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SECURITIES AND INVESTMENT REGULATIONS

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SAT sets aside the grant of in-principle approval to IMFI

After a prolonged tussle for over a year, SAT has quashed SEBI's order granting an in-principle approval to the *Institution for Mutual Fund Intermediaries* (IMFI), a body promoted by the *Association of Mutual Funds of India* (AMFI) to act as a self regulatory organisation (SRO) for mutual fund distributors.

SEBI initiated the process of setting up an SRO for regulating distributors of mutual fund products by inviting applications from eligible entities in March, 2013. Along with IMFI, the *Financial Planning Supervisory Foundation* (FPSF) and the *Organization of Financial Distributors* (OFD) filed their applications with SEBI. SEBI, in February, 2014, issued an in-principle approval to IMFI for being recognised as an SRO. This in-principle approval was challenged before SAT, by FPSF, on grounds of non-compliance with the SEBI SRO Regulations, 2004 and SEBI's bias in favour of IMFI due to SEBI's historical association with AMFI.

SAT found that SEBI had failed in complying with the requirements of the SEBI SRO Regulations, 2004 while granting the in-principle approval to IMFI. Therefore, SAT, vide its order dated September 30, 2015, quashed and set aside the said in-principle approval.

The Hon'ble Tribunal did not get into the merits of the arguments on bias, however, directed SEBI to *"select an applicant for grant of certificate of recognition in accordance with law after taking into consideration all relevant facts of each applicant without being influenced by any particular factor related to any particular applicant".*

SEBI has further been directed to consider the applicants afresh and pass a new order in compliance with the SEBI SRO Regulations, 2004, particularly, after granting an opportunity of hearing to unsuccessful applicants. *[Disclaimer: Finsec Law Advisors represented the appellant, FPSF]*

Finance Ministry's Report on Mis-selling

Mis-selling, in simple terms, is the selling of a financial product by a financial intermediary which is not suitable to its client. Recently, the Finance Ministry issued a report proposing measures for curbing mis-selling and rationalising distribution incentives in financial products.The primary objectives of the report are to bring some amount of uniformity in relation to the distribution of financial products in India and to improve the quality of the disclosures made to investors. The recommendations are broadly divided into two parts. The former outlines the broad principles that should be applicable to any retail financial product and the latter provides product specific recommendations.

The report recommends that all retail products ought to be structured with costs and benefits easily discernible for investors; which is a laudable suggestion. However, the proposal for homogenous cost structures for all product classes and cost caps for bundled products may be detrimental to innovation and growth within the market. The report proposes that product disclosures should be such that they can be easily understood by a retail investor. In addition, the report suggests the gradual phasing out of the up-front commission system for distribution of mutual fund products.

The report observes the lack of a regulatory framework for the financial product distribution business. At present, piece-meal efforts are underway, specifically in relation to the regulation of mutual fund product distribution through a self-regulatory mechanism. However, it appears that the report suggests a holistic regulation of the financial distribution business, as opposed to an isolated product / sector specific regulation. Although self-regulation may be an effective regulatory solution for the distribution industry, there may be a need for an all-encompassing self-regulatory body across all sectors covering all retail financial products.

In the background of the recent SAT decision quashing the in-principle approval granted to IMFI (promoted by AMFI) to act as an SRO for mutual fund distributors, it would be interesting to see whether the regulators would take into account the recommendations of the Finance Ministry report and opt for an SRO for distribution of all financial products or stick to its original stand of having an SRO only for mutual fund distributors.

7000 Crore SEBI Order Against PACL

In relation to an ongoing proceeding against Pearls Agrotech Corporation Limited (PACL) and its four directors, for illegal and fraudulent mobilisation of funds from the public, the SEBI Adjudicating Officer (AO) has passed a stupefying 7000 crore order, dated September 22, 2015, against the company and the directors; holding the company liable for registration as a CIS under Section 11AA of the SEBI Act, 1992.

As per the order, PACL was mobilizing money without obtaining the requisite registration under the SEBI Act and the CIS Regulations, 1999, and therefore, PACL and its directors had contravened Regulation 4(2)(t) of the SEBI (PFUTP) Regulations, 2003. It is important to note that, pursuant to an amendment in 2013, under Regulation 4(2)(t), the law presumes that illegal mobilization of money under a CIS is a fraudulent and unfair trade practice. Further, the maximum penalty for such practices under Section 15HA of the SEBI Act is Rs. 25 crore or three times the profit made out of such practices. It was alleged that PACL had illegally mobilized funds to the tune of approximately Rs. 2,423 crore after Regulation 4(2)(t) came into force i.e. on September 06, 2013. While determining the quantum of penalty, the AO considered October 01, 2013 as the cut-off date. However, the AO observed that the entire amount which had been illegally raised during the period under consideration can be treated as the amount of disproportionate gain or unfair advantage to PACL and its directors, as the company was not registered with SEBI as a CIS. Finding the instant case to be one fit for the maximum penalty, the AO imposed a fine of approximately Rs. 7,269 crore which is thrice the amount of illegal money mobilized by the company.

The AO ought to have ascertained and considered the "profit" or illicit gains made out of the mobilization of money, and not computed the penalty based on the whole amount that was collected. It is noteworthy that SEBI, by its order dated August 22, 2014, had already asked PACL to refund Rs. 49,100 crore that it had mobilized through 15 years. Therefore, PACL has not only been asked to refund the entire money collected, but also to pay a penalty of three times the amount of money collected, post October, 2013. On a lighter side, if the amendment of September 2013 had always been a part of the SEBI FUTP Regulations, or had it been made applicable retrospectively, the AO could have ordered a whopping penalty of Rs. 150,000 crore.

The Satyam Case: Insider Trading and Pledge

A SEBI Whole Time Member recently passed an order inter alia against relatives of Mr. Ramalinga Raju and entities belonging to the promoter group of Satyam Computers for violation of SEBI regulations on insider trading and fraudulent market practices. The impugned acts involved selling and pledging of shares of Satyam Computers held by them based on unpublished price sensitive information in their possession.

One of the entities against whom the order was passed was SRSR Holdings Pvt. Ltd., a holding company, which owned almost all of the shares held by the promoter group of Satyam. During the period between August 2007 and November 2008, various promoter group entities of Satyam had taken loans amounting to Rs. 1,258 crore from financial institutions and SRSR Holdings had pledged the shares of Satyam on their behalf as security for the loans. The lenders started invoking the pledge between December 23, 2008 and January 7, 2009, on account of shortfall in the margins. It may be recalled that Mr. Ramalinga Raju issued the now infamous letter disclosing financial irregularities in Satyam on January 7, 2009. The WTM in his order stated that SRSR Holdings was an "insider" and since SRSR Holdings could not have pledged the shares without Mr. Ramalinga Raju and Mr. Rama Raju's active connivance, SRSR Holdings had knowledge of financial irregularities in Satyam, which was an UPSI at that time. Lastly, the WTM concluded that the definition of "dealing in securities" included within it all commercial dealings related to the securities and consequently, pledging of shares amounted to "dealing in securities". The WTM held that pledging of shares by SRSR Holdings when under the possession of UPSI amounted to insider trading. SEBI has ordered SRSR Holdings along with the Rajus to disgorge Rs. 1,258 crore which according to SEBI was a wrongful gain made by the entity.

The SEBI order does not lay down a test for distinguishing genuine pledge transactions from fraudulent ones. Further, the SEBI order is based on the premise that it was *reasonably expected* that the promoter group entities had knowledge of fraud committed by Mr. Raju, but does not provide any instance to prove that the relatives and promoter group entities had actual knowledge of the fraud.

Streamlining Listing Requirements From Contract to Law

Based on the proposals made during the SEBI board meeting of November 19, 2014, SEBI on September 2, 2015 notified the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations). The Listing Regulations streamline and consolidate the erstwhile listing agreement requirements for different kinds of securities across various segments of the stock exchanges into a single comprehensive code. The regulations seek to establish sector and security agnostic principles which would serve as a guide for listed entities for making disclosures. In addition, all related disclosure requirements have been classified and collated to ensure ease of reference.

The Listing Regulations will come into force on December 1, 2015. The regulations would be applicable to all listed securities and not just to equity shares and convertible securities.

The Listing Regulations also align the existing listing requirements with the provisions of the Companies Act, 2013. For related party transactions (RPTs), the requirement to pass a special resolution (75%) has been replaced by an ordinary resolution (50%) with a prohibition on related parties from voting. Another major step is that the Listing Regulations now provide a framework for re-classification of promoters as public shareholders under certain circumstances. Although the idea of providing such a framework is good, the conditions for such re-classification may have to be revisited. The said norms regarding RPTs and re-classification of promoters have already come into force while the rest of the provisions will be applicable from December 1, 2015.

From here on, the listing agreement would be reduced to a fraction of its previous length and listed entities would have a period of six months form the notification of the Listing Regulations to execute it. Stock exchanges would be responsible for ensuring compliance with the listing obligations, and would be empowered to take action in case of non-compliance.

Overall, the conversion is a step in the right direction. However, given the principle based approach, materiality standards and subjective disclosure requirements are bound to oscillate for a while after the regulations come into force. On the brighter side, this is a major step to bring up the quality of post-listing disclosures to match primary market disclosures. Significantly, the Listing Regulations elevate the erstwhile contractual obligations of listed companies under the listing agreements to regulatory obligations.

About Us

Finsec Law Advisors is a financial sector law firm which provides regulatory advice and assistance focusing on the securities, investments and banking industry.

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