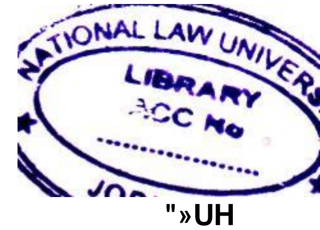

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FOREWORD

The theme of this issue of the Journal of Corporate Law & Governance is "The Ease of Doing Business: A New Era of Corporate Law in India". The year 2014 saw a dramatic turn of events as the new NDA led Government took reigns at the centre. For the first time in almost 3 decades, one single political party received an absolute majority at the centre. This wholehearted mandate from the people provided a significant impetus to the Government to take positive action to spur industrial growth by pushing forward the reform agenda which had been languishing for some years. One of the topics that has been a matter of great concern to Corporate India is to improve the ease of doing business in India. Being conscious of this concern, the Central Government has taken various steps which include the creation of the "Make in India" programme, stage wise liberalisation of FDI Policy, improvement of dispute resolution mechanism, establishment of E-Biz Portal, easing Export/Import requirements, increasing validity period for Industrial licenses. These policy decisions seem to be gradually percolating down into the bureaucracy and the polity, and changes are visible. There has also been significant emphasis on improving perception. As per the World Bank's rankings, India currently stands at 130 having improved from 142 the year before. Accountability is another major tool that is being employed whereby the Central Government invited the World Bank to compare the States on a similar pedestal as of June 2015; States that didn't fare well have geared up to make the necessary changes.

Given this background, this issue is well timed and having reviewed the manuscripts, I am certain that an informed reader is bound to be enthused by the contents. The article on *"The Challenges in Regulating Collective Investment Schemes in India: A Case for Effective Regulation"* by *Ms Paridhi Poddar* and *Ms Arunima Chatterjee* provides interesting insight into the current regulations and highlights how a multiplicity of regulators is probably only adding to the conundrum. If pursued appropriately, such schemes provide one of the best means of channelling savings' monies - one of the hallmarks of the Indian

household and mindsets - towards investments and accretions. The article makes a very effective case for more effective enforcement to deter ponzi schemes from robbing the retail investors of their dream of better returns on investment. Moving on, the "Startup India" initiative of the Honourable Prime Minister is another valuable programme which should spur indigenous innovation and entrepreneurship. However, for such start-ups, fundraising can be a challenge. In this backdrop, the dispensation provided by the Central Government in removing the minimum paid up capital requirement has no doubt been welcomed by the start-up community, and it also one of the reforms hailed by the world bank in its latest report. The article titled *"The Companies Amendment Act, 2015: Removal of the Minimum Paid-up Share Capital'"* by *Ms Ayushr Singhal* provides a good analysis on the rationale of dispensing with this requirement. Nevertheless, whether this is a minimum paid up capital requirement or not, businesses require funds. Aside from the organised primary markets, crowdfunding could be a potential alternative and the article *"Look Before you Leap: Regulating Equity Based Crowdfunding in India"* by *Mr Prateek Suri* provides an excellent comparative perspective of Indian vis-a-vis other jurisdictions. In signature style, the Securities and Exchange Board of India ("SEBI") has released a discussion paper on this issue and invited public participation. In my personal opinion however, given the relative lack of sophistication of our retail investors, and the traditional cautionary approach that Indian financial regulators adopt, there is probably some daylight between now and when crowdfunding will become a reality.

In the next phase of growth, assuming that a start-up survives its formative years and transforms into an SME enterprise, utilising the SME platform is an enthusing possibility for many such promoters. The SME platform has been widely used and the general perception towards the SME platform is definitely one of hope. In this context, the article, *"Start-Up Your Engines: Alternate Capital Raising Platforms for Entrepreneurs"* by *Mr Armaan Patkar and Ms Diya Uday* provides a good summary of the evolution of the regulatory framework and also provides a comparative perspective with other western jurisdictions. It eventually concludes that the regulations perform a good balancing act. The fact that smaller companies can access public funds in an orderly and organised manner is heartening *per se.* One would only hope that more companies see an opportunity and value in this approach. .

Moving on, in any equity based private fund raising, the investor is bound to expect some accountability towards his investment promises, and also, an effective mechanism to enforce such promises. In this context, arbitration has emerged as a significantly preferred mode of dispute resolution given the delays that plague Indian courts. While the Government has sought to allay some of those fears through the recent amendments, the article titles *"Making Business Dispute Resolution Easy in India: Arbitration Clause Needs to be Taken Seriously* by Prof Anurag K Agarwal illustrates how it could also be a pretty frustrating experience for a cross-border disputing party. Uncertainty, resulting from judicial flip-flop has been a nightmare for investors as also their legal advisors. One can only hope that the recent amendments will help settle the dust and expedite such matters. The growing emphasis on alternate dispute resolution generally speaking is also an initiative which the Central Government is pursuing to relieve the burden on courts and reduce case pendency.

A lot of this talk around businesses cannot be done in isolation of the fact that while companies are the main business vehicles, the driving force behind them are the entrepreneurs. It is the entrepreneur who takes significant risks and also investing his time and capital. It is possible that a business may fail, and leave nothing in its wake. In such a scenario, quick and efficacious insolvency scenarios that leave no stigma and allow the entrepreneur to start afresh are a must to create a healthy business environment. *Mr PSS Bhargava's* article, *"Court's Contribution to the Failure of the Corporate Rescue Regime - Lessons from the Past and the Vision for the Future"* highlights the significant vaccum in this area of legislation. The article highlights how not all forms of business have a forum available to resolve and insolvency scenario, and also mentions how courts' involvement in existing procedures has reduced their effectiveness. The Government already appears to be seized of these issues and is fairly clued into the various insolvency related reforms that it needs to introduce. Hopefully, in times to come, reforms would be forthcoming in this field as well.

Benny on *"Insider Trading and Front Running"* and by *Mr Tarun Jain* on *"Appraising the 'Goods and Service Tax' as a 'Means' (and not the 'End') to Improving the Business Climate of India"* touch upon two seminal issues impacting businesses. The former deals with protection and inspiring investor confidence in a company in terms of their fair dealings, and the latter deals with a long pending rationalization of the indirect tax structure of the country. The first article has analysed the recent changes to the insider trading norms threadbare and provides an interesting jurisprudential analysis of the genesis of regulation and prevention of insider trading. The new regulations bring with them their own set of challenges in various ways. The second article on the other hand assesses and analyses the current situation of the implementation of GST; something, which would bring India's taxation regime significantly at parity with western jurisdictions and also provide ease of compliance from a business perspective. The GST bill now remains stuck in Parliament for quite some time, but one can only hope that this issue will be resolved soon.

All in all, this issue should offer a wealth of information and insight to a reader, and some of the suggestions and observations may also assist in provoking a constructive discussion on the ways to achieving the objective of removing the hurdles and obstruction in doing business in India.

Ravindra Kulkarni
Senior Partner
Khaitan & Co

TABLE OF CONTENTS

Paridhi Poddar & Arunima Chatterjee, *The Challenges in Regulating Collective Investment Schemes in India: A Case for Effective Regulation* 1

Ayushi Singhal, *The Companies Amendment Act, 2015: Removal of the Minimum Paid-up Share Capital Requirement* 28

Prateek Suri, *'Look Before You Leap': Regulating Equity Based Crowd-funding in India* 42

Armaan Patkar & Diya Uday, *'Start-Up' Your Engines: Alternate Capital Raising Platforms for Entrepreneurs* 70

Prof. Anurag Agarwal, *Making Business Dispute Resolution Easy In India: Arbitration Clause Needs To Be Taken Seriously* 92

PSS Bhargava, *Court's Contribution To The Failure Of The Corporate Rescue Regime-Lessons From The Past And Vision For The Future* 108

Agranee Kapoor & Angeline Benny, *An InsidefR) Story: Bridging the Gap Between Statutory and Theoretical Perspectives* 126

Tarun Jain, *Appraising the 'Goods and Service Tax' as a 'Means' (and Not the 'End') to Improving the Business Climate of India* 143

SCHEMES IN INDIA: A CASE FOR EFFECTIVE REGULATION

PARIDHI PODDAR & ARUNIMA CHATTERJEE*

Ponzi schemes have existed in India since a fairly long time. Although it is easy to loosely describe such a scheme, the loopholes in the legal regulation of the same have been discovered with the unravelling of the Saradha scam which occurred in several parts of East India. The incident exposed the risks to the interests of smaller investors and depositors, thereby serving as a wake-up call for SEBI and other financial regulators. Although, the Government sought to remedy the situation with the promulgation of an ordinance within months, the authors believe that there still exists a lack of clarity within the regulatory framework. In this context, this research paper aims to chalk out and analyse the provisions of the SEBI Act and the SEBI (Collective Investment Schemes) Regulations. The authors also consider the successful regulation of mutual funds in India through the SEBI (Mutual Funds) Regulations and the provisions of Chapter IIIB of the RBI Act to suggest reforms. The paper concludes that there is a general need for more radical amendments along with an over-arching emphasis on financial awareness to weed out errant collective investment schemes from the market.

CONTENTS

I. *The Saradha Scam: An Introduction to the Menace of Collective Investment Schemes in India* **II.**
Collective Investment Schemes in India
III. *Mutual Funds in India*
IV. *Deposits Accepted by Non-Banking Financial Companies* V.
Insufficient Punishment = Ineffective Regulation?
VI. *Financial Literacy: The Way Ahead*
VII. *Conclusion*

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A collective investment scheme ('CIS'), in its most rudimentary sense, denotes the pooling of contributions by a group of investors for a specified purpose. In a CIS, investments are invited from the public at large and subsequent contributions are managed by an appointed third party to achieve the said purpose. In India, CISs are regulated by the Securities and Exchange Board of India ('SEBI'). In the present market scenario, an effective regulation of such investment schemes has assumed strategic significance as the pool of contributors essentially comprises of the small investors. However, peculiar obstacles within the Indian legal mechanism for the regulation of CISs have surfaced with the Saradha scam that occurred in West Bengal.

Through various schemes, the Saradha Realty India Ltd. ('Saradha Realty') collected Rs. 4,000 crore from nearly 1.4 million investors across the eastern part of India on payment of instalments varying from Rs. 10,000 to Rs.l, 00,000 for a fixed period of time.[1] Operating in as many as six states, the schemes primarily targeted rural population. Contributions were solicited using personal relations and agents were chosen keeping in mind their influence and authority in the locality. In lieu of their contributions, the investors were offered the option of receiving plots of land/flats, or a refund with returns up to 24 per cent after a fixed period of time. Although the company owned properties in West Bengal and Assam, the identification of the plots of land or flats was postponed to the time when the scheme finished its tenure. As a consequence, investors preferred opting for a refund of contributions with abysmally high returns.

In April 2010, SEBI received a letter from the Economic Offences Investigation Cell of the Government of West Bengal alleging that Saradha Realty collected deposits from the public in clear contravention

[1] *In Story ofSaradhas Crores Bengals Forgotten Hundreds,* INDIAN EXPRESS, April 28,2013, *available at* http://www.indianexpress.com/news/in-story-of-saradhas-crores-bengals-forgotten-hundreds/1108543/0; http://businesstoday.intoday.in/story/saradha-group-chit-fund-scam/1/194622.html (Last visited May 27, 2015).

of SEBI regulations.[2] Three years after receiving the said letter, SEBI passed a decision directing Saradha Realty to wind up its operations within three months and to refund the money collected.[3] Till such order was complied with, Saradha Realty and its Chairman and Managing Director Sudipta Sen were barred from participating in the securities market.

Despite the conviction, the sheer magnitude of the scam raised a disturbing question: why were the Indian regulators unable to identify and stop the snowballing of such a fraud into a scam? Was the larger confusion within the Indian financial regulatory system over the regulation of CISs responsible for this failure? . In the enacted pieces of legislations, it is not clear whether such schemes qualify as CISs in general, or as chit funds, mutual funds, or other deposits taken by non-banking financial companies ('NBFCs'). This distinction of the nature of the investment becomes significant because it supplies the governing law and the regulatory authority vested with the jurisdiction. For example, CISs are regulated by SEBI under the SEBI Act, 1992 ('SEBI Act') and the SEBI (CIS) Regulations, 1999 ('SEBI Regulations') whereas the deposits taken by NBFCs are governed by the Reserve Bank of India ('RBI') under the Reserve Bank of India Act, 1934 ('RBI Act'). Even within SEBI's jurisdiction, CISs and mutual funds are governed by separate regulations.[4]

In this context, the aim of this paper is to highlight the ambiguity surrounding the definition and how the same has contributed to the proliferation of fraudulent investment schemes in India. The paper argues that there is a need for clarity in the definition of CISs and a further need of giving more teeth to the regulatory powers of SEBI. It also notes the

[2] *Sebi tells Saradha Realty to wind up operations in three months,* BUSINESS STANDARD, April 24, 2013, *available at* *http://www.business-standard.com/article/markets/sebi-tells-saradha-realty-to-wind-up-operations-in-three-months-113042400026_1. html* (Last visited May 27, 2015).

[3] In the Matter of Saradha Realty India Ltd., WTM/RKA/ERO-CIS/19/2013 (April 23, 2013).

[4] Collective investment schemes are governed under the Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 whereas mutual funds are governed under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.

role financial awareness can play in the prevention of occurrence of ponzi scams.

II. COLLECTIVE INVESTMENT SCHEMES IN INDIA

SEBI was established for the regulation of the securities market in 1992 under the SEBI Act. Among its many functions, SEBI was entrusted with the registration and regulation of CISs.[5] In 1995, it became mandatory for a CIS to obtain a certificate of registration from SEBI in order to commence operations in the market.[6] Yet, a statutory definition and specific regulations for CISs were introduced only in 1999. This section briefly discusses the present position of laws governing CISs in India.

A. Context

Between the years 1995-99, there were increasing instances of entities issuing instruments in the form of agro-bonds to members of the public by offering extraordinary rates of return. These entities used to divert the funds for purposes other than those disclosed at the time of inviting investments. Such fraudulent schemes not only caused huge losses to the participating investors, it also eroded the confidence of the investors in the stability of the securities market.[7] Taking note of the situation, the Government of India issued a press release declaring that all such entities would be brought within the meaning of CISs.[8] The Government also issued directions to SEBI for the formulation of the draft regulations for CISs and for this purpose the Dave Committee was set up.[9] The Committee identified three important defining characteristics of CISs, namely, pooling of investments, management by entities and absence of day to day control of the investors.[10] Based on these

[3] *See* The Securities and Exchange Board of India Act, 1992, § ll(2)(c).
[6] *See id.*
[7] This was recorded in the Statement of Objects and Reasons of Securities Law (Amendment) Act, 1999.
[8] Press Release, SEBI, No. 143/97, (November 26,1997).
[9] *Id.*
[10] SA DAVE, REPORT OF THE COMMITTEE ON COLLECTIVE INVESTMENT SCHEME (Securities and Exchange Board of India) (1998), *available at*

recommendations, the SEBI Regulations and §11 AA of the SEBI Act were adopted. Taking note of this background, the judiciary and the SEBI tribunals have clarified that though SEBI Regulations were issued to regulate the plantation industry, the intention of the legislature was to endow it with an enlarged scope to bring within its scope all such schemes that embodied the four characteristics set out under § 11 AA of the SEBI Act.[11]

B. Definition of Collective Investment Schemes

Taking off from the above developments, the meaning of a CIS can be found in §2 (ba)[12] read with §11AA of the SEBI Act " Any scheme

http://www.sebi.gov.in/cms/sebi_data/pd_ffiles/21683_t.pdf; See page J.SUMIT AGARWAL & JOSEPH BABY, SEBI ACT: A LEGAL COMMENTARY ON SEBI ACT 1992 181 (2011).

[1] Alchemist Infra Realty Limited v. Securities and Exchange Board of India, Misc. Application No. 67 of 2013
and App. No. 124 of 2013 (SAT) (Unreported).

[12] §2(ba) reads, "collective investment scheme" means any scheme or arrangement which satisfies the conditions specified in Section 11AA.

[13] §11AA reads, "(1) Any scheme or arrangement which satisfies the conditions referred to in subsection (2) shall be a collective investment scheme.

(2) Any scheme or arrangement made or offered by any company under which,—

(i) the contributions, or payments made by the investors, by whatever name called, are pooled and utilized solely for the purposes of the scheme or arrangement;
(ii) the contributions or payments are made to such scheme or arrangement by the investors with a view to receive profits, income, produce or property, whether movable or immovable from such scheme or arrangement;
(iii) the property, contribution or investment forming part of scheme or arrangement, whether identifiable or not, is managed on behalf of the investors;
(iv) the investors do not have day to day control over the management and operation of the scheme or arrangement.

(3) Notwithstanding anything contained in sub-section (2), any scheme or arrangement

(i) made or offered by a co-operative society registered under the cooperative societies Act,1912(2 of 1912) or a society being a society registered or deemed to be registered under any law relating to cooperative societies for the time being in force in any state;
(ii) under which deposits are accepted by non-banking financial companies as defined in clause (f) of section 45-1 of the Reserve Bank of India Act, 1934(2 of 1934);

or an arrangement that satisfies the conditions laid down in sub-section (2) will qualify as a CIS for the purpose of SEBI Regulations.

For a review of the conditions prescribed under §11AA (2), it is also important to take a note of the various Supreme Court judgments that have added an entirely new dimension to the definition. For instance, the Supreme Court has explicitly held that the nature of the business of the managing company is not *res-integra* to the determination of whether it is a CIS or not.[14] What is required is that contributions for the scheme in question must be collected from the public at large for the purpose specified at the time of inviting investments.[15] "Where the investors belonged to a select group of 49, it was not possible to address the scheme under SEBI Regulations.[16] Similarly, to qualify as a CIS, it must also be shown that the contributions were made with a view to earn profits,

(iii) being a contract of insurance to which the Insurance Act,1938(4 of 1938), applies;

(iv) providing for any scheme, Pension Scheme or the Insurance Scheme framed under the Employees Provident Fund and Miscellaneous Provisions Act, 1952(19 of 1952);

(v) under which deposits are accepted under section 58 A of the Companies Act, 1956(1 of 1956);

(vi) under which deposits are accepted by a company declared as a Nidhi or a mutual benefit society under section 620A of the Companies Act, 1956(1 ofl956);

(vii) falling within the meaning of Chit business as defined in clause (d) of section 2 of the Chit Fund Act, 1982(40 of 1982);

(viii) under which contributions made are in the nature of subscription to a mutual fund;

shall not be a collective investment scheme.]"

[14] PGF Limited v. Union of India, AIR 2013 SC 3702,1151-55 as cited in the matter of Rose Valley Hotels and Entertainment Ltd., WTM/SR/ERO - CIS/11 /07/2013 0uly 10, 2013)(Unreported); Maitreya Services Private Ltd. v. Securities and Exchange Board of India, Misc. Application No. 52 of 2013 and App. No. 88 of 2013 (SAT) (Unreported); NGHI Developers India Limited v. Securities and Exchange Board of India, App. No. 225 of 2012 (SAT) (Unreported); Alchemist Infra Realty Limited v. Securities and Exchange Board of India, Misc. Application No. 67 of 2013 and App. No. 124 of 2013 (SAT) (Unreported).

[15] *See id.*

[16] In the Matter of Osian's Connoisseurs of Art Private Limited, WTM/RKA/IMD-CIS/16/2013(Unreported).

income, produce, or property. However, the SEBI Tribunal, SAT and the Supreme Court have taken a liberal view of "profits" to include appreciation of a plot of land,[17] holiday schemes[18] etc.[19] Another distinctive feature of CISs is the involvement of a third-party for management of the investment, which may be a person or company.[20] Consequently, investors neither have any day-to-day control on the operation of the scheme nor are they involved in the decision-making process of utilization of the pool of funds.

Despite these definitional guidelines, the determination of CISs is often difficult because a *prima facie* understanding of the transaction might lead to a different conclusion. This is evident from some of the contentions put forth by defendant companies.[21]

It is sometimes argued that the nature of the transaction is that of a sale and purchase of land and would not be subject to the CIS Regulations.[22] This was the case in the matter *oiPGF Limited* v. *Union of India,*[2i] where the Supreme Court held that the investigation of the nature of the transaction must check if the sale and purchase of land is a mere sham. Here, the appellant, PGF Limited offered a plot of land to be allotted on payment of timely instalments. This plot of land was not identified in the agreement signed between PGF and its investors. On behalf of PGF, it was argued that its business pertained to the sale and purchase of agricultural land, necessarily excluding the jurisdiction of

[17] PGF Limited v. Union of India, AIR 2013 SC 3702.

[18] Rose Valley Hotels and Entertainment Ltd., WTM/SR/ERO - CIS/11 /07/2013 (July 10, 2013) (Unreported).

[19] NGHI Developers India Limited v. Securities and Exchange Board of India, App. No. 225 of 2012 (SAT) (Unreported).

[20] *See* The Securities and Exchange Board of India Act, 1992, § 11AA(2).

[21] *See* Maitreya Services Private Ltd. v. Securities and Exchange Board of India, Misc. Application No. 52 of 2013 and App. No. 88 of 2013 (SAT) (Unreported); Alchemist Infra Realty Limited v. Securities and Exchange Board of India, Misc. Application No. 67 of 2013 and App. No. 124 of 2013 (SAT) (Unreported).

[22] *See,* Maitreya Services Private Ltd. vs. Securities and Exchange Board of India, Misc. Application No. 52 of 2013 and Appeal No. 88 of 2013 (SAT); Alchemist Infra Realty Limited vs. Securities and Exchange Board of India, Misc. Application No. 67 of 2013 And Appeal No. 124 of 2013 (SAT).

[23] PGF Limited v. Union of India, AIR 2013 SC 3702.

SEBI in the matter. However, the Court recognized that this was a mere sham and since all four characteristics of §11AA (2) were met, the scheme was considered to be a CIS.

At the same time, the enlisted conditions are not in themselves exhaustive; they are merely used as parameters to guide the adjudicatory bodies.[24] Other conditions may also be considered. In judicial decisions, room has been created for additional conditions such as the promise of extraordinarily high returns. For instance, in the matter of the *Maitreya Services Private Ltd.* before the Securities Appellate Tribunal, it was held that in situations where high returns are promised to investors in any form, a CIS may be said to be in place, subject to the fulfilment of other conditions as per law.[25]

Aside from these judicial parameters, sub section (3) of §11 AA creates as many as eight exceptions to the provisions of the SEBI Act and SEBI Regulations.[26] These exceptions include schemes offered by co-operative societies registered under the Cooperative Societies Act, 1912, or those under which deposits are accepted by non-banking financial companies as defined under § 451(f) of the Reserve Bank of India Act, 1934, or those under which contributions made are in the nature of subscription to a mutual fund are explicitly excluded.[27] While examining the constitutionality of §11 AA, the Supreme Court considered the justifications for carving out of these exceptions under sub section (3) of

[24] Rose Valley Hotels and Entertainment Ltd., WTM/SR/ERO - CIS/11 /07/2013, fl 7.3-7.6; Maitreya Services Private Ltd. vs. Securities and Exchange Board of India, Misc. Application No. 52 of 2013 and App. No. 88 of 2013 (SAT), 1 11; NGHI Developers India Limited vs. Securities and Exchange Board of India, App. No. 225 of 2012 (SAT) 1 17.

[25] This line of reasoning is significant since the CIS Regulations explicitly state that the CIS cannot offer guaranteed returns. *See,* Regulation 25, CIS Regulations, 1999; Maitreya Services Private Ltd. v. Securities and Exchange Board of India, Misc. Application No. 52 of 2013 and App. No. 88 of 2013 (SAT), 1 11; NGHI Developers India Limited v. Securities and Exchange Board of India, App. No. 225 of 2012 (SAT), 117.

[26] *See,* SEBI Act, 1992, §11AA(3).

[27] *Id.*

§11AA.[28] It noted that the artificial distinction created by the legislature was to avoid duplicity of applicable laws.

C. *Other Important Provisions of the SEBIAct*

Whereas § 11AA defines the expression CIS, § 12(1B) states that no person can sponsor or carry on a CIS until and unless such scheme is registered in accordance with the SEBI Regulations. The sub-section also provides for situations when registration would not be required depending on its period of operation. When the schemes in question operated before the commencement of the Securities Laws (Amendment) Act, 1995, and till the CIS Regulations were made, there is no need for a certificate of registration.[29]

The CIS Regulations provide for a two-tier structure which comprises of a trustee and a collective investment management company ('CIMC').[30] Reg. 3 further reinforces that no person other than a CIMC[31] which has obtained a certificate under these regulations shall carry on or sponsor or launch a CIS. In instances where the requirement of registration is not complied with, Reg. 73 states that the operation of such scheme must be wound up. It also requires that the investors under such scheme be repaid. The reach of Reg. 73 has been held to cover a "vast expanse of the corporate world and SEBI has jurisdiction over all such CISs which do or do not conform to the requirements of registration etc. laid down in the said Regulations irrespective of the date of launch of a scheme which according to SEBI has all the trappings of a CIS"[32].

[28] *See supra* note 23, f40.
[29] SEBI Act, 1992, proviso to §12(1B)
[30] *See* CIS Regulations, 1999, Reg. 16 which reads, "A scheme shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed duly registered under the provisions o
f the Indian Registration Act, 1908 (16 of 1908) executed by the Collective Investment Management Company in favour of the trustees named in such an instrument."
[31] *See* CIS Regulations, 1999, Reg. 3 which reads, "No person other than a Collective Investment Management Company which has obtained a certificate under the CIS Regulations can carry on or sponsor or launch a collective investment scheme."
[32] Alchemist Infra Realty Limited v. Securities and Exchange Board of India, Misc. Application No. 67 of 2013

The CIS Regulations also stipulate obligations for the CIMC[33] and the Trustees[34] in addition to an agreement between both parties regarding the management of the property of the CIS.[35] The proper management of the collected money and the investment property is ensured under SEBI Regulations through stipulations controlling disclosures made in the offer documents[36] and recording utilisation of money collected under the scheme.

Any failure to comply with these regulations is meted out with punishment stipulated under § 15D. The maximum fine that may be imposed on a defaulting person is one crore rupees.[37] However, when the

and App. No. 124 of 2013 (SAT), «f 17.

[33] *See* CIS Regulations, 1999, Reg. 14.

[34] *See id.,* Reg. 21.

[35] *See id.,* Reg. 20.

[36] *See id.,* Reg. 26.

[37] *See* SEBI Act, 1992, §15D - "If any person, who is-

(a) required under this Act or any rules or regulations made thereunder to obtain a certificate of registration from the Board for sponsoring or carrying on any collective investment scheme, including mutual funds, sponsors or carries on any collective investment scheme, including mutual funds, without obtaining such certificate of registration, he shall be liable to [a penalty of one lakh rupees for each day during which he sponsors or carries on any such collective investment scheme including mutual funds, or one crore rupees, whichever is less];

(b) registered with the Board as a collective investment scheme, including mutual funds, for sponsoring or carrying on any investment scheme, fails to comply with the terms and conditions of certificate of registration, he shall be liable to [a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less];

(c) registered with the Board as a collective investment scheme, including mutual funds, fails to make an application for listing of its schemes as provided for in the regulations governing such listing, he shall be liable to [a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less];

(d) registered as a collective investment scheme, including mutual funds, fails to despatch unit certificates of any scheme in the manner provided in the regulation governing such despatch, he shall be liable to [a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less];

(e) registered as a collective investment scheme, including mutual funds, fails to refund the application monies paid by the investors within the period specified in the regulations, he shall be liable to [a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less];

matter is addressed by the adjudicating authorities, it may be noted that the question of fine is not addressed[38]. The decision of SEBI in Saradha Realty prohibited the company and its managing director from accessing the capital market and further restraining them from buying, selling or otherwise dealing in the securities market till all its CISs were wound up and all the concerned investors were refunded. A reference was made to the Ministry of Corporate Affairs to initiate the process of winding up as well as a reference to the State Government to register either a civil or a criminal case against the company. In its landmark decision in *PGF Ltd*[39]*.*, the Supreme Court delivered a similar decision. It directed the CBI and the Department of Income Tax to conduct an investigation regarding the operations of PGF and subsequently launch appropriate proceedings if need be, without delving into the question of actual quantum of fine.

D. Interpretation of Relevant Provisions

The Apex Court has noted that the provisions laid down above are to be interpreted keeping in mind the intent of the legislature.[40] What is of relevance is the pith and substance of the provisions governing the operation of CISs. SEBI Regulations were particularly enacted in order to safeguard investors and bring about a greater transparency in the affairs of CISs. The essential and true character of the relevant legislations is to ensure the welfare of millions of innocent investors.[41]

SEBI Regulations were implemented on the basis of recommendations of the Dave Committee so as to "safeguard the interest of hapless investors hoping to earn huge profits by putting their life

(f) registered as a collective investment scheme, including mutual funds, fails to invest money collected by such collective investment schemes in the manner or within the period specified in the regulations, he shall be liable to [a penalty of one lakh rupees for each day during which such failure continues or one crore rupees, whichever is less]."

[38] *Supra* note 3.

[39] PGF Limited v. Union of India AIR 2013 SC 3702.

[40] Alchemist Infra Realty Limited v. Securities and Exchange Board of India, Misc. Application No. 67 of 2013
and Appeal No. 124 of 2013 (SAT), |24; Maitreya Services Private Ltd. v. Securities and Exchange Board of India, Misc. Application No. 52 of 2013 and App. No. 88 of 2013 (SAT), 118. " PGF Limited v. Union of India AIR 2013 SC 3702.

savings into schemes floated by various entities assuring the investors of exponentially high returns".[42] In light of its purpose, a wider interpretation of the Regulations is taken up.[43] Until and unless a scheme qualifies under the proviso set out under § 12(1B), each and every entity must obtain the certificate of registration prior to operation of any of its schemes. Thus, welfare of innocent investors has been recognized to be the most pertinent factor in determining the nature of an investment scheme.

E. Consequences of the Saradha Scam

In the context set out above, one needs to investigate why the Saradha scam unravelled in the way it did. The Saradha scam, as discussed previously, predominantly operated in rural parts of West Bengal. Under its schemes, the Saradha Group offered investors plots of land/flat or a refund of their contributions with returns up to 24 per cent. The schemes were ingeniously structured and planned in order to maximise gains. The fact that agents were appointed based on their general influence and reputation in the respective communities suggests the same. Given this leverage, it became easier to collect instalments from as many as 1.4 million investors[44]. Unfortunately, the scam was just the tip of the iceberg as since then, SEBI has found several instances of violations of CIS Regulations.[45]

The Saradha scam highlighted certain challenges with respect to regulation of CISs in India. The nature of the scam itself presented a problem because it did not explicitly qualify as a CIS, chit fund etc.[46] The tussle between the State Government, RBI, and SEBI only delayed the

[42] Alchemist Infra Realty Limited v. Securities and Exchange Board of India, Misc. Application No. 67 of 2013
and App. No. 124 of 2013 (SAT) ¶14.
[43] *See id.,* ¶16.
[44] *Supra note* 1.
[45] For example, recently, SEBI directed KBCL India Ltd. to stop collecting instalments and to refund the money already collected. *See generally,* in the matter of KBCL India Ltd., WTM/SR/ CIS- NRG7 21 /09/2013.
[46] It was not clear whether the scheme operated by Saradha Realty was in the nature of a chit fund, or deposits taken by a NBFC, or CIS. Thus, the responsibility to investigate and resolve the same was juggled between the State Government, the RBI and SEBI.

investigation. Another problem was that the SEBI was not equipped with the requisite tools to investigate instances of ponzi schemes as during the investigation, SEBI only had limited powers to acquire the necessary information.

Post the Saradha scam, the Securities Laws (Amendment) Ordinance (hereinafter First Ordinance) was promulgated in 2013 to enable SEBI to effectively regulate the operation of CIS. The aim was to allow SEBI to deem certain schemes or arrangements as CISs (where the corpus of funds was especially large) and to collect information for the purposes of ongoing investigations.

The First Ordinance sought to amend the Securities and Exchange Board of India Act, 1992, the Securities Contracts (Regulation) Act, 1956 and the Depositories Act, 1996.[47] The Securities Laws (Amendment) Bill, 2013 was introduced in Lok Sabha on the August 12, 2013 to replace the First Ordinance. Since the Monsoon session of Parliament concluded without the consideration and passage of the Bill, the Ordinance would have lapsed after the expiry of six weeks, i.e. on September 16, 2013 as per cl. (1) of Article 123 of the Constitution.[48] In order to keep in force the amendments that gave the legal backing to SEBI to tackle critical issues including powers to respond to the growing menace of illegal deposit taking and ponzi schemes, the Securities Laws (Amendment) Second Ordinance, 2013 ('2013 Ordinance'), prepared on the lines of the Securities Laws (Amendment) Bill, 2013 pending in Lok Sabha, was promulgated by the President.[49]

The 2013 Ordinance makes three significant additions to the definition of CISs found under § 11AA. First, the word "company" found in sub-section 2 is replaced by "person".[50] The word person has not been defined in the SEBI Act. But a comprehensive definition found in the Income Tax Act, 1961 highlights that a "person" may include not only an individual but also a Hindu undivided family, a company, a firm, an

See Statement of Objects and Reasons, Securities Laws (Amendment) Ordinance, 2013.
See The Constitution of India, 1950, Art. 123.
See Securities Laws (Amendment) Second Ordinance, 2013.
See id., cl. 3(ii).

association of persons or a body of individuals whether incorporated or not, a local authority, or any other artificial juridical person.[51] Even schemes or arrangement offered by persons can qualify as a CIS. Similarly, any company or even an LLP which offers such schemes can qualify as a CIS and be regulated by SEBI. Second, a new sub-section (2A) under cl. 3(iii) allows SEBI to prescribe additional conditions in accordance to the CIS Regulations for defining CIS. Third, a deeming proviso has been added which states that "pooling of funds under any scheme or arrangement" involving a corpus of Rs. 100 crores or more shall be deemed to be a CIS irrespective of whether it is registered with SEBI.[32]

Besides the above definitional changes, also it is noteworthy that concerted efforts were also made to embolden SEBI, particularly during the investigation process. The 2013 Ordinance empowers SEBI to call for information relevant for the purposes of the investigation.[53] This is similar to the power it has as a regulatory authority in cases of violations of other securities laws. When the accused entity refuses to furnish such information, SEBI can search and seize locations where such information may be hidden. Furthermore, it has clarified that the power to issue directions under § 11B would include the power to issue directions to the accused to disgorge any amount equivalent to the wrongful gains made as a result of the scheme.[54]

More recently, SEBI also amended the CIS Regulations in 2014.[55] It adds Reg. 4A and Chapter IXA as a supplement to the Ordinances discussed above. Regulation 4A requires an existing scheme or arrangement deemed to be a CIS to apply for registration under SEBI Regulations. Similarly, Chapter IXA provides for provisional registration for deemed CISs.

[51] See Income Tax Act, 1961, §2(31).

[52] Securities Laws (Amendment) Ordinance, 2013, Cl. 3.

[53] *See id.,* cl. 2.

[54] *See id.,* cl. 4.

[55] *See* Securities and Exchange Board of India, Collective Investment Schemes (Amendment) Regulations, 2014, *available at* *http://www.sebi.gov.in/cms/sebijdata/attachdocs/1389268161963.pdf*

While the changes brought as a result of a growing number of ponzi scams are welcome, they may not address all the challenges in the future entirely. First, it is not clear how SEBI will improve its system of regulation in terms of early detection of ponzi schemes. Another appalling fact is that unlike other financial schemes such as mutual funds[56] or alternate investment funds,[57] only one company has registered itself under SEBI Regulations as a CIMC till now. Further, the operation of a ponzi scheme may only come to the fore *ex-post* the investors have been cheated or defrauded, thereby defeating the preventing objective of the law. Second, questions with respect to the kind of punishment that must be meted out remain unanswered. Ponzi schemes result not only in the loss of investment but also in the erosion of the investor's confidence. When a person is found guilty of flouting the regulations formulated by SEBI, the decision of SEBI/SAT/Supreme Court only go as far as prohibiting further collection of money from investors and directing a refund. The question of deterrent punishment as a measure to check future scams has not been addressed.

In order to further the understanding of the nature of the challenges faced by SEBI, the authors would compare and contrast the regulation of mutual funds and NBFCs with that of CISs.

III. MUTUAL FUNDS IN INDIA

Any scheme under which contributions are made in the nature of a subscription to a mutual fund is excluded from the ambit of § 11AA.[58] Mutual funds are governed by SEBI but under a different set of regulations, namely, the SEBI (Mutual Funds) Regulations, 1996 ('Mutual Funds Regulations'). Although a mutual fund satisfies the four characteristics specified under § 11AA(2), it has been defined more

[56] There are 49 registered mutual funds as per SEBI records. *See* SEBI, *Name and Addresses of SEBI Registered Mutual Funds,* available at http://www.sebi.gov.in/investor/mfadd.pdf (Last visited June 15, 2015).

'7 Similarly, there are 103 alternative investment funds that have registered as per SEBI regulations. *See* SEBI, *Name and Addresses of SEBI Registered AIFs,* available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1381741901306.pdf. (Last visited June 15, 2015).

[58] *See* SEBI Act, 1992, §11AA(3).

specifically to mean a fund whereby resources are pooled by issuing units to the investors and the funds collected are invested in securities in accordance with the objectives purported under the scheme.[59] Under the Mutual Funds Regulations, an investment scheme will qualify as a mutual fund if such fund is established in the form of a trust to raise money from the public for the purpose of investing in the securities market.[60]

In India, under § 12(1) of the SEBI Act, a mutual fund is mandatorily required to be registered with SEBI before it can collect funds from the public.[61] For this, each applicant must satisfy the eligibility criteria set out in Reg. 7.[62] The registration process examines the

[59] SEBI FAQ on Mutual Funds, *available at,* http://www.sebi.gov.in/faq/mf_faq.html (Last visited June 15, 2015).

[60] Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Reg. 2(q).

[61] *See* SEBI Act, 1992, §12(1).

[62] Regulation 7 reads, "For the purpose of grant of a certificate of registration, the applicant has to fulfill the following, namely :—
(a) the sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions.
Explanation : For the purposes of this clause "sound track record" shall mean the sponsor should,—
(i) be carrying on business in financial services for a period of not less than five years; and
(ii) the networth is positive in all the immediately preceding five years; and
(iii) the networth in the immediately preceding year is more than the capital contribution of the sponsor in the asset management company; and
(iv) the sponsor has profits after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year;
[(aa) the applicant is a fit and proper person;]
(b) in the case of an existing mutual fund, such fund is in the form of a trust and the trust deed has been approved by the Board;
(c) the sponsor has contributed or contributes at least 40% to the net worth of the asset management company:
Provided that any person who holds 40% or more of the net worth of an asset management company shall be deemed to be a sponsor and will be required to fulfil the eligibility criteria specified in these regulations;
(d) the sponsor or any of its directors or the principal officer to be employed by the mutual fund should not have been guilty of fraud or has not been convicted of an offence involving moral turpitude or has not been found guilty of any economic offence;
(e) appointment of trustees to act as trustees for the mutual fund in accordance with the provisions of the regulations;

applicant's track record and general reputation in dealing with business transactions.[63] For this, the Board must be satisfied that the applicant's net worth is higher than the capital contribution made by the applicant to secure the scope of profit generation in the new venture.[64] In case of existing mutual funds, it also enquires into any charges of fraud or other economic offences pressed against the applicant.[65] It also ensures that the existing mutual fund has observed its statutory guidelines in the appointment of its trustees, custodians and the asset management companies.[66]

To further consolidate its goal of structuring investment regimes, the Regulations also dictate a set of obligations to be performed by the trustees, custodians and the asset management companies. For instance, in Reg. 18(12), the trust is held accountable for the usage of the funds of the unit holders - and further obligates them to observe a high standard of diligence in the performance of their functions.[67] Similarly, it binds the asset management company to undertake investment decisions[68] and to comply with the regulations[69] with due diligence. Chapter V essentially tries to nip any dubious schemes in the bud by incorporating transparency.[70] While Chapter VII spells out a comprehensive list of general obligations on behalf of the fund raisers, Chapter VIII outlines the rights of inspection and audit that are enjoyed by the SEBI. It is here noted

(f) appointment of asset management company to manage the mutual fund and operate the scheme of such funds in accordance with the provisions of these regulations; ll[(g) appointment of custodian in order to keep custody of the securities or gold and gold related instrument or other assets of the mutual fund held in terms of these regulations, and provide such other custodial services as may be authorised by the trustees.]"

[63] See ji, Reg. 7(a).

[64] See jd., Reg. 7(a)(iii), (iv).

[65] See *id.,* Reg. 7(d).

" *See id.,* Reg. 7(e), (f), (g).

[67] See *supra* note 60, Reg. 25A, B.

[68] See *id.,* Reg. 25(2).

[69] See *id.,* Reg. 25(1).

[70] This is sought through Reg. 29 and Reg. 30 which seek a complete disclosure of the investment objective in the offer document. Further, Reg. 31 also aims at prohibiting the publishing of any deceptive material or false opinion that purport to affect the investor decision.

that non-observance of these guidelines by the entities may eventually result in the suspension or cancellation of their registration, including even termination of their operations[71] or a complete transfer of the scheme to SEBI[72] or any designated authority.[73]

The punitive measures that can be taken in cases of violation of the CIS Regulations or Mutual Fund Regulations are similar. This is not entirely surprising considering that the ultimate aim of SEBI essentially is to ensure that any unfair practice in the investment markets is penalized and eventually curbed. With this intent, the SEBI Act and the CIS Regulations have vested the adjudicating courts and tribunals with certain disciplinary powers. The specification of obligations of each participating member is followed by punitive measures, listed under Reg. 68 and the SEBI (Intermediaries) Regulations, 2008. As elucidated above, Chapter V provides for the procedure in case of default.

IV. DEPOSITS ACCEPTED BY NON-BANKING FINANCIAL COMPANIES

Exceptions under § 11AA also include any scheme under which deposits are accepted by NBFCs.[74] Unlike the regulation of mutual funds discussed above, such deposits are regulated by the RBI and not SEBI. NBFCs are not banks, yet subject to the fulfilment of certain conditions, can accept public deposits.

§ 451 (f) of the RBI Act defines NBFCs and further provides qualifications for the institutions which can accept public deposits.[75] NBFCs may be financial institutions which are companies under the Companies Act. A financial institution is one which carries on as its business any of the activities specified under § 451 (c)[76] but does not include institutions engaged in agricultural operations, industrial activities, purchase or sale of any goods other than securities, or the purchase, construction or sale of immovable property. NBFCs may also

See id., Reg. 73(2).
See id., Keg. 73(3).
See *id.,* Reg. 73(4).
See SEBI Act, 1992, §HAA(3)(ii).
See Reserve Bank of India Act, 1934, § 45IA.
See id., § 451(c).

be non-banking institutions which are companies under the Companies Act, 2013 and have the principal business of lending or receiving deposits.[77]

In order to commence and sustain its operations, an NBFC must mandatorily obtain a certificate of registration from the RBI in addition to having a net owned fund of twenty-five lakh rupees.[78] The application must be made to the RBI within six months of commencement of business and such business can continue until the certificate is issued or the application is rejected. If the application is rejected, the RBI Act provides for a redressal mechanism. However, if the RBI does not issue the Certificate of Registration, an NBFC cannot continue its business.[79]

While the RBI processes applications for NBFCs, it is required to satisfy conditions which ensure that the depositors' interests are safeguarded.[80] It must be satisfied that the affairs of the NBFC are not being or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors.[81] Similarly, the RBI also considers the general character of the management or the proposed management of the non-banking financial company to ensure that it shall not be prejudicial to public interest or to the interest of its depositors.[82] Additionally, the NBFC must have adequate capital structure and earning prospects.[83] The RBI may also consider any other condition necessary to ensure that the commencement of or carrying on of the business in India by a non-banking financial company shall not be prejudicial to public interest or to the interest of the depositors.[84] Once the application has been accepted, the NBFC may carry on its business and accept public deposits.[85] The effectiveness of these provisions is evidenced from the fact

[77] *See id.,* § 451(f)(iii). This may *also include companies otherwise* notified by the Central Government.

/s *See supra note 69, §45IA(1).* [79]

RBI Act, 1934, §45IA (2).

[80]See^.,§451A(4).

[81]See^.,§451A(4)(a).

[82]Seei^§451A(4)(b).

[83]/i

- Unlike banks, NBFCs cannot accept demand deposits or issue cheques drawn on itself.

that the RBI website has a list of 254 registered NBFCs permitted to accept public deposits as on May 31, 2013.[86]

What is of greater significance is the degree of powers enjoyed by the RBI for the effective regulation of deposits accepted by NBFCs. The focal point of the RBI's powers is the protection of interests of the investors. Not counting the statutory requirements pressed on NBFCs[87], the RBI can issue directions with wide-ranging effects to regulate the activities of NBFCs. The RBI has the discretion to make policy changes and issue directions where it finds it necessary to preserve the interests of the depositors or the public at large. In public interest, the RBI can regulate or prohibit the issue of any prospectus or advertisement soliciting deposits of money.[88] It can further specify conditions subject to which any such advertisement may be issued.[89] In this way, directly or indirectly, the sanctity of information made available to investors by NBFCs to invite deposits is monitored and maintained. Similarly, the RBI can determine the policy and issue parallel directions related to capital adequacy, accounting standards etc.to all or any of the NBFCs.[90] Moreover, the RBI can collect information about the deposits received by NBFCs. On examination of this information, if it is found to be necessary, the RBI can issue directions with respect to the receipt of deposits, the payable rates of interest etc.[91] These provisions reiterate that protection of public interest is the paramount consideration. Besides these powers, a corresponding legal duty is imposed on NBFCs to furnish any and every information that is called for by the RBI.[92] This information is also required to be provided within the decided time period. The contravention or non-compliance with any provision found in Chapter

[86] RBI, List of Non-Banking Financial Companies (NBFCs) holding Certificate of Registration (CoR) to accept Public Deposits, September 30, 2014, *available at* http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/59260.pdf (Last visited June 15, 2015).
[87] *See* RBI Act, 1934, §§45IB and 45IC.
[88] *See id,* §45J.
[89] *See id.*
[90] *See id.,* §45JA
[91] RBI Act, 1934, § 45IA (2).
[92] *See id.,* §45M.

IIIB[93] of the RBI Act or any direction issued by the RBI would result in a ban from accepting any deposit.[94] Furthermore, if any NBFC violates any of the provisions of this Chapter, the RBI is empowered to prohibit it from accepting any deposits. Furthermore, §§ 45MB and 45MC enable the RBI to control the alienation of the company's property.

The study of the relevant mechanisms conducted above reveals some findings significant for the purpose of this paper. For convenience, we propose to divide the findings under two forthcoming sections. The first deals with the punishment meted out to those who violate provisions of the abovementioned regulations. We find that there is a disparity in terms of the punitive ability of SEBI *vis-a-vis* that of the RBI, in addition to a general lack of legislative interest to increase the standards of punishments. The second section deals with regulation under SEBI itself. In considering CISs and mutual funds, we attempt to explore reasons for the difference in terms of operation of the two regulations.

V. INSUFFICIENT PUNISHMENT = INEFFECTIVE REGULATION?

Sections I-III of this paper lay out the relevant provisions regarding the regulations of CISs, mutual funds, and deposits accepted by NBFCs. We find in comparison to SEBI, the RBI has a tighter grip on not only the regulation of deposits accepted by NBFCs but also the operation of these institutions altogether. Generally, a reading of Chapter IIIB of the RBI Act would underline the heavy impetus on public interest and the protection of depositors' interest. The RBI's mandate of protection of depositors' interest is reiterated in nearly every provision.[95] More specifically, the evaluation conducted by RBI is more rigorous, since it even investigates the capability of the NBFCs to repay their depositors among others.[96]

This is however not the case for the SEBI regulations. To register under one of the two remaining regulations discussed above, the

[93] RBI Act, 1934, Chapter IIIB.

[94] See^.,§45K(4).

[95] The consideration of public interest weighs in heavily particularly if RBI is to issue directions with respect to deposit-taking, or rate of interest offered.

[96] *See,* RBI Act, 1934, §45IA(4).

evaluation conducted by SEBI takes into account fewer factors, such as net worth. Unlike the RBI, SEBI does not have the ability to issue directions to registered entities for supervising their operations as its powers are restricted to the regulation of defaulting CISs/mutual funds.

Since it is possible for the RBI to issue directions and monitor the operation of NBFCs eligible to accept public deposits, it is contended that if a similar mechanism is created for SEBI to not only regulate but supervise the functioning of CISs, the regulatory framework would be more effective in preventing ponzi schemes. This is rightly evidenced by the fact that although provisions regarding NBFCs are more tedious in nature, there are 254 registered NBFCs which can accept public deposits. In contradistinction, since 1999, only one company has registered itself as a CMC.[97]

Another noteworthy finding in this context is that there is little discussion on enhancing the punitive measures applicable to those found guilty of flouting regulations. Despite being granted with such powers, in various judicial orders issued by the SEBI, there seems to be an odd imbalance between the gravity of the schemes in question and the final order pronounced to remedy the situation. For instance in the *MPS Greenery Developers Ltd.* case,[98] the investment entity was found to be in violation of the provisions of the CIS Regulations when it applied for a certificate of registration.. Subsequently, the issuance of the registration certificate was denied and a further embargo on its activities was imposed by SEBI. Hereafter, a writ petition was filed by MPS Greenery and a provisional registration was granted in their favour. However, the embargo on its operation was confirmed. Nonetheless, MPS Greenery disregarded the embargo and proceeded with operations to raise a further sum of Rs. 439 crores. In its decision, SEBI noted the "disastrous consequences" and the "imminent threats" posed by the operation of the scheme on the financial security of the investors. Yet, it was satisfied by

[97] *See* SEBI, *List of SEBI Registered Collective Investment Schemes,* http://www.sebi.gov.in/sebiweb/home/detail/23271/new/Registered-Collective-Investment-Management-Company (Last visited June 15, 2015).

[98] In the Matter of MPS Greenery Developers Limited, WTM/PS/37/CIS/ERG7 MAY/2012.

ordering a mere refund the collected sum and a ban on its operations till such refund was complete.

This imbalance is present in other cases as well. In the case against *M/s Rose Valley Real Estates Constructions Ltd.,"* the company raised an incredible sum of Rs. 1006 crores by offering a time-share based scheme. The company outrightly refused to cooperate with the process and further sought to conceal the true nature of its operations, in wanton disregard of the investigation carried out by SEBI. Here again, SEBI contended itself by ordering the refund of the sum and termination of operations. This is true even for the Saradha scam, where despite the fact that the Saradha Group raised a sum of 4000 crore from 1.4 million investors, and made a conscious effort to subvert the due course of the law by employing dilatory tactics like sending cartons of irrelevant information, the SEBI order that followed merely ordered the refund of the sum and a prohibition from operation till such refund.

This imbalance is odd because SEBI and the courts have not hesitated to use strong language to describe the harm caused to investors.[100] Each decision recites a zeal for the protection of investors. Given this overarching objective, an order of refund of the sum raised and an embargo on further operation does not seem to be severe enough - particularly when fraudulent entities do not cooperate in the investigation process and even create obstacles in the same.

Thus, there seems to be substantial evidence of the lack of enthusiasm/reluctance of the concerned legislating and adjudicating authorities towards the punitive sanctions and in a larger sense, the implementation of the regulations. The lack of enthusiasm results in the absence of deterrence; this may be perceivable in an understanding of how, time and again, such schemes are not only started illegally but also re-launched. Thus, the need of the hour is introduction of the principle of deterrence in ordering punishments as opposed to merely taking

[99] Rose Valley Hotels and Entertainment Ltd., WTM/SR/ERO - CIS/11 /07/2013.

[100] In the Matter of MPS Greenery Developers Limited, WTM/PS/37/CIS/ ERO/MAY/2012; Rose Valley Hotels and Entertainment Ltd., WTM/SR/ERO - CIS/11 /07/2013; In the Matter of Saradha Realty India Ltd., WTM/RKA/ERO-CIS/19/2013 (April 23, 2013).

corrective measures. Imposition of penalties in proportion to the gravity of the scam would go a long way in mitigating the menace of ponzi schemes.

VI. FINANCIAL LITERACY: THE WAY AHEAD

A second set of findings from the study of SEBI's regulation of CISs and mutual funds shows that, although the two mechanisms for CISs and mutual funds under SEBI are not entirely different, there remain certain significant differences in terms of their operation. This becomes particularly evident if we consider the registration process. The process being largely the same for both CISs and mutual funds, as on date, only one CIMC is registered under the CIS Regulations whereas nearly fifty asset management companies are registered under the Mutual Funds Regulations.[101] What is also important is that while there are fewer instances of fraudulent mutual fund related scams, the operation of such sham CISs affecting incredible number of affected investors is not uncommon.

This begs the question: what is the significance of this observation? These discrepancies in the effectiveness of the two kinds of regulations may be explained by the fact that there are two distinct markets for CISs and mutual funds. For reasons such as lesser degree of financial literacy, unavailability of proper documentation,[102] the demand and supply for mutual fund schemes are generally restricted to Tier I cities. On the other hand, fraudulent CISs are generally floated in semi-urban and rural areas.[103] The operation of these schemes hinges on the general lack of financial awareness and the influence wielded by agents. It becomes easier

[101] *See* SEBI, *List of SEBI Registered Collective Investment Schemes,* http://www.sebi.gov.in/sebiweb/home/detail/23271/new/Registered-Collective-Investment-Management-Company (Last visited July 21, 2015).

[102] See, KPMG, *Funds and Funds Management 2010,* https://www.kpmg.com/Global/en/IssuesAndlnsights/ArticlesPublications/Lists/Expired/Fund-man age/India_Funds_Mtg_regulation_2010.pdf, (Last visited July 15, 2015).

[103] The facts of the cases quoted in the previous section are used to conclude that CISs generally operate in semi-urban/rural areas.

in such a setting to offer extraordinary rates of return in exchange for investment.

There is a greater lesson in this discrepancy: greater financial literacy and awareness, particularly in rural parts of India, may be necessary to effectively eradicate errant schemes *ex-ante.*The authors propose that a substantial elimination of ponzi schemes from the financial market would take place if financial literacy is promoted by SEBI, as financial awareness would increase investments in the mutual fund industry even in remote villages and towns. Nonetheless, we do understand the gravity of the challenge that the SEBI faces in building up investor awareness in a developing country like India, where illiteracy still is a handicap for 41.3 per cent of the rural population.[104] In this regard, this section briefly theoretically captures some viable and feasible measures which would address the problem of financial illiteracy at its grass root level.

At the outset, a more concrete effort must be made by SEBI to create specific programmes to achieve greater levels of financial literacy. Collaborating with other regulators such as RBI or IRDA, SEBI could create a network of umbrella reforms. As opposed to creating an entirely new framework of agencies, SEBI could employ local and regional financial institutions such as existing regional rural banks and cooperative societies to conduct capacity-building programmes. This would necessarily go a long way in augmenting and updating their knowledge of various schemes available in the market. Though this requires a great deal of co-operation from the banking system of the country, a collaboration of this nature would eliminate the role of intermediaries that entities like the Saradha Group played in Eastern India. In order to implement this suggestion, SEBI can invoke commitment from huge investment companies as part of Corporate Social Responsibility to run such training workshops for its rural investors.[105] Moreover, provision of free advice

[104] *See* Census Report of 2011, *available at* http://censusindia.gov.in/Census_Data_2QQl/India_at_glance/literatesl.aspx (Last visited June 25, 2015).

[105] *See* UNITED NATIONS DEVELOPMENT PROGRAMME, FINANCIAL LITERACY AS A TOOL FOR FINANCIAL INCLUSION AND CLIENT PROTECTION, at x, (November 2012),

over the efficacy of designed schemes by independent institutions would also play a key role. Such programmes would not only create a fiduciary relationship between the potential investors and the company, it would also promote informed decision making.

Thus, we posit that if a majority of such measures are taken, the need for regulation of issuers would be largely substituted by a self-controlled mechanism. Though all the pitfalls in the market structure may not be revamped in the immediate future, however, these measures would certainly instate discipline and prevent occurrence of financial scandals in the economy.

VII. CONCLUSION

As the news of the extent of the Saradha scam was made public, the question that arose was why such schemes re-emerge despite the regulations already in place. In this paper, in order to understand why such schemes still thrive in India, the authors undertook a comprehensive study of the regulations governing CISs, mutual funds and NBFCs. The examination of the regulations drafted by the SEBI for regulating CISs and mutual funds, with a thorough perusal of the arrangement developed the RBI for controlling the functioning of the NBFCs highlight major challenges.

First, more often than not, the problem of ponzi schemes is detected ex post. SEBI must be able to detect and investigate the operation of any such fraudulent scheme as early as possible. A long term solution offered by the authors is to ensure this is creating greater financial awareness and literacy among investors in rural and semi-urban areas. This will allow investors to make sound financial decisions.

Second, the authors contend that SEBI must be empowered to a greater extent to effectively regulate and supervise the operation of CISs. Several instances were cited, such as the matters of Saradha Realty, MPS Greenery, and Rose Valley, where the Tribunal recognized the significance of protecting investors but failed to really "punish" the

available at http://www.in.undp.org/content/dam/india/docs/poverty/financial-liter acy-as-a-tool-for-financial-inclusion-and-client.pdf.

accused. In each of these cases, the Tribunal directed the accused company to refund the money to investors and wind up the operation of the scheme, without imposing any deterrent amount as fine. The authors thus assert that offences as serious as these merit graver punishments and imposing huge fines would go a long way in preventing such scams.

Realizing that ultimate purpose of provisions of the SEBI Act, and the SEBI Regulations is to "protect the welfare of innocent investors", the need of the hour is to embolden SEBI to ensure that there is an efficacious prevention of ponzi schemes. This should have ideally been seen as a preventive measure, rather than a response to a scam.

THE COMPANIES AMENDMENT ACT, 2015: REMOVAL OF THE MINIMUM PAID-UP SHARE CAPITAL REQUIREMENT

AYUSHI SINGHAL*

The notification of several portions of the new Indian Companies Act, 2013 ('2013 Act') is yet to take place. However the act is already due for amendment by way of the Companies (Amendment) Act, 2015 ('2015 (A) Act'), inter alia to facilitate the 'ease of doing business'. This amendment has received the assent of the President on 25th May, 2015 and may be notified in near future. This essay will analyze the effectiveness of removal of the requirement of the minimum paid-up share capital ('MPS').For the purposes of the present analysis, the essay will primarily be restricted to the 2013 Act and the 2015 (A) Act.

CONTENTS

/. Introduction
II. MPS Rules - How efficient are these?
III. The position in other countries
IV. Mechanism already existing in India for creditor protection
V. Conclusion

I. INTRODUCTION

Some seven men form an Association
(If possible, all Peers and Baronets)
They start off with a public declaration
To what extent they mean to pay their debts.
That's called their capital: if they are wary
They will not quote it at a sum immense
The figure's immaterial - it may vary
From eighteen million down to eighteen pence.
I should put it rather low;
The good sense of doing so

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Will be evident to any debtor.
When it's left to you to say
What amount you mean to pay,
Why the lower you can put it at, the better[1]

The provisions concerning MPS mandate that the company cannot commence business before the statutorily prescribed MPS has been subscribed for. Under the existing provisions of the Companies Act, 2013, the MPS for private limited companies is Rs. 1 lakhs,[2] whereas for the public limited companies it has been fixed at Rs. 5 lakhs.[3] Since the public companies have a larger number of subscribers, the legal capital for these is higher than that for the private.[4] This is termed as the price to be paid to get the benefit of limited liability.[5] In the backdrop of limited liability, two reasons have been identified traditionally for the inclusion of these rules-balancing the interests of creditors vis-a-vis the shareholders and balancing the concerns of the shareholders vis-a-vis the directors (The latter however being only a subsidiary concern).[6] It is only the first rationale which is deconstructed in this essay. It is argued that the removal of the requirement of a MPS is a step in the right direction since the MPS does not protect the creditors in any substantial manner. It is also shown that there exist more effective alternatives to the MPS requirements.

A company is believed to be a form of business wherein the risk shifts from the shareholders to the creditors, since a creditor is involving herself/himself in more risk while lending to a company, than when he

[1] GILBERT AND SULLIVAN, UTOPIA LTD OR THE FLOWERS OF PROGRESS (1983); John Armour, *Legal Capital: An Outdated Concept* (University of Cambridge, Working Paper No. 320, 2006) available at http://citeseerx.ist.psu.edu/viewdoc/download?doi = 10.1.1. 167.5378&rep = repl&type=pdf (Last visited August 5, 2015).
[2] The Companies Act, 2013, §2(68).
'*Id.,* §2(71).
[4] JANET DINE, MARIOSKOUTSIAS AND MICHAEL BLECHER, COMPANY LAW IN THE NEW EUROPE, 227-229 (2007) [hereinafter Dine et al., *Company Law].*
[5] *See* Preetha S., *The Fraudulent Trading Offence: Need For A Relook,* 4(2) NUJS L. Rev. 231,234 (2011); c.f.: Limited Liability Partnership Act, 2008: LLPs which are also limited liability concerns do not require an MPS.
[6] IL & FS Engineering and Construction Company Limited v. Wardha Power Company Limited, (2012) Indlaw AP 724 (It protects the shareholders from the actions of directors whereby they may decrease the value of the investments made by the shareholders).

is lending to a partnership or a sole proprietorship/As argued by David Kershaw, the risk taken by the creditors is multiplied, since the risk-taking profile of the company is accordingly altered; the company takes more risk because there is limited liability of members. [8]This leads to a continuous tussle between the interests of the creditors and the shareholders.[9] These include instances like "dividend payments, claim dilution, asset substitution, and underinvestment".[10] Take for illustration the case of asset diversion where the shareholders can transfer assets to themselves by buying back shares, paying dividends/inflated salaries etc. They can also employ claim dilution by issuing additional debt on the same assets, weakening the claims of the prior creditors on the company's assets. More importantly, the shareholders may choose a riskier investment than that envisaged by the creditors.[11] This has been explained by way of an illustration by Professors Enriques and Macey.[12] They ask the readers to assume that a firm owes a bank some money (say, 800 rupees) and has 200 shares of outstanding stock. There are two options of investment with this firm, 1) investing in investment A, which has 100% chances of returning 1000 rupees, 2) investing in investment B, which has 50% chances of returning 500 rupees and 50% chances of returning 1500 rupees. In both cases, the expected return is 1000 rupees, since in

Investment A: 100%>!'1000= 1000

Investment B: 50%*500 + 50%*1500= 1000

In the first investment, the bank will surely receive its dues amounting to 800 rupees and the shareholders will receive 200 rupees, while in the second case, the bank has a 50% chance of receiving 500

'Company Law Review Steering Group, *Modern Law for a Competitive Economy: The Strategic Framework* 81 (February 1999), URN 99/654; *See,* L. GULLIFER AND J. PAYNE, CORPORATE FINANCE LAW: PRINCIPLES AND POLICY 115-153 (Oxford: Hart Publishing, 2011).

[8]DAVID KERSHAW, COMPANY LAW IN CONTEXT 773 (2012).

[9] Luca Enriques and Jonathan R. Macey, *Creditors Versus Capital Formation: The Case against the European Legal Capital Rules,* 86 Cornell L. Rev. 1165, 1168-1170 (2001).

[ia]*Id.*

[n]Hansmann&Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts,* 100 YALE L.J. 879, 1879 (1991).

[12] *Supra* note 9.

rupees and 50% chance of receiving 800 rupees. In this case, the expected value for the bank is 650 rupees. While calculating in a similar manner, the total value for the shareholders is 350 rupees. Therefore the bank will want the company to invest in investment A, while the shareholders will want the investment B. It is argued that share capital in this case provides a cushion to the creditors in case the shareholders make decisions solely in their favor.

However, this analysis of the MPS rules gives only a partial picture of their viability.

II. MPS RULES- HOW EFFICIENT ARE THESE?

It is a sweeping generalization to assume that only shareholder interests can prove detrimental to the creditors and creditors are helpless in this regard. This is particularly true for the voluntary creditors who grant credit to the company on the basis of a contractual arrangement.

Creditors can also benefit at the expense of the shareholders, specifically those which exercise a control over the firm by virtue of giving large amounts of loans to the firm. They can force the companies to divert assets by asking them for prepayment of loans or reduction of dividends. They can also coerce companies into issuing additional equity thereby diluting the powers of individual shareholders. Depending upon the contract of credit, they can also ask the company to pursue the investment A in place of B in the above example.

Further, realistically, each of these risks, whether for the creditor or for the shareholders, is reduced considerably, since the parties seldom engage in only one transaction. In such a situation, it is unlikely that one will act in an unfavorable manner to the other, unless it is known that the particular transaction is the last transaction for both the parties with each other. Additionally, even in case it is the last transaction between the two parties, assuming that it is a market where information flows freely, other creditors are likely to be influenced to not lend money to the company who has siphoned creditors' money at earlier occasions. This will help maintain the balance between the interests of both the creditors and the shareholders. Even if a worst case scenario of insolvency of the company

is assumed, the management which governs the company will be cautious of its reputation in the market and will refrain from taking steps detrimental to the creditors, even when their financial assets are safe from any harm.

Therefore, the very requirement of the MPS is questionable.

Further, the protection offered by the MPS, is at best doubtful. First, the MPS required is believed to be extremely less to provide any meaningful protection to the creditors.[13] This is also true since it does not change with the change in the amount of debt accrued by the company or the kind of business being carried out by it. The protection offered by the MPS actually depends on the size of the firm.[14]

Second, the doctrine is based on the assumption that the creditors take into consideration the minimum legal capital rules while making decisions on lending.[15] However this is not true. MPS is effective only at the commencement of business of the company.[16] The creditors pay little significance to the MPS, since they are acquainted with the fact that the company can buy resources with this capital which decrease in value during the course of the business and that the company might also run into losses.[17] These MPS requirements, without coupling them with any corresponding regulation of the opposite side of the balance sheet, do not protect the creditors effectively. Hence, the creditors generally analyze the whole balance sheet. This was also the rational of UK's Jenkins Committee, when it refused to mandate a minimum capital provision as it was extremely easy to evade.[18] Therefore, the legal capital rules provide

[13] John Armour, *Legal Capital: An Outdated Concept* (University of Cambridge, Working Paper No. 320, 2006) available at http://www.cbr.cam.ac.uk/fileadmin/ user_upload/centre-for-business-research/downloads/working-papers/wp320.pdf (Last visited March 13,2016).
[14] DAVID KERSHAW, COMPANY LAW IN CONTEXT 814 (2012).
[15] FERRAN, PRINCIPLES OF CORPORATE FINANCE LAW 94 (2008).
[16] *See* Dine et al., *Company Law, supra* note 4 at 227
[17] LEN SEALY AND SARAH WORTHINGTON, SEALY'S CASES AND MATERIALS IN COMPANY LAW 463 (2010J; E. FERRAN, PRINCIPLES OF CORPORATE FINANCE LAW94 (Oxford: Oxford University Press, 2008); See also, Guinness v. Land Corporation of Ireland, (1882) 22 Ch D 349.
^*Report of the Company Law Committee,* Cmnd. 1749 (1962), |27; V. EDWARDS, EC

little assistance to the decision of creditors. In any case, the creditors can always take this factor into consideration while granting credit, without the legislature making it mandatory. The market forces should also mandate the inclusion of this capital in case the companies value it.[19]

An analogy might be drawn to the minimum reserve ratios required in banks. However, the reserves required in banks are proportionate and thus are effective, unlike in the case of a company, where there is a fixed amount irrespective of the debt. It is in fact difficult to determine a viable fixed amount in this regard.[20] At the same time, a proportionate system akin to banks might also discourage investment.

On the other hand, MPS acts as an obstacle for entering into the regime of companies and exploiting the various benefits offered by the company form of business. It also delays the formation of the business. This is one of the reasons why many countries have made it optional, providing flexibility to businessman and giving them the freedom of choice.[21]In fact in South-East Asia, India is the only other country apart from Maldives, which continues to have the requirement of a MPS.[22]

Conversely, removal of this requirement helps in many ways. It promotes the formation of companies as a result of a decrease in the cost of registration of companies. Companies are constituted for sectors which do not require the capital prescribed as the minimum capital for its business, contributing to the 'Make in India'concept.[23]

The removal of MPS by the 2015 (A) Act is particularly effective

COMPANY LAW 60-61 (1999).

[19] EILIS FERRAN, CREDITORS' INTERESTS AND "CORE" COMPANY LAW 314-323 (1999).

[20] Eilis Ferran, *The Place for Creditor Protection on the Agenda Modernisation of Company Law in the European Union,* 3 ECFR 178,188(2006).

[n] *Id.*

[I] *See* Massimo Miola, *Legal Capital and Limited Liability Companies: the European Perspective, 2* ECFR 413 2005[hereinafter *Mioh,LegalCapital]* (It can also be questioned whether creditor protection should actually be a function of company law or that of insolvency law).

-[3] 'Make in India' is a program launched by Prime Minister Narendra Modi in order to promote Foreign Direct Investment in India. It aims at making India a manufacturing hub.

when read in conjunction with the introduction of the One Person Companies (OPCs) by the 2013 Act. An OPC, as the name suggests, allows a single person to constitute a company and has reduced compliance requirements.[24] This will give a boost to small-scale businesses and entrepreneurship.[25] It will also be a key confidence booster for small entrepreneurs.

This does not, in any manner, lessen the protection provided to the creditors by the company's law.

There are two kinds of creditors, voluntary and involuntary. As discussed earlier, voluntary creditors can protect themselves in a multitude of ways even without the equity cushion. These creditors can adjust their rights and liabilities via contract. They can make up for a higher risk investment by charging a higher interest rate. On the other hand, a lower interest rate may be accompanied with a contract fixing the risk the company can take. The smaller creditors can free-ride on the protective covenants in the contracts entered into by the larger creditors.[26] The creditors can also ask for collaterals, lower dividend distributions, adherence to a financial ratio, for instance a debt-equity ratio, etc.

As suggested by Professor Armour, the involuntary creditors can also be protected in ways more efficient than the MPS rule.[27]The tort victims are the most obvious example of the involuntary creditors. Tortious liability will depend on the risks of hazardous activities being conducted by the business concerned. Not only is a blanket MPS for all the companies burdensome for the companies not involved in hazardous activities, but it is a very unreliable way of accounting for the

[24] For e.g., as per §96 of the Companies Act, 2013, an OPC is not required to hold an Annual General Meeting.

[25] The introduction of the OPC was recommended by the JJ Irani Expert Committee in the year 2005, so that the entrepreneurs are not dissuaded from formation of companies and reduce the requirement of time, energy and resources on the compliance with legal requirements.

[26] John Armour, *Legal Capital: An Outdated Concept* (University of Cambridge, Working Paper No. 320, 2006) available at http://citeseerx.ist.psu.edu/viewdoc/ download?doi = 10.1.1.167.53788crep = repl&type=pdf (Last visited August 5, 2015.

[27] John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law,* The Modern L.REV., 63, 3 pp. 355-378, 372, (May, 2000).

compensation the company might be liable for. Further there are more effective ways of achieving the goal of protection of these victims, for instance, mandating environment impact assessment of hazardous business concerns, requiring insurance of such activities, etc. The insurance premium would not only be pro-rata and therefore decrease the unreliability of a fixed minimum capital, but will also be more helpful since the insurance companies will keep a check and balance on the company's activities. The state in its capacity of a tax collector is also a non-adjusting creditor, but again there remain ways of protecting the state. A company has to pay tax only when profitable activities which require the company to pay tax are transacted. When the business is established for once, the creditors keep a check on the transactions so as to make sure that they are paid and government can take advantage of this scrutiny. Further, corporate veil piercing is also allowed in case the company is formed for the sole purpose of tax evasion.[28]It is only when the company is on the verge of shutting down that there may arise a situation where the tax remains unpaid, since the creditors might be paid from the unpaid tax amounts. This can be prevented by effective enforcement of mechanisms requiring for payment of tax in time before this money is used to pay the creditors off. Further, as in the previous case, the MPS certainly does not go very far in helping to solve this issue. Another category of involuntary creditors can be the trade creditors. These creditors however provide credit only on the basis of credit worthiness of a company and therefore can adjust their position to some extent and the MPS does little to affect their decision of adjusting since the creditors are aware of the fact that irrespective of the MPS, the companies can buy assets later, which decrease the value of equity or might run into losses as explained previously.

Thus, MPS is neither a necessity nor a want for the protection of creditors. A removal of the MPS rules does not leave the creditors unprotected as there are other ways in which similar creditor protection can be achieved. Conversely, the removal of the MPS requirements leads to a boost to the formation of companies, particularly in small-scale sectors.

Re. Sir Dinshaw Manakjee Petit, A.I.R. 1927 Bom 371.

III. THE POSITION IN OTHER COUNTRIES

This section will discuss the requirement of MPS in the countries forming part of the European Union, since it has recently constituted a commission to debate upon the feasibility of MPS requirements. Certain other countries where the debate for MPS has been raised and which provide lessons which can be learnt with regard to the rules have also been discussed.

The level of protection provided to the creditors and hence the method of setting an MPS/its existence varies from jurisdiction to jurisdiction. For instance, US laws provide a greater degree of flexibility with regards to legal capital requirements. It emphasizes on debtor/investor protection over creditor protection, unlike the rules in EU member states, where the minimum legal capital rules exist to protect creditors from opportunistic behavior of the equity holders.[29] "Law not contracts protects creditors in Europe.[30]" However even European countries are planning to do away with it[31] after the ECJ's decision in Centros[32] and European Commission's decision to reform the second directive;[33] thereby accepting the merits of a regime without a MPS requirement.

UK traditionally never required MPS, until the introduction of the European Union's Second Company Law Directive.[34] After this, there should be an MPS of at least €25,000 for the public companies in EU. As per §§761-763 of the UK Companies Act 2006, there should be an

[29] *See* Miola, *Legal Capital ,supra* note 19, at 420.
[30] Luca Enriques and Jonathan R. Macey, *supra* note 12, at 1165.
[31] *See* Armour, *supra* note 21.
[32] See for a discussion of the case, June Rhee, *Freedom of Establishment for Companies,A?R.* 17, 2015, available at http://corpgov.law.harvard.edu/2015/04/17/freedom-of-establishment-for-companies/#more-70698 (Last visited August 8, 2015); ci., G. J. VOSSESTEIN, MODERNIZATION OF EUROPEAN COMPANY LAW AND CORPORATE GOVERNANCE: SOME CONSIDERATIONS ON ITS LEGAL LIMITS 208 (2010).
[33] This was initiated as part of the 'SLIM' (Simpler Legislation for the Single Market) initiative and has been subsequently made a part of the Commission's High-Level Expert Group on Company Law. EU has also commissioned a feasibility study to debate over the status of legal capital.
[34] Second Council Directive 71/91/EEC, Art.6.

aggregate nominal value of allotted shares of at least £50,000 and each share should be paid up at least up to one quarter of its nominal value plus any premium payable on it. However there is no MPS for private companies or OPCs in the UK.

Germany is planning to introduce a new form of company without a legal capital, called the *"Unternehmensgriindergesellschaft"i5'm* order to facilitate start-ups, at the same time avoiding changes in the law for other companies, ultimately leaving it up to the companies to have a legal capital or not. The existing legal capital requirement is €25,000 [called as Stammkapital].[36]Both cash and kind contributions are allowed and the total amount of these contributions before registration should be at least €12,500.[37] Further, the contributions in kind should be fully performed[38] and l/4th of the nominal value of each share should be paid in cash before the registration application is made.[39] In case of a one person company (GmbH with one member), an additional security has to be paid for the amount unpaid on the shares.[40] For a public limited company, the minimum capital is €50,000.[41]It is required that at least 35% of the lowest issue price must be paid on shares subscribed for, by cash along with any premium.[42]

In France, a requirement of €7,500 as MPS existed till 2003 for the. *societe a responsabilitelimitee* (private companies) also, but there is no such requirement now.[43] The new provision is an exception to the general rule that for companies with limited liability there must exist a minimum amount of capital. For public companies, the MPS is €37,000 if it is a non-

[K] Miola, *Legal Capital, supra* note 19 at 429.

' Gesetzbetreffend die GesellschaftenmitbeschrankterHaftung, GmbHG (German Private Limited Liability Companies Act) APR.20, 1892 (Federal Law Gazette III 4123-1, §5(1).

[17] *Id.*

"Id., §7(3).

"Id., §7(2).

*>*Id.*

"Id., §7.

«*Id.*

[<J] CODE, DE COMMERCE[C.COM] art.223-3 (Fr.), amended on 1 August 2003).

publicly held company and €225,000 for a publicly held company.[44] This however does not apply to certain specially regulated incorporations such as the ones providing services of legal advice and accounting, which have a special provision in their articles.[45]

Similarly, in Italy, the MPS is €120,000; with an increased requirement for particular kinds of companies like banks and financial companies.[46] On the other hand, for the private limited companies, the MPS is €10,000 which is l/12th of that required for the public limited companies.

In Spain, this value is only €3,012 for a private limited company, but it must be fully paid up before incorporation. This is extremely less when compared to the MPS required for public companies, of €60,101,21.[47]

Comparable requirements exist across the EU, but as explained earlier, the EU is planning to relax these requirements because of concerns raised by various scholars regarding the efficiency and effectiveness of the MPS requirements based on the above lines.

However, there exists a second view on this issue. In Ghana, it is argued that a company must be sufficiently capitalized to avoid the risk of becoming insolvent as soon as it is established.[48] Therefore, it should have a minimum legal capital requirement. Nigeria has a similar rationale behind its legislation on MPS.[49] This is because a lack of MPS requirement promoted the registration of companies by people who were not genuinely interested in the conduct of the business.[50] It also resulted in the

"*Id.at* ,Art. L224-2.
[45] *Id.*
[46] MADS ANDENAS AND FRANK WOOLRIDGE, EUROPEAN COMPARATIVE COMPANY LAW 79(2009).
[4]7d.,at85.
[48] See, Ghana Companies Code Act 179 of 1963, §284(l)-(5).
[49] Working papers on the reform of Nigerian Company law (1) f95.45; there was no requirement of an MPS under the previous 1968 Nigerian Companies law.
[50] John Baloro, *Corporate law and national development; Thoughts on some aspects of corporate law reform in Swaziland,* 29(2) THE COMP AND INT'L L.. J. OF S. AFR., 130-140 (July 1996), available at http://www.jstor.org/stable/23250319 (Last visited August 6,

creation of companies for the sole reason of conducting fraudulent transactions. As explained earlier, while these might be valid concerns for company law, there are alternative ways to avoid such problems. Moreover, the same can be left to be resolved by free market forces.

IV. MECHANISMS ALREADY EXISTING IN INDIA FOR CREDITOR PROTECTION

There was no requirement of a MPS in the Companies Act, 1956 ('1956 Act') and the same was only introduced by way of an amendment to the Act in the year 2000. The author believes that various safeguards already exist in the Companies Act, 2013 for the protection of the creditors. This being the case, the MPS requirement does more harm than good in light of the arguments advanced above and the removal of the same by way of the 2015 (A) Act is a progressive step.

For instance, there are various rules for the mandatory disclosure of financial statements which assist the creditors to decide whether or not they should transact with the company. This method was developed in the US, after demands from the capital markets.[51] This also increases transparency in the functioning of the company and enhances accountability of the companies.

There are also provisions prohibiting the issue of shares at a discount. This is to avoid any difference between the actual value and paper value of the share capital. §53 of the 2013 Act provides that any shares issued at a discounted price should be void, except those issued under §54 of the 2013 Act. The section also provides for penalties in case the provisions are not adhered to. §79 of the 1956 Act provided for certain exceptions to this prohibition; however 2013 Act makes a departure from the same, the only exception in the latter being the sweat equity shares. Discount is not allowed even when the market quotation of shares is below the par value of the shares.[52] In case such an issue is made on discount, the amount is recoverable from the allottees at the winding up

2015).

[51] Miola, *Legal Capital, supra* note 19, at 422.

5-'Oarequm Gold Co. v. Roper, (1892) AC 125. For the English law, see English Companies Act, 2006, §580.

of the company or anytime before that.[53] This ensures that the capital of the company is not overvalued in order to avoid the creditors being misled.

Another important provision is the prohibition on the reduction of the share capital without following the procedure prescribed in the Act.[54]As per §66(i)[35] of the Act, any reduction made to the capital has to be subject to the confirmation by the National Company Law Tribunal. The tribunal, while adjudicating upon the application of the company to reduce the capital, has to ensure that the "debt or claim of <u>every</u> creditor of the company has been discharged or determined or has been secured or his consent is obtained"[56] (emphasis supplied). This makes the requirement of a share capital to protect the creditors almost redundant in a free economy. The creditors enter into contract after knowing completely well the share capital of the company they are transacting with. This knowledge, accompanied with the fact that the share capital cannot be reduced without their (creditors') consent puts things on a level playing field for both the creditor and company. This way the creditors enter into the contract with complete information of the share capital of the company and the principal characteristic of limited liability of the company. The state then should have no prerogative to take an extra step and protect the creditors from the consequences of a contract they have entered into with free consent.

Similarly, §67 of the Act also puts "restrictions on purchase by

"Welton v. Saffrey, (1897) AC 299 (HL).

[54] Similar is a case with the UK laws. In the UK, the companies can reduce their capital only by a special resolution confirmed by the court (Companies Act 2006, §§641 (l)(b), 645-651). Or for private companies by special resolution supported by a solvency statement by the directors filed with the registrar, provided that at least one shareholder will remain (Companies Act, 2006, §§641(l)(a), 642-644). Court has to be satisfied that affected creditors have been consented, been paid or had their debts secured.

[55] §66 has not been notified yet. Further, under the 1956 Act, the power of the creditors to object on the reduction of capital was limited to the cases when the reduction of liability related to the unpaid share capital or payment of any paid-up share capital to shareholders. For other cases, the creditors had to take consent of the court to object. The 2013 Act however provides for the authority of the creditors to object in every case the reduction of capital is being made by the company.

[56] The Companies Act,2013, §66(3).

company or giving of loans by it for purchase of its shares." This also helps the creditors in a similar manner as the previous section.[57]It is believed that the creditors are entitled to suppose "that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business".[58]There are limited ways in which such a buy-back can be effectuated[59] and safeguards have been made for the creditors even under those provisions. For instance under §68 of the 2013 Act, a company has to adhere to a 2:1 debt-equity ratio and has to file with the registrar and the SEBI a declaration of solvency, before it can buy its own securities.

Therefore, there already exist provisions in the Companies Act, 2013 for the protection of creditors and the requirement of MPS is redundant and burdensome.

IV. CONCLUSION

The 2015 (A) Act will remove the requirement of a MPS in India. MPS was introduced in order to protect the creditors from bad debts. However it has been argued in this essay, that such a requirement of protecting creditors is not necessary in a free market, where the creditors enter into a contract with complete knowledge of the limited liability and existing share capital of a company. Further, the involuntary creditors which cannot be protected by contracts, can be protected by mechanisms other than the MPS. For instance, mandatory insurance can be provided for, for companies working in hazardous industries in order to protect tort victims. It is also argued that the removal of the MPS has more benefits than harms and this has been recognized by many countries across the world. Particularly in India, the removal of the MPS read in conjunction with the introduction of the One Person Companies in the 2013 Act can act as a boost to the formation of companies and therefore to the idea of 'Make in India'. Lastly, it has been illustrated that the provisions in the 2013 Act without a MPS, are sufficient to protect the creditors.

[57] *See* Trevor v. Whitworth, (1887)12 App Cas 409.
[58] *Id.*
[59] The Comnam'ps Ar-r W11 K<r£e "-J""[1]

LOOK BEFORE YOU LEAP: REGULATING EQUITY BASED CROWDFUNDING IN INDIA

PRATEEK SURI*

Crowdfunding is becoming an increasingly popular source of raising external capital by early stage startups and small and medium enterprises (SMEs) in various economies. However, unlike donation based or reward based crowdfunding model, equity based crowdfunding involves the sale of securities to public through broad based solicitation and thus implicates securities regulations. Observing that legal limitations to facilitate the later, Securities and Exchange Board of India (SEBI) had floated a consultation paper on crowdfunding last year in June, inter alia, proposing a regulatory scheme for equity-based crowdfunding in India.

In consonance with its mandate, SEBI has sought to incorporate several investor protection measures, in order to foster the confidence of investors in the novel financing mechanism. However, this paper claims that in case of equity-based crowdfunding, where entrepreneurs seek relatively smaller offerings, such heavy-handed investor protection measures are inappropriate and burdensome. The measures incorporated would unduly raise the legal complications and cost of compliance, for the issuers or for the crowdfunding platforms, thereby discouraging the adoption of otherwise revolutionary financing mechanism.

Understandably, if the investors are not sufficiently confident that there are appropriate protections, market confidence would struggle, and capital formation would ultimately become difficult. However, for any regulatory framework to be encouraging (or even supportive) it must be sufficiently reactive to the needs and circumstances of all the players involved. Despite good intentions however, the proposed regulatory framework, if adopted unaltered, would not serve its purpose of addressing the funding gap experienced by start-ups and SMEs in India.

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The author believes that now is an appropriate time to review the proposed regulatory aspects of equity based funding and to assess alternative legal visions for the future and consider implications of the new policy as technology, practice, and policy continue to evolve, and collide into each other.

CONTENTS

/. Introduction
II. Background
III. Current Regime and Crowdfunding
IV. Proposed Regulatory Framework for Equity Based Crowdfunding
V. Learning from the United States' Experience
VI. Recommendations
VII. Conclusion

I. INTRODUCTION

In 2011, Bubble and Balm Company successfully raised £75,000 from 82 investors in return for 15 per cent of the company's equity through UK based crowdfunding platform Crowdcube, thus becoming the first company to utilize equity crowdfunding model to fund its startup.[1] In July 2013 however, the business closed overnight as a consequence of which the investors lost their entire investment.[2]

[1] E. Kirby & S. Worner, *Crowd-funding: An infant industry growing fast,25,)(lOSCO* Reseacrh Department, Working Paper No. SWP3/2014), available at http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf.

[1]T. Powley et *si., Alarm bells/or crowdfunding as bubblepopsfor soap start-up,* FINANCIAL TIMES Jul. 31, 2013, available at http://www.ft.com/intl/cms/s/0/8d680fd4-f9d9-lle2-b8ef-00144feabdc0.htral#axzz3fVzJnOI2 (last visited Sept. 12,2015).

Crowdfunding is the "use of the Internet to raise money through small contributions from a large number of people i.e. the crowd".[3] The process generally involve, an entrepreneur with a business plan but insufficient capital, publishing a request to raise funds for its business on a publically accessible internet site, whereby it discloses how it intends to use the money.[4] Along with the request, it also discloses as to what, the contributors will receive in return for their contributions. "The hope is that, although individual contributions may be small, their total will equal or exceed the entrepreneur's goal."[5] As a result, "anyone who can convince the public [that] he has a good business idea can become an entrepreneur, and anyone with a few dollars to spend can become an investor".[6] Due to its potential to raise small contributions from the millions over the internet, it has been touted as 'revolutionary'[7] and 'democratization of finance'.[8]

Securities regulatory bodies across various jurisdictions have acted to protect the 'financially unsophisticated crowd' or retail investors from the inherent risks involved in investing in early stage entrepreneurial ventures, as exhibited by the failure of Bubble and Balm Company. However, not every such crowdfunding call implicates securities law and

[3] C.S. Bradford, *The new federal crowdfunding exemption: Promise unfulfilled,* SEC. REG. L.J.195,196 (2012).

[4] Mat 196.

[5] C.S. Bradford, *Crowdfunding and- the Federal Securities Laws,* 1, COLUM. Bus. L. REV. 10 (2012).

[6] *Id.* at 10.

[7]. BRADFORD *supra* note 5 at 5; J. Thomas, *Making equity crowdfunding work for the unaccredited crowd,* 4, HARV. BUS. L. REV.62,62 (2014) (noting that "[t]he idea behind equity crowdfunding is both simple and revolutionary").

[8] A. A. Schwartz, *Keep It Light, Chairman White: SEC Rulemaking Under the CROWDFUND Act,* 66 VAND. L. REV.En Banc 43, 44- 45 (2013) (noting that the CROWDFUND Act of United States "aims to democratize the market for speculative business investments by allowing investors of modest means to make investments..."); See M. Landler, *Obama Signs Bill to Promote Start-Up Investments,* N. Y. TIMES, (Apr. 6, 2012) at A12, available at http://www.nytimes.com/2012/04/06/us/politics/obama-signs-bill-to-ease-investing-in-start-ups.html? _r = 0 (last visited Sept. 12, 2015).

attracts the attention of securities regulatory bodies.[9] Businesses and others use crowdfunding to raise money in a number of contexts that do not involve the sale of securities.[10] For instance, in reward based crowdfunding model,[11] the contributors expects a one time gift in return, e.g. an autographed copy of a music album or a consumer product, which would not ask for an interference of securities regulatory bodies. [n] However, if the investor expects a share in profit of the proposed venture or likewise, securities law gets implicated."

Observing the limited funding options available for startups and small entrepreneurial ventures, which has been aggravated by the 2008 financial crisis and the intractable conflict between traditional United States securities law and equity crowdfunding,[14] United States became one of the first countries to enact an enabling legislation to facilitate equity based crowdfunding, namely, Title III of the Jump Start Our Business Act ("JOBS Act") in 2012.[15] However, a minimal understanding of the 'crowd' with respect to the risks involved in dealing in financial markets coupled

[9] SEBI, *Consultation Paper on Crowdfunding in India* 9, June 17, 2014, available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1403005615257.pdf (last visited **Sept.** 12, 2015) [hereinafter SEBI Consultation Paper]; *cf* J. M. Heminway & S." R. Hoffman, *Proceed at your peril: Crowdfunding and the Securities Act of 1933,* 78, TEN. L. REV. 879, 884-905 (2010) (discussing what constitutes securities under United States' securities law).

[10]BRADFORD, *supra note* 5, at 14-27 (discussing different types of crowdfunding).

1 *Infra* Part II.B (describing different models of crowdfunding).

'- BRADFORD, *supra* note 5, at 9.

[13] SEBI Consultation Paper, *supra* note 9, at 29-30.

[14] *See Generally infra* Part V; See J.M. Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments That Begs for a Happy Ending,* 102 KEN.L.J.865, 866 (2013): (although certain exemptions are provided for selling of securities under the United States securities law, however "the then-existing exemptions under federal and state law did not permit broad-based solicitations of investors over the Internet").

[15] LANDLER, *supra note* 8 (reporting the signing of the JOBS Act into law).

with inherently high risk of investing in startups and small companies led the United States to adopt strong investment protection measures. As an undesirable consequence of which, the compliance cost increased among other things, both for the issuer and the crowdfunding platform, which commentators believe would render crowdfunding regulation unattractive for budding entrepreneurs.[16]

Meanwhile, India's securities market regulator Securities Exchange Board of India (SEBI) observing the rapid increase of crowdfunding platforms in India and discerning that the securities law would be implicated if such platforms were involved in crowd sourced equity funding, had floated a consultation paper in June 2014, wherein it had *inter alia* sought suggestions from public regarding viability of the proposed regulations.

This paper seeks to explore the possibility of having a regulatory framework, wherein a cost efficient regulatory environment could be created for advancing the utility of the equity based crowdfunding platforms without unduly sacrificing investor protection. The scope of this paper is limited to equity-based crowdfunding and it does not cover debt-based crowdfunding or fund based crowdfunding, which have been otherwise discussed in the SEBI's consultation paper.

The rest of the paper is organized as follows. Part II provides the background discussing what crowdfunding is and why its need has been felt. Part III familiarizes the reader with the avenues available for entrepreneurs for raising external capital under current regime and also describes why existing framework would be unsuitable for equity-based crowdfunding. Part IV briefly reviews the SEBI's proposed regulatory framework. Part V traces the development of targeted regulation to facilitate equity crowdfunding in United States of America and demonstrates how it has been allegedly rendered useless for early stage startups and small scale companies, due to increase in associated compliance cost and complications. Part VI provides targeted recommendations that balance the need for capital formation against the

See Generally infra Part V.

concern of investor protection, in part inspired from the United States' experience. Part VII provides concluding remarks.

II. BACKGROUND

A. From Crowdsourcing to Crowdfunding

Crowdfunding is a derivative of two distinct innovations, namely crowdsourcing and microfinance.[17] Crowdsourcing is an act of taking something that was once done by employees and outsourcing it to an undefined network of people via the internet in an open call for help.[18] Crowdsourcing in other words is akin to a participative activity over the internet in which various actors (including but not limited to individuals, institutions, nonprofit organizations and corporations etc.) propose to public to collaborate to a given task, for remuneration or in some cases pro bono.[19] Wikipedia and Linux operating system are two best-known examples of crowdsourcing.[20]

Microfinance, or microcredit on other hand, is the "providing [of] very small loans without collateral at full-cost interest rates that [are] repayable in frequent installments [sic]".[21] Microfinance originated in the 1970s with its primary aim of poverty alleviation in developing economies such as Indonesia, Bangladesh and Bolivia.[22] Grameen Bank of

[17] P. Belleflamme et al., *Crowdfunding: Tapping the right crowd,* 29.5 J. Bus. VENTURING, 585, 588 (2014) (stating that crowdfunding is rooted in crowdsourcing); BRADFORD, *supra* note 5, at 27.
[18] *See Generally* J. HOWE, CROWDSOURCING: WHY THE POWER OF THE CROWD IS DRIVING THE FUTURE OF BUSINESS (2009).
[19] E.E. Arolas & F.G. Guevara, *Towards an integrated crowdsourcing definition,* 38 J. INFO. SCI. 189, 197 (2012).
[20] *Id.* at 19; BRADFORD, *supra* note 5, at 27-28.
[21] U.N. DEV. PROG, *Essentials: Microfinance* 1 (1999) available at http://web.undp.org/evaluation/documents/Essential-on-microfinance.pdf.
[22] *Id. it A.*

Bangladesh, a microfinance institution, has lent over $9 billion in the past thirty years to micro-entrepreneurs in 37 countries,[23] certifying success of this innovative model. Crowdfunding essentially is an amalgamation of these two innovations having a utility of its own.

B. Types of Crowdfunding models

Broadly, four types of crowdfunding models are identifiable, distinguished by what investors are given in exchange for their contributions. The models are: (1) donation, (2) reward, (3) lending, and (4) equity.[24] Donation based model is the simplest of all as this type of fundraising allows donors ("crowd") to give their contributions to a cause they wish to support. This model is akin to charitable contribution wherein contributors give money for the cause they believe in, without expecting any return on their investment.[25] This model does not implicate securities law.

In contrast, the reward model, which is also the most common type of crowdfunding model,[26] offers something to the investor in return for the contribution. The rewards which the contributors get vary, generally in accordance with the amount contributed, from just immaterial acknowledgements, ranging from a mere thank-you mail to mentioning of the crowdfunder's name on the cover of a film DVD or music CD. A subset of reward-based model is pre-selling model, wherein the contributors are rewarded with the product being developed by the entrepreneur for which they pay in advance. Platforms like Wishberry[27]

[23] S. Khavul, *Microfinance: creating opportunities for the poor}* 24.3, THE ACAD. MGMT. PERSP.,58 (2010).
[24] *See Generally* SEBI Consultation Paper, *supra note* 9, at 2-4; BRADFORD, *supra* note 5, at 14-28.
[25] A.C. Fink, *Protecting the Crowd and Raising Capital Through the CROWDFUND Act,* 90, U. DET. MERCY L. REV. 1,9 (2012).
[26] BRADFORD, *supra* note 5, at 16.
[27] Wishberry, available at https://www.wishberry.in (last visited Sept. 10, 2015).

and Ketto[28] are engaged in reward based models in India and the offerings on these sites do not fall within the purview of SEBI.

In the third identified model i.e. peer to peer lending model, the rewards is the interest charged on the lent amount plus the payback of the principal amount after the lending period. The loans provided are unsecured and interest rate is usually decided by the crowdfunding platform.[29] Although, peer -to-peer lending model does not attract securities law in general, however, loan/notes/contracts can be traded on a peer-to-peer platform or a secondary market. Therefore, such contracts between the lender and the borrower qualify as security note thereby implicating securities law.[30]

Lastly, the equity based crowdfunding model, a large number of individuals are allowed to make small financial contributions towards a company and take an equity stake in the company in return.[31] The rewards are either shares of the venture, dividends and/or voting rights. This model is the most promising of all as it has the potential to provide finance for innovative business ideas that may struggle to attract funding under traditional models. This article focuses on equity based crowdfunding model as this model raises a myriad of regulatory issues, which are to be appropriately dealt, in order to realize its true potential in the Indian market.

-[8] Ketto, available at https://ketto.org/how-fundraising-works.php (last visited Sept. 11, 2015).

[25] *See generally* SEBI Consultation Paper, *supra* note 9, at 3; BRADFORD, *supra note* 5, at 20-23.

[K] *Id.*

:" *See generally* SEBI Consultation Paper, *supra* note 9, at 4; BRADFORD, *supra* note 5, at 20-23.

C *Equity Crowdfunding: An alternative Financing Option.*

One of the primary challenges faced by small and medium business enterprises is the capital gap.[32] Following 2008 financial crisis, traditional funding sources such as banks are reluctant to fund the new businesses due to a lack of collateral, operating history, and a proven track record.[33] Private financing from venture capital and angel investors is also not easily available and moreover there selective funding policies mean that they only fund a small number of businesses.[34] Moreover, "most people seeking to fund businesses and projects, especially younger entrepreneurs, do not have relationships with enough entities and individuals to create a stable source of venture capital without third-party assistance".[35] In such scenario, crowdfunding has the potential to solve a

[32] *See generally* J.E. Fisch, *Can Internet offerings bridge the Small Business Capital barrier?,* 2, J. SMALL & EMERGING BUS.L. 57, 60-63 (1998) (discussing how venture capitalists and angel investors are highly selective and funding through them is generally unavailable for early stage entrepreneurial ventures).

[33] E. Maltby, *Smaller businesses seeking loans still come up empty,* WALL STREET J. (June 30, 2011) at Bl, available at http://www.wsj.com/articles/SB10001424052702304314404576411901168183390 (last visited Sept. 10, 2015). (reporting that most of the loan recipients in 2011 appear to be large independent businesses with multiple revenue streams and significant collateral for loans rather than smaller companies); N. D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption,* 13 U. PENN. J. BUS. L.973, 974 (2010).

[34] R.B. Campbell, *Regulation A: Small Businesses' Search for 'A Moderate Capital',* 31 DEL. J. CORP. L. *77,* 81 (2006) (arguing that small businesses face structural challenges when entering capital markets and that the absence of available financial intermediation services requires them to find investors on their own); W.K. Sjostrom, Jr., *Relaxing The Ban: It's Time To Allow General Solicitation And Advertising In Exempt Offerings,* 32 FLA. ST. U. L. REV. 1, 3 (2004); D. Lavinsky, *Funding Fathers,* SMART BUSINESS, (August 27, 2010), available at http://www.sbnonline.eom/local/article/20471/65/0/funding_fathers.aspx (last visited Sept. 10, 2015) (noting that "[t]he vast majority of entrepreneurs have failed to raise venture capital, there are two key reasons for this, first, most entrepreneurs don't qualify for venture capital since they can't scale fast enough, nor do they have the potential for a large enough exit, and second, there are too few venture capitalists versus the masses of entrepreneurs who need money").

[35] CAMPBELL, *supra* note 34, at 89; *A Special Report on the World Economy: The Cost of Repair,* THE ECONOMIST (Oct. 7, 2010), available at http://www.economist.com/node/17173933 (last visited Sept. 10, 2015) (reporting the comments made by Steve

key problem of financing small businesses and to bridge the capital gap by helping budding entrepreneurs to locate a large number of potential investors in a cost-effective manner.

Besides, considering that the compliance costs involved in traditional equity fundraising, which can be exorbitant compared to the amount of funds that a small businesses would generally seek to raise, equity based crowdfunding seems more appropriate for small businesses than traditional equity markets.

D. Risks associated with equity crowdfunding

Promising, as it may seem, equity based crowdfunding is accompanied with potential risks to investors. First among those is fraud, which is endemic to securities market.[36] One of the main concerns for the finance regulatory bodies is the emergence of fraudulent campaign on crowdfunding websites, intending to defraud the investors by tricking them into investing in a sham venture.[37] Occurrence of fraud in securities market have been relatively frequent despite regulatory bodies' surveillance, most prominent of them being the Sahara scam in India and more contextually apt, "pump and dump" schemes in USA, wherein a

Jurvetson of venture capital firm Draper Fisher Jurvetson "that venture capital fundraising has been harmed immensely by the recent financial crisis").

[36] T.G. James, *Far From The Maddening Crowd: Does The Jobs Act Provide Meaningful Redress To Small Investors For Securities Fraud In Connection With Crowdfunding Offerings?,* 54 B.C.L.REV.1767, 1779 (2013); Laura Michael Hughes, *Crowdfunding: Putting a Cap on the Risks for Unsophisticated Investors,* 8 CHARLESTON L. REV.483, 495 (2013) (noting that "fraud is seemingly indigenous to the securities industry").

[37] D.S. Ellenoff, *Making Crowdfunding Credible,* 66 VAND . L. REV. EN BANC 19, 20 (2013).

very low priced unknown stock was sold at artificially inflated price, leading to heavy losses to the investors.[38]

Second concern arises due to the inherent risk associated with the start-up companies as these companies face high risks of failure and presents higher risk for investors when compared with more established companies.[39] A recent study conducted by Harvard Business School's Shikhar Ghosh depicts that up to 75% of all startups fail.[40] However, "if failure is defined as failing to see the projected return on investment," then more than 95% of startups fail.[41] Other concerns also exist such as those related to risk associated with financially unsophisticated retail investors, [42] risk associated with illiquidity due to lack of secondary market for crowdfunded securities [43] and general risks such as information asymmetry and internet based crimes.[44]

In conclusion, given the propensity of loss to investors as a result of investing in small businesses and the overarching fear of fraud in the internet based securities transaction, crowdfunding may, if under-

[38] *See generally* W.K. Sjostrom., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings,* 32, FLA. ST. U L. REV.l, 25-26 (2004); S.R. Cohn & G.C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns,* N.Y.U. J. L. Bus.l, 71-72 (2007).

[39] *See generally* HUGHES, *supra* note 36, at 501-504 discussing in detail the risk associated with startups); *See* K. Sigar, *Fret no more: inapplicability of crowdfunding concerns in the internet age and the JOBS Act's safeguards.* 64 ADMIN. L. REV. 473, 481 (2012).

[40] *See* D. Gage, *The Venture Capital Secret: 3 Out of 4 Start-Ups Fail,* WALL STREET J. (Sept. 20, 2012), available at http://www.wsj.com/articles/SB10000872396390443720204578004980476429190 (last visited Sept. 10, 2015).

[41] *Id.*

[42] *See generally* S. Choi, *Regulating Investors Not Issuers: A Market-Based Proposal,* 88 CALIF. L. REV. 279, 308 (2000) (arguing that [allowing truly unsophisticated investors to purchase securities of small speculative businesses...may lead to both mistake and fraud); *See* HEMINWAY & HOFFIMAN, *supra* note 9 ("[w]e find it unacceptable for a crowdfunding regulatory exemption to leave those who invest a small dollar value in a venture to fend for themselves.").

[43] *Id.*

[44] R. Pawhaet al., *Crowdfunding: Is India Ready?,* COMPANY L.J. 53 (2015) (noting that "...India has still not reached that stage where it can deal with internet security and awareness amongst people about how to deal with spam and fake web-portals).

regulated, foster a lack of trust in the crowdfunding securities market, irrespective of its remarkable potential in capital formation. Cases of investor losses and fraud, as well as inconsistent business practices, may contribute to perceptions that the crowdfunding market is dishonest or corrupt. Any perception of market unfairness or distrust may have serious effects on investor confidence and investment behavior. [45] Consequently, "as crowdfunding comes with both positive and negative consequences, a crowdfunding regulatory framework should be cautiously pursued and appropriately tailored to accentuate the positive and minimize the negative".[46]

E. Harnessing the wisdom of the crowd

In 2005, James Surowiecki in his book Wisdom of the Crowd argued that individual human beings are not perfectly designed decision makers, but when imperfect judgments are aggregated in the right way, collective intelligence is often excellent.[47] According to Surowiecki, crowds can be "wise"—rational, sensible, and intelligent.[48] He identifies three attributes of crowds that give them the ability to be wise namely, diversity, independence, and decentralization.[49] Consequently, under the right conditions, crowdfunding could benefit from "the wisdom of crowds," "the notion that "even if most of the people within a group are

[45] *Supra* note 44, at 936. [44]
Supra note 44, at 937.
[47] J.M. Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the Crowd,* 38VT.L.REV. 827, 830 (2013).
[48] JAMES SUROWIECKI, THE WISDOM OF CROWDS (2005).
" HEMINWAY, *supra* note 14, at 841-847 (2013) (discussing these attributes in detail and concluding that these elements are broadly satisfied in equity based crowdfunding and predicts that existence of these conditions enable efficacious information transfers and the wisdom of the crowd.").

not especially well-informed or rational...[the group] can still reach a collectively wise decision.[50]

Professor Bradford argues, that included in the safeguards of crowdfunding is the idea that "the wisdom of the crowd" will help to protect investors from the risk of fraud.[51] Crowdfunding may take advantage of crowd-based decision-making and *innovation, and apply it* to the funding of projects or businesses and thus some a commentator suggest that "it would be a great way to test out new ideas and finance micro startups and weed out bad business ideas at an early stage before millions or tens of millions of dollars have been wasted in their investment".[52] However, it should be acknowledged that this self-policing nature of crowd by itself would not be sufficient to instill confidence in the players of the market.

III.CURKEXT REGIME OF CROWDFUNDING

A. *Existing Routes to Access Capital*

Equity funding in India can be raised either from the public through stock exchanges in case of listed companies, or can be raised from investors through private placement offers.

B. *Public issue of Securities*

A company seeking to raise capital with public issue is required to comply with the requirements prescribed under Companies Act, 2013. Section 24 of the Companies Act, 2013 mandates that public issuance of securities and those private placements, which are proposed to be listed on stock exchange, are to be administered by SEBI.[53] Consequently, the applicable regulations of SEBI apply as well.

[50] BRADFORD, *supra* note 5, at 114.
[51] *Id.* at 135; SIGAR, *supra* note 39, at 489-493.
[52] N.D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption,* 13, U. PENN. J. BUS. L. 973, 1002 (2010).
[53] SEBI Consultation Paper, *supra* note 9, at 18.

The Companies Act, 2013 requires the company seeking to raise capital through public issue, to make a listing application to a recognized stock exchange. In addition, the company is required to file a detailed prospectus with the Registrar of Companies. The Companies Act, 2013 further specifies the details of disclosure to be made in the prospectus. Once the company has been successfully registered at a recognized stock exchange, it has to comply with the continuous listing requirements.

SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 applies in cases where an issuer intends to raise capital through public issue. The issuer thus has to comply with the requirements prescribed thereunder, which inter alia includes, appointment of merchant banker, registrar to issue, filing of draft offer document with SEBI, eligibility requirement such as track record, minimum promoter's contribution, lock-in requirements, requirements to have a monitoring agency, etc., apart from detailed disclosure requirements. [54] As a consequence the process of going public is generally accepted to be too costly for small or young entrepreneurs and thus unhelpful for raising relatively small capital.

In order to provide public financing opportunities to SMEs, SEBI has formulated specified framework for SME segment platforms on recognized stock exchanges, where SMEs can list their securities.[55] Relatively relaxed disclosure requirements for enterprises having post issue face value of less than 25 crores make this an attractive option, for SMEs.

However, this mechanism again would be unsuitable for early stage startups as 'issue-related expenses' is some cases can go up to 13.5 per

[54] *Id.*
[55] *Id.* at 21.

cent of the total issue size.[56] Issue-related expenses include merchant banker fees, underwriting commission, legal fees, printing and advertisement expenses and listing fees payable to the stock exchanges, among others.[57] Therefore, it has been argued that, "the SME Exchange will be more suitable for companies which have already achieved a minimum scale of operations, and not for early stage start-ups..."[58]

C. Private issue of Securities

Following the misuse of private issue, most prominently, by the notorious Sahara swindle,[59] the requirements to raise capital through private issue have been made rigorous. Companies Act, 2013 prohibits a private company from making an invitation to the public to subscribe to securities of the company.[60] Additionally, Chapter III - The Companies (Prospectus and Allotment of Securities) Rules, 2014, restricts the number of persons to whom private placement offer/invitation can be made to 200 individuals in the aggregate in a financial year. However, the offers made to, Qualified Institutional Buyers [QIBs] and employees of the company under a scheme of employees' stock option, are excluded from this count. QIBs are the entities such as a Mutual Fund, Foreign Portfolio Investor (FPI), Alternative Investment Funds, Scheduled Commercial Bank, IRDA registered Insurance company, etc.[61]

[56] S. Modak, *IPOs a costly affair for small companies,* BUS. STANDARD Sept. 27,2012 available at http://www.business-standard.com/article/markets/ipos-a-costly-affair-for-small-companies-112092700074_1.html (last visited Sept. 8, 2015).
[57] *Id.*
[58] *See generally* A. Agarwal & R. Mukherjee, *SME Stock Exchange- Viable option for Indian Startups to raise funds},* available at http://trak.in/tags/business/2012/08/10/sme-stock-exchange-indian-startup-raise-funds (last visited Sept. 8, 2015).
[59] Sahara India Real Estate Corporation Ltd. & Ors. v. Securities Exchange Board of India & Anr, (2013) 1 SCC 1, *See also* Arjya B Majumdar, *Regulating Equity Crowdfunding in India ■ A Response to SEBI's Consultation Paper* (22/06/2015), available at http://ssrn.com/abstract=2621488 (last visited Sept. 8, 2015) (discussing in details the factual matrix and legal issues related to the Sahara case).
[60] The Companies Act, 2013, § 2 (68) (iii).
[61] SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009, Regulation 2(zc).

Further, no person, other than the person to whom the offer had been made, is allowed to invest in the company. The value of such offer or invitation per person shall be with an investment size of not less than Rs. 20, 000 of face value of the securities. Moreover, a company offering securities through private placement is prohibited from releasing any public advertisements or from utilizing any media, marketing or distribution channels or agents to inform the public at large about such an offer.

D. Problems with the current regulatory regime

Equity based crowdfunding though is an altogether distinct and novel model of raising funds from the public, yet pre-existing securities laws would be implicated until new regulatory measures are adopted specifically targeting equity based crowdfunding. In such scenario, the current framework would bar an entrepreneur from raising money through private placement on crowdfunding website, as the idea of crowdfunding comprehends a large number of 'unknown' individuals i.e. 'crowd', contributing in small amounts to jointly fund the entrepreneur's venture. Whereas, the Companies Act, 2013 limits the maximum number of individuals that could contribute thorough private placement offer to 200 'known' individuals. Consequently, the very idea of crowdfunding runs against the concept of private placement as envisaged under the Companies Act, 2013.[62]

Moreover, the option to go public through registering the company at the main board of a recognized stock exchange is cost prohibitive and is generally accepted to be unsuited for start-ups or SMEs. Whereas, SEBI's initiative of having SME segment of exchanges is

[62] *Cf infra* Part IV (discussing the proposed framework wherein SEBI has sought to enable crowdfunding through private placement offers)

however it would be unsuitable for startups due to operational issues such as finding a merchant banker willing to underwrite a startup *100%* or lack of investors ready to make big investments in this sector.[64] Therefore, an alternative fund raising option in form of 'crowdfunding' would be timely in order to fill the capital gap, which is generally experienced by young entrepreneurs and startups.

IV. PROPOSED REGULATORY FRAMEWORK FOR EQUITY BASED CROWDFUNDING

SEBI has been established to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market. [65] Observing the rapid increase of crowdfunding platforms in India, SEBI issued a consultation paper on regulating crowdfunding in India as equity-based crowdfunding would involve sale of securities thereby implicating securities law.[66]

A. Eligible Investors & Investor caps

SEBI discerning, that financially unsophisticated retail investors would lack an understanding of the inherent risks involved in investing in start-up companies and recognizing that they may also not understand the illiquid nature of their securities offered, has proposed that only 'Accredited Investors' would be allowed to participate in crowdfunding. Accredited investors would include, Qualified Institutional Buyers

[63] *BSE expects to list 100 companies on its SME platform by December-end,* THE ECON. TIMES (Sept. 19, 2014) available at http://articles.economictimes.indiatimes.com/2014-09-19/news/54109222_1_bse-sme-sme-platform-institutional-trading-platform (last visited Sept. 8, 2015) (noting that "BSE is hopeful of listing a total of 100 companies on its SME platform by December-end (2014) (sic)).
[64] *See generally* A. Agarwal & R. Mukherjee, *SME Stock Exchange-Viable option for Indian Startups to raise funds}*', TRAK BLOG available at http://trak.in/tags/business/2012/08/10/sme-stock-exchange-indian-startup-raise-funds (last visited Sept. 8,2015) (noting that "[t]he SME Exchange will be more suitable for companies which have already achieved a minimum scale of operations, and not for early stage start-ups").
[65] Preamble to The Securities and Exchange Board of India Act, 1992.
[66] *See* SEBI Consultation Paper, *supra* note 9.

(QIBs), Companies incorporated under the Companies Act of India, with a minimum net worth of Rs. 20 Crore, HNIs with a minimum net worth Rs. 2 Crores or more and Eligible Retail Investors (ERIs). In addition, one must certify that it will not invest more than Rs. 60,000 in an issue through crowdfunding platform. There is also an overall cap of 10% of individuals net worth, which a retail investor can fund through crowdfunding.[67]

B. Limits & Conditions

Chapter III - The Companies (Prospectus and Allotment of Securities) Rules, 2014 specifies that in case of a private placement of securities the offer or invitation to subscribe shall not be made to more than 200 investors in a financial year.[68] In order to avoid legislative intervention, SEBI has decided to allow private placement offers through net-based crowdfunding platforms to a maximum of 200 HNIs and ERIs investors collectively, excluding QIBs. However, according to the proposed mandate, QIBs are to hold a minimum of 5% of the securities issued, in order to give some form of comfort to retail investors that the issuer is genuine, as one or more sophisticated investors have chosen to invest.

Further, the ERIs and HNIs are supposed to sign a 'risk acknowledgement' that they understand the risk of illiquid nature of investment and potential loss of entire investment, and that they can bear the loss. Accredited investors would need to maintain a demat account, as the issue would be required to be in demat form.

C. *Disclosure Requirements*

Understanding the importance of disclosures to reduce information asymmetry concerns, SEBI has proposed that crowdfunding

See SEBI Consultation Paper, *supra* note 9.
See id.

would follow a disclosure-based regime. The disclosures would required (i) when an issuer approaches the crowdfunding platform with the intention of raising funds from the accredited investors registered with the platform, and (ii) at regular intervals on an ongoing basis.

Company intending to raise funds through crowdfunding platform submit an private placement offer letter to the crowdfunding portal, which would inter alia contain, name of the company & registered office address, a description of the current/new venture for which the funds are being raised (anticipated business plan), issue size and specified target offering amount and intended usage of funds. A description on the valuation of securities offered, past history of funding, if any and history of any prior refusal from any crowdfunding Platform etc.

The private placement offer letter submitted by the issuer would then be circulated online only to those selected accredited investors who are registered with the crowdfunding platform and have made a commitment, not numbering more than 200, and excluding QIBs. Besides initial disclosures, the issuer would be required to make ongoing disclosures on biannual basis regarding the financial information and the state of the business.

D. Crowdfunding platforms

SEBI has proposed that any online offering or issue or sale through the internet can be made only through a SEBI recognized crowdfunding platform. Three classes of crowdfunding platforms are proposed: (i) Class I- recognized stock exchanges (RSEs) and SEBI registered depositories (ii) Class II- technology based incubators promoted by the central government or any state government fulfilling certain conditions as specified under the paper. A joint venture of Class I and Class II entities would also be eligible to set up a crowdfunding platform; and (iii) Class III- associations and networks of PE or angel investors, which specify certain conditions.

SEBI recognized crowdfunding platform would be obliged to conduct screening and basic due diligence of the issuers and investors. In this regard, a specific "screening committee" is to be constituted by every

crowdfunding platform. Lastly, crowdfunding platforms are inter alia barred from offering investment advice, solicit, manage funds or securities, incentivize employees for such sale of securities displayed on the platform or make recommendations to investors.

V. LEARNING FROM THE UNITED STATES' EXPERIENCE

This section reviews United States' experience of regulating equity crowdfunding, which has been heavily criticized for being overregulated leading to an increased compliance cost.[69] In effect, this section would demonstrate how otherwise revolutionary[70] equity crowdfunding could be rendered unhelpful for startups and small enterprises, by unwanted exercise of regulatory powers.

United States passed the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act (the "CROWDFUND Act") as Title III of the Jumpstart Our Business Startups Act ("JOBS Act") in March 2012,[71] which became law in the first week of April.[72] Among other things, the CROWDFUND Act permits unregistered public offers and sales of securities made under specified conditions by creating a new exemption from Securities Act of 1933 registration (the "crowdfunding exemption"). The registration exemption for crowdfunded offerings is codified in section 4(a)(6) of the 1933 Act.[73]

Similar to investor protection mechanisms sought to be incorporated by SEBI in the proposed regulation for Indian market, the CROWDFUND Act places a limit on issue of $1,000,000 in any twelve-month period (in reliance on the crowdfunding exemption)[74] and also limits the amount an investor can invest to the greater of $2,000 or 5

[69] HEMINWAY, *supra* note 14, at 880-885.
[70] BRADFORD, *supra* note 5, at 100.
[71] JOBS Act, Pub. L. No. 112-06, S. 302(A)-(B), 126 Stat. 306, 315-20 (2012).
[72] *Id.*
[73] *See* Securities Act of 1933,15 U.S.C. .§ 77d(a)(6) (2012).
[7]</^., § 77d(a)(6)(A).

percent of the annual income or net worth of such investor (for investors having the annual income or the net worth, less than $100,000) and 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000 (for investors having the annual income or net worth equal to or more than $100,000).[75]

For the sake of brevity the other requirements are briefly summarized here onwards.[76] The CROWDFUND prescribes that offerings must be conducted through a registered intermediary, either a broker (a pre-existing transactional intermediary recognized and regulated under federal and state securities law) or a funding portal (a new transactional intermediary created by the CROWDFUND Act). [77] Additionally, issuers must comply with a list of requirements that includes mandatory disclosures (defined in the statute by reference to eight broad subject-matter categories), limitations on advertising and promoter compensation, and periodic reporting. [78] The mandated disclosures on financial matters inter alia includes making available "financial statements reviewed by a public accountant who is independent of the issuer, using professional standards" for offerings over $100,000 but not over $500,000 in aggregate amount"[79] and audited financial statements for offerings over $500,000 up to the $1,000,000 cap.[80]

These elaborate compliance requirement in garb of investor protection have been heavily criticized by scholars and legal experts.[81]

[75] SECURITIES ACT, *supra,* note 73 at. § 77d(a)(6)(B).
[76] *See generally* BRADFORD, *supra* note 5, at 6-27; R. Stuart, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution,* 64 FLA. L. REV.1433, 1437-1443 (2012).
[77] SECURITIES ACT, *supra* note 73 at § 77d(a)(6)(C);
[78]/i.,§77d-(b)(i)-(4).
"Id.,% 77 d-(b)(i)(D)(ii).
[80]*Id.,% 77*d-(b)(i)(D)(iii).
[81] *See* COHN, *supra* note 38, at 880 ("the costs for small business issuers and intermediaries that are built into the CROWDFUND Act are too high in comparison to the expected benefits, especially for small aggregate offering amounts"); J.w". Parson, *Crowdfunding: The Real And The Illusory Exemption,* HARV. BUS.L.REV281, 284 (noting that "for a capital raise of $1 million (which is the maximum in retail crowdfunding), the SEC

Although the exact compliance cost is difficult to estimate given that the equity crowdfunding market is still in a nascent stage in the USA, but commentators have generalized the estimated cost associated with compliance of the crowdfunding exemption.[82]

For instance, Professor Bradford has observed that, "[t]he issuer disclosure requirements in the new crowdfunding exemption are neither simple nor inexpensive"[83] He has further criticized the USA congress for "a poorly drafted regulatory bundle of old ideas that is complicated, expensive, and unlikely to have much of an effect on the small business capital gap."[84] Similarly, Professor Stuart Cohn has observed that "[i]t is difficult to imagine that for offerings under $250,000 either issuers or intermediaries would be willing to undertake the time, cost and risk of potential liabilities. The mandated use of intermediaries, the significant role that intermediaries are expected to play, and the mandated disclosures all point to an impracticable exemption for relatively small offering".[85]

Industrial representatives have similar, opinion and one commentator has observed that, "[cjompared to other forms of crowdfunding and capital raising, equity crowdfunding for the public has

roughly estimates a cost of up to $152,260 which may be an underestimation. This could be prohibitively expensive for many small issuers" (footnotes omitted); THOMAS, *supra* note 7, at 63 ("on average, issuers must pay $2.5 million to initially register their securities under the Securities Act and an additional $1.5 million each year thereafter to comply with ongoing requirements, making registration impractical for most new ventures").

82 THOMAS, *supra* note 7, at 66.

83 BRADFORD, *supra* note 3, at 217; R.B. Campbell, *The New Regulation of Small Business Capital Formation: The Impact If Any of the JOBS Act,* 102 KENT. L. REV. 815,836 (2014) ("The Commission in its first iteration of its crowdfunding regulations has failed to appreciate the impact on small issuers of the relative offering costs generated by the crowdfunding disclosure obligations."),

84 BRADFORD, *supra* note 3, at 222.

85 COHN, *supra* note 38, at 1433.

the worst 'bang for your buck' in all of corporate finance."[86] Similarly, capital markets practitioner, Thomas Murphy, a partner at McDermott, Will & Emery in Chicago, has remarked that the crowdfunding exemption "will be one of the most expensive ways to raise money."[87] Concerns have also been raised for the significant costs that funding portals would incur in the registration process in addition to regular due diligence cost.[88] As a consequence the entrepreneurs and intermediaries are more prone to use other exceptions available to facilitate the crowdfunding process, then the crowdfunding regulation themselves.[89] In order for equity crowdfunding to the public to serve as a useful tool, as intended, one observer wrote, Congress needs to amend the JOBS Act to make it less onerous and costly,[90] however, an amendment seems less plausible at this stage.[91]

Hence, it is clear that "[i]f...the regulatory costs associated with crowdfunding are too high, then issuers will either use other means to raise capital or be unable to raise capital and ordinary investors will be denied the opportunity to make these investments."[92] Consequently, any regulatory framework to regulate such small offerings should perform a

[86]BRIAN KOM, *SEC Proposes Crowdfunding Rules,* FORBES, (Oct. 23, 2010), available at http://www.forbes. com/sites/deborahljacobs/20s3/lo/23/sec-proposes-crowdfunding-rules (last visited Sept. 5, 2015).

[87]Karol, *SEC's New Crowdfunding Rules Explained,* Fox Small Business Center (Oct. 24, 2013), available at http://smallbusiness.foxbusiness.eom/finance-accounting/203/o/24/sec-new-crowdfunding-rules-explained (last visited Sept. 8, 2015).

[88] HEMINWAY, *supra* note 14, at 883.

[89] *Id.* at 884 (noting that "[ajthough the CROWDFUND Act seeks to democratize capital creation by expanding the number and type of investors... market observers suggest that the costs of participation in the crowdfunding exemption are driving eligible issuers and intermediaries to the less costly, more efficient offering process under Rule 506 of Regulation D found in the 1933 Act" [footnotes omitted]).

[90] KOM, *supra* note 86.

[91] HEMINWAY, *supra* note 14, at 883.

[91] *Id.* at 888-889 ([amendment would] require abundant patience, sufficient skill, and ample political will, any or all of which may be lacking in the near or foreseeable future [sic]).

[92]D.R. Burton, Letter to the Securities and Exchange Commission (03/02/2014), available at http://www.sec.gov/comments/s7-09-13/s70913-192.pdf (last visited Sept. 5, 2015).

cost benefit analysis. Heavy-handed regulation advancing unwanted investor protection measures would render the crowdfunding mechanism unattractive for small entrepreneurs looking for some external capital. SEBI, learning from the USA experience, would have to appreciate that this new model of fund raising would require an enabling regulation, in pure sense of the term, on which small businesses and startups can rely as a viable source of financing.

VI. RECOMMENDATIONS

The author maintains that for proposed equity crowdfunding to be truly enabling, the market would require an effective balance of the costs and benefits to the core players in the market, i.e. "the three I's: issuers, investors, and intermediaries, to ensure that each is incentivized to participate". [93] In an effort to reduce undesirable barriers for crowdfunding, at the same time, maintaining investor protection and market integrity, the following is a list of targeted recommendations.

First, the primary safeguard that can potentially addresses the concerns related to investor protection is "the *de minimis* nature of crowdfunding: a low maximum on the offering size and a low maximum on the individual investment." [94] This in turn should ideally be compensated by the reduced disclosure requirement by issuers and the higher risks associated with investing in small businesses and start-ups. However, SEBI has proposed to keep a relatively high limit on offering size when compared to other nations.[95] Which seems highly unrealistic,

[93] HEMINWAY, *supra* note 14, at 886.
[94] SIGAR, *supra* note 39, at 495 (noting that "a low cap on the aggregate amount of offering mitigates the negative impact on the market as a whole").
[95] J. Soni & K. Bagchi, *Crowdfunding in India: A Tale of Misplaced Regulations,* 49 ECONOMIC & POLITICAL WEEKLY 14,16 (2014) (noting that "offering size is is pegged at Rs 6 crore in the US, Rs 20 crore in UK, Rs 9.8 crore in New Zealand, Rs 10 crore in Australia, Rs 7.8 crore in France and Rs 8.2 crore in Canada, India has pegged the maximum limit at Rs 10 crore")

as not many early stage ventures would intend to raise that much capital. [96] In addition, the inflated limit undesirably increases the disclosure requirements, among other things. Thus, SEBI should revise the limit at 5 crore, considering the requirements of the players involved or in alternative may observe tired approach: the first band can be capped from Rs 50,000 to Rs 5 crore and second band for the equity offerings in the range of Rs 5 crore to Rs 10 crore.[97] The second band may be imposed with more detailed requirements than the first band, thereby saving the issuer, seeking small offerings, from incurring unwanted regulatory costs and also ensuring the investors are protected where risks are comparatively high.[98]

Second, SEBI should recognize that the fundamental revolutionizing factor behind crowdfunding is the 'crowd' i.e. large number of people who invest small amounts through internet.[99] In view of the same, limiting the number of HNI and ERI to 200 individuals is highly impractical. Thus, appropriate amendments to the Companies Act, 2013 and Companies (Prospectus and Allotment of Securities) Rules, 2014 be made to allow private placement offer to 1000 investors or more for purpose of crowdfunding. Additionally, the mandated size of each investment should be reduced from INR 20,000.[100]

Third, the participation in the crowdfunding mechanism should not be limited to unlisted public companies and be expanded to include private companies, one person companies, Limited Liability Partnerships etc.[101] Relatively extensive filing requirement in case of unlisted public company, among other things, would unnecessary discourage the adoption of crowdfunding mechanism.

[96] *Id.*
[97] Soni & Bagchi, *supra* note 95, at 16.
[98] *Id.*
[99] PARSON, *supra* note 81, at 284. (noting that the meaning of crowd in United States context as "...more than 300 million Americans ("retail investors") who are normally shut out of this market because they do not qualify as accredited investors").
[100] Companies (Prospectus and Allotment of Securities) Rules, 2014, Rule 14(2) (c).
[101] P. Pandya & S. Jain, *SEBI Consultation Paper on crowd-funding in India - Key takeaways,* 122 COMPANY L. ADVISOR (Mag.) |4 (2014).

Fourth, as crowdfunding mechanism usually involves social media interactions, general solicitation and advertisement should be allowed in limited sense of providing notices over internet, that direct investors to the crowdfunding platform. However, issuers should be barred from advertising the terms of its offerings.

Fifth, the disclosure requirements should be standardized. This will better facilitate investors' decision-making and as the calculus of decision makers would then include comparative elements. [102] Incidentally, this might also limit information asymmetry.

Sixth, open communication channels and crowd rating system should be introduced, as this would essentially maximize the self-policing effort of the crowd. Successful examples of such policing in other industries include e-commerce companies such as eBay and Amazon, "which permit users to rely, to some extent, on user reviews to police against fraud or misleading information".[103]

Seventh, as an additional measure, interoperability amongst platforms should be mandated, as this would ensure that so that the individual investor caps are not breached consequently saving investors from risks.[104]

Eighth, in order to prevent internet related crimes, possibility of which is particularly more in case of India,[10'] sufficient internet security practices should be compulsorily followed by the crowdfunding

[102] HEMINWAY, *supra* note 14, at 827.
[103] *Investor Protection in Crowdfunding-Wby for 5 Years There Has Been No Fraud,* STARTUP EXEMPTION, (Jan. 11,2012), available at http://www.startupexemption.com/ archives/214#axzz3fwccqVzF (last visited Sept. 8, 2015).
[104] VIDHI CENTRE FOR LEGAL POLICY, Responses to SEBI consultation paper on crowdfunding 28 (2014), available at http://vidhilegalpolicy.in/s/Vidhi-Crowdfunding-Paper.pdf (last visited Sept. 8, 2015).
[105] PAWHA et al., *supra* note 44, at 53.

platform, as prescribed, inter alia in, the Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Uules, 2011.

Ninth, appropriate rules should be adopted in order to hold crowdfunding platforms liable for fraudulent statements made by others on their sites in two circumstances: "(1) if they know the posted material is fraudulent; (2) if they deliberately ignore red flags that should have alerted them to the fraud".[106]

Lastly, appropriate dispute resolution mechanism should be incorporated to assure investors that appropriate remedies are available to address their grievances. For doing the same existing threshold requirement for minority shareholder to bring suit, in cases of oppression and mismanagement, should be accordingly altered.[107]

VII. CONCLUSION

Crowdfunding is a novel corporate finance tool and the regulatory framework would shape its potential parameters. Supportive ecosystem and forward thinking regulations are required for its utility to be truly realized in Indian market. Participation of the crowd and of the entrepreneurs would largely be dependent on the enabling framework that is created. However, the proposed regulation in its present form would inevitably albeit undesirably deter the participation of all the players in market.

In light of the United States' experience the task before the Indian regulatory authority is of performing a thorough cost-benefit analysis of the proposed regulatory framework. Undeniably, promoting investor protection is a fundamental policy objective for any securities regulation, however, in view of the small offering that small entrepreneurs' expect and small amounts that investors would perhaps contribute, unwanted

[106] C.S. Bradford, *Shooting the Messenger: The Liability ofCrowdfunding Intermediaries for the Fraud of Others,* U. ClN. L. REV. 379, 381 (2014).
[107] Companies Act, 2013, § 241-245; *See* also VlDHI, *supra* note 104, at 11 (proposing for a similar change).

burdens should be proportionately reduced, to truly make crowdfunding a viable alternative for the budding entrepreneurs.

SEBI should aim to strike an appropriate balance that fosters both crowdfunding's promises as a means of raising investment funds for small businesses and allows individual retail investors to access business finance market, without discounting on the values central to capital markets and securities regulation i.e. investor protection. In this spirit, the article intends to contribute positively to the regulatory debate surrounding crowdfunding.

'START-UP' YOUR ENGINES: ALTERNATE CAPITAL RAISING PLATFORMS FOR ENTREPRENEURS

ARMAAN PATKAR & DIYA UDAY*

The stage has been set for entrepreneurs. India is looking to the young businessmen of today to be the leaders of tomorrow. This resonated in Narendra Modi's "Start-up India, Stand-up India" pitch in last year's Independence Day speech. He dreams of startups in every district in India, and of India being a global leader in entrepreneurial excellence. The fact is that India was not ready to realize this dream, and that it had become imperative to set up specialized alternate markets to raise capital for young entrepreneurs today, supported by a facilitative regulatory regime. Hopefully, the recent amendments to the securities regulatory framework of India will pave the way for a thriving market.

This article explores the Prime Minister's vision and the legal and regulatory framework needed to turn it into a reality. It deals with the experience of other jurisdictions with alternate capital raising platforms as well. This article also explores the evolution of the regulatory framework for small and growing businesses in India, which culminated in the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Fourth Amendment) Regulations, 2015, which came into force on August 14, 2015. While considering market sentiment and practice, this article assesses the current regulatory framework and sets out its comparative merits and demerits. In conclusion, the authors explain why they believe the new regulatory framework is a big step forward for India but that there is a long way to go, to start up India'.

CONTENTS

I. *Introduction*
II. *Global Experience*
III. *Institutional Trading Platform: The Beginning*
IV. *The Final Regulations*

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V. *Concluding Remarks*

I. INTRODUCTION

Start-ups today require early-stage investment to achieve the explosive growth that every entrepreneur dreams of. Their dreams are to set up business ventures that will change the world, best illustrated by the WhatsApp story.[1] Defying all logic and throwing away old-fashioned revenue or cash-flow based valuation methods, Facebook Inc. spent US$ 19 billion to acquire WhatsApp.[2] Considering the popularity of WhatsApp, this may seem perfectly reasonable to most. However, WhatsApp was generating little or no revenue and speaking strictly in monetary terms, Facebook spent US$ 19 billion to acquire almost nothing. In fact, the net operating losses of WhatsApp were approximately US$ 138 million, and the accumulated total deficit was US$ 429 million, as of December 31, 2013.[3] Yet, they were able to justify the valuation. That is the power of technology start-ups today.

[1] *See* WHATSAPP, https://www.whatsapp.com/ (last visited Apr. 3, 2016) (A cross-platform mobile messaging application for iPhone, BlackBerry, Android, Windows Phone and Nokia).

[2] *See Form 8-K, Current Report: Facebook Inc.,* U.S. SECURITIES AND EXCHANGE COMMISSION, https://www.sec.gov/Archives/edgar/data/1326801/000132680114000010/ form8k_2192014.htm (Feb. 19, 2014) (Facebook, Inc. acquired WhatsApp, Inc. using a two-step merger process whereby a merger subsidiary of Facebook merged with and into WhatsApp and subsequently, the surviving entity merged with and into an acquisition subsidiary of Facebook, Inc. After the second merger, the acquisition subsidiary continued to exist as a wholly owned subsidiary of Facebook, Inc. and consequently, Facebook completed the acquisition of WhatsApp. On closing the transaction, the shares of WhatsApp were cancelled in exchange for common stock of Facebook, Inc. valued at twelve billion U.S.D. Four billion U.S.D. was paid in cash to the existing WhatsApp shareholders. In addition, an issue of restricted stock units was granted to WhatsApp employees on closing the transaction, valued at three billion U.S.D based on the specified price); *see also, Form 8, Current Report,* U.S. SECURITIES AND EXCHANGE COMMISSION, https://www.sec.gov/Archives/edgar/data/1326801/000132680114000037/fb_8-kxclosingxo fxwhatsapp.htm.

[3] *WhatsApp Inc. Financial Statements, Years Ended December 31, 2013 and 2012 with Report of Independent Auditors,* U.S. SECURITIES AND EXCHANGE COMMISSION,

The jury is still not out on whether value driven acquisitions such as the Facebook-WhatsApp deal will work. Some believe that the 19 Billion U.S.D. valuation for a loss-making company is absurd and that the deal is set to fail. Others laud Facebook for looking to the future.[4] One cannot help but wonder what would have happened had Blackberry or Nokia, once formidable market leaders, looked to the future themselves. One way or the other, India needed to ensure that it was not left behind.

Therefore, it was not surprising that on 8th August 2015, the Securities and Exchange Board of India ("SEBI") permitted listing of technology start-ups on Institutional Trading Platforms ("ITP"). This allows eligible companies to list their shares on ITPs' and issue shares, by private placement or public offer, without triggering the relevant initial public offer ("IPO") provisions of the applicable SEBI Regulations. On one hand, SEBI sought to provide easy exit opportunities to investors, and on the other, to facilitate investment in a sector where promoters have had restricted access to funds[5]. *Prima facie,* this looks like a win-win situation for all concerned parties.

http://www.sec.gov/Archives/edgar/data/1326801/ 000132680114000047/exhibit991auditedwhatsappi.htm (June 6, 2014).

[4] *Id.* (In view of Whatsapp's net loss of US$ 138 million, as on December 31, 2013, per its regulatory filings). *See also,* D. Gelles, *Facebook's $21.8 Billion WhatsApp Acquisition Lost $138 Million Last Year,* N.Y. TIMES, Oct. 28, 2014, http://dealbook.nytimes.com/ 2014/10/28/facebooks-21-8-billion-acquisition-lost-138-million-last-year/?_r=l (D. Gelles points out that Facebook paid roughly 2,000 times the annual revenue of WhatsApp as its acquisition price). *See also,* J. Constine, *A Year Later, $19 Billion For WhatsApp Doesn't Sound So Crazy,* TECH CRUNCH, Feb. 19, 2015, http://techcrunch.com/2015/02/19/crazy-like-a-facebook-fox/ (However, some do believe that this courageous acquisition, was not as crazy as everyone thought. One of the arguments put forth by J. Constine was that this prevented WhatsApp from competing with Facebook, either by itself or by a competitor, such as Google, acquiring Whatsapp).

[5] *Discussion Paper on Alternate Capital Raising Platform and Review of other Regulatory Requirements,* SECURITIES AND EXCHANGE BOARD OF INDIA, (Mar. 30, 2015),http://www.sebi.gov.in/cms/sebi_data/attachdocs/1427713523817.pdf [hereinaf ter *Discussion Paper].*

II. GLOBAL EXPERIENCE

While preparing the regulatory framework and drafting the regulations for ITPs, SEBI had a wealth of global experience to draw from. The question is whether SEBI has utilized the available experience of other countries to draft a framework fit for India.

Before we delve into a comparative study on regulations governing start-ups in different jurisdictions, let us briefly identify the issues that start-ups have faced in India and abroad. Start-ups are perceived as high-risk ventures, and not without reason. The inherent nature of start-ups, especially technology start-ups, makes investment risky.[6] What's here today may be gone tomorrow. The promoters of such companies are rarely well versed in the ways of the capital market. They therefore rely on well wishers, friends and family to fund their ventures. When these avenues dry up, they approach banks for loans. However, most technology start-ups are 'asset light',[7] and therefore, raising debt becomes extremely difficult without sufficient collateral.

To counter this problem, some countries provide for separate exchanges for start-ups and other small business that may or may not be affiliated with the main exchanges of those countries. Other countries have created multi-tier systems with their stock exchanges, with each tier

[h] *See* C. Mims, *Maybe There isn't a Bubble, but there's Plenty of Risk,* WALL ST. J., Dec. 29, 2014, http://www.wsj.com/articles/rich-valuations-dont-mean-theres-a-tech-bubble-1419898716 (Many start-ups with no revenue and sky-high valuations have disappeared almost overnight. However, people continue to invest in "pockets of exuberance"). *See also,* Asher Abraham, *If it's so risky, why invest in startups?,* LINKEDIN, Aug. 20, 2014, https://www.linkedin.com/pulse/20140820131816-23710036-if-it-s-so-risky-why-invest-in-startups (Investing in a start-up is risky, as many studies show that of them startups fail or barely make returns for their investors. There are multiple risks such as the startups often make wrong assumptions, markets change quickly, and technology advances rapidly. However, it is also believed that with the right investment strategy, the *potential* return on investment is very high). *See also,* M. Zwilling, 7 *Ways Startups Get Tagged as Too Risky by Investors,* FORBES, Nov. 30, 2015, http://www.forbes.com/sites/martinzwilling/2011/11/30/7-ways-startups-get-tagged-as-too-risky-by-investors/#6bff721f2781 (For a summary of the key risks in investing in start-ups). [7] Asset-light companies have little or no tangible property to use as collateral to raise debt. The value of the business *inter alia* is in the website or the application and the intellectual property that goes with it.

catering to different companies based on a wide variety of criteria. The commonality between the two systems is that they are accompanied by regulatory relaxations favouring easy entry and exit. This helps realize the ultimate goal of having a specialized market place, acting as an incubator to businesses that are not ready to immerse themselves in the public capital markets.

A. *Canada*

In addition to ordinary companies listing on the Toronto Stock Exchange ("TSE") in Canada, start-ups and small and medium enterprises C'SMEs") may list on the TSX Ventures ("TSXV") platform. TSXV is essentially geared towards small and early stage companies looking to access public venture capital for initial growth and to gain a foothold in the public market. Once such companies establish themselves, they may consider *'graduating'* to the TSE and fully exploit the Canadian capital markets. As incentives for migration to the main board, TSXV provides a waiver of application fees, credit of transaction fees in certain cases, usage of existing issuer information to prevent an overlap of filings and in some cases, sponsorship requirements may be waived for qualified TSXV issuers.[8] Further, the listing requirements of TSXV are tailor made to, *inter alia,* suit different industry sectors, stages of development, financial performance and operational resources. TSXV also provides for mentorship programs for such companies.[9]

[8] *Sponsorship Policy Statement 2 - Qualifications Required to Act as Sponsor,* TORONTO STOCK EXCHANGE, http:// tmx.complinet.com/fr/ display/display.html?rbid=2075& element_id=344&print = 1 (last visited Apr. 3,2016) (In certain cases, a company seeking listing may have to engage a sponsor, a participating organization which has been granted access to TSX's trading system. When engaged as a sponsor in regard to an Issuer, the Sponsor is required to assess and determine whether it is appropriate and advisable to monitor, restrict or discontinue certain activities of itself and of its employees in relation to the securities of such Issuer, including: trading, advising and dissemination of research material).

[9] *See Guide to listing,* TORONTO STOCK EXCHANGE, http://www.tsx.com/resource/ en/181 (Mar. 8, 2016).

To support TSXV, the TSE created TSX Ignite,[10] an information resource platform committed to the growth and development of SMEs in Canada which aims to provide greater visibility and investor awareness for SMEs. It provides dynamic innovation-based and industry-specific expertise in fields that transcend traditional financial services, such as, technology, clean technology and life sciences.[11]

B. China

The ChiNext market on the Shenzhen Stock Exchange ("SZSE") provides an important platform for implementing the Chinese national strategy of independent innovation by accelerating growth in emerging industries.[12] Under the Chinese securities law, a company applying for a public offering listed on the main board of SZSE is required to have, *inter alia,* a well-operated organizational structure, sustainable profitability and a sound financial position.[13] The company is required to abide by minimum profitability, net cash-flow and revenue requirements. It is also required to have at least RMB 30 million[14] of the share capital pre-offer.[15]

On the ChiNext platform, the minimum profitability, net profits and revenue requirements are significantly lower. The requirement of total share capital of not less than RMB 30 million is to be maintained after the public offer, and not before it. However, ChiNext companies still have to justify sustainable profitability on the same lines as companies on the main board. This would require the company assuring the stock exchange that no circumstances exist or may come about which may have a significant adverse impact on its sustainable profitability, such as change

[10] *Toronto Stock Exchange and TSX Venture Exchange Support SMEs in Canada with Launch of New Program,* TORONTO STOCK EXCHANGE, http://www.tmx.com/ newsroom/press-releases?id=47&year=2014 (Mar. 27, 2014).
[1] *Listing Guide,* Tsx IGNITE, www.tsxignite.com/en/listing-guides.php (last visited Apr. 3, 2016).
[12] *About ChiNext,* SHENZHEN STOCK EXCHANGE, http://www.szse.cn/main/en/ chinext/ (last visited Apr. 3, 2016).
[13] *Listing Requirements,* SHENZHEN STOCK EXCHANGE, www.szse.cn/main/en/ ListingatSZSE/Listing Requirements/ [hereinafter *SSE Listing Requirements].*
[14] *Rules Governing the Listing of Shares,* SHENZHEN STOCK EXCHANGE, § 5.1.1 (2009), http://www.szse.cn/main/files/2009/ll/05/860391378693.pdf.
"Id. at It

of business model, products or services etc.[16] This also applies to market conditions where the company is also required to look into the effect of changes in its position in the industry, business environment, key contracts, intellectual property and any other circumstances which may have a significant adverse impact on its sustainable profitability.[17] This is a well-thought out provision that recognizes the vulnerability of a company at a nascent stage and therefore seeks to allow listing, provided that the company has a sound future.

In Chinese Taipei, the "Emerging Stock Board", under the main Gre-Tai Securities Market, performs a similar role as an alternate capital raising platform for start-ups and small businesses.

C *Hong Kong*

The Growth Enterprise Market (GEM)[18] in Hong Kong recognizes that emerging and growing enterprises, even with good business ideas and growth potential, will more often than not fail to meet profitability/track record requirements of the Hong Kong Stock Exchange. Consequently, such companies are unable to obtain a listing. GEM removes these entry barriers[19] and allows companies incorporated in Hong Kong, Mainland China, Bermuda and the Cayman Islands to get listed on GEM.[20] GEM does not assess the commercially viability of applicant companies, but

[16] *See SSE Listing Requirements, supra* note 13.
[17] *Id.*
[18] *See* GROWTH ENTERPRISE MARKET, http://www.hkgem.com/root/e_default.aspx (last visited Apr. 3, 2016) (GEM is a market operated by the Stock Exchange of Hong Kong and governed by the Board of the Stock Exchange of Hong Kong).[hereinafter GEM WEBSITE]
[19] *The Market for Growth Enterprises,* GROWTH ENTERPRISE MARKET, http://www.hkgem.com/aboutgem/e_ default.htm (last visited Apr. 3, 2016).
[20] *GEM Listing Rules,* HONG KONG EXCHANGES & CLEARING LTD., § 11.05 , http://en-rules.hkex.com.hk/net_ file_store/new_rulebooks/c/o/consol_gem.pdf (last visited Apr. 3, 2016) (" *The issuer must be duly incorporated or otherwise established under the laws of Hong Kong, the PRC, Bermuda or the Cayman Islands'). See also, List of Acceptable Overseas Jurisdictions,* HONG KONG EXCHANGES & CLEARING LTD., Mar. 17, 2016, https://www.hkex.com.hk/eng/ rulesreg/listrules/listsptop/listoc/list_of_aoj.htm (In case of listing of the primary platform of the Hong Kong Stock Exchange, a number of other "Accepted Overseas Jurisdictions" have been ruled to be acceptable as an issuer's place of incorporation).

does require that the companies seeking listing on GEM have an 'active business pursuit' for 24 months prior to listing, under substantially the same management and ownership.[21]

Though this exemption is also found in other countries such as Japan, Canada, U.K. etc., GEM provides this exemption to offer investors an opportunity to invest in "high growth, high risk" businesses. A natural consequence of this is that GEM is intended for professional and informed investors, embodying the principle of *caveat emptor.*[21] In fact, the GEM website describes GEM as a *'Buyer's Beware Market for Informed Investors'* .[2i] However, GEM is supported by a strong disclosure regime aimed at fostering self-compliance.[24] Post-listing, GEM also requires issuers to establish a strict corporate governance base to comply with the GEM listing rules and proper business practices.[25] GEM imposes certain minimum public float requirements, based on market capitalisation of

[21] *Listing Matters: FAQs,* GROWTH ENTERPRISE MARKET, http://www.hkgem.com/investor/publications/brochure/e_FAQchap3.pdf (last visit ed Apr. 3, 2016).

[22] Latin phrase for *"buyers beware"* or *"let the market decide"*.

[23] GEM WEBSITE, *supra* note 18. *See also Growth Enterprise Market,* HONG KONG EXCHANGES & CLEARING LTD. (1999), https://www.hkex.com.hk/eng/stat/statrpt/ factbook/documents/fb99_12.pdf.

[24] *See* GEM WEBSITE, *supra* note 18 (Listing applicants are required to disclose in detail its past business history and its future business plans which are key components of the listing documents. After listing, a GEM issuer is required to make half yearly comparison of its business progress with the business plan for the first 2 financial years, publish quarterly accounts in addition to half yearly and annual accounts and a shorter period is allowed to make this information available to the public).

[25] *See Listing Rules,* GROWTH ENTERPRISE MARKET, http://www.hkgem.com/listingrules/e_default.htm (last visited Apr. 3, 2016) (These measures include the appointment of a qualified accountant to supervise its finance and accounting functions, designating an executive director as the compliance officer, appointment of 2 independent directors and the establishment of an audit committee. In the first 2 years after listing, a GEM issuer is also required to retain a sponsor to advise and assist the company and its directors in the discharge of their listing obligations. Amongst its duties, a GEM sponsor is required to conduct due diligence and to satisfy itself, to the best of its knowledge and belief and having made due and careful enquiries, that proper disclosures have been made).

applicant companies, and also requires the companies to have at least one hundred public shareholders post-listing.[26]

D. Japan

Japan's biggest stock exchange, the Tokyo Stock Exchange ("Tokyo SE") divides its companies in five equity markets. Three of the five markets, i.e. the first, second and the third market, are classified based on size and business presence. Of the five, the market of the high-growth and emerging stocks ("MOTHERS") allows emerging companies with high growth potential to raise funds in an orderly manner,[27] thereby facilitating the growth of new industries, and also providing investors with a variety of investment vehicles in the Tokyo SE.[28] Once MOTHERS companies achieve their targeted growth, they may apply for the reassignment to the First Section or Second Section as they grow and develop.[29]

MOTHERS accepts listing applications from any company with high growth potential and unique and excellent proprietary technologies or know-how in any industry or sector.[30] The Tokyo SE vets eligibility criteria prior to listing and conducts individual examinations with respect to, *inter alia,* fair price, protection of investors and public interest.[31]

[26] *Id.* (In cases of market capitalization less than HK$1 billion, the minimum public float shall be 20% subject to a minimum of HK$30 million and in case of market capitalization higher than HK$1 billion, it shall be HK$200 million or 15% of the issued share capital, whichever is higher).

[27] *See New Listing Guidebook for Foreign Companies 2015,* TOKYO STOCK EXCHANGE (2015), http://www.jpx.co.jp/equities/listing-on-tse/new/guide/tvdivq0000002h72-att/tvdivq000000v5rn.pdf. [hereinafter *Listing Guidebook]*

[28] *Tokyo Stock Exchange Inc. Securities Listing Regulations (Rule 1 through Rule 826),* JAPAN EXCHANGE HOLDINGS, Rule 102, 13 0une 1, 2015), http://www.jpx.co.jp/english/rules-participants/rules/ regulations/tvdivq0000001vyt-att/securities_listing_regulations%28Rl_to_R.826%29_20150601.pdf.

[29] *Listing Guidebook, supra* note 27. (Reportedly, 73 companies listed on Mothers, or 19% of all companies, 382 companies, that have gone public in that market, have been successfully reassigned to the First Section at the end of March, 2015).

[30] *See Listing Guidebook, supra* note 27.

[31] *The Tokyo Stock Exchange - IPO Overview,* LEGALINK (Sept. 2010), http://www.legalink.ch/Root/Sites/legalink/Resources/Questionnaires/LPOs/Asia/Legalink%20IPO_Tokyo.pdf.

Companies can get listed on MOTHERS despite non-profitability and also benefit from a relaxed requirement of being operational (under the same management) for one year of business before listing, as opposed to the three years in the case of tier 1 and 2 companies.[32] However, in a measure to ensure market transparency, MOTHERS companies are required to periodically publish details of their financial performance and hold corporate information sessions. In addition, for tier 1 and 2 companies, the Tokyo SE mandates a 6 month lock-in period on any shares issued during the financial year prior to listing, which includes shares converted from preferred stock or through the exercise of options or warrants.[33] In case of companies listed on MOTHERS, this requirement is completely waived.[34]

E. The United Kingdom (U.K.)

The Alternative Investment Market (AIM) is a sub-market of the London Stock Exchange. It allows smaller companies to list in a flexible listing regime. It does not prescribe any requirement for minimum capitalisation, number of public floated shares, turnover / profitability or a requirement to have a trading record. In addition, AIM allows migration to the London Stock Exchange, using shares to fund acquisitions and access retail investors. However, interestingly, due to a favourable tax regime among other factors, more companies have moved back to the AIM from the main market, than *vice versa?*[5]

As regards regulation, AIM is a largely self-regulated market where companies are subjected to supervision by the issuer's underwriter, who is referred to as a Nominated Adviser ("NOMAD"), essentially a corporate finance advisor who ensures compliance with the AIM rules. The NOMAD guides companies seeking listing on the AIM and

[32] *See Listing Guidebook, supra* note 27 (Number of consecutive years of conducting business) and at p. 40 (Number of consecutive years of business conduct).

[33] Such conversions are to be notionally treated as third party transfers by way of legal fiction.

[34] *See Listing Guidebook, supra* note 27.

[35] 1. KASSAM & P. MLADJENOVIC, INVESTING IN SHARES FOR DUMMIES (2010).

continues its role post-listing.[36] AIM also requires its companies to set-up certain systems, procedures and controls, prior to admission to the AIM, to enable them to comply with the AIM Rules.[37]

F. The United States Of America (U.S.)

If a start-up company wants to raise money from the American public, it has to comply with the U.S. securities laws and the intense scrutiny of the U.S. Securities and Exchange Commission.[38] The U.S. securities laws require, *inter alia,* registration of public issues with the concerned authorities. However, there are several exemptions built into the securities laws of the U.S.[39] which allow listing without prior registration.

In addition, the Obama government introduced the Jumpstart Our Business Startups Act ("JOBS Act") to improve access to the public capital markets by removing unnecessary or overly burdensome regulations.[40] Significantly, it allows general solicitation of investors/advertisement to investors in cases where companies are

[36] *AIM Rules for Nominated Advisers,* LONDON STOCK EXCHANGE (May 2014), http://www.londonstockexchange.com/companies-and-advisors/aim/publications/ aim-rules-for-nominated-advisers.pdf.
See also Choosing your advisors, LONDON STOCK EXCHANGE, http://www.london stockexchange.com/companies-and-advisors/aim/for-companies/choosing/advisor.ht m (last visited Apr. 3, 2016).

[37] *A Guide to AIM,* THE LONDON STOCK EXCHANGE (2015), http://www.londonstockexchange.com/companies-and-advisors/aim/publications/do cuments/a-guide-to-aim.pdf. *See also* Holland Bendelow, *The Essential AIM Stock Market Guide,* HOLLAND BENDELOW FLOTATION CONSULTANTS (2013), http:// www.hbcg.co.uk/wp-content/uploads/2013/07/The-Essential-AIM-Stock-Market-Guide-2013.pdf.

[38] *See* Securities Act, 1933, Section 4(a)(2). (Transactions by an issuer not involving any public offering, are exempted under Section 4(a)(2) of the Securities Act of 1933).

[39] There are three exemptions from American securities regulations in R. 504, 505 and 506 of Title 17, Chapter II, Part 230, Regulation D—Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933. These rules *inter alia* provide exemptions in certain cases by prescribing minimum size of the issue, time-period of the issue or mandatorily requiring a certain number / percentage of accredited investors.

[40] Jumpstart Our Business Startups Act, *available at* http://www.gpo.gov/fdsys/ pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf [hereinafter JOBS Act].

exempted from certain securities regulations.[41] The U.S. also has small growth specific markets such as the NYSE MKT LLC and the BX Venture Market.

III. INSTITUTIONAL TRADING PLATFORM: THE BEGINNING

A. *The Small A nd Medium Enterprises Platform*

The current ITP framework started as a separate trading platform for SMEs to list and trade their securities. The primary basis for this platform was the size of the companies and therefore, if the SME exceeded the prescribed limit for post-issue share capital, being ten crore rupees in this case, a requirement to make an IPO would trigger automatically.[42] This platform was meant to allow certain companies to list on ITPs under a simpler regulatory regime and transition into the main markets when ready. At this point, technology start-ups were not in vogue and were not specifically considered for this platform. It was merely a separate platform for SME trading and soon, SME platforms became operational.[43] However, in line with the constantly evolving global market, the Government decided to push the agenda of start-ups in the Union Budget for 2013-14.

B. *The Union Budget 2013-14: Government Intent*

Keeping with the changing times, P. Chidambaram, the Finance Minister of India, declared his intention to incentivize start-ups by

[41] *See* JOBS Act, *supra* note 40 (This was earlier banned as exempted companies were not subject to regulatory scrutiny applicable in case of a public issue. It was therefore considered that such issues should then conform to other features of private placement as well and that advertisement / solicitation would effectively make it a public offering).

[42] *See Circular no. CIR/MRD/DSA/17/2010: Setting up of a Stock exchange/a trading platform by a recognized stock exchange having nationwide trading terminals for SME* SECURITIES AND EXCHANGE BOARD OF INDIA (May 18, 2010), http://www.sebi.gov.in/cms/sebi data/attachdocs/1288155570736.pdf,

[43] *See BSE-SME Brochure,* BOMBAY STOCK EXCHANGE-SMALL & MEDIUM ENTERPRISES, http://www.bsesme.com /downloads/BSESMEEBOOK.pdf (last visited Apr. 3, 2016). *See also, Emerge Brochure,* NATIONAL STOCK EXCHANGE, http://www.nseindia.com/emerge_itp/Emerge_ITP_Brochure.pdf (last visited Apr. 03, 2016) (The Bombay Stock Exchange and the National Stock Exchange launched the BSE SME Exchange and Emerge, respectively).

permitting them access to the Indian capital markets in his Budget Speech for the year 2013-14.[44] It was decided to allow SMEs and start-ups to list on the SME platform without having to go through the rigors of a full-blown public listing. This was made possible through the SEBI (Listing of Specified Securities on Institutional Trading Platform) Regulations, 2013 ("2013 Regulations").

To achieve the objectives stated in the aforementioned budget speech, the 2013 Regulations amended the SEBI (Issue of Capital and Disclosure Requirements) Regulations, the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("Takeover Code") and the SEBI (Delisting of Equity Shares) Regulations, 2009 ("Delisting Regulations")[45]. A new Chapter XC was added to the ICDR Regulations,[46] which permitted SMEs[47] that satisfy certain eligibility criteria specified in Regulation 106Y, to issue and list their shares on ITPs without an IPO, which are *inter alia* as follows:

(i) An operating history of less than ten years;

(ii) The paid-up capital of the company must not exceed 25 crore rupees and the revenue of the company did not exceed any of the previous financial years;

(iii) At least one year of audited financial statements for the immediately preceding financial year;

(iv)The 2013 Regulations also provided that company should not be one which is, or whose promoters, group companies or directors are named in the list of wilful defaulters released by the Reserve Bank of India (RBI), or have a winding up petition admitted or

[44] P. Chidambaram, *Budget Speech, 2013-14,* UNION BUDGET (Feb. 28, 2013), http://indiabudget.nic.in/budget2013-2014/ub2013-14/bs/bs.pdf.
[45] The effect of the amendments was that the provisions of the Takeover Code and the Delisting Regulations do not apply to companies listed on the ITP's.
[46] *See* ICDR Regulations, *infra* note 61(Titled *'Listing and Issue of Capital by Small and Medium Enterprises on Institutional Trading Platform without Initial Public Offering').*
[47] SEBI (Listing of Specified Securities on Institutional Trading Platform) Regulations, Reg. 106X (l)(b) (2013). (The definition of SME *inter alia* includes a start-up company), [hereinafter Institutional Listing Regulations]

proceedings referred before the Board of Industrial and Financial Reconstruction, or regulatory action taken by SEBI, RBI and other regulators against the company.[48]

(v) In addition, the 2013 Regulations prescribed minimum investment requirements with respect to holding of securities specified investors such as, *inter alia,* alternate investment fund, venture capital fund, angel investors, SEBI approved lenders, QIBs etc.

Under the 2013 Regulations, start-ups could apply for listing by filing an information document with the ITP. However, the 2013 Regulations did not permit issue of securities to the public in any manner. What was given was only an option to raise money via private placement or by way of rights issue without an option for renunciation of rights.[49] This was a major limitation, as access to the public capital markets continued to elude start-ups.

As can be seen from the above highlighted points, the 2013 Regulations only took the size and age of companies into account. It did not take into account the special needs of start-ups, especially in rapidly developing fields such as information technology, software etc. Though start-ups were covered under the 2013 Regulations, not much was on offer for them. Unsurprisingly, newspapers began reporting that major e-commerce start-ups in India were looking to list overseas, due to favourable overseas regulatory frameworks.[50]

C *Sebi Discussion Paper On Alternate Capital Raising Platforms*

Post the 2013 Regulations, SEBI consulted various bodies, including start-ups, with a view to accommodate a larger number of growing companies and initiated a discussion paper to review the current regime. Citing developments in the United States, Europe, China and

[48] Within 5 years of the date of the application for listing.

[49] See Institutional Listing Regulations, *supra* note 47, Reg.l06ZA.

[50] Peerzada Abrar, *Mass exodus: Tech startups may shift overseas as young ventures face regulatory hurdles in India,* THE ECONOMIC TIMES, Jan. 5, 2015, http://articles.economictimes.indiatimes.com/2015-01-05/news/57705517_1_east-india-company-uk-trade-tech-startups.

other markets, SEBI anticipated knowledge based companies aiming to list overseas due to a conducive regulatory environment. To prevent this exodus, SEBI made several proposals to woo start-ups to remain in India and list on the ITPs.[51]

IV. THE FINAL REGULATIONS

On June 23,2015,[52] SEBI announced that it had decided to simplify the framework for raising capital in case of technology start-ups and other eligible companies on the ITP. In doing so, SEBI took into consideration the special nature of start-up companies and tailor-made the provisions. For example, SEBI realized that conventional valuation parameters such as price to earning ratios and earning per share ratios may not work for start-ups and therefore, the basis of the issue price may be supported by other disclosures (but not projections), as deemed fit by the issuers.[53]

Accordingly, the SEBI notified the SEBI (Issue of Capital and Disclosure Requirements) (Fourth Amendment) Regulations, 2015,[54] whereby it introduced a fresh Chapter XC ("ITP Regulations") to the ICDR Regulations.[55] It was clarified at the outset that the ITP[56] shall be accessible to both institutional investors[57] and non-institutional investors,[58] which was a welcome initiative. In case of matters not

[51] *See Discussion Paper, supra* note 5.

[52] Press Release, SEBI Board Meeting (June 23, 2015), *available at* http://www.sebi.gov.in/sebiweb/home/detail/ 31307/yes/PR-SEBI-Board-Meeting.

[53] *Id.*

[54] Notified in the Official Gazette of India on 14/08/2015 vide Notification No. SEBI/LAD-NTP/GN/2015-16/008.

[55] This Chapter replaced the existing Chapter XC introduced by the 2013 Regulations.

[56] SEBI ITP Regulations, Reg.l06(W)(l)(a) (2015). (Defined to mean "the trading platform for listing and trading of specified securities of entities that comply with the eligibility criteria specified in regulation 106Y"). ["ITP Regulations"]

[57] *Id.* at Reg. 106X(l)(b)(Defined to mean "(i) qualified institutional buyer; or (ii) family trust or systematically important NBFCs registered with Reserve Bank of India or intermediaries registered with the Board, all with net-worth of more than five hundred crore rupees, as per the last audited financial statements").

[58] *Id.* at Reg. 106W(3).

specifically provided for or excluded by the ITP Regulations, the provisions of the ICDR would continue to apply *mutatis mutandis.*^

A. Eligible Entities for Listing

The ITP Regulations provide two classes of eligible entities. The first class is based on the type of company and its processes.[60] To qualify under this class, an entity must provide products, services or business platforms by the 'intensive' use of technology, information technology, intellectual property, data analytics, bio-technology or nanotechnology. However, it must also involve substantial value addition and at least twenty five per cent of its pre-issue capital must be held by a qualified institutional buyer(s)[61] as on the date of filing of the draft information document or draft offer document with the SEBI, as the case may be.

The second class of eligible entities are any entities which have at least fifty per cent of the pre-issue capital held by qualified institutional buyer(s) ("QIBs") as on the date of filing of the draft information document or draft offer document with the SEBI, as the case may be. This protective measure ensures that retail investors, who are not considered to be informed or sophisticated investors, are guided in their investments by being allowed to access only companies deemed worthy of QIB investment. A further restriction is placed on persons holding individually, or collectively with persons acting in concert,[62] more than 25% of the post-issue share capital in any of the two classes of entities, as above.

By limiting the eligibility criteria as above, SEBI has taken away minimum size, revenue, age requirements. The minimum holding requirement, especially in the second class, is quite high and SEBI may consider lowering this requirement further. Further, companies are

[59] *Id. at* Reg. 106W(2).

[60] M^Reg. 106Y(l)(a).

[61] *See* SEBI ICDR Regulations, Reg. 2(l)(zd) (2009), *available at* http://www.sebi.gov.in/cms/sebi_data/commondocs/icdrFeb2016_p.pdf (For the definition of qualified institutional buyer), [hereinafter ICDR Regulations].

[62] ITP Regulations, *supra* note 56 at Reg. 106X(l)(c) (Which defines "persons acting in concert" with reference to Regulation 2 (1) (q) of the Takeover Code).

requires to have *''substantial value addition'*. It remains to be seen as to whether this will be clarified by SEBI or subjected to judicial interpretation.

B. Raising Capital on an ITP

i. Listing without Public Issue

An eligible entity may seek listing of its securities on the ITP without a public issue under the ITP Regulations.[63] It may do so by filing a draft information document instead of a draft offer document in case of IPO's. Before getting listed, the entity shall obtain an in-principle approval from the ITP stock exchange.[64] If the company decides to go in for a regular public offer, the disclosure norms applicable in case of draft offer documents continue to apply.[65] However, the ICDR Regulations dealing with the following do not apply in cases of listing without a public issue:[66]

(i) Allotment, issue opening / closing, advertisement, underwriting, pricing, dispatch of issue material;

(ii) other such provisions related to offer of specified securities to public;

(iii) provisions relating to minimum public shareholding shall not apply to entities listed on ITP without making a public issue[67];

(iv) The prohibition under Regulation 26(5) of the ICDR Regulations on IPO's in cases where the company has outstanding convertible securities (into equity) shall not apply provided the instruments were issued in a prior IPO and where the conversion price was

[63] *Id.* at Reg. 106Z.
[64] *Id.* at Reg. 106Z(4).(Once in-principle approval of the ITP is granted, there is an automatic deemed waiver of by SEBI under Rule 19(7) of the Securities Contracts (Regulation) Rules, 1957 from the requirements of Rule 19(2)(b), which *inter alia* provides minimum public float requirements. It is clarified that this waiver is only for the purpose of listing on the ITP and for no other purpose).
[65] *Id.* at Reg. 106Z(2).
[66]/i at Reg. 106Z(3).
[67] Mat Reg. 106Z(7).

determined and disclosed in the prospectus of the earlier issue. This applies to ESOP's as well.

(v) The proviso to Regulation 106W(2) also provides, *inter alia,* that the requirements of Regulation 26(1) and (2) of the ICDR Regulations shall not apply to companies listing their securities under Chapter XC. This is an exemption from *inter alia* minimum asset / net worth restrictions, profitability track record requirements.

ii. Listing Pursuant to Public Issue

The ITP Regulations, for the first time, also permit eligible entities to file a draft offer document with SEBI and undertake an offer to the public. In such cases, the minimum ticket size for an investor is ten lac rupees and a minimum number of two hundred allottees. Of the allotment to the public, seventy-five per cent is to be allotted to institutional investors,[68] and twenty-five per cent to non-institutional investors.[69] In case of under-subscription in the non-institutional investor category, the securities shall be available for subscription under the institutional investors' category.[70]

The allotment to institutional investors may be on a discretionary basis whereas the allotment to non-institutional investors shall be on a proportionate basis, with the mode of allotment disclosed prior to or at the time of filing of the Red Herring Prospectus. Additionally, in case of discretionary allotment to institutional investors, no institutional investor shall be allotted more than ten per cent of the issue size/[1]

The offer document is required to disclose the broad objects of the issue,[72] as opposed to IPOs, where disclosure of the objects of the issue,

[68] There is no separate allocation for anchor investors.
[69] j-j-p Regulations, *supra* note 56 at Reg. 106ZA(4).
[70] *Id.* at Reg. 106ZA(5).
[71] *Id.* at Reg. 106ZA(6), (7) and (8).
[72] *Id.* at Reg. 106ZA(Reg. 106ZB(4) of the ITP Regulations requires that specified securities allotted on a discretionary basis be locked-in in accordance with the requirements for lock-in by anchor investors on the main board of the stock exchange, as specified under clause 10(j) in Part A of Schedule XI of the ICDR Regulations).

its purpose, the means of financing the project, proposed deployment status of the proceeds at each stage of the project, interest of promoters and directors, etc. are required. This is in line with the major international jurisdictions and gives much needed breathing room to start-ups[73]. As regards the basis of the issue price in the offer document, it may include disclosures, as deemed fit by the issuers, with the only requirement being that the disclosures should be such, as to enable investors to take informed decisions and suitably caution investors regarding the basis of valuation.[74] The question remains as to what will qualify as *'sufficient caution'* from an investor protection standpoint and may require judicial legislation or clarifications from the SEBI from time to time.

a. Lock-In Provisions

Under the extant 2013 Regulations, a minimum of 20% of the pre-issue capital was subject to a lock-in period of 3 years.[75] The ITP Regulations require that all shareholders maintain their pre-issue holding of capital for six months, post allotment or listing without public issue. This does not apply to equity[76] under ESOP / ESPS[77] or held by a VCF / Category I AIF/FVC investors[78]. The post listing (without IPO) lock-in will also not apply. In case of listing without a public issue, the lock-in period will not apply to equity held by non-promoters, if they have held such equity for at least one year before the date of listing.[79]

During the period of lock-in, the promoters will be allowed to pledge the locked-in shares with any scheduled commercial bank or public

[75] *Discussion Paper, supra* note 5.
[74] ITP Regulations, *supra* note 56 at Reg. 106ZA(9).
[75] *Id.* at Reg. 106ZB.
[76] The Explanation to Reg. 106ZB of the ITP Regulations provides that the holding period of compulsorily convertible securities (into equity) before conversion shall be taken into account when calculating the lock-in period.
[77] This is subject to the condition that full disclosures are made as per Part A of Schedule VIII of the ITP / ICDR Regulations.
[78] In case of securities held by VCF / Category I AIF / FVCF's, there is a lock-in of at least one year from the date of purchase of the securities, which may or may not extend beyond the date of the issue.
[79] j-pp Regulations, *supra* note 56 at Reg. 106ZB.

financial institution as collateral security for a loan.[80] In addition, these securities may be transferable in accordance with Regulation 40 of the ICDR Regulations.[81]

b. Once Listed, What's Next?

The securities on the ITP may be traded in lots of ten lac rupees.[82] A listed entity can exit the ITP by obtaining approval of the shareholders by way of a special resolution, provided that 3 conditions are satisfied. First, at least 90% of the votes must be in favour of exit. Second, a majority of the non-promoter votes must be in favour of exit. Thirdly, the stock exchange on which the company is listed, must approve of the exit. In addition, securities may be delisted by the stock exchange in case of non-compliance of listing conditions[83].

Once listed on the ITP, a company has the option to migrate to the main board of the stock exchange three years post-listing. This will be subject to ordinary eligibility and regulatory requirements. However, in case of a start-up, it may choose to stay on the ITP for more than 3 years, if required, to prepare the company in terms of finance, processes, compliances etc. and seek to do a full-blown IPO only when fully prepared.[84] Further, there are no automatic exit triggers based on size, age or revenue requirements as was the case under the 2013 Regulations.

Grandfathering provisions for companies listed under the 2013 Regulations have been provided whereby they may continue to be guided by the existing regulatory framework including applicable relaxations from compliance with corporate governance requirements. All directions, guidelines, instructions or circulars, issued by SEBI shall also remain in

[80] Provided the pledge is included in the terms of the loan sanction.
[81] ICDR Regulations, *supra* note 61 at Reg. 40 (which provides *inter alia* that during the Lock-in period, promoters may transfer shares *inter se* or within the promoter group or to a new promoter. However, the remainder of the lock-in period will continue with the transferee.
[82] ITP Regulations, *supra* note 56 at Reg. 106ZC.
[83] *Id.* at Reg. 106ZD (The manner of delisting shall be prescribed by the Stock Exchange).
[84] *Id.* at Reg. 106ZE.

force as long as the companies remain listed or until SEBI notifies otherwise.[85]

V. CONCLUDING REMARKS

On the whole, the ITP Regulations appear to have adopted the right blend of regulatory relaxations and investor protection. Looking at the intangible and dynamic nature of start-ups, flexibility in terms of the objects of the issue has given start-ups the freedom to mould their business plans to suit their evolving needs. Furthermore, the discretion given to promoters to determine issue price, subject to suitably cautioning investors, is a welcome measure, implicitly following the *caveat emptor* principle. However, this is a high-risk, high-gain proposition, and therefore, SEBI may consider introducing elements of the U.K. system of nominated advisors, to ensure that the discretion is judiciously and carefully exercised.

However, SEBI ought to have introduced a requirement to justify sustainable profitability, at least on A *prima facie* basis, to be eligible to list on the ITP, as is the case with listing on the ChiNext. This would act as an entry barrier for weak startups and would ensure that only companies with a stable future get listed. The ITP Regulations could have also provided incentives for migration to the primary stock markets by extending migration fee waivers in such cases to reduce transaction costs. The minimum trading lot of ten lac rupees is also on the higher side and may result in illiquidity, which would defeat the very purpose of the ITP Regulations, which is to provide easy access to funding for start-ups. In these respects, the ITP Regulations represent a missed opportunity to 'Start-up India'.

Regardless, the ITP Regulations are a big step in the right direction which will allow for easier financing for Start-ups, if they decide to list on ITPs. Keeping financing considerations aside, an aspect that may be overlooked is the likely positive impact of listed entity visibility on stock exchanges, since most start-ups are relatively unknown. Before the ITP Regulations, these start-ups would rely on word of mouth or social media

[85] *Id.* at Reg. 106ZF.

to get recognized, and stake a claim to their piece of the pie. The flip side is that this may tempt retail investors to invest in risky businesses, without fully understanding what they are dealing with. To counter this, the SEBI imposed investment restrictions such as lock-in and minimum informed investor requirements. This was a prudent investor protection measure because it is not only start-up promoters who dream of deals like the Facebook-WhatsApp acquisition, but also retail investors, who would gladly tag along for the ride. Even SEBI has recognized that start-ups fail to achieve projected returns 95% of the time.[86]

The move to include technology Start-ups in the ICDR regulatory framework by setting up ITPs is clearly in line with Narendra Modi's call to "Start-up India, Stand-up India". As an alternate capital raising platform, it has all the basic elements required to thrive as a capital market. However, constant vigilance by SEBI may be required as this is an unpredictable market. Consequently, it is likely that there will be amendments to the ITP Regulations, and even departures from the underlying ideologies. The next few years may be spent in trial and error with the SEBI having to intervene and issue clarifications on issues such as what constitutes "substantial value addition" or "suitable cautions", failing which it may become necessary to involve courts as a last resort. In this scenario, we may see the ITP Regulations mirroring the dynamic nature of start-ups themselves.

[86] *See* D. Gage, *The Venture Capital Secret: 3 Out of 4 Start-Ups Fail,* WALL ST. J., Sept. 20, 2012,
http://www.wsj.com/articles/SB10000872396390443720204578004980476429190.
(Failure to realize projected return on investment is often considered to be a failure).

MAKING BUSINESS DISPUTE RESOLUTION EASY IN INDIA: ARBITRATION CLAUSE NEEDS TO BE TAKEN SERIOUSLY

PROF. ANURAG K AGARWAL*

Dispute resolution through arbitration is the chosen method for businesses, however, it has often been experienced that due to a poorly drafted arbitration clause in the main contract or in a separate contract, there is no effective arbitration between the parties and there is a new dispute regarding the existence of the arbitration clause, which has to be resolved at the preliminary stage so as to enable the parties to take part in arbitration proceedings or go ahead with litigation in the public courts. The possibility of a decision regarding the interpretation of arbitration clause be appealed in a higher court depends on the nature of parties and the amount at stake. Litigious parties, not willing to settle, have no qualms infighting it out till the highest court. And, in this process the original dispute takes a back seat. The paper examines some interesting disputes regarding the arbitration clause, which were decided by courts, and could have easily been avoided had the parties been cautious at the time of entering into the contract. The paper also provides suggestions for some common and avoidable problems to help businesses save time, effort and money which otherwise get wasted in getting the dispute resolution clause interpreted in court.

CONTENTS

I. Introduction
LT. The Model Law, the 1996 Act and the Arbitration Agreement
III. Problems and Suggestions
IV. Conclusion

I. INTRODUCTION

In October 2015, the World Bank released the rankings - benchmarked to June 2015 - of countries in regard to the ease of doing

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business.[1] India overall ranked 130in the list of 189 countries and under the head 'enforcing contracts', India ranked 178 whereas Singapore ranked 1. These numbers speak volumes about the importance given to contracts in India. It is quite obvious that typically contracts are not taken seriously and formation of a contract often takes place in a casual manner.

Astute businesspersons, however, pay attention to contract formation and various clauses. At the time of entering into a contract, prudent business parties are not only thinking about the performance of contract, but also about the resolution of disputes, in case a dispute arises at a later date. The firm of the future would not like to live in uncertainty and would prefer to nip in the bud any dispute which arises. Still better, it would prefer to avoid any disputes, so that there is no need of any resolution of disputes. The word 'dispute' itself connotes negative meaning, and any firm - particularly the firm of the future - would not like to waste its time, effort, and money on dispute resolution. Thus, it becomes extremely important for such a firm to think well in advance about the dispute resolution clause while drafting a contract for business.

It becomes critical in case it is an international contract, involving laws of two or more countries. Most business contracts, of late, prefer an arbitration clause for resolution of disputes. Noted Indian jurist and lawyer Nani A. Palkhivala had expressed his views about the international commercial arbitration in the following words:

> *"...when the International Chamber of Commerce at Paris started offering the services of its Court of Arbitration, businessmen in different countries found it convenient to avail themselves of that facility. In course of time that 'convenience' became a 'preference' and the preference has now ripened into a necessity. ... If I were appointed the dictator of a country, in the short period between my appointment and my assassination I would definitely impose a law making international arbitration compulsory in all international commercial contracts...."*[2]

[1] World Bank Group: Doing Business, http://www.doingbusiness.org/rankings (last visited Sep. 24,2015).
[2] NAM A. PALKHIVALA, WE, THE NATION: THE LOST DECADES, 205,209 (1994).

Such are the advantages of international commercial arbitration; however, the arbitration clause has to be taken seriously. Any firm which accepts such a clause mechanically, without paying due attention, usually finds itself at the receiving end.

II. THE MODEL LAW, THE 1996 ACT, AND THE ARBITRATION AGREEMENT

The United Nations Commission on International Trade Law (UNCITRAL) produced the final draft of a Model Law on international commercial arbitration in 1985. This law was recommended by the General Assembly of the UN on December 11,1985, to all member states. India, in furtherance of this recommendation, enacted The Arbitration and Conciliation Act, 1996, and repealed the then existing law on arbitration, The Arbitration Act, 1940.

Section 7 of the 1996 act defines arbitration agreement and lays emphasis on the fact that any arbitration agreement must be in writing. This is clearly a deviation from the well-established contract law in India, which recognises an oral agreement to be as good as a written agreement. While mentioning that the arbitration agreement should be in writing, the section gives it a broad interpretation and includes even exchange of letters, telegrams, etc. The basic purpose has been to reduce the disputes regarding the existence of an arbitration clause itself. The section, as amended by the Arbitration and Conciliation (Amendment) Act 2015 stands as follows:

> *"Section 7- Arbitration agreement.—*
>
> *(1) In this Part, "arbitration agreement" means an agreement by the parties to submit to arbitration all or certain disputes which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not.*
>
> *(2) An arbitration agreement may be in the form of an arbitration clause in a contract or in the form of a separate agreement.*
>
> *(3) An arbitration agreement shall be in writing.*

(4)An arbitration agreement is in writing if it is contained in—

(a) a document signed by the parties;

(b)an exchange of letters, telex, telegrams or other means of telecommunication including communication through electronic meanswhich provide a record of the agreement; or

(c) an exchange of statements of claim and defence in which the existence of the agreement is alleged by one party and not denied by the other.

(5) The reference in a contract to a document containing an arbitration clause constitutes an arbitration agreement if the contract is in writing and the reference is such as to make that arbitration clause part of the contract."

Practically, clauses in any contract must be plain, simple and fully convey the intention of both the parties. At times, this does not happen and clauses in the *contract, prima facie,* are conflicting or contradictory. Some of the cases illustrate the point well.

A. Coal India versus Canadian Commercial Corporation(CCC)

In a case decided by the Calcutta High Court in 2013,*Coal India versus CCC*[3] - the dispute resolution clause created confusion regarding the country whose law would be applicable. The matter pertained to a contract between Coal India Ltd, an Indian public sector undertaking and Canadian Commercial Corporation, a Canadian public sector organisation, for developing and managing the opencast Rajmahalcoal mine in the state of Jharkhand.The clauses as cited in the judgement were as follows:

"Clause 32. Governing Law

This Contract shall be subject to and governed by the laws in force in India.

[3] Coal India Limited v. Canadian Commercial Corporation, 2013 (2) CHN 494.

Clause 34.0 Disputes

34.1 The Parties mutually agree that in the event of a dispute of any nature whatsoever, related directly or indirectly to this Contract, they shall use every means at their disposal to settle said disputes on an amicable basis.

34.2 Should the Parties fail to reach an agreement within thirty (30) days after the dispute arises or any such greater period as may be mutually agreed upon the dispute may be submitted by either party to arbitration for final settlement under the Rules of Conciliation and Arbitration of the International Chamber of Commerce, Paris, France, by one or more arbitrators appointed in accordance with the Rules.

34.3 Said arbitration shall be held in Geneva, Switzerland and be conducted in the English Language.

34.4 The Parties mutually agree that if the decision rendered as a result of the aforementioned conciliation or arbitration involves the payment of compensation, the amount of such compensation shall be expressed and payable in Dollars.

34.5 Both Parties shall make endeavours not to delay the arbitration proceedings. The decision of the arbitrators) shall be final and binding on both the parties. Enforcement thereof may be entered in any court having jurisdiction."

The dispute arose as to which law would be applicable after the arbitral tribunal had given its award - Indian, French, Swiss, or English as some of the sittings were also held in England. The Indian party, Coal India, insisted that Indian law would apply and courts in India had the jurisdiction. On the other hand, CCC argued that courts in India did not have any jurisdiction. The Calcutta High Court agreed with CCC and held:

"...Indian law, although specified in Clause 32, would have no bearing in the field of arbitration.... In any event, Indian Court could not have any role to play at all, firstly, as the parties agreed to exclude it

> *that we find on a combined reading of Clause 34, secondly, the law of arbitration being silent, the venue would be the guiding force that would be abroad and thirdly, the arbitration was between an Indian party and a foreign party, having not specifically agreed to be bound by the Indian arbitration law."*

This problem could have been avoided by proper drafting of the clauses, leaving no doubt regarding the jurisdiction of courts and the law governing the arbitration.

B. NNR versus Aargus

In another case, *NNR versus Aargus*[4], the Delhi High Court decided in favour of interpretation of clauses as suggested by the foreign company. Aargus was an Indian freight and cargo company. It entered into a contract with a Chinese company named NNR, which itself was a joint venture between a Japanese company NNR Global Logistics and another Chinese company, Shanghai YUD International Forwarding Co. Ltd., for acting as each other's agent in the business of international freight and cargo. The contract contained an arbitration clausewhich provided that ICC Paris rules would be followed, however, the parties did not mention anything about the place of arbitration. The clause was as follows:

> *"Arbitration: In case any dispute arises in connection with this agreement, both parties shall make their best efforts to settle it amicably. However, if said efforts have been exhausted such disputes shall be finally settled under the rules of conciliation and arbitration of the International Chambers of Commerce."*

Later, a dispute arose and NNR suggested Kuala Lumpur in Malaysia as the venue of arbitration. It was objected to by the Indian companyAargus, however, subsequently ICC Paris fixed the seat of arbitration at Kuala Lumpur. Arbitration proceedings, therefore took place at Kuala Lumpur, and the arbitrator allowed NNR's claims.Earlier,

[4] NNR Global Logistics (Shanghai) Company Limited & Anr. v. Aargus Global Logistics Private Limited & Anr., 2012 VIIIA.D. (Delhi.) 125.

NNR had written a letter to Aargus, and the relevant portion as cited in the judgement is as follows:

> *"In view of the fact that the closest connection of the Agreement is with India, Indian law may be applied as the substantive law of the Agreement and the arbitration may be held in the English language. However, the arbitration agreement itself would be exclusively governed by the laws of Malaysia."*

Aargus challenged the award in the Delhi High Court and the short question for consideration for the High Court was whether it had any jurisdiction to hear the matter. Based on the changed law in the country, after the *Balco*[5] decision, pronounced by a Constitutional Bench of the Supreme Court on September 6, 2012, the Delhi High Court had no doubt that it did not have any jurisdiction to hear the matter as the parties had, expressly or impliedly, agreed to the jurisdiction of Malaysian courts once the award had been made. The High Court cited the relevant portion from the *Balco* judgement,

> *"...the legal position that emerges from a conspectus of all the decisions, seems to be that the choice of another country as the seat of arbitration inevitably imports an acceptance that the law of that country relating to the conduct and supervision of arbitrations will apply to the proceedings."*

Had the parties been more aware and cautious and provided the details regarding the venue of arbitration in the dispute resolution clause itself, there would have been no reason to file a petition in the Delhi High Court, and the parties could have saved themselves from something they never wanted to do - to go to a court of law.

C. *Gujarat NRE Coke Ltd. versus Gregarious Estates Incorporated*

Gujarat NRE (Natural Resources Environment) Coke Ltd, an Indian company, entered into a Charter Party Agreement with Gregarious Estates Incorporated, a Singaporean shipping company in

[5] Bharat Aluminium Company Limited (BALCO) & Ors. v. Kaiser Aluminium Technical Service, Incorporate & Ors., (2012) 9 S.C.C. 552.

2008.In simple words, a Charter Party Agreement is a contract between the owner of a vessel and the charterer for using the vessel. The shipping company was supposed to make the vessel available at Dalian shipyard in China. According to Gujarat NRE, the agreement was signed in Kolkata - this fact itself would have given jurisdiction to the Calcutta High Court - however, records later showed that the contract was concluded in London. Gujarat NRE had entered into the contract with the shipping company to bring coal from foreign countries to India for consumption in its power plants at different places. Interestingly, all those places were outside the jurisdiction of the Calcutta High Court. The Charter party contained a dispute resolution clause, which was as follows:

> *"Cl. 84 - Arbitration General Average/Arbitration in London and . English Law to apply. Latest BIMCO/LMAA Arbitration Clause to apply with US $100,000 for Small Claims Procedure. Dispute Resolution Clause English Law, London Arbitration*
>
> *(a) This contract shall be governed by and construed in accordance with English Law and any dispute arising out of or in connection with this Contract shall be referred to arbitration in London in accordance with the Arbitration Act 1996 or any statutory modification or re-enactment thereof save to the extent necessary to give effect to the provisions of this Clause. The Arbitration shall be conducted in accordance with the London Maritime Arbitrators Association (LMAA). Terms current at the time when the arbitration proceedings are commenced. '**

It needs to be noted that the Arbitration Act 1996 referred to in the above-mentioned clause is not the same as that of the 1996 act of Indian law. The Indian law on the same subject is titled the "Arbitration and Conciliation Act, 1996," whereas the English law is titled the "Arbitration Act, 1996." Hence, it is quite clear from the clause in the Charter party agreement that the reference was to the English Law, and not to the Indian law.

[6] Gujarat NRE Coke Limited & Anr.v. Gregarious Estates Incorporated & Ors., 2014 (1) C.H.N. (CAL.) 64.

Disputes arose between the parties and Gujarat NRE filed a case in Kolkata courts to restrain the other party from initiating arbitration proceedings, and if already started, stay the proceedings, whereas Gregarious Estates filed a case in London courts and also started arbitration proceedings in London. The lower court in Kolkata observed that it did not have competence, due to lack of jurisdiction, to hear the matter and hence denied passing any order restraining arbitration. Against this order, Gujarat NRE filed an appeal in the Calcutta High Court.

It was argued by the shipping company's lawyers that when the parties had entered into the arbitration agreement and decided to have any disputes resolved in London, it would have been very clear between the parties that the seat of arbitration was specified as London, the applicable law was specified as English Law, and the procedure to be followed for resolution of disputes was the London Maritime arbitration procedure. After agreeing to these details, the parties were not at freedom to resile, and as according to the parties, the dispute resolution was envisaged to take place in London, Indian courts had no jurisdiction over the dispute and as to how the arbitration was conducted. In other words, it was simply a case when the parties had excluded the jurisdiction of the Indian courts, and accepted the jurisdiction of the English courts in furtherance of the arbitration to be conducted in London. Ignoring these dauses and insisting on the matter to be heard in an Indian court - the Calcutta High Court - Gujarat NRE was unnecessarily trying to interfere with the arbitral proceedings in London, and any other legal proceedings associated with said arbitration in London. Party autonomy is sacrosanct ^n arbitration matters; however, a party is not free to do anything :ontrary to the provisions of the contract. In any case, provisions of the irbitration agreement could not be ignored.

The counsel for Gujarat NRE Coke made the argument, quite surprisingly, that Indian courts were free despite the existence of an irbitration clause providing arbitration in London, to examine the matter :>n two grounds: convenience and cost. Thus, the lawyer argued that it vould neither be convenient nor cost-effective for the Indian party to go :o London to contest both the arbitration and the suit in the English

court, and for this reason the matter fell within the jurisdiction of the Indian courts, particularly the Calcutta High Court, and it was a bounden duty of the court to decide the matter.

The Calcutta High Court did not agree with the contention of the lawyer for Gujarat NRE and decided on the basis of the dispute resolution clause in the contract itself, which excluded the jurisdiction of Indian courts as far as arbitration and related matters were concerned.

The clause, read as a whole, does not appear to be ambiguous, and it can be said to be simple stubbornness on the part of one party to file a petition in the court and clogging courts' dockets. It is, however, neither for the first time, nor for the last time that such a matter has been raised in the court. It depends on the courts as to how they treat a dispute resolution clause and how they dispose of the matter.

D. Wellington A ssociates versus Kirit Mehta

In the case of *Wellington Associates versus Kirit Mehta",* the Supreme Court of India in 2000 faced the problem of interpreting the dispute resolution clause. Wellington Associates was a company registered in Port Louis, Republic of Mauritius. In 1995, it entered into a contract with Kirit Mehta, promoter and Managing Director of an Indian company, CMM Ltd. Mumbai for dealing in equity shares. While entering into the contract, the parties had agreed to the following dispute resolution clause:

> *"Clause 4: It is hereby agreed that, if any dispute arises in connection with these presents, only Courts in Bombay would have jurisdiction to try and determine the suit and the parties hereto submit themselves to the exclusive jurisdiction of the Courts in Bombay.*
>
> *Clause 5: It is also agreed by and between the parties that any dispute or differences arising in connection with these presents may be referred to arbitration in pursuance of the Arbitration Act, 1947 (sic), by each*

[7] Wellington Associates Limited v. Kirit Mehta, A.I.R. 2000 S.C. 1379.

> *party appointing one arbitrator and the arbitrators so appointed selecting an umpire. The venue of arbitration shall be at Bombay."*

The clauses, as is obvious, did not give a clear indication as to whether the parties wanted the disputes to be resolved in court or whether they intended for the matter to be resolved through arbitration In case any of the clauses are ambiguous, typically one party would like to go ahead with one interpretation, whereas other party would prefer to stick to the other interpretation. The same happened in this case. When a dispute arose between the parties, Wellington Associates invoked arbitration clause and appointed their arbitrator, however, Kirit Mehta denied the arbitration clause and said that the jurisdiction lay with the courts in Bombay and the matter could not be referred to arbitration by relying on the words used in clause 5 - *may be referred* - and argued that *'may be'* meant that it was not at all mandatory to refer the matter to arbitration, however, it was simply a suggestion and provided a choice to the parties. On the contrary, Wellington Associates argued that *'maybe'* had to be interpreted as *'shall',* because once the parties had entered into a contract providing a dispute resolution clause with arbitration as the mechanism for resolving disputes, it was a mandatory clause and with that clause the parties had agreed to exclude the jurisdiction of courts.

On this point alone, the matter reached the Supreme Court, which decided in favour of Mehta and held that in case contradictory provisions existed in any dispute resolution clause in a contract, it was not possible to understand the real intention of the parties and hence the parties were at liberty to invoke arbitration or not.

These contradictory provisions in the contract nullified the existence of any dispute resolution clause and the parties were back to square one. The parties to any contract are always free to refer any dispute to arbitration, if they had not decided to do that before the dispute arose, and they are also free to file the case in the lowest court of competent jurisdiction if they don't want to take the matter to arbitration. However, in case the parties had decided to refer any matter to arbitration, the parties waive their freedom and become bound to get the dispute resolved through arbitration only.

E. Enercon (India) versus Enercon GmbH[8]

In a case involving two wind energy companies - one German and one Indian - besides the original business dispute, there was a dispute between the parties regarding the dispute resolution clause itself. The German company insisted that there had been mutual communication through letters, e-mail and even text messages, which should all be interpreted to be leading to a concluded contract with the dispute resolution clause providing for arbitration in London. On the other hand, the Indian company was of the view and argued the same in the court that there had never been a concluded contract between the parties, and in the absence of a concluded contract, there was no question of an arbitration clause which the parties had agreed upon.

To get this issue resolved the parties filed several petitions - in the district court in Daman, in the Bombay High Court, in the Supreme Court of India, and also in courts in London. Finally, the matter was decided by the Supreme Court of India in February 2014, when the court held that it appeared that when the parties had decided to enter into business agreement in 1994, they had since been decided that the dispute shall be resolved through arbitration in London. And, therefore, the absence of a concluded contract after ten years of the initial contract - in 2004 - would not cast a shadow on the applicability of the dispute resolution clause agreed by the parties in the very beginning. But, it had been a very long legal journey for both the parties and the parties must have wasted huge sums of money, time and effort. All these resources could have been very well utilised by the parties for their business had the parties been a bit more cautious at the time of entering into the contract, and making it clear as to whether the arbitration clause would be applicable or not.

III. PROBLEMS AND SUGGESTIONS

A. Undue Haste

One of the most commonly observed reasons for confusion in dispute resolution clause is the undue haste with which parties act at the

Enercon (India) Limited & Ors. v. Enercon GMBH & Anr., 2014 (2) S.C.A.L.E. 452.

time of entering into a business deal. As is normally seen, there is a tendency to pay utmost attention to the business details, however, legal aspects take a back seat and often dispute resolution clauses do not even find mention in the list of agenda items to be discussed between the parties at the time of negotiation. This is of utmost importance for businesspersons would not like to be embroiled in controversies in dispute is unnecessarily, particularly those disputes which can be easily avoided by being clear at the time of formation of contract. A little bit of circumspection at that time is of great value for the future relationship to be strong.

B. Lack of Understanding

It has also been observed on a number of occasions that business parties do not have a very good or clear understanding regarding the dispute resolution procedure to be followed, particularly when they are entering into an international business contract. Lack of knowledge and understanding of the legal aspects, coupled with aversion for the legal issues makes it uncertain and unpredictable and if both the parties remain oblivious of critical legal issues, then, of course, they suffer whenever a dispute arises; and, at that time the party in a better bargaining power position is able to dominate, which precisely is contrary to the objective of a weaker party in a business contract at the time of formation of contract. On eof the main purposes of entering into a contract is to strengthen the position of the weak party and provide legal ammunition in the form of enforceable clauses in the contract. It is, therefore, necessary that the parties themselves develop an understanding of the legal provisions, and if they are not in a position to do that, they should be willing to take the help of legal counsel at the earliest opportunity, preferably at the time of formation of the contract.

C. *The devil is in the detail*

A closely related issue with 'lack of understanding' is the importance of going into the details of contract, particularly the dispute resolution clause mentioning arbitration. It is very often seen that if one of the parties is able to understand the skeletal structure of the contract and other clauses, there may be certain very important and critical words

and phrases used in the clauses which may, along with punctuation marks, give an entirely different meaning to what the parties, specifically one of the parties, understood while entering into the contract. There should not be any disconnect with the understanding between the parties and what is written in the clause, and to ensure that there is no difference. It is essential for the parties to understand the details of the dispute resolution clause to the last word and the last punctuation mark. For this purpose the help of an able legal counsel is needed, and, therefore, for successful businesses - which in other words, also means successful dispute resolution, and avoidance - a competent legal counsel act as the friend, philosopher and guide. The beauty of law is and its interpretation and a single line contract may suffice the purpose if the parties have clarity, however, in case the parties are not clear about it, extremely long contracts even with hundreds of pages may not serve the purpose.

D. Too Vague or Too Precise

On many occasions, the dispute resolution clauses are found to be extremely vague with just a faint idea expressed in writing about how the parties intend to resolve the dispute in case a dispute arises. Such a clause works very well when the parties have mutual trust and faith and are willing to resolve the dispute in an amicable manner with their best efforts, however, it has been experienced that whenever a dispute arises the parties are not willing to agree on anything, and the dispute resolution clause itself becomes the first victim. It is therefore important not to leave the dispute resolution clause too vague and at least specify some of the essential elements, such as the applicable law, jurisdiction of which court, institutional or ad-hoc arbitration, seat of arbitration, number of arbitrators, language to be used, and a couple of other essential things which the parties can very well anticipated at the time of entering the contract. But, making the dispute resolution clause too precise also has its own problems. The major problem is that of tying the hands of the parties at the back and leaving them with almost no option and flexibility in making prudent choices at the time of resolving the dispute. It is very simple to understand that when a dispute arises, one party would like to continue delaying the resolution, whereas, the other party would like to hasten the process. A little bit of flexibility is definitely needed, and if the

parties had made the resolution clause so precise that there is no room for flexibility, then things become absolutely rigid and it is difficult to make it work. Hence, a fine balance needs to be achieved and that depends on the discretion of the parties at the time of entering the contract.

E. Unworkable

Besides the reason of the dispute resolution clause being either too vague or too precise, there are other reasons, which may make the resolution clause unworkable. The most notable reasons are the nomination of an unsuitable person as arbitrator at the outset, or the parties being in agreement for the arbitral expenses at the time of entering the contract without understanding the implications. It is extremely important for the parties to understand at the time of the formation of contract that the clause must be realistic in nature and therefore the parties must make efforts to resolve the business dispute, rather than trying to set very high standards which may not be achievable for the parties concerned. This may be related to the qualifications of an arbitrator, choice of venue, choice of organisation in case the parties have decided to go for institutional arbitration, the engagement of lawyers, etc. For every such thing, there are different levels of services available, and it is for the parties to decide - jointly and severally - as to how to prioritise their requirements and to what level - both high and low - each would like to swing.

F. Heavily One-Sided

It is the endeavour of the party having more bargaining power in a contractual relationship to get the contract, including the dispute resolution clause, drafted in a manner which suits that party, however, the extra zeal and enthusiasm to get a contract drafted in a manner which is heavily tilted in its favour may boomerang, even if the other party is willing to sign on the dotted line. The most important thing for a contract is that it should be fair, and even if the party with a better bargaining power has got the contract drafted to suit it, it should not be heavily onesided as such contracts may not be upheld in a court of law, particularly in democratic countries with evolved judiciary, keeping public interest in mind. Egalitarian values and public interest are paramount in a large

number of countries were one-sided contracts are looked down upon, and courts - as we have seen very often in India - can go to the extent of exercising their extraordinary discretion to terminate such contracts. Thus, it is important for prudent business is to realise that lop-sided contracts in favour of one party may not serve the purpose at the end of the day. Hence, the contracts should be reasonable and just, providing almost equal and fair opportunity to both the parties to the contract, both performance and resolution of any disputes.

IV. CONCLUSION

Dispute resolution clauses, as we have understood, must not be taken lightly and if they find a place in the contract, must be dealt with due caution and care. These clauses are not just technical formalities to be completed in a draft agreement for the purpose of somehow getting the task of formation of contract completed. Application of mind is required to understand the nitty-gritty of the dispute resolution clause, so that the parties are able to understand the real implications - particularly related to time, expenses and achievable results - and do not fall prey, later on, to another dispute arising because of the dispute resolution clause itself. Agreeing to any dispute resolution clause, proposed by one of the parties, in a mechanical manner can be detrimental to business and even to individuals making decisions for the business.

Clarity of thought and purpose is the foremost requirement for the parties in business as to how they would like to resolve the disputes and the dispute resolution clause can be termed to be serving its real purpose if it reflects the true understanding between the parties. In international commercial contracts, such clarity may be missing due to a large number of factors to be considered at the time of formation of contract. It is better to take a little bit more time to arrive at a decision regarding giving consent to the dispute resolution clause rather than wasting time, effort and money in interpreting it later.

This will undoubtedly help in improving India's position in the international rankings for doing business.

COURT'S CONTRIBUTION TO THE FAILURE OF THE CORPORATE RESCUE REGIME- LESSONS FROM THE PAST AND VISION FOR THE FUTURE

PSS BHARGAVA*

Drawing from the ripple effect of the failure of a corporate body on the economy and other stakeholders, a highly efficient insolvency/rescue regime has always been desirable. While attempts are being made to overhaul the existing regimes, this project aims at looking at a peculiar cause for the failure of the existing rescue regime (SICA). While appreciating the changes that are being effected (by the Companies Act, 2013), this paper primarily ventures to see if such peculiar cause is sufficiently addressed.

While the Indian corporate rescue law was criticized for reinforcing the 'debtor in possession' model and has been notorious for its vulnerability to misuse, very less literature has been dedicated to identify the contribution of courts to its failure. While an effective rescue/insolvency regime is a precondition to reasonable allocation of risks among the stake holders, the judicial anxiety in protecting the employees or its predisposition with revivalist tendencies (devoid of the commercial viability), ended up in allocating the risks unreasonably and more importantly, in an uncertain manner. Interestingly, in balancing the stakeholder interests, the courts in one set of cases have upheld the economic logic behind the collective process of rescue, and in the other set of cases have ended up interfering with the rescue regime, thereby forcing the stakeholders to pursue individual remedies to save costs. Given the insolvency laws and the diverse remedies available to the secured creditors, and in the light of above analysis, the author would suggest that the overall process which ought to be a collective rescue mechanism balancing the interests of all the stakeholders, is invariably skewed in favor of some stakeholders, thereby unreasonably allocating the risks.

By indicating the need for maintaining the balance of stakeholders' interests, the author concludes by comparing and contrasting the provisional rescue regime as enshrined in the Companies Act, 2013 with the existing one,

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thereby attempting to evaluate the degree of insulation from the judicial interference that it manages to achieve.

CONTENTS

I. *Introduction*
II. *SICA- Operational Ambit*
III. *Scope of Analysis*
r *Analysis of the Judicial Approach*
v. *Role of high Courts post winding up recommendation by the BIFR*
v. *Giving Precedence to SICA*
VI. *Misuse of Moratorium*
VII. *Observations*

I. INTRODUCTION

The need for an effective corporate insolvency or rescue mechanism stems from its commercial relevance to the economy. As it is evident from the common experience, a failure of a corporate body may end up in having a ripple effect on the economy, thereby impacting the shareholders, creditors, employees, consumers and the economy as a whole. Thus, a highly efficient and effective insolvency/rescue regime is always desirable. Conceptually, a rescue regime is said to be for the benefit of the debtor, and an insolvency regime is said to be for the benefit of a creditor. The main tasks of either of them shall be minimising the overall costs/losses, and this is done through an agile separation of the viable business from the non viable ones, and timely reorganisation of the former and/or swift liquidation of the latter.[1]

An effective insolvency/rescue regime must aim at *a reasonable allocation of risks* so as to address the creditor interests by maximising returns, to promote economic growth through efficient reallocation of resources, to incentivise the development of credit markets, to protect other stakeholders such as employees and shareholders, thereby ultimately leading to enhancement of investor confidence by simplifying

[1] MINISTRY OF FINANCE, GOVERNMENT OF INDIA, INTERIM REPORT OF THE BANKRUPTCY LAW REFORM COMMITTED at 12 (Feb. 2015).

the exit route.[2] However, certain practice related and procedural issues have led to the failure of either of the regimes in India, which led to a situation where the creditors started preferring the individual recovery proceedings over the collective regimes. The problem with such approach is that while the debt enforcement forms an integral issue of any insolvency regime, the subjugation of otherwise economically viable companies to such piecemeal recovery proceedings leads to conflicts, disorderly distribution, delays and depletion in value of the company, which could have otherwise been rescued.[3] Therefore this trade off between an efficient rescue and insolvency regime and the individual recovery proceedings must always be highlighted so as to minimise the costs and maximise the productivity of economic resources.

While the liquidation proceedings in India are enshrined in the Companies Act, 1956[4], the statutory rescue procedure is handled by the Sick Industries Companies Act, 1985 ('SICA'), the only central law dealing with the subject.[5]

II. SICA - OPERATIONAL AMBIT

The corporate rescue procedure in India is encompassed in the SICA, but it is limited to the industrial companies, i.e. the Act is operationally limited to only India's organised manufacturing sector. Therefore, any comment on India's rescue procedure and the impact of such procedure on the India's economy must always be juxtaposed with the fact that they are limited to only industrial companies, and that there is no statutory policy governing the non-industrial companies. A brief understanding of the literature surrounding the need for State intervention into the industrial sickness can be closely related to its concern with the impact of such sickness on the stakeholders.

While the early concerns have been *"to strengthen the industrial sector in newly independent India",* the other broader concerns such as *"an*

[2] *Id.* at 8.
[3] *Id.* at 13.
••Companies Act, 1956, Part VII.
[5] Nimrit Kang & Nitin Nayar, *The Evolution of Corporate Bankruptcy Law in India,* MONEY AND FINANCE, ICRA Bulletin, Mar. 2004.

anxiety to protect the workers of sick industrial companies from unemployment"[6] have emerged significance over the course of years. Therefore it appears that an ambitious *pro-revival* stance seems to have percolated into the official policy, rather attributed to the official policy, given the broader concerns such as protection of employment, productive assets or the health of the economic industry per se. The pro-revival approach *(devoid of the commercial viability)* became so deeply entrenched that, as we shall see in the later analysis, it also percolated into the judicial system.

While the *P. Tiwari Committee* explicitly recommended the setting up a *non-court* authority for the purposes of making a choice between rehabilitation and liquidation (as the severe delays caused in the liquidation proceedings were attributed to the courts)[7] which the Act ended up in enacting successfully. The implementation of the Act and the interference of the courts into its implementation ended up in increasing the overall costs by creating a *scope for delays and frivolous proceedings.*

While it is evident that the Act aimed at decreasing the overall costs of rescue/liquidation by *insulating it from the influence of the courts,* and thereby, consequentially increasing the value for the creditors, the practice of the Act indicates that the courts succumbed to the dilatory tactics and thereby increased the costs.[8] Though this may sound to be a historical claim, it is not devoid of *contemporary and contextual significance.*

[6] Kristin Van Zwieten, *Corporate Rescue in India: The Influence of the Courts,* Legal Research Paper Series, Paper No. 37/2014, 1, JOURNAL OF CORPORATE LAW STUDIES 2015, (July 2014).
[7] Deepti Kanojia & Meenakshi, *Insolvency Law in India with Special Reference to Corporate Insolvency,* 3.1, INT. J. OF TRADE AND COMMERCE—IIARTC, 121-126 (2014).
[8] Editorial, *Bankrupt Process,* THE FINANCIAL EXPRESS, Feb. 12, 2015, *available at* http://www.financialexpress.com/article/fe-columnist/editorial-bankrupt-process/41793/.

III. SCOPE OF ANALYSIS

While the process under SICA is often divided into five stages[9], i.e. the stage of application, investigation, decision making, formulation of a scheme, and winding up,, and there are demands for amendments (rather, an overhaul) to almost each of these stages, this paper limits itself to the concerns with the stage of making the choice/decision between the liquidation and rehabilitation, and *especially in such cases, wherein the court has read that the power of BIFR to recommend the liquidation proceeding shall only be the last resort[10] or that there shall be moratorium against any other action by any creditor.[1]* 'Though the liquidation regime and the rescue regime are two separate areas of research with their own limitations and research questions, this paper deals with specific provisions of SICA, whereunder the logical corollary of the impossibility of the rescue shall result in winding up.

While the conventional criticisms against SICA, for reinforcing the *debtor in possession model* of operation which ultimately end up either in practice of dilatory tactics by the debtors who exploit the moratorium procedure, or in siphoning of assets by the managers or in seeking further loans through coercion, are already in place,[12] this paper concentrates on those cases wherein the desired effects of the Act, which was originally seemed to have been designed for providing a swift remedy in case of a liquidation or rescue, have been affected by the courts assumed interpretative power, so much so that a demand is currently being made to immediately substitute the rescue procedure with a comprehensive insolvency code encompassing a swift rescue and liquidation procedures.

This paper considers the issue of delay in the disposal of winding up petitions by the HCs, despite a confirmed opinion by BIFR to this effect, and the issue of grant of moratoriums to the debtor companies by the courts, which

[9] Sidharrth Shankar, *Base Insolvency Law on Viswanathan Committee Report,* THE FINANCIAL EXPRESS, Mar. 2, 2015, *available* ddittp://www.financialexpress.com/ article/fe-columnist/base-insolvency-law-on-viswanathan-committee-report/49242/.

[10] Maharashtra Tubes Ltd v. State Industrial and Investment Corporation of Maharashtra Ltd, (1993) 78 Comp Cas 803 [6].

[1] Real Value Appliances Ltd v. Canara Bank, AIR 1998 SC 2064.

[12] Zwieten, *supra* note 6.

end up in paying lip service to the dilatory tactics employed by the debtors. By inferring that the delay in decision making in cases of winding up petitions and the grant of moratoriums ultimately end up in forcing the creditors to enforce security interests rather than invoking the insolvency proceedings, this author reaches the conclusion *that the benefits otherwise available to various stakeholders, shall thenceforth be restricted to only one set of stakeholders, thereby severely crippling the object and purpose of an insolvency regime.*

IV. ANALYSIS OF THE JUDICIAL APPROACH

To understand the approach of the courts in respect of the corporate rescue regime, this paper compares two sets of cases. One set of cases deal with the judgments which upheld *the overriding effect ofSICA over other laws,* and the other set of cases deal with those judgements which often seem to be *intervening in the rescue procedure,* thereby rendering the procedures ineffective and increasing the costs for the stakeholders.

The reason for adopting a *compare and contrast* analysis of the two sets of cases is to bring forth the fact that while the courts were dealing with the same issue of balancing competing interests in both the set of cases, it is surprising that one set of cases resonates and bolsters the demand for an agile rescue regime and the other set of cases reflect the actions of the court which end up in diluting the letter and spirit of the law meant for an effective and swift rescue or liquidation regime. This analysis of the cases which are decided under the Act and the cases which are decided in connection with the Act, aims to point out that the courts have been facing the same issues, but they ended up with decisions having diverse and unintended consequences.

On analysis, it is found that while the provisions of the Act explicitly seem to be insulating the decision making from the ambit of the courts, the claim that the courts have been instrumental in the failure of the rescue regime not only reminds us the fact that the courts still retain

the power to liquidate the company or the power to review the decision oftheBIFR.[13]

The set of cases which upheld the overriding power of SICA over other recovery procedures such as the RDDB Act, help us understand the judicial stance with respect to the rescue procedure and thereby, indicating the explicit recognition of commercial significance of the swift and effective rescue regime for the overall benefit of the stakeholders.

The set of cases in which the courts have either permitted the exploration of rehabilitation option (by grant of a moratorium) even after recommendation of liquidation by the BLFR, or the cases in which the court ventured into the merits of the recommendations of the BIFR to suggest that the option of liquidation shall be the last resort, suggest that by imposing its priorities, the courts have not only delayed the identification and bringing into effect a swift rescue process, but they also fell prey to the dilatory tactics, which ultimately ended up in increasing the costs for the stakeholders. Given the delays in affecting a winding up, these procedural delays meant a further increase in the costs and a further delay in the *pre winding up procedures.*

While calling for a recognition of a more central role for the courts in understanding the failure of SICA, Kristina Van Zweiten theorises that *the judicial practice of permitting companies to explore rehabilitation options even after the recommendations of liquidation by the BIFR* and the *differential treatment of various stakeholders* while granting moratoriums have ultimately ended up in failing to achieve swift remedies.[14] As the ramifications of the cases suggest, this assumption of the power by the courts is not only a digression from the letter of the Act but also from the spirit of the Act.

V. ROLE OF HIGH COURTS POST WINDING UP RECOMMENDATION BY THE **BIFR**

Given the recommendations of the Tiwari Committee with respect to the delay in the processing of the winding up proceedings and

Sick Industrial Companies (Special Provisions) Act, 1985, § 20(2).
Zwieten, *supra* note 6.

the subsequent enactment of the SICA, this Section deals with the approach of courts in conceptualising the role of High Courts in case of a recommendation of winding up by the Board, given the balance that must be stricken between the intention of the Act and the practical implementation of it.

In the Case of *D Ravi Kumar v. Union of India*[13], the employees of a company, which was recommended to be wound up by the BIFR, filed a petition before the single judge bench of Madras HC challenging the constitutionality of Section 20 (2), which provided that *"'the High Court shall on the basis of the opinion of the Board, order winding up of the sick industrial company'"*, on the ground that the section does away with the exercise of judicial discretion or judicial application of mind by the High Courts, which is otherwise mandated by the Companies Act, 1956. However, interestingly, rather than considering whether the assailed Section is directory or mandatory, the division bench held that, 'irrespective of the nature of the Section, the application of the Section either ways shall be constitutional as the sick companies form a class by themselves and hence they can be subjected to differential treatment'.

The constitutionality of Section 20 was again challenged before a division bench of the Madras High Court in the case of / *M Malhotra v. Union oflndia*[16]. The court after an analysis of the scheme of the Act and various provisions there under held that, the proceedings before the BIFR are judicial proceedings, and are conducted by a body of expert personnel. However, an interpretation of Section 20 indicates that *"it is not possible to hold that even though the opinion submitted by the Board forms the basis for directing the winding up of the sick industrial company by the High Court, the High Court is precluded from examining the correctness of such opinion".* The court held that it is always open for the High Court to examine the correctness of the opinion. The court held that once a recommendation to this effect has been made by the board, the procedure for winding up must be carried on as per the provisions of the Companies Act. Considering the fact that the board shall pass the recommendation of winding up after a thorough scrutiny under Section 16, the court held

D Ravi Kumar v. Union of India, AIR 1995 Mad 58.
J M Malhotra v. Union of India, 1997 89 Comp Cas 600 Mad.

that *it is always open* for the High Court to either carry on with the opinion of the board or to examine the opinion.

This position changed significantly, after the Supreme Court has held that *"'the company judge is not to act like a post office and merely stamp his approval on the opinion of the Board and order winding up of the company. He must consider the recommendation of the Board,* ***form his own opinion*** *and thereafter proceed with the matter".*[17] Relying upon this judgment many cases thereafter considering the question whether the High Court is bound by the recommendation of the BIFR have held that *"the court is not bound by the opinion of the Board. It is in fact obligatory upon the court to examine the opinion of the Board. The court may decide either to proceed with winding up or to even reject the opinion of the Board."*[18]

However, as was cited in the case of *BIFR v. Unity Steels*[19]*,* clear concerns have been expressed with respect to the reading down of the Section 20. When it was submitted that "the very purpose of the enactment might be defeated and might lead to absurd result and serious consequences might flow fro not following the mandatory sense appearing in Section 20", High Court held that such argument might seem attractive, but the fact that it runs counter to the observation of the Supreme Court in the V R Ramaraju case binds it to read the provision accordingly.

Some balance was sought to be maintained in the case of *M/S Sauparnika Beverages Pvt Ltd. v. M/S Karnataka State Industrial and Infrastructure Development Bank*[20]. While the court held that the High Court cannot pass an order of winding up straight away, it held that *"the opinion of the Board cannot be brushed aside. While the High Court is bound to form its own opinion, upon recommendation by the board, the company judge may dispense with the usual practice of issuing notice to the company*

[17] V.R. Ramaraju v. Union of India, [1997] 89 Comp Cas 609.

[18] Ashoka Alloy Steels Ltd. v. BIFR, 2008 142 Comp Cas 915 HP.

[19] BIFR v. Unity Steels Ltd, (2002) 109 Comp Cas 236.

[20] M/S Sauparnika Beverages Pvt Ltd v. M/S Karnataka State Industrial and Infrastructure Development Bank, O.S.A. No. 3 of 2014.

before ordering advertisement of the winding up petition. The court may also appoint, if it deems fit, a provisional liquidator at the initial stage itself.

VI. GIVING PRECEDENCE TO **SICA**

The principle question in the case *K S L Industries v. M/s Arihant Threads Ltd*[21], which was decided by a three judge bench of the Supreme Court, was whether Section 22 of SICA acts as a bar against the recovery proceedings under the RDDB Act. The point of difference between the referring judges was with respect to the prioritization between RDDB and SICA. While Thakkar J held that the RDDB Act which was enacted after the SICA must be given a preference, Kabir J held that since Section 34 of the RDDB Act contains the words *"in addition to and not in derogation of SICA"*, the provisions of SICA would prevail over the act. The impact of either of the views is on the bank, i.e. the creditor. If the view taken by Thakkar J prevails, then the bank can immediately enforce its claims through the recovery officer, and if the other view prevails, then the bank has to wait till the proceedings before BIFR are completed, and appropriate decision is taken there under.

The other important point of consideration in this fact scenario is that firstly, the appeal before BIFR was made by the company after an order for recovery has been passed by the DRT, and secondly, the company was reluctant to attend any proceedings before the DRT. And it is the company which approached the Delhi High Court requesting it to declare the order of DRAT (DRT) as invalid as the proceedings before BIFR were pending.

In deciding upon the precedence of one over the other, the Supreme Court held that *"in view of the non obstante clause contained in both, one of the important tests is the purpose of the two enactments. It is important to recognize and ensure that the purpose of both enactments is as far as possible, fulfilled"*. While drawing the objects behind enactment of SICA, the Supreme Court held that *"the ill effects of sickness such as loss of production, loss of employment, loss of revenue to the Central and State Governments and locking up of investible funds of banks and financial*

K S L & Industries v. Arihant Threads Ltd , (2015) 1 SCC 166.

institutions were of serious concern. In order to fully utilize the productive industrial assets, afford maximum protection of employment and optimize the use of funds of the banks and financial institutions, it was found imperative to revive and rehabilitate the potentially liable sick industrial companies". A legislation for timely determination of a body of experts for providing *preventive, ameliorative, remedial and other measures* was felt necessary, as the *"multiplicity of laws and agencies made the adoption of a coordinated approach for dealing with sick industrial companies difficult".*

The Act defines a 'sick company' as one whose accumulated losses at the end of a financial year are greater than its net worth[22], and it aims to revive and rehabilitate not all sick companies but those (schedule to the IDRA) which presumably are vital to the economy of the nation. The Act contains important provisions dealing with inquiry, assessment of viability and preparation and sanction of a scheme for the proper management of the sick industry. Per Section 18 of the Act, the scheme may comprise of *amalgamation of the sick industrial company with a transferee company, the alteration of the memorandum or articles of association, reduction of the interest or rights of the shareholders and for continuation of legal proceedings, the sale or lease of the industrial undertaking etc.*

Considering the import of the powers of the board, the Supreme Court held that the provisions of Section 22 have been duly enacted to make it easy for the board to evolve a scheme reconstruction. The Supreme Court held that given the multitude of remedies available to the creditors in order to enforce their debt (attachment/auction sale etc), a provision such as Section 22 is quintessential for the purposes of evolution of an effective scheme of reconstruction.

The court was called on to decide if the proceeding for recovery of debt would fall within the ambit of Section 22. While rebutting the claim that the proceeding shall always lie but it is only the enforcement of the order so made against the properties of the company that is stalled, the court answered that *"it appears that the legislative purpose for reconstruction of companies could be thwarted if creditors are allowed to*

The Sick Industrial Companies (Special Provisions) Act, 1985, § 3 (O).

encumber the properties of the company with decrees of the DRT while the BIFR is engaged in reviving the company". By holding that the protection under Section 22 is extended to all suits of recovery of money or property or enforcement of guarantee, the court held that the purpose of the act *"is to protect the properties of the sick industrial company and* ***the company itself*** *from the winding up or levy execution or distress against its properties by its creditors".* However, such protection is not absolute, as the permission of the Board can be sought while undertaking any such action.

The Supreme Court makes an important observation that *"SICA is a special law, which deals with the reconstruction of sick companies and matters incidental thereto, though it is general as regards other matters such as recovery of debts. The RDDB Act is also a special law, which deals with the recovery of money due to banks or financial institutions, through a special procedure; though it may be general as regards other matters such as the reconstruction of sick companies which it does not even specifically deal with. Thus the purpose of the two laws is different".* By upholding that there is necessarily a difference between the two non- obstante clauses of Section 22 of SICA and Section 34 of RDDB Act, the Supreme Court suggested that the overriding effect of one act over the other must be decided on the basis of the broader considerations of the policy and purpose of each of the Acts.[23]

The Supreme Court held that *"'the purpose of one is to provide ameliorative measures for reconstruction of sick companies, and the purpose of the other is to provide for speedy recovery of debts of banks and financial institutions."* Though the court relied upon the specific provision of RDDB Act which saved the SICA, the court laid down that terms suit and proceedings must be given a wider meaning so as to give effect to the intention of the parliament i.e. *"to protect the properties of a sick company, so that they may be dealt with in the best possible way for the purpose of its revival by the BIFR".*

Therefore, the instant case points certain important commercial realities which are very useful for the purposes of our discussion. It is very important to note the interaction between the debtors and creditors on

[23] Ram Narain v. Simla Banking & Industrial Co. Ltd, AIR 1956 SC 614.

the one side and the position of law on the other. In the instant case the debtor company upon default of loan repayment, refused to appear before the DRT. Instead, when the matter was being pursued by the recovery officer, the debtor company voluntarily submitted an application under SICA before the BIFR for declaring it as a sick industry. Once the application was filed, it sought protection under Section 22 of the SICA against the proceedings under RDDB Act, which the courts were very obliged to grant.

Also, the High Court and the Supreme Court, after a careful analysis of the objects and purposes of the Acts, ultimately ended up in upholding the overriding effect of SICA over the recovery proceedings, citing the speciality and the imperativeness of such interpretation.

As was held in cases such as *Asian Bearings and Tools v Coastal Chemicals Limited*[24], the words "shall lie" and "be proceeded with" have different import. *"'In case of former there is an initial bar itself for filing any application and in case of the latter where the application for winding-up are already pending prior to application before BIFR, such proceedings shall be stayed, unless the consent to proceed with has been obtained from the board".*

VII. MISUSE OF MORATORIUM

However, while the intention of the courts in upholding the overriding effect of the SICA is to protect the properties of the sick industry and in fact the sick industry *per se* from multitude of actions of the creditors, the fact that such broad interpretation would leave sufficient gaps for the debtors to arm twist the creditors must be kept in mind. Also this must be read in conjunction with the scope of moratoriums granted under Section 22.

Apart from the above judgments which commented upon the scope of Section 22, the judgements such as *Rishabh Agro Industries Ltd. v. P.N.B. Capital Services Ltd*[25] and *M/s. Foremost Industries (India) Ltd. v The*

Asian Bearings and Tools v. Coastal Chemicals Limited, 1996 86 Comp Cas 590.
Rishabh Agro Industries Ltd. v. P.N.B. Capital Services Ltd., (2005) 5 SCC 515.

AAIFR[26], have clarified that *"the reference made under Section 15 of the Act before BIFR would still be maintainable even though the petitioner company has been directed to be wounded up by the High Court of Bombay and the official liquidator was duly appointed"*. However the important take away from the judgment is the observation made by court in response to the creditor's claim that the application at BIFR has been made in a mala fide manner to further delay the proceedings.[27] The court held that *"the Board of Directors continue to hold all residuary powers for the benefit of the company which includes the power to take steps for its rehabilitation. If there existed a power, its exercise cannot be termed to be mala fide only because it was exercised after the winding up order has been passed"*.

While it is necessary to believe that *"Section 22 was not meant to bring dishonesty nor can it be so operated so as to encourage unfair practice "*[28] and that *"the court should ensure that the same are not interpreted in the manner which may promote any illegality, malpractice, fraud or dishonesty"*[29], *"there is no dearth of instances, where unscrupulous companies had misused this provision by manipulating sickness to ward of legitimate claims of creditors"*[30].

The issue presented by Section 22 is the vulnerability of its abuse. Though a few courts have been holding that *"the protection ofSICA cannot be extended to industrial companies and managements which indulge in shady and dishonest deals, causing serious prejudice to interests of companies as well as their creditors"*[31], the major hurdle that any court faces is lack of jurisdiction.

The case of *Bank of New York Mellon v Zenith InfoTech Limited*[32], wherein the court explicitly held that the erosion of the net worth of the

[26] M/s. Foremost Industries (India) Ltd. v. The AAIFR, (2000) 4 Company Law Journal 362 (Del).
[27] M/S. Zenith Infotech Ltd. v. Union Of India, 2015(147) DRJ 58.
[28] Dy. CTO v. Corromondal Pharmaceuticals, AIR 1997 SC 2027.
[29] N.K. Industries Ltd. v. State Bank Of India, 2002 GLH (1) 773.
[30] Commercial Tax Officer v. Corromandal Pharmaceuticals, AIR 1997 SC 2027.
[31] Vijay Agarwal v. BIFR, [2000] 2 Comp. LJ. 156
[32] Bank of New York Mellon v. Zenith InfoTech Limited, Company Petition No. 28 of 2012 (Bombay High Court, June 30, 2013).

company was a direct consequence of the promoters/directors' actions, and that they have siphoned away the moneys from the company with the sole object of denying payments to the bondholders is very significant for the purposes the analysis. The court also explicitly recognised that it was aware of the fact that *"severalpetitions since the year 1998-2000 seeking winding up of companies have not seen the light of day for the last 10 to 15 years, since this court is not allowed to proceed with the matter in view of Section 22 ofSICA".* However, the court falls back to the conventional argument of the role of the court to point out that it can only interpret and not legislate. The court held that *"If a provision of law is misused and subjected to the abuse of process of law, it is for the legislature to amend, modify or repeal it by having recourse to appropriate procedure, if deemed necessary",* and that any determination by it as to the *bona fides* of the application before the BIFR would amount to trespass of the powers of the BIFR.

Therefore, the reading that the provisions of SICA override the recovery procedures may be for protecting the properties for the formulation of effective revival scheme. The fact that in the process, the debtors are being given sufficient space for acting deviously must not be discounted.

VIII. OBSERVATIONS

Given the delay in disposing the winding up petitions and the mismatch in the intention and implementation of the statute, the impact on the credit availability as a result of this is noteworthy.[33] Further, these inefficiencies coupled with the provisions such as Section 15, which exempts the proceedings under the SARFAESI 2002 from the grant of moratorium,[34] raises another crucial issue for consideration, as it allows the secured creditors to rip the company off the assets even while the proceedings before the BIFR are pending, while the other creditors are

[i3] *A bankruptcy code that works for all,* LIVE MINT, Mar. 17, 2015, *available at* http://www.livemint.com/Opinion/vcvAc3SEKJxhrLAcs7n7tIP/A-bankruptcy-code-that-works-for-all.html?utm_source=copy. [34] Dena Bank v. AALFR, W.P. (C) 2385/2012 (Delhi High Court, July 8, 2014).

left in a long wait till the process is decided or disposed.[35] While it may appear that the position of the secured creditors have been strengthened by the current scheme of things, the fact that consequentially the position of unsecured creditors, the employees and the non voluntary creditors is threatened calls for a revaluation of the statutory mechanism addressing the issues[36].

The analysis of the cases in the previous sections decisively point out that *the pro revival stance of the court, the delays in disposition of the winding up petitions and the grant of moratoriums* contribute to the failure of the corporate rescue regime of India, thereby the creditors are left with no other option but to pursue individual recovery proceedings. The creditors' position is even more threatened by the misuse of moratorium by the debtors, which can potentially stall other remedies. While the secured creditors are to a certain extent guarded by SARPAESI 2002, the position of unsecured and non voluntary creditors is vulnerable. Therefore, the practice of the rescue/ liquidation regime is ultimately resulting in an *unreasonable uneven division of risks.*

It is in this context that the interim recommendations of the Bankruptcy Law Reform Committee must be contextualised. The committee aptly pointed out that *"in the absence of an efficient corporate rescue and liquidation regime in India, it is difficult to prevent creditors from initiating separate debt enforcement actions even for viable businesses, thereby leading to conflicts, disorderly distribution, delays and depletion in value of the company".*[37] The committee pitches for a *"well-functioning, collective corporate rescue and liquidation regime in India that creates the right incentives for all the stakeholders to be involved in the process".*

While the committee suggests further improvements to the provisions of the Part XIX of the Companies Act 2013, the new

[35] Vinod Kothari, *SARFAESI Act and woes of the 'abated',* THE BUSINESS LINE, Jan. 31, 2011, *available at*http://www.thehindubusinessline.com/todays-paper/sarfaesi-act-and-woes-of-the-abated/article2327585.ece.
[36]Aparna Ravi, *Indian Insolvency Regime in the Practice, An Analysis of Insolvency and Debt Recovery Procedure,* ECONOMIC AND POLITICAL WEEKLY, Vol. No. 51, Dec. 19, 2015.
[37]MINISTRY OF FINANCE,s«pr4 note 1, at 13.

provisions are not altogether meritless. When one carefully observes the changes being brought about by the sections of Chapter XIX, one may easily identify that some of the provisions thereto are designed specifically to address the issues raised by the practice of the current SICA regime.

Firstly, the rescue system is made applicable to *all companies,'** unlike the current regime which is applicable to only scheduled industries. Secondly, the creditors *{secured* only) are also given a *right to file an application* with the Tribunal for declaration of sickness,[39] unlike the SICA regime wherein the directors were *obligated* to file an application before the BIFR. This may necessarily address the concerns with the laxity of the directors. To make this possible, the regime incorporates *Liquidity Tes/^*rather than the balance sheet test as a precondition to the filing of application for declaration of sickness. Once the company fails to meet the demand made by the secured creditors *{constituting 50% or more of the outstanding debt of the company)* within the statutory notice period (30 days), an application can be made by any of them for such declaration and the Tribunal shall determine the sickness within 30 days[41].Thirdly, and most importantly, there is no automatic moratorium on other judicial proceedings upon mere filing of an application with the Tribunal.[42] In fact, the company should make an application to the tribunal for grant of such moratorium. It is left to the discretion of the tribunal whether to grant such moratorium. This is a big and necessary deviation from the previous regime, where under the moratorium was highly misused. However, it is to be noted that an application post declaration of sickness, for the purposes of revival or rehabilitation can be filed only by a secured creditor or the company.[43] The company is also given an option to submit a revival or rehabilitation plan for the perusal of the Tribunal. Fourthly, the regime envisions a participatory role for the creditors at two stages, i.e. at the stage of decision making as to whether a company is eligible for rescue or it should

[38] The Companies Act, 2013, § 253 (1).
[39] *Id.*
[40] *Id.*
[41] The Companies Act, 2013, § 253 (8).
[42]M§§253(2)&253(4).
[43] *Id.* § 254.

be directed towards winding up and also in the stage of preparation of an appropriate scheme for the rescuing the company. To facilitate this coordination, the new regime envisions an appointment of an Administrator so as to coordinate with the creditors and submit a report as to whether it would be possible to revive or rehabilitate the sick company.[44]Upon consideration of such report and on the date of hearing, the Tribunal shall consider the decision of the creditors.[45] If three fourths of the creditors present and voting resolve that it shall not be possible for company to be revived and rehabilitated, then the Tribunal shall order for initiation of winding up proceedings. If the creditors vote in favour of the revival, then the Tribunal shall appoint a Company Administrator to prepare such scheme of revival. Even after the appointment of an administrator, the scheme prepared by him shall be subjected to the vote of the creditors. If it is passed by the different classes of the creditors as per the prescriptions thereto, it is only then such scheme shall be sanctioned. Else, the scheme shall fail and the Tribunal shall order winding up accordingly.[46]

While the larger issues for the corporate rescue procedure such as extension of protection to the secured creditors, empowering the unsecured creditor to file the application, reworking of the winding up mechanism, envisioning criteria for *'likelihood of sickness' are* still to be evolved and the Insolvency and Bankruptcy Code 2015, based on the final recommendations of the BLRC, is still pending before the Lok Sabha, it is noteworthy that these new provisions, at least on paper, are designed to specifically address the concerns raised by the previous regime.

Given that the SICA (Repeal) Act, 2002 and the Chapter XIX of the Companies Act, 2013 are yet to be notified, it is interesting to see how the above concerns coupled with the reformations being made through the Insolvency Code shall be incorporated and it shall also be challenging to see how these reforms address the commercial world in the near future.

Id. § 256.
Id. § 258.
Id. § 265.

AN INSIDE(R) STORY: BRIDGING THE GAP BETWEEN STATUTORY AND THEORETICAL PERSPECTIVES

AGRANEE KAPOOR & ANGELINE BENNY*

"Size, we are told, is not a crime. But size may, at least, become noxious by reason of the means through which it was attained or the uses to which it is put."'

The sheer scale at which insider trading takes place in the world is massive. However, in most cases, it goes undetected and thus, there is no documentation of the same. The perspective on the matter has been varied and there have been people who have argued for its validity and those who have vehemently opposed it. As seen in judgements across jurisdictions, the predominant sentiment towards the practice is negative and each country has regulations that seek to control the trading of information which is selectively available to a limited number of people. This paper seeks to assess the matter from an empirical as well as a theoretical perspective. The former deals with details on the kinds of theories pertaining to insider trading, a comparative study of laws on the matter across the world and lastly, it addresses the changes within insider trading regulations in India. The latter seeks to delve upon the ethical and economic perspectives given by different theorists to understand the reasons for and against the practice of insider trading. The aim of this paper is to arrive at a perspective which views the empirical and theoretical perspectives in tandem.

CONTENTS

/. *What constitutes insider trading?*
II. *Empirical A nalysis*
III. *Theoretical Analysis*
IV. *Conclusion*

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[1] Louis D. BRANDEIS, OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT 163 (2009).

I. WHAT CONSTITUTES INSIDER TRADING?

There are two theories used to understand the concept of insider trading namely the classical theory and the misappropriation theory. They categorize what level of involvement in sharing of information would constitute insider trading i.e. while the classical theory would implicate an individual directly involved, the misappropriation theory would extend the ambit to individuals indirectly involved as well.

CLASSICAL OR TRADITIONAL THEORY underpinned the stance that implicated any person who was directly involved in the passing off of insider information by misuse of a place of power as a person guilty of insider trading.[2] They had access to highly sensitive information which placed them in a position of power and thus, they were involved in disclosing this information to outsiders. The basic underlying feature of this theory is that the information must be given by a person who is part of the firm or has direct access to the information.[3]

MISAPPROPRIATION THEORY was first adopted in the case of *United States v. James Herman O'Hagan.*[4] A company named Grand Metropolitan PLC (Grand Met) wanted to buy stock in Pillsbury Company and retained Dorsey and Whitney (law firm based in the same area) as their legal counsel for the transaction. The respondent was a partner in the law firm and had no relation to this particular matter. However, he, as a third party who had no direct relation to the matter, misused the information that he had indirect access to by virtue of being part of the firm. He violated the fiduciary duty he had towards the firm and therefore, despite the lack of his direct involvement in the transaction, he was held guilty of insider trading.[5]

[1] *See* Steven Glaser & Daniel Weinstein., *Law on Insider Trading and Misappropriation Theory Remains Unsettled,* N.Y. L.J. (2014); SEC v. Texas Gulf Sulphur Co., 401 F.2d 8:33, 848-49 (2d Cir. 1 968).
"*Id.*
[4] United States v. James Herman O'Hagan, 521 U.S. 642 (8th Cir. 1997).
"*Id.*

II. EMPIRICAL ANALYSIS

A. A comparative study of Insider trading norms around the world

The United States was one of the earliest nations to formulate laws and recognize insider trading as a practice.[6] It also has inflicts the heaviest penalties and has often been regarding as the country with the most stringent insider trading laws.[7] The statute which governs the regulations is the Securities and Exchange Act, 1934 which is accompanied by the rules enacted by the Securities and Exchange Commission (SEC).

The United Kingdom has a Securities and Investment Board (SIB) and the Financial Services Authority (FSA) to oversee matters relating to insider trading. The statutes governing matters relating to insider trading are the Company Securities Insider Dealing Act, 1985 (re-enacted in 1993), the Financial Services and Markets Act, 2000 as well as Part V of the Criminal Justice Act, 1993. Additionally, the Insider Dealing Directive and European Union Directive on Insider Dealing and Market Manipulation are applicable.[8] [9]

As the law currently stands, only individuals can be prosecuted for insider trading. Moreover, as the Companies Act, 1980 construes insider trading as a criminal offense, *mens rea* must be proved where the same has been alleged. The Indian position, however, does not consider the question of *mens rea* and imposes only civil liabilities on those found guilty of insider trading.

It is apparent that the legal position regarding insider trading across jurisdictions is to penalize individuals who participate in it. The following section of the paper seeks to analyze the prevalent regulations in India to understand if she adopts a similar position in relation to insider

[6]Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation,* 26 GA. L. REV. 184 (1991).
[7] *Insider Trading: Tipping the Scales,* THE ECONOMIST (2011), *available at* http://www.economist.com/node/21532280.
[8] Council Directive 89/552 Co-ordinating Regulations on Insider Trading, OJ EC 18/11/1989, L 334/30 (Nov. 13, 1989).
[9] Directive 2003/6/EC of the European Parliament and Council (fan. 28, 2003).

trading.

B. A n Introduction to Insider Trading norms in India: SEBI Regulations

The Securities and Exchange Board of India (SEBI) recognized the need for regulation of insider trading and hence, formulated the SEBI (Insider Trading) Regulations, 1992. The Company Securities Insider Dealing Act, 1985 formed the basis for the SEBI Regulations of 1992. These regulations established the basic legal framework, which was then enhanced by the amendments in 2002, 2003, 2008 and 2011, taking into account various complexities in practice that arose with the passage of time. For instance, it was in the aftermath of the *Hindustan Lever Ltd. v. SEBI* case that the definition of 'insider' was amended in 2002 to read *"anyone who has access to the UPSI independent of any connection to the company in addition to a person who is or was connected to the company. "*[w] Moreover, the acquittals on appeal in the cases of *Rakesh Agrawal v. SEBI* and *Samir C. Arora v. SEBI* have exposed the lacuna in these Regulations.[1112]

Therefore in 2015, a new set of regulations called the SEBI (Prohibition of Insider Trading) Regulations, 2015 (hereinafter '2015 Regulations') as envisaged by the N. K. Sodhi Committee were notified and these sought to replace the existing framework under the amended 1992 Regulations.

C. *Sebi Guidelines 1992 and 2015: A comparative study*

The 2015 Regulations seek to clarify the regime on Insider Trading and have deviated from its predecessors while defining terms. A plethora of new terms have been incorporated, beginning with the addition of the post of 'Compliance Officer' to ensure the company's compliance with

[10] Hindustan Lever Ltd. v. Securities & Exchange Board of India, 1998 18 S.C.L. 311 (AA) (India).

[1] Rakesh Agrawal v. Securities & Exchange Board of India, 2004 49 S.C.L. 351 (SAT) (India).

[12] Samir C. Arora v. Securities & Exchange Board of India, 2005 59 S.C.L. 96 (SAT) (India).

these Regulations.[13] 'Generally available information' has been defined to offer a contrast to what constitutes unpublished price sensitive information (hereinafter UPSI),[14] an exclusionary approach to defining UPSI while providing an illustrative list of UPSI alongside the same to lend clarity. UPSI now includes information not only relating to the company but also to its securities. 'Dealing with securities' which constituted the operative part once price sensitive information was obtained from insiders has been replaced by 'trading' which has a wider ambit.[15] It now includes activities such as pledging which were not strictly within the contours of buying, selling or subscribing. Following the same, working day has been re-defined as trading day.[16]

(i) Connected Persons: A new angle to who can be called an insider

The distinction between connected persons and 'person is deemed to be a connected person' has been eliminated and the scope of the term 'connected person' has been further widened to include those who are in frequently in communication with the company and are expected to have access to unpublished price sensitive information (UPSI).[17] This criterion of frequent communication changes the earlier requirement of a relation with the company in a 'formal capacity'. Furthermore, 'immediate relatives' has been defined in the Regulations and this categorization also comes under the umbrella term of 'connected persons'.[18]

Whilst this presumption of connected person is a legal fiction that can be rebutted, the sheer number of individuals who would satisfy the criteria would make it a task for the Compliance Officers in terms of keeping a tab on the said individuals. This expansive definition of connected persons, in turn, enlarges the scope of the term 'insider' which includes connected persons in addition to any person who is possession

[13] SEBI (Prohibition of Insider Trading) Regulations, 2015 at Regulation 2(c) ["Insider Trading Regulations"].
[14] Insider Trading Regulations, *supra* note 13 at Reg. 2(e).
[15] *Id. ax* Reg. 2(1).
[16] *Id.* at Reg. 2(m).
[17] *Id.* at Reg. 2(d).
[18] *Id.* at Reg: 2(f).

of or has access to UPSI.[19]

(ii) A new paradigm - Restrictions on Communication of UPSI and Trading by Insiders

Restrictions on communication of UPSI and 'Trading' by insiders have been delineated into two separate Regulations: Regulation 3 covers communication of UPSI while Regulation 4 encompasses matter relating to insider trading.

Regulation 3 incorporates restrictions on communication of UPSI relating to securities proposed to be listed as well unless the communication was for *'legitimate purposes, performance of duties or discharge of legal obligations'.*[10] However, *'legitimate purpose'* has not been defined in the Regulation and unless there is development on its meaning either through case law or by a clarification released by the Board; the term will continue to be shrouded in mystery.

There existed a practical issue while implementing the previous Regulations, i.e., trading based on information obtained after exercising due diligence could have lead to technical violations of the prohibition on trading. However, the 2015 Regulations have addressed this concern and granted a way out. It provides an exception when there is an open offer obligation under the takeover regulations and the Board of Directors consider this to be in the best interests of the Company.[21] Instances where open offers have not been made and the transactions are in the best interests of the Company, the UPSI shall be made generally available at least two days prior to the transaction. This exception applies to Mergers and Acquisitions as well since the term 'such as' is inclusive of transactions of the same species.

The innovative concept of a trading plan has been charted out in Regulation 5 of the 2015 Regulations. It enables insiders who are otherwise prohibited under Regulation 4 to trade in securities as per a preapproved trading plan. However, such a trading plan does not

Id. at Reg. 2(g). *Id.* at Reg. 3(1). Insider Trading Regulations, *supra* note 13 at Reg. 3(3).

guarantee blanket immunity from prosecution. If the release of the UPSI was manipulated so that trading as per this plan would become profitable, it would contravene Regulation 4. This could lead to initiation of proceedings for breach of SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to the Securities Market) Regulations, 2003. The Disclosure regime under the new Regulations is also better structured as initial and continual disclosures.[22] Additionally, connected persons can also be asked to disclose holdings and trading.[23]

Lastly, Regulation 4 presumes that trade would made in reference to the UPSI in case possession of the same was established. However, it also provides three exceptions to insider trading:-[24]

1. The transaction is an off-market *inter-se* transfer between promoters who were in possession of the same UPSI without breaching Regulation 3 regarding communication of the UPSI. Further, both parties should have made a conscious and informed trade decision;

2. In case of non-individual insiders, the insiders who made decisions did not possess such UPSI at the time of making the decision. Moreover, there was no breach of the arrangements that were in place to prevent disclosure of the same;

3. The trades were in line with the trading plan in place.

On the contrary, only one statutory defence is available under the Companies Act, 2013.

(iii) Understanding the dichotomy in the regulatory regime

It has to be brought to the fore that there exist two overlapping regulatory regimes concerning insider trading after the passing of the Companies Act, 2013 - one, under the SEBI Regulations and the other, under Section 195 of the Companies Act, 2013 which was formulated in accordance with the 1992 Regulations. The notification of the 2015

Id. at Reg. 7(1) & (2). *Id.* at Reg. 7(3). *Id.* at Reg. 4(1).

Regulations calls for re-viewing the latter.

While the 2015 Regulations provides three circumstances that may be pleaded as defenses to insider trading under the aforementioned Regulation 4, the Companies Act, 2013 still provides only one, i.e., that the communication was required in the ordinary course of business or profession or employment or that it was under any law.[25] This may lead to an anomalous situation where the same set of circumstances may lead to exoneration under the Regulations while the person may be liable under the Companies Act, 2013. Section 195, which was based on the 1992 Regulations, needs to be amended in order to bring it in line with the 2015 Regulations.

More importantly, Section 195 of the Companies Act, 2013 includes public unlisted companies and private companies as well. Since insider trading as a concept is only relevant in markets wherein price discovery is possible, i.e., the liquid secondary market comprising of securities in which only listed companies are a part, it is goes against the very definition of insider trading to apply it to unlisted companies. For these aforementioned reasons, Section 195 of the Companies Act, 2013 should be revised in order to prevent a contradiction between the previously parallel regimes under the Companies Act and the SEBI Regulations regarding Insider Trading.

D. The Chinese Wall

The 1992 Regulations was amended in 2002 to introduce Chinese Walls as a part of the 'Model Code of Conduct for Prevention of Insider Trading for Other Entities'.[26] Currently, the 2015 Regulations sets 'Minimum Standards for Code on Conduct' as included in Schedule B and calls on companies and market intermediaries handling UPSI in the course of their business operations to implement 'Codes of Fair Disclosure and Conduct'. These codes are to be displayed on the website and the stock exchanges are to be intimated of the same. The 'Minimum

[25] Companies Act, 2013, § 195.

[26] SEBI (Prohibition of Insider Trading) (Amendment) Regulations, 2002, Schedule I, Pan B, Model Code of Conduct for Prevention of Insider Trading for Other Entities, § 2.4.

Standards' along with the 2002 amendment lay down the legal framework for a 'Chinese Wall'.[27]

A 'Chinese Wall' operates as a metaphorical wall; an information barrier to prevent insider trading.[28] It prevents conflict of interests between brokers and dealers within multiservice broker-dealer firms in situations where the company may obtain UPSI from its corporate clients which can be passed on by the retail brokers, who make recommendations to other clients after relying on this UPSI.[29] Chinese Walls prevent the dissemination of information from one department to another and this could even manifest in physical segregation of the departments to different floors within a building or buildings.[30]

The concept was introduced in the settlement between SEC and Mernll Lynch in 1968 where Merrill Lynch's Statement of Policy embodied the concept of prohibiting disclosures by members of the Underwriting Division of information obtained from corporate that were not intended for the investing public.[31] It was further expounded upon across jurisdictions in the United Kingdom as compliance with the following requirements:

- Physical segregation to provide insulation to the information;

- A periodic programme to emphasis the restriction on communicating confidential information;

- Procedures and record for situations wherein crossing the wall is

[27] Insider Trading Regulations, *supra* note 13 at Schedule B, No. 2, Minimum Standards for Code of Conduct to Regulate, Monitor and Report Trading by Insiders.
[28] C A Quinn, *The Securities Amendment Act 1988 and The Chinese Wall, 7* OTAGO L. REV. 141 (1989). *Seealso,* Stephen Clark, *Insider Trading and Financial Economics: Where Do We Go From Here?,* 16 STAN. J.L. BUS. & FIN. 43, 81 (Fall, 2010)
[29] Robert C. Pozen and Judy K. Mencher, *Chinese Walls For Creditors' Committees,* 48 BUS. LAW. 747, 754 (1993).
[30] Ted Kamman and Rory T. Hood, *With the Spotlight on The Financial Crisis, Regulatory Loopholes, and Hedge Funds, How Should Hedge Funds Comply With The Insider Trading Laws?,* COLUM. BUS. L. REV. 357,431-432,434 (2009).
[31] In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 SEC 933, Exchange Act Release No. 34-8459 (Nov. 25,1968).

imperative;

- Compliance Officers to monitor the Chinese Wall;
- Disciplinary Action in case of any breach.[32]

One of the basic principles to prevent insider trading would be to limit communication of UPSI on a 'need to know' basis, i.e., information must be transmitted only to designated persons in cases where the information is essential for the discharge of their duty.[33] The designated person would be permitted to cross the wall to the extent that the UPSI is essential for the said person performing their function.

Chinese Walls are effective to the extent that having an organizational separation would prevent accidental disclosure of UPSI, i.e., disclosure over and above those on a 'need to know' basis.[34] However, it cannot prevent intentional transmission of such UPSI; it could only possibly hinder the attempt to get the information to a person not permitted to 'cross the wall'. Since transmission of UPSI to tippees predominantly constitutes insider trading and building a Chinese Wall cannot stop this phenomenon,[35] they have only a limited applicability.

On the other hand, prompt disclosure of UPSI is a more feasible option as it narrows the time frame wherein insider trading of any sort would occur.[36] This has been realized in principle within the SEBI (Prohibition of Insider Trading) Regulations, 2015.[37]

[32] Prince Jefri Bolkiah v. KPMG [1999] 1 All E.R. 517 (UKHL) (Eng.).
[33] Insider Trading Regulations, *supra* note 13 at Schedule B, Minimum Standards for Code of Conduct to Regulate, Monitor and Report Trading by Insiders.
[34] Christopher M. Gorman, *Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?,* 9 FORDHAM J. CORP. & FIN. L. 475, 490 (2004),*available at* http://ir.lawnet.fordham.edu/jcfl/vol9/iss2/5 ["Gorman"].
[35] Daniel Sullivan, *Big Boys and Chinese Walls,* 75 U. CHI. L. REV. 533, 556-557 (Winter, 2008).
[36] Gorman, *supra* note 34 at 498.
[37] Insider Trading Regulations, *supra* note 13 at Schedule A (Principles of Fair Disclosure for purposes of Code of Practices and Procedures for Fair Disclosure of Unpublished Price Sensitive Information).

III. THEORETICAL ANALYSIS

A. *Does insider information constitute property?*

A property rights perspective would term insider trading as a practice which involves violates property rights of individual. This is because it is seen as an intangible and valuable property which the firm must retain and that it should not be shared openly outside the firm.[38] This perspective can be explained with help from the dichotomy of property, which was discussed extensively by Margaret Radin in her work, *Property and Personhood?*[9]

Radin explains the dichotomy of property from the personhood perspective which seeks to create a hierarchy of entitlements, i.e., the more closely connected with personhood, the stronger the entitlement.[40] This gives an adequate explanation of the categorisation of various commodities in this hierarchy and this proves to be a departure from the utilitarian approach. It is premised on the understanding that rights which come within a general justification form a continuum, from fungible (exchangeable) to personal. The crucial point of difference between the two is that while fungible rights may be overridden, personal ones must not be overridden. [41]

This continuum is beneficial since multiple issues fall within the range of this continuum, some may be entirely personal while others may be exchangeable, entirely or only to an extent. Many relationships between persons and things fall within this range. If this dichotomy is to be reduced to two end points, it is done to facilitate a choice between which property must be given more weightage than the other in terms of the protection accorded.[42] As a solution to this dichotomy, Radin emphasises the *simplicity in hypothesizing that personal property should he*

[38] JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 3 (1st ed. 1991) ["Macey"].
[39] Margaret Jane Radin, *Property and Personhood,* 34 STAN. L. REV. 957 (1982) ["Radin"]; *See* Macey, *supra* note 38.
[40] *See* Radin, *supra* note 39.
[41] *Id.*
[42] *See* Radin, *supra* note 39.

affected by property rules while fungible property by liability rules which she believes provides a more "moral" explanation to the hierarchy .[4j]

This distinction drawn between personal and fungible property is rather feeble as it overlooks the subjectivity of the importance people attach to commodities. She categorises the degree of attachment that one has to a commodity according to the pain one feels at its loss. This conclusion made by Radin is often seen as controversial as it overlooks the concept of endowment effect, i.e., greater importance is given to an object which is in one's possession.[44]

This was depicted in an experiment conducted by Jack Knetsch where one set of people were given mugs with the option of trading it with chocolate while the second set were given chocolate with the option of trading it with a mug.[45] Roughly ten percent of the participants of the experiment wished to barter the commodity.[46] The prior sense of entitlement furthered this tendency to hold on to one's initial possession.[47]

The property perspective is also one which is difficult to expound on with respect to insider trading. This is primarily due to the complex nature of information involved in case of insider trading. If we were to apply Radin's perspective on the matter, the information would be personal property of the firm which cannot be exchanged. However, if we were to form the perspective delivered by the critique, it would lead us to conclude that property is classified on the basis of how much pain we would feel at its loss. Both seem to do a certain degree of injustice as each kind of commodity, tangible or intangible must be assessed circumstantially.

[43] *Id.*
[44] Lyle Brenner et al., *On the Psychology of Loss Aversion: Possession, Valence and Reversals of the Endowment Effect,* 34 J. CON. RES. 369, 369 (2007).
[45] Jack L. Knetsch, *The Endowment Effect and Evidence of Nonreversible Indifference Curves,* 79 AM. ECON. REV. 1277,1278 (1989).
[46] *Id.*
[47] DANIEL MILLER, MATERIAL CULTURE AND MASS CONSUMPTION 107 (1st ed. 1987).

B. The Kantian perspective on ethical justifications for insider trading

The theory propounded by Immanuel Kant to determine whether an action was ethical was divided into two categorical imperatives.[48] The first one furthered the idea that for an act to be ethically justified, the person engaging in the act must not have an objection to most people indulging in the same act.[49] At a preliminary level, it would seem like this wouldn't be agreeable to most people as they would not want every individual to gain from inside information. However, individuals would settle for such insider information being provided to the masses as it would be a better bargain due to higher share prices.

The second categorical imperative justifies decisions on the basis that they were not being made in order to only further one's own interests using others as a means in the process but also aimed at giving the other individuals a freedom of choice.[50] This would imply that there was consent given before the transaction took place. At a surface level assessment, it would seem like no individual would be willing to consider trading based on inside information. However, an alternate perspective would indicate that there was consent as insider trading would result in exchange of shares at a higher price.

Thus, it is evident that the majoritarian ethical perspective on the matter leans towards the justification of the practice of trading insider information.

C. An economic perspective

The fundamental goal of any economic study would be to ensure that the market functions efficiently and at a near perfectly competitive level. The economic perspective on insider trading has seen a constant tussle in the conflicting views regarding whether insider trading is an ethically permissible practice or not.[51] It is also in line with the utilitarian

[48] IMMANUEL KANT, CRITIQUE OF PURE REASON 415 (2nd ed.1787).
[49] MANUEL G. VELASQUEZ, BUSINESS ETHICS: CONCEPTS AND CASES 97 (5th ed. 2002).
[50] *Id.* at 47.
[51] Henry G. Marine, *In Defense of Insider Trading,* HARV. BUS. REV. 113 (1966); H.L. Wilgus, *Purchase of Shares of Corporation by a Director from a Shareholder,* 8 MICH. L.

perspective[52] which in turn has two different ways of viewing the practice which have evolved over time. The earlier set of theorists believe that an action would be beneficial if the *"result is the greatest good for the greatest number'*[63] The modern utilitarian perspective views it differently as they deem any act which leads to gains as one which is utilitarian.[54] Since the economic and utilitarian perspectives are largely focused on the functioning of the market, this part of the paper deals with two market indices which are affected by the practice of insider trading namely stock price information and liquidity.

(i) Stock Price Information

It has been theorised that an analogy can be drawn between the securities market and the Brownian effect in physics.[55] The latter concept pertains to the behaviour of and interaction between gas molecules whereby through such interaction, a random pattern is created. Manne opines that in the securities market, the stock price would behave in a similar manner in the absence of additional inside information.[56] He further emphasises that stock price information becomes less arbitrary when information is available.

The faction in support of insider trading argues for the benefits of the practice laying special emphasis on the fact that permitting insider trading would indirectly result in faster flow of information in the market with reference to share prices.[57]This means that those in support of insider trading suggest that the practice results in more accurate prices due to the

REV. 267 (1910).

[52] JOHN. R. BOATRIGHT, FINANCE ETHICS: CRITICAL ISSUES IN THEORY AND PRACTICE 25 (2010).

[53] *See* Robert W. Mc.Gee, *Analysing Insider Trading from the Perspectives of Utilitarian Ethics and Rights Theory,* JOURNAL OF BUSINESS ETHICS 66 (2009).

[54] *Id.*

[55] HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 96-97 (1966); Jonathan Macey, *Securities Trading: A Contractual Perspective,* 50 CASE W. RES. L. REV. 269 (1999).

[56] *Id.*

[37] Macey, *supra* note 38; Zohar Goshen and Gideon Parchomovsky, *On Insider Trading, Markets, And "Negative"Property Rights In Information,* 88 VA. L. REV. 1229 (2001).

disclosure of information regarding the same.[58]

The argument put forth by the other side is that lack of regulations would cause delay in the information reaching the market, which would consequently hamper the efficient functioning of the capital market.[59] Essentially this means that the people benefitting from the information would be driven to prevent such information from being made available to the public and deliberately hamper disclosure. This would in turn adversely affect market and prevent it from functioning efficiently[60]

(ii) Liquidity

If the investor is able to sell off securities at a requisite price with very little notice or within a short span of time, such a characteristic is known as liquidity.[61] The three elements of market liquidity are:

i) whether the price permits investors to sell or buy stock promptly;

ii) the price at which the shares are sold should be at a price which were predicted as the *earning prospects* by the market;

iii) the information regarding prices must be circulated and shared at a low price.[62]

Insider trading often has an adverse impact on the liquidity in the market and thus, is considered a deterrent for perfect competition conditions. The fundamental reason for this is the relation between liquidity and efficiency of the market. The delay in disclosure of inside information and the redistribution of wealth from the outsiders to the

[58] Henry Manne, *Insider Trading and Property Rights in New Information,* 4 C ATO J. 933 (1985).
[59] Laura N. Beny, *A Comparative Empirical Investigation of Agency and Market Theories of Insider Trading,* Discussion Paper No. 264 15 (1999), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/264.pdf.
[60] Macey, *supra* note 38 at 11.
[61] *Id.* at 7-8.
[62] Macey, *supra* note 38.

insiders has a negative impact on the liquidity of the market.[63] Additionally, it interferes with the investors decisions who invested their capital under the belief that it wouldn't be affected by such practices.[64]

IV. CONCLUSION

There has been a two pronged analysis of the issue of insider trading i.e. the empirical analysis and the theoretical analysis. A comparative survey of various jilrisdictions including India revealed a propensity for legal action against those involved in insider trading. Specifically, with respect to India, the 2015 SEBI Regulations were scrutinized to observe the changes brought about to ensure strengthened protection against insider trading. Section 195 of the Companies Act, 2013 was discussed in order to highlight its conflict with the 2015 Regulations.

Following this survey of the legal framework, the theoretical perspectives were examined to verify if they reflect the empirical reality that sought the prohibition of insider trading. In the case of insider trading, the discussion should not remain restricted to whether the spectrum can be applied to it or the degree of pain felt by its loss but rather the bigger picture of its effect on the market and how it substantially affects a larger set of people due to the actions of a relatively smaller setf The bigger question lies in whether insider trading benefits the market by increasing efficiency and its liquidity. The efficiency of the market and its liquidity are of paramount importance while assessing the validity of insider trading. The model of utilitarianism as propounded by John Stuart Mill and Bentham is the model that emphasizes the importance of maximum utility. It seeks to establish an ideal market situation by which every individual receives profits and the functioning of the market is at a level of maximum efficiency.

■:' As insider trading decreases efficiency and liquidity in the market, it keepsjfhe market from working at maximum efficiency. Since the ultimate aim of rfiarkets is to operate at maximum efficiency, insider

[63] Reinier Kraakman, *The Legal Theory of Insider Trading Regulation in the United States,* in EUROPEAN INSIDER DEALIN^ 52 (1991).

[64] Lawrence M. Ausubel, *insider Trading in a Rational Expectations Economy,* 80 AM. ECON. REV. 1022, 1023 (19^P)I

trading and its detrimental effects within the market create an aversion to the practice. This provides an explanation for the empirical data that discloses strong regimes against insider trading in most jurisdictions despite the leanings of ethical justifications towards it.

APPRAISING THE 'GOODS AND SERVICE TAX' AS A 'MEANS' (AND NOT THE 'END') TO IMPROVING THE BUSINESS CLIMATE OF INDIA

TARUNJAIN[S']

The Constitution (One-Hundred and Twenty-Second Amendment) Bill, 2014 currently pending consideration of the Parliament seeks to usher a new indirect tax regime in India purported as the 'Goods and Service Tax'. The avowed intent of this Amendment Bill, in terms of its "Statement of Objects and Reasons" (^1) is to "replace a number of indirect taxes being levied by the Union and State Governments and is intended to remove cascading effect of taxes and provide for a common national market for goods and services." The proposed change is of such wide proportion that it has been described by the incumbent Union Finance Minister as "the single biggest tax reform since independence",[1] as the earlier reforms on the subject have had limited perspective. This article seeks to revisit the applicable constitutional and legal postulates governing the levy of various indirect taxes in India so as to seek a theoretical as well as pragmatic appraisal of the changes envisaged under GST. The idea is to undertake a legal-commercial examination of the existing and proposed state-ofaffairs to draw meaningful lessons as to whether GST aids businesses generally, and positively redraw the business climate of India.

CONTENTS

I. *Introduction: Setting the Context*
II. *Movement to GST: A Backgrounder*
III. *What is 'GST? Why 'GST?*
IV. *Examining the'Amendment Bill'*
V. *Assessing the Business Impact of 'GST* VI. *Issues to the Ironed Out: Wish-List on 'GST* VII. *Conclusion*

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'G57*w *single biggest tax reform since 1947: FM Arunjaitley,* THE ECONOMIC TIMES Pec. 19, 2014), http://articles.economictimes.indiatimes.com/2014-12-19/news/57233471_ 1_gst-council-finance-minister-arun-jaitlev-tax-rate (last accessed on Aug. 31, 2015).

I. INTRODUCTION:SETTING THE CONTEXT

The economic outlook of a country is often determined by the regulatory regime which lays down the rules of the game in so much so that businesses' interact and undertake transactions. The domestic polity of a country and its constitutional structure often reveal a conscious choice of the economic design, and thus to a large extent set the limitations on the economic outlook. The Constitution of India is no exception. The framers of the Indian Constitution aspired the country to have an integrated common-market where free movement of goods would be the order of the day. While they did provide for free movement of labour and capital by positioning them at a high pedestal as fundamental rights[2] and thus obligated the State-actors to ensure that these freedoms were effectuated in practice,[3] a similar freedom required to percolate free movement of goods and services within the length and breadth of the country was, however, not stated in unbridled terms. Instead, the constitution-framers satisfied themselves with a mere declaration to this effect and that too a conditional one in the Constitution.[4]

The idea of a common-market has also not seen the light of day partly on account of the federal structure provided for in the Constitution.[5] It is the constitutional scheme that legislative powers (including powers to levy taxes) are distributed between the constituents units of the Indian federation. This constitutional scheme has further resulted[6] in the subjugation of this enshrined goal of a common-market in

[2] Part - in of the Constitution of India provides for "fundamental rights" wherein Article 19(l)(d), (e) and (g) secure to all citizens the rights "to move freely throughout the territory of India", "to reside and settle in any part of the territory of India", and "to practice any profession, or to carry on any occupation, trade or business" respectively.
[3]See, *e.g.,* M. Nagaraja v. Union of India, (2006) 8 S.C.C. 212; I.R. Coelho v. State of Tamil Nadu, (2007) 2 S.C.C. l(In terms of the judicial declarations, Fundamental Rights under the Constitution of India are stipulations against the State i.e. the State instrumentalities are obliged to secure the rights and freedoms enshrined therein to the citizens or other persons to whom the rights secure).
**See* INDIA CONST, art.301 (states that "Subject to the other provisions of this Part, trade, commerce and intercourse throughout the territory of India shall be free"). [5]*See* INDIA CONST, art.301 read with INDIA CONST. Schedule - VII. [6] Probably the constitution-framers were alive to this possibility, as reflected in Article 303(1) of the Constitution.

as much as the exercise of these legislative powers by the respective institutions has led to fragmented markets which are governed by distinct set of laws varying across jurisdictions often comprising of small territories within the country. The country, consequently, has witnessed diverse legislative and regulatory rules which have been perceived to come in the way of attainment of the common-market vision.[7] It is in this context that a harmonized 'Goods and Service Tax' ("GST") has been proposed as a measure to cure all ills that plague the indirect taxation regime in India.

While there is no exhaustive enumeration of the variables constituting business climate of a country, there is consensus that the taxation regime indeed constitutes a key variable of the business climate.[8] It is in this context that GST is cited[9] not just as a relevant variable for a discussion on the business climate of India but is instead envisaged as a driving catalyst which shall change the way businesses' operate in India in a manner such significant that the business climate of the country shall change on a positive whole. It is in this aforesaid background that this article proposes to undertake an inquiry on the expected fallouts of the

[7]*See,* eg.,Varshney General Sales v. State of Uttar Pradesh, (2003) 203 S.T.C. 202 (AIL).
[8] 'Paying Taxes' is one of the category on which a country is rated on the 'Ease of Doing Business' rankings. This essentially "addresses the taxes and mandatory contributions that a medium-size company must pay or withhold in a given year, as well as measures the administrative burden in paying taxes". World Bank Group, http://www.doingbusiness.org/data/exploretopics/paying-taxes/what-measured (last accessed Aug. 31, 2015).
'SELECT COMMITTEE OF THE RAJYA SABHA ON THE AMENDMENT BILL, REPORT OF THE SELECT COMMITTEE OF THE RAJYA SABHA ON THE AMENDMENT BILL, f
1.11 (2015), (vide % 1.11 states "GST will simplify and harmonise the indirect tax regime in the country. It is expected to reduce cost of production and inflation in the economy, thereby making the Indian trade and industry more competitive, domestically as well as internationally. It is also expected that introduction of GST will foster a common or seamless Indian market and contribute significantly to the growth of the economy"). ["Select Committee Report"]

proposed GST regime and its ability to cater to a larger context by moulding the business climate of the country in a positive way.

II. MOVEMENT TO GST: A BACKGROUNDER

As stated above, the Constitution of India provides for a federal set-up. The scope and distribution of the legislative powers between the constituent units of the federation i.e. the Parliament and the State Legislatures is provided for in Schedule - VII of the Constitution, which is comprised of three lists; List - I entails the subjects whereupon the Parliament has the sole domain to make laws, List - II entails the subjects whereupon the State Legislatures alone can make laws, and List - III identifies the subjects whereupon both Parliament and State Legislatures are competent to make laws. The distribution of the taxation subjects between the two constituents and the movement thereon can be described as under;

(i) The 'taxes on the sale or purchase of goods'[10] and 'taxes on the entry of goods into a local area for consumption, use or sale therein'[11] are within the sole legislative domain of the State Legislatures. The legislative competence with respect to a number of other indirect taxes is also vested into the State Legislatures.[12] The tax on inter-state sale and purchase of goods are subject to a Parliamentary law but the levy is administered and the collections thereto are appropriated by the States on the basis of the principles stated in the Parliamentary law.[13]

(ii) Originally, the taxes on the sale of goods were levied on first-point sale basis in terms of the respective State Sales Tax/Trade Tax enactments (subject to the Central Sales Tax Act, 1956) and the

[m]*See* Entry 54, List - II.
[n]*See* Entry 52, List - II.
[i2]*See, e.g.,* Entry 55, List II (taxes on advertisements), Entry 57, List - II (taxes on vehicles), Entry 62, List - II (taxes on luxuries, including taxes on entertainments, amusements, betting and gambling), etc.
[13]&eEntry 92A, List - I read with Article 286 of the Constitution of India (The tax is levied under Central Sales Tax Act, 1956). *See also* Tata Iron & Steel Co. Ltd. v. State of Bihar, A.I.R. 1958 S.C. 452: (1958) S.C.R. 1355 (for delineation of applicable principles).

'entry of goods' was subject to tax under the respective State Entry Tax enactments. This scenario prevailed till the reform process set in whereupon these levies were replaced by Value Added Tax model wherein under the levy was shifted from first-point sale taxation to multiple-point stage taxation to tax the value-addition at each supply-chain.[14]

(iii) A tax on services did not form part of the original constitutional design. It was conceptualized and administered for the first time in 1994 on a limited basis. [15]The Finance Act, 1994, levying service tax, prescribed a positive-list of services subject to tax whereby the activity in question was required to be covered under the definition of one of the enumerated services in order to be liable to tax. This regime was replaced by the negative-list regime ushered in 2012.[16]Currently, all services other than those covered under a prescribed negative list or those exempted otherwise are subject to service tax. This tax is levied and appropriated by the Central Government.

(iv)In contrast to these transactional taxes, i.e., taxes on transactions involving supply of goods or services, the Parliament imposes a

[14]*See* EMPOWERED COMMITTEE OF STATE FINANCE MINISTERS, A WHITE PAPER ON STATE-LEVEL VALUE ADDED TAX(for an official background note and changes proposed from Sales Tax to Value Added Tax models), http://finmin.nic.in/reports/whitepapervat.pdf(lst visited Aug. 31, 2015). [15]*See*Tarun Jain, *Service Tax on Lotteries: An Enigma!,* 200 EXCISE AND CUSTOMS REPORTER 49SF-60SF (2013) and Tarun Jain, *Levy of Tax on Services in Jammu and Kashmir: A contrast with Rest of India,* 201 EXCISE AND CUSTOMS REPORTER4SF-14SF(2014) (for, *inter alia,* a detailed discussion on the legal background of service tax in India and the principles governing the levy).

[16]*See* Tarun Jain, *Negative List for Service Tax: Some Musings* 189(3)EXCISE AND CUSTOMS REPORTER, 19SF-26SF (2012) (for a detailed account the reasons for the change from the positive-list to negative-list regime of service tax).

duty of 'excise'[17] upon 'manufacture'[18] of goods. As a general rule, the levy is upon a value which determined in accordance with the statutorily prescribed methodology[19] whereas in certain cases it is levied on the basis of the final price at which the product is sold to the consumer.[20] Such duty paid on manufacture is available as credit to the next stage manufacturer, but not to a seller of goods.[21]

In the aforesaid state-of-affairs, there is no interaction between the manufacturing stage of commodities and selling stage in as much as the availability of the credit of the duty on inputs is concerned. On account of the difference in the institution levying the tax, the credit of taxes paid under the Parliamentary law at the time of manufacture or those paid on services are not available for set-off against the taxes paid under the State legislations on entry of goods or sale within their territories. This positioning of indirect taxes leads to what the economists describe as "cascading effect of taxes"[22] and is directly at variance with a harmonized tax regime for an entire country.

Taking note of ills plaguing the existing system, a proposal was mooted in 2007 to shift from the existing scheme of multiple Parliamentary and State levies to a broad-based harmonized indirect tax

[17] Under Central Excise Act, 1944 exercising power under Entry 84, List - I. However the levy of excise duties on (i) alcoholic liquors for human consumption, (ii) opium, and (iii) other narcotic drugs and narcotics are constitutionally reserved for the States under Entry 51, List - II.
[18] Defined in §2(f), Central Excise Act, 1944. *See* Union of India v. Delhi Cloth and General Mills, A.I.R. 1963 S.C. 791: [1963] Supp (1) S.C.R. 586 entailing the legal principles governing levy of excise duty.
"See id. §4.
[20]*See id.* §4A. (These valuation rules are popularly known as 'MRP based valuation' as MRP connotes the 'Maximum Retail Price' at which the product can be sold to the consumers).
[21] The eligibility to obtain credit depends upon the status of the person in terms of CENVAT Credit Rules 2004, Rule 3 of which allows only the 'manufacturer or producer of final products or a provider of taxable services' to take credit of the duty paid on inputs or capital goods used for manufacture or providing taxable services.
[22]*See generaly* THIRTEENTH FINANCE COMMISSION, REPORT OF THE TASK FORCE ON GOODS AND SERVICE TAX (2013). ["Thirteenth Finance Commission"]

mooted as 'Goods and Service Tax'.[23] After numerous discussions with various stakeholders and having come to a political bargain with the States through the forum of Empowered Committee of State Finance Ministers, the proposal was instituted in the form of Constitution (One Hundred and Fifteenth Amendment) Bill, 2011 and presented for consideration before the Parliament. This Bill of 2011 formed the subject-matter of scrutiny of the Parliamentary Standing Committee on Finance which in its 73rd Report[24] examined the issues thread-bare to suggest various changes. Taking note of the Report and further deliberations on the unresolved issues the Government of India introduced a revised Bill, the "Constitution (One Hundred and Twenty-Second Amendment) Bill, 2014"("the **Amendment Bill")** in the Parliament seeking to amend the Constitution and introduce a harmonized GST in the country. The Bill was passed by the Lower House on 6th May, 2015 and as date of writing this article was pending consideration of the Upper House of the Parliament.

III. WHAT is 'GST'? WHY 'GST'?

Before we dwell upon the impact and analysis of GST as can be culled out from the Amendment Bill and the attendant circumstances, it is essential to first ascertain its meaning and conceptual foundations. "GST is a tax on goods and services with comprehensive and continuous chain of set-off benefits from the producer's point and service provider's point upto the retailer's level. It is essentially a tax only on value addition at each stage."[25] While this conceptually places GST, this simplistic

[23] *See* Tarun Jain, *Harmonized 'Goods and Service Tax' in India: A Backgrounder,* 191(1) EXCISE AND CUSTOMS REPORTER 1SF-20SF (2012) (for a detailed background of the constitutional, legal and factual aspects leading to the proposal to transition to GST).

[24] STANDING COMMITTEE ON FINANCE (2012-13), SEVENTY THIRD REPORT (2013),http://www.prsindia.org/uploads/media/Constitution%20115/GST%20SC%20Report.pdf. (last visited Aug. 31, 2015).

[25] EMPOWERED COMMITTEE OF STATE FINANCE MINISTERS, FIRST DISCUSSION PAPER ON GOODS AND SERVICE TAX IN INDIA(2009). ["First Discussion Paper"]

narration does not appropriately underscore the importance and relevance of GST.

In the existing constitutional and legal dynamics governing the levy of indirect taxes in India, GST essentially represents two distinct attainments under the Indian policy. Firstly, it envisages the levy of a tax, hitherto unprecedented, simultaneously by the Parliament and State Legislatures and thus GST is often colloquially referred as a dual-levy[26] in the Indian context. Secondly, the introduction of GST postulates a "comprehensive indirect tax reform"[27] based on a consolidation exercise whereby the existing indirect taxes would be subsumed to form an amalgam.

On the first count, the change is significant both on a constitutional and legal-theory count as also in view of the change in the practical dimension of the manner in which taxes are imposed in India. On the constitutional front, GST represents a significant shift as it seeks to attain "co-operative federalism"[28] in India, a concept which has rarely even formed a subject-matter of academic inquiry much less pressed into action in the Indian polity. Thus, the GST regime will be an unprecedented legal traverse in the Indian constitutional set-up capable of igniting numerous jurisprudential shifts and unsettling a number of federal aspects of the Constitution which are more or less settled as on date.

This aspect is further accentuated owing to its intertwined relationship with the pragmatic considerations, relating from the implementation of the proposed levies under the GST regime. Under the existing set-up, the rule has attained an axiomatic status that there can be only one law governing one levy. The dual nature of GST implies that on any and every aspect relating to levy and collection of GST in India, one can expect two sets of governing laws. To illustrate, in the event the transaction is one of sale or service, one typically applies the State VAT

[26]First Discussion Paper, *supra* note 25at f3.2.

[17]*Seeid.atM.\.*

[n]*See* Arun Jaiteley, Speech on the floor of the Lok Sabha during the passage of the Amendment Bill (on May 6, 2015).

law or Service Tax law respectively in today's scenario. Thus, the tax-compliance requires only one set of law to be examined. In the GST regime, however, either of transactions will require analysis of two laws, i.e., the Central GST law ("CGST") and the State GST law **("SGST")** and the rules made thereunder. In the event the GGST and SGST are not *parimateria* and even if they differ in minor aspects, tax-compliance may pose a challenge. While it is understood that there exists and in-principle agreement between the Central and State governments over the parity in the implementation of the GST, nonetheless, the ground-rules governing the determination of tax liabilities and their enforcement will undergo a substantial change.

The second substantial change owing to onset of GST is also accentuated by a shift in constitutionally sanctioned legislative landscape and has substantial bearing on the state-of-affairs on the pragmatic front especially in so far as ground-level tax-enforcement and compliance is concerned. This aspect also reveals a substantial attainment over the cascading effects.[29]As stated above, under the existing constitutional scheme various subject-matters of taxation are identified and distributed between the Parliament and State Legislatures. The following table reveals this factual position as on date.

Parliamentary tax-subjects	**State tax-subjects**
J. aruamciiLary laA-suujecis	Land revenue (Entry 45 of List -
1. Taxes on income (Entry 82 of List -1) . Customs duties (Entry 83 of List -1) 3. Excise duties (Entry 84 of List	Taxes on agricultural income (Entry 46 of List - H) Succession tax on agricultural land (Entry 47 of List - II)

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[19]*See* Sacchidananda Mukherjee, *Present State of Goods and Services Tax (GST) Reform in India,* 162 NIPFP WORKING PAPER (2015) (for a general appraisal of the various supplies where input credit is lost leading to cascading effects which and related ills will be addressed by the GST). ["Sacchidananda Mukherjee"]

re LAW AND GOVERNANCE

4. Corporation tax (Entry 85 of List -1)
5. Taxes on capital value of assets (Entry 86 of List - I)
6. Estate duty (Entry 87 of List - I)
7. Succession tax (Entry 88 of List - 1)
8. Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights (Entry 89 of List - I)
9. Taxes on transactions in stock exchanges and futures markets (Entry 90 of List - I)
10. Stamp duties on various negotiable instruments such as bills of exchange, cheques, promissory notes, bills of lading, letters of credit, etc. (Entry 91 of List-I).
11. Taxes on sale or purchase of newspapers and on advertisements published therein (Entry 92 of List - I)
12. Tax on inter-state purchase or sale of goods (Entry 92A of List -1)
13. Tax on inter-state consignment of goods (Entry 92BofList-I)
14. Taxes on services (Entry 92C of List - I)

4. Estate duty on agricultural land (Entry 48 of List - II)
5. Taxes on land and building (Entry 49 of List-II)
6. Taxes on mineral rights (Entry 50 of List-II)
7. State Excise duties (Entry 51 of List - II)
8. Entry taxes on goods (Entry 52 of List - II)
9. Electricity duty (Entry 53 of List - II)
10. Taxes on sale and purchase of goods (Entry 54 of List - II)
11. Taxes on advertisements (Entry 55 of List - II)
12. Taxes on goods and passengers carried by road or on inland waterways (Entry 56 of List - II)
13. Taxes on vehicles (Entry 57 of List - II)
14. Taxes on animal and boats (Entry 58 of List - II)
15. Toll Taxes (Entry 59 of List - LT)
16. Professional Taxes (Entry 60 of List - II)
17. Capitation Taxes (Entry 61 of List - II)
18. Taxes on luxuries, entertainment, amusements, betting and gambling (Entry 62 of L,ist - II)
19. Stamp duty on certain documents (Entry 63 of List - II)

Originally, GST was proposed to act as a grand consolidation exercise whereby all indirect taxes from amongst the tax-subjects enumerated above were to be merged and thereupon a single levy, i.e., the GST was to be imposed.[30] The political-bargain, however, has not been able to attain this ideal and instead the GST as it is proposed under the Amendment Bill seeks to subsume a significant number of indirect taxes but not all indirect taxes. An examination of the taxes being subsumed will be undertaken in the latter half of this article. The purpose will suffice, however, at this stage to note that diverse taxing powers will be subsumed into one harmonized tax regime. The rules being framed under GST are expected to be uniform across States; the idea being to create a common national market. Further, given the fact that the nature and form of tax varies currently since a number of taxes are not interlinked rendering them non-creditable in conjoint and further supplies. This leads to a cascading effect of taxes. Consequently, the subsumation exercise is also expected to end the cascading and reduce the overall tax-cost embedded in supplies.

The applicable legal regime relating to existing indirect taxes has practically led to distortion of market forces in as much as tax-costs result into a significant factor in pricing decisions and also accentuates inflationary forces on account of the cascading effect.[31] The remedy to

[30] Thirteenth Finance Commission, *supra* note 22 at f5.24(ii)(which recommended that "all major indirect taxes (excluding customs) and all cesses and surcharges should be subsumed into the Central and State GST. Specifically, stamp duty, taxes on vehicles, taxes on goods and passengers and taxes and duties on electricity should be subsumed in GST").See *also* Thirteenth Finance Commission, *supra* note 22 atf5.24(ix) (The Report further recommended that "no exemptions should be allowed, except for a common list applicable to all states as well as the Centre, which should only comprise: (a) unprocessed food items; (b) public services provided by all governments excluding railways, communications, public sector enterprises; (c) service transactions between an employer and employee and (d) health and education services").

[31] *See* Select Committee Report,.*supra* note 9; Thirteenth Finance Commission, *supra* note 22;Tarun Jain, *supra* note 23.

these ills necessarily requires a change in the constitutional and legal landscape which is sought to be achieved by GST as provided for in the Amendment Bill.

At this stage, it is also expedient to note the official justification given for introduction of GST. It has *inter alia* been stated[32] that "the introduction of GST at the Central level will not only include comprehensively more indirect Central taxes and integrate goods and service taxes for the purpose of set-off relief, but may also lead to revenue gain for the Centre through widening of the dealer base by capturing value addition in the distributive trade and increased compliance." Further, "in the GST, both the cascading effects of CENVAT and service tax are removed with set-off, and a continuous chain of set-off from the original producer's point and service provider's point upto the retailer's level is established which reduces the burden of all cascading effects. This is the essence of GST, and this is why GST is not simply VAT plus service tax but an improvement over the previous system of VAT and disjointed service tax. The GST at the State-level is, therefore, justified for (a) additional power of levy of taxation of services for the States, (b) system of comprehensive set-off relief, including set-off for cascading burden of CENVAT and service taxes, (c) subsuming of several taxes in the GST and (d) removal of burden of Central Sales Tax ("CST"). Because of the removal of cascading effect, the burden of tax under GST on goods will, in general, fall."

IV. EXAMINING THE 'AMENDMENT BILL'

The Amendment Bill seeks to amend the Constitution in a number of ways. To take cue from the Statement of Objects and Reasons accompanying the Amendment Bill, *inter alia* the following changes are proposed. It is noteworthy that most of these changes are unprecedented both in design and form.

(i) Conferment of "concurrent taxing powers on the Union as well as States... to make laws for levying goods and service tax on every

"First Discussion Paper, *supra* note 25 at ff 1.13-1.14.

transaction of supply of goods or services or both".[33]This change is necessitated out of the political consensus that GST must be on a "dual-basis"[34]permitting both the Central and State Government to tax the same supply as opposed to the existing legal regime which only provides for exclusivity of taxing powers between the Parliament vis-a-vis the State Legislatures.

(ii) The GST "shall replace a number of indirect taxes being levied by the Union and State Governments" and, as discussed above, this is proposed as it is likely to "remove cascading effect of taxes and provide for a common national market for goods and services."[35]

(iii) GST would not "be levied on all transactions involving supply of goods and services" as some of them "are kept out of the purview of"[36] GST. It is pertinent to note that while at paragraph 2(g) of this Statement it is provided that all goods and services, except alcoholic liquor for human consumption (and petroleum and petroleum products for a limited time-frame) are covered under GST, the Select Committee Report records the submissions of the Ministry of Finance, Government of India that *inter alia* electricity has also always been intended to be excluded from the ambit of GST.

[i3]*See infra* note 40 (Statement of Objects and Reasons accompanying the Amendment Billfl).
[34] First Discussion Paper, *supra* note 25 at f3.2.
[K]*Seeid.3.t\\.*
[i6]*Id. See also* Select Committee Report, *supra* note 9.

(iv) While the optimal scenario would be to subsume all indirect taxes,[37] the GST will only subsume certain Parliamentary and State taxes.[38]

(v) A new constitutional body i.e. the 'Goods and Service Tax Council' shall be constituted "to examine issues" relating to GST and "make recommendations to the Union and the States on parameters like rates, exemption list and threshold limits. "[39]The Amendment Bill provides extensively for the scope of the Council's powers and the manner of its functioning, decisionmaking etc.[40]It appears that the Council is sought to be positioned as a supra-legislative body as it is expected to recommend even on aspects which are perceived as exclusively legislative functions such as "model Goods and Service Tax Laws, principles of levy", "rates including floor rates with bands of goods and service tax", etc.[41]

The Amendment Bill carries 21 clauses providing for these and other incidental changes to be carried out in the Constitution to usher in the new indirect tax regime. These include changes in constitutional

"Thirteenth Finance Commission, *supra* note 22.
[38] First Discussion Paper, *supra* note 25 at f2(b) (The Parliamentary taxes subsumed are "Central Excise Duty, Additional Excise Duty, Excise Duty levied under the Medicinal and Toilet Preparations (Excise Duty) Act, 1955, Service Tax, Additional Customs Duty commonly known as Countervailing Duty, Special Additional Duty of Customs, and Central Surcharges and Cesses so far as they relate to the supply of goods and services." [Statement of Objects and Reasons accompanying the Amendment Bill, paragraph 2(a)] The State taxes subsumed are "State Value Added Taxes / Sales Tax, Entertainment Tax (other than the tax levied by the local bodies), Central Sales Tax (levied by the Centre and collected by the States), Octroi and Entry Tax, Purchase Tax, Luxury Tax, Taxes on lottery, betting and gambling; and State cesses and surcharges in so far as they relate to supply of goods and services"). *"See supra* note 25 at f2(i). [40]THE CONSTITUTION (ONE HUNDRED AND TWENTY-SECOND AMENDMENT)
BILL, 2014, CI. 12(Vide Article 279A sought to be inserted in the Constitution), http://www.prsindia.org/uploads/media/Constitution%20122nd/Constitution%20%2 8122%29%20as%20passed%20by%20LS.pdf. ["Amendment Bill"].
[4i]*See id. See also* Select Committee Report, *supra* note 9 (It is relevant to note on this aspect that Note of Dissent to the Select Committee Report has specifically pointed out that the GST Council is seen as eroding legislative sovereignty).

provisions relating to legislative powers and their distribution amongst the Parliament and State Legislatures in so far as taxes on supply of goods or services are concerned, provisions relating to distribution of finances amongst the Central and State Governments; provision for "compensation to the States for loss of revenue arising on account of implementation of GST",[42] transitional provisions, etc.

Compared from its 2011 version, the Amendment Bill carries two significant changes. Firstly, a provision exists stipulating a temporary additional tax of upto one percent on inter-State movement of goods, the proceeds of which shall be assigned to the State from which the supply of the goods originates.[43] It is argued that this additional levy is "market distorting" and interferes with the design of the harmonized GST styled on the lines of a "destination based consumption tax".[44] Secondly, the Amendment Bill is conspicuous by absence of a GST Dispute Settlement Body which was extensively provided for as a constitutional body accompanying the GST Council in the 2011 version. Instead the Amendment Bill relegates to the GST Council the decision "about the modalities to resolve disputes arising out of its recommendations."[45] This is a significant omission as the members of the GST Dispute Settlement Authority, as provided for in the 2011 version, were independent of the members of the GST Council and had significant powers to "adjudicate any dispute or complaint" which was (a) "arising out of any deviation from recommendations" of the GST Council or (b) which resulted "in a loss of revenue" to the Central or State Governments or (c) which affected "the harmonized structure of the goods and service tax". This omission

"*See id.* at CI. 19.

[43]&e *id.* at CI. 18.

"*See* Arun Jaitley, Speech on the floor of the Lok Sabha during the introduction of the Amendment Bill (April 24, 2015). ["24 April Speech"]&e *also* Select Committee Report, *supra* note 9 (the Note of Dissent to the Select Committee Report).

[45]Se<? Amendment Bill, *supra* note 40 at Cl. 12 (Article 279A(11) sought to be inserted in the Constitution under Clause 12 of the Amendment Bill).

has also been opposed on a variety of grounds principally involving concerns relating to impassionate redressal of dispute arising out of deviation of the GST design by one or more actors.[46]

V. ASSESSING THE BUSINESS IMPACT OF 'GST'

The proposed GST with its innate nuances, as understood from the Amendment Bill, is intrinsically a positive reform for a business perspective. The new regime proposes commonality of taxes being levied in the country, both in spirit and form, which is a huge contrast from the existing state-of-af fairs. The official reason mooted for GST is equally balanced in so far as its positive effect on businesses is concerned. On it has aspect it is official declared[47] that GST is likely to achieve a "collectively positive-sum game" *inter alia* in the following terms;

> *"The GST at the Central and at the State level will thus give more relief to industry, trade, agriculture and consumers through a more comprehensive and wider coverage of input tax set-off and service tax set-off, subsuming of several taxes in the GST and phasing out ofCST With the GST being properly formulated by appropriate calibration of rates and adequate compensation where necessary, there may also be revenue / resource gain for both the Centre and the States, primarily through widening of tax base and possibility of a significant improvement in tax-compliance. In other words, the GST may usher in the possibility of a collective gain for industry, trade, agriculture and common consumers as well as for the Central Government and the State Governments. The GST may, indeed, lead to the possibility of collectively positive-sum game."*

Besides this broad declaration in order to realize the potential changes it is also necessary to enumerate the perceived gains in simplest of terms both from the perspective of interface with tax-administration *per se* as also from a tax-compliance perspective. When GST is positioned

[46]&e Select Committee Report, *supra* note 9 (inter alia, the Note of Dissent to the Report of the Select Committee Report).
[47]First Discussion Paper, *supra* note 25 at f 1.15. *SeealsolA* April Speech, *supra* note 44.

as a medium to attain "common national market for goods and services", it necessarily spells out the following practical aspects for business;

(i) Uniform laws across Centre and States. This will rule out the differences in interpretation and ensure commonality of understanding on all aspects relating to statutory provisions and subordinate legislations.

(ii) Common registration across Central GST and State GSTs, a common tax-return, and a common challan for tax payment.[48]This is supplemented by "a common portal providing three core services (registration, returns and payments)",[49] thus accentuating the technological infrastructure's availability to all tax-payers irrespective of their geographical positioning and applicable jurisdiction. These will go a long way to rule out the anomalies and hardships arising out of the differences in form and reporting requirements which is perceptually very common in the existing scenario.

(iii) Credit availability of 'Integrated Goods and Service Tax' **("IGST")** which will replace the CST paid by the selling dealer in the exporting State to the purchasing dealer in the importing State.[30] This is at a positive contrast from the existing CST regime where such credit is not permitted and thus cascading effect on this account is specifically avoided specially in case of inter-state supply of goods.

[48]EMPOWERED GROUP ON IT INFRASTRUCTURE ON GST, The IT Strategy for GST, fl.2, http://finmin.nic.in/gst/IT_Strategy_for_GST_verO.85.pdf (Last visited August 31,2015).

""*Id.*

[x]*See id.at%2.3.*

(iv) Capturing invoice-level information in the GST infrastructure[51] along with tracking of goods movement across States will ensure that credit availability based on such invoices is known at the very outset to the business. Thus, on account the implementation of GST, a large number of disputes relating to denial of credit on account of improper invoices which plague the country and are a vexed issue currently, will be done away with.

Moreover, the availability of credits and removal of cascading effect will on an overall lead to "improving the competitiveness of domestic industries in international market by removing hidden and embedded taxes".[52]The most significant and measurable outcome of this exercise is the reduction in the final prices of the goods and services. Significant effort has been spent on estimating the economic benefits and the overall gain to the economy on account of the transition to GST.[53]Economic projections consistently reveal, in view of the expansion of the tax-base on account of GST, that there is a simultaneous reduction in the tax-element built in the price of the goods and services supplied in India while still leading to increased revenue collection which provides added fiscal space to the Governments to implement their reform / welfare agendas.[54]

Further, by mitigating unilateral action of the governments in view of the fiscal federal design that GST ensues, businesses are insulated from their spontaneous tax-choices and instead governed by prudent tax regulations. This consequently implies long-term benefits for the business which are likely to be passed on the consumers in view of rules of competition. The lessons from similar broad-based transitions from the sales tax to value-added tax regimes in the context of tax on supply of goods and the positive-list to negative-list regime in the context of tax on services are well documented to the effect that such transitions have

[51]*Seeid.* atf4.1.

[52]See Sacchidananda Mukherjee, *supra* note 29.

"See, *e.g.*, Thirteenth Finance Commission, *supra* note 22; Sacchidananda Mukherjee, *supra* note 29.

[54]5ee, *e.g.*, MINISTRY OF FINANCE, REPORT ON THE REVENUE NEUTRAL RATE AND STRUCTURE OF RATES FOR THE GOODS AND SERVICES (GST) (2015). *See also* Thirteenth Finance Commission, *supra* note 22..

proved mutually beneficial by furthering of the goals of the tax-administration in form of increased tax revenues as also the wish-list of the tax-payers in the form of simplified compliances and overall reduction in the tax-element in the supplies.

To single out a key constituent reform in the GST, entry taxes on goods are being abolished. These taxes, which are largely non-creditable, have largely been responsible for creation of innumerable fragmented markets in the country. The levy of this tax is one of the most litigated ones both in terms of its application as also its coverage, which varies from State to State.[55] The fluctuating legal tests sanctioning the levy[56]have only ensured that its enforcement is mired in legal controversies.[57]Similarly, synergies are perceived from the abolition of State-level entertainment taxes which owing to their archaic legislations are constantly the subject-matter of judicial scrutiny.[58]0n this front alone, GST represents a milestone leap in the existing indirect tax regime for integration of these taxes alone imply removal of domestic barriers to free trade.

On a broad-level, minus the ground-details, it can indeed be concluded that GST will improve the 'business climate' of the country which is "usually associated with low state and local taxes, right to work laws, little union activity, and a cooperative governmental structure."[59]

[i5]*See e,g.,* Maharashtra Provincial Municipal Corporation Act, 1949, § 127. (In the State of Maharashtra entry tax can be levied in the forms of "Octroi", "cess in lieu of Octroi", "local body tax in lieu of octroi").

^*Compare* Jaiprakash Associates Ltd. v. State of Madhya Pradesh (2009) 7 S.C.C. 339, with Jindal Stainless Ltd. v. State of Haryana, (2006) 7 S.C.C. 241 (to examine the oscillating legal position adopted by the Supreme Court on the nature of levy).

[57] Jindal Stainless Ltd. v. State of Haryana, (2010) 4 S.C.C. 595 (The Supreme Court in this decision has referred for reconsideration the legal issues relating to nature and levy of entry tax to a larger bench).

[5S]*See, e.g.,* Tata Sky Ltd. v. State of Madhya Pradesh, (2013) 4 S.C.C. 656.

[59] Thomas R. Plaut & Joseph E. Pluta, *Business Climate, Taxes and Expenditure, and State Industrial Growth in the United States,* 50 S. ECON. J. 99 (1983).

VI. ISSUES TO THE IRONED OUT: WISH-LIST ON 'GST'

The idea of GST is much larger that the Amendment Bill is currently designed to provide for. The Amendment Bill must therefore be seen only as a means and not as the panacea that GST promises in the Indian context. It is therefore essential that one examines the wish-list of further attainments post the Amendment Bill's enforcement for hidden in this list are the further synergies businesses can expect.

A. Way forward on GST structure

The first and foremost challenge to the attainment of a common national market is the coverage of GST. It is evident from the above discussion that certain indirect taxes as also certain goods and services are likely to be excluded from its ambit. The exclusions from GST may be on account of political compulsions owing to variety of factors but they do not make economic sense. Dr. Rathin Roy, Director, National Institute of Public Finance and Policy (NIPFP) categorically stated[60] before the Parliamentary Committee that "the more items you exclude from the GST and more distortions you create, the lower will be that net benefit". This is partly on account of the fact that "the fewer items we exempt, the greater ability to have lower rate"[61] of GST. Clearly therefore the design of GST must be all-inclusive.[62] However, this is not currently being provided for.

In the meanwhile i.e. till the time the GST is implemented in the form provided in the Amendment Bill, certain legislative subjects relating to indirect taxes will continue to hold the field in parallel with GST. For illustration, electricity duty; taxes on goods and passenger carried by road or inland water ways; taxes on vehicles; taxes on animals and boats; toll taxes; stamp duties etc. can simultaneously be imposed by the States along with GST. Similarly terminal taxes on good and passengers; taxes on stock exchange transactions etc. can be imposed by the Parliament along with

[m]*See* Select Committee Report, *supra* note 9 at f 9.1.
[61]*See id.ax %* 9.4.
"FOURTEENTH FINANCE COMMISSION OF INDIA, REPORT OF THE FOURTEENTH FINANCE COMMISSION OF INDIA (2015), 113.30. *See also* Thirteenth Finance Commission, *supra* note 23.

GST. Thus it is seen that GST as introduced by the Amendment Bill does not clean-up the fragmented indirect tax landscape completely even though there can be no doubt that the Amendment Bill indeed substantially undertakes this clean-up exercise.

The Amendment Bill is apparently alive to this aspect and provides for k. The GST Council is vested with the discretion to recommend on subsuming other taxes[63] and goods and services[64] in the GST. One can hope that sooner or later all taxes on all forms of supply of goods and services will form the GST amalgam towards complete attainment of the twin goals of establishing a common national market and undoing cascading effect.

B. Ensuring commonality of design and form across the country

From a practical perspective, it is to be appreciated that GST is positioned as a dual levy i.e. it would be administered in parallel both by the Central Government and State Governments. Therefore it is essential that the legislations enabling the two levies are consistent both in terms of statutory provisions they carry as also on a number of related fronts such as scope of levy in the form of taxable event being described, the charging provision being stipulated, the threshold limit being provided for being exigible to tax, the coverage of exemptions, the valuation methodology, the availability of credit etc.[65] Similarly, from the recordkeeping perspective one single format for the entire country is ideal and essential as introduction of separate State-specific requirements would ensure multiplicity of paper work and also duality of form which is

[a]*See* Amendment Bill, *supra* note 40, at CI. 12 (Article 279A(4)(a),proposed to be inserted in the Constitution in terms of Clause 12 of the Amendment Bill).
[M]*Id.* (Article 279A(4)(b), proposed to be inserted in the Constitution in terms of Clause 12 of the Amendment Bill).
[65]First Discussion Paper, *supra* note 25 at f3.26(vii) (states that "to the extent feasible, uniform procedure for collection of both Central GST and State GST would be prescribed in the respective legislation for Central GST and State GST").

unacceptable in a harmonized regime. From an ease-of-doing-business perspective, it lis essential that synchronized record keeping policies are introduced and maintained.

Furtk er, the Information-Technology Infrastructure should be geared up to truly achieve -the "single window clearance" model. A new entity has, been, instituted to rnjajrijtain the 'Goods and ^Service Tax Network' ("GSTN") which would be entrusted with maintaining this technology backbone. Its vision document, read ajqrig with the publicly? available informatipn[66]on its expected .manner of functioning =is indeed heartwarming on,this asbect. Nonetheless,,at no point, it can be under-emphasized that there, must be a common electronic-gateway for all GST compliances irrespective of physical positioning of the subject-matter of supply or the location of the transacting parties along with the availability of standardized formats for statutory filing and ensuring a common and seamless interaction with all the assesses being covered under GST.

C. *Input-tax credit policy and mechanism*

Designing an efficient and effective input-tax credit regulation is perhaps the biggest enigma for policy-makers. The very fact that GST is an indirect tax and one on consumption,[67]it is essential that the businesses are kept tax-neutral in all scenarios. If tax-compliance is to be attained in its entirety, it is axiomatic that the business is rendered tax-neutral by ensuring availability of input-tax credit. This aspect is addressed under 'principle of fiscal neutrality' or alternatively 'principle of tax neutrality' and nas a number of incidental aspects.[68] The two most prominent of these are that, firstly,, the tax must;flow-through the business to tne consumer[69] and secondly that "in order to preserve neutrality of VAT" that the output tax rate "as a general rule, deduction of the VAT applied

^*See supra* note 4§.

b7*See supra* note 44.

bS*See* STEPHAN SMITH, THE DEFINITIVE REGIME FOR VAT 5-8 (1997) (for the meaning and dimension of neutrality in a VAT system).

^Organisation for Economic Cooperation and Development, International VAT / GST Guidelines, 12.3(2014).

at the preceding stage"[70] This is the international consensus on this aspect.[71]

The issue is so significant that non-availability of input-tax credit has led to high-staked litigation across the globe on account of tax-motivated schemes being designed to artificially, reduce non-creditable taxes.[72] To achieve a tax-compliant regime, therefore, it is essential that input-tax credit scheme proposed under the GST is a well thought-out one. Indian courts are replete with challenges to denial of input-tax credit and pernaps the largest cxiurjk of indirect tax cases revolve around input-tax credit related issues. Further, this aspect attains a vital significance in the GST design as it is the most vital pjyot which, ensures against casqading effect, Thus, even if in-principle?. the idea underlying GST is to undo jhe cascading effect, it will remain illusory in the absence of efficiency-laden input-tax credit rules.[73]

Some of the aspects which can be considered while framing of the input-tax credit regulations are enumerated as under:

(i) It would be an ideal setting to have a common and centralized pool for GST; meaning thereby that there should not be any differentiation of input-tax credit in GST and input-tax credit on any account should be available to meet the output-tax liability on any account. The experience of input credit scheme under Central Excise and Service Tax has shown that litigation ensues

[70] Preamble to EC VAT Directive (EC) No. 112/2006 of 28 Dec. 2006, CI. 30.

[71] *See supra* note 69.

[72] *See* Case C-255/02, Halifax PLC; v. Commissioner of Customs & Excise, 2006, http://curia.europa.eu/juris/showPdf.jsfpdocid = 65780&doclang=EN. (last visited Feb. 27, 2016). *See also,* McDowell & Co. Ltd. v. Commercial Tax Officer, A.I.R. 1986 SC 649.

[73] First Discussion Paper, *supra* note 25 (notes that the input-tax credit rules under the Central Excise, Service Tax and. Value Added Tax legislations have addressed the cascading effect to certain extent and the position under GST is a reform thereon).

particularly on account of the non-acceptability of the revenue authorities of a particular input-tax being creditable in view of the tax being claimed as input not matching with the definition of input-tax or its attributes under the credit scheme/[4] It is therefore essential that credit scheme is devised by adopting an in-principle approach rather than a formalistic-approach[75] such that there is no dispute on the eligibility to credit.

(ii) It must also be ensured that the criteria's for availing credit should not vary and instead be common across-the-board for all States under all GST legislations.

(iii)The eligibility for input-tax credit should be defined in widest of terms such that input-tax credits are not left unusable on any account. Non-allowance of credit leads to blockage of working capital and is actually amounts to double-taxation[76], the cascading effects apart. This is not entirely a conducive scenario for business and must therefore be addressed.

(iv) Restrictions on any availing of input-tax credit, if any, must be minimal and on a very clearly defined space. This is required in order to ensure that unwarranted disputes do not crop up in so far as availing of input-tax credit is concerned.

(v) The existing scheme of differentiating credit into variants such as capital goods, inputs, input services, etc. must be revisited as a further bifurcation of input-tax credit on these and other accounts leads to increase in tax-compliance costs, interpretation issues, etc.

In short, the key objective in devising the input-tax credit scheme should be that there is free-flow of credit both within the Centre and State

[74], *See, e.g.,* Coca Cola India Pvt. Ltd. v. Commissioner of Central Excise,2009 (15) S.T.R. 657 (Bom.); Maruti Suzuki Ltd. v. Commissioner of Central Excise, (2009) 9 S.C.C. 193.
[75]*See, e.g.,* Rule 2(k) and Rule 2(1) of the CENVAT Credit Rules, 2004 (which regulate the input-tax credit on goods and services).
[76]*See generally* Security Printing and Minting Corporation of India Ltd. v. Gandhi Industrial Corporation, (2007) 13 S.C.C. 236; Salora International Ltd. v. Commissioner of Central Excise, (2012) 9 S.C.C. 662.

GST regimes as a robust input-tax credit scheme alone would effectively determine the success of GST.

D. Revisiting Tax-administration profile

GST calls upon a fundamental change of outlook in the behavior and response mechanism of tax-authorities. Since the GST regime is unprecedented and its effective implementation is imperative for the success of this reform, it is essential that the tax-administration substitutes its adversarial outlook to guidance-oriented outlook.[77]Both the tax-payers as also the consumers (who are perhaps the biggest stakeholders of GST) must be ably guided by the tax-administration even if it requires hand-holding in the initial years of GST implementation. The fact that tax-administration needs to undergo a service-oriented transformation has already been officially documented.[78] Perhaps GST presents the right opportunity to undertake this reorientation.

Since GST also represents a reform, there is no reason to confine the ambit of reform to the legislative structure alone. If the tax-administration also undergoes an ideological transformation on a parallel, the same will only lead to further growth on account of increased tax-compliance. To illustrate, when the service tax regime underwent a diametric shift from positive-list approach to negative list, the tax-administration issued a comprehensive service-tax guide explaining the changes in simplistic language. The stipulations in the guide were caveated in so far as it carried a declaration that the explanation in the guide was not enforceable in courts. Nonetheless, the guide did serve a purpose in as much as it brought on record the understanding of the tax-

[I]*See generally* TAX ADMINISTRATIVE REFORMS COMMISSION, FIRST REPORT ON TAX ADMINISTRATION REFORM IN INDIA: SPIRITS, PURPOSE AND EMPOWERMENT (2014). [n]*See id.*

administration and based thereon commercial decisions were taken by the businesses while adopting tax-positions.

A similar exercise in the context of GST will indeed be useful. More utility can be added by the tax-administration if it can be geared to provide proactive clarifications on tax positions individually and to businesses at large. An official restatement of the tax position at an early stage of legislative or regulatory change ensures that even tax-payers are able to mould their actions in advance towards due compliance, reducing the scope for disputes and even litigation at a later stage. In fact, a clarification in advance often leads clarity on the issue which indirectly leads to correct pricing-decisions and thus the business decision-making is undertaken on economic and commercial considerations rather than basis tax-positions. A dedicated Guidance Cell empowered to issue formal and legally binding advices within the tax-administration and mandated to act as a single-window system for any and every clarification on any arising interpretative Issue out of implementation of GST would indeed further the idea of reforming the tax-administration in a long way. The higher the level of interaction of such Cell with the businesses and a time-bound response to representations and queries would lead to greater synergy and higher tax compliance for then the GST would be enforced by the tax-payers and tax-administration together rather than as fo;3. Given the level of technological advancement, adoption of interactive web based system which envisages circulation of tax-interpretations or policy decisions to the tax-payers and the other revenue authorities by the Cell would go a long way in establishing a business friendly environment.

E. Moderating legislative and regulatory changes

Frequent legislative and regulatory changes in the tax landscape works to the detriment of tax-payers and tax-administration alike for both have to change their positions as also revisit the past transactions. The changes arise either on account of need to address modifications in tax-environment or deviant behavior. Changes are also required to fix drafting errors or to undo unintended consequences. Nonetheless the fact remains that the changes lead to significant business costs as even minor legislative or regulatory changes can lead to increased compliance costs and like.

On this count, since GST in itself represents the biggest tax-change in Indian tax-landscape, the tax-administration would be well advised to keep the subsequent changes to the minimum, the amendments being confined to those aspects which are truly essential towards a harmonized design of the tax.

Further, the current practice of introducing the changes from a past date or from the date of notification of the change also requires scrutiny. It may well be worth a confidence-garnering opportunity for the tax-administration if it adopts a policy of giving a lead time, say one to three months, by way of advance notification of the changes sought to be implemented. The advance notifications accompanied by a policy note setting the contours of the proposed change would also ensure that rationale behind the change are understood in their correct spirit by the business leaving little scope for ambiguity or subsequent interpretational dispute.

F. Efficient dispute-resolution mechanism

On the dispute-resolution front, unlike its 2011 version, the Amendment Bill does not lay down any guidance and leaves it to the wisdom of GST Council to lay down the modalities for dispute resolution. This implies that GST disputes will have to traverse the existing system. With the Supreme Court having, in-principle, permitted the existing system of specialized tax-adjudication[79], it is expected to continue under the GST regime. However there is no reason not to imbibe the learnings from the existing regime and undertake reform in the adjudication machinery as its fairness and efficiency also constitutes a vital element of reform.

Currently, the tax-deviations at the first level are booked by departmental officers and also adjudicated by them. In practice, it is

[79]Madras Bar Association v. Union of India, (2010) 11 S.C.C. 67.

generally the same person carrying out the functions of a complainant, interpreter as also adjudicator. This imputes sizeable doubt over the impartiality of the proceedings as also violates an essential principle of natural justice that justice should not only be done but also seems to be done.[80] In the past, a number of administrative reform commissions have recommend to cut the Gordian-knot between the departmental officers who investigate tax-violations and those who are entrusted with adjudicatory and appellate functions, yet the practice continues.[81]The GST regime could be the reason for adopting this change which would all be welcome as it would give the revenue officers sufficient leeway to adopt a principle approach rather than the approach which obliges giving due weightage to departmental views as also monetary tax-collection targets.

Further, the adjudication provisions under the existing law only lay down directory timeframe for fiscal adjudication. These could well be reinforced in the GST regime by stipulation of consequences for failure to act in the stipulated timelines such that tax-disputes are resolved within reasonable periods and not unduly prolonged with the interest-clock ticking in the meanwhile. Additionally, the out-of-court settlement of tax-disputes, which is partially instituted in the existing regime in the forms of Settlement Commission, Advance Ruling Authorities etc., can be further worked upon such that disputes are resolved at the earliest and without ado in the GST regime.

While the aforesaid discussion essentially constitutes a wish-list on certain ground-level aspects under the GST, these would essentially determine the smoothness with which GST is transitioned. There is no doubt that GST, given its intent and design, is one key reform which *sui generis* carries the ability to mould the business climate of the country. Thus, it essential that the finer nuances of the regime are threshed out in greater detail such that the intention behind the onset of this new requirement is not lost and is instead accentuated in practice.

[8C]'See *generally* Rv. Sussex Justices, Ex parte McCarthy, [1924] 1K.B. 256; Oryx Fisheries Pvt. Ltd. v. Union of India, (2010) 13 S.C.C. 427. [81]5ee *supra* note *77.*

VII. CONCLUSION

An exercise to understand the fallouts of the implementation of GST in India is best undertaken in the relative constitutional and legal background which is the impetus to the GST. A comparative appraisal of the existing landscape with the position under the proposed regime essential reflects that the change is not one of mere nomenclature but essential seeks to undo the inefficiency which creeps into the system due to disjoint structures owing to their legal setting. By reforming the very structure, the perpetuated ills are sought to be addressed in a manner which has the potential to snowball its effect on the economy, albeit in a positive way.

There is no doubt that the GST regime sought to be introduced under the Amendment Bill is not the optimally efficient one. Enough academic and economic analysis has already concluded this aspect. However it is exactly at this stage that it is important to underscore the positioning of the Amendment Bill as a "means" i.e. a stage of the large reform agenda that GST represents. There is enough intrinsic evidence in the Amendment Bill that the law-makers are conscious of the part-performance on the GST agenda and therefore have provided adequate room for further improvement of the attainments sought to be achieved under the Amendment Bill.

Examined in this light, an adjudication of the relative merits and demerits of the Amendment Bill reveals stupendous success on atleast three counts; (a) unshackling the constitutional fetters which do not permit integration of all indirect taxes; (b) evidencing broad-consensus of the country being of one view that GST represents the way-forward; and (c) fostering a significant movement on the reform agenda that GST represents. Given the near unanimity that GST has to be all-inclusive, it is likely one can witness the further steps on that front in near future. In the meanwhile, the initial lessons learnt from the implementation of the legal position arising out of the Amendment Bill will also be known

rendering the law-makers wiser for further refinement towards adoption of an ideal indirect tax design that GST represents.

In as much as GST represents a win-win scenario for businesses, consumers and the national economy alike, which fact stands acknowledged both in expert reports as also in the considered opinion of the legislatures, the fact that Amendment Bill may not represent an ideal design of GST to some should not come in the way of its adoption for even GST is not an end itself; it only reflects the decades old unfinished agenda of reform. GST would form the pedestal for the Indian economy to be buoyed by tax-efficiency and thus is indeed a significant movement towards improving the business climate of the country.