

VOL 46 | NO. : 11 | Pg. 1-168 | NOVEMBER 2016 | ₹100/- (Single Copy)

CHARTERED SECRETARY

THE JOURNAL FOR CORPORATE PROFESSIONALS



FOCUS ON...

COMPETITION LAW



THE INSTITUTE OF
Company Secretaries of India

IN PURSUIT OF PROFESSIONAL EXCELLENCE
Statutory body under an Act of Parliament

Website : www.icsi.edu

Regulating Research Analysts - An in-depth study of Securities and Exchange Board of India (Research Analysts) Regulations, 2014



Rahul P Sahasrabuddhe, FCS

Founding Partner
SPRS and Co.
Company Secretaries, Mumbai

rahul@sprscs.com

PROLOGUE

Albert Einstein once said, if we knew what it was we were doing, it would not be called research. Research is a systematic and scientific process which leads to a detailed study of a subject, especially in order to discover (new) information or reach a (new) understanding. Human being could evolve from apes to current form only because of his appetite for constant improvement in all his deeds and ability to analyze and think.

The purpose of this article is to make an analysis of Securities And Exchange Board of India (Research Analysts) Regulations, 2014. The Regulations empower SEBI to govern Research Analysts and Research Entity. Company Secretaries has been recognized to conduct Annual Audit of Research Analysts and Research Entity.

WHY RESEARCH ANALYSIS?

Based on number of factors, research can be categorized as quantitative research and qualitative research. In spite of the fact that quantitative and qualitative analysis overlap each other in number of ways they both are fundamentally poles apart. Quantification of data is at the core of quantitative analysis whereas qualitative research is required for in depth understanding of reasons and motivations to get further insights. Many areas of life, may it be at macro level, say, exploring new market, need for infrastructure facilities, introduction of new taxes, (at micro level) buying a new car or a mobile phone, is preceded by one or the other kind of research. A person may risk taking a new product, car or mobile phone without a proper research but a corporate venturing without a proper and systematic research may result into a negative hit to its balance sheet. Hence, there is need to engage a research mechanism to take an informed decision.

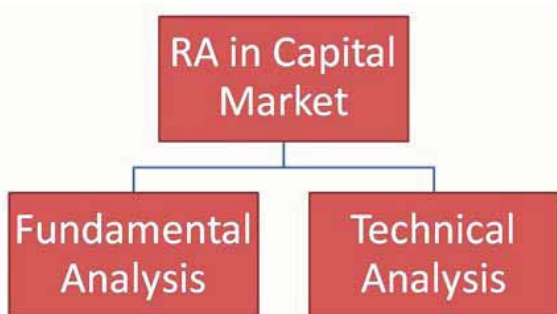
RESEARCH ANALYSIS AND CAPITAL MARKET

Institutional Investors and seasoned investors does a sincere analysis pre and (on a regular basis) post investments. Research Analysis (RA) (hence forth to be used as terminology of Capital Market) can be categorized into Fundamental Analysis and Technical Analysis.

Fundamental Analysis includes analysis of a particular stock based on analysis of economy, industry to which it belongs and company analysis. Chronologic analysis of word and country specific economy, Industry and Company; may divide fundamental analysis into "top down" or "bottom up" approach.

Technical Analysis on the other hand, presumes price of a particular stock has already effected or affected by the economy, industry or Company's outlook and it is more of analysis of psyche of market players. Based on investment decisions to be taken by the market player, Fundamental and Technical Analysis can also be categorized as "Buy Side" and "Sell Side" analysis.





Research Analysis is a very important aspect of capital market industry and no intermediaries especially, Stock Brokers, Underwriters, Merchant Bankers, Portfolio Managers, Mutual Funds, Debenture Trustees, bankers to an issue and others would like to take investment decisions without having a very strong in-house research department.

In spite of being an inalienable part of Capital Market in particular and Indian economy in general, till November 29, 2014, there was no direct Regulations as such, regulating the conduct of RA, however, SEBI vide gazette notification dated September 1, 2014 issued Securities And Exchange Board Of India (Research Analysts) Regulations, 2014 (hereinafter referred to as "RA Regulations") and brought research analysts under its direct regulatory control.

SEBI in its Annual Report for the year 2015-16 reasoned introduction of instant regulations as "a move to safeguard Indian markets from any manipulative research reports or misleading advice coming from any unregulated entity, SEBI has notified norms for 'research analysts' to ward off any conflicts of interest in their activities." These regulations came into existence with effect from November 30, 2014.

Particulars	2014-15	2015-16
Registered Research Analysts	26	261*

* Includes 3 proxy advisers.

** Source: SEBI Annual Report 2015-2016 (http://www.sebi.gov.in/cms/sebi_data/attachdocs/1471609638850.pdf)

KEY DEFINITIONS UNDER THE RA REGULATIONS

According to Regulation 2 (1) (u) 'research analyst' means a person who prepares, publishes and provides research report, makes buy/sell/hold recommendations, gives price target, offers concerning public offer. Such advice should be related with securities which are either listed to be listed on the stock exchange(s).

Regulation 2 (1)(h) defines "independent research analyst" as a person whose only business activity is research analysis or preparation and/or publication of research report. It may be noted that there are very few market players who acts as independent research analyst and Research Analysis is one of the activities of a financial conglomerate. Whereas Regulation 2 (1)(v) defines "research entity" as an intermediary registered with SEBI and providing merchant banking, investment banking, brokerage, and/or underwriting services and also issues research report or research analysis in its own name through the individuals employed by it.

As per Regulation 2 (1)(w) "research report" means any written or electronic communication involving any research analysis, opinion or recommendation pertaining to any listed or to be listed securities or public offer. Such opinion or analysis should result into providing a basis for investment decision however, research report does not cover comments on general trends, economic, political conditions, periodic report to mutual fund unit holders or portfolio management

service provider to its clients, Comments on general trends in the securities market; non client centric internal communication, offer document, statistical summary, technical analysis relating to demand and supply in a sector or the index. It is quite surprising that macro level technical analysis of sector or an index is excluded while micro level technical analysis is still in the ambit of this regulation. This exclusion is intriguing.

"Subject Company" is defined in regulation 2 (1)(z) as the company whose securities are the subject of a research report or a public appearance. This is quite interesting as the word "company" is defined in Section 2 (20) of Companies Act, 2013 as company incorporated under this Act or under any previous law, where as many entities are listed on Stock Exchanges, which are body corporate and not a company.

REGISTRATION OF RESEARCH ANALYSTS

The SEBI vide PR No. 148/2016 dated October 20, 2016 has introduced online system for Investment Advisers and Research Analysts to promote ease of operations in terms of e-registration, compliance reporting, etc.

No person is allowed to act as RA or Research Entity (RE) unless he has obtained a Certificate from SEBI. However, SEBI registered Investment Advisor, Credit Rating Agencies, Asset Management Company or fund manager are exempt from such certification provided it abides with Chapter III of this regulation dealing with "Management of Conflicts of Interest and Disclosure Requirement". Regulation 4 makes it mandatory for any research analyst located outside India and issuing research reports on Indian Capital Market to enter into a formal agreement with Research Analyst or Research Entity.

SEBI before granting certificate under this regulation shall take into consideration following points:

1. Any individual, partnership firm, limited liability partnership or body corporate may be registered as RA.
2. Every individual Research Analyst or employee of Research Entity working as Research Analyst must be certified as Research Analyst. SEBI vide Notification under regulation 3 of the Securities and Exchange Board of India (Certification of Associated Persons in the Securities Markets) Regulations, 2007 dated March 24, 2015 has made it mandatory that any person acting or desirous of acting as research analyst shall obtain certification from the National Institute of Securities Markets (NISM) by passing the "NISM-Series-XV: Research Analyst Certification Examination. It is been clarified by SEBI in "Frequently Asked Questions w.r.t SEBI (Research Analyst) Regulations, 2014" that certification requirement is limited to those employees who are working with research entity as research analyst and employees working in other departments like clerical, marketing, back office department, support services etc, are not covered.
3. Individual and partnership registering as research analyst need to have net worth of Rs. 1 lac and in case of LLP and body corporate thenet worth requirement is Rs. 25 Lacs.

Certificate once granted shall be valid for 5 years and the same may be renewed subject to the condition that the applicant submits formal application within 3 months of expiry of its registration. On obtainment of registration, the registered entity may use the term "Research Analyst" in all correspondence with its clients.

REGULATOR FOR RESEARCH ANALYSTS

SEBI is empowered to delegate, administration, supervision and regulation of Research Analysts. The Board may also make it mandatory for every research analyst to become member of such

Research Analysis is a very important aspect of capital market industry and no intermediaries especially, Stock Brokers, Underwriters, Merchant Bankers, Portfolio Managers, Mutual Funds, Debenture Trustees, bankers to an issue and others would like to take investment decisions without having a very strong in-house research department.

body. SEBI is yet to notify any such body to act as regulator for RAs.

Note: The only association of Capital Market Intermediaries recognized by SEBI is Association of Mutual Funds of India (AMFI). AMFI is a non-profit organization, an association of all the registered Asset Management Companies in India.

MANAGEMENT AND CONFLICT OF INTEREST AND DISCLOSURE REQUIREMENT

Chapter III of the Regulations deals with internal control, policies, limitations on trading by research analysts, compensation to be paid to research analysts and contents, limitations and disclosures to be made in research report, general responsibilities of research analysts and maintenance of records.

Establishing Internal Policies and Procedures

Regulation 15 mandates that every research analyst and research entity shall have written internal control policies governing dealing and trading by research analysts in their personal accounts with specific reference to-

1. Address conflict of Interest
2. Promote unbiased research reports
3. Prevent use of research report to manipulate securities market.

Conflict of Interest

The (Cambridge) dictionary meaning of Conflict of Interest is “a situation in which someone’s private interests are opposed to that person’s responsibilities to other people.” Conflicts of interest arise when a financial service provider, or an agent within such a service provider, has multiple interests that create incentives to act in such a way as to misuse or conceal information needed for the effective functioning of financial markets. Generally Financial Intermediaries offer catena of services to its target customers and that may spread across financial planning, insurance advisory, personal financial advisory, life and general insurance advisory, portfolio management, stock broking, depository, proxy advisory, research. Similarly, financial intermediary houses also cater to institutional client set up where in they offer merchant banking, underwriting, and financial advisory in addition to earlier discussed services. All these services are interlinked and hence many situations give rise to conflict of interests.

Case study

A Financial Conglomerate has few entities registered as Stock

Broker, Portfolio Manager, Research Analyst, and Depository Participant. A research analyst publishes a report with a long view with respect to (say) ABC Limited, a pharmaceutical company. However, on releasing this research report he dumps his own long position in the open market to book profit. Herein, the research analyst had taken an exact opposition position which was contrary to recommendations.

Similarly, a research analysts changing his view on a particular stock through his report so as to profit his employers stock broking arm, a sister concern to earn more brokerage.

There is nothing wrong in have conflict of interests per se however, overbearing of self interest over client’s interest is undesirable.

Unbiased Research Report

Research Analyst should be unbiased in drawing a research conclusion in its research reporting. An intermediary which had given merchant banking services in an IPO should not create any pressure on research analyst to publish a favorable report for the same company. Control measures like physical and procedure Chinese walls are tools to avoid such conflict situations.

Use of research report to manipulate market

A report not depicting correct information about a particular stock may have been drawn by a research house for manipulative market practices. This no doubt will have impact on goodwill of the research house however; control mechanisms must be in place to avoid such malpractices.

Limitations on trading by research analysts

Regulation 16 prescribes following limitations on trading by research analysts:

1. Personal trading activities of employees of research entity shall be monitored and recorded and a formal approval process of every trade needs to be followed by Compliance Department.
2. Independent Research Analyst or person employed in research entity shall not deal or trade in securities within 30 days before and 5 days after publication of research report covering Subject Company.
3. Independent Research Analyst or person employed in research entity shall not enter into any trade contrary to his recommendations.
4. Independent Research Analyst or person employed in research entity shall not subscribe or receive securities of any issuer, of the same industry, which research analyst tracks.
5. Any exceptions or exemptions to the policy may specifically be provided.

Every Capital Market Intermediary is required to have a policy under SEBI (Prohibition of Insider Trading) Regulations, 2015. A compliance of this policy would ensure compliance with regulation 16.

Compensation of Research Analysts

While dealing with compensation to be paid to employees of research entity, Regulation 17 states that payment of compensation including bonus, increment shall not be linked to any merchant banking, investment banking or brokerage transaction of the research entity or any of its sister concern. The compensation paid to research employees of entity shall be documented, approved and reviewed annually by the Board of Directors or committee of Directors of the Research Entity. It may also be noted that head of the merchant banking, investment banking or broking division of the research entity shall not be part of such decision making process.

Limitations on publication of research report, public appearance and conduct of business, etc.

Brokerage and merchant banking houses also acting as research entity shall not publish or distribute research report or make any public appearance like arranging a road show, conference call, host an investors' meet for an issuer company, in which it has acted as manager or co manager for any of its public issue for a period of 45 days from the date of offering in case of initial public offer and 10 days in case of further issue offering. The above time limit in respect of a Research entity, who has also acted as an underwriter for a particular issue shall be 25 days from the date of offerings made. Research Analyst is also barred from participating in any communication concerning business engagement with any of the current or prospective investment banking, merchant banking or brokerage client. However, these restrictions does not bar research analyst from engaging in any investor education activities where in a brief about the proposed deal is discussed.

A research analyst is required to make following disclosures in every research report:

1. All the material information about business activities of Research Analyst
2. Disciplinary actions history
3. Terms and conditions on which research report or services are being offered
4. Details of associates and such other information necessary for readers to make an informed investment decision based on research report
5. Financial interest of the research analyst or research entity in the subject company
6. Holdings in excess of 1% or more securities of the subject company in the subject company by research analyst or research entity and such other material conflict of interest
7. Details of any compensation received by research entity or research analysts from Subject Company
8. In case of any public appearance by the research analyst or employee of research entity compensation details are also needs to be disclosed.

Research Analyst or Research Entity may not publish any disclosures above which may reveal material non public information regarding any potential investment banking, merchant banking or block deal.

Contents and distribution of research report

Research Entity making the research report must ensure that every research report published by it is based on reliable information and facts. In case of usage of rating system the same shall be clearly defined in the research report. Research Report may also contain graphic representation of price or price targets, subject to the fact that every report must contain daily closing price of the subject company in the given graph and performance of the stock for the period for which such target is given or 3 years, whichever is shorter.

Research Report once published cannot be released to select individuals or clients. Also research entity sourcing research report from a third party needs to vet the same before making any release.

Proxy Advisor

Though, proxy advisory services are a nascent concept in India but they have already made a huge impact in corporate decision making process. Proxy advisor is a subject expert providing professional advice to institutional investor or shareholder of a company in relation to exercising of their rights in the company which also includes recommendation of public offer or voting recommendation on any agenda item. Provisions of Chapter II to VI of Research Analysts regulations are applicable mutatis mutandis

to proxy advisory services firms except to the fact that employees of the proxy advisory firms should have a minimum educational qualification as graduate and SEBI has been empowered to introduce a certification requirement.

GENERAL RESPONSIBILITY OF RESEARCH ANALYSTS

Regulation 24 describes general responsibilities of Research Analysts:

1. Research analyst or research entity shall maintain an arm's length relationship between its research activity and other activities.
2. Research analyst or research entity shall abide by code of conduct as specified in Third Schedule of the regulation.
3. Research analyst or research entity must obtain prior approval from SEBI in case of any change in management control.
4. Research analyst or research entity shall provide all the necessary information, details as sought by SEBI.
5. Research analyst or research entity must adhere to certification requirement of all its employees at all the time.

Maintenance of Records

Regulation 25 prescribes records mandatorily required to be maintained by Research analyst or research entity. They are as follows:

1. Research Report duly signed and dated
2. Research recommendations
3. Rationale for arriving at research recommendation
4. Record of public appearance.

Records, if any kept in electronic form, may be digitally signed.

All the above records are required to be maintained for a period of 5 years.

SEBI's Right to Inspect

SEBI may suo motu or upon receipt of complaint from any person may carry out inspection of research analyst or research entity. The board may appoint an inspecting authority to carry out such inspection and may exercise this power with or without giving any notice to the research analyst or research entity. On receiving any such notice research analyst or research entity must cooperate with the officials of the Board. Inspecting authority is required to submit a report to the board on completion of inspection. Based on the inspection report, the board may issue necessary directions to research analyst or research entity to refund any money collected as fees, charges or commission, with interest and prohibiting research analyst or research entity to act as such with immediate effect. SEBI has also been empowered to prohibit research analyst or research entity from accessing capital markets.

Compliance Officer

Regulation 26 mandates, that a research analyst which is body corporate or LLP is required to appoint Compliance Officer who shall be responsible for monitoring the Compliances under this regulation.

Annual Compliance

Regulation 25 (3) prescribes that Research analyst or research entity shall conduct annual audit in respect of compliance with Research Analyst regulations. RA regulations fall short of prescribing any report format or time limitation for conducting of Audit. The Audit Report is expected to contain all the required compliances of RA Regulations (suggestive format of Audit Report is enclosed).

Opportunity For Company Secretaries

Members of ICSI or ICAI are identified professionals to do this audit. It would have been appropriate to include the word "practicing

member of" before ICSI or ICAI, as current regulations indicate that even employee members of these professional bodies can act as auditor. However, looking at the spirit of the regulation and to bring in third party audit and their views in compliant running of the research house, audit under regulation by independent professionals is the need of the hour.

SUGGESTIVE FORMAT OF ANNUAL COMPLIANCE AUDIT REPORT

(Pursuant to Regulation 25(3) of Securities and Exchange Board of India (Research Analysts) Regulations, 2014)

To,
XXXXXXXXXX

We have conducted the "Annual Compliance Audit as prescribed under Regulation 25(3) of Securities and Exchange Board of India (Research Analysts) Regulations, 2014" (hereinafter referred to as "Annual Compliance Audit") of XXXXXXXXXXXXXXXX (hereinafter referred to as "the Company") which is a Research Entity as per Securities and Exchange Board of India (Research Analysts) Regulations, 2014 (hereinafter referred to as "RA Regulations"). Research Analyst Audit was conducted in a manner that provided us a reasonable basis for evaluating the corporate conducts and statutory compliances.

Based on our verification of the necessary Registration Certificate, other required certificates, documents, records, forms, internal policies, procedures and other records maintained by the Company and also the information provided by the Company, its officers, agents and authorized representatives during the conduct of Research Analyst Audit, we hereby report that in our opinion, the company has, during the audit period covering the financial year ended on 31st March, 2016 (hereinafter referred to as "the audit period") complied with the statutory provisions listed hereunder and also that the Company has proper compliance mechanism in place to the extent, in the manner and subject to the reporting made hereinafter:

1. The Company has obtained Certificate of registration from the Securities and Exchange Board of India (hereinafter referred to as "SEBI") as per RA Regulations.
2. The Company has employed XX (XX) Research Analysts as mentioned in "Exhibit A".
3. As per information/records provided by the Company, the Net Worth of the Company as on March 31, 2016 is Rs. XXX /- (Rupees XXX Only) and the company has complied with capital adequacy requirements as per Regulation 8 of RA Regulations.
4. Mr. XXX has resigned from the office of Director of the Company with effect from XXXX. The Company vide its letter dated XXX has informed about this change in the Directorship in compliance with Regulation 13 of RA Regulations.
5. The Company has used the term "Research Analyst" in its correspondence relating with Research Reports, Research Notes, Research update, etc. with its clients.
6. The Company has required internal control policies and procedures governing the dealing and trading by any research analyst as detailed in "Exhibit B". The Compliance Officer is in charge of implementation and review mechanism of these policies.
7. The Company is having in place appropriate mechanisms to ensure independence of its research activities from its other

business activities.

8. The Remuneration and Compensation paid to Research Analysts has been approved by the Board of Directors/Committee appointed by the Board of Directors, vide Board Resolution passed in the meeting for Board of Directors held on XXXX.
9. The Company has well defined Organization Structure as mentioned in "Exhibit C" and that no employee has been supervised or controlled by any employee of the merchant banking or investment banking or brokerage service divisions of Company.
10. The Company has not acted as Underwriter of any IPO or manager/co-manager of public offering during the year under review.
11. The employee has not participated in business activities designed to solicit investment banking or merchant banking or brokerage services business, such as sales pitches and deal road shows.
12. The employee has not engaged in any communication with a current or prospective client in the presence of personnel from investment banking or merchant banking or brokerage services divisions or company management about an investment banking services transaction.
13. The Company has provided unbiased review in its research report to a company or industry or sector or group of companies or business group. The research analysts have prepared his research report based on documents, papers, records and information available in Public Domain.
14. The Company has disclosed all the required and material information about itself, disciplinary history, the terms and conditions on which it offers research report; details of associates and such other information as is necessary to take an investment decision.
15. The company has drafted rating system to rate a particular security and same rating policy is being adhered to while rating a particular security which is being published in the research reports or public appearances for the period under review.
16. The employee or directors of the company has given disclosure about the registration status and details of financial interest in the subject company while public appearance.
17. The research report has not been made available selectively to internal trading personnel or a particular client or a class of client in advance of other clients who are entitled to receive the research report.
18. The Company has maintained arms length relationship between its research activity and other activities.
19. The Company is in compliance with the Code of Conduct as prescribed under Regulation 24(2) and third schedule of RA Regulations.
20. The Company has maintained all the necessary records required as per regulation in physical/electronic form.
21. The Company has appointed a Compliance Officer for monitoring the compliance of the provisions of RA regulations and circulars issued thereon by the SEBI.
22. The Company has not contravened any regulation or circulars issued by the SEBI.

Signature:

Date: XXXX

Place: XXXX

CS