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SEBI's new initiative: Sidepocketing in mutual funds and review of start-up regulations



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Introduction

1. In its meeting on December 12, 2018¹ SEBI Board took certain important decisions which will have an impact on the mutual funds, mutual fund investors, start-ups, investment limits for foreign portfolio investors and companies. The amendments to the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 will have an impact on the Indian corporates. In last 1-2 weeks some amendments have been notified or the Regulations have been amended. This article is a compilation and analysis of the decisions taken by the SEBI Board in its meeting on December 12, 2018.

Creation of Segregated Portfolio by Mutual Funds

2. Before understanding the impact of the SEBI Board decision, let us first understand the meaning of the term 'Creation of segregated portfolio by Mutual Funds'. Creation of Segregated Portfolio is a mechanism to separate distressed, illiquid assets from more liquid assets in a mutual fund portfolio to deal with a situation arising due to a credit event. With a segregated portfolio, investors who may take the hit when the credit event happens shall get the upside of future recovery, if any.

The SEBI Board noted the proposal to allow Mutual Funds to create segregated portfolios with respect to debt and money market instruments subject to various safeguards. This facility will be available to Mutual Funds based on credit events. Creating segregated portfolios may be optional for mutual funds, but approval of trustees is necessary for activating such a portfolio. The SEBI Board noted the recommendations of Mutual Fund Advisory Committee. The Board also took note of the proposal to review the valuation norms applicable to mutual fund schemes investing in debt and money market instruments.

The decision has been taken by the SEBI Board to ensure fair treatment to all investors in case of a credit event and to deal with liquidity risk, permit creation of segregated portfolio of debt and money market instruments by mutual funds schemes.

SEBI's move comes in the wake of defaults by Infrastructure Leasing & Financial Services (IL&FS) leading to Net Asset Values (NAVs) of various debt schemes taking big hits. The loss in NAV of debt schemes exposed to debt papers of IL&FS was sharp, more than 8% in some cases.

In relation to the decision taken by the SEBI Board, SEBI has issued a Circular² in this regard. SEBI has clarified that the existence of the provisions for segregated portfolio should not encourage the Asset Management Companies to take undue credit risk in the scheme portfolio. SEBI has stated that any mis-use of the provisions of segregated portfolio would be considered serious and stringent action may be taken.

Review of framework for Institutional Trading Platform

3. SEBI Board has, in principle, approved the proposals for amendments to the Regulations pertaining to Institutional Trading Platform ('ITP') in the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018. SEBI Board, while approving the proposals, considered the recommendations of the Primary Market Advisory Committee and the public comments on the Consultation Paper.

The relaxation in the norms relating to start-up listing follows tepid market interest in the existing platform (*i.e.*, Institutional Trading Platform) and demands from various stakeholders to make the norms easier. The objective of the amendments was also to make the platform more accessible in the wake of expanding start-up activities in India. Taking into consideration the difficulties in the compliance requirements for start-up listing, the concept has not kept pace.

3.1 The key proposals approved by SEBI Board are as follows:-

- (1) Renaming of the platform to 'Innovators Growth Platform' ('IGP'),
- (2) For the eligibility for listing on the IGP, the issuer shall have to be a company which is intensive in the use of technology, information technology, intellectual property, data analytics, bio-technology or nano-technology to provide products, services or business platforms with substantial value,
- (3) 25% of the pre-issue capital of the Issuer Company for at least a period of 2 years should have been held by: (i) Qualified Institutional Buyers, (ii) Family trust with net-worth of more than Rs. 500 crores, (iii) Category III FPI, (iv) Pooled investment fund with minimum assets under management of USD 150 million and registered with a financial sector regulator in the jurisdictions where it is resident, (v) Accredited Investors for the purpose of IGP,
- (4) Not more than 10% of the pre-issue capital may be held by Accredited Investors,
- (5) The existing requirement of cap on holding of not more than 25% of the post-issue capital by any person (individually or collectively with persons acting in concert) to be deleted,
- (6) The minimum application size and minimum trading lot to be Rs. 2 Lakhs and in multiples of Rs. 2 Lakhs thereof,
- (7) There would not be any requirement of minimum reservation of allocation to specific category of investors,
- (8) Minimum number of allottees has to be 50,
- (9) Minimum net offer to public should be in compliance with Minimum Public Shareholding norms and minimum offer size has to be Rs. 10 crores,
- (10) IGP to be designated as a platform for start-ups with an option to trade under regular category after completion of 1 year of listing subject to compliance with exchange requirements.

Clubbing of investment limits for Foreign Portfolio Investors (FPIs)

4. After considering the recommendations of the SEBI working group under the Chairmanship of Shri Harun R. Khan and comments received from the public, the SEBI Board has decided that the clubbing of investment limit for FPIs should not be done on the basis of same set of beneficial owners as per the Prevention of Money-laundering (Maintenance of Records) Rules, 2005. The proposal that clubbing of investment limits for FPIs will be on the basis of common ownership of more than 50% or common control was approved. However, in the case of appropriately regulated public retail funds, investment limits will not be clubbed on the basis of common control.

In this regard, SEBI will make necessary amendments to SEBI (Foreign Portfolio Investors) Regulations, 2014 and issue necessary circulars/guidelines to implement the aforesaid changes.

Amendment to SEBI (Issue of Capital and Disclosure Requirements)

Regulations & review of OFS framework through Stock Exchange mechanism

5. Before understanding the impact of the SEBI Board decision, let us first understand the meaning of the term 'offer for sale' ('OFS'). It is a process through which the shares are sold through the exchange platform for the listed companies. The OFS mechanism was introduced to enable compliance of the provisions relating to minimum public shareholding. However, later, on the Government started using the OFS mechanism to divest its shareholding in public sector enterprises.

Under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, in case of any increase or decrease in estimated issue size by more than 12%, fresh filing of the offer document with the Board is required. At present, such requirement is for both fresh issues and offer for sale. In case of an Offer For Sale (excluding fresh issue component), the SEBI Board has approved that fresh filing of offer document with SEBI will be required, when there is a change in either the number of shares offered for sale or the estimated issue size, by more than 50%.

In order to expand the universe of companies to whom OFS mechanism is available (presently being top 200 companies by market capitalization) and to bring clarity to the conditions laid down for cancellation of OFS, SEBI Board approved the modifications to the existing OFS mechanism: (i) Expanding the list of eligible companies, and (ii) Cancellation of offer.

With the SEBI Board's decision, the OFS mechanism will be available for shareholders of companies with market capitalization of Rs.1,000 crores and above, with the threshold of market capitalization computed as the average daily market capitalization for 6 months prior to the month in which the OFS opens. The SEBI Board also approved of the proposal wherein if the seller fails to get sufficient demand from non-retail investors at or above the floor price on T day, then the seller may choose to cancel the offer, post-bidding, in full (both retail and non-retail) on T day and not proceed with offer to retail investors on T+1 day.

SEBI Board's decision to ease OFS norms is likely to help a number of small companies, including public sector firms. The simplified process will result in more action in OFS. There is also a probability that there will be more OFS issues than FPOs.

Amendment to the SEBI Takeover Code

6. Presently, under the SEBI's Takeover Code, 2011 *i.e.*, SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 shares taken by way of encumbrance are treated as an acquisition and shares given upon release of encumbrance are treated as a disposal. Such acquisition and disposal are required to be disclosed. At present, such disclosure requirement is not applied to a scheduled commercial bank or public financial institution as pledgee in connection with a pledge of shares for securing indebtedness in the ordinary course of business. The SEBI Board has, in principle, approved that the aforesaid exception to the disclosure requirement will also apply to: (i) Deposit taking Housing Finance Companies (HFCs) or HFCs with asset size of Rs. 500 crores or more, registered with National Housing Bank, and (ii) Systemically important Non-banking Financial Companies. Pursuant to the amendment, shares taken by way of encumbrance (or shares given upon release of encumbrance) by the said HFCs and NBFCs shall not be treated as acquisition (or disposal) for the purpose of disclosure requirements under the Takeover Code.

In relation to the decision taken by the SEBI Board, the regulations were amended by the SEBI (Substantial Acquisition of Shares and Takeovers) (Third Amendment) Regulations, 2018.

Role of Custodians in Commodity Derivatives Market to enable institutional participation

7. The SEBI Board discussed on the proposal for allowing custodial services in goods underlying commodity derivative contracts in order to enable participation of institutional investors in commodity derivatives market. In this regard, the Board approved of the proposed amendments to the SEBI (Custodian of Securities) Regulations, 1996. However, the process will pick up only when the settlement is based on delivery instead of cash now.

Consultation Paper on Uniform Valuation Methodology for Pricing of Corporate Bonds

8. On the uniform valuation methodology for pricing of corporate bonds, the SEBI Board approved following in the matters:

- (i) SEBI not to pursue the exercise for determining a uniform bond valuation methodology to be followed by all regulated entities across the financial sector. The Department of Economic Affairs, Ministry of Finance, however, will undertake the exercise of bringing uniformity in the valuation process for corporate bonds for all regulated entities across the financial sector.
- (ii) SEBI to prescribe guidelines for pricing of corporate bonds, which shall be followed uniformly across all the mutual funds.
- (iii) SEBI to evolve a supervisory and regulatory framework for pricing agencies, which would provide services related to pricing of corporate bonds to Mutual Funds.

Based on the Consultation Paper floated by the SEBI and the feedback received from public, the relevant Regulations would be notified. Taking into account the IL&FS fiasco, the SEBI Board has taken a quick decision of prescribing the guidelines for pricing of corporate bonds.

Madhabi Puri Buch, Whole-Time Member, SEBI said: "The improvements that we expect will be in two areas with regard to- valuation for bonds papers which have a maturity of less than 60 days and also papers which are downgraded to below investment grade. Right now, the guidelines are very generic and we expect to improve."

Conclusion

9. In the recent times SEBI Board has taken some significant decisions that have a bigger impact on the mutual fund industry and the investors, start-ups and corporates in relation to the amendment to SEBI (ICDR) Regulations and SEBI Takeover Code. The concept of introducing uniform valuation methodology for pricing of corporate bonds in new and will be tested in near future. This decision will have a significant impact on the investors and credit rating agencies.

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[1.](#) SEBI Press Release No. 51/2018, dated 12-12-2018
[2.](#) SEBI/HO/IMD/DF2/CIR/P/2018/160, dated 28-12-2018