activity, which is to sell mutual fund products. However, SEBI recently clarified the scope of this exemption in the FAQs for Investment Adviser Regulations, wherein it stated that this exemption is available for those mutual fund distributors who were only distributing mutual fund products. If the mutual fund distributor is also in the business of selling other products like insurance, securities, tax free bonds, etc. or provide financial planning services for his or her clients, they will not be able to avail of this exemption. Interestingly, some of the circulars issued by SEBI for mutual fund distributors under the Mutual Fund Regulations require mutual fund distributors to carry out some kind of financial planning in order to determine the suitability of the mutual fund products for their clients, often without any consideration. Compliance with these circulars may expose the mutual fund distributors to the risk of having to register under the Investment Adviser Regulations. So now we have a situation where the mutual fund distributors may shy away from carrying out proper financial planning lest they may attract the wrath of SEBI for providing "investment advice" without registration. This would naturally affect the suitability of the mutual fund products being distributed by them and may end up harming the investor – exactly the situation that SEBI wanted to avoid. The mutual fund circulars were issued prior to the notification of the Investment Adviser Regulations and they have not been suitably amended to take into consideration the provisions of these regulations. One would hope that SEBI takes a more nuanced approach towards drafting these regulations to ensure a seamless regulatory regime for the financial services industry.

2. *Bar on individuals from carrying out both advisory and distribution activities*

There are lakhs of people in India who distribute financial products under a sole proprietorship model. However, as mentioned above, if they are in the business of distributing more than one financial product and provide some incidental investment advice in the process of distributing such financial products (for which they don't receive any compensation) they are still at risk of being categorized as investment advisers under the Investment Adviser Regulations. The Investment Adviser Regulations and the FAQs are not clear whether incidental advisory services provided by multi-product distributors would still come under the purview of the regulations. The Investment Adviser Regulations allows individuals to register themselves as investment advisers. However, the moment such individuals register under the extant regulations, they will not be able to carry out their distribution / execution activities as the Investment Advisers Regulations require registered investment advisers to "segregate" advisory activities from all other activities. Such segregation would be impossible to achieve under a sole proprietorship. Surely, such restrictions on the distributors are unintended consequences as the objective of SEBI was to regulate investment advisers, not put individual distributors out of business. Additionally, many individual distributors may find it tough to comply with the minimum net worth requirement or meet the minimum qualification criteria required under the Investment Adviser Regulations.

3. *Arms-length relationship between advisory and other activities*

This is yet another example of the vagueness that pervades Investment Adviser Regulations. The regulations requires a firm which is registered as an investment adviser to maintain arms-length relationship between its advisory activities and other activities. The regulations do not define what the phrase means nor do they provide any guidelines as how to achieve it. It is also not clear whether the "arms-length relationship" means that an entity has to have a "Chinese wall" between its advisory and non-advisory activities. We see this term being used in the Research Analyst Regulations, as well, but no clarity has been provided as to its meaning.

Summary of discussion held at the Round Table

- Nobody wants to fall within the ambit of the term advisor as they would come within the regulatory purview of SEBI. Hence, most market participants prefer to fall in the incidental exemption. Further, in the present scenario, it is not monetarily viable to only advise clients as there are better returns from the manufacturer's side. While there are several lakh distributors, only 230 persons are registered as investment advisers. This might result in a move away from all advisory services.
- There was a discussion of how some persons in SEBI believe that, in the case of banks

acting as distributors, while advise pertaining to a single product may attract regulatory oversight, offering a bouquet of products instead of single products is acceptable.

- Concerns were expressed regarding how the requirements of conducting appropriateness and suitability are present within the Code of Conduct specified in the Mutual Fund Regulations but these had not been considered while drafting the IA Regulations.
- The foreign model called 'customary portfolio advise' was discussed. The process begins with financial planning at the outset, followed by the distributor choosing products based on the extensive due-diligence they undertake. The products that are suitable are put in a list called the white list or the focus list. Clients are given the option to decide what to invest in based on their risk appetite. Foreign models did not include the provision of sell advise. It was observed that some entities in India which undertake such activities sought registration from SEBI as an investment advisor.
- The issue of the various overlaps within SEBI regulations was discussed. For instance, the departments in charge of mutual funds and investment advisers steer clear of each other. Further, the example of advisory fees was discussed. As there is no clear demarcation, intermediaries are taking interpretations as they deem fit.
- There is also uncertainty regarding the No-objection certificate to be obtained by NBFCs if they intend to undertake investment advisory.
- SEBI is concerned about the IA registrations not taking off and about how grass-root investment advisers are not applying.
- The view that investment advisory is a noble profession must still develop in India. Abroad, truly independent and customised advice is given great importance. While it is not the culture here, at some point, when the regulatory arbitrage goes away, it might happen. The SRO that is being set up for distributors might solve the issue as distributors might be subject to the same stringent requirements as investment advisers.

II. Key Issues under the Research Analyst Regulations

1. *Broad definition of "research analyst"*

A research analyst has been defined to mean a person who is primarily responsible for preparation or publication of the content of the research report or provides a research report or makes a 'buy/sell/hold' recommendation or gives price target or offers an opinion concerning a public offer. For instance, if a broker sends an email advising his client to buy or sell or hold a particular stock at a given price the broker would now be considered a research analyst. He or she would not be able to send that email without registration as a research analyst, as the Research Analyst Regulations do not exempt a broker from registration unlike Investment Adviser Regulations which do provide an exemption for registered brokers who provide investment advice to clients incidental to their primary activity. The above mentioned advice would also satisfy the definition of investment advice, but the Investment Adviser Regulations exempt the broker from registration as the advice provided therein is incidental to the primary activity and the broker is not remunerated for the advice. Was it the intention of SEBI to prevent registered brokers from providing incidental investment advice to their clients by bringing them within the purview of the Research Analyst Regulations or is it just a case of an over broad definition of the term "research analyst"? If SEBI's intention was the former then brokers would require to seek additional registration under the Research Analyst Regulations for what is a routine job for them and would increase the cost of compliance for them.

2. *Conflict between research analysts and fund managers*

Fund managers registered under the SEBI PMS Regulations are exempt from registration under the Research Analyst Regulations. Indeed, research activity is one of the most important functions of fund managers who invest for their clients. PMS entities who also publish research reports for clients are required to comply with Chapter III of the PMS Regulations. Chapter III puts certain restrictions on the personal trading activity of the analysts who are involved in the publishing of a research report and on the research entity which publishes the research report. However, it is not clear whether the trading restrictions mentioned therein are applicable when the trades are made on behalf of the PMS clients. The Research Analyst Regulations do not provide any clarity in this regard and in the absence of any clarity, most PMS entities would be hesitant in publishing research report as that would mean that the trading restrictions that would kick in would put their PMS clients at a disadvantage. Rather than promoting objective and accurate market research, the Research Analyst Regulations will now have the effect of stifling research in such organizations. Greater thought ought to have been put in by SEBI to iron out such issues and ensure that businessmen or their clients do not suffer in the bargain. Lack of clarity not only increases compliance costs but also fails to achieve the very objective for which the regulations were notified in the first place.

3. *Regulation of foreign research analysts*

The definition of research analysts is broad enough to cover even those analysts who issue research reports on Indian securities. Further, the Research Analyst Regulations require any person located abroad who issues research reports about securities in India to enter into an agreement with a research analyst or research entity registered in India. The definition of "research report" exempts periodic reports or communication prepared for unit holders of mutual funds, AIFs, clients of portfolio managers and investment advisers. However, if an investment manager of an FPI issues a research report about its portfolio companies to its investors or limited partners, the same is not exempt from the definition of a research report. It is strange that the Research Analyst Regulations has exempted communication to mutual fund unit holders and clients of PMS and investment advisers from the definition, but has not exempted communication from the investment manager to the investors of an FPI. This has created a peculiar situation where the investment manager desirous of issuing research reports to his investors will have to either register himself as a research analyst or enter into an agreement with a domestic research analyst and ensure that the research report is routed through the domestic research analyst. Whether there is any rational for not including investment managers of FPIs and their sub-accounts in the exemption to the definition of "research report" or whether this is another instance of plain oversight and poor drafting is debatable.

Summary of discussion held at the Round Table

- It was noted that conflict of interest, providing misleading information in reports and front running are the main concerns. For instance, an entity handling a public issue may also issue research report on the matter. The Research Analyst Regulations are very broad and cover nearly everyone, including proxy advisors, who do anything remotely related to research.
- Concerns over the NISM examination requirements were expressed. For instance, persons who are already established in the field and are in possession of superior qualification are also required to take the examination.
- There is an overlap among the Investment Adviser, Portfolio Management and Research Analyst Regulations. There is need for better demarcation.
- Another concern was regarding the absence of the exemption from the requirement to register for broker. This exemption is present within the investment adviser Regulations
- Concerns regarding foreign fund managers sending reports to their foreign clients regarding Indian securities were expressed. The issue of detection persists and the only mechanism of enforcement is when such a case arises.