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## SEBI to tighten noose on side deals between PE Investors and Promoters



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### Introduction

1. SEBI, in its board meeting held on September 23, 2016<sup>1</sup>, took some significant decisions which will have a wider impact on the corporates, foreign investors, compliance officers, portfolio managers, SEBI-registered intermediaries and Indian investors at large. Some of the important decisions taken by the SEBI Board include allowing Foreign Portfolio Investors ('FPIs') to trade directly in corporate bonds (i.e., without a broker), proposed amendments to Infrastructure Investment Trusts Regulations, Real Estate Investment Trusts Regulations, Investment Advisers Regulations and ICDR Regulations. This article is a summary of the key decisions taken by the SEBI Board and its impact on the concerned market intermediary or market.

### Liberlised norms for FPIs:

### Summary of the Decision

2. Regulation [21\(4\)\(d\)](#) of SEBI (FPI) Regulations, 2014 states that *"The transaction of business in securities by a foreign portfolio investor shall be only through stock brokers registered by the Board"*. Further, the broker is required to be a qualified member of Recognized Stock Exchange in accordance with Rule [8](#) of the Securities Contracts (Regulation) Rules, 1957. The SEBI Board proposed to allow FPIs (Category - I & Category - II) to have an option to directly access corporate bond market without brokers. SEBI Board sanctioned the proposal of allowing access to FPIs to Over-the-Counter, Request for Quote and Electronic Book Provider platforms of Regional Stock Exchanges will only for proprietary trading. SEBI Board resolved to take up the proposal with the Government for amending to Rule 8(4) of the Securities Contracts (Regulation) Rules, 1957 to permit FPIs to become members of RSE for the limited purpose of proprietary trading.

### Analysis of the Decision

**2.2.** Presently, FPIs can trade in the Indian markets only through stock exchange registered brokers. The proposed move of allowing FPIs to trade directly in corporate bond market without broker aims at deepening the corporate bond market by attracting more overseas funds and reducing their cost of investments in India. The said decision will help FPIs in increasing their margins per share, which will ultimately increase their profits from trading of corporate bonds. Such trading will also develop liquidity in the corporate bond market, which will be beneficial for other investors as well. From the perspective of

broker, it will have a negative impact as their revenues will get affected. For operationalising the SEBI Boards' decision, it is necessary that the FPI Regulations and Securities Contracts (Regulation) Rules are amended in this regard.

Currently, investments made by SEBI-registered FPIs in domestic capital market stand at Rs. 11.5 lakh crore. This includes Rs 8.45 lakh crore in equities and Rs 3.06 lakh crore in debt. Depending on the response in the corporate bonds market, FPIs may give FPIs direct access to other segments of the capital markets at a later stage<sup>2</sup>.

## **Amendments proposed to InvIT Regulations & REIT Regulations:**

### **3. Summary of the Decision**

**3.1** After extensive public consultation process, the SEBI Board approved of amendments to SEBI (Infrastructure Investment Trusts) Regulations and SEBI (Real Estate Investment Trusts) Regulations.

The proposed amendments to InvIT Regulations relate to:

- (i) Allowing InvIT to invest in two level SPV structure through Holding Company (Holdco), subject to sufficient shareholding in the Holdco and the underlying SPV and other safeguards including:
  - (a) InvIT to have right to appoint majority directors in the SPV(s),
  - (b) Holdco to distribute 100% cash flows realised from underlying SPVs and at least 90% of the remaining cash flows.
- (ii) Reducing mandatory sponsor holding in InvIT to 15%,
- (iii) Remove the limit on the number of sponsors of InvIT,
- (iv) Rationalizing the requirements for private placement of InvIT,
- (v) Amending the definition of the valuer,
- (vi) Clarifying the definition of 'associates' and 'related parties' in the regulations.

The proposed amendments to REIT Regulations relate to:

- (i) Allowing REIT to invest in two level SPV structure through Holding Company (Holdco), subject to sufficient shareholding in the Holdco and the underlying SPV and other safeguards including the following:
- (ii) Clarifying the definition of 'real estate property' in the regulations, subject to certain conditions:
  - (a) REIT to have right to appoint majority directors in the SPV(s),
  - (b) Holdco to distribute 100% cash flows realised from underlying SPVs and at least 90% of the remaining cash flows
- (iii) Remove the limit on the number of sponsors and introducing the concept of sponsor group
- (iv) Allowing REITs to invest upto 20%, in under construction assets
- (v) Amending the definition of the 'valuer'
- (vi) Clarifying the definition of 'associates' and 'related parties' in the Regulations.

### **Analysis of the Decision**

**3.2** As per extant regulations, InvITs can hold infrastructure assets either directly or through single layer Special Purpose Vehicle ('SPV'). Vide the SEBI Board's proposed amendments, InvITs are allowed to invest in infrastructure projects through Holding company structure whereby infrastructure projects/assets are held by the SPV, subject to compliance of certain conditions. By this proposed amendment, the infrastructure assets in India which are generally held through different SPVs, in turn, are held by a Holding Company. Vide the proposed amendments, the number of sponsors for REITs can go up to 5 from 2. Pursuant to the SEBI Board's approval, 20% of REIT money can now be used for under construction

projects compared to 10% earlier. The relaxation in the REITs & InvITs norms will attract more companies to raise funds under the said route and at the same time, investors can diversify their portfolio by investing in different investment products with unique risks and returns.

## **Proposed amendments SEBI (Investment Advisers) Regulations, 2013:**

### **4. Summary of the Decision**

**4.1** SEBI (Investment Advisers) Regulations, 2013 provide for exemptions from registration as an 'investment adviser' for certain entities who provide investment advice as an incidental activity to their primary activity. With an objective to specify uniform standards, SEBI proposes to float Consultation Paper on the following points:

- (i) Re-look on the exemption from registration as an investment adviser provided to Mutual Fund Distributors, SEBI registered intermediaries, etc., for providing investment advice as an incidental activity to their primary activity,
- (ii) Granting of time period of 3 years to mutual fund distributors who seek to migrate as an investment adviser so as to enable them to obtain necessary certification and to comply with other requirements specified in the SEBI (Investment Advisers) Regulations,
- (iii) Segregation of investment advisory services through a separate subsidiary within a period of three years,
- (iv) Clarification in respect of investment product and investment advice given in electronic/broadcasting media,
- (v) Applicability of advertisement code to be followed by any person including the investment advisers while issuing advertisement,
- (vi) Restriction on providing trading tips via bulk SMS, email, etc., and restriction on soliciting investors by offering schemes/competitions/games/leagues/etc., related to securities market and covering these activities under the advertisement code as well as under the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003,
- (vii) Clarity between the activities of 'investment adviser' and 'research analyst',
- (viii) Clarity on mode of acceptance of fee,
- (ix) Requirement of providing 'Rights and Obligations' document to the clients,
- (x) Requirements for providing Online Investment Advisory Services and Use of Automated Tools.

### **Analysis of the Decision**

**4.2** With an objective to prescribe uniform standards and address the gaps or overlaps in legal or regulatory standards governing all the intermediaries/persons engaged in providing investment advisory services, SEBI Board has approved to amend Intermediaries Regulations, after detailed consultation process. SEBI Board proposes to tighten the provisions relating to investment advisors by: (i) Segregating 'investment advisory services' through a separate subsidiary within a period of 3years, (ii) Applicability of the Advertisement Code, (iii) Clarification regarding the 'investment product' and 'investment advice' given in electronic/broadcasting media, (iv) Restriction on providing trading tips via bulk SMS, email, etc., and restriction on soliciting investors. Vide the SEBI Board's approval, it seems that SEBI proposes to overhaul the Regulations relating to Investment Advisors w.r.t. proposed exemptions, increasing the ambit of investment adviser Regulations, their marketing techniques, restriction on trading tips, clarity on activities of 'investment adviser' and 'research analyst', etc.

## **Proposed amendments to SEBI (Portfolio Managers) Regulations:**

### **5. Summary of the Decision**

**5.1** Pursuant to the announcement by the Finance Minister in the Union Budget 2015-16, Income Tax Act, 1961 was amended by inserting Section 9A (known as 'Safe Harbour Norms'). This section provides that fund management activity carried out through an 'Eligible Fund Manager' located in India acting on behalf of an 'Eligible Investment Fund' (i.e., overseas fund) shall not constitute business connection in India of such fund, subject to the fund and the fund manager meeting certain specified conditions. After exhaustive consultation process, SEBI Board approved of the amendments to SEBI (Portfolio Managers) Regulations, 1993. The salient features of the proposed amendments are:

- (i) Insertion of a separate Chapter II-A 'Eligible Fund Managers' which will apply to Eligible Fund Managers exclusively pertaining to their activities as portfolio managers to 'Eligible Investment Funds'.
- (ii) Procedure for an existing SEBI registered Portfolio Manager to function as an 'Eligible Fund Manager',
- (iii) Procedure for registration of an existing foreign based fund manager desirous of relocating to India or a fresh applicant to function as an Eligible Fund Manager,
- (iv) Obligations and Responsibilities of Eligible Fund Manager,
- (v) Since Eligible Investment Funds will be governed by the norms or disclosure requirements of the jurisdiction from where they raise funds, certain provisions of SEBI (Portfolio Managers) Regulations shall not be applicable on Eligible Fund Managers,
- (vi) Inclusion of CFA from CFA Institute as an eligible qualification for principal officer of a portfolio manager.

### **Analysis of the Decision**

**5.2** With an objective to make it easier for foreign fund managers keen to relocate to India, SEBI Board approved of the proposal to allow them to act as Portfolio Managers under a relaxed regulatory regime. The proposed amendment to the Portfolio Managers Regulations is in line with the Finance Minister's announcement in the Union Budget 2015-16 and then the amendment to Income Tax Act by introduction of Section 9A ('Safe Harbour Norms'). Pursuant to the proposed amendments approved by the SEBI Board, the existing SEBI-registered Portfolio Manager will also be allowed to act as 'Eligible Fund Manager' with prior intimation from SEBI and subject to the compliance of prescribed conditions. Vide the proposed amendments, SEBI has also introduced a mechanism for registration of an existing foreign-based fund manager desirous of relocating to India, or as a fresh applicant.

### **Employee Reservation in Issues**

## **6. Summary of the Decision**

**6.1** SEBI Board noted that as per extant provisions, ICDR Regulations provide that an issuer can make reservation for employees which shall not exceed 5% of post-issue capital of the issuer company and the value of allotment to any employee in pursuance of reservation shall not exceed Rs. 2 lakhs. Based on representations, SEBI Board considered and approved of the proposal to allow allotment to employees in excess of the extant limit of Rs. 2,00,000/- per employee under employee reservation quota. Pursuant to the SEBI Board's resolution, the application for shares of the value in excess of Rs. 2,00,000/- shall be considered as application for additional shares and shall be considered only in the event of under-subscription in the employee reservation portion. The unsubscribed shares available in the employee reservation portion shall be allotted on a proportionate basis to the employees who have applied for the additional shares. SEBI Board approved of the proposal that value of total allotment to an employee under the employee reservation portion, including the additional allotment, shall not exceed Rs. 5,00,000/-.

### **Analysis of the Decision**

**6.2** Pursuant to the existing provisions in the SEBI (ICDR) Regulations, an issuer company can make reservation for employees which cannot exceed 5% of the post-issue capital. The Regulations also provide that the value of allotment to any employee, in pursuance of reservation, cannot exceed Rs. 2,00,000/-. Pursuant to the SEBI Board's decision, the employees can apply up to Rs. 5,00,000/- under the 'employee reservation quota'. Considering the possible under-subscription by particular employee(s), the SEBI Board's approval provides flexibility for allotment of shares, on proportionate basis, to the employees who have applied for additional shares. Such flexibility is not there for any category of investors in the IPO. In order to give effect to the SEBI's Board decision, the SEBI (ICDR) Regulations are to be amended.

## **Corporate Governance Issues in Compensation Agreements**

### **7. Summary of the Decision**

**7.1** SEBI Board noted that there are instances of Private Equity ('PE') Funds entering into compensation agreements with promoters, directors and key managerial personnel of listed investee companies, based on performance of such companies. However, when such reward agreements are executed without prior approval of shareholders, it could potentially lead to unfair practices. SEBI Board approved of the proposal for initiation of public consultation process on corporate governance issues in 'compensation agreements'. The consultation paper proposes to seek public comments on the possible amendments to SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, which include:

- (i) Adding new provision that would require disclosures and prior approval of shareholders by way of an ordinary resolution, and
- (ii) In case of existing profit sharing agreements, such agreements shall be informed to the stock exchanges for public dissemination, and
- (iii) Approval shall be obtained from their boards and shareholders within stipulated timelines.

### **Analysis of the Decision**

**7.2** 'Managerial Remuneration' and its disclosures to the shareholders has always been a topic of concern for the listed companies. Vide the SEBI Board's decision, it can be said that SEBI proposes to regulate and monitor the compensation agreements entered into by the promoters, directors and Key Managerial Personnel ('KMP') with the PE investor in the company. It is a matter of debate, as the agreement would be between promoters, directors and KMP with the PE investor in the company and not between PE investor and the company. Therefore, company is not privy to the contract. However, proposed approval is required to be obtained from the board of directors and the shareholders of the company, where company is not a party to the contract. Since the company is not a direct party to the proposed transaction with PE Investor, the beneficiaries (i.e. promoters, directors and KMP) may misuse or misappropriate the funds of the company. The proposed amendment will affect the companies which are funded by PEs and that have compensation agreements with the promoters, directors and KMPs. The proposed amendment may not affect a promoter driven company. The said amendment will be notified by amending Listing Obligations and Disclosure Requirements, Regulations.

## **Permanent registration to be granted to market intermediaries**

### **8. Summary of the Decision**

**8.1** The Board noted that SEBI has already provided for permanent registration to stock brokers and sub-brokers subject to meeting conditions, on a continuous basis. Based on experience gained and in order to facilitate 'easy of doing business' for market intermediaries, SEBI Board decided to grant permanent registration henceforth to 11 categories of intermediaries.

### **Analysis of the Decision**

**8.2** The SEBI Board has decided to grant permanent registration to the following categories of intermediaries: (i) Merchant Banker, (ii) Registrar to an Issue & Share Transfer Agent, (iii) Bankers to an Issue, (iv) Underwriters, (v) Credit Rating Agency, (vi) Debenture Trustee, (vii) Depository Participant, (viii) KYC Registration Agency, (ix) Portfolio Managers, (x) Investment Advisers, (xi) Research Analysts. SEBI Board proposes that the provisions relating to satisfaction of 'fit and proper person' criteria is complied by the respective intermediary on continuous basis. SEBI also proposes to put in place an on-site and offsite supervision mechanism, which may include inspections, reporting, etc. With respect to the decision relating to 'permanent registration' for intermediaries, it is essential that SEBI has robust enforcement mechanism for detecting and resolving frauds and misrepresentations. Though the decision has been taken by the SEBI Board under the garb of 'ease of doing' business, it is essential that such 'permanent registration' is not misused by the said intermediary.

## **Conclusion**

**9.** Most of the key decisions taken by the SEBI Board will require the amendment to the respective Regulations. The proposed amendment to the Listing Regulations w.r.t. the compensation agreements by promoter/directors/KMP with PE funds, would require some more time as the amendment is proposed to be taken after noting stakeholder's suggestions after floating consultation paper. The SEBI Board's significant decisions which will have a wider impact on the India Inc. and foreign investors would be: (i) Opening gates to the FPIs to trade directly in Corporate Bonds, (ii) Amendments proposed to InvIT Regulations & REIT Regulations. The compliance officers of the company and the prospective PE investors in the company will have to ensure compliance and disclosures for the compensation agreements.

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1. Press Release [PR No. 139/2016], dated September 23, 2016.

2. [http://economictimes.indiatimes.com/articleshow/  
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