UPDATES

Financial Regulatory Regime – Legal Milestones Financial Year 2020-21 and a Look Ahead

14 April 2021

This update covers:

1 The Year that Was

With COVID-19 reaching Indian shores in early 2020, the financial year (FY) 2020-21 passed addressing short and long-term consequences of the pandemic. The challenges of the pandemic, including the lockdown and social distancing norms, did not slow down regulatory action and securities market litigation, with virtual hearings replacing the traditional in-person proceedings.

The financial services regulators of the country, including the Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI), remained proactive in terms of policy decision making, as well as enforcement. As crude oil prices crashed in the US and dipped into red, the ripples were felt in the commodities market in India, a situation which the Indian market had neither contemplated nor was prepared for. The settlement on the Multi Commodity Exchange of India Limited (MCX) based on these negative values created a furore but was addressed by SEBI thereafter.

> The financial year 2020–21 put the securities and financial markets in India under an unprecedented stress test. Reacting proactively, the financial services regulators introduced measures not only to manage and curtail risks, but also to boost investor confidence. This update summarises some of these developments along with our expectations for the year ahead.

On the governance front, the implementation of the segregation of roles of the chairman and the MD/ CEO in listed companies, which was earlier slated to come into force in April 2020, has been deferred for another two years. Further, disclosure norms for listed entities were expanded to include initiation of forensic audit (along with the other relevant details), as well as final forensic audit report (other than for forensic audit initiated by regulatory/enforcement agencies) along with comments from the management of the listed entity.

2 Major Developments in the Financial Year 2020-21

2.1 Broker defaults and changes by SEBI in margin collection

Given the continued instances of misappropriation and/or misuse of client securities by brokers in 2020, SEBI undertook extensive discussions with stock exchanges, clearing corporations, depositories and brokers, to revamp the process of margin collection and mitigate these risks. Through a circular dated 25 February 2020, SEBI mandated the collection of margin in the form of securities through a specific pledge mechanism with effect from 1 September 2020. Pursuant to the above, stock exchanges/clearing corporations have also revised the process of margin collection from members.

As a part of its efforts to make the monitoring mechanism more proactive in identifying risks and early warning triggers which could eventually lead to default on the part of trading and clearing members, SEBI on 1 July 2020, issued a circular (July Circular) laying down the standard operating procedure and steps to be followed by the stock exchanges, clearing corporations and depositories in cases of potential or likely defaults. Pursuant to the implementation of the July Circular, stock exchanges and clearing corporations sought undertakings from members on access to their bank accounts in case of a potential default. However, this was met with concerns from the market on the scope and reach of such undertakings.

2.2 Review of the regulatory framework for Investment Advisers

In January 2020, SEBI initiated a consultation process on its proposal for strengthening the regulatory framework for Investment Advisers (IAs). Pursuant to the consultation process, changes were introduced in the regulations governing IAs through an amendment notification in July 2020 (Amendment) which came into force in October 2020.

Under the erstwhile provisions, IAs were not restricted from providing advisory and distribution services to the same client. However, post the Amendment, non-individual IAs are obligated to have client level segregation at group level for investment advisory and distribution services, i.e. the same client cannot be offered both advisory and distribution services within the group. Further, non-individual IAs are required to appropriately segregate their activities as investment advisers and distributors.

Some of the other changes the Amendment introduced are:

- personnel requirements (such as appointment of principal officer by the IAs, qualification requirements of the principal officer and persons associated with investment advice);
- increased net worth requirements;
- submission of audit report to SEBI; and
- permission to provide implementation services to advisory clients through direct schemes/ products in the securities markets. However, IAs are precluded from receiving any consideration (including fees/ commissions, etc.) for such services.

2.3 Additional clarifications on the digital database under insider trading laws

In 2018, SEBI had introduced a provision in the SEBI (Prohibition of Insider Trading) Regulations (PIT Regulations) regulations directing all listed companies to create and maintain a 'structured digital database' (with appropriate audit trails, internal controls, and time stamps) with the names and PAN (or equivalent identifier) of those who received unpublished price sensitive information (UPSI).

Through a clarification in July 2019 and an amendment in July 2020, the requirement of creating the database was extended to all SEBI registered intermediaries and fiduciaries (such as audit firms, law firms, consultants, etc.) that handled UPSI. It was also clarified that this database must specify the nature of the UPSI involved and details of persons with whom such information has been shared by original recipients. The data so collated is to be preserved for 8 years. However, in the event of receipt of any information from SEBI on an ongoing investigation or proceedings, the relevant information in the structured digital database must be preserved till the completion of such proceedings.

Expanding on the requirements regarding the database, SEBI, through revised FAQs issued in October 2020, further clarified that each entity must also maintain details of other advisers and firms as well as natural persons involved in the price-sensitive event.

2.4 Clarifications pertaining to fraudulent and unfair trade practices

In furtherance of its mandate to curb fraudulent and unfair trade practices in the securities market, and to strengthen the enforcement mechanism, SEBI amended the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 (PFUTP Regulations) on 19 October 2020. The amendment clarifies, with retrospective effect, that acts involving diversion/ misutilisation of funds/ assets or concealment as well as manipulating the books of accounts or financial statements of listed companies are deemed to be unfair trade practices. As such, the element of dealing in securities or the element of inducing others to deal in securities need not be specifically proved in such cases.

2.5 Bilateral Netting of Qualified Financial Contracts Act, 2020 and related notifications

With a view to reduce credit risk exposure and systemic risk in the financial market, the Bilateral Netting of Qualified Financial Contracts Act, 2020 (Netting Act) was notified with effect from 1 October 2020. The Netting Act, based on the Model Netting Act by the International Swaps and Derivatives Association, confirms the enforceability of bilateral netting and provides the framework for offsetting claims between two parties to a financial contract in order to determine a single net payment obligation.

The Netting Act covers qualified financial contracts (QFCs) (to be notified by the Central government, or the RBI/ SEBI/ Insurance Regulatory and Development Authority of India/ International Financial Services Authority) entered into on a bilateral basis between Qualified Financial Market Participants (QFMP), either under a netting agreement or otherwise, where at least one of the participants is regulated by any of the regulators mentioned above. The definition of QFMP is broad, and includes not only regulated entities (such as banks, insurance companies, pension funds, etc.), but also individuals, partnership firm, company, any other person or body corporate and includes any international or regional development bank or other international or regional organisation. Further, regulators are permitted to specify any other regulated entity as a QFMP.

On 9 March 2021, in exercise of its powers under the Netting Act, the RBI (i) notified 'derivative' (as defined under the Reserve Bank of India Act, 1934 (RBI Act)) and 'repo' and 'reverse repo' (each as defined under the RBI Act) as QFCs for the purposes of the Netting Act; and (ii) specified the following entities as QFMPs: (a) entities licensed by the RBI to do banking business but not included in the second schedule to the RBI Act, (b) Export-Import Bank of India, (c) National Bank for Agriculture and Rural Development; (d) Small Industries Development Bank of India; (e) National Housing Bank, (f) Factors; and (g) Asset Reconstruction Companies. Subsequently, on 30 March 2021, the RBI also issued amendments to the prudential guidelines in this regard.

Actions under the Netting Act are ring fenced from any adverse impact of insolvency laws, including the Insolvency and Bankruptcy Code, 2016.

Please click here for a more detailed analysis.

2.6 Enhanced governance norms for mutual funds and alternative investment funds

In order to enhance governance obligations of mutual funds (MFs) and alternative investment funds (AIFs) investing on behalf of, and for the benefit of their investors, SEBI introduced a stewardship code for all MFs and AIFs in relation to their investment in listed equities in December 2019. The code was slated to come into effect from 1 April 2020, however, its implementation was deferred to July 2020 on account of the pandemic.

Being institutional investors in the investee company, the code imposes obligations on MFs and AIFs in relation to engagement, supervision, intervention, voting decisions, avoidance of conflict, etc. The code also requires MFs and AIFs to report compliance with stewardship obligations to their investors.

Separately, through a circular dated 5 March 2021, SEBI issued additional guidelines on voting by mutual funds in investee companies, so as to foster transparency and exercise of greater diligence. The circular identifies certain specified matters on which mutual funds will be compulsorily required to vote with effect from 1 April 2021, including matters pertaining to corporate governance, changes to capital structure, appointment and removal of directors, related party transactions, management compensation, etc., as well as any matter that may affect the interests of the unitholders and/ or shareholders.

2.7 Amendments to the MF regulatory framework

To bring about greater accountability to the functions performed by fund managers and dealers, SEBI introduced a code of conduct through an amendment to the SEBI (Mutual Funds) Regulations, 1996 (MF Regulations) on 29 October 2020. The amendment requires the chief executive officer (regardless of the designation) of the asset management company (AMC) to ensure that the AMC has adequate systems in place to ensure compliance with this code, and report any breach to the board of the AMC and the trustee.

SEBI also undertook a comprehensive review of the MF Regulations from a policy change perspective and notified certain key amendments to the MF regulatory framework with effect from 5 March 2021.

One such key amendment was in relation to the relaxation in the profitability criteria for being eligible as a sponsor of an MF. Prior to the amendment, to be eligible as a sponsor one of the prescribed eligibility criteria for an entity was a profitability criteria i.e., to have profits in three of the last five years, including the fifth year. To facilitate innovation, expansion, and new entrants in the mutual fund sector, SEBI has now eased this profitability criteria. Henceforth, entities that do not meet the prescribed profitability criteria would still be eligible to set up an MF or acquire an AMC, if the specified net worth criteria (INR 100 crores) is met, and is maintained on a continuous basis till the satisfaction of the profitability criteria. Additionally, through the amendment, the reporting requirements and compliances of the AMC and trustee have been made more robust. The scope of key personnel of AMC has also been expanded to ensure better compliance.

2.8 Key changes approved by SEBI pursuant to its board meeting held on 25 March 2021

On 25 March 2021, the SEBI board considered and approved various amendments to the prevalent regulatory framework. While the amendments are yet to be notified, some of the key changes approved are:

- rationalisation of the framework pertaining to the reclassification of promoter/ promoter group entities;
- requirement of prior approval of SEBI in case of a change in control of a portfolio manager;
- key amendments to the listing regulations, such as (a) revised norms for disclosures by listed entities in respect of analyst/ institutional investor meets; (b) applicability, constitution and role of risk management committee; (c) requirement for formulation of the dividend distribution policy; (d) harmonisation of timelines for submission of periodic reports by companies (such as shareholder pattern, corporate governance report and statement of investor complaints); (e) introduction of business responsibility and sustainability report for top 1000 listed companies (by market capitalisation) on a voluntary basis for FY 2021–22, and on a mandatory basis from FY 2022 – 23, etc.

2.9 RBI introduces Margin for Derivative Contracts Regulations, 2020 under foreign exchange norms

In October 2020 and February 2021, the RBI notified regulations and issued directions to regulate the posting and collection of margin for permitted derivative contracts between a person resident in India and a person resident outside India. The framework provides clarity on the nature of, and the manner in which authorised dealer (AD) banks may post or collect margins and interest thereof within and outsider India, whether on their own account or on behalf of their clients.

2.10 Legal Jurisprudence during the year

Despite the challenges of the pandemic, courts and regulators continued to discharge their judicial, investigative and supervisory functions .

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- The much-awaited decision of the Supreme Court of India in the Tata-Mistry dispute was pronounced on 26 March 2021. At the heart of the dispute was the removal of Cyrus Mistry as the executive chairman of Tata Sons, and subsequently, as the director of Tata Sons and other companies within the Tata group. While answering all legal questions in favour of the Tata group, the Supreme Court held that the allegations of oppression and prejudice could not be sustained, and that Cyrus Mistry could not be reinstated as director on the boards of various Tata group entities.

  One of the interesting aspects of the decision is the observation made by the Supreme Court regarding the duty of directors, in that a nominee director owed fiduciary duties to two entities, one of which was the shareholder that nominated such a director, and the other, the company on whose board the director is nominated. Given the prominence that the Supreme Court has accorded to a nominee director's duties to its nominating shareholder, it appears that such duties may emerge differently and gain subjectivity, based on the identity and nature of the nominating shareholder, which in the case of this dispute were public charitable trusts and therefore, less controversial. This is one of the first decisions to interpret directorial responsibility under the Companies Act, 2013 and may have far-reaching implications in the Indian corporate governance landscape.

- In relation to the enforcement of insider trading norms, the orders in the WhatsApp leak case and the Manappuram Finance Limited (MFL) case are of particular importance.

  i. In the WhatsApp leak case, SEBI penalised individuals employed with financial intermediaries for sharing financial information of certain listed companies, prior to their publication. These cases involved penalising the tippee-turned-tipper, when the original tipper could not be traced. The question was whether the transmission of information by the tippee to other persons over WhatsApp constituted communication of UPSI in breach of the insider trading regulations. In arriving at its decision, SEBI rejected the contention raised that the information shared was in the nature of 'heard on street' (i.e., a common practice among traders, market analysts, institutional investors etc. whereby unsubstantiated gossip is widely shared and is clearly understood as speculation/rumours in the market), and thereby available to the public, and observed that: (a) information was not generally available, but instead was circulated in a closed group; and (b) information was not based on market research/ generally available information.

     On 22 March 2021, the Securities Appellate Tribunal (SAT) set aside the SEBI order. In doing so, it considered and analysed the definitions of UPSI and 'insider' under the PIT Regulations to arrive at the conclusion that generally available information could not be regarded as UPSI, and that information could constitute UPSI only when the recipient of such information had knowledge of its nature as UPSI.

  ii. In the MFL matter, SEBI was concerned with the trades executed by certain AMCs and whether they were motivated by certain information in a research report published by Ambit Capital Private Limited (Ambit). The allegation was that MFL had shared this information with Ambit, prior to it being disclosed to the stock exchanges and that trading by the AMCs, as recipients of the research report, would be insider trading. Interestingly, in the orders passed in this matter, SEBI exculpated the AMCs by holding that these persons could not have known that the research report contained UPSI, since the same were said to be compiled on the basis of publicly available information. As such, the trading entities were extended the benefit of being *bona fide* unaware tippees.

     Please click here for a more detailed analysis.

- Recently, SEBI also shed light on the interpretation of certain provisions of the SEBI (Investment Advisers) Regulations, 2013 through its order in respect of *Money Maker Research Pvt Ltd and others*. It held that:
  i. investment advisers are required not only to communicate the client's risk profile prior to collection of any fees or payments, but also, the manner in which such categorisation is arrived at;
  ii. any fees collected for rendering investment advice has to be reasonable and that it cannot be disproportionate to the annual income or the proposed investments by the client; and
  iii. investment advice should necessarily correspond to the risk appetite of its recipient.
- In its order in the matter of *Kirloskar Brothers Limited*, SEBI penalised certain individuals, including directors, for dealing in securities while in possession of non-public information. In doing so, it clarified that:
  i. Section 12(A)(e) of the SEBI Act, 1992 prevents a person from dealing in securities if such person possesses any of the two categories of information, i.e. material information *or* non-public information, in the manner prohibited by any of its regulations;
  ii. where the non-public information is price sensitive, dealing in securities is regulated under the PIT Regulations; and
  iii. dealing in securities while in possession of the non-public information / material information which undermines ethical standards and good faith dealings between parties engaged in business transactions, is unfair trade practice which is prohibited under PFUTP Regulations.

  However, this order has been partially stayed by the SAT through an interim order passed in December 2020.

3 Looking Ahead

Drawing from the experience of a tumultuous FY 2020-21, the trend of virtual hearings and conferences by regulators may become more frequent and regular. It is expected that the measures put in place by regulators to maintain resilience of market as well as market participants are likely to continue in the near future.

With a legal framework to govern data protection and privacy on the horizon, we expect a major change in policies and procedures adopted by data collectors and processors in order to comply with this new law.

The Netting Act is likely to have a major impact in over the top (OTC) derivative transactions by ensuring that financial participants are not required to set aside more capital for trading in the OTC derivatives market. Given its potential to reduce hedging costs and liquidity requirements, it will also encourage greater participation in credit default swaps.

In its commitment to strengthen and revitalise the regulatory framework for derivatives, the RBI has proposed draft directions in relation to (a) credit derivatives and rupee interest rate derivatives transactions undertaken in OTC markets and on recognised stock exchanges in India; (b) market makers in OTC derivatives; and (c) variation margins. Upon their notification, these directions should provide additional clarity on the regulatory framework and encourage greater participation in derivatives.

In January 2021, the RBI issued a discussion paper proposing a scale-based regulatory approach for NBFCs, with an objective to replace the existing one-size-fits-all regulatory approach. The revised framework proposes that the degree of regulation should be commensurate with the systemic significance of the NBFC, in terms of risk the entity poses to the financial system and scale of its operations. Upon finalisation, the regulatory framework for NBFCs is likely to undergo substantial changes.

Additionally, SEBI's proposed legislative reforms in relation to independent directors, particularly the dual vote mechanism for the appointment and removal of independent directors, as well as the grant of performance-based compensation to independent directors, aligned with the general principle of more 'skin in the game' is likely to have a steady but profound impact not only on the institution of independent directors in India, but also on the role of public shareholders and shareholder activism.

For a round -up of some of the key legal developments in the financial year 2020-2021 across other practices and a brief insight on what to expect in the year ahead, please read our practice-wise updates, which can be accessed here.
