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The Securities And Exchange Board Of India's Proposed Reforms To Revitalise The Capital Market

By Harshita Srivastava, Ruchi Biyani, and Vyapak Desai, of Nishith Desai Associates, Mumbai.

The Securities and Exchange Board of India ("SEBI"), at its board meeting on August 16, 2012, introduced a series of proposed reforms to the primary and secondary market in order to provide stimulus to the securities market. The reforms primarily aim at revitalising the mutual fund industry and the capital raising process in India.

Alongside these changes, SEBI also finally rolled out the regulatory framework governing investment advisors.

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 toward that end, which are as follows:

Facilitation of Capital Raising by Issuers

In order to achieve the threefold purpose of 1) shortening the fund raising process for issuers, 2) enabling compliance with the minimum public shareholding requirement, and 3) streamlining the disclosure process in initial public offerings ("IPOs"), SEBI proposed the following measures:

1. Promoters' contribution made easier: Under Regulation 32 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("ICDR"), the promoters of an issuer company are required to contribute in the public issue to the extent of 20 percent of the post-issue capital, and such promoter contribution shall be locked up for a period of three years. Consequently, it was observed that promoters of issuer companies were often unable to meet the statutory 20 percent contribution requirement themselves. Therefore SEBI has proposed that, in order to satisfy the statutory requirement, promoters may now take the aid of SEBI-registered alternative investment funds ("AIFs") such as small and medium-size enterprise ("SME") funds, infrastructure funds, private equity funds, *etc.*, subject to a maximum of 10 percent.

Implication: According to Siddharth Shah, Partner in the Corporate and Securities Practice at Nishith Desai Associates, Mumbai, this flexibility is likely to open up more avenues for participation by private equity funds while easing the burden on promoters. However, it is yet to be seen whether the 10 percent contribution made by SEBI-registered AIFs will also be subject to similar lock-up requirements and whether they will also be regarded as promoters for all other purposes of the offer documents.

2. Additional methods for compliance with minimum public shareholding requirement: In its first board meeting of 2012, SEBI had decided to provide alternative methods to enable companies to comply with the minimum public shareholding requirement of 25 percent, with the introduction of 1) the Institutional Placement Programme and 2) the offer of shares for sale through stock exchanges. Acting further in this line, SEBI has decided to prescribe additional methods for complying with the 25 percent requirement, which include rights issues and bonus issues. SEBI has also specified that, although it may come up with additional options, the existing options may also undergo some modifications in order to make them more attractive.

Implication: Implementation of the SEBI proposal in terms of rights issues and bonus issues remains largely to be tested, especially in the case of rights issues, which of late have not seen a favorable response from the market due to the lack of investor participation.

3. Pricing norms for qualified institutional placements ("QIPs") modified: To enable QIPs to flourish even in worsening market conditions, SEBI has allowed issuers to offer a maximum discount of 5 percent to the price calculated as per the ICDR.

Implication: This is likely to create incentives for qualified institutional buyers as well as private equity investors, and could kick start the otherwise slowed down institutional placement process.

4. Reduction in average market capitalisation for fast track issues: Under Regulation 10 of the ICDR, every listed company wishing to raise capital under the fast track route was required to have market capitalisation of INR5,000 crore, which has now been reduced to INR3,000 crore, so as to facilitate further public offerings and rights issues through the fast track route.

The fast track issuance route was introduced in 2007 to enable listed companies to have quick access to further capital. However, due to the onerous market capitalisation requirement, this route was not used frequently by listed companies seeking to raise capital.

Implication: It seems that the proposed reduction in the market capitalisation requirement may be attractive to listed companies that might have been waiting to opt for this route for a long time now.

5. Re-filing of the prospectus not required: Unlike the existing threshold of 10 percent, any addition to or deletion from the objectives of the issue resulting in a change in estimated issue size or estimated means of finance by more than 20 percent will not require any refiling of the offer document with SEBI.

Implication: The proposal seeks to alleviate issuer companies' burdens, both in terms of administration and costs involved, in the process of re-filing the offer document the moment they breach the threshold of 10 percent. Issuer companies are now accorded more flexibility in determining the utilisation of IPO proceeds. In a rapidly changing external environment, such flexibility could prove to be very valuable.

6. Additional disclosures: In addition to the existing disclosure requirements, it is proposed that listed companies shall file a comprehensive annual disclosure statement with SEBI, which is aimed at providing updated information to investors. SEBI's proposal is directed toward alignment of the existing disclosure requirements in India with the 20F filing prescribed by the U.S. Securities and Exchange Commission ("U.S. SEC") by which foreign private issuers provide certain information to the U.S. SEC.

Implication: While the proposal will certainly go a long way toward ensuring transparency and disclosure by Indian corporates, compliance mechanisms will have to be put in place for listed companies to comply with requirements associated with continued listing, thereby resulting in increased compliance costs and management time.

Increasing Access to IPOs by Retail Investors

1. With the aim of increasing the participation of investors in the IPO process, SEBI has resolved to widen the broker network of stock exchanges for the purpose of distributing IPOs in electronic form. IPOs may be accessed by members of the general public, either physically or electronically, through the channel of brokers. Those who prefer not to deal with brokers may download the application forms directly through the website of the stock exchange and 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 the availability of shares in the aggregate. The minimum application size for all investors is proposed to be increased to between INR10,000 and INR15,000, as against the existing INR5,000 to INR7,000. Although the minimum application size has been increased, by assuring a minimum bid allotment, SEBI intends to satisfy a larger number of smaller applicants in the case of oversubscribed issues. We hope that this proposal attracts wider participation by the retail public in the primary market and leads to an improvement in the liquidity of stocks.

Improving the Quality of Public Offerings

1. In order to ensure the invigoration of SMEs and to improve the quality of issues on the main market segment, it is proposed that only those issuer companies which have a minimum average pre-tax operating profit of INR15 crore will be allowed to participate through the profitability route. All others will be able to access the markets either through small and medium exchanges or through the compulsory book building route with an increased qualified institutional buyer participation of 75 percent, as opposed to the existing 50 percent.

2. While the ICDR did not impose any cap on the objectives of an issue, SEBI has decided that "general corporate purposes" as an objective of an issue should not ex-

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ceed 25 percent of the issue size. Additional mechanisms for monitoring the issue proceeds are to be introduced.

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 becoming compliant, and such schemes shall be restricted from acquiring shares from the secondary market. Although this change may have a significant impact on listed companies that do not have a legally compliant stock option scheme in place, it is rather surprising to note that SEBI has not provided any rationale behind such proposal.

Amendments to the SEBI (Issue and Listing of Debt Securities) Regulations, 2008

Disclosures in relation to the issuance of debt securities: SEBI has approved amendments to the disclosure requirements in the offer documents/information memorandum in connection with the public issue and 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 the issuance of debt securities. The key additional disclosures that have now been included are details of changes in capital structure over the last five years and details of default/delay in borrowing over the last five years.

Implication: Since the introduction of the Debt Regulations in 2008, SEBI has from time to time undertaken a series of reforms in order to make the regulatory framework for debt markets more robust. Along the same lines, these additional disclosure requirements have been included/standardised with a view to aligning them with the disclosure requirements in the offer documents as applicable in the case of public issues of equity shares.

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

Mutual Funds

With a view to promoting sustainable growth of the mutual fund industry and effective channelisation 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 has been permitted: Total Expense Ratio 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 Total Expense Ratio assumes significance from the investor's perspective because the costs coming out of the fund affect the investor's returns. Being mindful of the fact that mutual fund products require deeper penetration into the market, SEBI has introduced the concept of fungibility of Total Expense Ratio so as to provide greater flexibility regarding the allocation of costs to mutual fund managers. Whether this will allow managers to load some of the distribution costs onto 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 depend solely on mutual fund products, but to a large extent on distribution networks. In order to widen distribution networks, SEBI has decided to streamline the registration process for distributors by including postal agents, retired government officials, retired teachers, *etc.,* among those who can distribute simple products.

3. Alignment of interests: In order to align the interests of the various stakeholders, distributors and asset management companies, SEBI has decided that the brokerage and transaction cost chargeable to a scheme for execution of trade should be capped at 12 basis points in the case of cash market transactions and 5 basis points in the case of futures and options transactions. Also, to avoid differential treatment to different classes of investors in the same scheme, 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: In 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 the lack of a Permanent Account Number, bank accounts, *etc.* Going forward, small traders will be allowed to participate in mutual fund schemes by way of cash transactions to the extent of INR20,000, subject to compliance with 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 asset management companies which, *inter alia,* are as follows: 1) asset management companies to provide monthly portfolio disclosures on their websites; 2) establishment of a new self-regulatory organisation for the regulation of distributors; and 3) asset management companies 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.

Conclusion

It is commendable that SEBI has proposed these reforms, considering the weak sentiments of the Indian capital markets, with a view to strengthening investor confidence and providing a boost to the economy. Recognition of a problem is the first step toward solving the problem, and acknowledgment by the regulator of the need to jump start the primary market will surely be welcomed by market constituents.

While the introduction of the reforms is a proactive step by the capital market regulator to address the lackluster market, it is only upon release of the fine print of the regulatory framework that we will be able to judge the extent to which the new set of reforms will change the grim state of affairs.

The text of SEBI's press release on its August 16, 2012, board meeting can be accessed at http://www.sebi.gov.in/sebiweb/home/list/4/23/0/0/Press-Releases.

Harshita Srivastava and Ruchi Biyani are Associates, and Vyapak Desai is a Senior Associate and Head of the Capital Markets Practice, at Nishith Desai Associates, Mumbai. They may be contacted at harshita.srivastava@nishithdesai.com, ruchi.biyani@nishithdesai.com, and vyapak.desai@nishithdesai.com.

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