SEBI's Big Bang Changes: Impact Analysis

Published on Tue, Aug 21,2012 | 15 27, Updated at Tue, Aug 21 at 15:32Source : Moneycontrol.com

By: Harshita Srivastava & Ruchi Biyani, Attorneys, Nishith Desai Associates

The Securities and Exchange Board of India ("SEBI") at its board meeting held on August 16, 2012 has introduced substantial reforms to the primary and secondary market in order to provide stimulus to the securities market. The reforms primarily aim at revitalizing the mutual fund industry and the capital raising exercise in India. Alongside, SEBI has finally rolled out the regulatory framework governing the investment advisors. With the introduction of a separate regulation, all investment advisors which are primarily engaged in rendering advice pertaining to investments will now be subject to registration and regulation by SEBI.

I. Amendments To The Sebi (Issue Of Capital And Disclosure Requirements) Regulations, 2009

After a detailed review of the extant legislative and regulatory framework of the primary market, SEBI felt the need for invigoration of the primary market and accordingly suggested a slew of reforms in relation thereto which are as follows:

Increasing the reach of IPOs to retail investors:

1. Similar to the reforms suggested in the mutual fund segment and with the aim of increasing participation of investors in the initial public offering ("IPO") process, SEBI has resolved to widen the broker network of stock exchanges for the purpose of distributing IPOs in electronic form. The IPOs may be accessed by the members of the general public, either physically or electronically, through the channel of brokers. For those who do not prefer to deal with brokers may download the application forms directly through the website of the stock exchange and also view the status of their applications online. The facility of Application Supported by Blocked Amount ("ASBA") will also be made available to applicants applying through this route.

2. The share allotment procedure is proposed to be modified to ensure that every retail applicant, irrespective of the size of his application, gets a minimum bid allotted subject to availability of shares in aggregate. The minimum application size for all investors is proposed to be increased to INR 10,000 - INR 15,000 as against the existing INR 5,000 - INR 7,000. By doing so, SEBI intends to gratify more number of smaller applicants in cases of oversubscribed issues. This would also ensure wider participation of retail public in the primary market thereby improving liquidity of the stock.

Facilitation of capital raising by issuers:

For the purpose of (i) achieving a speedy completion of the fund raising process by the issuers, (ii) enabling compliance with the minimum public shareholding requirement, (iii) streamline the disclosure process in IPOs, SEBI has proposed the following measures:

1. <u>Reduction in average market capitalisation for fast track issues</u>: Under Regulation 10 of the SEBI (Issue of Capital & Disclosure Requirements) Regulations 2009 ("ICDR"), every listed company desirous of raising capital under a fast track route was required to have a market capitalisation of INR 5,000 crore. This market capitalisation has now been reduced from INR 5,000 crore to INR 3,000 crore so as to facilitate further public offerings and rights issue through fast track route. As a matter of recapitulation, the fast track issuance route which was introduced in 2007 for enabling listed companies' to have quick access to further capital. However this route never really took off because the requirement of INR 5000 core market capitalisation was seen as one of the hindrance for listed companies to opt for capital raising under fast track route. In such circumstances, the reduced market

capitalisation requirement as proposed by SEBI can act as breather for listed companies waiting to opt for this route.

2. Promoters’ contribution made easy: Under Regulation 32 of the ICDR, the promoters of the issuer company are required to contribute in the public issue to the extent of 20% of the post issue capital and such promoter contribution shall be locked in for a period of three years. The requirement being very onerous in nature, it was observed that the promoters of issuer companies were often unable to meet the statutory 20% contribution requirement themselves. As a result of this, SEBI has proposed that in order to satisfy the statutory requirement, the promoters may now take the aid of SEBI registered Alternative Investment Funds (“AIF”) such as SME funds, infrastructure funds, private equity funds etc. subject to a maximum of 10%. Such flexibility is likely to open up more avenues for participation by private equity funds while easing up the burden of promoters. However, it is yet to be seen whether the 10% contribution made by SEBI AIFs will also be subject to similar lock-in requirements and whether they will be regarded as promoters.

3. Additional methods for compliance with minimum public shareholding requirement: In its first Board meeting of the year 2012, SEBI had decided to provide alternative methods for companies to increase their public shareholding to 25% or more with the introduction of (i) Institutional Placement Programme and (ii) Offer for sale of shares through stock exchanges. Further in line with the same, SEBI has in this board meeting decided to prescribe additional methods for complying with the 25% requirement which methods include rights issue and bonus issue. SEBI has also specified that it may come up with additional options to meet the minimum public shareholding requirement and existing options may undergo some modifications in order to make them more feasible. However, the implementation of the SEBI proposal in terms of rights issue/ bonus issue remains largely to be tested especially in case of right issues which off late has not seen favorable response from the market.

4. Re-filing of the prospectus not required: Unlike the erstwhile threshold of 10%, any changes upto 20% in the objects of the issue will not warrant any re-filing of the offer document with the SEBI. The proposal seeks to save the issuer companies of the hassle and costs involved in re-filing of the offer document each time they breached the threshold of 10%, thereby offering the companies more flexibility on utilization of IPO proceeds. In a rapidly changing external environment, such flexibility would prove to be very valuable.

5. Pricing norms for QIPs modified: To enable QIPs to flourish even in deteriorating market conditions, SEBI has allowed issuers to offer a maximum discount of 5% to the price calculated as per the ICDR. This is likely to create incentive for QIBs as well as private equity investors and could kick start the institutional placements in a weak primary market.

6. Additional Disclosures: In addition to the existing disclosure requirements, it is proposed that listed companies shall file a comprehensive annual disclosure statement with the SEBI, which filings are aimed at providing updated information to the investors. The SEBI’s proposal is directed towards the alignment of the existing disclosure requirements in India with the 20F filing prescribed by the United States Securities and Exchange Commission (“US SEC”) by which foreign private issuers provide certain information to the US SEC. While the proposal will certainly go a long way in ensuring transparency and disclosure by Indian corporates, compliance mechanisms will have to be put in place for listed companies in order to comply with requirement associated with the continued listing thereby resulting in more increased compliance cost and management time.

Improving the quality of public offerings

1. The issuers with a minimum average pre-tax operating profit of INR 15 crore will be only ones allowed to participate through the profitability route. All other issuer companies will be permitted to access the markets either through the small and medium exchanges (“SME”) or compulsory book building route with increased qualified institutional buyer participation of 75%, as opposed to the existing 50%.

This will ensure invigoration of the SMEs and also ensure better quality of issues on the main market segment.

2. In order to lend more clarity to the capital raising process, SEBI has decided that ‘General Corporate Purposes’ as an object of the issue should not exceed 25% of the issue size. It is noteworthy that under the extant regulatory framework, there is no cap imposed in this regard.

3. Listed companies are required to frame employee stock option schemes only in accordance with the extant SEBI Guidelines in relation to employee stock option plans and employee stock option schemes. Companies whose stock option plans are not in compliance with the guidelines shall be granted time for doing so and such schemes shall be restricted from acquiring shares from the secondary market. Though this change may

have significant impacts on listed companies who do not have a proper stock option scheme in place which is in compliance with applicable laws, it is rather surprising to note that SEBI has not provided any rationale behind such proposal.

4. Additional mechanisms for monitoring the issue proceeds to be introduced.

II. Investment Advisors Regulations Finally Introduced

After release of the concept paper on regulation of investment advisors in 2011, SEBI has finally approved the much debated and dreaded framework regulating the investment advisors. As clarified in the concept paper, the Investment Advisors Regulations shall apply to all individuals, body corporate and partnership firms providing investment advice and therefore entities engaged in selling financial products shall not be governed by these regulations.

Introduction of the Investment Advisors Regulations is the second development relating to legal regime governing the Indian fund industry after the recent notification of the AIF Regulations. The Indian asset management and financial advisory business has been growing at a rapid pace and therefore SEBI first in 2007 felt the need to regulate working of investment advisors. The Investment Advisors Regulations emanates after a lot of consultation from the industry which had apprehension about the legal regime having an adverse impact on the industry.

Persons falling under the gamut of the Investment Advisors Regulations:

The Investment Advisors Regulations require all persons providing investment advice to investors in return for consideration, to seek registration with SEBI. It has also been clarified that investment advice given without consideration through media at large shall not be considered as investment advice. While initially SEBI will directly register and regulate all investment advisors, eligibility criteria such as qualification and net worth requirements shall also be prescribed for investment advisors. As a result, the Investment Advisors Regulations can be regarded as an omnibus regulation requiring all investment advisors to be registered with SEBI unless particularly exempted.

Segregation of advisory and distribution business:

It is important to note that the press release provides that remuneration / consideration for investment advice can only be received from the client being advised and not from any other person. Additionally, banks or body corporate engaged in distribution, referral or execution business alongside investment advisory business will now be required to segregate their investment advisory business from the rest and provide such investment advisory services through a subsidiary or department.

Categories of certain person exempt: While the fine print of the Investment Advisors Regulation is yet to be released, the press release exempts certain categories of persons from registration under the regulations. These categories include:

1. Stock and sub brokers, merchant bankers and portfolio managers already registered with SEBI providing investment advice incidental to their primary activity (exempt only from registration requirement.
2. Distributors registered with All India Mutual Fund Industry (“AMFI”) providing investment advice incidental to their primary activity.
3. Fund manager of mutual fund or alternative investment fund.
4. Professionals such as lawyers, chartered accountants providing advice incidental to their professional services.
5. Persons providing advice exclusively in areas like insurance and pension products provided regulated by sectoral regulators.
6. Persons providing general comments in good faith about market trends.

These regulations bring a large number of investment advisors under SEBI’s regulatory supervision which were until now falling outside its purview. While the detailed regulations in this regard are yet to be notified, SEBI has broadly classified categories of persons subject and exempt from these regulations.

Position under US laws:

Drawing an analogy from the law in the United States from where most of our securities laws have found origination, the Investment Advisers Act of 1940 generally defines an "investment adviser" as any person or firm that: (1) for compensation; (2) is engaged in the business of; (3) providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications. A person or firm must satisfy all three elements to be regulated under the Investment Advisers Act of 1940(US Investment Advisors Act) wherein these elements are construed broadly. For example:

• With respect to "compensation," the receipt of any economic benefit suffices. To be deemed compensation, a fee need not be separate from other fees charged, it need not be designated as an advisory fee, and it need not be received directly from a client.

• With respect to the "business" element, an investment advisory business need not be the person's or firm's sole or principal business activity.

• Finally, a person or firm satisfies the "advice about securities" element if the advice or reports relate to securities. The Division of Investment Management has stated that providing one or more of the following also could satisfy this element: advice about market trends; advice in the form of statistical or historical data (unless the data is no more than an objective report of facts on a non-selective basis); advice about the selection of an investment adviser; advice concerning the advantages of investing in securities instead of other types of investments; and a list of securities from which a client can choose, even if the adviser does not make specific recommendations from the list.

While broadly the definition and scope of investment advisor in the last consultative paper by SEBI in 2011 also contains similar elements as provided under the US Investment Advisors Act, it is important to note that the US Investment Advisors Act governs investment advisors providing advice about ‘securities’. The Indian Investment Advisors Regulations being an omnibus regulation covers all advisors including financial planners providing investment advice whether or not relating to securities. However, it is important to note that the term ‘securities” have been very broadly defined under the US Investment Advisors Act.

This move could likely impact some of the offshore asset managers, both private equity and hedge funds, having advisory set ups in India which could now potentially fall within the ambit of these regulations. However, the fine print is important to see if there are any safe harbors for such advisors who only advise offshore managers and not the clients directly. It is important to note that the US Investment Advisors Act provides a specific exemption to foreign private advisor subject to fulfillment of certain conditions,

Obligation of the investment advisors: The press release further indicates that the investment advisors like other intermediaries will also have to comply with their code of conduct, fiduciary responsibility, record keeping and risk profiling of clients as may be prescribed in detail in the regulations.

Until now the investment advisors were contractually governed by their investment advisory agreement for their obligation and any breach of obligation there under would have constituted a breach of contract. With the regulations prescribing fiduciary obligation of the investment advisor to the investors, the investment advisor are now statutorily required to provide investment advice in the best interest of the investor. This will surely cast a much higher degree of responsibility and accountability upon the investment advisor.

III. Amendments To The Sebi (Issue And Listing Of Debt Securities) Regulations, 2008

SEBI has approved the amendments to the disclosure requirements in the offer documents/ memorandum in connection with the public issue & listing of non-convertible debt as well as privately placed debt securities which are listed or sought to be listed under the SEBI (Issue and Listing of Debt Securities) Regulations, 2008 (Debt Regulations).

In addition to disclosures required to be made under the Companies Act, 1956, the Debt Regulations also prescribe certain disclosures to be made in the offer documents / information memorandum in case of issuance of debt securities. The key additional disclosures that have now been included are details of change in capital structure over the last five years and details of default / delay in borrowing over the last five years.

Since the introduction of Debt Regulations in 2008, SEBI has time to time undertaken a series of reforms in order to make regulatory framework for debt markets more robust. On the same lines, these additional disclosure requirements have been included / standardized with a view to align the same with the disclosure requirements in the offer documents as applicable in case of public issue of equity shares.

Shelf placement document for frequent issue of debt securities through private placement: The concept of shelf placement document valid for a period of 180 days has also been introduced in case of frequent issue of debt securities through private placement. Until now facility of shelf prospectus was only available for public issue of debt securities. Thus, easing administrative burden and compliance cost on the issuers.

IV. Mutual Funds

With a view to promote sustainable growth of the mutual fund industry and effective channelization of domestic savings, SEBI has suggested a long term policy in relation to mutual funds, the main features of which are as follows:

1. Fungibility of Total Expense Ratio ("TER") has been permitted: TER is a measure of the total costs associated with managing and operating a mutual fund. These costs consist primarily of management fees and additional expenses such as trading fees, legal fees, auditor fees and other operational expenses. The size of the TER assumes significance from the investor's perspective because the costs coming out of the fund affect investor's returns.

Being mindful of the fact that the mutual fund products require deeper penetration into the market, SEBI has introduced the concept of fungibility of TER so as to provide greater flexibility towards allocation of costs to mutual fund managers. Whether this would allow managers to load some of the distribution costs on to the scheme, a long standing demand from the industry, is yet to be seen.

2. Need for robust distribution networks: The success of the mutual fund market does not alone depend on the mutual fund product, but to a large extent is dependent on the distribution networks. In order to strengthen the distribution network, SEBI has decided to streamline the registration process for distributors by including postal agents, retired government officials, retired teachers etc. for distribution of simplistic products and by reducing the fees for National Institute of Securities Market and AMFI registration. SEBI has also hoisted the idea of categorizing the certification and registration process depending on products and services offered

3. Alignment of interests: In order to align the interests of the various stakeholders, distributors and asset management companies ("AMC"), SEBI has decided that the brokerage and transaction cost chargeable to the scheme for execution of trade should be capped to 12 bps in case of cash market transactions and 5 bps in case of F&O transactions. Also, to avoid differential treatment in the same scheme to different classes of investors, SEBI is of the view that all new investors will be subjected to a single expense structure under a single plan and there shall be a separate plan for direct investments with a lower expense ratio.

4. Enhanced participation: As a welcome move, SEBI has decided to make mutual fund products accessible to small farmers and traders who otherwise were not able to deal in such products owing to procedural formalities like lack of PAN/ bank accounts etc. Going forward, the small traders will be allowed to participate in mutual fund schemes by way of cash transactions to the extent of INR 20,000 subject to compliance of the provisions of the Prevention of Money Laundering Act, 2002. Further, it is decided that the service tax payable on investment management fees should be charged to the scheme.

5. Firming up the regulatory framework: In order to make the regulatory system more accountable, SEBI has suggested certain additional disclosures by the AMCs which inter alia are as follows: (i) AMCs to provide monthly portfolio disclosures on their website; (ii) set up a new self-regulatory organization for regulation of distributors; (iii) AMCs to publish half yearly financial statements on their websites and an advertisement in this regard to be published in one national and one regional newspaper.

Considering the grim state of capital markets, the introduction of the above reforms would stimulate the securities market in India. While the introduction of the reforms is a proactive step by capital market regulator to address the lack luster market, however, only upon release of the fine print of the regulatory framework on the above, one would be able to determine the extent to which the new set of reforms will be able to provide the required boost to the economy. Further, as they say that recognition of an issue is half the problem solved and hence acknowledgment by the regulator of the need to jump start the primary market will surely be welcomed by the market constituents.