Corpsec Hotline

August 27, 2012

SEBI INTRODUCES CAPITAL MARKET REFORMS

Brief snapshot of the recent SEBI Board meeting

- Substantial changes proposed to regulatory framework on IPOs;
- Introduction of investment advisors regulations requiring the investment advisors to be registered with SEBI;
- Strengthening the disclosure requirements for issuance of debt securities for both public and private issues;
- Reforms in the mutual fund industry by firming up the regulatory framework and alignment of interest of the market participants.

INTRODUCTION

The Securities and Exchange Board of India ("**SEBI**") at its board meeting held on August 16, 2012 has introduced a series of reforms to the primary and secondary market in order to provide stimulus to the securities market. The reforms primarily aim at revitalizing the mutual fund industry and the capital raising exercise in India. Alongside, SEBI has finally rolled out the regulatory framework governing the investment advisors. For a detailed analysis about the investment advisors regulations, please refer to our hotline: "**Investment advisors: It's time to register!**"

KEY HIGHLIGHTS OF THE SEBI BOARD MEETING PRESS RELEASE

1. **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 in relation thereto which are as follows:

   1. **Facilitation of capital raising by issuers**

      In order to achieve the three-fold purpose of (i) a speedy completion of the fund raising process by the issuers, (ii) enabling compliance with the minimum public shareholding requirement, (iii) streamlining the disclosure process in initial public offering ("IPO"), SEBI has proposed the following measures:

      - **Promoters' contribution made easy :** Under Regulation 32 of the SEBI (Issue of Capital & Disclosure Requirements) Regulations 2009 ("ICDR"), the promoters of the issuer company are required to contribute in the public issue to the extent of 20% of the post issue capital and such promoter contribution shall be locked in for a period of 3 (three) years. Consequently, it was observed that the promoters of issuer companies were often unable to meet the statutory 20% contribution requirement themselves and therefore SEBI has proposed that in order to satisfy the statutory requirement, the promoters may now take the aid of SEBI registered Alternative Investment Funds ("AIF") such as SME funds, infrastructure funds, private equity funds etc. subject to a maximum of 10%.

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

      - **Additional methods for compliance with minimum public shareholding requirement :** In its first Board meeting of the year 2012, SEBI had decided to provide alternative methods to enable companies to comply with the minimum public shareholding requirement of 25%, with the introduction of (i) Institutional Placement Programme and (ii) Offer for sale of shares through stock exchanges. Acting further in line with the same, SEBI has decided to prescribe additional methods for complying with the 25% requirement which methods include rights issue and bonus issue. 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 : The implementation of the SEBI proposal in terms of rights issue/ bonus issue remains largely to be tested especially in case of right issues which off late has not seen favorable response from the market due to lack of investor participation.

      - **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% to the price

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calculated as per the ICDR.

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

- **Reduction in average market capitalisation for fast track issues :** Under Regulation 10 of the ICDR, every listed company desirous of raising capital under a fast track route was required to have a market capitalisation of INR 5,000 crore, which market capitalisation has now been reduced to INR 3,000 crore so as to facilitate further public offerings and rights issue through the fast track route.

  As a matter of recapitulation, the fast track issuance route which was introduced in 2007 for enabling listed companies' to have quick access to further capital. However due to the onerous market capitalization requirement, this route was not as often resorted to by listed companies desirous of raising capital.

  Implication: It seems that the proposed slashed down market capitalisation requirement can act as breather for listed companies who were waiting to opt for this route for a long time now.

- **Re-filing of the prospectus not required :** Unlike the existing threshold of 10%, any addition or deletion to the objects of the issue resulting in a change in estimated issue size or estimated means of finance by more than 20%, will not warrant any re-filing of the offer document with the SEBI.

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

- **Additional Disclosures:** In addition to the existing disclosure requirements, it is proposed that listed companies shall file a comprehensive annual disclosure statement with the SEBI, which filings are aimed at providing updated information to the investors. The SEBI's proposal is directed towards the alignment of the existing disclosure requirements in India with the 20F filing prescribed by the United States Securities and Exchange Commission ("US SEC") by which foreign private issuers provide certain information to the US SEC.

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

2. **Increasing the reach of IPOs to retail investors:**

   - With the aim of increasing 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. The IPOs may be accessed by the members of the general public, either physically or electronically, through the channel of brokers. For those who do not prefer to deal with brokers may download the application forms directly through the website of the stock exchange and also 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.
   - 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 availability of shares in aggregate. The minimum application size for all investors is proposed to be increased to INR 10,000 - INR 15,000 as against the existing INR 5,000 - INR 7,000. Although the minimum application size has been increased, by assuring a minimum bid allotment, SEBI intends to gratify more number of smaller applicants in cases of oversubscribed issues. We hope that this proposal attracts wider participation of the retail public in the primary market and leads to improvement in the liquidity of stocks.

3. **Improving the quality of public offerings**

   - In order to ensure invigoration of the SMEs and better 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 INR 15 crore will be allowed to participate through the profitability route. All others will be able to access the markets either through the small and medium exchanges ("SME") or through the compulsory book building route with increased qualified institutional buyer participation of 75%, as opposed to the existing 50%.
   - While the ICDR did not impose any cap on the objects of the issue, SEBI has decided that 'General Corporate Purposes' as an object of the issue should not exceed 25% of the issue size. Additional mechanisms for monitoring the issue proceeds to be introduced.
   - 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 doing so and such schemes shall be restricted from acquiring shares from the secondary market. Though this change may have significant impacts on listed companies who 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.

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

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

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

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

3. **Mutual Funds**

With a view to promote sustainable growth of the mutual fund industry and effective channelization of domestic savings, SEBI has suggested a long term policy in relation to mutual funds, the main features of which are as follows:

- **Fungibility of Total Expense Ratio (“TER”) has been permitted :** TER 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 TER assumes significance from the investor’s perspective because the costs coming out of the fund affect investor’s returns. Being mindful of the fact that the mutual fund products require deeper penetration into the market, SEBI has introduced the concept of fungibility of TER so as to provide greater flexibility towards allocation of costs to mutual fund managers. Whether this would allow managers to load some of the distribution costs on to the scheme, a long standing demand from the industry, is yet to be seen.
- **Need for robust distribution networks:** The success of the mutual fund market does not alone depend on the mutual fund product, but to a large extent is dependent on the distribution networks. In order to strengthen the distribution network, SEBI has decided to streamline the registration process for distributors by including postal agents, retired government officials, retired teachers etc. for distribution of simplistic products.
- **Alignment of interests:** In order to align the interests of the various stakeholders, distributors and asset management companies (“AMC”), SEBI has decided that the brokerage and transaction cost chargeable to the scheme for execution of trade should be capped to 12 bps in case of cash market transactions and 5 bps in case of F&O transactions. Also, to avoid differential treatment in the same scheme to different classes of investors, 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.
- **Enhanced participation:** As 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 lack of PAN/ bank accounts etc. Going forward, the small traders will be allowed to participate in mutual fund schemes by way of cash transactions to the extent of INR 20,000 subject to compliance of 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.
- **Firming up the regulatory framework:** In order to make the regulatory system more accountable, SEBI has suggested certain additional disclosures by the AMCs which inter alia are as follows: (i) AMCs to provide monthly portfolio disclosures on their website; (ii) set up a new self-regulatory organization for regulation of distributors; (iii) AMCs 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 the aforementioned reforms considering the weak sentiments of the Indian capital markets with a view to strengthen investor confidence and provide boost to the economy. As they say that recognition of an issue is half the problem solved and hence acknowledgment by the regulator of the need to jump start the primary market will surely be welcomed by the market constituents. While the introduction of the reforms is a proactive step by capital market regulator to address the lack luster market, however, it is only upon release of the fine print of the regulatory framework that one would be able to determine the extent to which the new set of reforms will change the grim state of affairs.

– Harshita Srivastava Ruchi Biyani & Vyapak Desai
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