# Understanding the Securities Laws (Amendment) Bill, 2003

M. S. Sahoo*

The Securities Laws (Amendment) Bill, 2003 was introduced in the monsoon session of the Parliament to provide for (a) demutualisation and corporatisation of the stock exchanges, (b) fill up certain identified regulatory gaps such as units of mutual funds, delisting of securities, clearing corporation, protection of client assets etc. for which there were no statutory provisions, and (c) strengthen penal framework. This paper is an attempt to understand the provisions of the Bill.

## Demutualisation of Exchanges

Historically the exchanges were formed as 'mutual' organisations. They are generally "not-for-profit" and tax exempted entities. The trading members who provide broking services, also own, control and manage such exchanges for their common benefit, but do not distribute the profits among themselves. In contrast, in a "demutual" exchange, three separate sets of people own the exchange, manage it and use its services. The exchanges frame and enforce rules, which may not always further the public interest (interest of investors and society) and the private interest (interests of trading members) simultaneously. Theoretically public interest gets precedence in a demutualised exchange while private interest gets precedence in a mutual exchange in formulation and implementation of the rules. As the self (private interest) sometimes gets precedence over regulation (public interest), mutual exchanges do not offer an effective model for self-regulatory organisations. Besides addressing this malaise, the demutualisation offers several advantages. The limitations of a mutual structure has been realised time and again by the exchanges and the regulators. Recent happenings, particularly the 2001 stock market scam, made it clear that failure of the 'mutual' stock exchanges to resolve conflict of interest satisfactorily contributed to undesirable transactions in securities, which the SCRA aims to prevent. In order to address the malaise, the Finance Minister in March 2001 proposed corporatisation of stock exchanges by which ownership, management, and trading membership would be segregated from each other. The Joint Parliamentary Committee on the Stock Market Scam called for expeditious corporatisation and demutualisation of the stock exchanges. The implementation of this proposal, however, required certain amendments in the SCRA. The Securities Laws (Amendment) Bill, 2003 proposes these amendments.

The SCRA permits different structures for stock exchanges. That is why some exchanges are association of persons, some are company limited by shares, and some others are company limited by guarantee. Since the law permits any form for a stock exchange, it may not be possible to mandate a particular form (corporate form) for all exchanges. Similarly, the SCRA does not prohibit brokers from owning and managing an exchange. It may not, therefore, be possible to mandate a demutualised structure for all exchanges. In order to mandate these, the Bill seeks to amend the SCRA to specify that only a corporate entity can be a stock exchange and the exchange must be demutualised. The process of demutualisation involves segregation ownership, management and trading rights. However, the process of corporatisation would involve offering shares to public, including brokers. It is possible that the brokers subscribe for the shares and in terms of their rights under the Companies Act, get themselves elected to the board of directors. It may so happen that a stock exchange has only broker shareholders in the general body and broker directors in the governing body. Thus, even though an exchange is corporatised, it would not be demutualised, as the same set of people would be owning and managing the exchange and also trading on the exchange. The Bill, therefore, seeks to restrict the participation of broker-shareholders in the general body as well as in the management of the exchange to ensure that the corporatised exchange is really demutualised.

The Bill makes it mandatory that all stock exchanges, if not corporatised and demutualised, shall be corporatised and demutualised on and from a date appointed by SEBI. It obligates the exchanges to submit a scheme for corporatisation and demutualization to SEBI for approval. SEBI shall not approve any scheme of demutualization and corporatisation if the issue of shares for a lawful consideration or payment of dividend or provision of trading rights in lieu of membership card of the members of an exchange is proposed out of any reserves or assets of the exchange. If a scheme is approved, it shall be published immediately and shall be binding on all persons and authorities. SEBI may reject a scheme after giving a reasonable opportunity of hearing to the concerned exchange and the persons. Any person aggrieved by an order of SEBI can prefer an appeal before SAT.

While approving the scheme, SEBI may, by order, restrict (a) voting rights of the broker shareholders, (b) the rights of shareholders or brokers to appoint the representatives on governing boards, and (c) the maximum number of broker directors on the governing board, which shall not exceed one fourth of the total strength of the governing board. Such order shall be published in the

*Chief General Manager, SEBI. The understanding expressed in this paper are of the author and not necessarily of NSE or his employer.

official gazette. Within 12 months of this publication, the concerned stock exchange shall, either by fresh issue of equity shares to the public or in any other manner, as may be specified by SEBI, ensure that at least 51% of its equity shares is held by public other than shareholders having trading rights. SEBI may extend this period by another 12 months in public interest.

If an exchange is not corporatised and demutualised or fails to submit a scheme for the same or the scheme is rejected by SEBI, the recognition granted to such exchange shall stand withdrawn.

**Regulatory Gaps**

In view of so many regulators and so many statues governing securities market, it is quite natural that there are regulatory gaps and overlaps. The Bill seeks to remove a few regulatory gaps.

***Units of Mutual Funds:*** Units of mutual funds (MFs) resemble securities. They represent the interest of the unit holder in the specific scheme just as securities represent the interest of the holder in the issuer. The unit holder has similar rights as a security holder has on the future performance of any underlying asset or group of assets. Special kinds of units (units of assured return schemes), which represent the rights of investors on a fixed income flow over the future years or a fixed maturity value at the end of a specified period, are similar to debentures issued by companies. The units are issued, dematerialised, listed, and traded on exchanges in a manner similar to any other security. These are transferred from one holder to another or sold back to the issuer, at pre-specified or market determined values, just like shares, debentures and other securities are. The holders of units and securities have the same need for safety, liquidity and return. Despite such close similarities between units and securities, they are not explicitly treated legally at par. While the trading of securities issued by corporates is governed by SCRA and regulatory framework developed thereunder, trading of units are not subject to similar regulatory framework. In fact, trading of units is not subject to any regulatory framework. This presents a case of regulatory gap and this is one of the reasons why the secondary market for units has not developed appreciably. The easiest way to develop the market for units of MFs and protect the investors investing in them is to consider the units to be securities so that the regulatory framework applicable to trading of securities would also apply to trading of units and SEBI which has the responsibility to protect the interests of investors in securities, can protect the interest of holders of units of MFs also. Since the jurisdiction of SEBI is limited to securities market and the units of MFs are not explicitly recognised as securities in law, the actions of SEBI in protecting the interests of investors in units of MFs and developing a market for them is being challenged before the courts of law. In an appeal before SAT, an appellant contended that he was not covered by the Rules as he was not dealing in securities, but in units of MFs which are not securities and hence the SEBI had no powers, authority or jurisdiction to conduct any enquiry or impose any penalty on him. While disagreeing with this, the SAT considered the units of MFs to be securities in view of the object and purpose underlying the SEBI Act. This judicial pronouncement needs to be codified in law. The Bill, therefore, proposes to expand the definition of 'securities' to include units or any such instrument issued to the investors under any mutual fund scheme.

***Delisting of Securities:*** Listing and delisting are two sides of the same coin. There is a substantial body of law that governs listing. The Companies Act makes it mandatory for a company issuing shares to public to list its securities on a stock exchange. The SCRA obliges the company to comply with the conditions of listing. It also allows a company to prefer an appeal before Securities Appellate Tribunal if a stock exchange refuses listing. The SCRR prescribe requirements for listing on a stock exchange. It also regulates suspension and withdrawal of trading. So much of care and concern about listing. Even there are provisions about suspension of listing in statutes, rules and regulations. Unfortunately, delisting does not find place in any statute, rules or regulations. It was so far being regulated through a circular of SEBI, now by guidelines. Since the delisting is at least as important as listing, it is necessary that both have same level of legal backing.

Since no such statutory provision exists, doubts are raised if delisting is at all permissible under the laws. It is argued in some circles that delisting should not be permitted at all. They argue that it is the intention of legislature, as there are statutes and rules to govern listing, but no statute/rule provides for delisting. It is probably considered that listing is so sacrosanct that once a security is listed, it should not be delisted. An investor subscribes to an issue on the basis of the contents in the prospectus which may state that the security would be listed on stock exchanges. Once he subscribes to the issue, he takes an irreversible decision, as the promises in the prospectus are irreversible. Hence if one considers investors interest to be the predominant and sole factor, there should not be any delisting of securities. Another school argues that listing agreement is essentially a contract between a company and an Exchange. Like any contractual relations, it must have also a way to terminate the relationship in certain circumstances. If there is a way to get in, there must be also a way to get out. Should the exchange and the company consider terminating their relationship, after taking care of interest of the affected third parties (investors), they should be permitted to do so. In view of pros and cons of delisting, it may not be desirable to put an absolute ban on delisting but it may be regulated. The statute and rules must provide a framework for delisting, as it provides for listing. If it is in the interest of investors, it must be permitted. If it is not in the interest of investors, delisting may be allowed only if investors are adequately protected.

The Bill proposes a framework for voluntary and compulsory delisting. A stock exchange may delist securities, after giving the concerned company an opportunity of hearing, if (a) the company has incurred losses or its networth has been reduced to less than its paid up capital, (b) the securities have not been traded continuously, (c) the company has failed to comply with listing agreement or provisions of any law, (d) the company fails to redress complaints of investors, (e) the company or its promoters or directors indulge in insider trading or unfair trade practices in securities, (f) the promoters or directors or persons in management indulge in malpractices, (g) the addresses of promoters or directors are not known or false, (h) trading in securities has remained suspended for more than six months, and (i) public shareholding has come below the limits specified in the listing agreement. The Bill empowers SEBI to specify additional grounds on which securities may be delisted. A listed company or an aggrieved investor can file an appeal before SAT against the decision of the exchange delisting the securities. The Bill allows a company to delist its securities from an exchange. It can, however, do so only after it has obtained prior approval of the holders of securities by a special resolution passed at a general meeting, given an opportunity to the shareholders to exit at a fair price, and complied with such conditions as may be prescribed by the Exchange or SEBI.

*Clearing Corporation:* The securities laws do not explicitly recognise existence of clearing corporation. They talk only about trading and not about settlement, which is left to byelaws of the exchanges. The byelaws are supposed to provide for clearing house (not clearing corporation) for settlement of securities transactions. However, clearing house has limitations in the age of anonymous order book ushered in by screen based trading system. The current trading system does not allow participants to assess the counter party risk and, therefore, requires the exchanges use a clearing corporation to provide novation and settlement guarantee.

The Bill inserts a new section to provide that an exchange may, with the approval of SEBI, transfer the duties and functions of a clearing house to a clearing corporation for the purpose of the periodical settlement of contracts and differences thereunder, and the delivery of and payment for securities. SEBI shall approve such transfer if it is in public interest or in the interest of trade. Every clearing corporation must be a company and its byelaws must be approved by SEBI. The various provisions in the SCRA such as grant and withdrawal of recognition, supersession of management, suspension of business etc. applicable to stock exchanges shall, mutatis mutandis, apply to clearing corporations. This means that the clearing corporations must be recognized and subjected to the same regulatory framework as the stock exchanges are.

*Client Assets:* The intermediaries handle the money and the securities on behalf of clients and hold these in their custody on their behalf. At times, the intermediaries like depositories hold the assets as registered owner on behalf of beneficial owners. They have generally been advised by SEBI to segregate their assets from those of their clients and not commingle the assets of the clients. However, there is a doubt if the assets of the clients can be attached in case of insolvency of the intermediaries. There is no statutory backing to protect the investors in case of insolvency of intermediaries. In order to provide this protection of assets held in trust on behalf of investors, the Bill proposes that an investor can entrust the money or securities to any intermediary (stock broker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser, depository, depository participant, custodian of securities, FIIS, credit rating agencies and such other intermediary) to be dealt or held on his behalf and at his instance. The intermediary shall hold such assets in trust and shall not have any right, title or interest of any nature therein. He shall deal with such assets as directed by the investor and shall be accountable for the same. Such assets shall not form part of assets of the intermediary and no authority can attach or seize such assets. If a broker or sub-broker fails to segregate the assets of the client or clients or uses the assets of a client for self or any other client, he can be penalized by an adjudicating officer up to Rs. 1 crore.

**Scheme of Penalty**

The securities market is an integral part of the economy. It has the potential to destabilise other sectors. It is, therefore, necessary that the penalty for offences in the securities market is deterrent. The first step in this regard is to make all the offences in the securities market cognisable, as a few offences under the SCRA are. Accordingly the Bill proposes to make all the offences listed in section 23 cognisable.

The penalty prescribed under the SCRA is ridiculously low. Many of the offences under the SCRA attract a penalty of Rs. 1,000, on conviction. For example, non-compliance of listing agreement, which can put investors to untold miseries and make a mockery of corporate governance norms, can be punished upto Rs. 1,000 on conviction. Listing agreement can be effectively used to discipline a listed company, if its non-compliance invites a deterrent penalty. Accordingly, the Bill proposes to increase penalty from Rs. 1,000 to an imprisonment upto 10 years or fine upto Rs. 25 crore or both. The Bill empowers SAT and Courts to compound any offence punishable under the SCRA, not being an offence punishable with imprisonment only, or with imprisonment and also with fine, either before or after institution of any proceeding.

The Bill lists out a wide range of violations along with maximum penalties leviable. It empowers SEBI to appoint an officer not below the rank of a division chief of SEBI to be an adjudicating officer to adjudicate these violations. He will hold an enquiry after giving the person concerned a reasonable opportunity of being heard for the purpose of imposing penalty under sections 23A to 23F. While adjudging the quantum of penalty, he shall have due regard to amount of disproportionate gain or unfair advantage wherever quantifiable made as a result of the default, the amount of loss caused to an investor or any group of investors as a result of default, the repetitive nature of the default and seriousness of the offence or violation. Table 1 presents the penalties envisaged in the Bill for different violations.

**Table 1: Penalties proposed in the Securities Laws (Amendment) Bill, 2003**

| Section | Offence | Penalty |
|---|---|---|
| 23(1) | Various offences | Imprisonment upto 10 years or fine upto Rs. 25 crore or both |
| 23A | Failure to furnish information, books etc. or maintain books, records etc. as required under listing agreement or byelaws of an exchange | Rs. 1 lakh for each day during which such failure continues or Rs. 1 crore, whichever is less |
| 23B | Failure to enter into an agreement with client | |
| 23C | Failure to redress the grievances of investors by a broker, sub-broker, a listed or proposed to be listed company, after being called upon to do so by SEBI or Exchange | |
| 23D | Failure by a broker or sub-broker to segregate assets of clients or uses the assets of a client for self or another client | Penalty not exceeding Rs. 1 crore |
| 23E | Failure to comply with listing agreement or delisting norms by a person or company managing CIS or Mutual fund | Penalty not exceeding Rs. 25 crore |
| 23F | Dematerialisation in excess of the listed securities | |
| 23G | Failure or neglect by an Exchange to furnish periodical returns or to comply with any direction of SEBI | |
| 23H | Failure to comply with any provisions of the Act, rules, articles or byelaws of exchange or directions issued by SEBI, for which no separate penalty has been prescribed | Penalty not exceeding Rs. 1 crore |

The Bill provides that non-payment of penalty imposed by an adjudicating officer or non-compliance with any of his orders or directions would be an offence punishable with imprisonment for a term between one month and ten years, or with fine upto Rs. 25 crore or with both. In order to avoid conflict of interest, the Bill provides that all sums realized by way of penalties shall be credited to Consolidated Fund of India.

To ensure fair enquiry and penalty, the Bill provides that appeal against the orders or decision of SEBI rejecting the scheme of demutuialisation submitted by an exchange, of an adjudicating officer imposing monetary penalty or of an Exchange regarding listing or delisting of securities can be preferred before SAT. Any person aggrieved by an order of SAT can prefer a further appeal before Supreme Court only on a question of law.

The Bill provides that that no court shall take cognisance of any offence punishable under the Act or any rules made thereunder except on a complaint made by central/state government, SEBI, a stock exchange or a person. Any offence punishable under the Act shall be tried by a 'court of session' instead of 'a presidency magistrate or a magistrate of the first class' as provided now.

The amendment Bill inserts section 12A to empower SEBI to issue directions to any stock exchange, clearing corporation, any agency or person providing trading, clearing or settlement facility in respect of securities and to any company whose securities are listed or proposed to be listed on a stock exchange. Such directions can be made only on being satisfied after inquiry that it is (i) in the interest of investors or orderly development of securities market, (ii) to prevent the affairs of any exchange, clearing corporation etc. from being conducted in a manner detrimental to the interest of investors or of the securities market, or (iii) to secure the proper management of any such entity.

### Other Amendments

The amendment Bill also proposes the following amendments:

*Derivatives:* It amends the definition of 'derivatives' to include swap, options and hybrid instruments and other contracts for differences. These are not securities as such and not based on underlying securities, but can be traded and regulated under SCRA, if these are considered derivatives and consequently securities. This will help the market for these instruments to develop.

*Spot Transactions:* Market has moved to T+2 rolling settlement in April 2003 and is scheduled to move to T+1 by April 2004. Since T+2 is as good as spot transactions, there is no need to allow spot transactions or exempt them from the regulatory framework. Besides, the spot transactions have been allegedly misused for manipulative purposes. It may, therefore, be desirable to regulate spot transactions. The Bill proposes to withdraw the exemption for spot transactions in general. It grants the exemption only in respect specified types of spot transactions from the regulatory framework. It also empowers central government to regulate spot transactions, including exempted transactions, in the interest of trade or public interest.

*Depositories Act:* The Bill amends the Depositories Act to provide that any person aggrieved by an order of SAT can prefer an appeal before Supreme Court on a question of law arising out of the order. Earlier it was appellable to High Court.

This Bill has been introduced in the Parliament under article 117(1) of the Constitution of India. It has been referred to the Standing Committee on Finance for Examination.

❑❑❑