



# SECURITIES LAW

## The e-Newsletter



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## INTERVIEW WITH MR. UMAKANTH VAROTTIL



### ABOUT MR. UMAKANTH

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#### **1. What in your opinion has caused a soaring number of foreign portfolio investors to flee Indian Markets in 2018?**

It is often difficult to identify a specific factor or set of factors that causes foreign portfolio investors to engage in an orchestrated exit from a market. In the Indian context, reasons attributed include higher US yields, the rupee depreciation and fears of a backlash arising out of a US-China trade war. From a legal and regulatory perspective though, the debate surrounds a SEBI circular issued on 10 April 2018 that tightens the norms for foreign portfolio investments. It effectively prohibits Indian residents or persons of Indian origin from being beneficial owners of foreign portfolio investors investing into India. Although not explicitly stated, SEBI's objective appears aimed at tackling the problems surrounding round-tripping of funds. SEBI has subsequently sought to allay fears, but the extent to which it has calmed nerves remains to be seen.

#### **2. What measures do you suggest for Securities Exchange Board of India (SEBI) and Securities Appellate Tribunal (SAT) to improve their regulatory and adjudicatory efficiencies?**

From a regulatory perspective, SEBI operates as a "mini-state" as it exercises powers of subordinate legislation, acts as an executive in implementing securities regulation and also adjudicates disputes in the field. A credible regulator is required to exercise these powers in a transparent and efficient manner. In doing so, SEBI can adopt a number of measures. SEBI can roll-out a more consultative process while enacting regulations. Various interest groups must be consulted on a meaningful basis and a robust regulatory impact assessment can be rolled out to ensure that the costs of regulation do not outstrip the benefits. The enforcement front requires the greatest amount of attention where SEBI has had mixed success. For example, there is a need for more energetic prosecution of high-profile cases involving matters such as insider trading and market manipulation to restore dented market confidence. This requires greater focus on organisational issues and capacity building measures. While SEBI's powers under legislation have been constantly enlarged over the years through amendments to the law, institutional reforms must keep pace with the exponential growth in the securities markets.

While the SAT has performed an important role in India's securities markets, it has more recently gone into crisis mode. It has been operating without quorum since February 2018 and with only one technical member since July 2018 when its presiding officer, also a judicial member, retired. While the sole member has been taking up urgent



and interim matters, hundreds of securities appeals have been held in abeyance. To avoid such situations in the future, a proper succession planning mechanism must be put in place.

**3. *The Harun Rashid Khan Committee is attempting to provide a regulation revamping FPI Norms, what are your views regarding the same?***

SEBI constituted the Committee with a view to address the concerns raised by its April circular on foreign portfolio investments and KYC norms. Acting with such a mandate, the Committee in its interim report released in September 2018 sought to mitigate the rigour of the SEBI circular. For example, the Committee observed that several aspects of the SEBI circular such as disclosure of beneficial ownership were overbroad in nature as they were premised on the law relating to money laundering whose objectives were different from eligibility for investment as foreign portfolio investors. The Committee also seeks to address other anomalies in the SEBI position on KYC requirements and several prohibitions in structuring portfolio investments into India. Although these measures will help cushion the impact of the extensive KYC requirements that SEBI imposed, much would depend upon the extent to which SEBI retracts from its original approach by operationalizing at least some of the Committee's recommendations.

**4. *In light of the IL&FS downfall, should NBFC norms be tightened? How will it affect the market?***

The norms pertaining to the regulation of oversight of NBFCs has come under severe scrutiny in the light of the IL&FS crisis. For example, NBFCs may tend to take on short-term liabilities while they have long-term, often illiquid, financial assets thereby creating an asset-liability mismatch. This can impact creditors of NBFCs and, left unchecked, lead to systemic issues. Capital adequacy is another aspect worth considering further. Apart from norms on the financial side, emphasis must be placed on corporate governance of such financial institutions, especially on matters such as risk management that play an important role. At the same time, there is a need for caution against going down the slippery slope. Excessive regulation would create constraints that would put several small NBFCs out of the market by placing high barriers to entry and operation. One might expect considerable regulatory thought and action from the Reserve Bank of India in this area in the near future.

**5. *You are running a pioneer blog on corporate law 'IndiaCorpLaw' which has gained authority and popularity in the legal fraternity, please tell us what motivated you to start the blog and what are the challenges involved in managing it?***

The IndiaCorpLaw Blog was established over ten years ago when legal blogging had just become popular. The motivation was to engender a discourse on matters of corporate and commercial law. Unlike conventional forms of legal writing, blogging allows for speedy dissemination of information and analysis on the latest legal developments. Although the Blog was established with minimal expectations, it has enjoyed a wide readership that includes practitioners, academics and students. While the regular contributors constitute a small core, the Blog relies extensively on the "crowdsourcing" model by which we are able to carry guest posts from a diverse range of contributors.

There are challenges galore. The core group of contributors consists of busy individuals and we find it difficult to fit regular contributions into our schedule. While the Blog has fortunately enjoyed a constant pipeline of guest submissions, we also carry the unenviable burden of reviewing them and quite often declining several quality



submissions as guest contributors keep raising the bar. On occasion, it has been a challenge to maintain the regularity and consistency in posting. There is always room for improvement.

#### 6. *How can law schools inculcate securities laws in their curriculum?*

Given the importance of the capital markets to an economy, law schools ought to offer courses relating to securities regulation as upper-level electives or seminar courses. A pre-requisite is that students should have already taken a basic course on Company Law or Corporate Laws. Given the increasingly cross-border nature of securities transactions and their regulation, some emphasis on teaching comparative perspectives would be tremendously useful to the students. This field gives scope to teaching by adjunct faculty and practitioners. Specialised co-curricular activities surrounding securities laws such as moot courts, essay writing competitions and even prospectus drafting exercises would help inculcate practical skills among students. It is heartening to note that some headway has already been made in India on some of these areas.

#### 7. *What would you advise students wanting to pursue a career in securities law?*

A wide range of career options is available to those seeking to pursue securities law. There is a small, but fast growing, band of niche securities law practitioners in India. Some are involved on the transactional and advisory side, while others on the litigation front. It goes without saying that the larger full-service law firms have substantial securities law or capital market teams with the requisite expertise. Other options include in-house legal practice either with corporates (as issuers) or even with investment banks and other intermediaries that require specialised legal advice. The regulatory authorities such as SEBI have themselves provided useful avenues for lawyers seeking career options in the field.

Interested students would do well to take appropriate courses in law school, keep up to speed with market developments and participate in co-curricular activities in the area. Internships in the capital markets field will certainly provide a flavour for the types of issues a prospective lawyer is likely to encounter. Students would also do well to equip themselves with a basic understanding of corporate finance and accounting as they are an integral part of securities law practice.

#### **RECENT DEVELOPMENT IN COMMODITIES DERIVATIVE MARKET**

*By – Apurva Vikram Singh (Attorney Advocate),  
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“When you look at a commodities market you need hedgers and speculators. If you don’t have one, you don’t have a market. That’s how it works.” – **T. Boone Pickens**

Organized commodity derivatives in India started around 1875, scarcely about 10 years after they begun in Chicago. In any case, many expected that

derivatives fueled pointless hypothesis and were impeding to the solid working of the business sectors for the hidden products. Anyway with the benefits earned in commodity market during the decade (2001-02 to 2011-12), has constrained the producers to reexamine their choice of forbidding the commodities market in India. Since, 2002 the Indian Legislature facilitated the limitations and in 2006 the commodity market earned exchange esteem from the future exchanging products for more than US\$ 1 trillion. It initiated a series of unsettling macro-economic effects owing to its large size and volatility.



The prime stimulus of this market is to give a component to decide the possibilities without bounds creation and utilization which will be applied as a powerful influence for the present costs. In this manner, this market set up a connection between the present and future production and utilization cycles in this manner encouraging the transient smoothing of costs. At present the Indian product showcase receives a two-level structure for the component of the framework, viz. Local structures and Countrywide structure. There are 21 regional exchange markets in India. The nationwide national exchanges are multi-commodity electronic exchange with a decentralized possession design. Right now there are nineteen exchange market working at national level, out of which six markets are the prime controllers. They are Multi Commodity Exchange (MCX) Mumbai, National Commodity and Derivatives Exchange (NCDES) Mumbai, National Multi-Commodity Exchange (NMCX) Ahmadabad, Indian Commodity Exchange, the ACE Derivatives Exchange and the General Commodity Exchange. The commodity markets in India are managed by the Forward Markets Commission of India set up in 1953.

In September 2013, the administrative body FMC has been brought under the control of the Ministry of Finance. At present 46 commodities are exchanged six National Exchanges and 11 Commodity specific exchanges. The prospects exchanging agriculture commodities establish the aggregate turnover in 2013-14, with food items contributing 55.6 for every penny and non-agriculture commodities contributing 17.5 for each penny. In any case, the volume of exchange has declined by 39 for each penny amid 2012-13, over the earlier year. The commodities and derivatives market in the nation is directed by FMC and SEBI Government of India. The Forward Markets

Commission has been converged with SEBI with impact from September 28, 2015.

### **FMC/SEBI Merger**

The merger of the two markets (FMC and SEBI), that pursued 12 years of consultations, was a remarkable occasion in India's financial market history. In the Union Budget 2015-16, the Hon'ble Union Finance Minister Arun Jaitley had proposed the merger of FMC with SEBI "to fortify regulation of commodity forward markets and reduce wild speculation". To empower the equivalent, the Finance Act, 2015 accommodated for amending the Securities Contracts (Regulation) Act, 1956 (SCRA) and the Forward Contracts (Regulation) Act, 1952 (FCRA). Government canceled Forward Contracts (Regulation) Act, 1952 (FCRA) w.e.f. September 29, 2015 making ready for the merger of the FMC with the SEBI. The Forward Contracts Regulation Act (FCRA) stands canceled, and the direction of the commodity derivative market shifts to SEBI under the Securities Contracts Regulation Act (SCRA), 1956. The merger of the two controls had been prescribed by different boards of trustees including FSLRC to pick up economies of scale and extension and make the direction of commodity market more compelling. "The merger will build economies of degree and economies of scale for the legislature, trades, money related firms and partners".

### **Sector-Wise Commodity Market Development**

The highest traded commodity with 46% per share and estimation of Rs 78.63 lakh crores, trailed by the vitality products with estimation of Rs 37.68 lakh crores and offer of 22%, base metals with an estimation of Rs 32.60 lakh crores and offer of 19% and the agriculture products quote estimation of Rs 21.56 lakh crores and 13% share. Out of the nineteen trade showcases, the six trades – MCX, NCDEX,



NMCE, ACE, and ICE adds to 99.71 per penny of aggregate estimation of the items exchanged.

#### *MCX Mumbai*

The main commodity exchanged in this trade was silver with an offer of 27.46 for each penny. The aggregate amount exchanged for silver was 7.11 lakh tons at Rs 4086933.38 crores. The second is gold with the offer of 25 for every penny and estimation of Rs 3720129.35 crores. Further, crude oil, copper and gaseous petrol with 20.04 for each penny, 9.70 for every penny and 4.52 for every penny share.

#### *NCDEX Mumbai*

In this exchange market, soya oil has been the main commodity being exchanged with an offer of 34.88 for each penny. Pursued by soybean, mustard seed, and castor seeds with 13.64 for each penny, 11.27 for each penny, 9.98 for every penny, and 5.87 for each penny share.

#### *NMCE Ahmedabad*

In this market, espresso gained the most extreme offer of 11 for each penny, which was cited at Rs 19425.91 crores and volume of 14.39 lakh tons. The prepared cost of jute in this market was Rs 18375.45 crores and volume of 68.18 lakh tons. Aluminium was exchanged all agreements for Rs 14850.14 crores and volume of 13.62 lakh tons.

#### *ICEX Mumbai*

The real commodity traded this market are unrefined petroleum, gaseous petrol, silver, copper, gold and iron mineral. Their offer in all-out exchange esteem is 24.55 for each penny, 18.34 for every penny, 16.79 for every penny, 16.02 for every penny, 11.79 for each penny and 7.23 for each penny individually.

### **Challenges to Commodities Market**

Our nation, being firmly farming based has to battle with the long haul decrease and unpredictability of real commodity costs on worldwide markets. The long haul decrease in real costs reflects the propensity for profitability and creation to develop at a quicker rate than interest, prompting over-production which hampers the value given to the farmers. Though the unpredictability reflects the effect of exogenous factors, such as climate on our production of commodities. These issues are exacerbated by market bends, taxes and endowments in created nations, levies in creating nations and the market control in some product supply chains of huge transnational companies.

### **Conclusion**

India is one of the best makers of an expansive number of commodities ranging from agricultural to non-agricultural items, with a long history in its exchanging market. These business sectors have been encountering high points and low points since its origin, yet with fortifying of the working our nation has possessed the capacity to convey a level of stability to this market. It has been progressing in innovation, transparency and exchanging action with the expulsion of government insurance from various commodities. In this way the progression turns out to be a major exercise for all the developing economies that the estimating and price risk management to be left to the market powers instead of to be reliant on the managed value system. In this manner, all the above exercises will go about as a harbinger to the achievement of the commodity markets in our nation.



## **SEBI (APPOINTMENT OF ADMINISTRATOR AND PROCEDURE FOR REFUNDING TO THE INVESTORS) REGULATIONS, 2018 – AN INSIGHT**

*By – Devina Srivastava (Symbiosis Law School, Pune)*

### **Introduction**

The Securities and Exchange Board of India (“SEBI”), on October 3, 2018, notified and brought into effect the SEBI (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018 (“the Regulations”). The aim of the Regulations is to provide for appointment of an Administrator to recover investors’ dues from listed companies in case of their failure to comply with disgorgement or refund orders passed by SEBI under the relevant provisions of the Securities and Exchange Board of India Act, 1992 (“SEBI Act”), the Securities Contracts (Regulations) Act, 1956 and the Depositories Act, 1996. The Regulations govern for the following aspects:

- Appointment of the Administrator;
- Sale of properties attached by the Recovery Officer appointed by SEBI;
- Recovery of disgorgement amounts directed by SEBI;
- Collection of claim documents and verification of claims of investors;
- Refund of monies to the investors;
- All matter incidental or connected thereto.

It is pertinent to discuss the appointment, role and functions of the administrator as well as the recovery process under the Regulations for a comprehensive understanding.

### **Appointment of the administrator**

The Administrator will be appointed by SEBI after an attachment order is passed by the Recovery Officer against a defaulter. He should be a registered

Insolvency Resolution Professional and not have any conflict of interest with the defaulter, its directors, promoters, key managerial personnel and its group entities. The terms and conditions of appointment of the Administrator will be decided by SEBI on a case-to-case basis.

### **Role and functions of the administrator**

The Administrator, subject to directions by the Recovery Officer, will collect information relating to properties owned by the defaulter and claims of investors, make a record of properties attached in by the Recovery Officer, arrange for a proclamation of the sale of the properties, sell the attached properties, open a bank account (under control of the Recovery Officer), deposit the sale proceeds of properties in it, call for claims from investors for refund, verify claims, and settle them.

For the purpose of discharging these functions, the Administrator can engage the services of a Chartered Accountant, a Registered Valuer, a Registrar and a Share Transfer Agent. However, the fees to be paid to these professionals should be within the overall fees fixed by SEBI for the Administrator.

The Regulations also list a number of general obligations and responsibilities of the Administrator, such as that he shall maintain a high standard of integrity, promptitude and fairness in the conduct of his work and act with due skill, care and diligence. The Administrator is entrusted with wide powers which must be exercised fairly and under the supervision of the Recovery Officer.

To ensure that the Administrator carries out his functions properly, the Regulations mandate that the Administrator will submit a monthly report or a report as and when called for by the Recovery Officer detailing the progress of his work.



### **Refund of monies to investors and completion of recovery process**

After verification of claims of the investors, the Administrator will consider the monies available for distribution and determine whether the whole amount or a proportionate amount is to be repaid to the investors. The Administrator will then, in consultation with the Recovery Officer, repay the money to the eligible investors through pay orders, demand drafts or electronic transfer. The amount remaining will be retained in the interest-bearing escrow account for a period of 3 years to satisfy any further claims and then be transferred to the Investor Protection and Education Fund of SEBI. A legible claim can then be honoured from this fund for a further period of 3 years. In case the monies realized are more than the amount due to investors, the excess will be refunded to the defaulter after 3 years of completion of the refund process.

After completion of repayments or recovery of the disbursement amount, the Administrator has to file a detailed report to the Recovery Officer or SEBI, as the case may be.

### **Costs incurred in Administration and priority in the distribution of sale proceeds**

All costs incurred in the administration process, including the Administrator's fee, will be borne by the defaulter. In case the defaulter is unable to pay, the monies recovered by the Board shall be appropriated in priority to the other liabilities. As per Regulation 11, the proceeds from the sale of properties will be distributed in the following order of priority:

1. The costs of administration incurred by the Board;
2. Monies payable to investors;
3. Any other penalty or fees due from the defaulter to SEBI.

### **Default by the Administrator**

As per Regulation 16, in case of default by the Administrator, the Recovery Officer can not only recommend his replacement but can also recommend initiation of appropriate legal action to SEBI. SEBI can then, or on its own motion, remove the Administrator, forward the matter to the Insolvency and Bankruptcy Board of India for action or issue directions against the Administrator practicing in the securities market. Thus, serious consequences ensue in case of any default by the Administrator.

### **Issues and Nuances**

Though the Regulations are a positive step in the direction of a modern and comprehensive regime on investor protection, they are still fraught with certain uncertainties. Primarily, there is a lack of clarity on the applicability of the Regulations *vis-à-vis* the Insolvency and Bankruptcy Code of India, 2016 (IBC). The controversy is pertinent as both, the SEBI Act, 1992, under Section 28A (3), as well as the IBC, under Section 238, delineate their non-obstante nature.

Thus, ambiguity arises in the case of an insolvent company, against which recovery proceedings are initiated under the Regulations as well as action under the IBC. In such a case, would the moratorium under Section 14 of IBC apply to the recovery process under the Regulations? As per Regulation 3(2), the Regulations will be inapplicable in cases where an administrator or any other person is appointed by a Court for the purposes of recovery and/or repayment to investors. However, the term 'court' is not defined anywhere, leading to ambiguity about whether an order by the National Company Law Tribunal (NCLT) appointing an insolvency professional would frustrate recovery proceeds under the Regulations or not. Applying the



principle of interpretation, *ejusdem generis*, it seems likely that even an order by NCLT would be considered a court order. However, since the purpose of both legislations are different, as the IBC intends to provide a mechanism for resolution of insolvency while the Regulations provide for recovery of money by investors, it is possible that there would be a deadlock between the two legislations. This will be further aggravated by the different waterfalls of priority provided under the IBC and the Regulations. Hence, clarity is required in this regard.

### **Conclusion**

Though the Regulations pose certain issues, which can only be clarified by their practical operation, they are a significant step towards ensuring a better investor-protection regime in India. What is notable is that they provide for technology-driven solutions such as an e-auction, online notices, online verification of claims of investors and payment of money through electronic transfer using NEFT or RTGS. The Regulations are progressive and noteworthy.

### **SECURITIES AND EXCHANGE BOARD OF INDIA (BUYBACK OF SECURITIES) REGULATIONS, 2018**

*By – L Sai Charan, NUALS*

On March 28<sup>th</sup> 2018, SEBI published a report which included new draft regulations replacing the SEBI (Buyback of Securities) Regulations, 1998 and SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and invited public consultation on the same. The primary purpose behind enacting these regulations was to enhance the existing provisions and make it more user friendly. The language of the regulations was simplified and redundant provisions were removed. Further, new provisions complying with the Companies Act, 2013

and SEBI Circulars were incorporated in the newly drafted regulations.

This note contains a brief analysis of the SEBI (Buyback of Securities) Regulation, 2018 (hereinafter ‘New Regulations’) and compares it with SEBI (Buyback of Securities) Regulation, 1998 (hereinafter ‘Old Regulations’).

The new regulation, has brought in many changes to avoid ambiguity and uncertainty vis-à-vis buyback of shares.

### **Definition of ‘Buyback Period’**

Although the term ‘buyback period’ was mentioned in various provisions, it was not defined in the old regulations. To provide certainty, the new regulations under regulation 2(d) defines ‘buyback period’ as the time period between approval for the buyback of shares by the company and completion of the payment for the acquisition of shares from the shareholders. It begins either on the date of resolution by the Board of directors or date of declaration of results of the postal ballot for special resolution, authorising the scheme of buyback of shares and ends on the date of payment of consideration by the company to its shareholders.

### **Conditions and requirements of buyback of shares (Regulation 4)**

- Maximum Limit of buyback of shares and specified securities:

Regulation 4 stipulates that the maximum limit of buyback shall be 25% or less the aggregate of paid-up capital and free reserves of the company. In case of buyback of equity shares, total paid-up capital equity capital in the financial year shall be taken into consideration. Further, post buyback of shares, the ratio of the secured and unsecured debt of a company shall not be more than twice the paid-up capital and free reserves.



### **Prescribed manner for buyback of shares and specified securities**

Essentially, all shares or other specified securities involved in the buyback scheme shall be fully paid-up. A company may buy back its shares in three methods: *firstly*, it may buy the shares of the existing shareholders or other specified securities holders on a proportionate basis through the tender offer. *Secondly*, it can buy shares and other specified securities from the open market through the book-building process, or stock exchange. *Thirdly*, the company may buy shares and other specified securities from odd-lot holders. In case of a company buying shares from the open market, it is obliged not to buy back shares more than or equal to 15% of the paid-up capital and free reserves of the company.

Further, a company is obliged to buy back shares and other specified securities only through its (a) free reserves; (b) the Securities Premium Account; or (c) the proceeds of the issue of any shares or same kind of shares or same kind of other specified securities. Further, no such buy-back shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

### **Prohibition on purchase of own shares or securities**

Regulation 4(x) prohibits a company directly or indirectly to purchase its own shares or other specified securities:

- Through any subsidiary company including its own subsidiaries;
- Through any investment company or group of investment companies.

### **Compliance and requirements for buy-back**

Regulation 5 provides that the company by virtue of its Articles of Association shall be empowered to buy-back shares or other specified securities. A

special resolution shall be passed at the general meeting permitting the buy-back. However, in case the buyback is 10% or less than the total paid-up equity capital and free reserves of the company, it shall be authorised by the Board of Directors through a resolution passed at its meeting of Board of Directors.

### **Time period for completion of buyback process**

Regulation 5(ii) stipulates that every buy-back shall be complete within a period of one year from the date of passage of the special resolution at the general meeting or the resolution passed by the board of directors of the company. After the expiry of the buyback period, the company shall file the return with Registrar of the Companies and the Board containing relevant particulars relating to the buyback scheme within a period of 30 days.

### **Timeline for public announcement**

Regulation 7(i) postulates that a company which has authorised the buyback scheme either through special resolution or a resolution passed by board of directors, shall within two working days publish the results of the meeting. The timeframe of 2 days was incorporated in the regulations to remove uncertainty with respect to initiation of the buyback scheme.

### **Manner in which buyback is offered**

Regulation 9 provides that a company offering buyback shall announce a record date publicly, to determine the eligible security holders for participating in the scheme. The letter of offer along with the tender form shall be dispatched to the eligible security holders. This may also be done electronically in accordance with the Companies Act, 2013. However, in a case where an eligible public shareholder does not receive tender offer/offer form, he may participate in the buy-back offer and tender shares in the manner provided by



the Board. An unregistered shareholder may also tender his shares for buy-back by submitting the duly executed transfer deed for transfer of shares in his name, along with the offer form and other relevant documents as required for the transfer.

### **Register of buy-back scheme**

Under Regulation 13, a company is obliged to maintain a register which shall include all details of shares or securities bought such as consideration paid for the shares or securities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities and such other particulars as prescribed under Section 69 of the Companies Act, 2013.

### **Escrow Account**

The Company is obliged to conduct the buyback scheme through an Escrow Account. As per Regulation 9(xi), it shall deposit certain amount into the Escrow Account as security for performance of its obligations under the regulations. Further, the new regulations have permitted the company to maintain the cash components of the Escrow Account in an interest-bearing account. This allows the company to accrue interest for the amount deposited in the Escrow Account.

The regulations as discussed above have been amended and modified to prevent lack of clarity and ambiguity regarding them. The regulations were amended to comply with the recent amendments to the Companies Act, 2013. Further, certain circulars were included in the regulations making them comprehensive in nature. Finally, the regulations strive to prescribe a hassle-free manner for buying back of shares.

## **DISSECTING SUDHIR MENON HUF V. ASST. CIT: TAX IMPLICATIONS OF RIGHTS ISSUE**

*By – Suyash Bhamore, NLIU Bhopal*

### **Background and Context**

Rights issue of shares is an option given to the shareholders subsisting in the company to subscribe to additional shares at a cost lower than the actual market price. Computation of capital gains and the consequently arising tax liability from acquisition and renunciation of right shares has always been a vexing issue for the stakeholders as well as the tax authorities. A renounceable right issue refers to a type of share which vests with the existing shareholders the power to abstain from exercising his right to apply for those shares and instead allows transfer of his right in favour of third parties, who then gain the right to apply for the concerned shares.

While apprehensions concerning capital gains tax lie at the forefront of the populace dealing in equity share transactions, they often ignore the tax insinuations flowing from the head of 'other income'. One such issue was underlined by the Mumbai Income Tax Appellate Tribunal ("ITAT") in its ruling of *Sudhir Menon HUF v. Asst. CIT*, wherein it was held that notional income generated from receipt of shares at a value subservient to the fair market value ("FMV") would not attract tax, as long as the shares were allotted proportionately to all shareholders.

The discussion revolved around Section 56 (2) (vii) of the Income Tax Act, 1961 ("the Act") which provides for taxing any individual or a Hindu Undivided Family on the notional income arising on account of receipt of any property for consideration which is less than its FMV. Although this Section was made inoperative owing to The Finance Act, 2017, it does not bereave the order of its importance, as the Finance Act, 2017 simultaneously introduced



Section 56 (2) (x) as a substitute of Section 56 (2) (vii). Notably, Section 56 (2) (x) of the Act encompasses the exact same language as 56 (2) (vii), except that it is applicable to all kinds of assesses instead of just individual and Hindu Undivided Family. (“HUFs”)

The order has cemented the position that tax implications do not arise when there is proportionate allotment of shares. Nevertheless, there still remains ambiguity concerning the status of tax implications flowing from renounced right shares. The article aims to test if renunciation of right shares by an existing shareholder to a third party beneficiary would lead to a disproportionate allotment and thus attract the provision contained in Section 56 (2) (x) of the Act.

### **Ruling of the Tribunal**

The tribunal was faced with the issue of whether the assessee could be taxed on the difference between FMV and subscription price of the shares, as ‘Income from other sources’ under Section 56 (2) (vii) (c) of the ITA.

Section 56 (2) (vii) (c) has been provided herein below for the reader’s perusal –

*“56(2) the following incomes, shall be chargeable to income-tax under the head “Income from other sources”, namely: —*

*(vii) where an individual or a Hindu undivided family receives, in any previous year, from any person or persons on or after the 1st day of October, 2009, —*

*(c) any property, other than immovable property, —*

*(i) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;*

*(ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration.”*

It is amply clear from the language used in Section 56 (2) (vii) (c) that the assessee must be in receipt of some property, for the earnings to be chargeable to income tax under the head of “income from other sources”. In a similar vein, the Tribunal noted that issue of additional shares proportional to existing shares creates no additional property receivable by the shareholder, resulting in accrual of no additional income. Therefore, issuance of shares as per proportionate allotment was made immune to tax liability under Section 56(2) (vii). Proportional allotment in context of rights issue refers to allocation of shares on a pro rata basis. For instance, a holder of two shares would be entitled to one right share; thus, as long as the scheme of apportionment of shares runs along these lines, the assessee would be exempt from tax liability.

It must be realized that while coming out with such a statement, the tribunal has restricted the order’s applicability only to situations where there is a proportionate allotment of shares, and not a disproportionate allotment. The fact that rights issue shareholders typically carry with them a right to renounce the shares warrants a further analysis of the ruling at hand. There is a substantial uncertainty surrounding the issue of whether subscription by renounced rights share by third parties amounts to a disproportionate allotment of shares.

### **Analysis**

The tribunal has made it clear in the first place itself, that the order shall be binding on all kinds of shares and not just right issues, for two reasons – first, the said offer of issuance of shares could not be treated



as a rights issue as Section 81 of the erstwhile Companies Act, 1956 did not provide for rights issue by a private company; and second, no right of renunciation was granted to the shareholders in the instant case by the issuing company. Consequently, the ambit of this ruling is applicable to any share issuance by a company, whether as a rights issue or otherwise, thereby importing a larger scope of application to it.

The Tribunal's ruling stems from the rationale that only disproportionate allotment, as opposed to proportionate allotment, is equivalent to receipt of additional property. Accordingly, disproportionate allotment induced due to renunciation of the right to participate in favour of a third party would be hit by Section 56 (2) (vii).

It is important to understand the tribunal's rationale behind creating a dichotomy between proportionate and disproportionate allotment to answer the question satisfactorily at the end of the discussion. In the opinion of the tribunal, issuing of shares in nature of rights issue was only an apportionment of the value of their existing shareholding. In simple words, when additional shares are offered to a person on a basis proportionate to his existing shareholding there is no receipt of additional property. The receipt of the property occurs only their allotment, effective from the date on which they come into existence. There exists only the right to apply for such shares, which when exercised results in complete materialization of the shares. Extending this logic further, the author opines that renunciation of shares leads to disproportionate allotment of shares and hence creation of an additional property, which is not a result of the previous shareholding of the new right bearer.

On a concluding note, the researcher is of an opinion that although the tribunal has not addressed the issue concerning renounced right shares, an inference

based analysis of the ruling reinforces the stance taken by the researcher, that renounced right shares would attract tax liability under the head of 'income from other sources' owing to Section 56 (2) (x) of the Act.

### RECOGNIZING MARKET GAUGING VIS-À-VIS INSIDER TRADING REGULATIONS IN INDIA

*By – Ram Kumar & Nayan Mittal, Symbiosis Law School, Pune*

#### **Introduction**

The preamble to the SEBI Act provides for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto. In order to fulfil this broad mandate of investor protection, SEBI requires listed companies to adhere to the strict disclosure requirements as per the securities law of the country and more specifically the laws governing insider trading.

The basic tenant of Insider Trading regulation has two fundamentals:

- Indian Investors contribute their capital towards the market, with the objective to earn dividend and earn shareholder value. While investing there should be a sense of security in the minds of investors that the marketplace is disseminating information indiscriminately and those who are privileged with special information about crucial events should not trade ahead and reap the profits/avoid the losses to the detriment of those typical investors who buy or sell stock without the advantage of such "confidential" Information.



- Secondly, the Prohibition of Insider Trading (“PIT”) Regulations also prohibit insiders from communicating Unpublished Price Sensitive Information (“UPSI”) relating to the company or securities, to any person except where such communication is in furtherance of legitimate purpose, performance of duties or discharge of legal obligations.

T K Vishwanathan committee’s report on fair market conduct has noted that there is no strict definition of the term, “Legitimate Purpose” either under the Act or PIT Regulations, 2015 and it would be not wise to confine it within the broad contours of an inclusive definition or otherwise. The correct test would be to judge the legitimacy of any communication on the basis of facts and circumstances keeping in mind that the regulations were framed with the intention to regulate, not stop genuine corporate transactions from taking place.

#### **Communication of information to undertake market gauging**

The legitimacy of communicating information by merchant bankers while conducting *market gauging* exercise, with the aim to calculate the potential demand for the securities was for the first time questioned by SAT in the recent judgement of Factorial Master Fund v. SEBI, dated June 29, 2018.

#### **Analysis: SAT Order in the matter of Factorial Master Fund**

In India, SEBI for the first time recognised the practice of market gauging when it passed its final order dated December 08, 2016 against Factorial Master Fund directing it to disgorge certain amount on account of violation of Insider Trading Regulation for dealing in the scrip of L&T Finance Holdings Limited (“LTFH”) while in possession of UPSI which it received by virtue of being a

participant in the market gauging exercise. However, The Whole Time Member negating the liability of merchant banker, in this case, observed that communication of UPSI between the merchant banker and Factorial was in the ordinary course of business or employment, having been made as part of a market gauging exercise prior to the launching of the offer for sale (“OFS”). The same was also pointed out by the Hon’ble SAT while giving its judgment.

Further SAT gave another dimension to the whole aspect by observing as under

*“Before parting, we would like to bring it to the notice of SEBI that the question as to whether investors participating in the market gauging exercise should be allowed to trade in all segments of the market prior to the issue opens needs to be looked into.”*

#### **What are Market Gauging/Market sounding exercises?**

In capital market transactions, such as raising capital through IPO’s, FPO’s, private placements, Private investment in public equity (“PIPE”) deals etc., pre-soundings and pre-marketing activities take place in advance of capital raisings, prior to formal announcements to gauge interest in, or support for, a particular transaction. As part of such activities, inside information is likely to be disclosed to market participants.

*For e.g.* A company planning to raise capital through private placement will appoint various intermediaries such as Law Firms, Merchant Banker, Underwriters, to assist it in the completion of the transaction. The appointed merchant banker before taking any concrete step towards crystallisation of the transaction will first reach out to sophisticated institutional investors/High Net-worth Individuals/QIBs etc. to gauge their interest.



This investor feedback exercise is important to ascertain the commercial feasibility of the proposed transaction i.e. whether the success of the transaction is probable. As a part of such Market Gauging exercise, the merchant banker is bound to disseminate certain information to the selected investors. This act of making a person an “insider” by providing them with inside information is called wall-crossing.

It is pertinent to note that there is no regulatory definition of market gauging in India.

### **Global Recognition of Market Sounding practice in commercial transactions: Comparison with India**

Article 11 of European Market Abuse Regulation (EU) No 596/2014 defines the practice as,

*“A market sounding comprises the communication of information, prior to the announcement of a transaction, in order to gauge the interest of potential investors in a possible transaction and the conditions relating to it such as its potential size or pricing, to one or more potential investor.”*

Article 11 further states that disclosure of inside information made in the course of a market sounding shall be deemed to be made in the normal exercise of a person’s employment, profession or duties where the disclosing market participant complies with the following conditions:

- I. The disclosing market participant shall make and maintain a record of all information given to the person receiving the market sounding, and
- II. Inform the person receiving the market sounding that he is prohibited from using that information, or attempting to use that information, by acquiring or disposing of,

for his own account or for the account of a third party, directly or indirectly, financial instruments relating to that information, and

- III. Inform the person receiving the market sounding that he is prohibited from using that information, or attempting to use that information, by cancelling or amending an order which has already been placed concerning a financial instrument to which the information relates, and
- IV. Inform the person receiving the market sounding that by agreeing to receive the information he is obliged to keep the information confidential.

In India, there is a need for discussion papers/consultative notes and/or proper guidance by SEBI as to the conversations that may be engaged in with prospective investors while conducting such market gauging. Moreover, there is a need to bring in designated rules for practices under such exercises in order to eliminate the possibility of a potential violation of Insider Trading Regulation. Following recommendations may be adopted:

### **Recommendations given by T K Vishwanathan committee report**

1. Since the definition of “Legitimate Purpose” for the communication of UPSI may be defined restrictively or expansively, the discretion should be given to the Board of Directors of listed companies/intermediaries to define its entity’s policy regarding legitimate purpose based on the business or industry related needs.
2. The listed company/ merchant bank/ other intermediary engaged in the market gauging exercise must maintain an



electronic record containing details of the individuals/entities with whom UPSI is shared and the nature of such information.

3. The listed entity/intermediary engaged in market gauging exercise must enter into confidentiality agreement/Non-disclosure agreement with potential investors in order to ensure compliance with PIT Regulations.

### **Recommendations given by Authors**

1. Trading done ahead of market gauging exercises may invite Insider Trading Regulations. The company must decide in advance whether any inside information will be disseminated while carrying out market gauging and must take adequate steps to protect it.
2. There must be an express agreement wherein the potential investor undertakes not to trade in the securities of the company, till the time information is cleansed. Therefore, entering into a mere Confidentiality Agreement/ Non-Disclosure Agreement will not suffice. (As seen in the case of *Mark Cuban vs. SEC*) Hence express standstill agreements must be signed during such market gauging exercises for not trading in the scrip of the company till the time inside information is cleansed.
3. The market sounding exercise should take place as close as possible to the launch of the transaction.
4. The compliance team of the entity going for the issue must be notified about the market sounding exercises that may take place. The compliance team may be made

responsible to notify any suspicious trading in the scrip of the company ahead of such gauging exercise, by the potential investors.

5. Exceptions must be carved out for potential investors, trading ahead of a market gauging exercise, done with a legitimate objective, such as to acquire toehold in the company in order to check the viability/sustainability of a merger.
6. The intermediaries involved in such exercises should be cautious of mentioning the name of the company while carrying out market gauging exercise. There should be a clear demarcation in exercises wherein discussions are carried out on a no-name basis and feedback exercises wherein names are explicitly mentioned. This is so as to prevent potential leakage of UPSI. Many-a-times, it is possible for investors to complete mosaic of information already available in the market and mix it with information so obtained during market gauging and make it the basis for trading in the scrip of that company which is illegal.

### **IMPACT OF SEBI'S NEW KYC NORMS ON FPIs**

*By – Syamantak Sen & Khushbu Turki, National Law Institute University, Bhopal*

#### **Introduction**

The Securities and Exchange Board of India (SEBI) is the Indian regulatory authority, which monitors the activities in the securities market to facilitate efficient mobilization and allocation of resources and prevent any malpractices. Important stakeholders in the Indian Stock Market are the foreign investors who purchase securities and other financial assets in the country, but do not participate



actively in the management of those assets. Such investors are referred to as Foreign Portfolio Investors (“**FPIs**”).

The SEBI has prescribed certain Know Your Client (“**KYC**”) norms for these FPIs, depending upon the category they fall into. These norms are fundamentally administered by the provisions of the Prevention of Money Laundering Act, 2005 (“**PMLA**”) and the Prevention of Money Laundering Rules, 2005 (“**PMLA Rules**”). In a circular dated 10<sup>th</sup> April 2018, SEBI tightened these norms and disallowed Resident Indians (“**RI**s”), Non Resident Indians (“**NRI**s”), Persons of Indian Origin (“**PIO**s”) and Overseas Citizens (“**OC**s”) from being beneficial owners (“**BO**s”) of a foreign portfolio investment.

This move to amend the KYC norms for FPIs was primarily to curb money laundering and round tripping of funds, which is a common strategy involving the sale of certain assets from one company to another with an agreement to purchase the assets back sometime in the future, so as to present an inflated revenue figure. SEBI considered it essential to curb such practices, especially in cases where the investment was being routed through high risk jurisdictions, i.e. countries with a known history of funding terrorist activities or money laundering. Accordingly, existing FPIs were provided a time frame of six months from the date of the circular to comply with the requirements stipulated therein.

### **Regulatory changes in KYC norms over time**

#### **A. FPI Regulations, 2014**

The Foreign Portfolio Investors Regulations, 2014, specified three categories of FPIs. Category I FPIs enlisted the lowest risk entities like foreign governments and government related foreign investors. Category II FPIs comprised of broad-based funds, appropriately regulated entities, funds

whose investment manager was appropriately regulated, university funds and the like. Category III covered the FPIs who were not eligible under the first two categories. Category I and II FPIs were classified as low-risk investors while Category III FPIs were considered to be high-risk investors. The review in KYC norms was to be based on this risk categorization of the FPIs.

#### **B. Introduction of new norms**

Recently, the SEBI came out with several regulatory changes governing the FPI regime in the April 10 circular. Some key ones included changes in the KYC requirements for FPIs and confinements on FPI investments.

As per the SEBI circular dated September 12, 2018, eligible foreign investors would be subject to KYC review as and when there would be any change in material information / disclosure. It was however decided that henceforth there would be a comprehensive KYC review of FPIs on a periodical basis and the KYC review, including a change in BOs/ their holdings, would be done based on risk categorization of FPIs. In case of high risk clients, including those coming from high risk jurisdictions, it would be done on a yearly basis. In case of all other clients, the KYC review would be conducted every 3 years.

The September 12<sup>th</sup> circular had also exempted FPIs from furnishing certain KYC documents depending on the risk involved. This provision was also modified by the SEBI, which instructed that in respect of exempted documents, the FPIs concerned would submit an undertaking that they would provide the relevant documents as and when demanded by the Law Enforcement Agencies. Further, Category III FPIs, had previously been exempted from submission of proof of address of BOs, Senior Management and Authorised



Signatories. But since Category III FPIs are high risk investors, it was decided that a “declaration on letter head” would be provided by them.

The FPIs were also asked to disclose names and addresses of the beneficial owners; whether they were acting alone or together through one or more natural persons as a group; jurisdiction of tax residence; and the percentage of shareholding capital held by the BOs in the FPI. In case of companies/trusts represented by service providers like lawyers/accountants, FPIs were asked to provide information of the real owners/effective controllers.

The existing FPIs were asked to provide these documents within six months from the date of the April 10<sup>th</sup> circular. Failure to comply with the same before the deadline would lead to a prohibition on the concerned FPI from making any new purchases in the market.

### **C. Modifications to the circular**

Given the extensive debate generated by the SEBI circular among market participants and its far-reaching implications on investments in India through the FPI route, a working group was constituted by SEBI to look into the concerns of various stakeholders like FPIs and suggest changes.

A new circular came out on September 21<sup>st</sup>, incorporating certain changes in policy, as suggested by the Working Group. It stated that the BO criteria in the PMLA rules would be made applicable only for KYC and not for determining the eligibility of the FPIs and that where no BO could be identified based on the controlling ownership; a Senior Managing Official (“SMO”) would be identified as the BO.

It also asked the SEBI to do away with the additional KYC requirements for BOs in case of Government-related FPIs (Category I FPIs). For Category II & III

FPIs from high risk jurisdictions, KYC review would be done annually and for all other cases, it would be done at the time of continuance of FPI registration.

SEBI also extended the deadline for complying with the new KYC norms and gave two years to the existing FPIs and new applicants from the date of coming into force of the amended regulations or from the date of registration, whichever would be later in order to comply with its revised norms.

### **Importance of foreign portfolio investments**

Foreign Portfolio Investment is one of the largest types of capital flows into India. The advent of portfolio investment supplements domestic saving. It also helps in improving the investment rate. It reduces the pressure of foreign exchange gap for developing countries like India, making it easy to import necessary investment goods. Foreign portfolio investment also facilitates the induction of financial resources from capital-abundant countries, where expected returns are low, to capital-scarce countries, where expected returns are high. This gives an upward thrust to the domestic stock market prices, along with an increase in output. FPIs put resources into Indian capital markets and have long been a key driver of Indian stocks.

### **Impact of the new norms**

The new norms require the FPIs to disclose quite a lot of information regarding the BOs and hence they have not gone down well with all the FPIs. Many of them have raised serious privacy concerns about the kind of information being demanded in the KYC, which includes the address, date of birth, tax residency number and passport number besides other details, of the BO. They claim it to be far more than the disclosure norms in other countries and many FPIs have admitted to being uncomfortable about sharing too much information with a country,



which does not have stringent data protection or privacy laws yet.

Many FPIs claim that the new norms have a retrospective effect as they are obligated to disclose information related to investments made by the investors in the past. They also believe that the requirement of excessive documentation and authentication costs would ultimately strain their existing resources.

As the new norms come into effect, many global investment firms which are unwilling to divulge too much information regarding their BOs and SMOs might not be seen investing in the Indian Stock Market in the near future. It seems as if the SEBI, in its fear to address the risk of round-tripping, might have swung the pendulum too far, and driven off many legitimate investors, which could lead to market instability in the future.

#### **SEBIS REVISED KYC ACCESS NORMS FOR FPIs**

By – Akshay Awasthi, RGNUL, Patiala

#### **Background**

Securities and Exchange Board of India issued a notification (CIR/IMD/FPIC/CIR/P/2018/64) on April 10, 2018 revising the KYC norms related to beneficial ownership in foreign portfolio investment (**hereinafter FPI**). The capital markets regulator has made applicable to KYC the beneficial ownership criteria in the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 (PMLA Rules). However, the above notification was short lived as it was revised by the regulator issuing two circulars on September 21, 2018 (CIR/IMD/FPIC/CIR/P/2018/131 and CIR/IMD/FPIC/CIR/P/2018/132) based upon recommendations of working group headed by Mr. Harun Rashid Khan, making the PMLA Rules applicable for KYC

purpose only and not to determine eligibility of the FPIs.

Below mentioned is the corpus of the SEBI notification which has regulated the KYC norms with respect to FPIs.

#### **Relaxations to Non Resident Indians/ Overseas Citizens of India / Resident Indians**

**NRIs / OCIs / RIs** are permitted to have economic interest in FPIs subject to certain restriction. An Investment by a single NRI / OCI / RI in a FPI should be less than 25 per cent of the corpus of the FPI - Investments by all NRIs / OCIs / RIs taken together should be less than 50 per cent of the corpus of a FPI. However, these persons cannot be in

control of the FPI and only investment managers can control the FPI if they are properly regulated and are registered with SEBI.

**Investment by RI:** RIs can invest in FPIs on the condition that the India exposure of such FPIs is less than 50 per cent of its global portfolio. Further, the investment by RIs should be made under the Liberalized Remittance Scheme (LRS) of the RBI.

**Foreign investors are not restricted to Senior Managing Officials** of a FPI notwithstanding their identification as BO.

**NRIs / OCIs / RIs permitted to be in control of FPIs:** An investment management entity (IM) owned and / or controlled by NRIs / OCIs / RIs can be in control of the FPI provided the entity complies with one of the following conditions-

- i* Such IM is regulated in its home jurisdiction and registers itself with SEBI as a non-investing FPI or;
- ii* Such IM is incorporated or set up under Indian laws and registered with SEBI.

## Revised KYC norms

The key features of the revised KYC framework provided in the circulars of 21 September are discussed below:

- i Identification of beneficial owners:* FPIs are required to identify their BOs in accordance with Rule 9 of the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 (PMLA Rules). Generally, BOs are the natural persons, who have controlling ownership interest in the FPI and who exercise control in the FPI, whether acting alone or together.

Client	Beneficial owner
<b>Company</b>	Person controlling ownership interest or who exercises control through other means.
<b>Partnership Firm</b>	Person with ownership of/entitlement to more than 15% of capital or profits of the partnership.
<b>Unincorporated Association or BOI</b>	Person with ownership/entitlement of more than 15%

- ii FPIs based in high risk jurisdiction:* If the FPI is based in a high risk jurisdiction (as identified by its local custodian in accordance with the relevant SEBI circular, the controlling ownership thresholds (for the purpose of BO identification) of 25 per cent / 15 per cent discussed above, would stand reduced to 10 per cent for all FPIs (irrespective of their legal form). Also, additional documents are required by such FPIs.

- iii Principle to be followed for identification of BOs:* If the controlling ownership interest in the FPI is held by another entity, there is a need to identify natural person(s) having controlling ownership interest in such intermediate entity. However, if such intermediate entity is eligible to register in India as a Category I FPI, there would be no need to identify BOs of such an entity.

- iv Intermediate entity name to be disclosed:* Even if no natural person is ultimately identified as the BO of the FPI but there is an entity that holds controlling ownership interest in the FPI, holding percentage of such entity needs to be disclosed to the custodian in the stipulated format.

- v Definition of SMO:* SMO is defined to mean an individual as designated by the FPI, who holds a senior management position and takes key decisions relating to the FPI.

- vi Listed FPIs at par with non-listed ones:* Though Indian PMLA rules exempt listed companies to identify their BOs, this exemption is not extended to FPIs.

- vii FPIs issuing ODIs:* FPIs which issue Offshore Derivative Instruments (ODIs) such as Participatory Notes (P-Notes) or swaps, also need to identify and verify BOs in the entities which subscribe to the ODIs issued by the relevant FPI. Further, BO identification is to be in accordance with the guidelines provided in the 21 September circular.

### Personal information of BOs

- i Identity document number* to be submitted while providing BO information in the stipulated format, instead of providing the



tax residency number/ social security number/ passport number, the FPI can provide any government issued identity document number e.g. driving license.

- ii *Data security* to be taken into account by the KYC Registration Agency (KRA) which includes protection of the personal information of BOs reported by the FPIs and access of such information to market intermediaries has to go through an authentication process where the FPI or its global custodian specifically approve access to information.

### **Periodic KYC review**

FPIs now shall be subject to KYC review by the SEBI as per the following timelines. In general, as and when there is any change in material information/ disclosure takes place. For Category II and Category III FPIs based in high risk jurisdictions, it has to be once a year. For Category II and Category III FPIs not based in high risk jurisdictions, it has to be at the time of continuance (akin to renewal) of FPI registration i.e. every three years.

Note: If an FPI does not submit KYC documents by the required timelines, it would not be permitted to execute purchase transactions.

### **Timeline for Compliances**

The timeline for compliance differs from case to case, as Existing FPIs need to provide the details of the BOs and relevant KYC documentation within six months from the date of the circular i.e. by 20 March, 2019. If an FPI fails to provide details up to March, 2019, it would be barred to execute purchase transactions after that date. Such an FPI would get a further period of six months to divest its holdings. If in case an FPI remains non-compliant even after 180 days after 20 March 2019 (i.e. the period allowed

divesting holdings), its FPI registration will become invalid and it would need to divest its holdings immediately.

### **Comments**

The regulations would affect/regulate the foreign investment in India through FPIs which amounted to 144682 INR crores in Financial Year 2017-2018. The regulations are indeed a gateway to efficient regulation on fund structures involving Indian citizens. The provisions as to periodic review in KYC at times when any change occurs in the disclosure, the disclosure of exempted documents upon demand by the regulator, invalidating the registration of those who have not complied with the said changes before 20<sup>th</sup> March, 2019 etc., would lead to efficient regulation of FPIs by the market regulator. The other viewpoint is that the regulation has hit hard the investors as it devoid them from holding controlling stakes in the FPIs. The move I believe will affect the investors in two ways, firstly, it will act as a detriment for investors who though well regulated by SEBI, but will not be able to hold controlling stakes in FPIs, and, secondly, it will put a procedural fetter on investors as now they have to get registered manager entities with SEBI as non-investing FPIs. Overall, the regulation has tried to create a balance between the investors and regulators.

### **IMPROVEMENTS SUGGESTED IN THE SURVEILLANCE, INVESTIGATION AND ENFORCEMENT MECHANISM OF SEBI**

By – *Mrigank Shekhar, Guru Gobind Singh Indraprastha University, Delhi*

The Committee on Fair Market Conduct (Hereinafter referred to as “the Committee”) led by Dr. T.K. Viswanathan released its Report on August 08, 2018. In the Report, the Committee made suggestions for changes in the structure and powers



of the Securities Exchange Board of India (SEBI), in order to deal with market manipulations, fraud, insider trading and the code of conduct related to insider trading. It also made suggestions with regard to the surveillance, enforcement and investigation mechanisms of SEBI.

The Committee's recommendations with regard to the latter involved incorporating and utilising technology and analytics in the monitoring of markets. The following are the aspects of these mechanisms specifically addressed in the Report:

### **High Frequency Trading (HFT) or Algorithmic Trading (Algo Trading)**

Some of the problems and concerns posed by HFT/Algo Trading are the high speed of trading, the high number of orders in comparison to actual trades (high order to trade ratio), the high rate of cancellation of orders, the possibility of unusual price behaviours etc. These aspects of Algo Trading, in the view of the Committee, could pose risks to the proper functioning of the securities market; hence, a need was felt for improved monitoring of these types of trading.

The Committee suggested several measures for bettering surveillance of HFT/ Algo Trading:

- Allotting Unique Identification Numbers (UIN) to algorithms. This would help in identifying algorithms much more quickly and would also help in detecting algorithms which generate manipulative trades.
- A self-certification mechanism to ensure the ethical use of technology by brokers for HFT/Algo Trading. This would improve the accountability of the brokers regarding the algorithm or technology being utilised by them.

- “Model Risk Checks for Algo Trading” prescribed by SEBI and the exchanges. These model risk checks include- ‘price range checks’, ‘order value checks’, ‘quantity checks’, etc.

### **Suggestion for Checking Manipulations**

The Committee, considering the effect of an improved monitoring mechanism, observed that the number of cases before SEBI will rise on its implementation.

To address this, it suggested a ‘two-tiered approach’ for examination and enforcement. The first tier, consisting of designated SEBI officials, would deal with high-risk cases, novel types of manipulations and those cases involving large-cap companies. Other regular cases will be handled by other officials. The logic behind this approach is that cases which may prove risky and sensitive as well as those which are novel or unprecedented in nature need immediate attention and need to be resolved more quickly in order to prevent a widespread negative impact on the market.

The Committee also considered the possibility of increased manipulations in certain illiquid stocks and those which have low market capitalization, as manipulation in the price and volume of such stocks becomes easier due to their lack of liquidity. To deter manipulations in such stocks, SEBI suggested increasing the cost of trading in such stocks, applying graded surveillance and control measures and requiring 100% dematerialization of shares of companies dealing in such stocks.

### **Power to Tap Phones and Intercept Calls**

Currently, SEBI has the authority to ask for call records only; details such as the information related to the numbers called or the duration of the call can



be requested by SEBI for the purpose of investigation under SEBI Act, 1992.

In order to improve the monitoring of insider trading and other frauds in the securities market, the Committee has recommended giving SEBI the power to wiretap phones and intercept calls and other electronic communication. This would help in collecting strong evidence especially against repetitive offenders in cases of market manipulations and other violations. The Committee also deliberated whether such power should be exercised by SEBI directly or through other enforcement agencies. It settled on recommending direct exercise of this power by SEBI. However, this power would not be absolute, as the Committee recommended that such authority should be used with proper checks and balances.

#### **Whistle Blower Mechanism**

In the absence of a mechanism for whistle-blowing, there is little incentive for a person with information relating to frauds and other violations to come forward as such person will be prosecuted as well. This could result in valuable information which can help investigations being lost. Thus, to improve the monitoring of frauds and market abuse, a whistle blower mechanism was considered essential by the Committee. The Committee considered a provision which is included under the SEBI Act, 1992, namely Section 24B. Section 24B grants Central Government the 'Power to Grant Immunity'. Under this section, the Central Government can grant immunity to any person penalties under the SEBI Act.

The Committee suggested that the role of the Central Government should be reduced and the Central Government should in fact, delegate this power to SEBI. It was suggested that suitable amendments be

made to the provision to give SEBI the power to grant immunity.

#### **Cooperation with Other Agencies**

The Committee recommended that SEBI increase its cooperation with other agencies of the government such as the Reserve Bank of India, Enforcement Directorate, Central Board of Direct Taxation and others which are established to deal with economic offences, in order to facilitate better investigation, enforcement and collection of evidence. The Committee also called for the establishment of an information exchange mechanism between these agencies.

#### **Use of Front entities or Mule Accounts**

Recommendations were also made by the Committee to prevent the use of front entities or "mule accounts" for layering of funds or securities. This was done in order to prevent individuals from being used as a front by the real offenders to remain untraced and to escape prosecution. The person responsible for creating such accounts and directly or indirectly operating them were recommended to be held responsible in case of any manipulation that may take place through such accounts.

#### **Conclusion**

The Committee has made several notable suggestions in the Report. It has suggested providing SEBI the power to tap phones and intercept calls; this power will help in tracking offenders and aid in investigation by assisting in collecting strong evidence. The Committee also pointed out that a system of oversight and checks and balances is to be established, this will ensure that there is no misuse of this power.

Another notable suggestion was providing immunity to whistle blowers; this will improve the reporting and discovery of frauds and other offences being



committed, as such protection will act as an incentive for persons with knowledge of any unlawful dealings to voluntarily come forward and report the same.

Since, its emergence in the late-2000s, Algo Trading has become immensely popular and according to the Committee, there are several risks posed by Algo Trading, it was thus, essential that it should be effectively monitored. The suggestions in this regard in the Report will improve transparency in Algo Trading as it focuses on the accountability of brokers and ensures that manipulative trades are traceable.

It is evident from the recommendations in the Report that the Committee is in favour of SEBI adjusting to and making use of new technologies in improving the monitoring of the markets so that it stays well equipped to deal with new challenges and issues in the future.

## SECURITIES UPDATES

### AUGUST

**Aug 3, 2018**

SEBI/HO/MIRSD/DoP/CIR/P/2018/117

SEBI issued a circular dealing with the role of sub-broker vis-à-vis authorised person wherein it highlighted that under the current framework, there is no difference in the operative role of a sub-broker and that of an authorized person. In a meeting held on June 21, 2018, SEBI decided to discontinue with Sub-Broker as an intermediary to be registered with SEBI. It stated that no fresh registration shall be granted to any person as sub-broker and the registered sub-brokers shall have time till March 31, 2019 in order to migrate to act as an authorised person and/or trading member.

**Aug 10, 2018**

SEBI/HO/MIRSD/DoP/CIR/P/2018/119

SEBI issued a circular related to enhance monitoring of qualified registrars to an Issue and Share Transfer Agents. A committee was constituted by SEBI under the chairmanship of Former Deputy Governor, RBI, to review the regulations and relevant circulars pertaining to Market Infrastructure Institutions (“MIIs”). Based on the recommendations of the Committee and the public comments received on the same, SEBI in its meeting decided that while changes in ownership structures of RTAs may not be required, the QRTAs may be required to comply with enhanced monitoring requirements, through adoption and implementation of internal policy framework; and periodic reporting on key risk areas, data security measures, business continuity, governance structures, measures for enhanced investor services, service standards, grievance redressal, insurance against risks, etc.

**Aug 16, 2018**

CIR/DDHS/P/ 121/2018

SEBI issued a circular related to streamlining the process of public issue under the SEBI (Issue and Listing of Debt Securities) Regulations, 2008(SEBI ILDS), SEBI (Issue and Listing of Non-Convertible Redeemable Preference Shares) Regulations, 2013 (SEBI NCRPS), SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 (SEBI SDI) and SEBI (Issue and Listing of Debt Securities by Municipalities) Regulations, 2015(SEBI ILDM). It was stated that in order to make the existing process of issuance of debt securities, NCRPS and SDI easier, simpler and cost effective for both issuers and investors under the SEBI ILDS, SEBI ILDM, SEBI NCRPS and SEBI SDI regulations respectively, it has been decided to reduce the time taken for listing after



the closure of the issue to 6 working days as against the present requirement of 12 working days.

**Aug 16, 2018**

SEBI/HO/DDHS/CIR/P/2018/122

With a view to ease the process of issuance of securities on electronic book platform, SEBI allowed investors to place multiple bids in a private placement issue on debt basis and permitted depositories to act as facilitators. It also allowed closed bidding on electronic book platform, along with open bidding through its circular.

**Aug 21, 2018**

IMD/FPIC/CIR/P/2018/214

SEBI has proposed certain amendments to its Circular No. CIR/I CIR/IMD/FPIC/CIR/P/2018/64, which prescribed Know Your Client Requirements for Foreign Portfolio Investors and the said power was exercised in pursuance of its powers under S. 11(1) of the SEBI Act, 1992.

**Aug 24, 2018**

SEBI/CIR/MRD/DoP-1/P/125/2018

With a view to facilitate physical settlement of equity derivatives contracts, it was decided to permit Stock Exchanges to set their trading hours in the SLB segment, subject to certain conditions. The circular was issued in pursuance of S. 11(1) of the SEBI Act, 1992, to protect the interests of investors in securities and to promote development of, and to regulate the securities market.

**SEPTEMBER**

**Sept. 19, 2018**

SEBI/HO/MIRSD/DOS3/CIR/P/2018/130

Vide Gazette Notification No. SEBI/LAD-NRO/GN/2018/36 dated September 11, 2018, in respect of SEBI (Credit Rating Agencies) (Second

Amendment) Regulations, 2018 SEBI stated that a CRA may undertake the rating of financial instruments under the respective guidelines of the financial sector regulators/ authorities such as SEBI, RBI, IRDA, PFRDA, MCA and IBBI as mentioned in the appended Annexure. It further stated that CRAs may also undertake research activities, incidental to rating, such as research for Economy, Industries and Companies.

Also in pursuance of the concerns of market participants with regard to Circular No. SEBI/HO/MIRSD/DOP2/CIR/P/2018/86 dated May 30, 2018 dealing with guidelines in respect of the process for review of rating, SEBI modified para 1 of the aforementioned circular clarifying that cases of requests by an issuer for review of the rating(s) provided to its instrument(s) shall be reviewed by a rating committee of the CRA consisting of a majority of members that are different from those in the Rating Committee of the CRA that assigned the earlier rating, and at least one-third of members are to be independent. It further clarified that all other provisions of this circular shall remain unchanged.

**Sept. 21, 2018**

CIR/IMD/FPIC/CIR/P/2018/131

SEBI Board in its meeting held on September 18, 2018 in relation to the circular No CIR/IMD/FPIC/CIR/P/2018/64 dated April 10, 2018 on Know Your Client (KYC) requirements for Foreign Portfolio Investors (FPIs) decided that Beneficial ownership criteria in Prevention of Money-laundering (Maintenance of Records) Rules, 2005 (hereinafter referred as PMLA Rules) should be made applicable for purpose of KYC and not for determining eligibility of FPIs.

Furthermore, it stated that there will be a separate set of norms for determining conditions where Non Resident Indians (NRIs) and Overseas Citizens of



India (OCIs) and Resident Indians (RIs) are constituents and also the basis for clubbing of investment limits and that the Amendments in SEBI (FPI) Regulations, 2014, wherever necessary, will be notified separately. It also made certain modifications to KYC requirements for FPIs provided in Circular No. CIR/ MIRSD/11/2012 dated September 05, 2012 and subsequent SEBI circular No. CIR/MIRSD/07/2013 dated September 12, 2013.

#### **Sept. 21, 2018**

CIR/IMD/FPIC/CIR/P/2018/132

SEBI board, on the recommendations of the SEBI H.R. Khan Working Group, decided that Beneficial Ownership criteria in PMLA Rules, 2005 should be made applicable for purpose of KYC and not for determining eligibility of FPIs. The circular also said that the clubbing of investment limits for FPIs should not be done on the basis of Beneficial Owner as per PMLA Rules. A separate set of norms for determining conditions where NRIs and OCIs and RIs were constituents were notified. The circular mentioned that the amendments in SEBI (FPI) Regulations, 2014, would be notified separately. Existing FPIs and new applicants shall be given a time period of 2 years from the date of coming into force of the amended regulations or from the date of registration, whichever is later in order to satisfy these eligibility conditions.

#### **Sept. 28, 2018**

SEBI/HO/CDMRD/DMP/CIR/P/2018/133

As a result of the amendments to the *Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012* being notified in the Gazette of India on April 02, 2018, there would be no separate category of 'Commodity Derivatives Exchanges' w.e.f October 1, 2018. However, all the norms issued for Commodity

Derivatives Exchanges till date shall be applicable to Commodity Derivatives Segments of Recognised Stock Exchanges/Recognised Clearing Corporations to the extent applicable.

### **OCTOBER**

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#### **Oct. 3, 2018**

No. SEBI/LAD-NRO/GN/2018/39

SEBI released Securities and Exchange Board of India (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018 in order to lay down the regulations related to appointment of administrators and procedure for refunding of the investors.

#### **Oct. 9, 2018**

SEBI/HO/CDMRD/DMP/CIR/P/2018/134

Prior to 9<sup>th</sup> October 2018, the foreign entities were not permitted to directly participate in the Indian commodity derivatives market, even if they import/export various commodities from/to India. Pursuant to feedback received from the market participants during the consultative process, it has been decided to permit foreign entities having actual exposure to Indian commodity markets, to participate in the commodity derivative segment of recognized stock exchanges for hedging their exposure. Such foreign entities shall be known as "Eligible Foreign Entities" (EFEs).

#### **Oct. 11, 2018**

SEBI/HO/FPIC/CIR/P/2018/135

For the purpose of transparency in the processing of applications for FPI registration, it has been decided that the average time taken by the DDPs in processing such applications be disseminated on SEBI's website on a monthly basis. The same has been decided pursuant to Regulation 7(2) of the



Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014.

**Oct. 16, 2018**

SEBI/HO/CDMRD/DMP/CIR/P/2018/136

SEBI has issued this circular to maintain uniformity for obtaining samples of goods at the Exchange accredited warehouses. To resolve potential disputes arising from varied approaches being followed by the exchanges for assaying, SEBI has advised that at least four samples are taken in the presence of depositor and of which one is used for analysis, the one is kept with WSP for comparison purposes, one is given to depositors while one kept for record/lab reference purpose.

**Oct. 22, 2018**

SEBI/HO/IMD/DF2/CIR/P/2018/137

SEBI has issued a circular with regard to Performance Disclosures for Mutual Funds and to bring transparency in Total Expense Ratio (TER). It has introduced guidelines to regulate scheme related expenses and up fronting of trail commission based on SIP inflows at mutual fund level. It allows additional TER to be charged up to 30 bps on daily net assets of the scheme based on inflows from beyond top 30 cities (B-30 cities). In addition to this, certain other guidelines have been issued with regard to the disclosure of expenses and scheme performance by AMCs.

**NOVEMBER**

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**Nov. 1, 2018**

SEBI/HO/CFD/DIL2/CIR/P/2018/138

Vide this circular SEBI introduced UPI as a payment mechanism with application supported by block amount to further streamline the process upon several meetings with the stakeholders.

**Nov. 4, 2018**

SEBI/HO/MIRSD/DOS3/CIR/P/2018/139/2018

This circular attempts to bring about standardized norms for transfer of securities in physical mode. Vide this circular SEBI has established a standard framework for transfer of securities in physical mode. This step has been taken to address the various difficulties faced by the investors in transmission of such shares.

**Nov. 13, 2018**

SEBI/HO/MIRSD/DOS3/CIR/P/2018/140

The circular pertains to Guidelines for Enhanced Disclosures by Credit Rating Agencies (CRAs). Vide this circular SEBI has laid down stricter closure guidelines for credit rating agencies, this move is seen in relation to the recent IL&FS crisis due to which light shortcoming occurred in the rating process.

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