DEVELOPMENTS IN SECURITIES LAW

IN JANUARY

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ACUITY LAW

ABOUT ACUITY LAW

Acuity Law was founded in November 2011. Acuity Law comprises of a team of young and energetic lawyers led by Souvik Ganguly and Gautam Narayan, who have deep and diverse experiences in their chosen areas of practice. We have advised Indian and multinational companies, funds, banks and financial institutions, founders of companies, management teams, international law firms, domestic and international investment banks, financial advisors and government agencies in various transactions in and outside India.

Acuity Law takes pride in rendering incisive legal advice taking into consideration commercial realities. Our areas of practice are divided into two departments.

The Corporate practice is led by Souvik Ganguly and the Disputes practice is led by Gautam Narayan.

As part of the Corporate practice, Acuity Law advises on:

- Mergers and acquisitions;
- Distressed mergers and acquisitions;
- Insolvency Law;
- Private Equity and Venture Funding;
- Employment and labour laws
- Commercial and trading arrangements; and
- Corporate Advisory

As part of the Disputes practice, Acuity Law under the leadership of Gautam Narayan advises and represents clients on domestic and cross - border:

- Civil disputes;
- Criminal law matters; and
- Arbitration matters

Acuity Law actively follows legislative and policy developments in its chosen areas of practice and shares such developments with clients and friends on a regular basis.

If you want to know more about Acuity Law, please visit our website www.acuitylaw.co.in or write to us at al@acuitylaw.co.in.

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INTRODUCTION

This newsletter covers key updates about the developments in Indian securities law during the month of January 2019. We have summarized the key regulatory developments including informal guidance relating to insider trading and preferential allotment of optionally convertible debentures, regulatory changes brought about or proposed by the Indian capital market regulator in relation to the use of artificial intelligence in the securities market, synchronization of delivery and trading lot sizes, takeover norms, regulations governing foreign portfolio investment and a consultation paper on revision of norms applicable to infrastructure investment trusts and real estate investment trusts. Please see below the summary of the relevant regulatory developments and reports.

A. Informal Guidance issued by SEBI

In 2003, the Securities Exchange Board of India ("**SEBI**") introduced the Informal Guidance Scheme ("**Scheme**") in the interest of better regulation and development of the Indian securities market. Under the Scheme, parties may seek guidance from SEBI in case of any queries, in relation to any proposed action / inaction or interpretation of Indian securities laws. The informal guidance is not binding on SEBI.

1. OFF-MARKET INTER-SE PROMOTER TRANSACTIONS NOT EXEMPT FROM INSIDER TRADING REGULATIONS

SEBI on 21 January 2019 issued an informal guidance in the matter of M/s. Shreevatsaa Finance and Leasing Limited ("**SFLL**"), whereby SEBI clarified that off-market inter-se transactions between promoters are not exempt from the application of the SEBI (Prohibition of Insider Trading) Regulations, 2015 ("**PIT Regulations**"), but may be used as a defence against an allegation of insider trading.

The applicant, a promoter and 64.61% shareholder of SFLL, sought to acquire an additional 10.39% of the shareholding of SFLL from Agarni Leasing and Finance Private Limited ("**ALFPL**"), a promoter company of SFLL, by way of an off-market transaction ("**Transaction**"). By virtue of his status as a promoter, the applicant would always be in possession of unpublished price sensitive information ("**UPSI**") of SFLL. The applicant sought guidance on whether the Transaction would be exempt from the general prohibition against trading by insiders while in the possession of UPSI, or whether the applicant will be required to formulate an approved trading plan under the PIT Regulations.

SEBI held that the PIT Regulations generally prohibit insiders from trading in listed or proposed to be listed securities on the stock exchange, when in possession of UPSI. However, circumstances such as off-market, conscious and informed inter-se transactions between promoters in possession of the same UPSI, can be used as a defence against allegations of insider trading. SEBI highlighted that such defence does not amount to an exemption and consequently, the applicant must formulate a trading plan in accordance with the PIT Regulations.

2. PREFERENTIAL ALLOTMENT OF OCDS NOT EXEMPT FROM ICDR REGULATIONS

SEBI on 19 October 2018, issued an informal guidance in the matter of GMR Infrastructure Limited ("**GIL**"), whereby it clarified that preferential issue of optionally convertible debentures ("**OCD**") will not be exempt from the application of the provisions on the relevant chapter on preferential issue under the SEBI (Issue of Capital and Debt Instruments) Regulations, 2009 ("**ICDR Regulations**"). Upon a request by GIL, SEBI maintained the confidentiality of the informal guidance for 90 days and consequently,

disclosed the informal guidance to the public on 28 January 2019.

GIL, a public limited company, proposed to issue unlisted unsecured OCDs to an Indian entity, for settlement of a debt owed to this Indian entity's foreign holding company.

Under the ICDR Regulations, the provisions of Chapter VII dealing with preferential issue, are not applicable to cases of preferential issue of equity shares pursuant to conversion of loan or option attached to convertible debt instruments. Hence, GIL sought clarification on whether the issue of the proposed OCDs would be exempt from compliance with Chapter VII and consequently, whether restrictions relating to tenure of OCDs, lock-in period and conversion price contained therein, would be applicable.

SEBI held that Chapter VII of the ICDR Regulations will be applicable at the time of preferential allotment of OCDs, but not at the time of conversion of the OCDs into equity shares. Therefore, GIL will have to abide by restrictions contained in Chapter VII relating to the tenure of the OCDs and lock-in period for the subsequent equity shares.

B. Circulars

1. CIRCULAR FOR REPORTING REQUIREMENTS FOR USE OF AI AND ML APPLICATIONS AND SYSTEMS BY MARKET INTERMEDIARIES

SEBI has issued regulatory reporting requirements to be complied with by market intermediaries offering or using artificial intelligence ("**AI**") or machine learning ("**ML**") applications or systems, *vide* its circular no. SEBI/HO/MIRSD/DOS2/CIR/P/2019/10 dated 04 January 2019 ("**AI Circular**").

SEBI recognized that market intermediaries and participants are increasingly using AI and ML as product offerings in investor and consumer facing products, such as 'robo-advisors,' which are software platforms that provide digital financial advice based on mathematical rules or algorithms, without human intervention. The AI Circular constitutes the first step by SEBI to regulate the use of AI and ML systems in the securities market.

The key points of the AI Circular are:

1. Scope: The AI Circular covers any set of applications / software / programs / executable / systems (computer systems) that are offered to investors (individuals and institutions) by market intermediaries to:

   i. facilitate investing and trading; or

   ii. disseminate investments strategies and advice; or

   iii. carry out compliance operations / activities,

   where AI / ML is portrayed as a part of the public product offering or under usage for compliance or management purpose. The AI Circular has provided a list of systems / applications categorized as AI or ML, in an annexure.

2. Reporting requirement: All stock brokers / depository participants using the specified AI / ML technologies are required to make quarterly reporting submissions as specified in the AI Circular, within 15 days of the end of the quarter, with effect from the quarter ending in March 2019. These submissions must then be consolidated and submitted by stock exchanges and depositories to SEBI in the

manner as provided in Annexure C of the AI Circular, within 30 days of the end of the quarter. Further, SEBI is currently undertaking a market survey exercise to create an inventory of AI / ML tools used in the securities market, in order to gain a better understanding to formulate appropriate regulations in the future.

2. SEBI ISSUES POLICY ON ALIGNMENT OF TRADING LOT SIZE AND DELIVERY LOT SIZE

SEBI *vide* its circular no. SEBI/HO/CDMRD/DNPMP/CIR/P/2019/023 dated 23 January 2019 has directed stock exchanges to ensure uniformity between the sizes of trading lots and delivery lots in the commodity derivatives market.

A trading lot size represents the standard quantity of the underlying commodity corresponding to a single derivatives contract position, whereas a delivery lot size represents the standard quantity of the underlying commodity, in multiples of which delivery is permitted after the expiry of the contract.

However, SEBI may exempt the requirement for uniform trading lot and delivery lot size on a case-by-case basis, based on detailed representations made by exchanges establishing the rationale, physical market practices, feedback from stakeholders etc. In such instances, stock exchanges are required to have established an adequate mechanism, to ensure that no participant is put at a disadvantage due to disparity between the trading and delivery lot sizes.

3. SEBI AMENDS THE TAKEOVER CODE; EXTENDS CERTAIN EXEMPTIONS TO NBFCs AND HFCs

SEBI has introduced certain amendments to the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("**Takeover Code**") *vide* the SEBI (Substantial Acquisition of Shares and Takeovers) (Third Amendment) Regulations, 2018 ("**Amendment**") on 28 December 2018. The Amendment exempts certain classes of non-banking financial companies ("**NBFCs**") and housing finance companies ("**HFCs**") from the requirement to make disclosures under the Takeover Code for acquisitions and disposals which result from any encumbrance and release of such encumbrance. The Amendment has come into effect from 31 December 2018.

An HFC must be registered with the National Housing Bank for carrying on the business of housing finance and must either be deposit taking, or have an asset size worth INR 5 billion or more. A systematically important NBFC has the same meaning as afforded to it under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, that is, an NBFC recognized as 'systemically important' by the Reserve Bank of India.

Prior to the Amendment, only scheduled commercial banks and public financial institutions, who acquired or disposed of shares in their capacity as a pledgee in connection with a pledge of shares for securing indebtedness in the ordinary course of business, were exempted from making disclosures under the Takeover Code. However, the Amendment has extended this exemption to HFCs and systematically important NBFCs.

4. SEBI AMENDS THE FPI REGULATIONS

SEBI, on 31 December 2018, notified certain amendments to the SEBI (Foreign Portfolio Investors) Regulations, 2014 ("**FPI Regulations**") *vide* SEBI (Foreign Portfolio Investors) (Third Amendment) Regulations, 2018 ("**FPI Amendment**"). The FPI Amendment came into effect on 31 December 2018.

Some key points of the FPI Amendment are:

1. Eligibility criteria for NRI, OCI and RI to be constituents of FPIs: Under FPI Amendment, the contribution of an individual non-resident Indian ("**NRI**") or Overseas Citizen of India ("**OCI**") or any resident of India ("**RI**") cannot exceed 25%, and the aggregate contribution of NRIs, OCIs and RIs cannot exceed 50%, of the total contribution in the corpus of the foreign portfolio investor ("**FPI**"). Further, the NRI / OCI should not be in control of the FPI, unless the existing FPI is:
   1. an offshore fund for which SEBI has issued a no-objection certificate ("**NOC**");
   2. controlled by an investment manager which is controlled and / or owned by an NRI, OCI or RI, and is:
      - a) appropriately regulated in its home jurisdiction and registered with SEBI as a non-investing FPI; or
      - b) Incorporated / set up under Indian laws and registered with SEBI.

   However, these eligibility criteria will not be applicable to non-investing FPIs or FPIs which propose to invest or invest only in schemes floated by mutual funds in India.

2. Clubbing of limits: Prior to the FPI Amendment, investments in which the same set of beneficial owners invested through multiple entities, were clubbed together for the purpose of calculation of investment limits. The FPI Amendment specifies that the investment limits for entities will be clubbed if the entities have common ownership, directly or indirectly, of more than 50% or have common control. However, this threshold will not be applicable if:
   1. the FPIs are an appropriately regulated public retail funds ("**PRF**"); or
   2. The FPIs are PRFs which are majority-owned by appropriately regulated PRFs on a look-through basis; or
   3. The FPIs are PRFs and their investment managers are appropriately regulated.

   PRFs are mutual funds or unit trusts which are open for subscription to retail investors without any specific type of requirements for investors, or are insurance companies where segregated portfolio with one to one correlation with a single investor is not maintained, or are pension funds.

3. 'Opaque structure': In the interest of transparency, the FPI Regulations require the designated depository participants to ensure that FPIs do not have an 'opaque structure.' Prior to the FPI Amendment, the term 'opaque structure' was defined as any structure where details of the ultimate beneficial owner is not accessible. The

FPI Amendment has expanded the scope of 'opaque structure' to include structures where applicant or its investor(s) identified on basis of threshold for identification of beneficial owner have issued any bearer shares or maintain any outstanding bearer shares. However, if an undertaking is submitted in that regard by the applicant / investor(s), then they will not treated as having an 'opaque structure.'

1. SEBI RELEASES CONSULTATION PAPER FOR AMENDMENTS TO REGULATIONS GOVERNING INFRASTRUCTURE INVESTMENT TRUSTS AND REAL ESTATE INVESTMENT TRUSTS

C. Consultation Paper

On 25 January 2019, SEBI issued a consultation paper ("**Consultation Paper**") to review the existing legal framework relating to infrastructure investment trusts ("**InvIT**") and real estate investment trusts ("**REIT**") to provide for flexibility and increased access to issuers. Currently, InvITs are regulated by the SEBI (Infrastructure Investment Trusts) Regulations, 2014 ("**InvIT Regulations**") and REITs are regulated by the SEBI (Real Estate Investment Trusts) Regulations, 2014 ("**REIT Regulations**"). All stakeholders have been invited to provide their comments on the Consultation Paper by 18 February 2019.

Some key recommendations of the Consultation Paper are:

1. Reduction in the minimum allotment and trading lot for publicly issued InvITs and REITs: Under the existing InvIT Regulations, the minimum subscription amount in an initial offer or follow-on offer from any investor is INR 1,000,000 and the prescribed trading lot is INR 500,000. Under the existing REIT Regulations, the minimum subscription amount in an initial offer or follow-on public offer is INR 200,000 and the prescribed trading lot is INR 100,000. However, SEBI has observed from the feedback of stakeholders, that these limits appear to be too high. In order to encourage participation of a larger number of retail investors, the Consultation Paper proposes to reduce the minimum application and trading lot for publicly issued InvITs and REITs as follows:
   i. At the time of initial / follow-on issue, the minimum application and allotment lot shall be of 100 units and the value of each lot shall be between INR 15,000 – INR 20,000.
   ii. Allotment is to be made in multiples of a lot.
   iii. After initial listing, a trading lot shall be of 100 units.
2. Increase in investment limits of InvITs: Under the existing InvIT Regulations, the aggregate consolidated borrowings and deferred payments of the InvIT, net of cash and cash equivalents, cannot exceed 49% of the value of the InvIT's assets. Further, any borrowing exceeding 25% of the value of the InvIT's assets requires approval from unit holders and mandatory credit rating. However, such restrictions appear to be detrimental to the profitability of InvITs, as they result in inability to offer incremental returns as compared to other alternative investment avenues. Further, they limit the ability of InvITs to acquire new assets, which in turn, affects profitability. Therefore, the Consultation Paper proposes to increase the debt limit of InvITs from 49% to 70% for acquisition of new infrastructure assets, subject to certain conditions, such as approval by 75% of the unit-holders, minimum AAA credit rating of the consolidated or project debt

and minimum track record of at least 3 years of continuous distribution post-listing. Such InvITs will also have to make additional disclosures.

3. Liberalised regulatory framework for privately placed InvITs: Under the existing InVIT Regulations, all units of InVITs, whether issued publicly or privately placed, must be listed. Therefore, the governance norms for all units of InVITs are equally stringent. In order to bring about flexibility in privately placed units of InvITs, the Consultation Paper recommends the formulation of a new legal framework, wherein:

   i. the number of investors and extent of investment by a single investor, will be determined by the issuer;

   ii. the leverage shall be determined by the issuer after consultation with investor;

   iii. the assets may be completed, under construction or both;

   iv. the minimum investment by an investor shall be not less than INR 10 million; and

   v. the units of such InvITs cannot be listed on stock exchanges.

   Additionally, the regulatory framework for privately placed listed InvITs will be made applicable for the proposed framework for privately placed unlisted InvITs, subject to the necessary amendments. Existing privately placed listed InvITs may migrate to the proposed framework for private unlisted InvITs, either by securing the approval of 90% of the unitholders by value, or by delisting from stock exchanges.

   Therefore, it is evident that the securities market is moving towards securing larger participation in the fields of infrastructure and real estate in India, by liberalizing regulations to encourage greater flexibility and larger participation from private players including retail investors.