FINSEC

Law Advisors

SECURITIES AND FINANCIAL REGULATIONS ROUNDTABLE
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APPROACH PAPER

INTRODUCTION

Finsec Law Advisors and the *Securities Markets Association of India*, supported by the *US India Business Council*, successfully conducted the first high level **Securities Market and Investment Regulations Roundtable** on 28 March, 2014. 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 28th March, 2014 Roundtable was the first of a series of proposed discussions to engage with key decision makers within regulators, financial market experts, academia and industry.

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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NEW CODE FOR CORPORATE GOVERNANCE: COST BENEFIT ANALYSIS

SEBI, in its board meeting held on 13 February 2014, approved several modifications to the Listing Agreement in an attempt to revamp the corporate governance norms in the country. SEBI has heavily relied on the "Consultative Paper on Corporate Governance norms in India" which was released on 4 January, 2013. While a number of the changes have already been incorporated within the Companies Act, 2013, the relevant sections have not been notified as yet. In certain circumstances, SEBI has prescribed more stringent norms than what exists under the Companies Act.

Summary of discussions held at the Round Table

- The main purpose of better corporate governance is to improve investor confidence. But SEBI must also focus on other means of improving the same, for instance, by allowing easier delisting for defaulting entities so as to protect innocent investors.
- The attendees discussed how the norms simply increase the compliance obligations on companies.
- The attendees pointed out that the new SEBI rules, allowing suspension of trading of a company's scrip due to defaults of its management, effectively harm investors and do nothing in aiding investor confidence.

KEY PROPOSALS AND IMPACT

- **General principles of corporate governance** - SEBI has proposed the creation of overarching "*General principles of Corporate Governance*", based broadly on international best practices and the Guiding Principles. Application of specific rules in the Listing Agreement would be in alignment with these Principles.

  Impact: *These will aid in understanding how specific rules in the Listing Agreement are to be interpreted as, in case of ambiguity, rules shall be implemented in a manner so as to achieve the objectives of the principle.*

- ***Independent Directors:*** The new norms primarily focus on ensuring independence and effectiveness of independent directors. Limits on tenure and on number of directorships, provisions for separate meetings of such directors, etc. have been specified. Other obligations on boards include succession planning and performance evaluation of directors.

  Impact: *The role of an independent director has increased significantly since a third of every listed company's board must comprise independent directors. Further, they play* *an important role in the audit committee and the remuneration and nomination committee. While the norms attempt to bring in duly qualified persons into boardrooms, some of the requirements are too onerous which may lead to a shortage in the number of independent directors in the long run.*

Summary of discussions held at the Round Table

- A major point for discussion in relation to independent directors was in relation to their qualifications and eligibility requirements. Some suggested that an examination may be a minimum threshold to ensure that companies do not appoint directors with absolutely no understanding of the industry or of corporate mechanisms. They noted that promoters often appoint persons with zero qualifications (barbers, drivers, sportsmen, etc.) for such important directorships.

- In relation to women directors, the attendees pointed out that while the move is well intentioned, companies usually end up appointing relatives of people in the management, defeating the purpose of the provision.

- Another important point was in relation to attendance and how the new provisions do not mandate a sufficiently stringent attendance requirement. They raised doubts as to how an independent director will be able to perform the various essential functions assigned to him and will be able to discover issues/defaults without attending board meetings.

- The attendees discussed the increased role of independent directors within every company. Committees such as the stakeholder grievance committee, which are chaired by independent directors, place a huge responsibility on them. Some expressed a view that with such onerous responsibilities being placed on independent directors may effectively allow the rest of management to sit back and let independent directors run the company.

- The attendees were concerned about the increased liability to be borne by independent directors. They are also expected to be aware of all internal and external developments of the industry. Additionally, the defences that were originally available to directors in relation to IPOs have also been taken out.

- With all these responsibilities, independent directors now fear taking up such positions out of fear of repercussions. The removal of ESOPs as a mode of remuneration does not aid the cause.

- Some were of the view that all the additional responsibilities might result in independent directors simply raising questions to create an appearance of activity. While no development of business may result, the compliance requirements on CSs and CFOs will increase. Additionally, companies are now required to provide additional facilities for separate meetings, meetings of committees, etc. Companies will have to ensure that the independent directors are comfortable while occupying such chairs and all of this will add to the company's costs.

- ***Related Party Transactions*****:** There are extensive provisions on related party transactions. The definition of RPTs has been broadened and is set to not only be prescriptive but also highlight possible abuse of control and/or influence which might result in the violation of minority shareholders' rights. Additionally, the new norms mandate prior approval from the audit committee and also from non-interested shareholders, in case of material RPTs.

  Impact: *These new norms will considerably aid in protecting the interests of minority shareholders and prevent abuse of the dominant position held by those in control. However it is important for regulators that not all RPTs are bad and they are an important tool for synergies among group companies.*

Summary of discussions held at the Round Table

- The attendees were concerned about the broadly worded definition of 'related party'. Companies will have to keep a track of several remotely related persons' activities. It is very easy for a company to miss out some related persons' activities.
- Some attendees were concerned about the lack of clarity regarding methodologies and procedures involved in the Audit Committee approval process.

- ***Policies for whistle-blowers, remuneration, risk management, divestment of material subsidiaries:*** Companies will be required to frame policies for whistle-blowers, remuneration, risk-management, divestment of material subsidiaries, etc.

  Impact: *These policies will be highly beneficial to the companies, employees, shareholders and the general public at large as they will help usher in a culture of having clear and certain mechanisms in place and reduce misconduct. However, the new norms are silent on the format of these policies. The effectiveness of these proposals can only be gauged after companies frame these policies and bring them into effect.*

FOREIGN PORTFOLIO INVESTORS

Based on the K.M. Chandrasekhar Committee Report, SEBI has instituted a new class of foreign investors. As per the SEBI (Foreign Portfolio Investors) Regulations, 2014 notified on 7 January, 2014, the existing categories of FIIs, FII sub-accounts and QFIs will now be categorised as a single investor class i.e., foreign portfolio investors or FPIs.

KEY PROPOSALS AND IMPACT

- ***Certificate of registration:*** An applicant will not be required to approach SEBI for being registered as an FPI. Instead, applicants will have to make an application to designated depository participants who would grant a certificate of registration, upon the receipt of which the FPI can deal in securities specifically enlisted under the Regulations.

  Impact: *There are two implications that fall out of this mechanism. Firstly, the DDP in question may not be adequately equipped to undertake the risk assessment as expected by the Regulations. The requirement of merely having a global presence may not be sufficient to enable a DDP to undertake the risk assessment in every regulatory jurisdiction. Secondly, in contrast to the previous situation, a DDP may adopt an over-cautious attitude towards granting registrations which may result in unnecessary delays in the registration process due to rejection of applications and subsequent appeals before SEBI. The positive flip to the new registration requirement is that foreign investors would not have to seek registration with the market regulator, i.e., SEBI.*

- ***Risk profiling:*** FPIs have been categorized into three categories based on their risk profile. Category I would comprise government and government related investors, Category II would comprise appropriately regulated broad based funds, other appropriately regulated entities, broad-based funds which are not appropriately regulated but whose investment manager is appropriately regulated, university funds, university related endowments, pension funds etc. Category III would be a residual category for investors who do not fall under Categories I and II. Category III and broad-based funds under Category II which are not appropriately regulated but whose investment manager is appropriately regulated are not permitted to issue offshore derivatives instruments.

  Impact: *Prior to the Regulations, all foreign portfolio investors were either clubbed as FII or QFI and there was no requirement for them to be segregated on the basis of their regulatory status. This categorization ensures market regulators in monitoring risks of hot money and money-laundering in the securities market and checks that unregulated entities do not take exposure in the Indian markets by issuing off-shore derivative instruments.*

- ***Investment restrictions:*** Unlike the previous regime for FIIs, FPIs will be permitted to invest only in securities listed or proposed to be listed. Furthermore, the investment limit has been capped at ten percent of the total issued capital of an investee company and if the ultimate beneficial owner(s) invest through multiple entities, these entities would be treated as part of the same investor group and their combined shareholding would be considered for determining compliance with the investment limit.

  Impact: *Under the earlier regime, FII entities were permitted to make investments under the FDI route so long as such investments were in compliance with the FDI Policy. However, it is not yet clear whether FPI entities are permitted to make investments under the FDI route and whether their holding under the routes will be clubbed for the purposes of the investment limit of 10%. It is also not clear from the current regime on the treatment accorded to pre-existing investments made by a registered FII under the FDI route.*

- ***Clarity in tax treatment:*** The tax department is yet to issue a circular clarifying that FPI entities will get the same status under the tax laws as was accorded to FPIs. In absence of a specific notification from the tax authorities, it is still uncertain how transactions by FPIs will be taxed under Indian laws.

- ***Status of protected cell companies:*** The Regulations have made a departure from the existing regime in relation to protected cell companies. Earlier, protected cell companies or segregated portfolio companies were prohibited from investing through the FII route. However, this restriction may now be relaxed in case an applicant

  - is regulated in its home jurisdiction;
  - each fund or sub fund in the applicant satisfies broad based criteria;
  - gives an undertaking to provide information regarding its beneficial owners as and when SEBI seeks this information.

  Impact: *This is a welcome move by SEBI to permit cell companies to invest in India under the FPI route. It not only enhances investment avenues for Indian companies but also removes impediments faced by genuine foreign investors to make investments in India.*

Summary of discussions held at the Round Table

- The attendees pointed out that further clarity regarding - what would constitute FDI and what would constitute FPI is required. In addition, Attendees observed a lack of synchronicity between Regulators and pointed out that alignment of tax treatment would be a crucial factor in the successful implementation of the FPI regime.

- In relation to the change in the registration mechanism, Attendees observed that a requiring a designated depository participant which would be a "*bank with a global presence*" to carry out the functions of registration as opposed to the statutory regulator would not be an effective mechanism. Attendees regarded regulatory oversight as an inalienable requirement in the registration process. Representatives from potential DDPs present at the Roundtable remarked that the obligations for DDPs were too onerous and banks would be reluctant to take up such responsibilities due to operational difficulties. Some Attendees pointed out that the test of "*bank with a global presence*" is not an appropriate test and may also act as an entry barrier for domestic banks.

- Attendees were of the view that the regulatory approach has been unfairly tilted towards attracting foreign capital. A stronger impetus towards attracting domestic capital is necessary and the regulator must take measures to encourage investment by domestic investors. In addition, Attendees highlighted that; *hot money* is being readily accepted into the country whereas investments into the real economy have been made difficult.

- Attendees deliberated upon the policy disjunct in the regulatory framework governing FII and FDI. Hitherto, long term investments through the FDI route have been considered as a matter of national policy as opposed to an investment made through the FII route which is strictly regulated by the securities regulator as FIIs participate in the secondary market. Attendees discussed the need to maintain the distinction between FDI and FII and considered the ill effects of FDI being camouflaged as FII in light of the current mismatch of objectives between the national FDI policy and the regulatory framework for FIIs or FPIs.

LONG TERM MUTUAL FUND POLICY REPORT

The SEBI in consultation with the Mutual Fund Advisory Committee has issued the Long Term Mutual Fund Policy Report, recommending certain changes which are likely to have a major impact on the mutual fund industry as well as capital markets in India. The Report expresses concerns about the low penetration of mutual funds as a viable product for long term household savings in India. As per the Report, a majority of the population prefers investing in bank deposits, sovereign-guaranteed savings schemes with very little exposure to capital markets, insurance products and the like for long term investments, but most are unaware of the savings potential and risks involved in the mutual fund sector. The Report feels that lack of a long term policy view of mutual funds in India has resulted in lack of adequate knowledge of the mutual fund sector in India and recommended a host of reforms to spur growth in this sector. The Report felt that there is an urgent need for a long term policy for Mutual Fund Industry to project Mutual Fund schemes as a long term savings/investment avenue for households. The Report identified certain issues impeding the flow of long term savings into the mutual fund sector and has suggested certain key changes, the most important of which are highlighted below.

KEY CHANGES AND IMPACT

- ***Tax Related Incentives:*** Since mutual fund products in India have to compete with long term investment products like NPS, EPF / PPF and insurance which provide assured return coupled with tax returns, investments in mutual funds will only be attractive if tax incentives are extended to long term mutual fund plans as well. Although schemes like the ELSS, Pension Schemes provide certain incentives under Section 80C and RGESS provides incentives under Section 80 CCG of the Income Tax Act, 1961, the Report feels that there are not enough pension schemes in the market that qualify for tax incentives and that other financial products crowd out mutual funds under Section 80C. The Report recommends re-structuring Section 80C/80CCG to make mutual funds attractive for long term investing. The Report has also recommended increasing the limit of tax exemption under Section 80C to Rs. 2 lakhs and include investments in ELSS, RGESS and MFLRP within this limit.

  Impact: *The tax incentives proposed in this Report is a potential game-changer for the mutual fund industry. It will help channelling household income into long term mutual funds, which in turn will help increase liquidity in capital markets in India. It will also help unsophisticated investors participate in the capital markets without taking on excessive risks themselves and reap its benefits.*

- ***Capital Adequacy of AMCs:*** The Report has recommended that the minimum net worth of AMCs be increased from Rs. 10 crores to Rs. 50 crores. The Report observes that the smaller mutual fund houses faced serious stress during the 2008 financial crisis and the recent hike in short term interest rates by the RBI and that the AUM of 19 AMCs which have net worth of less than Rs. 50 crores, is 6% of the total AUM by the mutual fund sector. Given that 94% of the total Mutual Fund industry AUM is contributed from the 26 AMCs having net worth more than Rs. 50 crores the Report has recommended that minimum net worth of AMCs (except Infra Debt Funds) be increased to Rs. 50 crores within 3 years. However, AMCs are also barred from launching or managing new schemes till net worth has been increased to Rs. 50 crores

Impact: *Although it is indeed vital that AMCs have adequate net worth to meet any shortfall in cash faced by its funds, it is also important to note that some of the smaller mutual fund schemes have also given the largest returns to its investors and it is also unclear as to how this measure will help in increasing quality of mutual funds in India. This will also act as a barrier for investment as smaller players will find it hard to raise Rs. 50 crores.*

- ***Relaxation in investment guidelines for EPFO and Central Public Sector Enterprises ('CPSE'):*** The Report note that provident fund schemes like the EPFO are not permitted to invest in equity and equity oriented schemes by mutual funds due to a notification issued by the Labour Ministry in 2013. The Report states that since the objectives of investment in EPFO and mutual funds are similar in that investors are looking for building up long-term savings, it is only reasonable that a small portion of the funds of EPFO should be routed through the capital markets with a long-term perspective that would benefit the members. This move would make available thousands of crores which can be invested in the capital markets thereby increasing liquidity. The Report recommends that EPFO be allowed to invest upto 15% of the corpus into equity or equity linked schemes.

  Similarly, the Report also recommends that all CPSEs be allowed to invest their surplus funds in all mutual funds, as opposed to investing in only public sector mutual funds.

  Impact: *This recommendation is important not only because it enhances liquidity in the capital markets, but also helps in diversification of shareholding in companies thereby improving corporate governance. Today, most listed companies – even the BSE 30 and Nifty 50 companies are substantially funded by the promoters whose average shareholding range around 40-50%, while globally shareholding in publicly held companies is in the range of 5-10%. Increased participation by mutual funds and other institutional shareholding will not only help in diversifying shareholding in companies, it will also help in achieving better corporate governance practises.*

- ***Enhancing Disclosures:*** The Report has recommended that mutual funds be subject to a more robust disclosure regime. In this regard, the Report recommends that mutual funds disclose the AUM from different categories of schemes, AUM from B-15 towns, etc. and has *inter alia* proposed that the AMCs disclose the voting data on a quarterly basis, provide specific reasons in support of their voting decisions, provide auditor's certification on voting reports and review of the vote decision by board of AMC and Trustees.

Impact: *While it is certainly undeniable that mutual funds should be subject to an efficacious disclosure regime that makes it simple for an unsophisticated investor to discern the merits of investing in a particular mutual fund scheme, it is also crucial to ensure that the mutual fund sector is not subject to a burdensome disclosure regime that imposes high costs on disclosure. The SEBI should also ensure that there is no 'information overload' in the disclosures made by the AMCs that obscures data that is most crucial for investors to discern the merits of investing in a particular mutual fund scheme.*

Summary of discussions held at the Round Table

- That there is absolutely no logical link between the quality of the AMCs and minimum net worth requirements;
- The minimum networth of Rs. 50 crores appears to be an arbitrary figure as in the event of a mutual fund house going bust, given that the assets under management are far greater than Rs. 50 crores, it will not be able to meaningfully contribute towards paying off the investors;
- If SEBI is really concerned with the ability of the AMCs to refund its investors, then perhaps the networth requirements have to be tied up with the Assets under management. For example, SEBI should consider mandating that the networth of the AMCs should be an 'X' percent of the assets under management. That would help the AMCs refund their investors better in times of stress.

INVESTMENT ADVISERS REGULATIONS, 2013

KEY PROPOSALS AND RECOMMENDATIONS

- ***Exemption from registration to investment advice incidental to primary activity:*** There is an exemption from registration provided to any distributor of mutual funds, or any advocate, solicitor or law firm or any member of Institute of Chartered Accountants of India or Institute of Company Secretaries of India or Institute of Cost and Works Accountants of India or Actuarial Society of India or any stock broker or sub-broker, portfolio manager or merchant banker registered with SEBI who provide investment advice which is incidental to their primary activities or professional services. However there is no clarity on what constitutes "incidental investment advice".

- ***Problems of segregation of investment advisory services from distribution/execution services:*** The IA Regulations impose an obligation on an investment adviser to segregate investment advisory services from its distribution/execution services. However investment advisers who are run in the form of sole proprietorships would find it difficult to segregate its investment advisory department from its distribution/execution departments. Effective segregation of investment advisory services and distribution/execution services is possible only if investment advisers are run in the form of a company. So investment advisers who are run in the form of sole proprietorships would have to be incorporated as companies and incorporation as a company is costly and time consuming in comparison to setting up sole proprietorships. So disclosures by investment advisers to clients about their distribution/execution services are enough to tackle concerns about conflict of interest.

RESEARCH ANALYST REGULATIONS, 2013

KEY PROPOSALS AND RECOMMENDATIONS:

- ***Non-Applicability of the disclosure obligations under the RA Regulations to TV anchors/research departments of TV channels giving recommendations concerning securities:*** A research analyst or an intermediary or an asset management company or fund mangers of AIFs, proxy advisory service providers or their employees or directors who makes commentaries or recommendations concerning securities or public offers through public media are subject to the disclosure obligations under the RA Regulations. However the TV channel anchors who provide recommendations to buy and sell securities in the market on TV shows or the research departments of these TV channels are not subject to the disclosure obligations under the RA Regulations.

- ***Non-Applicability of the RA Regulations to trading/dealings in securities by close relatives of individual research analysts:*** A research analyst or an intermediary is restricted in making recommendations on securities in which they have traded or dealt in any manner. However the RA Regulations do not restrict any close relatives of an individual registered as a research analyst from trading or dealing in securities relating to which the research analyst has made any recommendations.

- ***Applicability of the RA Regulations to Foreign Research Analysts or Team of Research Analysts with Members in India and abroad:*** The wide definition of 'research analyst' would also include foreign-based research analysts providing reports to foreign clients on Indian listed securities. This would impose a severe restriction on the operation of foreign research entities providing their analysis to foreign investors. Further entities with research teams comprising of members both within India and abroad will also face problems. Members of the research teams who are located abroad will also come within the ambit of the RA Regulations and are required to register with SEBI. This would be burdensome for foreign research analysts on one hand and would not serve the mandate of protection of domestic investors on the other hand.

- ***Double Registration of Brokerage Houses& Merchant Bankers who are already with SEBI:*** Brokerage firms or merchant bankers are already registered with SEBI under the SEBI (Stock-Brokers and Sub-Brokers) Regulations, 1992 and the SEBI (Merchant Bankers) Regulations, 1992 respectively. So brokerage firms or merchant bankers who publish research reports are again required to register with SEBI as research analysts under the RA Regulations. This would unnecessarily result in a burden of double registration of the same entities with SEBI. It would be less costly and time consuming if the SEBI(Stock-Brokers and Sub-Brokers) Regulations, 1992 and the SEBI(Merchant Bankers) Regulations, 1992 contain provisions on the obligations to be fulfilled by brokerage firms and merchant bankers who publish research reports within these Regulations itself and these entities are required to register only once with SEBI.

- ***Issues with Segregation of Research Analyst Departments from Other Departments of the Same Entity:*** There is an obligation on a research analyst or an intermediary to maintain an arms-length relationship between its research activity and other activities which may impair its neutrality in respect of activity as research analyst. So there is a need to segregate and maintain a Chinese wall between the research departments and the investment banking/brokerage departments of the same entity. So if all these departments take different decisions with respect to the matters relating to the same company as there is no communication between the different departments on account of the Chinese wall and they may be subject to regulatory action.