

SEBI's new initiative to bar wilful defaulters from fund-raising



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Introduction

1. SEBI, in its Board Meeting held on March 12, 2016¹, approved of certain new initiatives which include imposing restrictions on wilful defaulters, proposing brightline tests for acquisition of 'control' under the SEBI Takeover Regulations, 2011, reviewing the manner of dealing with Audit Reports containing qualifications and approving of the Budget for 2016-17. Certain decisions taken by the SEBI Board will have an impact on the overall market, market participants and also on the market intermediaries. The article is a compilation of the decisions taken by the SEBI Board along with their impacts and analysis.

2. Imposing restrictions on the wilful defaulters

2.1 Summary of the Decision: With an intention of restricting wilful defaulters from accessing capital markets for raising funds from public, SEBI Board approved of the following proposals:

- (i) If the issuer-company or its promoter or its director are in the list of wilful defaulters, SEBI proposes to prohibit the issuer-company from making public issue of equity securities or debt securities or non-convertible redeemable preference shares;
- (ii) If any company or its promoter or its director is categorized as 'wilful defaulter', then such persons may not be allowed to take control over other listed entity;
- (iii) However, if listed company or its promoter or its director is categorized as 'wilful defaulter', and there is a take-over offer in respect of the listed company, then the promoter or its director may be allowed to make competing offer for the said listed company in accordance with the Takeover Code, 2011;

(iv) SEBI also proposes to amend the criteria for determining a 'fit and proper person' in the SEBI Regulations to include that no fresh registration shall be granted to any entity if the entity or its promoters or its directors or key managerial personnel, as defined under the SEBI (ICDR) Regulations, 2009, are included in the list of 'wilful defaulters'.

2.2 Analysis of the decision: RBI defines 'wilful defaulter' as an entity that defaults on its payment obligations even if it has the financial capacity to pay the debts. In January 2015, SEBI had floated Discussion Paper titled as "Proposed Amendments to Regulations framed under SEBI Act, 1992 for Imposing Restrictions on Wilful Defaulters". SEBI proposed to amend ICDR Regulations, 2009. In addition to decisions taken by the SEBI Board, SEBI *vide* the Discussion Paper had recommended that existing listed companies or their promoters or group company or director of the Issuer categorized as 'wilful defaulter' may make rights issue/private placement to Qualified Institutional Buyers, with full disclosures in the offer document. SEBI had also recommended that issuer-company shall not make public issue of debt securities, if the issuer, its promoter, group company or director of Issuer of such securities, is in the list of the 'wilful defaulters', published by the RBI or it is in default of payment of interest or repayment of principal amount in respect of debt instruments issued by it to the public, if any.

In the recent SEBI Board Meeting, it also proposed to amend the criteria for determining a 'fit and proper person'. Such criteria have been defined in Regulation 7 and Schedule II of SEBI (Intermediaries) Regulations, 2008. It states that SEBI may take the following criteria in relation to applicant or intermediary, the Principal Officer and key management persons by whatever name called:

- (a) Integrity, reputation and character;
- (b) Absence of convictions and restraint orders;

- (c) Competence including financial solvency and net worth.

It is noteworthy that SEBI's move has come when the banks have moved the Apex Court against Vijay Mallya, who has been declared as 'wilful defaulter'. Under the extant regulatory framework, the wilful defaulters are allowed to come out with an IPOs by making requisite disclosures in the Offer Document.

SEBI Board has approved of the proposal that if any company or its promoter or its director is categorized as 'wilful defaulter', then such persons will not be allowed to take control over other listed entity. However, it is noteworthy that SEBI Board has proposed to allow wilful defaulters to make counter-offers to avoid hostile takeovers, *i.e.*, Promoter declared as wilful defaulter will be allowed to make an open offer to defend similar bid by another entity.

3. Brightline tests for acquisition of 'control' under the Takeover Code

3.1 Summary of the Decision: SEBI Board considered and approved of the proposal for initiation of public consultation process regarding the introduction of brightline tests for acquisition of 'control' under the SEBI (SAST) Regulations, 2011 ('Takeover Code'). The Board noted that multiple regulators apply the test of control from different perspectives and arrive at differing results which may lead to ambiguity.

With an objective of identifying the bright lines for 'control' in the Takeover Code, SEBI has suggested the following proposals for consideration:

- (i) **Framework for protective rights:** The Board has proposed introducing illustrative list of protective rights which would not amount to acquisition of control. Grant of such rights to an investor may be subject to obtaining public shareholders' approval (majority of minority),

- (ii) **Adopting numerical threshold:** The Board has proposed amending the definition of control such that control is defined as:
- (a) right or entitlement to exercise at least 25% of voting rights of a company, irrespective of whether such holding gives *de facto* control and/or
 - (b) the right to appoint majority of the non-independent directors of a company.

3.2 Analysis of the Decision: Clause (e) of sub-regulation (1) of Regulation 2 of the Takeover Code, 2011 defines 'control' as an inclusive definition, which includes the following:

- (i) Right to appoint majority of directors, or
- (ii) Right to control the management or policy decisions exercisable by a person(s) acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

The proviso to clause (e) of sub-regulation (1) of Regulation 2 clarifies that a director or officer of the Target Company shall not be considered to be in control over such target company, merely by virtue of holding such position.

The Board has observed that the definition is based on certain defined principles rather than on rules. It assessed the 'control' definition and observed that it requires consideration of facts and circumstances of each case, resulting in multitude of opinions. Bright Line test refers to simple and basic Standard that can be applied for removing ambiguity and resolving contentious issues. After completing the public consultation process and notifying the amendment to Takeover Code, it is noteworthy that in cases of mergers and acquisitions, the acquirer would be considered as gaining 'control' of the target company, if he fulfils the bright line tests relating to acquisition of voting rights, control over operations and influence in board decisions.

There have been many cases, including in the much-talked about Jet-Etiad deal, when the issue of control was debated a lot and it was felt that SEBI needs to put in place specific guidelines defining bright lines to determine the 'control'. The fair trade regulator, CCI had first pointed out in its order on Jet-Etiad deal that the various pacts between the two companies indicated Etiad's joint control over Jet².

4. Review of manner of dealing with Audit Reports containing Qualifications

4.1 Summary of the Decision: SEBI noted that it has put in place a mechanism for reviewing the audit qualifications contained in the audit reports, which have been incorporated in the SEBI (Listing and Other Disclosure Requirements) Regulations, 2015 ('Listing Regulations'). With an objective that the impact of audit qualification is disseminated without any delay, SEBI Board has approved of the following revised procedure to deal with such matters:

- (i) Listed entities shall be required to disclose cumulative impact of all audit qualifications on relevant financial items in separate form, called "Statement on Impact of Audit Qualifications" instead of present Form B. Such disclosure would be in a tabular form along with Annual Audited Financial results filed in terms of the Listing Regulations,
- (ii) Where there are no audit qualifications, the existing requirement of filing Form A signed by top officials/directors of the company and auditors shall not be necessary,
- (iii) The company's management shall have the right to give its views on the audit qualifications in new form,
- (iv) The existing requirement of adjustment in the books of account of the subsequent year shall not be necessary.

4.2 Analysis of the Decision: Pursuant to Regulation 33 of the Listing Regulations, the listed entity shall submit audited standalone financial results for the financial year within 60 days from the end of financial year along with the audit report and either Form A (for audit report with unmodified opinion) or Form B (for audit report with modified opinion). *Vide* the SEBI Board's decision the listed entities will be required to disclose the cumulative impact of all the audit qualifications on relevant financial items in a separate form, called 'Statement on Impact of Audit Qualifications' instead of the present form. It is proposed that the new mechanism will be applicable from the financial year ended March 2016, as well as for the earlier cases.

5. Approval of the SEBI Budget 2016-17 & proposed activities

5.1 Summary of the Decision: The SEBI Budget for 2016-17 was considered and approved by the Board. The Board discussed the plan of action for the said period. Some of the important proposed activities are as follows:

- (i) Significant increase in investor's education and awareness efforts along with a target of having at least one Resource Person in each district of the country for providing such programmes on a regular basis in their areas,
- (ii) Providing more clarity on the definition of the term 'control' under different regulations of the SEBI,
- (iii) Energizing Institutional Trading Platform (ITP), REITs, InvITs and Municipal Bond Markets,
- (iv) Encouraging ease of doing business through system driven disclosures,
- (v) Encouraging dividend distribution policy by listed companies,
- (vi) Encouraging delisting of suspended companies,
- (vii) Enhanced supervision of stock brokers and other intermediaries,
- (viii) Raising standards for Credit Rating Agencies,
- (ix) Strengthening the surveillance mechanism,
- (x) Development of integrated database on commodity derivatives, augment supervision of the market and introduction of new products and allowing new participants,
- (xi) Encouraging use of technology to streamline KYC procedure and augment the reach and depth of the market (especially for mutual funds),
- (xii) Completion of the construction of National Institute of Securities Market, Campus at Patalganga and to develop it as a world class institution for training, certification and research in the area of financial markets.

5.2 Analysis of the Decision: The decisions taken by the SEBI Board with respect to the important proposed activities are significant, since the decisions have a very wide impact on the investor's base, market intermediaries and the overall market. The proposed activity for energizing Institutional Trading Platform (ITP), REITs, Invits and Municipal Bond Markets will help investors in investing in different class of securities and will help issuer companies in raising funds from certain class of investors. The proposed decision of encouraging the ease of doing business through system driven disclosures, encouraging dividend distribution policy by listed companies will assist companies in disclosures to stock exchanges and decision making relating to distribution of dividend. Last year, SEBI proposed that dividend distribution policy will be mandatory for certain class of companies for initial years. However, SEBI has not taken any final decision on the same. SEBI Board's decisions relating to encouraging delisting of suspended companies will assist investors in getting unlocked their dead investments and

will help companies in reducing the burden of compliance cost.

Conclusion

6. The decisions taken by the SEBI Board with respect to imposing restrictions on wilful defaulters and introducing brightline tests for acquisition of 'control' under Takeover Code are need of the hour, considering the recent incidents of Vijay Mallya and Jet-Etihad

deal. Such decisions in future will definitely protect the interests of capital market and of investors'. Certain decisions of the SEBI Board relating to energizing Institutional Trading Platform, REITs, InvITs and Municipal Bond Markets, encouraging ease of doing business through system driven disclosures, encouraging dividend distribution policy and delisting of suspended companies will strengthen the market, regulatory mechanism and bring in more investors' participation in the long-term.



1. SEBI Board Meeting dated March 12, 2016. PR No. 56/2016.
2. Published on www.economictimes.com on March 12, 2016. http://economictimes.indiatimes.com/articleshow/51371535.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst