SEBI's new initiative: Stringent norms for P-Notes and Dividend Distribution policy for Listed Cos.

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Introduction

1. SEBI Board, in its meeting held on May 19, 2016, took several crucial and important decisions, which include tightening of provisions relating to offshore derivative instruments ('ODIs', referred to as Participatory Notes, 'P-Notes'), mandatory formulation of Dividend Distribution Policy for top 500 listed companies, amendments to the SEBI (Infrastructure Investment Trusts) Regulations, 2014, proposed amendments to securities laws, etc. The article is a compilation and analysis of the prominent decisions taken by the SEBI along with its impact on the securities market and market participants.

2. Tightening of screws on P-Notes

2.1 ***Summary of Decisions*****:** SEBI Board noted and discussed the concerns raised by the Special Investigations Team (SIT) with regard to identification of beneficial owners and transferability of P-Notes and, accordingly, the Board approved of the following additional measures for the purpose of enhancing the transparency and control over the issuance of P-Notes:—

2.1.1 *Applicability of Indian KYC/AML norms for client due diligence***:** Presently, the P-Note issuers follow the KYC/AML norms of either the jurisdiction of the end beneficial owner or of the jurisdiction of the issuer. With an objective to bring uniformity in KYC/AML norms, SEBI Board has decided that Indian KYC/AML norms will now be applicable to all P-Note issuers. It is proposed that the KYC/AML norms applicable to P-Note issuers will be the same as that for all other domestic investors. P-Note issuers shall be required to identify and verify the beneficial owners in the subscriber entities, who hold in excess of the threshold, *i.e.*, 25% in case of a company and 15% in case of partnership firms/trusts/unincorporated bodies (as defined under Rule 9 of the Prevention of Money-laundering (Maintenance of Records) Rules, 2005). In such cases, the P-Note issuers shall be required to identify and verify the person(s) who control the operations of these entities.

2.1.2 *Prior permission for Transferability of P-Notes (Amendment to the SEBI (Foreign Portfolio Investor) Regulations, 2014)***:** Presently, P-Note subscribers are not required to take prior permission of the P-Note Issuer for transfer of instruments to another investor offshore.

With an objective to tighten the P–Note regime and to have more control over issuance and transfer of such instruments, the SEBI Board has decided that the P–Note subscribers will have to seek prior permission of the original issuer for further/onward issuance/transfer of P–Notes.

2.1.3 *Reporting of complete transfer trail of P–Notes***:** As per the extant provisions, the details of the P–Note holders have to be mandatorily reported to the SEBI on a monthly basis. The issuers are also required to capture the details of all the transfers of the P–Notes issued by them. These can be made available to the SEBI on demand. The SEBI Board has decided that in the monthly reports on P–Notes, all the intermediate transfers during the month would also be required to be reported.

2.1.4 *KYC Review***:** The SEBI Board has decided to review the KYC review on the basis of the risk criteria as determined by the P–Note issuers, as: *(i)* At the time of on-boarding and once every three years for low risk clients, *(ii)* At the time of on-boarding and every year for all other clients.

2.1.5 *Suspicious Transactions Report***:** P–Note issuers shall be required to file suspicious transaction reports with the Indian Financial Intelligence Unit ('FIU'), if any, in relation to the P–Notes issued by it.

2.1.6 *Reconfirmation of P–Note positions***:** P–Note issuers shall be required to carry out reconfirmation of their positions on a semi-annual basis.

2.1.7 *Periodic Operational Evaluation***:** The SEBI Board has approved of a proposal where the P–Note Issuers will be required to put in place necessary systems and carry out a periodical review and evaluation of its controls, systems and procedures with respect to the ODIs.

2.1.8 *Analysis of the Decision***:** Before the SEBI's decision is analyzed, it is necessary to understand the basic concept of P–Notes and mechanism of investments. P–Notes are instruments issued by registered FPIs to overseas investors who intend to invest in Indian stock markets without obtaining SEBI-registration. Therefore, through this mode there is high possibility of round-tripping and money laundering. In the Board Meeting, the SEBI Board has proposed tighter rules for P–Notes with an objective of curbing the potential for money laundering through such investment route. The decision is based on SIT's Report that had made some critical observations on P-Notes and suggested increased regulation of fund flows through the route.

The proposal about the applicability of Indian KYC/AML norms to all P–Note issuers will have bigger impact on the foreign investments in the stock market. It is also proposed that P–Note issuers will be required to identify and verify beneficial owners in the subscriber entities, who hold in excess of 25% for company and 15% in case of partnership firms/trusts/unincorporated bodies. Such identification and verification of beneficial owners will also have a far-reaching impact on the investment through this route, though it will assist the Indian regulators in tracking the beneficial owners of P–Notes. The monitoring is proposed to be enhanced, whereby there would be monthly reporting on all the intermediate transfers on the P–Notes.

The proposal whereby P–Note subscribers will have to seek prior permission of original ODI issuer for further issuance/transfer, will have a significant impact on the Indian stock market, as every downstream transfer of P-Note will require prior consent, thereby making the entire process cumbersome and unattractive for the foreign investors.

2.2 *Dividend Distribution Policy for listed companies*

2.2.1 *Summary of the Decision***:** With an objective of assisting investors in taking well informed investment decisions, the SEBI Board approved of the proposal for formulation and disclosure of the Dividend Distribution Policies ('DDP')

in the annual reports and on their websites. However, it is proposed that such provisions will be applicable for the top 500 listed companies (by way of market capitalization).

SEBI has prescribed the following disclosure parameters in the DDP:—

(i) Circumstances under which shareholders can or cannot expect dividend;

(ii) Financial parameters that will be considered while declaring dividends;

(iii) Internal and external factors that would be considered for declaration of dividend;

(iv) Policy as to how the retained earnings will be utilized; and

(v) Provisions in regard to various classes of shares.

When the company proposes to declare dividend on the basis of parameters other than what is mentioned in DDP or proposes to change its DDP, the same along with the rationale shall be disclosed.

2.2.2 *Analysis of the Decision*: The decision taken by the SEBI Board will assist the investors (retail and institutional, both) in getting a clear picture on the returns from the investments made in listed companies. The DDP will also assist the investors in identifying stocks that match with their investment objectives. However, there could be a possibility that the DDP can be vaguely worded and the compliance of the provisions by listed companies may be in letter and not in spirit. From the perspective of company law and considering the fiduciary duty of directors towards the company and other duties of the directors, the dividend (whether interim or final) is always at the discretion of the Board of Directors. Such decision is taken considering the financial condition of the company (whether, profits or losses) sources, cash flow, transferability to reserves, timing of declaration of the dividend. If the DDP is detailed in nature, the minority shareholders or some institutional shareholders can misuse the Policy in extracting dividend from the company, which would otherwise be used in expansion activities of the company.

There have been complaints from various investor groups that companies were not distributing their extra profits among the shareholders. Some of the countries such as Brazil, Chile, Venezuela, Columbia and Greece are said to have made it mandatory to pay dividend to shareholders depending on the size of profits[1].

2.3 ***Amendments to the SEBI (Infrastructure Investment Trusts) Regulations, 2014***

2.3.1 *Summary of the Decision*: With an objective to smoothen the registration process of Infrastructure Investment Trusts ('InvIT') for launching offers, SEBI Board has approved of the proposal of floating a consultation paper proposing certain changes/providing clarification in InvIT Regulations. It is proposed that the consultation paper will cover the following points:—

(1) Allowing InvITs to invest in 2-level SPV structure,

(2) Mandatory sponsor holding in InvIT to be reduced to 10% from current requirement of 25%, subject to certain conditions,

(3) Increase in the number of sponsors from 3 to 5,

(4) Other operational requirements, such as aligning regulations in line with the provisions of the Companies Act, 2013 and SCRR, filing of Project Implementation Agreement at the time of filing of offer document, etc.

2.3.2 *Analysis of the Decision*: The proposed move of the SEBI to amend the InvIT Regulations is with an objective of easing the registration process for launching more offers. The decision of allowing InvITs to invest in 2-level SPV structure, reducing the mandatory sponsor holding in InvIT to 10% (from 25%), increasing the number of sponsors from 3 to 5, is one of the striking

features of the SEBI's decision. However, the amendment to the Regulations will require time, as the same will be effective after the public consultation process is complete. The Board's decision will also improve the investment avenues for investors.

2.4 ***Guidance Note on Settlement and procedural changes in processing of Compounding applications***

2.4.1 *Summary of the Decision***:** SEBI Board noted that the Settlement Regulations were formulated primarily to settle minor and technical violations not having wider impact on the market so that enforcement is concentrated on major and significant cases. The Board also noted that during 2015-16, the number of settlement cases have come down putting pressure on the enforcement system. The Board observed that there are certain doubts on the interpretation of Reg. 5(2)(*b*) of the Settlement Regulations and an internal Guidance Note was issued for clarifying the doubts. Reg. 5 relates to 'Scope of settlement proceedings' and Reg. 5(2)(*b*) states that specified proceeding, shall not be settled, if it involves fraudulent and unfair trade practices including front running, which in the opinion of the Board are serious and have a market-wide impact or have caused substantial losses to or affect the rights of investors in securities, especially retail investors and small shareholders.

The defaults which in the opinion of the SEBI Board have a bearing on securities market as whole and not just the listed security and its investors may be considered to have 'market wide impact'. The Board noted that the 'assessment of facts' and 'circumstances' while deciding the seriousness of the default shall take into account the weight and sufficiency of the evidence. The Board approved to incorporate the Guidance Note in the Regulations. SEBI Board noted that procedure can be simplified in disposing of matters relating to prosecution for non-payment of penalty, where compounding request has been filed and where full penalty is paid along with interest.

2.4.2 *Analysis of the Decision***:** The SEBI Board proposes to prohibit settlement through consent mechanism only in the case of offences that has market-wide impact and hurt investors substantially. The move is aimed at reducing the regulatory and administrative burden. However, the phrase 'market-wide impact' is a subjective. Final rules will help in concluding whether a particular rule will fall under the consent mechanism or not. The final rules will assist us in understanding the real impact of the SEBI's decision and the manner in which the cases will be bifurcated as 'market wide impact' or not.

2.5 ***Amendments to the Securities Law – SEBI Act, Securities Contracts (Regulation) Act and Depositories Act***

2.5.1 *Summary of the Decision***:** SEBI Board noted that during 2014, the Parliament had amended the SEBI Act, 1992, Securities Contracts (Regulation) Act, 1956 and Depositories Act, 1996, providing for minimum and maximum monetary penalties and discretion to impose appropriate penalty by the Adjudicating Officer. The Board observed that such amendments are prospective in nature and not applicable to cases falling between the year 2002–2014. It noted the SC's ruling in *SEBI* v. *Roofit Industries Ltd.* [2015] 63 taxmann.com 331/ [2016] 133 SCL 1 and observed that there is a urgent need to clarify the monetary penalty provisions in the securities laws, relating to cases prior to 2014. Accordingly, the SEBI Board approved to send a proposal to the Central Government for amendments to the said laws.

2.5.2 *Analysis of the Decision***:** In the *Roofit Industries Ltd.* case *(supra)*, SEBI had challenged SAT's decision to reduce the amount of fine. While rejecting the plea, the Apex Court did not accept that section 15J of the SEBI Act, 1992 gives discretion to Adjudicating Officers in deciding the penalty quantum. In *Siddharth Chaturvedi* v. *SEBI*[2], SC referred the matter to Larger Bench to rule on interplay between section 15A (which prescribes the quantum of penalty for failure to furnish any document/

return, etc., under the SEBI Act limiting it to lesser of ₹ 1 cr. or ₹ 1 lakh for each day during which failure continues) and section 15J (which prescribes the factors to be taken into consideration while adjudging quantum of penalty) of the SEBI Act.

The SEBI Board's decision is in the interest of the all the stakeholders and the authorities under the securities law. However, such clarity can either be provided by the detailed ruling by the Larger Bench of the Apex Court or by amending the securities law legislation (which is a time consuming process). As many as 36 cases have been remanded back to the SEBI for passing fresh orders by the SAT. Also, around 3,000 adjudication actions remain pending as on March 2016, of which 90% pertain to the period between 2002 and 2014[3].

Conclusion

3. With an objective to undertake the activities of publishing research papers, policy notes, concept notes, etc., in addition to delivering lectures and seminars, the SEBI Board also approved of the establishment of the SEBI Chair at the National Institute of Securities Markets. The Board also approved of the proposal of introducing Pension Scheme under New Pension Scheme (NPS) for the permanent staff members of the SEBI. However, the decision taken by the SEBI Board of tightening the provisions for P–Notes had a significant impact on the stock market and also a prospective impact on the foreign investors. The SEBI Board's decision of introducing the Dividend Distribution Policy is welcome initiative, however, its effectiveness will depend on the compliance level by the top 500 listed companies. In near future, the formulation of Dividend Distribution Policy will be made applicable to all listed companies. The decision of sending the proposal to the Government to amend the securities law (*i.e.*, SEBI Act, Securities Contracts (Regulation) Act and Depositories Act) is one of the pro-active decisions taken by the Board.

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1. Source Economic Times: http://economictimes.indiatimes.com/articleshow/52348044.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst
2. [2016] 67 taxmann.com 250 (SC)
3. Source Business Standard: http://www.business-standard.com/article/pti-stories/sebi-to-ask-govt-to-amend-laws-for-clearer-penalty-provisions-116051901509_1.html