KHAITAN &CO
Advocates since 1911

UPDATE

ERGO

Analysing developments impacting business

SEBI APPROVES CHANGES TO REGULATIONS APPLICABLE TO LISTED ENTITIES

5 July 2019

The Board of the Securities and Exchange Board of India ("**SEBI**"), at their meeting held on 27 June 2019, has approved several changes to the regulations applicable to listed entities. The amendments to the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**Listing Regulations**"), the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("**Takeover Regulations**"), and the SEBI (Prohibition of Insider Trading) Regulations, 2015 ("**Insider Trading Regulations**"), are discussed below.

- **Increase of materiality threshold for Royalty and brand usage payments to related parties**

SEBI had previously prescribed that, effective from 1 April 2019, payments made to related parties towards brand usage or royalty are to be considered material if the transaction(s) exceed 2% of the annual consolidated turnover of the listed entity during a financial year. Such transactions require the approval of the shareholders, with no related party permitted to vote in favour of the transaction.

SEBI's Board has now decided to increase the materiality threshold for such related party transactions from 2% to 5% of the annual consolidated turnover of a listed entity. SEBI's Board has also approved deferral of the applicability of this provision by three months to 30 June 2019 from earlier date of 1 April 2019. The relevant circular notifying the amendments is expected in due course.

Comment:

This amendment is a result of several representations made by the industry to SEBI after this new requirement was introduced in May 2018. Royalty or license fees transactions are not uncommon in large groups. Many listed entities pay their parent company royalties or license fees for using their brands. The 2% threshold was perceived to be low compared to the thresholds for other related party transactions. Hence, there was a demand to increase this threshold to 5%. SEBI's decision will bring necessary relief to the industry.

- **Disclosures of encumbrance of shares by promoters**

The Takeover Regulations mandate the promoters to make disclosures to the stock exchanges and the listed entity regarding shares of listed entity encumbered by them.

This disclosure is required at the time of creation, invocation and release of the encumbrance.

SEBI has decided to expand the scope and meaning of the term 'encumbrance' to henceforth include:

- any restriction on the free and marketable title to shares, whether executed directly or indirectly, by whatever name called;
- any pledge, lien, non-disposal undertaking ("**NDUs**");
- any covenant, transaction, condition or arrangement in the nature of encumbrance, by whatever name called, whether executed directly or indirectly.

Comment:

*Currently, the term "encumbrance" under the Takeover Regulations includes a pledge, lien or any such transaction, by whatever name called. The Frequently Asked Questions on the Takeover Regulations ("**FAQs**") published by SEBI additionally laid down the principles to determine which arrangements would qualify as creation of an encumbrance of shares, and included NDUs. Considering that FAQs do not have the force of law, by virtue of the latest amendments, SEBI intends to include the necessary provisions in the Takeover Regulations. Now, pledge, negative lien, NDUs or any other restrictions on free and marketable title to securities would qualify as an encumbrance. The aforesaid amendments have been introduced to address concerns around creative structures employed by the promoters, especially in the context of raising funds from mutual funds/NBFCs. The expanded scope of 'encumbrance' has opened another set of concerns – whether it brings within its ambit restrictive rights in relation to a share transfer such as right of first offer, put options or call options, etc.*

Additionally, where the combined encumbrance by the promoters and the persons acting in concert with them ("**PACs**") exceeds 20% of the total share capital of the listed entity or 50% of their shareholding in the listed entity, the promoters are now required to separately disclose to the stock exchanges detailed reasons for creation of such encumbrance. The stock exchanges would be required to disclose and maintain details of such encumbrances along with the purpose of the encumbrance on their website.

Further, the promoters would be required to annually declare to the audit committee of the listed entity and to the stock exchanges that they along with PACs have not made any encumbrance directly or indirectly, other than already disclosed, during the financial year.

Comment:

These amendments would provide greater transparency to investors who in most instances are unaware of the reason for which encumbrance has been created by promoters over a substantial number of shares in listed entities.

- **Closure of the trading window by listed entities**

Pursuant to the Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2018, which came into effect from 1 April 2019, a listed entity can close its trading window immediately at the end of every quarter till 48 hours after the declaration of financial results. The stock exchanges later issued circulars on 2 April 2019 clarifying that this requirement is mandatory.

SEBI has now decided to expressly state the above requirement as part of the Insider Trading Regulations and to set out some types of transactions which would not be subject to such closure of trading window. Specifically, designated persons of listed entities can undertake the following transactions even if the trading window is closed:

- off-market inter-se transfer between insiders;
- transaction through block deal window mechanism between insiders;
- transaction due to statutory or regulatory obligations;
- exercising of stock options;
- pledging of shares for bona fide transaction such as raising of funds and transactions for acquiring shares under further public issue, right issue and preferential issue;
- exercising conversion of warrants / debentures;
- tendering shares under buy-back, open offer and delisting etc. under respective regulations, subject to the specified conditions.

SEBI has also approved amendments clarifying the term 'material financial relationships'.

Comment:

By prescribing that the trading window must be closed immediately at the end of every quarter till 48 hours after the declaration of financial results, the designated persons in several listed entities were left with a very limited period to undertake legitimate transactions not being in the nature of insider trading. Specifically, employees attempting to exercise stock options and promoters participating in buybacks were most affected. This clarification is a welcome move whereby legitimate transactions not being in the nature of insider trading can be undertaken freely without concerns regarding closure of the trading window. However, it must be noted that, if the person undertaking the trade is in possession of unpublished price sensitive information, the trade may be undertaken only if they are eligible to avail any of the defences specified in the Insider Trading Regulations.

- *Arindam Ghosh (Partner), Malav Shah (Principal Associate), Shashank Patil (Senior Associate) and Anvita Mishra (Associate)*

For any queries please contact: editors@khaitanco.com

Mumbai
One Indiabulls Centre, 13th Floor
Tower 1 841, Senapati Bapat Marg
Mumbai 400 013, India

T: +91 22 6636 5000
E: mumbai@khaitanco.com

New Delhi
Ashoka Estate, 12th Floor
24 Barakhamba Road
New Delhi 110 001, India

T: +91 11 4151 5454
E: delhi@khaitanco.com

Bengaluru
Simal, 2nd Floor
7/1, Ulsoor Road
Bengaluru 560 042, India

T: +91 80 4339 7000
E: bengaluru@khaitanco.com

Kolkata
Emerald House
1 B Old Post Office Street
Kolkata 700 001, India

T: +91 33 2248 7000
E: kolkata@khaitanco.com