FINSEC
Law Advisors

Securities and Investment Regulations

Newsletter June 2016

Risk Mitigation Measures for Clearing Corporations

After SEBI's guidelines issued on August 27, 2014, regarding Core Settlement Guarantee Fund (CSGF), Default Waterfall and Stress Test, SEBI on May 04, 2016 issued further guidelines to strengthen the risk management measures for clearing corporations, under the SEBI (Stock Exchanges and Clearing Corporations) Regulations, 2012. The new guidelines prescribe that the investment policy of clearing corporations must be based on the highest degree of safety and least market risk. Investments should broadly be in Fixed Deposits/ Central Government Securities and Liquid schemes of Debt Mutual Funds, subject to applicable restrictions and investment thresholds. Such investments would count as "liquid assets" for calculating the net worth of the clearing corporation.

SEBI has also decided to reduce the provisioning requirements imposed on stock exchanges for guaranteeing settlements. Until now, Regulation 33 of the SECC Regulations required stock exchanges to transfer 25% of their total profits, annually, to their clearing corporation. Pursuant to the August 27, 2014 circular, SEBI required the creation of a CSGF, against which no exposure is allowed. The minimum corpus for the CSGF is calculated though a dynamic formula. Based on the recommendations of the K.V. Kamath Expert Committee, SEBI has decided to remove the requirement to transfer 25% of profits by stock exchanges, as the minimum corpus available in the CSGF of the clearing corporations is seen to be sufficient to cover shortfalls. However, any later shortfall in the corpus has to be replenished immediately. These changes would have a positive effect on the profitability of stock exchanges without blocking excess capital and should be welcomed.

Illegal 'trading tips' through SMS and WhatsApp messages

SEBI issued an order on May 12, 2016, against two individuals who provided investment related advisory services without a certificate of registration from SEBI. The individuals were offering for a fee, trading tips and stock specific recommendations through mobile SMSs/WhatsApp messages and on their website which contained enticing and misleading claims. SEBI had issued an ad interim ex-parte order in June 2014 (which was subsequently confirmed in September 2014), directing the entities to cease and desist from acting as investment advisors. Further investigation has now revealed that the individuals provided investment advisory services without registering under the SEBI (Investment Advisers) Regulations, 2013 and have also violated provisions of the SEBI (PFUTP) Regulations, 2003 (the anti-fraud regulations of SEBI). SEBI, among other directions, issued an order to impound the unlawful gains of over Rs. 5 crore (Rs. 50 million) jointly and severally from the entities.

Apart from this instance, SEBI has taken action (between December 2014 and July 2015) against six other unregistered individuals/entities for providing investment services to the general public. SEBI also issued a press release recently cautioning the public to deal only with SEBI registered investment advisers and research analysts, and to check the registration status of the entity/person on the SEBI website before availing any such service. SEBI has specifically cautioned against trading based on tips received through SMS/ other form of communication from such entities and not to get misled by advertisements through public media, telephone calls, mass messaging which solicit investments or promise unrealistic returns.

Procedural Guidelines for InvITs

SEBI, on May 11, 2016, issued procedural guidelines for public issue of units by infrastructure investment trusts (InvITs). The circular applies to InvITs that invest a minimum of 80% of their assets in completed and revenue generating projects, as only these are permitted to undertake public issue of units under the SEBI (Infrastructure Investment Trusts) Regulations, 2014. As the regulations already deal with the appointment of merchant bankers, filing of offer documents, public consultation requirements, etc., the circular merely provides additional clarity on the procedure.

Further, the circular discusses certain other requirements which the regulations are silent on, such as allocation limits and price determination. In relation to allocation limits, investment by institutional investors has been limited to a maximum of 75% with the remainder being allocated to other investors. In case of under-subscription in any category, the unsubscribed portion may be reallocated to other categories. In regard to the issue price, InvITs may set a fixed price in consultation with the merchant banker or determine the price through the book building process.

SEBI's circular comes at the right time as two entities have successfully obtained certificates of registration from SEBI. However, the larger concern of increasing the number of active InvITs remains. This may be addressed by a consultation paper that was discussed in SEBI's most recent board meeting, which proposes changes to the regime and may smoothen the process of registration and subsequent issue of units. The press release states that SEBI proposes to permit InvITs to invest in two-level SPV structures, reduce mandatory minimum sponsor holding from 25% to 10%, increase permissible number of sponsors, etc. Any further relaxation in the somewhat rigid requirements would enable better use of these vehicles and further investments in the infrastructure sector, which India needs.

What is reasonable due diligence?

SAT, in the matter of Almondz Global Securities Ltd., recently passed an order on May 13, 2016, which touched upon the long debated question of - *What is reasonable due diligence for a merchant banker?*

The merchant banker in this case was prohibited by SEBI from taking up any new assignment or being involved in a new issue of capital for a period of 5 years on the ground of *"complete failure to carry out reasonable due diligence"* while preparing the prospectus of the issuer company. The questions that arose were: a) Were the steps taken by the Appellant towards due diligence of the company sufficient in law?; and b) If not, is the 5 year debarment imposed by SEBI just and proper in the facts of the case?

It was argued that the Appellant, as a legitimate part of its due diligence exercise, had obtained various Statutory Auditors' certificates and had made its own exhaustive enquiries independently as well with the management. In addition, the Appellant had also obtained due diligence reports of the legal advisor to the IPO. Based on the facts of the case, SAT found, on principle, that the Appellant did not perform its duty properly. However, SAT also opined that *"It is settled law that due diligence means reasonable diligence expected from a Merchant Banker. A Merchant Banker cannot be expected to start a due diligence exercise with a presumption of fraud or mischief to be committed by a company whose IPO is to be issued through the Merchant Banker. A Merchant Banker cannot be expected to act like an investigating agency and start with a note of suspicion as regards the bona fides of the company..."* Further it was observed that a merchant banker conducts its due diligence based on the material brought before it by an issuer company and it cannot be expected to perform this duty in a vacuum when information is not made available to it.

Relying on *Chander Kanta Bansal* v. *Rajender Singh Anand*, SAT held that due diligence in law means reasonable diligence and doing ***"everything reasonable, not everything possible"***. SAT held that a punishment of five years of debarment is extremely harsh and highly disproportionate and hence quashed the remnant punishment. This judgment lucidly provides the necessary jurisprudence for ascertaining liabilities of merchant bankers in the capital raising process and comes as a relief to the merchant banking community.

Key Developments from the SEBI Board Meeting

SEBI in its board meeting dated May 19, 2015 took some key decisions including the following:

Offshore Derivative Instruments (ODIs)

Noting the concerns raised by the Special investigations Team with regard to identification of beneficial owners and transferability of ODIs, SEBI has decided to issue additional measures for the purpose of enhancing the transparency and control over the issuance of ODIs. The board has decided to mandate Indian Know Your Customer (KYC) norms upon issuers of ODIs who till date, followed KYC norms of their home jurisdictions or jurisdictions of holders of these instruments. Further, issuers will now identify and verify the beneficial owners in the subscriber entities, who hold in excess of 25% in case of companies and 15% in case of unincorporated entities.

Further, issuers will have to conduct KYC reviews at the time of on-boarding and subsequently, every three years for low risk, and every year for all other clients. Other obligations include, reporting all intermediate transfers that take place in a month (as opposed to recording end holders at the end of every month under the current regime) in the monthly report on ODIs, filing of suspicious transaction reports with the Financial Intelligence Unit, carrying out reconfirmation of ODI positions on a semi-annual basis and putting in place systems and carrying out periodical reviews and evaluation of controls, systems and procedures with respect to ODIs.

Notably, ODI subscribers will now have to seek prior permission of the original ODI issuer for further/onward issuance/transfer of ODIs. In light of the falling reliance on P-notes / ODIs in recent years due to relatively enabling direct investment norms, such measures are expected to raise the cost of issuance and holding of ODIs; making them less attractive, specially for the issuing entity. The law at times imposes regulatory burden on the issuing entity for something which it is able to enforce only by way of contract. If the end investor acts in violation of the law, it would only be in breach of the contract, which the issuing entity would possibly be hauled up for a regulatory violation.

Guidance Note on Settlement Proceedings

SEBI has decided to issue a guidance note clarifying whether violations relating to fraudulent and unfair trade practices may be settled under the SEBI (Settlement of Administrative and Civil Proceedings) Regulations, 2014. These regulations were formulated primarily to settle minor and technical violations which do not have a wider impact on the market thereby allowing enforcement to concentrate on major and significant cases. Until now, based on a conservative approach, all violations involving fraudulent and unfair trade practices have been kept out of the purview of these regulations despite there being sufficient discretion under Regulation 5(2)(b). By way of the guidance note, SEBI is set to clarify that, based on the facts, circumstances and sufficiency of evidence, SEBI would permit the settlement of cases involving fraudulent and unfair trade practices which do not have a bearing on the securities market as whole even if they effect a particular listed security and its investors. This is a welcome move to somewhat widen the scope of consentable cases thereby reducing the enforcement workload of SEBI on more minor cases.

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.

www.finseclaw.com