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# FOREWORD

India is one of the world's fastest-growing economies and has always been committed to fostering an environment conducive to business growth and development. Over the years, the country has made significant strides in its framework, with a particular focus on business laws. The aim is to strike a delicate balance between protecting the interests of entrepreneurs, investors, and consumers while facilitating economic growth and development.

In 2022-23, India's business landscape witnessed a series of significant legal changes, signalling the government's unwavering commitment to streamlining the regulatory framework and fostering ease of doing business. The Securities and Exchange Board of India ("**SEBI**") introduced significant reforms in the capital markets. In 2022-23, SEBI implemented measures to enhance corporate governance, investor protection, and transparency. The regulatory framework for initial public offerings (IPOs) was revamped to streamline the listing process, monitor the movement of funds, and make it more efficient. SEBI also focused on strengthening regulations related to insider trading, market manipulation, and disclosures, with an emphasis on stricter enforcement.

However, despite these positive developments, challenges remain in implementing and effectively enforcing these norms. Bureaucratic inefficiencies, and the need for clarity in interpretation continue to hinder the seamless execution of these legal reforms. Additionally, the ever-

evolving business landscape and emerging avenues present new challenges that necessitate ongoing adaptation and reform in the legal framework.

Going forward, it is essential for India to maintain a proactive approach to reforms. Addressing the challenges surrounding implementation and enforcement will be crucial in realizing the full potential of the recent legal developments. Moreover, legislators must remain vigilant and responsive to the changing dynamics of the business environment. Issues such as corporate governance, insider trading, and social stock exchange will require continuous attention and robust legislation to support India's economic development.

With this, the Editorial Board is pleased to present Volume VI Issue I of the Journal on Governance. The theme for this Issue is "**New Developments in Business Laws: Mending the Failures or Bolstering the Existing Challenges?**". The Board has carefully chosen articles and research papers furthering critical research on the interplay of contemporary corporate law issues, both from an academic and industry perspective. This Issue presents six articles that will certainly arouse interest of all legal professionals, academicians, students and our avid readers.

The first article, "**Keeping Pace with Market Manipulation: Evaluating Liability Standards for Digital Securities Market**" deals with an intricate issue. It focuses on manipulation of securities market by dissemination of misleading information through social media. This wave of market manipulation, which has been plaguing the capital markets

since long, has only got worse with increase in use of digital platforms and lack of accurate information. Addressing this problem, the authors analyse the changes and amendments introduced by SEBI to prevent market manipulation. The authors undertake a cross-jurisdictional analysis and draw parallels from EU jurisdiction to construct a well-balanced solution in complex digital landscape for India.

The second article, "**Virtual Power Purchase Agreements: Legal Status & Regulatory Framework in India**" focuses on renewable energy projects and ESG norms. It highlights the sudden growth in the use of virtual power purchase agreements by corporates to achieve the renewable energy targets. These agreements support the company to fulfil their part on compliance and governance norms. While these virtual power purchase agreements have gained significant popularity in USA, their validity and legal status remains marred by uncertainty in India. Identifying this issue, the author analyses the legislative landscape of the electricity sector and examines the regulatory approach to fulfil India's climate and governance norms. In its pursuit, the author examines the implications of certain key legislative changes and draws a clear picture with respect to the legal status of virtual power purchase agreements in India.

The third article, "**Characterizing SPACs: The Challenges to Indian Regulation**" addresses the issues and challenges pertaining to Special Purpose Acquisition Company in India. SPACs have gained considerable recognition in USA as an alternative to traditional IPOs and a viable

investment vehicle. A similar trend has been witnessed in India with investors and regulatory authorities scrambling to tap on the opportunity and regulate the market. Focusing on this issue, the authors analyse the characteristics of SPACs and examines the US approach to regulate them, to identify and formulate the best framework for the Indian SPACs market.

The fourth article, "**Proxy Advisory Firms and Corporate Governance in India and United States: Regulatory Framework and Emerging Issues**" delves into the emergence of the concept of proxy advisory firms and analyses the regulatory framework in USA and India. Proxy advisory firms have been a boon to shareholders in many aspects, from providing sound recommendations with regards to financial transactions, compensation, and helps promote strong corporate governance. While discussing the positives, the author also addresses pertinent issues that have arisen including heavy influence on institutional investors, lack of transparency and etc. The author concludes on an optimistic note by stressing on the importance of independence and equitability in the present proxy advisory industry for paving the way towards greater corporate governance and accountability in future.

The fifth article, "**Fractional Share Investing in India: A Step in the Right Direction**", looks into the feasibility of fractional investing from the viewpoint of Indian regulatory framework. The Indian Securities market has had a conservative approach towards the concept of fractional investing in general, due to the various complications that may arise in its

implementation. Despite these issues, fractional investing is a concept that is thriving in other countries, notably USA, Japan and Canada. Recently, the Company Law Committee, 2022 in its report has recommended permitting fractional shareholding in India as well. The author delves into the merits and demerits of fractional share investing and adopts a stance in favour of it due to the large scale economic benefits that the concept can yield. The author concludes by analysing the best practices from various jurisdictions and suggesting a feasible method for implementation of fractional share investing in India, through which the drawbacks can be circumvented too.

The sixth and the final article of this issue, "**Incorporating Shareholder Ratification in the Companies Act, 2013: Relevance for Corporate Governance**", focuses on concepts of shareholder ratification, corporate governance, corporate democracy, and shareholder activism to delineate a lacuna in Indian corporate law. In the Terrascope Ventures case, the Securities Appellate Tribunal held that shareholders can post-facto ratify an unauthorized action by the director, and this decision is a dangerous precedent, considering the unrestricted power that it vests upon shareholders. Owing to the lack of statutory guidelines, it is the need of the hour to make some changes in law, to avoid oppression and mismanagement of minority shareholders and class actions. The author discusses the possible roadblocks and opportunities and concludes with suggestions for the incorporation of shareholder ratification in the Companies Act, 2013.

All in all, we are sure that 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 and deliberations on addressing these emerging issues in the field of corporate law. Finally, we would like to take this opportunity to thank the editorial board members, contributing authors, and our Chief Editor, Dr. Manoj Kumar Singh for making Volume VI, Issue I of Journal on Governance possible.

Shreya Rajasekaran & Vedaant S. Agarwal

Editors-in-Chief, Journal on Governance

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# KEEPING PACE WITH MARKET MANIPULATION: EVALUATING LIABILITY STANDARDS FOR DIGITAL SECURITIES MARKETS

*Deesha Reshmi & Ojasav Chitranshi*[1]

## ABSTRACT

*Market manipulation has evolved parallel to the evolution of capital markets with the advent of digital platforms. It is no doubt that the Indian market regulator, the Securities and Exchange Board of India ("**SEBI**") is facing challenges to curtail such misdemeanours. A good instance is that of the trading in the scrips of Sadhna Broadcast Limited where the circulation of misleading information through YouTube videos lead to manipulation in the form of pump and dump.*

*It is essential to curb market manipulation as it among other things, undermines the efficient allocation of capital, impairs investors' trust, and imposes substantial social and financial costs on the markets. However, it is becoming increasingly difficult to capture and curb such misdemeanours because of the internet's complexities. This article aims to assess the liability standard necessary to capture the dissemination of information that has the potential to lead to market manipulation through social media.*

*It is realized that the United States, where the Gamestop incident (the case study of this article) occurred relies on the standard of scienter. As will be discussed in the article, this standard is marred with confusion as scienter can range anywhere from intent to deceive to knowing of undisclosed facts or recklessness. In contrast, in India, recent amendments have added the knowledge and recklessness standards in the relevant provisions. Finally, the EU jurisdiction whose regulations are focused on the market*

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*rather than individual practices is examined with the aim to contribute to the ongoing efforts to prevent and curtail market manipulation in today's complex digital landscape.*

**Keywords:** Market manipulation, social media, Gamestop, scienter, recklessness.

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## I. INTRODUCTION

The influence of social media is significantly increasing in the context of the securities market as opinions expressed online have begun to sway people's investment decisions.[3] Although social media has certain advantages such as improvement in market transparency and efficiency, it has given rise to various issues in the securities market due to the

[3] D.K. Agarwal, *Social media is seeking to influence your investing behaviour: Will you follow the herd?*, THE ECO. TIMES, May 21, 2022, https://economictimes.indiatimes.com/markets/stocks/news/social-media-is-seeking-to-influence-your-investing-behaviour-will-you-follow-the-herd/articleshow/82853180.cms?from=mdr.

unregulated dissemination of information across multiple platforms.[4] This is largely due to the ability of social media platforms to disseminate news and information quickly and widely, which can have a significant impact on market sentiment and investor behaviour.

Extant literature classifies manipulation into three divisions — trade-based, action-based and information-based.[5] Information-based market manipulation is a type of market manipulation where individuals or entities use non-public information to influence the market in their favour. This can be done through various methods such as spreading false rumours, providing misleading information, or withholding material information from the public. The focus of this article will be information-based market manipulation where the dissemination of such information is undertaken through social media platforms. Pump & Dump is one of the schemes in which such type of market manipulation is used. In the securities market, Pump and Dump schemes have existed for quite some time. It is essentially a practice in which the prices of a security are inflated through the use of false or misleading information. Consequently, when the price of a share soars, the fraudsters immediately sell the shares, and the new owner of the share loses a substantial portion of their capital gains because the price of the security falls substantially.[6]

For instance, the stock price of GameStop, a videogame company, registered on NASDAQ, hit a new high of $347.51 on January 2021, a rise

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[4] Mohamed Al Guindy, The Role of Social Media in Financial Markets, (Smith School of Business, Queens University, Thesis, June 2017) https://qspace.library.queensu.ca/bitstream/handle/1974/15915/AlGuindy_Mohamed_201706_PhD.pdf?sequence=2.

[5] Samira Khodabandehlou & Syeed Alizera, *Market Manipulation Deduction: A Systematic Review*, SCIENCE DIRECT, (last accessed Mar. 25, 2023) https://www.sciencedirect.com/science/article/abs/pii/S0957417422014555?via%3Dihub.

[6] David Nam & David Skillicorn, *Detecting Stock Manipulation from Online Forums*, (Feb. 15, 2022) https://arxiv.org/pdf/2301.11403.pdf

of 1700% from its December 2020 closing price.[7] The spike happened as hordes of retail investors organized themselves on the subreddit r/wallstreetbets ("*Redditors*") and other social media platforms, and coordinated their buying efforts to challenge a group of hedge funds that had bet against the success of GameStop, a struggling video game retailer, by short-selling its stock. They took it upon themselves to squeeze the large institutional investors that were short-selling GameStop's stock.[8] The coordinated buying effort caused a short squeeze,[9] where short sellers were forced to buy shares to cover their losing positions, driving up the stock price of GameStop and causing significant losses for the hedge funds.[10]

Similarly, on August 7, 2018, Tesla CEO Elon Musk tweeted to his 22 million followers that he (1) could take Tesla private at $420 per share, (2) had gotten the necessary financing, and (3) that the only remaining question was a shareholder vote.[11] The tweet led to significant market disruptions and on an investigation, the U.S. Securities and Exchange Commission ("**SEC**") found that Mr Musk's tweets on August 7, 2018, led to a six per cent surge in Tesla's stock price.[12]

As evident, the rapid decline or rise in the market value of a security can be attributed in part to a lack of high-quality information, as illustrated by the instances highlighted above. The practice of engaging in

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[7] Victoria Chiu & Moin A. Yahya, *The Meme Stock Paradox*, 3 CORP. & BUS. L.J. 52, 52 (2022).
[8] *Id.* at 54.
[9] Iris H.-Y. Chiu, *Social Disruptions in Securities Markets - What Regulatory Response Do We Need?*, 28 RICH. J.L. & TECH. 46, 63 (2021).
[10] *Id.* at 57.
[11] MARCO VENTORUZZO & SEBASTIAN MOCK, COMMENTARY ON MARKET ABUSE REGULATION, 418, (Oxford U. Press, 2nd ed. 2022)
[12] Press Release, Securities and Exchange Commission, Elon Musk Charged With Securities Fraud for Misleading Tweets (Sept. 27, 2018), https://www.sec.gov/news/press-release/2018-219

such conduct in order to artificially influence stock prices is widespread.[13] Although stock manipulation has been around forever, the advent of technology and the spread of social media have made it easier for a wide variety of manipulators to reach a wide audience.

Addressing challenges such as the *Gamestop* requires a coordinated effort between financial authorities and intelligence communities to establish clear rules and guidelines to combat information operations and maintain financial stability. On these lines, the SEBI made an amendment to the Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market Regulations, 2003 ("**PFUTP**") in January 2022.[14] Notwithstanding the impossibility of eradicating disinformation entirely, the primary purpose of this is to minimise its spread. In order to accomplish this, SEBI has adopted the U.S. recklessness standard.[15] Yet, the adopted standards are beset by substantial obstacles. Hence, in this article, the authors aim to assess the liability of a *Gamestop*-like incident in India and propose measures to prevent market manipulation through social media. In the process, *firstly*, they will explain the relationship between financial markets and social media. (**Part II**). *Secondly*, the authors will analyse the Gamestop incident as a case study to understand the standard of scienter in the US and its limitations (**Part III**). *Thirdly*, the authors will draw a contrast by exploring the EU jurisdiction regulations whose focus is on the market effects rather than individual practices (**Part IV**). *Fourthly*, the authors will examine recent amendments in India that have added knowledge and recklessness standards in relevant provisions (**Part V**). *Finally*, the authors will conclude by highlighting the importance of preventing information-based market manipulation as it undermines

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[13] Fox, Merritt B., et al, *Stock Market Manipulation and Its Regulation*, 35, YALE J. REG. NO. 1, 67, 116 (2018).

[14] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations, 2022, Gazette of India, pt. III sec.4, Reg. 4 (Jan. 25, 2022).

[15] Shubhankar & Dhaval, *Social Media and Financial Market: SEBIs Welcome Move?*, INDIAN REV. CORP. & COM. L. (Oct. 22, 2022) https://www.irccl.in/post/social-media-and-financial-markets-sebi-s-welcome-move

the efficient allocation of capital and impairs investors' trust. The authors will also emphasize the need for regular review and updation of these measures to ensure their effectiveness.

## II. INTERRELATION BETWEEN FINANCIAL MARKET & SOCIAL-MEDIA

The influence of social media on the securities market has been a subject of much debate and discussion in recent years. On the one hand, social media platforms can provide valuable information and insights into the market and individual stocks,[16] as well as facilitate public discussion and analysis. This can help investors make informed investment decisions and increase transparency in the market.[17]

On the other hand, social media can also contribute to market volatility and the spread of misinformation.[18] For example, false rumours or hoaxes can quickly spread through social media, leading to panic and rapid price movements in the market. Additionally, automated trading algorithms can amplify the impact of social media sentiment, creating further price movements in response to news or rumours.[19] For instance, news regarding the "devaluation of the RMB currency rate," "imminent release of many prohibited sales," "geopolitical instability," "overseas movement of domestic money," and "the unstable scenario" activated China's stock market's circuit breaker mechanism.[20] These rumours spread rapidly on the Internet via social media, resulting in decreased investor

[16] Claudia Biancotti & Paolo Ciocca, Financial Markets and Social Media: Lessons From Information Security, (Carnegie Endowment for Int'l Peace, Working Paper no. 10, 2021), https://carnegieendowment.org/files/Biancotti_Ciocca_FinCyber.pdf.
[17] *Id.* at 1.
[18] *Id.* at 3.
[19] Kenneth Rapoza, *Can Fake News Impact the Stock Market?*, FORBES (Feb. 26, 2017) https://www.forbes.com/sites/kenrapoza/2017/02/26/can-fake-news-impact-the-stock-market/?sh=ebc98e32fac0
[20] Hua Zhang et al., *Effect of social media rumors on stock market volatility: A case of data mining in China,* 10, FRONT. PHYS. 1, 2, (2022).

confidence, collective position reduction, financial risks, and even civil unrest.[21]

Thus, in the era of big data, such instances are not new and it becomes essential to examine the mechanism to curb the influence of social media on the securities market, in order to assure the proper operation of financial systems.

## III. THE GAMESTOP SAGA

The GameStop controversy was a significant event in the world of finance that occurred in January 2021.[22] It was triggered by a group of retail investors who organized on the subreddit r/wallstreetbets and other social media platforms[23] and coordinated their buying efforts to challenge a group of hedge funds that had bet against the success of GameStop, a struggling video game retailer, by short-selling its stock. [24]

One of the retail investors was Keith Gill, an ordinary guy who had been bullish on GameStop since 2019 and frequented a Reddit community called WallStreetBets ("**WSB**").[25] The WSB was a website where individuals discussed their stock market wins and losses and offered witty observations.[26] Mid-January 2021 marked the beginning of a price increase for GameStop, coinciding with the rise in popularity of Gill's continual analysis regarding escalating gains and other observations concerning the rising likelihood of a short-squeeze.[27]

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[21] *Id.*
[22] Rob Davies, *GameStop: how Reddit amateurs took aim at Wall Street's short-sellers*, THE GUARDIAN, (Jan. 28, 2021) https://www.theguardian.com/business/2021/jan/28/gamestop-how-reddits-amateurs-tripped-wall-streets-short-sellers
[23] Chiu & Yahya, *supra* note 6 at 56.
[24] *Id.* at 57.
[25] John P. Anderson et al, *Social Media, Securities Markets and the Phenomenon of Expressive Trading*, 25 LEWIS & CLARK L. REV. 1223, 1226 (2022).
[26] Chiu & Yahya, *supra* note 6.
[27] S*upra* note 22 at 1227.

Gradually, large numbers of individuals began to purchase and hold GameStop shares alongside him.

Once the GameStop hysteria went viral, people who had heard of the trend but were not experienced investors also wanted to join in.[28] These investors began purchasing GameStop stock based solely on memes, trends, or the thrill of being a part of the madness; there was no basis for their actions in principle.[29] This resulted in the emergence of a new kind of trader known as expressive traders,[30] who were not solely motivated by profit but instead traded as a form of social protest, social anger, social influence, or artistic expression.[31]

Further, as expressive traders continued to purchase GameStop stock, its price continued to rise, and the pressure (squeeze) on hedge funds that had shorted the stock intensified.[32] As the price of GameStop continued to climb, some short sellers were compelled to cover their short positions by purchasing the stock at inflated rates. Due to this pressure, famous hedge funds such as Melvin Capital were compelled to abandon their short position in GameStop, reportedly incurring enormous losses.[33]

Amid the frenzy, Robinhood, a prominent retail investment app, suspended certain trading of GameStop shares and increased margin requirements claiming "recent volatility" as the reason for the limitations.[34] In an effort to protect their clearing houses and the market's liquidity,

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[28] Chiu & Yahya, *supra* note 6 at 56.
[29] Kevin Stankiewicz, *Massachusetts regulator says GameStop speculation is a danger to the whole market, as TD Ameritrade restricts trading*, CNBC (Jan. 27, 2021), https://www.cnbc.com/2021/01/27/gamestop-speculation-is-danger-to-whole-market-massachusetts-regulator.html
[30] John P. Anderson et al., *Expressive Trading, Hypermateriality, and Insider Trading*, 23 TENN. J. BUS. L. 443 (2022).
[31] *supra* note 22 at 1223.
[32] Chiu & Yahya, *supra* note 6 at 58.
[33] Lu Wang, et al., *Hedge Fund Pressure Lingers With Short Sellers' Targets Rallying*, BLOOMBERG (Jan. 29, 2021), https://www.bloomberg.com/news/articles/2021-01-29/hedge-fund-pressure-lingers-with-short-sellers-targets-rallying
[34] Chiu & Yahya, *supra* note 6 at 59.

other brokerage firms imposed similar restrictions on the stock.[35] The restrictions sparked an outcry on social media, prompting the SEC to investigate WSB and other social media platforms that contributed to driving up GameStop's stock price for evidence of fraud.[36]

As of April 2023, GameStop's price has stabilized somewhat, clocking in at around $20 which is close to its closing price in December 2020.[37] However, congressional hearings on the matter remain ongoing and there has been no conclusive finding.

Therefore, the GameStop controversy can be said to have sparked a larger conversation about the role of retail investors in the stock market, the ethics of short-selling, and most importantly about the potential impact of social media on financial markets and the need to regulate the same not only in the USA but around the world.

### A. PROOF OF INTENT STANDARD

In the United States, market manipulation through social media has become a severe concern. Although the United States has legislative measures in place to address it, their effectiveness is uncertain due to the higher degree of culpability (intent – as will be explained in the article) required to establish guilt under the legislation. Market manipulation, in the USA, is understood as behaviour aimed to deceive investors or alter the price of securities.[38] This can involve a variety of behaviours, including the dissemination of false information, the creation of false demand for securities, and the artificial inflation or deflation of the price of securities.

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[35] *Id.* at 59.
[36] *Id.* at 60.
[37] GameStop Corporation Common Stock, NASDAQ, https://www.nasdaq.com/market-activity/stocks/gme (last accessed at April 25, 2023)
[38] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 186 (1976).

Section 10(b) of the Securities Exchange Act of 1934,[39] when read along with Rule 10b-5 of SEC Rules, 1934,[40] serves as the primary and the most pursued[41] federal legislation that prohibits market manipulation through social media. According to Section 10(b), it is unlawful for any individual to employ manipulative or deceptive devices in the purchase or sale of any security.[42]

The SEC enforces Section 10(b) of the Securities Exchange Act of 1934 through Rule 10b-5. The rule expressly states that it will be unlawful for any person to directly or indirectly utilize any means or instrumentality of interstate commerce to commit any act that could potentially operate as fraud or deceit against any individual concerning the purchase or sale of a security. These twin provisions have been the most commonly employed anti-fraud provisions, preventing market manipulation by outlawing misrepresentations, devices, schemes, and artifices.[43]

In order to establish a violation of Section 10(b) and Rule 10b-5, six elements are to be proved out of which the most controversial one is that of *scienter*. The term scienter is a multi-faceted concept and its meaning can range from intention, knowledge to recklessness.[44] Its requirement was first discussed in *Herman & MacLean v. Huddleston*.[45] In this case, the United States Supreme Court recognized recklessness as a form of scienter that could satisfy the requirements for civil suits under Section

[39] Security Exchange Act of 1934 §10(b), 15 U.S.C.S. (1934).
[40] SEC Rules, Rule 10b-5 (1934).
[41] Wendy Gerwick Couture, *Prosecuting Securities Fraud Under Section 17(a)(2),* CLS BLUE SKY BLOG (Mar. 20, 2019) https://clsbluesky.law.columbia.edu/2019/03/20/prosecuting-securities-fraud-under-section-17a2/
[42] Security Exchange Act of 1934 §10(b), 15 U.S.C.S. (1934).
[43] SEC Rules, Rule 10b-5 (1934).
[44] Elaine E. Bucklo, *The Supreme Court Attempts to Define Scienter under Rule 10b-5: Ernst &(and) Ernst v. Hochfelder*, 29 STAN. L. REV. 213 (1977).
[45] Herman & MacLean v. Huddleston 459 U.S. 375 (1983).

10(b) and Rule 10b-5 and mere negligence was not enough to meet the scienter requirement.[46]

This ruling highlighted the need for a clear and concise definition of recklessness that eventually got settled in the landmark case of *Sundstrand Corporation v. Sun Chemical Corporation* ("Sundstrand"), where the Court defined recklessness as "*highly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care*" that presents a risk of misleading buyers or sellers that is either known to the defendant or so obvious that the actor must have been aware of it.[47] However, the court in Sundstrand added that recklessness "s*erve[s] as a proper legally functional equivalent of intent, because it measures conduct against an external standard that, under the circumstances of a given case, leads to the conclusion that the reckless man must bear the risk of his [conduct]*". So, while the Court established that recklessness would implicate a higher degree of negligence, the additional subjective criteria of equating it to intention spurred confusion and cases relying on *Sundstrand* although used the definition provided in the case, began using fraudulent intent also as a criterion to prove recklessness and scienter.

An instance of this is the case *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*,[48] in which the Court held recklessness as a functional equivalent for intent, requiring proof of something more heinous than even white heart/empty mind or good faith. Similarly, in the case of *Webb v. Solar City Corp*,[49] the Ninth Circuit explained that the scienter standard requires facts demonstrating an intent to deceive, manipulate or defraud, or "deliberate recklessness."[50]

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[46] *Supra* note 35.
[47] Sundstrand Corp. v. Sun Chemical Corp., 434 U.S. 875 (1977).
[48] Fla. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 654 (8th Cir. 2001).
[49] *Webb v. SolarCity Corp.*, 884 F.3d 844, 851 (9th Cir. 2018).
[50] *Id.*

Thus, in order to establish a violation of Section 10b of the SEC Act, it has become imperative to demonstrate that the defendant acted with either an intention to deceive, defraud or with recklessness. This mandate of proving intent or recklessness, which constitutes a subjective standard, has raised the level of liability to a higher threshold, since mens rea (intent), a requirement in criminal cases, is being imported into civil suits (market manipulation). The undue incorporation of this requirement results in an unnecessary burden on the authorities and delay in resolving controversies, like GameStop.

On the contrary, Section 17(a) of the Securities Act of 1933[51] is another key anti-fraud provision that makes it illegal to use any manipulative or deceptive device or contrivance in connection with the offer, purchase, or sale of any security, or to make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading.[52]

Section 17(a) applies to all individuals and entities involved in the offer, purchase, or sale of securities, including brokers, dealers, investment advisers, and issuers of securities. This section is often used in conjunction with other provisions of the Securities Act, such as Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, to prosecute securities fraud.[53] Though Section 17(a)(2)[54] is similar to Rule 10b-5[55] in that it allows for the prosecution of securities fraud, as described above. Nonetheless, the primary distinction between the two rules is that Section 17(a)(2) does not rely on intent (i.e., "scienter" or

[51] Securities Act of 1933, §17(a).
[52] *Id.*
[53] *The Guide to Securities Fraud Elements and SEC Rule 10b-5*, BNS&K, https://bnsklaw.com/the-guide-to-securities-fraud-elements-and-sec-rule-10b-5/ (last visited Feb. 24, 2023).
[54] Securities Act of 1933, §17(a)(2).
[55] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 186 (1976).

recklessness on the part of the defendant).[56] Instead, the liability under this provision arises if the defendant has acted negligently.[57]

The liability on individuals under Section 17(a)(2) accrues if they have acted negligently by failing to conduct due diligence on material information that could result in fraud or market manipulation. In *SEC v. Shanahan*,[58] this criterion was elucidated in a concise manner. In this matter, it was decided that Section 17(a)(2) requires the defendant to act as a reasonably prudent person would have under the same circumstances.[59] Hence, the defendant must exercise reasonable care when transmitting information regarding the acquisition and sale of shares.[60] Moreover, prior to communicating with investors or the broader public, the defendants must conduct the necessary investigation.[61]

Section 17(a)(2) only requires proof of negligence,[62] which is significantly less burdensome than proving intent (mens rea), and ensures greater accountability. This indicates that the use of Section 17(a) may be applicable to cases where scienter (intent) cannot be proved under Section 10(b) read with Rule 10-5.

## IV. EFFECTS-BASED LIABILITY

In Europe, the relationship between digital media and financial markets is regulated by a number of different laws and regulations. The primary law governing this relationship is the Market Abuse Regulation, 2016[63] ("**MAR**") a market-centric legislation that applies across the European Union.

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[56] *Supra* note 51.
[57] Aaron v. SEC, 446 U.S. 680, 695, 697, 700-01 (1980).
[58] SEC v. Shanahan 600 F Supp. 2d 1054 (2011).
[59] Merritt B., *supra* note 12.
[60] *Id.*
[61] Aaron v. SEC, 446 U.S. 680, 695, 697, 700-01 (1980).
[62] Pagel, Inc. v. SEC, 803 F.2d 942, 946 (8th Cir. 1986)
[63] European Union (Market Abuse) Regulations 2016 [S.I. No. 349 of 2016]

MAR marks a culmination of European and American experiences, with an aim of curbing incessant market manipulation.[64] The same is evident from the fact that the regulation not only covers regulated markets within its ambit but also moves a step forward in protecting Multilateral Trading Facility ("**MTF**") and Organised Trading Facility ("**OTF**") against manipulation, any spot commodity contract markets and markets of all types of financial instruments.[65] In contrast, Rule 10b-5 issued by the U.S. Securities and Exchange Commission, only protects regulated markets against manipulation and some other instrumentality of commerce.[66] MAR, over and above these protections, also prescribes regulations requiring disclosure of insider knowledge, with an aim to curb market manipulation via egregious dissemination of false and misleading information.

Now, with respect to the relationship between digital media and financial market in Europe, Article 12(1)(c) of MAR is of relevance.[67] The article defines the concept and constituent of market manipulation and under Para (1) lit (c) it states that if a person knowingly *"disseminates any information or rumours through the media, including the internet, that gives, false or misleading signals with respect to the supply, demand, or price of a financial instrument, and due to that information, the price of such financial instruments, rises at an abnormal or artificial level",*[68] the person will be held liable for market manipulation.[69]

The dynamic rise of technology, and the advent of social media platforms, has meant that the internet age has been marred with challenges, including false and propaganda-oriented news and content, and with the era of 'influencers' finally catching up, article 12(1)(c)

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[64] Ivan Klepitskij, *Market Manipulation in Russia and in Europe: A criminal law dimension*, 4, RUSSIAN L. J., 120, 121 (2016).
[65] *Id.* at 122.
[66] *Id.* at 123.
[67] European Union (Market Abuse) Regulations 2016, [S.I. No. 349 of 2016] art. 12(1)(c).
[68] *Id.*
[69] Chiu, *Supra* note 8 at 401.

particularly gains relevance in tackling such challenges head-on. Nonetheless, liability under it is contingent upon the fulfilment of certain conditions, which include:[70]

1. First, the **information disseminated impacts a financial instrument**, a related spot commodity contract or an auctioned product based on emission allowances. 'Information' as understood broadly, would include rumours.[71]
2. Second, it needs to **give or be likely to give, false or misleading signals**, or to secure, or be likely to secure, prices at abnormal or artificial levels that depend on a case to case basis. The existence of false or misleading signals qualifies as market manipulation provided that these signals affect, even if it is to a lesser extent, the price of a financial instrument.[72]
3. Third, **the intention is not required to be proved**. A person may not intend to defraud or take advantage of his/her position or try to benefit from the losses of others but still, the liability can be attributed to such a person.[73]
4. Fourth, this form of market manipulation requires the dissemination of information through the media, including the internet and any other means (e.g., social media platforms).[74]

A fair perusal of the aforesaid elements makes it eminent that an intent to mislead or divulge false signals, or an attempt to manipulate the market and prices at irregular or artificial levels, is not a pre-requisite for ascertaining liability under the Article concerned.[75] It's highly likely that the element of intent was deliberately excluded from administrative and civil sanctions, to enforce more stringent standards across the board, so as

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[70] *Supra* note 62 at 123.
[71] SUSSANE KALSS ET AL., A COMMENTARY ON EU MARKET ABUSE REGULATION, 175 (Edward Elgar Publishing Ltd., 1st ed. 2021).
[72] *Id.*
[73] Chiu, *supra* note 8 at 420.
[74] *Id.*
[75] Chiu, *supra* note 8 at 65.

to ensure that entities responsible for the dissemination of false or misleading information in the first place, are duly made liable for the consequences or damages arising as a result of the same. Consequentially, liability might be ascertained in actions leading to market manipulation in violation of Article 12(1)(c), even if undertaken in good faith, and not malafide.

An example could be that of the UK's Financial Conduct Authority ("**FCA**"), which has utilised its supervisory authority to crack down on a financial app's use of social media influencers to promote the app and its ensuing financial services.[76] The regulatory body warned such social media influencers about the potential dangers of endorsing financial goods without a disclaimer or a declaration along the lines of "sponsored content", and that the lack of such disclaimers makes it highly probable that they are sending false or mixed signals to the investors, thereby attracting liability under the incumbent law.[77] Although the influencers themselves may not intend to manipulate the market, the authority is concerned that their actions could have that effect.

In contrast, when we look at the criminal liability of market manipulation in the EU, intent is a pre-requisite for ascertaining liability under Article 5(1) of the Market Abuse Directive on Criminal Penalties,[78] which requires member states to ensure that market manipulation is handled as a criminal offence only in extreme instances and when committed intentionally.[79] Therefore, Member States need to see intent (subjective element) only when it comes to qualifying and penalising market manipulation as a criminal offence.

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[76] Allen & Overy, FCA clamps down on investment app's use of social media influencers, JDSUPRA (Mar. 3, 2022) https://www.jdsupra.com/legalnews/fca-clamps-down-on-investment-app-s-use-2184710/
[77] *Id.*
[78] Market Abuse Directive on Criminal Penalties, 2014 art. 5(1).
[79] *Id.*

Hence, since intent is not a *sine qua non* under Article 12(1)(c). The European approach appears to be more practical and conducive, particularly in civil cases where proving intent (mens rea) is difficult. Furthermore, the definition of market manipulation stated in Article 12(1)(c) is all-encompassing, including all conceivable forms of market manipulation that may occur through online or social media platforms. As a result, it may serve as a better legal standard for other countries to adopt.

## V. THE PFUTP REGULATIONS

The attributes of fairness, integrity and transparency have been held as the hallmarks of the stock market in India.[80] The SEBI, the watchdog,[81] is empowered[82] to check on the potential market abuse under PFUTP Regulations. These regulations are a combination[83] of principle-based and rule-based approaches which ensure that there are not only broad principles available for ensuring fair markets[84] (under regulations 3 and 4(1)) but also rules available which prohibit an illustrative list of identifiable unfair and manipulative trade practices.[85] (under regulation 4(2)).

Among other things, the scope of these regulations covers market manipulations,[86] a broad concept defined as the creation of *artificiality*,[87] an

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[80] Securities and Exchange Board of India v. Rakhi Trading Pvt. Ltd., 2009 SCC OnLine SEBI 306.
[81] *Id.*
[82] NK SODHI, REPORT OF THE HIGH LEVEL COMMITTEE TO REVIEW THE SEBI (PROHIBITION OF INSIDER TRADING) REGULATIONS, 1992 20 (2013) https://www.sebi.gov.in/sebi_data/attachdocs/1386758945803.pdf
[83] TK VISWANATHAN, REPORT OF THE COMMITTEE ON FAIR MARKET CONDUCT 21 (2018) https://www.sebi.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html
[84] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2022 Reg. 3-4.
[85] *Id* Reg. 4(2)
[86] *Id.*
[87] SEBI v. Shri Kanaiyalal Baldevbhai Patel, 2017 15 SCC 1.

unwarranted interference in the operation of supply and demand that undermines the market's integrity and efficiency.[88] The person behind this artificiality takes advantage of its impact and successfully manipulates the market. Regulation 4 has been drafted in general terms to cover diverse situations and possibilities.[89]

This broad definition is a double-edged sword as it captures many scenarios but is also difficult to prove.[90] This can result in a difficult balancing act for regulators, who may overstep and restrict the free market, or overlook fraudulent activities.[91] Coupled with the ambiguities (as highlighted below), it creates an uncertain environment for market participants, leading to confusion and potentially harmful consequences for regulators and the market.

There are two different provisions which may be potentially used to capture the dissemination of false information on social media. Regulation 4(2)(a) which in 2018 adopted the knowledge standard captures practices which involve "*knowingly indulging in an act which creates false or misleading appearance of trading in the securities market*".[92] Similarly, Regulation 4(2)(k) which has in 2022 adopted the recklessness standard with the "*disseminating information or advice through any media, whether physical or digital, which the disseminator knows to be false or misleading in a reckless or careless manner and which is designed to, or likely to influence the decision of investors dealing in*

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88 N Narayanan v. Adjudicating Officer, SEBI, (2013) 12 SCC 152.

89 TK VISWANATHAN, REPORT OF THE COMMITTEE ON FAIR MARKET CONDUCT 20 (2018) https://www.sebi.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html

90 Gina-Gail S. Fletcher, *Legitimate yet Manipulative: The Conundrum of Open-Market Manipulation*, 68 DUKE L.J. 479, 516 (2018).

91 Dr. Poornima Advani, *A Case of Ambiguities: Examining the Regulations Prohibiting Market Manipulations in India*, 3 NLUD J. L. STUD. 63 (2021).

92 Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2022 Reg. 4(2)(a).

*securities*."[93] While the former is generally worded, the latter specifically concerns itself with manipulative practices which involve the use of media

### A. The Ambiguity of Mens Rea

The Supreme Court has held in seminal rulings, such as *SEBI v. Kanaiyalal Baldevbhai Patel*[94] that mens rea is not necessary to prove offences under Regulation 4 due to the civil nature of the PFUTP regulations.[95] Further, it has also been held[96] that mens rea is not an essential requirement to impose penalties altogether under Chapter VIA of the SEBI Act, 1992.[97]

However, the ambiguity regarding this interpretation has arisen where the legislature, through the 2018 amendment[98] to the PFUTP Regulations inserted the word '*knowingly*' into the definition of 'dealing in securities' leading to the speculation that the accusation of market manipulation now requires the element of *mens rea.*[99] Additionally, a similar interpretation has been drawn in the case of *R.S. Agarwal v. SEBI,*[100] where it was held that it is necessary to establish a motive while proving charges of fraud.

However, in the authors' opinion, such speculations are unfounded. It is to be noted that offences which do not form a part of the general penal law, but arise from a breach of duty[101] create a regime of strict liability[102]

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[93] *Id* Reg. 4(2)(k).
[94] SEBI v. Kanaiyalal Baldevbhai Patel, (2017) 15 SCC 1.
[95] SEBI v. Shriram Mutual Fund, (2006) 5 SCC 361.
[96] *Id.*; In the matter of Inland Printers Limited, Adjudication Order no. AK/AO- 25-29/2017.
[97] In the matter of Inland Printers Limited, Adjudication Order no. AK/AO- 25-29/2017.
[98] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations, 2018.
[99] Advani, *supra* note 86, at 70.
[100] R.S. Agarwal v. SEBI, 2019 SCC OnLine SAT 5.
[101] J.K. Industries Ltd. & Ors. v. Chief Inspector of Factories and Boilers, (1996) 6 SCC 665.
[102] *Id.*

wherein penalties are leviable for breach of civil obligations.[103] Such offences exclude mens rea[104] and the omission or commission of the statutory breach itself leads to liability.[105] Similarly, the penalties under Chapter VI-A of the SEBI Act (which are relevant for the apportionment of penalties under the PFUTP Regulations)[106] do not deal with criminal offences. Following this, the commission of the proscribed actus reus itself leads to penalties *even* in the absence of mens rea.

Hence, an appropriate interpretation of the term '*knowingly'* would be that the defendant either knew or consciously disregarded the fact that the results of his conduct were reasonably certain to occur.[107] The standard of knowledge that the legislature has adopted is an awareness or understanding of a fact or circumstance— a state of mind where there is no substantial doubt about the existence of a fact.[108] It is not to be confused with *mens rea.* Although the concepts go hand-in-hand but knowledge can exist without mens rea— it is possible for a person to have *awareness* of a certain outcome that may occur as a result of their actions, even though they do not *intend* for that outcome to happen.[109]

### B. THE STANDARD OF RECKLESSNESS

Another regime of liability that has been created is under the 2022 amendment to the PFUTP Regulations.[110] This amendment added the terms 'in a *reckless* or *careless* manner' to the provisions regarding the

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103 *Supra* note 87.
104 R.S. Joshi v. Ajit Mills Ltd., (1997) 4 SCC 98.
105 J.K. Industries Ltd. & Ors. v. Chief Inspector of Factories and Boilers, (1996) 6 SCC 665.
106 SEBI Act of 1992, Chapter VI-A, Section 15HA
107 UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, SECURITIES FRAUD LIABILITY OF SECONDARY ACTORS, GAO-11-664 at 9 (2011) https://www.gao.gov/assets/gao-11-664.pdf
108 *Knowledge,* BLACK'S LAW DICTIONARY, (9th ed. 2009)
109 *Id.*
110 Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) (Amendment) Regulations, 2022.

manner in which the dissemination of information can lead to manipulative, fraudulent, and unfair trade practices.[111]

This addition should be seen in light of global trends. For instance, in the US, the Dodd-Frank Act reduced the standard of pleading[112] by replacing the word '*knowingly*' with '*knowingly or recklessly*'.[113] This significantly expanded the SEC's power to pursue enforcement actions by increasing the exposure to liability.[114] Following this, the Court in *Sundstrand* appropriately held that recklessness is a higher degree of negligence (which is a departure from ordinary care)[115] to '*an extreme departure from the standards of ordinary care*'.[116] That is, the dissemination of information must be such that it must be made with a deliberate disregard for a known risk of misleading investors that are either known to the speaker or so obvious the speaker must have known of it.[117]

Whereas in India, although there has not been a case adjudicated on the Regulation 4(2)(k) of the PFUTP post the amendment, domestic courts have interpreted this standard in terms of tort law and secondary liability in securities fraud (i.e., for persons not directly involved in the violation, but provide substantial assistance to the same – for instance, Chartered Accountants). Recklessness has been held to be '*gross negligence*'[118] and is carried out with a certain indifference or disregard to the

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[111] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2022 Reg. 4(2)(k).
[112] UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, SECURITIES FRAUD LIABILITY OF SECONDARY ACTORS, GAO-11-664 at 26 (2011) https://www.gao.gov/assets/gao-11-664.pdf
[113] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).
[114] William Savitt & Noah B Yavitz, *The Securities Litigation Review: USA*, L. REV. (22 May, 2022) https://thelawreviews.co.uk/title/the-securities-litigation-review/usa
[115] *See* Donoghue v. Stevenson, 932 HL 31.
[116] Sundstrand Corp. v. Sun Chemical Corp., 434 U.S. 875 (1977).
[117] UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, SECURITIES FRAUD LIABILITY OF SECONDARY ACTORS, GAO-11-664 at 9 (2011) https://www.gao.gov/assets/gao-11-664.pdf
[118] Dr. Suresh Gupta v. Government of N.C.T. of Delhi, (2004) 6 SCC 422.

known risk.[119] Further, while apportioning liability for secondary actors (Chartered Accountants in this case) in securities fraud, the SAT observed that equating mens rea to recklessness is erroneous.[120]

## VI. ANALYSIS

Subjecting the *Gamestop* incident to three jurisdictions has given interesting revelations about the standard of liability that exist in the three different legal systems. So, the question that remains is which of these standards would be able to appropriately capture the liabilities that have arisen.

When it comes to the *Gamestop* incident, it is realized that the following facts concern the *Redditors*:

1. Intention – While some of them were engaged in *expressive* trading which was a common intention to create an artificial short-squeeze, the others genuinely believed that the stock was underpriced and were interested in holding it for the long run.
2. Knowledge – The *Redditors* may not have had the knowledge that the information that they were disseminating is false (and may also have believed it to be true)

Therefore, it is realized that a wider net of liability is required to capture the activities that took were underway here. In the US regime, it is realized that under Section 10-b, there is no settled position regarding the meaning of *scienter* and the term is often interpreted to mean 'intent to deceive'. This standard may not be wide enough as discussed, as *Redditors* may have genuinely believed that the stock was undervalued and was intending to hold it for a long-term. When it comes to India, the two standards of *knowledge* and *recklessness* are in their nascent stages and have not been subjected to judicial scrutiny. The former standard, as attempted

[119] State v. Sanjeev Nanda, (2012) 8 SCC 450.
[120] Price Waterhouse v. SEBI, 2019 SCC OnLine SAT 165.

to be defined by the authors, may not be sufficient to apportion liability as there is no conclusive proof as of now that there was the knowledge that the information being disseminated was false. When it comes to recklessness, the standard that is established is that of *gross negligence* — regarding which the duty of care remains undefined. The SEBI has informed that it will soon prescribe regulatory standards,[121] and it is the authors' recommendation that there is a need to impose on the Internet personalities strict standards when sharing information with the general public. The standards could be in the form of disclaimers and encompass the following points:

i. Emphasizing that the blog/video's contents are founded on the financial influencer's personal research and experience;[122]

ii. Reminding that the general public should not accept the contents and information provided in the blog/video as completely true without verifying them;[123] and

iii. Informing that the public should not exclusively rely on the contents and information presented in the blog/video and must carry out their own research and due diligence before investing in any specific security.[124]

Further, implementation of such standards can be undertaken by requiring the Internet personalities to register with the SEBI for the purposes of preaching information which has the potential to affect the securities market. Such registration may be done on the basis of the

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121 *SEBI to roll out guidelines for financial influencers on social media*, ECO. TIMES (last visited 22 May 2023) https://economictimes.indiatimes.com/markets/stocks/news/sebi-to-roll-out-guidelines-for-financial-influencers-on-social-media/articleshow/95577926.cms?from=mdr

122 Gail Rose Anne C. Egar, *The Battle on the Digital Trading Floor: A Review of the Securities Regulation Code vis-a-vis Information-Based Manipulation of Securities through the Internet*, 94 PHIL. L.J. 559, 593 (2021).

123 *Id.*

124 *Id.*

number of followers and the engagement that the personalities might garner.

Whereas the liability in the EU is attributed from an effects-based[125] or consequentialist perspective. This means that even if the *Redditors* did not intend to manipulate the market, they could be held liable if the effects of misleading demand or abnormal prices are secured. A similar interpretation was drawn by the Supreme Court in *SEBI v. Rakhi Trading Pvt. Ltd.* ruling that the trades undertaken were to manipulate the market, it also observed that there had been a "*restriction on the free and fair operation of market*" and that the price discovery system was affected. Further, in the recent case of the pump and dump scheme involving YouTube videos for dissemination of misleading information,[126] emphasis was laid on the impact the misleading information had on the market (by comparing prices before and after the misleading information was released). Having an effects-based liability regime ensures that the liability is not limited to intention, scienter, or knowledge. However, on the flip side, such a regime may treat two similar activities differently only on the basis of the results that they have generated.

Following this discussion, it is realized that the duty-based regime where liability is apportioned on the basis of the contravention of the minimum duty established by law, i.e., the standard of *recklessness* is the most conducive one. As discussed above, the SEBI has to underline these minimum standards of responsible behavior which will allow the market to function in a fair and transparent manner while allowing for free speech to prevail. The standard of recklessness thus defined appropriately balances the need to prevent market abuse with the need to ensure that legitimate market activities are not unduly restricted. By holding market participants to a minimum standard of conduct, the duty-based regime provides clarity and predictability, allowing market participants to understand what is expected of them and to act accordingly.

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[125] SEBI, *Supra*, note 8 at 51.
[126] Chiu *Supra,* note 1

## VII. CONCLUSION

In conclusion, information-based market manipulation has become a critical issue globally, and countries worldwide are grappling with its complexities as evident from instances like GameStop, Elon Musk's tweet etc. This unlawful activity involves the dissemination of false or misleading information, which is intended to influence the price of securities and gain financial advantage. Market manipulation can destabilize financial markets, erode investor confidence, and have significant economic consequences.

The United States has been at the forefront of implementing laws to combat market manipulation. Section 10b of the Securities Exchange Act of 1934 prohibits fraud and manipulation in securities transactions. However, the provision has a problematic requirement of proving intent or *scienter* which can be challenging to establish in civil cases.

On the contrary, the European Union under Article 12 of the MAR prohibits insider trading and market manipulation and does not require proof of intent. The regulation broadly defines manipulation and prohibits actions distorting the market, including disseminating false or misleading information. It is realized that MAR's effectiveness lies in its ability to detect and punish market manipulation, regardless of whether the perpetrator intended to do so. The regulation provides a more robust legal framework to tackle market manipulation, and its approach can be relied upon to address the issue of information-based market manipulation. However, as discussed earlier such open-ended and broad scope of this regime creates a system of uncertainty where two similar actions undertaken may lead to different results – and has the potential to stifle innovation in the market.

Finally, despite the PFUTP Regulations being relatively new, they appropriately balance the need to prevent market abuse with the need to ensure that legitimate market activities are not unduly restricted. This regime can help capture liability for market manipulation through social

media by holding individuals accountable for their actions and ensuring that they adhere to minimum standards of responsible behaviour. A duty-based regime where liability is apportioned on the basis of contravention of the minimum duty established by law is the most conducive one. The SEBI needs to underline these minimum standards of responsible behaviour which will allow the market to function in a fair and transparent manner while allowing for free speech to prevail.

Hence, information-based market manipulation is a global problem that requires effective legal intervention to protect the integrity of financial markets and it is crucial to continue exploring and implementing effective legal frameworks to address this problem and ensure fair and transparent financial markets.

# 'VIRTUAL' POWER PURCHASE AGREEMENTS: LEGAL STATUS AND REGULATORY FRAMEWORK IN INDIA

*Dr. Deborshi Barat*[*]

## ABSTRACT

*Power purchase agreements (PPAs) and virtual PPAs (VPPAs) have gained popularity among corporate buyers in the US and other countries who want to quickly achieve their renewable energy (RE) targets. VPPAs, in particular, have become increasingly attractive. Procuring renewables through a VPPA has also become an essential aspect of business branding worldwide, as it demonstrates a company's commitment to complying with green mandates. In India, too, recent reports suggest that VPPAs are essential to meet corporate needs and wants, particularly in the country's expanding commerce and industry ("**C&I**") segment, and given India's ambitious climate-related targets.*

*Due to the increasing demand from investors regarding environmental, social, and governance (ESG) standards, companies may want to transition completely to renewable energy (RE). However, there may be various reasons preventing them from doing so, including the inherent risks associated with RE generation. Additionally, physical power purchase agreements (PPAs) may not be feasible for smaller projects. Despite India's newly democratized 'open access' regime, commercial and industrial (C&I) consumers with lower energy requirements or inconsistent demand may not yet have an economical way to obtain renewable energy. In this regard, VPPAs may provide a perfect solution, both at a private/corporate level as well as at a public/national scale.*

*Nevertheless, if an entity needs/wants to acquire or generate RE at scale – the question is whether it can enter into a VPPA in India – given the country's present regulatory landscape. I argue that despite persisting uncertainties about the legal status of VPPAs, recent legislative and policy changes in India, along with a proliferation of*

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*'corporate' PPAs involving RE procurement, suggest significant promise in respect of achieving both clarity and use, commensurate with India's power needs in the future.*

**Keywords** – Virtual Power Purchase Agreements, Renewable Energy Certificates, Electricity, SEBI, CERC.

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## I. INTRODUCTION

Power purchase agreements (PPAs) have been in existence for a considerable period. A PPA is a legal agreement between an electricity producer and a buyer, wherein the buyer agrees to procure electricity from the producer at an agreed-upon price for a specific duration whereas A Virtual PPA is a multi-year bilateral renewable energy contract that does not involve the physical delivery of energy from the vendor to the customer, it is essentially a financial agreement. A Virtual Power Purchase (VPPA), also known as Financial/ Synthetic PPA is a long-term contract – typically 10 to 20 years- between a developer of renewable energy project, and a interested energy buyer.

According to a report published last year by the International Energy Agency ("**IEA**") in collaboration with the World Bank and the World

Economic Forum (such report, the "**IEA Report**"),[1] in order to reach net-zero emissions on a global scale, annual investments in respect of renewable energy into developing countries need to expand sevenfold in the next eight years – from less than US$ 150 billion (as per 2020 levels) to over US$ 1 trillion by 2030. Further, the IEA Report highlights how countries of the Global South find themselves at an inherent disadvantage: allegedly, such disadvantage arises on account of limited access to international capital at a scale required for addressing paradigmatic policy change in response to a climate crisis. Further, the effects of such infirmity are exacerbated when developing countries need to reconcile national energy security concerns with global ones. Although financial resources are abundantly available worldwide, channeling such funds into appropriate economies, sectors, and projects remains challenging.

A different but more recent report – published by Bloomberg NEF ("**BNEF**")[2] in association with the Power Foundation of India (the "**BNEF Report**")[3]— claims that India will require an investment of US$ 223 billion to meet its 2030 climate targets related to wind and solar capacity installations alone. In yet another outlook, the IEA predicts that India is poised to witness the largest increase in energy demand across nations, especially over the next two decades.[4]

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[1] FINANCING CLEAN ENERGY TRANSITIONS IN EMERGING AND DEVELOPING ECONOMIES, IEA , June 2021, https://www.iea.org/reports/financing-clean-energy-transitions-in-emerging-and-developing-economies.

[2] Similar to RECAI (see above), India has consistently ranked among the top-10 emerging markets covered by Climatescope, BNEF's flagship report analyzing market attractiveness for energy transition investment.

[3] SHANTANU JAISWAL & ROHIT GADRE, FINANCING INDIA'S 2030 RENEWABLES AMBITION, WHITE PAPER, Bloomberg NEF, June 22, 2022, https://assets.bbhub.io/professional/sites/24/BloombergNEF-Financing-India%E2%80%99s-2030-Renewables-Ambition-2022.pdf.

[4] "INDIA ENERGY OUTLOOK 2021" WORLD ENERGY OUTLOOK SPECIAL REPORT, IEA, February 2021, https://iea.blob.core.windows.net/assets/1de6d91e-e23f-4e02-b1fb-51fdd6283b22/India_Energy_Outlook_2021.pdf.

On their part, investors may want to (continue to) invest in India[5] because they need a suitable 'home' for the trillions which have been pledged to meet the goals of the Paris Agreement.[6] After all, going by records, Indian RE projects yield much higher equity returns (almost 15%)[7] than those in developed markets. Foreign investors, in particular, may find India attractive for several reasons. For instance, the prospect of securing up to 100% ownership in a renewables project[8] (unlike in China) might particularly appeal to some, along with the prospect of entering into a long-term (25-year) power purchase agreement ("**PPA**") secured by sovereign guarantee via the Ministry of New and Renewable Energy

[5] India's RE programme, driven by private sector investment, attracted close to US$ 65 billion between 2014 and 2019 itself, while FDI inflows in the non-conventional energy sector between April 2000 and June 2022 totaled US$ 12.5 billion. Further, India's extant FDI policy encourages foreign investors to enter into joint ventures (JVs) with Indian partners for financial and/or technical collaborations, as well as to establish RE-based power generation projects. At any rate, it makes sense for outside investors to partner up with local firms that are familiar with the Indian market and currently maintain operations. Irrespective, a diverse set of foreign investors have already set up shop either by going solo or joining local (and/or foreign) power producers to tap into India's growing RE market.

[6] The Paris Agreement is a legally binding international treaty on climate change. It was adopted by 196 Parties at the 21st session of the Conference of the Parties (COP 21) held in Paris on December 12, 2015, and it entered into force on November 4, 2016. Its goal is to limit global warming to well below 2, and preferably to 1.5, degrees Celsius, compared to pre-industrial levels.

[7] See ARJUN DUTT, LUCILA ARBOLEYA, AND PABLO GONZALEZ, CLEAN ENERGY INVESTMENT TRENDS 2020: MAPPING PROJECT-LEVEL FINANCIAL PERFORMANCE EXPECTATIONS IN INDIA, COUNCIL ON ENERGY, ENVIRONMENT AND WATER (CEEW) AND IEA, November 2020, https://www.ceew.in/cef/solutions-factory/CEEW-CEF-clean-energy-investment-trends-2020.pdf .

[8] At present, up to 100% foreign direct investment ("**FDI**") is allowed under the automatic route (*i.e.*, no prior government approval is required) for RE generation and distribution in India (subject to provisions of the Electricity Act, 2003, as amended from time to time (the "**Electricity Act**")).

("**MNRE**")[9] or otherwise underwritten by government agencies such as NTPC Limited ("**NTPC**").[10]

Meanwhile, a continuing rise both in India's economy and population will lead to even higher power demand in the future. According to a separate report focusing on the electricity market,[11] India is already the third-largest consumer globally, accounting for 9% of global growth. Moreover, Indian solar and wind projects have among the lowest costs in the world, largely on account of increased scale and competition: indeed, at present, solar and wind power are about 50% cheaper than their coal-fired equivalent.[12]

Thus, as a matter of national interest, innovative contractual arrangements related to the RE sector might be useful in light of India's ambitious climate targets. According to both, the IEA Report and the BNEF Report, meeting such targets will require a significant scaling up in terms of RE capacity-addition as well as procurement, including through increased private sector participation. Since political lags, socioeconomic exigencies, and democratic bottlenecks may retard state-led action, corporate and/or private initiatives in the energy markets might be necessary for securing India's desired transition.[13] Such initiatives may

[9] The development and growth of RE in India are administered by the MNRE, which functions as the nodal agency of the government for all matters relating to RE developments.

[10] Formerly, the National Thermal Power Corporation Limited.

[11] ELECTRICITY MARKET REPORT, IEA, July 2021, https://iea.blob.core.windows.net/assets/01e1e998-8611-45d7-acab-5564bc22575a/ElectricityMarketReportJuly2021.pdf

[12] Solar and wind power are available at Rs. 2 - 2.5/kilowatt-hour ("**kWh**") (US$ 26 - 32/megawatt-hour) in the market. In February 2021, India witnessed an 18% year-on-year decline to a new record low in respect of solar tariff, translating to about Rs. 1.99/kWh with zero inflation indexation. Some forecasts suggest that Indian solar will likely reach Rs. 1.00/kWh by 2030.

[13] M. Vandenbergh, *Private Environmental Governance*, 99 CORNELL L. REV. 129 (2013). ; M. VANDENBERGH, J. GILLIGAN, BEYOND POLITICS: THE PRIVATE GOVERNANCE RESPONSE TO CLIMATE CHANGE, (2017); Sarah E. Light & Eric W. Orts, *Parallels in Public and Private Environmental Governance*, 5 MICH. J. ENVTL. & ADMIN. L. 1 (2015).

include institutional adoptions of RE procurement and value chain decarbonization – pursuant to which gaps in governance and state capacity are filled, especially those related to the power sector, specifically in terms of climate change.

In the United States, for instance, private governance initiatives – including in the form of corporate commitments to, and concomitant demands for, fossil fuel-free electricity derived from renewable sources, have increased RE installations both (i) directly, by driving the addition of renewable generation capacity to various parts of the US grid, as well as (ii) indirectly, by triggering a political demand for public policy and regulatory interventions that expand corporate access to RE.[14] One such procurement pathway, especially common among large corporate buyers, is the 'virtual' power purchase agreement ("**VPPA**"). Through a VPPA, companies can use their purchasing power in a way that adds new renewable generation capacity in electricity markets. In a VPPA, the company agrees to purchase a portion of the energy generated by a renewable energy project, typically wind or solar, without physically receiving the electricity at its facilities. Instead, the renewable energy is sold into the grid, and the company is credited for the energy it has contracted to purchase, allowing it to offset its energy consumption and greenhouse gas emissions. VPPA is a tool used by companies to decarbonize their energy consumption while also supporting the development of renewable energy projects[15].

Nevertheless, given that an entity needs/wants to acquire RE at scale – the question is: should, and *can*, it enter into a VPPA in India?

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[14] Tzankova Zdravka, *Public Policy Spillovers from Private Energy Governance: New Opportunities For The Political Acceleration Of Renewable Energy Transitions*, 67 ENERGY RES. & SOC. SCI. (2020).

[15] RACHIT KANSAL, INTRO. TO THE VIRTUAL POWER PURCHASE AGREEMENT, ROCKY MOUNTAIN INSTITUTE, (2018), https://rmi.org/wp-content/uploads/2018/12/rmi-brc-intro-vppa.pdf.

A VPPA is generally a good idea to help a company speedily scale up renewables in its power mix, not just for reasons of cost and branding, but also for compliance and reputational reasons – given expected future trends. More than 80% of all PPAs signed with corporate buyers in the United States, for example, are estimated to be 'virtual'.[16] Large Indian companies with significant exports could similarly 'green up' their products/services to maintain acceptability in developed, climate-conscious markets.

However, the legal status and applicable regulatory regime concerning VPPAs are still uncertain in India. While conditions are ripe for the introduction and use of these contracts, a clarificatory initiative from the government could serve as a starting point. Recent legislative changes in the Indian electricity sector, however, might be a harbinger of such future initiatives.

This article proceeds in four parts. The first part provides a background to India's climate ambitions and the current policy landscape concerning its electricity sector, especially in connection with RE, along with new changes in the corresponding legislative regime and its appurtenant regulatory structure. Next, the second part provides a broad overview of PPAs and 'corporate' PPAs and then seeks to explain the rise in the use of the latter in recent times, especially in India. It also examines the implications of certain key legislative changes (as discussed in the previous part) in the context of the Indian government's strategic attempt to create a suitably conducive environment for increased RE procurement and capacity addition. In the third part, key distinctions between 'physical' and 'virtual' PPAs are discussed. The fourth part probes the main question regarding the legal status of VPPAs in India, including in light of regulatory tussles and jurisdictional confusion concerning electricity

[16] *See* Benjamin Grayson, *Corporate VPPAs: Risks and sensitivities*, PROJECT FINANCE, NORTON ROSE FULBRIGHT, (June 16, 2020), https://www.projectfinance.law/publications/2020/june/corporate-vppas-risks-and-sensitivities/.

derivatives, as well as through creative interpretive possibilities. Having found certain irreconcilable areas of overlap, it then proceeds to analyze the US position in this regard. The fifth part attempts to articulate potential lessons for India in the future about promoting clarity and precision as far as VPPAs are concerned, including via lessons from past practices, global best practices, and alternative present trends. The sixth part concludes.

## II. BACKGROUND

India's climate-related targets are ambitious. At the 26th session of the Conference of the Parties ("**COP 26**") held in Glasgow in 2021, the Indian Prime Minister promised to achieve net-zero greenhouse gas ("**GHG**") emissions for the country by 2070 (the "**COP Statement**").[17] Among other things, India also aims to (i) reach 500 gigawatts ("**GW**") of non-fossil energy capacity (which, when done, will be the world's largest expansion in this regard)[18] and (ii) meet 50% of its energy requirements exclusively from RE – both by 2030.[19] A few months ago, the Union Cabinet approved these targets as part of the country's updated Nationally Determined Contribution ("**NDC**") under the auspices of the United Nations Framework Convention on Climate Change ( "**UNFCCC**").[20]

### A. INDIA'S PAST PERFORMANCE AND FUTURE PROSPECTS

To be sure, India appears to be on the right track regarding its pivot towards renewables. For example, in the draft National Electricity Plan

[17] National Statement by Prime Minister Shri Narendra Modi at COP26 Summit in Glasgow, (November 2, 2021) ("**COP Statement**"), https://www.mea.gov.in/Speeches-Statements.htm?dtl/34466/National+Statement+by+Prime+Minister+Shri+Narendra+Modi+at+COP26+Summit+in+Glasgow.
[18] https://www.investindia.gov.in/sector/renewable-energy.
[19] *See* COP Statement.
[20] *See* Ministry of Environment, Forest and Climate Change, Press Release, (August 3, 2022), https://pib.gov.in/PressReleasePage.aspx?PRID=1847813.

for 2022-2027 ("**NEP**")[21] released by the Central Electricity Authority ("**CEA**") in September last year,[22] the MoP estimates that solar energy will emerge as dominant in coming years,[23] even though coal will continue to remain a staple in the country's energy mix.[24] Back in 2017, India started adding more renewables relative to coal within this mix, and such a trend is likely to continue well into the future. For context – while the country plans to add 35 GW of coal to its extant capacity by 2031-32, it is looking to add almost ten times that amount to solar, and three times that amount to wind, respectively, within the same period. As of May 2022, its installed capacity in RE stood at 160 GW, already representing 40% of its aggregate.[25] Moreover, India has continued to rank third in the world: (i) for total renewable capacity additions, as well as (ii) in respect of the Renewable Energy Country Attractiveness Index ("**RECAI**") published biannually by EY (behind China and the US).[26]

However, despite this accelerated pivot, India's annual rate of RE capacity addition (going by the current record) is nowhere close to what is necessary for achieving its NDC target. The country needs to add 50 GW of RE capacity every year.[27] Yet, as recently as in 2021, notwithstanding its high global rank, India managed to add only about 15 GW, compared to

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[21] Electricity Act, 2003, § 3(4) stipulates that the CEA must prepare an NEP pursuant to the National Electricity Policy and notify such plan once every five years.

[22] Available at: https://cea.nic.in/wp-content/uploads/irp/2022/09/DRAFT_NATIONAL_ELECTRICITY_PLAN_9_SEP_2022_2-1.pdf.

[23] According to the government, even among promising RE resources available in India, solar energy has the highest potential. In most parts of the country, 250 to 300 days every year are both clear and sunny. The annual radiation is comparable with that received in the tropical regions of the world. The equivalent energy potential is about 6,000 million GWh of energy per year. See https://mnre.gov.in/solar/rpo/ .

[24] The NEP estimates a 40% increase in domestic coal requirement in 2031-32. In 2021-22, India's domestic coal requirement was 678 million tonnes (MT). It will increase to 831.5 MT by 2026-27, and to 1018.2 MT by 2031-32. At present, a little above 50% of the total installed capacity in the Indian energy sector comes from coal.

[25] About 400 GW of total installed capacity.

[26] See https://www.ey.com/en_in/recai.

[27] In 2021, despite ranking third globally for total RE capacity additions, India added only about 15 GW in 2021, following China (136 GW) and the US (43 GW).

three and nine times that amount added by the US and China, respectively.[28] Therefore, according to the NEP, massive investments in RE[29] will be required over the next few years.

### B. THE STANDING COMMITTEE

Happily, the Indian government appears to be thoroughly alive to the country's present climate needs and appurtenant capital requirements. Under a report on the prevailing constraints in India's RE sector – as submitted to the Indian Parliament in February last year[30] – a standing committee (the "**Standing Committee**") was able to zoom in on many of the key issues involved and provided recommendations accordingly. For instance, having rightly identified the 'huge gap' between the required and actual investment for RE capacity addition in the country, the Standing Committee suggested, *inter alia*, that the MNRE should[31] (i) seek alternative financing mechanisms, and (ii) prescribe 'Renewable Finance Obligations' (like Renewable Purchase Obligations – discussed below).[32] Further, the Standing Committee commented on the tariff regime in respect of RE and issued suggestions for improvement.

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[28] In 2021, China added 136 GW and the US added 43 GW in total renewable power capacity. See https://www.investindia.gov.in/sector/renewable-energy .

[29] Amounting to about 13 trillion INR, according to the NDC Press Release.

[30] STANDING COMMITTEE ON ENERGY (17th Lok Sabha), *Financial Constraints in Renewable Energy Sector,* (February 3, 2022) https://eparlib.nic.in/bitstream/123456789/835464/1/17_Energy_21.pdf .

[31] The growth of RE in India is administered by the MNRE, which functions as the nodal agency of the government for all matters relating to RE development.

[32] *Id.*

### C. TARIFFS

The Electricity Act, 2003, as amended from time to time (the "**Electricity Act**")[33] provides for two methods of tariff discovery: (i) the first is a tariff determined by the central (*i.e.*, the central electricity regulatory commissions, or the "**CERC**") and/or state commissions, while (ii) the second is a tariff discovered through competitive bidding. Under the first method, the CERC may determine (1) a generic tariff (for certain specified categories of RE projects), or (2) on a case-by-case basis (pursuant to the specifics of a project) – subject to existing regulations that stipulate parameters and eligibility criteria.[34] Under the second method, the tariff may be determined through an auction. Pursuant to Section 63 of the Electricity Act,[35] the MNRE has issued several guidelines related to competitive bidding processes, including in respect of procuring power for solar, wind, and wind-solar hybrid projects.[36] In this mechanism, the final contract price is given by the lowest bid offered in

[33] Since RE is part of the electricity sector, it is governed by the Electricity Act, which provides a framework for the generation, transmission, distribution, trading, and use of electricity. The MoP administers the implementation of the Electricity Act and primarily plays a supervisory role in overseeing the development of the electricity sector in the country.

[34] See the Central Electricity Regulatory Commission (Terms and Conditions for Tariff Determination from Renewable Energy Sources) Regulations, 2020, issued by the CERC under § 61 read with § 178 (2)(s) of the Electricity Act, available at: https://cercind.gov.in/2020/regulation/159_reg.pdf. While these regulations will remain in effect until March 31, 2023, the tariff norms specified herein will continue to remain applicable until revised norms in respect of such tariff are notified pursuant to a subsequent re-enactment of these regulations.

[35] "*Section 63*. Determination of tariff by bidding process: Notwithstanding anything contained in Section 62, the Appropriate Commission shall adopt the tariff if such tariff has been determined through transparent process of bidding in accordance with the guidelines issued by the Central Government".

[36] *For example*, the Guidelines for Tariff Based Competitive Bidding Process for Procurement of Power from Grid Connected Solar PV Power Projects, issued on August 3, 2017; the Guidelines for Tariff Based Competitive Bidding Process for procurement of RE power from 2500 MW ISTS Connected Blended Wind Power Projects, issued on June 25, 2020; etc.

the auction. Therefore, the bidders who can accept this price will be awarded the PPA.

A key reason for introducing a 'reverse' auction was to promote competition in the sector. This requirement reduces the overall cost of power procurement and was designed to benefit consumers. However, while these reverse auctions have been useful for discovering low tariffs (resulting in extremely low bids), several projects were adversely affected and/or became unviable – especially where developers faced the 'winner's curse' with rising import prices in respect of necessary RE components (even leading to situations of unmet demand). According to recent reports, however, it appears that this mechanism may soon be done away with, or substantially modified, in light of stakeholder concerns.[37]

### D. RPOs, RECs, and MBED

Nevertheless, an important element of support for power producers has been provided through a regime of renewable purchase obligations ("**RPOs**"). Thus, the Electricity Act requires certain categories of obligated entities (such as state-owned/licensed electricity distribution companies ("**discoms**")) to purchase a minimum percentage of electricity from RE sources. Moreover, when such obligated entities face procurement-related issues due to variations in (i) RE quality, and/or (ii) RE potential across different states, RE certificates ("**RECs**") may be used.

RECs are market-based tradeable instruments that represent the environmental attributes of RE (but not the actual power itself). RECs thus allow obligated entities to meet their RPOs without actual procurement. However, on account of sub-par compliance with the RPO

[37] *See*, *e.g.*, "THE E-REVERSE AUCTION ARRANGEMENT IN RENEWABLE ENERGY SECTOR MAY END SOON: MNRE SECRETARY," CONFEDERATION OF INDIAN INDUSTRY (CII), (July 14, 2022), https://www.cii.in/PressreleasesDetail.aspx?enc=NaF8wVKn4KZOchZuuY8qiWGLh1dJkoP5UoJAUwhds0s=.

regime in the past, the CERC issued new regulations[38] in May 2022 in an effort to develop the RE-market through REC trading (discussed further below).

Furthermore, in a bid to develop (and integrate) the electricity market pursuant to the Union government's vision of 'One Nation, One Grid, One Price', the Ministry of Power ("**MoP**") circulated a discussion paper among key stakeholders in June 2022 with respect to a proposed framework for a 'Market-Based Economic Dispatch' ("**MBED**"). While various states in India, fearful of eroding autonomy, seem to be opposed to this idea (*i.e.*, a centralized model of scheduling power dispatches), the pooling of resources under MBED may potentially reduce power procurement costs and improve resource efficiency.

### E. AMENDING THE ELECTRICITY ACT

In addition, a bill that seeks to amend the Electricity Act was introduced in Parliament in August 2022 (the "**Electricity Bill**").[39] The Electricity Bill requires an obligated entity (*e.g.*, discoms) to ensure that their RPOs remain above a prescribed percentage, failing which a penalty may be imposed. However, while procuring electricity, financially-stressed discoms often default on, or significantly delay, payments – or even attempt to renegotiate PPAs. Such conduct has been identified by independent power producers ("**IPPs**") and other key stakeholders as a major risk factor in the sector, leading some foreign lenders to even refuse loans where projects are contracted directly with discoms.

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[38] The Central Electricity Regulatory Commission (Terms and Conditions for Renewable Energy Certificates for Renewable Energy Generation) Regulations, 2022, Gazette of India, pt. II sec.3(i), https://cercind.gov.in/regulations/REC-Regulations-2022.pdf.
[39] The Electricity (Amendment) Bill, 2022.

### F. OPEN ACCESS

The open-access rules of 2022 in respect of 'green energy' (the "**Open Access Rules**")[40] were notified by the MoP in June last year. The Open Access Rules, *inter alia,* seek to increase both the ease and scale of consumer access to green energy.[41] In the pre-open access era, Indian consumers could procure power from discoms alone. Over time, the government has allowed consumers with a minimum load requirement to buy electricity directly from power producers. Importantly, the new rules now seek to further democratize the regime (where large users can pick a supplier of choice among multiple options) by enabling increased private participation in the distribution business.[42]

### G. BECOMING NET-ZERO

A few months before the COP Statement was issued in 2021, during an Independence Day address, the Prime Minister had pledged that India would achieve energy independence (*i.e.*, the country would end its coal and oil imports) by 2047.[43] While solar could become the biggest source of energy in the future where India is concerned – a country with almost

[40] The Electricity (Promoting Renewable Energy Through Green Energy Open Access) Rules, 2022 (the "Open Access Rules"), Gazette of India, pt. II sec.3(i).

[41] *See* Press Release "Ministry of Power notifies 'Green Energy Open Access' Rules to accelerate ambitious renewable energy programmes," PIB, New Delhi, July 19, 2022, https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1842737#:~:text=The%20Green%20Open%20Access%20is,of%20Green%20Power%20from%20Discoms.

[42] While a system of multiple suppliers is not new, such suppliers were previously not required to allow new participants to openly access their network. However, new distribution licensees will now be permitted to use the existing network (upon payment of applicable charges). In other words, while the extant Electricity Act already allows multiple discoms to operate in the same supply area, it still requires them to distribute electricity through their own network. Now, the Bill does away with such requirement. Instead, a discom will now need to extend access to all other discoms operating in the same area to its own network. Thus, the existing monopoly that discoms hitherto enjoyed in respect of both area and supply appears to be drawing to a close.

[43] *Modi Sets 2047 Target For Becoming 'Energy Independent'*, ECON. TIMES, (August 15, 2021), https://economictimes.indiatimes.com/industry/renewables/modi-sets-2047-target-for-becoming-energy-independent/articleshow/85342916.cms?from=mdr.

300 days of sun a year – coal-fired power plants still account for more than half of the country's total installed capacity. As far as becoming 'net-zero' by 2070 is concerned, several techno-economic challenges remain, most of which will need to be addressed soon to achieve 100% RE status over the long term.

If achieving RE-related targets, and reducing GHG emissions quickly, serve as the main motivation for India's climate goals, VPPAs might help in significant measures. Relative to other options, a VPPA may be able to provide the fastest pathway toward driving down carbon emissions. As of date, no better alternative exists in respect of securing large amounts of carbon-free electricity at scale. Further, VPPAs typically result in additionality – *i.e.,* they add new RE facilities to the grid.

## III. OVERVIEW

### A. PPAs

In public-private partnerships (PPP) within the energy sector, a PPA is usually the main contract between a set of public and private sector entities. A PPA enables an entity to procure electricity directly (*i.e.*, 'offtake') from a producer of power. Discoms are the main off-takers in India:[44] they first procure power from "**gencos**" (generating companies)[45] and then distribute such power onwards – via grid[46] transmission – to and among end-users, including across segments like commerce and industry ("**C&I**"), agriculture, households, etc.[47] Pursuant to a PPA, the genco

[44] Private utilities serve only 10% of the country's power consumers. Globally, too, 70% of distribution utilities are publicly owned; the remaining 30% of the privately owned companies are located primarily in middle and high-income countries.

[45] Gencos, too, can be either state-owned or private. For instance, NTPC Limited and Adani Power Limited, respectively.

[46] Private discoms may also own assets on the grid, in whole or part (the distribution licensee model – as opposed to the franchisee model, where the grid assets are not owned). E.g., Tata Power Company Limited (Tata Power), New Delhi.

[47] The vast majority of consumers in India continues to be served by state-owned utilities.

raises monthly invoices for the units of power sold/supplied. In turn, discoms are obliged to meet the applicable demand in their respective supply areas. For instance, the Maharashtra State Electricity Distribution Company Limited (MSEDCL), India's largest discom, distributes power to the entire state of Maharashtra (including some parts of suburban Mumbai).[48]

### B. CORPORATE PPAs

However, PPAs may also be entered into between two or more private parties ("**Corporate PPAs**"), especially in jurisdictions where a competitive power market exists – such as the one increasingly emergent in India. In fact, Corporate PPAs have proliferated over the past few years, and in this country in particular. Specifically, concerning RE, India appears to have witnessed one of the largest spikes in the world, next only to the US.[49]

In the context of *renewable* PPAs – *i.e.*, where parties specifically contract to procure RE – a genco will produce electricity from RE sources (e.g., solar or wind energy), and another entity (discoms or private

[48] Mumbai is served by three private distribution licensees: Adani Electricity Mumbai Limited (AEML), Tata Power Company Limited, Tata Power, and the Brihanmumbai Electricity Supply and Transport Undertaking (BEST).
[49] *See* PB Jayakumar, *India becomes 2nd largest market on corporate renewable power*, BUS. TODAY, (January 6, 2020), https://www.businesstoday.in/latest/economy-politics/story/india-becomes-2nd-largest-market-on-corporate-renewable-power-241943-2020-01-06 .

parties/companies) will agree to buy it. Such a PPA might also include the purchase of renewable attributes[50] in respect of the underlying power.

A Corporate PPA differs from the traditional model (*i.e.,* 'utility' PPAs) – where discoms (*i.e.,* utilities) invite bids from power generators and then select a seller at the end of the bidding process through a pre-announced, templated mechanism, subject to financial and technical qualification. Instead, in a Corporate PPA, a non-utility company looks to design a bespoke power purchase arrangement with an appropriate energy producer, commensurate to the former's appetite and commercial requirements.

### C. WHY ARE SO MANY CORPORATE PPAS GETTING SIGNED IN INDIA?

To begin with, an entity may have unique consumption needs, whether sector- or company-specific, including in terms of running and/or expanding its business further. For example, companies engaged in sectors such as those related to technology, infrastructure, construction, the automotive industry, textiles, etc. – and especially those with high power requirements (like running a data center or a high-load factory in a concentrated hub) – may find it worthwhile to *secure* their power supply to reduce business disruption. More generally, however, two separate reasons have converged at this particular time, and such convergence partly explains the rise of Corporate PPAs involving RE. The reasons are as follows:

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[50] Typically, Energy Attribute Certificates (EACs) represent the environmental attributes from the generation of one megawatt-hour (MWh) of energy produced by renewable sources. Consumers can use EACs to make reliable claims about their energy use. When a genco injects an electrical charge into the grid in one location and a consumer takes the same amount of charge off the grid from some other location, there is no way to track the electricity through the grid. Accordingly, the only reliable way for making claims about a specific kind of use in respect of electricity taken off the grid is to have a system that books all injected charges as unique units (in MWh). These booked units can then be traded independently from the underlying electricity.

a) The high coal-based tariffs on the grid – coupled with the fact that non-fossil RE is now widely available in India, and that too for cheap (especially solar energy, on account of substantial gains made in photovoltaic ("**PV**") cell/module-based technologies); as well as

b) The new and innovative business models are now being embraced by large Indian corporate houses, particularly those with international collaborations/presence/ambitions.

Aside from these reasons, sustainability and climate sensitivity are both important goals today, due to the strong focus on Environmental, Social, and Governance ("ESG") standards and the arrival of green taxonomies in the country. In the future, these standards may also be applied to unlisted companies. Further, even while pursuing creative eco-labelling practices (whether to impress investors and/or customers, or to distinguish one's 'brand' from the rest), companies need to look out for 'greenwashing' laws that are expected to go beyond extant corporate governance-related disclosure and reporting standards.[51] Accordingly, a demonstrable trail of direct RE procurement (through renewable PPAs) might enable such entities which are involved in environment/climate-

[51] Including the extant Business Responsibility and Sustainability Reporting ("**BRSR**") framework for the top 1,000 listed companies. The Securities and Exchange Board of India ("SEBI"), as part of its efforts to enhance disclosures on ESG standards, introduced new requirements for sustainability reporting by listed companies. The new reporting format under BRSR aims to establish links between the financial results of a business with its ESG performance. This can make it easier for regulators and investors, and allied stakeholders to obtain a fair estimate of overall business stability, growth and sustainability (hitherto based on financial disclosures alone). SEBI has mandated that the BRSR will be applicable to the top 1,000 listed entities by market capitalisation for reporting on a voluntary basis for the financial year (FY) 2021–22 and on a mandatory basis from FY 2022–23. Thus, India's top 1,000 listed companies by market capitalisation are required to prepare and submit a report under the BRSR framework to the Ministry of Corporate Affairs (MCA) starting with FY 2022-23. The submission will be through the MCA21 portal – the e-governance application of the Ministry of Corporate Affairs (MCA).

friendly messaging to *not* run afoul of the law, even in unforeseeable (but likely) compliance requirements of the future.

In addition, the Indian government's firm pivot towards RE – pursuant to lofty climate goals under the Paris Agreement – has produced a plethora of green policies and regulations, including the democratized open access and REC regimes, respectively. Increasingly, the government has sought to create a business environment punctuated by incentives and opportunities to go green. As a result, the number of Corporate PPAs in the RE sector has mushroomed and is likely to grow further still.

On the supply side generally, the energy market is dominated by private players (barring a few notable exceptions like NTPC).[52] In respect of RE in particular, the power production space is getting populated quickly (including by IPPs) and a growing number of foreign gencos, duly benefiting from India's liberalized FDI policy on RE. From such gencos' perspective, a Corporate PPA makes a lot of sense. After all, a corporate buyer (*i.e.,* a private party) is much more likely to pay up (and on time) compared to cash-strapped discoms with a history of delayed or failed payments, including late attempts at contract renegotiation. Besides, discoms may refuse to buy from private gencos unless the latter bid really low (which, in turn, can make the project unviable in the long run, especially with rising costs associated with inflation, inputs, indirect tax, and imports). Thus, rather than face suboptimal situations such as those involving: (i) unmet demand (on account of project failure), or (ii) unmet supply (because of unsold capacity), private gencos can inject excess RE into the grid for corporate off-takers – especially those in the C&I segment with high(er) power requirements. In the end, the risk allocation regime under a PPA is crucial, especially with regard to the genco's ability to raise finance for its project, as well as to recover capital costs and earn a return on equity. For that matter, certain Indian states offer waivers on

[52] NTPC Limited (formerly, the National Thermal Power Corporation Limited) is a government agency.

open access charges from time to time, which further encourage IPPs to enter into Corporate PPA arrangements.

### D. WILL THIS TREND CONTINUE? WHY?

To be sure, Corporate PPAs have already been entered into by the 'big boys' of Indian business. The United States, however, has witnessed a number of relatively smaller companies enter this market too. To overcome the burden of long-term, high-volume commitments, smaller entities pool their power needs together, and each contract for a portion of the aggregate capacity. Additionally, the smaller participants can partner with an 'anchor tenant' — a larger and more experienced purchaser with a strong balance sheet, superior bargaining power, and previous accounting/legal experience in this regard. Indeed, making projects viable requires some part of the project to be hedged. One option, accordingly, is to have a larger company provide cover through a PPA.

Earlier, small and mid-sized players in the C&I segment were happy to receive power from local utilities. These buyers might now discover that the Corporate PPA model works well for them too, especially to purchase RE. Such PPAs will allow them to combine forces and purchase power at a certain price, for a given time, from a specific project. This, in turn, will enable C&I purchasers to avoid high upfront costs and provide them with access to better opportunities – relative to pursuing such opportunities alone.

In India too, this 'group captive' structure brings together equity from multiple off-takers, along with an IPP's own. In particular, the structure has the advantage of routing RE-related capital from those companies in the C&I segment which otherwise might not have invested in renewables. Unfortunately, certain states where this model previously existed, have subsequently levied an additional surcharge, leading to suboptimal results.

## E. ANALYSIS OF RECENT LEGISLATIVE DEVELOPMENTS

Certain legislative changes deliberated upon, and subsequently introduced, by the CERC over the last two years have been mentioned above. The following sub-sections discuss and analyze such changes in greater detail.

### 1. Implications of the Open Access Rules

The Open Access Rules aim to remove certain procedural obstacles related to RE procurement. These obstacles explained the scant use of open access in India in the past. Accordingly, the new rules not only enable (i) faster (and deemed) approvals, (ii) rationalization of charges/tariffs/processes, and (iii) the voluntary purchase of RE by C&I consumers – but more importantly, these rules also reduce open access transactional thresholds in respect of RE from 1 MW to 100 kW, thus paving the way for small consumers to purchase 'green energy'[53] easily. In addition, captive consumers can avail of RE under the Open Access Rules with no minimum limit.[54]

Earlier, as mentioned above, on account of higher eligibility thresholds in respect of load, only large C&I establishments found open access feasible. Consumers with power requirements below 1 MW could not procure RE – except through green tariffs in certain states, and that too upon payment of additional premium to discoms. Under the new relaxation, however, even small and medium-sized enterprises with modest energy requirements can procure RE via open access. Since C&I

[53] § 2(d) of the Open Access Rules defines "green energy" as the electrical energy from renewable sources of energy, including hydro and storage (if the storage uses renewable energy) or any other technology as may be notified by the Government of India from time to time, including any mechanism that utilizes green energy to replace fossil fuels such as the production of green hydrogen or green ammonia as per appropriate provisions under the Open Access Rules.

[54] § 2(b) of the Open Access Rules defines an 'entity' as "any consumer who has contracted demand or sanctioned load of 100 kW or more except for captive consumers: Provided that in case of captive consumers there shall not be any load limitation".

consumers constitute more than 50% of the aggregate power demand (and consumption) in India, a more democratized and inclusive open access regime will significantly increase RE procurement through Corporate PPAs.

### 2. Implications of the RPO Regime

As discussed, the Open Access Rules, read with the Electricity Act and the National Tariff Policy, refer to a set of buying obligations (RPOs) in respect of RE. Specifically, the rules stipulate a uniform regime of RPOs for all obligated entities in respect of a particular distribution area. Thus, such purchase obligations apply across multiple categories of obligated entities – which include open access customers, along with discoms and captive power producers – all of which are obligated to purchase a minimum share of their electricity from RE sources as per their RPO targets.

Accordingly, an 'entity' (as defined under section 2(b) of the Open Access Rules) may set up a power plant from RE sources of whatever capacity for its consumption anywhere in India. In such cases, the generating plant may be installed by the entity itself or by a genco with which such entity enters into a PPA. In addition, an entity may procure RE through open access from any genco either directly or indirectly. Thus, the avenues and reasons for entering into a corporate PPA have both burgeoned in recent times.

## IV. PHYSICAL PPAS VS. VPPAS

Broadly, a PPA for RE may be structured as (i) a regular (or 'physical') PPA; or (ii) a synthetic (or 'virtual') PPA (VPPA). VPPAs assume greater importance when a country's electricity sector moves from a centralized model to a market-oriented one.

A physical PPA involves the delivery of electricity from a power project to a buyer.[55] However, while the buyer receives electricity from a genco in this case, in a VPPA, it does not. Instead, the genco sells the produced power that is *notionally* the subject of such contract in the open market, including through power exchanges (collectively, the "**power pool**"). Conversely, the buyer procures the electricity *actually* required to run its business from someone else in the power pool (including from a discom, if required), through a separate transaction, independent of the VPPA.[56]

So, if VPPAs themselves do not beget power, why should entities enter into them? Because, among other things, a VPPA related to RE might produce Energy Attribute Certificates ("**EACs**") (e.g., Guarantees of Origin in the EU, or RECs in India),[57] which, in turn, can count towards RE-based procurement mandates (e.g., renewable portfolio standards in several US states, or RPOs for obligated entities in India).[58]

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[55] Physical PPAs can be structured as: (i) a tripartite agreement between the customer, the genco, and the discom (a 'sleeved' PPA, where the power produced by the genco is delivered from the grid to the customer through a discom); or (ii) an integrated bilateral agreement between the genco and the consumer.

[56] Alternative procurement options could include a discom, a power exchange, separate bilateral arrangements (signing a physical PPA with a different power producer), or even a 'captive' mode.

[57] RECs are a type of EACs. Globally and generally, an EAC is a contractual instrument that represents information about the origin of the energy generated. It allows markets to track RE production and permits consumers to make credible claims of RE use. Each certificate acquired and then 'retired' (*i.e.,* indicating that it is taken out of the marketplace) certifies the use of a specific quantity of renewable electricity (typically 1 MWh). In most markets with an EAC scheme in place, attribute certificates can be acquired "bundled" (the electricity and the certificates are sold and delivered together) or can be purchased "unbundled" (the certificates are purchased separately, independent of any specific purchase of physical electricity). The most widely used energy attribute systems are guarantees of origin (GOs) in Europe and RECs in the US. Another popular scheme for unbundled EACs is the International Renewable Energy Certificates ("**I-RECs**") program. The Green Certificate Company Limited ("**GCC**") issues I-RECs in India, which can be traded internationally. Thus, India-based gencos can transfer I-RECs to entities outside India.

[58] Pursuant to Section 86(1)(e) of the Electricity Act, 2003, as amended from time to time (the "**Electricity Act**"), certain categories of 'obligated entities' (such as discoms,

As a result, VPPAs can be useful for such entities which are required by law to meet RPOs or their equivalent, especially in locations where renewable resources are unevenly and/or intermittently available.

In addition, VPPAs provide guaranteed revenue by hedging a power project against fluctuations in electricity prices. However, unlike its physical counterpart, a VPPA, in essence, is a financial instrument: the genco produces and sells *actual* electricity in the spot market at a floating rate, while the counterparty agrees to buy a *notional* quantity of such electricity at a price which is fixed during contract inception. The fixed price that a VPPA establishes is typically called the 'strike price'.[59] If the wholesale (floating) market price[60] exceeds the strike price, the buyer needs to be paid the difference. Conversely, if the market price is lower, the buyer must make up the difference. Thus, a VPPA might be characterized as a 'contract for differences' ("**CFD**")[61] – although such

open access consumers, captive power producers) are required to purchase a minimum percentage of electricity from RE sources as a percentage of their total consumption of electricity (Renewable Purchase Obligations, or "**RPOs**"). Moreover, when such obligated entities face procurement-related issues due to variations in (i) RE quality, and/or (ii) RE potential across different states, RECs may be used to meet RPOs. Such statutory RECs are market-based tradeable instruments that represent the environmental attributes of RE (but not the actual power itself). Thus, RECs allow obligated entities to meet their RPOs without actual procurement. In addition, a bill that seeks to amend the Electricity Act (the Electricity (Amendment) Bill, 2022) was introduced in Parliament this August (the "**Electricity Bill**"). The Electricity Bill imposes penalties for non-compliance with RPOs.

[59] While VPPAs are typically signed for a fixed price, there are possible variations: for example, the strike price could be floating (with a discount on the market price or not), hybrid (involving both fixed and floating components, whether in terms of percentage value of output or in respect of time/term), and/or be subject to an escalation mechanism (in nominal/percentage terms or indexed to inflation). Further, ceilings and floors can be introduced to act as an additional safeguard.

[60] Real-time prices in the power exchange.

[61] As used for electricity, a CFD is an instrument/mechanism that converts the risk of a variable price into a fixed price. CFDs are legal in India, as well as in most countries of the world.

characterization is problematic in the US – or as a fixed-for-floating swap.[62]

In the US in particular (but elsewhere too), VPPAs have appealed to a wide variety of corporate buyers, including for the purpose of meeting renewable obligations and/or targets quickly – and especially in order to woo stakeholders via a sustainability-driven platform. Further, the VPPA model suits companies that have fragmented demand across different locations. In addition, VPPAs are not directly impacted by changing regulations and prices in the electricity sector. Instead, these contracts can be structured and adapted for a wide range of purposes: for instance, to underwrite the financing of large-scale RE projects. Further, from a buyer's perspective, publicizing compliance with 'green' targets (by procuring renewables through a VPPA) has become an important element of business branding across the world.

Recent reports[63] related specifically to India appear to conclude that, given the country's large (and expanding) C&I segment,[64] VPPAs are essential to meet corporate RE demands – consistent with India's climate goals.[65] Arguably, C&I consumers can meet their RE obligations/needs through physical PPAs alone, especially under India's newly democratized Open Access Rules. However, physical PPAs have certain limitations. For instance, if and when, on account of low RE prices relative to (high) coal-based tariffs, or in response to customer/investor demand with respect to ESG standards, a company seeks to shift completely – and quickly – to RE, it may not be able to do so for various reasons, including on account of seasonal, technological, and/or other variabilities inherent in RE generation.

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[62] CFDs that are not swaps could be illegal in the US.
[63] *See*, for example, WWF-INDIA, VIRTUAL POWER PURCHASE AGREEMENT FOR C&I CONSUMERS IN INDIA, JUNE 2022.
[64] Estimated to be in excess of 50% of the country's aggregate power consumption base.
[65] India has set a target of 500 GW of RE installation by 2030 and 'net-zero' emissions by 2070, among other things.

Further, despite relaxed transactional thresholds pursuant to the new Open Access Rules in India,[66] physical PPAs are not viable for projects below a logistical minimum[67] due to economies of scale. Accordingly, consumers in the C&I segment with lower load requirements, and/or having fragmented demand across diverse geographies,[68] do not yet have access to a cost-effective mechanism to procure RE. On the other hand, a single VPPA may be able to aggregate demand across a diversity of consumers and locations. Further, aggregated VPPAs can help smaller buyers get together under a single contract without a specific 'anchor tenant' and reap the benefits of scale.

Lastly, EACs can accelerate an entity's energy transition by adding value to the production of RE. In effect, gencos can sell the energy produced, *as well as* the EACs related to such energy. Accordingly, through the use of this complementary income stream, gencos can better secure the economic viability of RE projects.

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[66] As mentioned above, the Open Access Rules have reduced transactional thresholds in respect of RE to 100 kW.
[67] Usually 5 MW.
[68] Consumers with offices, plants, factories, data centers, hubs, manufacturing facilities, etc. across different geographies are required to sign multiple (physical) PPAs.

## V. CAN AN ENTITY ENTER INTO A VPPA IN INDIA?

Generally speaking, when a genco (or other eligible entity) produces/purchases RE in excess of compliance requirements, it may be issued an EAC from a designated agency (*e.g.*, the National Load Despatch Centre ("**NLDC**")[69] in India) for each (additional) megawatt-hour ("**MWh**") of electricity generated/purchased.[70] If such EACs are included in a VPPA, the genco (or other entity) might be contractually required to transfer those to the VPPA counterparty. In turn, the transferor can be compensated for the EACs so transferred through the fixed price that it receives from a such counterparty.

### A. BUNDLED AND UNBUNDLED EACS

However, EACs may not always be included in a VPPA. Further, EACs can be traded separately,[71] independent of, and apart from, a VPPA. Thus, 'bundled' EACs – *i.e.,* when EACs are sold together with their associated energy – are particularly useful for financing new projects, since gencos can show potential lenders guaranteed revenue streams from both 'products' (electricity *and* EACs). On the other hand, 'unbundled' EACs are not tied to the underlying power and do not lead to new RE

[69] The NLDC has been designated as the 'Central Agency,' pursuant to Regulations 2(b) and 3 of the Central Electricity Regulatory Commission (Terms and Conditions for Renewable Energy Certificates for Renewable Energy Generation) Regulations, 2022.
[70] For instance, pursuant to recently notified regulations in India, RECs may be issued by a central agency to RE-based gencos, captive power plants/ generating stations, distribution licensees, as well as 'open access' consumers, subject to eligibility and other requirements.
[71] Central Electricity Regulatory Commission (Power Market) Regulations, 2021, Gazette of India, pt. III sec. 4.

being generated.[72] Since most 'voluntary' purchasers (as opposed to 'compliance' purchasers) seek to procure additional RE because of stakeholder demand, unbundled EACs offer limited opportunity to distinguish the brand. When they are bundled, the vintage and source of EACs are clear. When unbundled, it can be more difficult to verify such factors, potentially compromising ESG-related claims.

### B. RECs IN INDIA

In India, erstwhile regulations related to RECs (the "**2010 REC Regulations**")[73] introduced dealing in unbundled RECs. Such dealing could only be done, however, on power exchanges approved by the CERC. In May this year, on account of perceived deficiencies in the 2010

[72] What is known as 'additionality,' especially in the US. For instance, notional RE and bundled RECs, as acquired through a VPPA, are directly attributable to new 'additional' RE projects which add clean energy to the grid, displacing fossil equivalents: thus, in effect, such project would not have happened 'but for' the VPPA. Unbundled RECs are often used by large companies because they can be spread over several manufacturing locations. While unbundled RECs have the advantage of low prices, the disadvantage is that a company cannot claim any significant additionality. In fact, the use of unbundled RECs poses a potential reputational risk for large companies, including allegations of 'greenwashing'.

[73] The Central Electricity Regulatory Commission (Terms and Conditions for Recognition and Issuance of Renewable Energy Certificate for Renewable Energy Generation), Regulations, 2010, Gazette of India, pt. III sec. 4 (the "**2010 REC Regulations**").

REC Regulations,[74] the CERC issued new ones (the "**2022 REC Regulations**").[75] Among other changes, the 2022 REC Regulations permit the use of electricity traders by eligible entities for exchanging/selling RECs. However, the new regulations do not provide for the sale of bundled RECs through bespoke bilateral arrangements, as Indian corporate buyers (which are looking to enter into VPPAs) might seek/need.

While pursuant to the 2022 REC Regulations, RECs can be issued by the NLDC (the designated central agency in this regard) to eligible entities[76] (subject to restrictions/qualifications),[77] such centralized issuance itself may not be enough to make VPPAs viable. Commercially speaking, RECs need to be transferred by such eligible entities (or issued directly by the central agency) to private/corporate counterparties for both VPPA entities to derive maximum benefits from their contract. Therefore, the REC framework could be better articulated in light of such requirements.

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[74] The 2010 REC Regulations were intended to help obligated entities fulfill their respective RPOs. However, over time, price distortions arose in respect of RECs traded on power exchanges, essentially on account of a demand-supply mismatch. Further, there was sub-par compliance with the RPO regime among obligated entities. In effect, the erstwhile REC mechanism had been designed pursuant to market conditions at a time when RE prices were higher than those from conventional sources of energy, which situation has now drastically changed. With increased RE capacity installed across the country, as well as increased market-based products and procurement options introduced over the last few years, there has arisen a clear need to reform the Indian REC mechanism. Accordingly, in order to address some of these issues and in light of such changed circumstances, pursuant to public and stakeholder consultations, the CERC issued new regulations in respect of RECs which, *inter alia,* seek to (i) introduce a market-driven pricing, including by removing the erstwhile floor and forbearance prices related to RECs; (ii) allow trading of RECs through electricity traders (in addition to trading through power exchanges); (iii) extend the validity of RECs to perpetuity (until redeemed) (earlier, these were valid for 1,095 days only); etc.

[75] The Central Electricity Regulatory Commission (Terms and Conditions for Renewable Energy Certificates for Renewable Energy Generation) Regulations, 2022, Gazette of India, pt. III sec. 4 (the "**2022 REC Regulations**").

[76] Including to to eligible (i) gencos, (ii) captive generating plants, (iii) distribution licensees, and (iv) open access consumers.

[77] Regulation 4 ("Eligibility for Issuance of Certificates") of the 2022 REC Regulations.

In that context, in September 2022, a detailed procedure with respect to implementing the 2022 REC Regulations (the "**Procedure**") was published by the Power System Operation Corporation Limited (POSOCO) on the website of the Indian REC registry.[78] Like the main 2022 REC Regulations, the Procedure has been formulated pursuant to public/stakeholder consultations. Such Procedure requires electricity traders to have back-to-back arrangements with both buyers and sellers before applying for a trade request to the central agency. Thus, it is possible that bundled REC transfers will be expressly provisioned for in the future, whether through the 2022 REC Regulations and/or the Procedure (including reformulations thereof) or via separate explanatory statements.

Alternatively, (non-statutory) RECs can be obtained from other sources, such as the International REC ("**I-REC**") Standard Foundation.[79] The advantage with I-RECs is that these certificates can be

[78] See *Step-wise Description of the Procedure for Redemption through Electricity Trader(s)* in "Procedure for Implementation of REC Mechanism in Compliance of Central Electricity Regulatory Commission (Terms and Conditions for Renewable Energy Certificates for Renewable Energy Generation) Regulations, 2022," Power System Operation Corporation Limited (POSOCO), September 2022, pp. 99-100, pursuant to Regulations 2(g) and 16 ("Detailed Procedure") of the 2022 REC Regulations; available at: https://www.recregistryindia.nic.in/index.php/publics/Reference_Documents.

[79] I-REC is a global standard introduced in a growing number of countries in Asia, Africa, the Middle East, and Latin America, typically where no similar scheme exists (I-RECs are currently available in over fifty countries). It is a recognized tool to document reduced greenhouse gas emissions and improve sustainability ratings. Similar to RECs and Guarantees of Origin, each I-REC represents proof that 1 MWh of RE has been produced and includes the environmental benefits which such RE has generated. The I-REC registry electronically issues I-RECs based on a genco's output. When a company buys I-RECs as documentation for their electricity consumption, such I-RECs are cancelled in the registry. This standardized instrument makes it possible to track ownership, verify claims, and ensure that I-RECs are only sold once (*i.e.*, no double counting). An I-REC for electricity, specifically ("**I-REC(E)**") is an exchangeable EAC that conveys information about the production of a unit of electricity – such as (i) where the electricity was produced, (ii) the capacity of the production facility, and (iii) the energy source. I-REC(E)s can be used for a variety of requirements. Further, the use of I-REC(E)s is accepted by relevant consumer claim standards including the Greenhouse Gas Protocol (GHGP), CDP (Carbon Disclosure Project), RE100, and others.

utilized by companies with international operations to appeal to global customers. The Green Certificate Company Limited (GCC) issues I-RECs in India.[80]

### C. SEBI vs. CERC

A year ago, the MoP issued a press release announcing the start of a new era in the Indian power market.[81] The announcement stemmed from a Supreme Court ("**SC**") order (such order, the "**SC Order**") pursuant to which a long-standing turf battle between the Securities and Exchange Board of India ("**SEBI**") and CERC had been finally resolved.[82] Among other things, the dispute involved ascertaining the appropriate regulatory jurisdiction with regard to forward and derivative contracts in the electricity sector. Pursuant to the SC Order, CERC and SEBI decided that the former would regulate physical delivery-based forward contracts,[83]

[80] In fact, GCC certifies RE generation around the world. The I-REC Standard Foundation often approves GCC as the default issuer of I-REC(E)s in case no other suitable local issuer can be identified. Registration can take place through issuance countries. See https://www.irecstandard.org/india/. In August 2016, Statkraft AS, one of Europe's largest RE gencos, became the first company to offer renewable power tracked by the I-REC Standard in India, with I-RECs generated in cooperation with its Indian hydropower partner Malana Power Company Limited. See Statkraft AS, *Statkraft is the first supplier of I-RECs in India*, GLOBENEWSWIRE NEWS ROOM (2016), https://www.globenewswire.com/news-release/2016/08/08/1833955/0/en/Statkraft-is-the-first-supplier-of-I-RECs-in-India.html.

[81] *See* MINISTRY OF POWER, GATE OPENED FOR THE POWER MARKET REFORMS - 10 YEARS LONG PENDING JURISDICTIONAL ISSUE RELATED TO POWER MARKET BETWEEN CERC AND SEBI RESOLVED BY HON'BLE SUPREME COURT, October 7, 2021, https://pib.gov.in/PressReleasePage.aspx?PRID=1761701 (the "**Press Release**").

[82] Power Exchange of India Ltd. (through its Vice President) v. Securities and Exchange Board of India & others, CIVIL APPEAL Nos. 5290-5291 of 2011 with C.A. Nos. 6311-6314 of 2021 @ SLP(C) Nos.17300-17303/2011 C.A. Nos. 5292-5295/2011, Supreme Court of India, October 6, 2021.

[83] Forward contracts are referred to as term-ahead contracts under the Central Electricity Regulatory Commission (Power Market) Regulations, 2021, Gazette of India, pt. III sec. 4 (the "**2021 Power Market Regulations**"), and as Non-Transferable Specific Delivery contracts ("**NTSDs**") under the SCRA.

while financial and commodity derivatives in electricity[84] would be regulated by the latter.

Before the SC Order was issued, the MoP had set up a committee on the 'Efficient Regulation of Electricity Derivatives' (the "**Committee**") to address such jurisdictional issues.[85] Once the Committee submitted its report (the "**Committee Report**"),[86] insofar as SEBI and CERC managed

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[84] Except NTSDs as defined in the SCRA.

[85] According to the Press Release: "[The] Ministry of Power took the initiative of resolving the jurisdictional issue between SEBI and CERC with regard to various forms of contracts in electricity for Efficient Regulation of Electricity Derivatives by constituting a committee on 26th October, 2018, under the Chairmanship of the Additional Secretary, Ministry of Power with representatives from Department of Economic Affairs (Ministry of Finance), Central Electricity Authority, Central Electricity Regulatory Commission (CERC), Power System Operation Corporation Limited (POSOCO), Security Exchange Board of India (SEBI), Indian Energy Exchange, Power Exchange of India Limited and Multi Commodity Exchange to examine the technical, operational and legal framework for electricity derivatives and to give recommendation in this regard".

[86] In the Committee Report dated October 30, 2019 with respect to the regulatory jurisdiction of SEBI and CERC, respectively, the Committee had recommended as follows:

*1.* All Ready Delivery Contracts and Non-Transferable Specific Delivery ("**NTSD**") Contracts (as defined in the Securities Contract (Regulation) Act, 1956, as amended ("**SCRA**")) in electricity entered into by members of the power exchanges registered under CERC (Power Market) Regulations, 2010, shall be regulated by CERC subject to the following conditions:

i. the contracts are settled only by physical delivery without netting;

ii. the rights and liabilities of parties to the contracts are not transferable;

iii. no such contract is performed either wholly or in part by any means whatsoever, as a result of which the actual delivery of electricity covered by the contract or payment of the full price therefor is dispensed with;

iv. no circular trading shall be allowed and the rights and liabilities of parties to the specific delivery contracts shall not be transferred or rolled over by any other means whatsoever;

v. the trading shall be done only by authorised grid connected entities or trading licensees on behalf of grid connected entities, as participants;

vi. the contracts can be annulled or curtailed, without any transfer of positions, due to constraints in the transmission system or any other technical reasons, as per the principles laid down by CERC in this regard.

However, once annulled, the same contract cannot be reopened or renewed in any manner to carry forward the same transaction.

to agree on its terms, the SC was happy to bless such terms and allowed the respective regulatory bodies to proceed as necessary.

### D. ELECTRICITY DERIVATIVES

Significantly, erstwhile regulations related to the power market, as notified by the CERC in January 2010 (the "**2010 Power Market Regulations**"),[87] applied to, and included, *financially settled electricity derivatives contracts transacted in the over-the-counter market* (together, the "**Necessary Specification**").[88] However, a Bombay High Court judgment issued in February 2011 ("**the HC Verdict**") declared the 2010 Power Market Regulations inoperative as far as electricity futures and

vii. all information or returns relating to the trade, as and when asked for, shall be provided to CERC, who shall monitor the performance of the contracts entered into on the power exchanges.

*2*. Commodity derivatives in electricity, other than NTSD contracts as defined in the SCRA, shall fall under the regulatory purview of SEBI.

*3*. The Central Government reserves the right to impose additional conditions from time to time as it may deem necessary.

*4*. A Joint Working Group between SEBI and CERC may be constituted with Terms of Reference as agreed in the Committee's report.

[87] The Central Electricity Regulatory Commission (Power Market) Regulations, 2010, Gazette of India, pt. III sec. 4 (the "**2010 Power Market Regulations**").

[88] *See* Regulation 4(ii) of the 2010 Power Market Regulations: "*Financially settled electricity derivatives contracts transacted in OTC market* – It is a contract which derives its value from an underlying asset (e.g. day ahead electricity contract or other spot market contract or other reference index). The contract price is fixed at the time of transaction. The final financial settlement price is based on the spot price of the underlying asset or any other predefined reference index as agreed between the parties at the expiry of contract. These contracts can be Derivative Contracts, swap and other structured contracts etc." Further, *see* Regulation 3(i) of the 2010 Power Market Regulations: "*Over the Counter Market* – Over the Counter Market is the inter-State market where buyers and sellers directly transact or transact through an Electricity Trader, and where the price and terms of the contract are determined through negotiations as agreed between the parties or through competitive bidding process or through a Electricity Trader. The risk in contracts executed in such markets is managed between the parties themselves or by the Electricity Trader, as the case may be."

forward contracts were concerned.[89] On the other hand, while revised regulations related to the power market (the "**2021 Power Market Regulations**")[90] now include within their scope, *inter alia*, contracts related to RECs (those transacted on power exchanges)[91] and delivery-based over-the-counter ("**OTC**") contracts,[92] such new regulations neither mention nor presumably apply to, *financially* settled electricity derivatives contracts transacted in the OTC market (*i.e.*, the new regulations omit the language of the Necessary Specification).[93] Thus, it appears that the 2021 Power Market Regulations apply only to *physically* settled OTC contracts.[94]

Pursuant to approval from the erstwhile Forward Market Commission ("**FMC**," since merged with SEBI),[95] the Multi Commodity Exchange of India Limited (MCX), a commodity derivatives and stock exchange that now operates under the regulatory framework of SEBI (and was previously operating under the (now-repealed) Forward Contracts (Regulation) Act, 1952 ("**FCRA**")), had commenced trading in electricity

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[89] Multi Commodity Exchange of India v. CERC & others, W.P. Nos. 1197/2010 and 1604/2009 along with N.M. Nos. 100 and 71/2010, Bombay High Court, Judgement dated February 7, 2011

[90] The 2021 Power Market Regulations.

[91] Regulation 4(1)(b) of the 2021 Power Market Regulations.

[92] Regulation 4(2) of the 2021 Power Market Regulations.

[93] *See* Regulations 2(ao), 2(bc), and 2(bd) of the 2021 Power Market Regulations: "*Over the Counter (OTC) Market*" is a market where OTC contracts are transacted between sellers and the buyers directly or through a trading licensee as defined in the Central Electricity Regulatory Commission (Procedure, Terms and Conditions for grant of trading licence and other related matters) Regulations, 2020. Further, OTC contracts are those contracts which are transacted outside electronic platforms registered as a power exchange under the 2021 Power Market Regulations (*see* Regulations 2(an) and 2(as) of the 2021 Power Market Regulations).

[94] *See* Regulation 7 ("*Contracts transacted in the OTC Market*"), and particularly, Regulation 7(3) of the 2021 Power Market Regulations: "*Settlement Conditions*: The settlement of contracts transacted in the OTC Market shall be only by physical delivery of electricity".

[95] *See* SEBI, FINANCE MINISTER UNVEILS MERGER OF FMC WITH SEBI, (September 28, 2015) https://www.sebi.gov.in/media/press-releases/sep-2015/finance-minister-unveils-merger-of-fmc-with-sebi_30729.html; and SEBI, DEVELOPMENTS IN COMMODITIES MARKETS - POST MERGER, (September 30, 2016), https://www.sebi.gov.in/media/press-releases/sep-2016/developments-in-commodities-markets-post-merger_33395.html.

futures and forwards back in January 2009. Around that time, however, Power Exchange of India Limited (PXIL), a power exchange, had argued before the CERC that it was the latter that had exclusive jurisdiction in the matter. This challenge, as well as various regulatory, legislative, and judicial developments subsequent to, and connected with, such challenge, ultimately led to the HC Verdict – which, in turn, was issued a decade before the SC Order.

At present, according to the Committee Report (as approved by the SC Order), non-transferable specific delivery contracts, as defined in the Securities Contracts (Regulation) Act, 1956, as amended (the "**SCRA**," and such contracts, "**NTSDs**"), ought to be regulated by CERC, while commodity derivatives in electricity *other than* NTSDs ought to be regulated by SEBI. The SCRA defines a 'derivative' to include commodity derivatives,[96] which, in turn, include CFDs that derive their value from the price of underlying goods.[97] On the other hand, NTSDs are defined as non-transferable commodity derivatives which provide for the *actual* delivery of specific goods over a specified term at a fixed price.[98] Since VPPAs do not involve the actual delivery of electricity to counterparties, it appears that if and when VPPAs are interpreted as non-NTSD commodity derivatives (pursuant to the Committee Report and the SCRA), SEBI, rather than CERC, will have regulatory jurisdiction over such contracts.

However, since VPPAs are neither intended for *trading* on exchanges (as forward contracts in the secondary market), nor are meant to be transferred to third parties – it could well be argued that VPPAs are privately settled, bespoke, and untraded OTC contracts, and hence do not fall within SEBI's regulatory ambit either. On the other hand, under the 2021 Power Market Regulations: (i) REC contracts can be traded on

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96 SCRA, § 2(ac)(C).
97 SCRA, § 2(bc)(ii).
98 SCRA, § 2(ca) read with § 2(ha).

power exchanges,[99] and (ii) REC transactions can be undertaken under the Procedure related to the 2022 REC Regulations[100] – both of which are under CERC's sphere of influence.

In this situation of jurisdictional overlap, it might be useful to look at foreign regulatory frameworks for guidance.

### E. THE US POSITION

Global practice suggests that VPPAs are usefully governed by regulations related to the derivatives market. In the United States, for instance, a buyer under a VPPA is not required to obtain authorization from the Federal Energy Regulatory Commission ("**FERC**") – the US equivalent of India's CERC.[101] Thus, in the US, a VPPA is not subject to FERC jurisdiction *per se*, since such a contract does not provide for the sale of either electricity, capacity, or ancillary services.

However, (i) *documentation* related to VPPAs is often formulated as long-form confirmations under an International Swaps and Derivatives Association (ISDA) Master Agreement (the standard contract used for OTC derivatives transactions), and (ii) *transactions* related to VPPAs are typically structured as 'swaps' – a type of OTC derivative regulated by the Commodity Futures Trading Commission ("**CFTC**"). Further, swaps are

[99] Regulation 4(1)(b) of the 2021 Power Market Regulations.
[100] Regulation 5(4) of the 2021 Power Market Regulations.
[101] Under the Federal Power Act, the FERC regulates sales of electric energy at wholesale in interstate commerce. More specifically, FERC has exclusive jurisdiction over the transmission of electric energy in interstate commerce, and over the sale of electric energy at wholesale in interstate commerce, and all facilities for such transmission or sale of electric energy. The 'facilities' subject to FERC's jurisdiction include contracts for sale at resale (wholesale) of electric energy, capacity, and ancillary services.

subject to the Dodd-Frank Act ("**Dodd-Frank**")[102] with reporting, record-keeping, and registration requirements.[103]

In the Indian context, the erstwhile FMC – now merged with, and replaced by, SEBI – corresponded somewhat with the CFTC in terms of regulatory scope. In addition, the Reserve Bank of India ("**RBI**") deals with certain categories of OTC derivatives, including certain kinds of swaps.[104] The Dodd-Frank, on the other hand, has no precise equivalent in India. The erstwhile FCRA was repealed when the FMC merged with SEBI. Pursuant to such repeal and merger, respectively, regulation of the commodity derivatives market shifted (from FMC) to SEBI under the SCRA.[105] Thereafter, SEBI created a separate 'Commodity Derivatives Market Regulation Department' and amended existing regulations and laws, including the SCRA. Further, a year after the merger, in consultation with SEBI, the Central Government notified certain goods (the "**CG Notification**")[106] for the purpose of, and with regard to, Section 2(bc) of the SCRA.[107] The language of Section 2(bc)(ii) of the SCRA read with the

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[102] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") . In the aftermath of the 2008 financial crisis, the Dodd-Frank Act enhanced the regulatory authority of the Commodity Futures Trading Commission (the "**CFTC**") to oversee the swaps market.

[103] Specifically, the parties are required to, *inter alia*, report on the terms of the swap and file quarterly reports to entities designated by the CFTC in this regard. In addition, records of the swap transactions need to be maintained.

[104] *See* FINANCIAL MARKETS REGULATION DEPARTMENT, RBI, MARKET-MAKERS IN OTC DERIVATIVES DIRECTIONS, (September 16, 2021.

[105] With effect from September 28, 2015. *See* PRESS INFORMATION BUREAU, GOVERNMENT OF INDIA, MINISTRY OF FINANCE "GOVERNMENT ISSUES NOTIFICATION TO REPEAL THE FCRA, 1952 AND SHIFT THE REGULATION OF THE COMMODITY DERIVATIVES MARKET TO SEBI WITH EFFECT FROM 28TH SEPTEMBER, 2015 (September 2, 2015).

[106] Notification No. S.O. 3068(E) dated September 27, 2016; *See also* SEBI, LIST OF COMMODITIES NOTIFIED UNDER SCRA, (September 28, 2016).

[107] § 2(bc) of the SCRA: "commodity derivative means a contract -

> (i)for the delivery of such goods, as may be notified by the Central Government in the Official Gazette, and which is not a ready delivery contract; or
>
> (ii) for differences, which derives its value from prices or indices of prices of such underlying goods or activities, services, rights, interests and events,

CG Notification suggests that the goods so notified are in respect of (1) such commodity derivative contracts that are non-delivery and non-security-based; and thereby, relate to (2) CFDs, the value of which is derived from, *inter alia,* the price of such underlying goods as notified. Significantly, electricity is included within this list, as notified through the CG Notification.

The US Congress passed the Commodity Futures Modernization Act ("**CFMA**") in the year 2000 to provide legal certainty for swap agreements. The CFMA explicitly prohibited the Securities Exchange Commission (the "**SEC**," SEBI's counterpart in the US) and the CFTC from regulating the OTC swaps markets. This limited the SEC's ability to detect and deter fraud in the swaps markets. Title VII of Dodd-Frank, however, addresses this gap by providing a comprehensive framework for regulating such markets. Thus, Dodd-Frank divides regulatory authority in respect of swap agreements between the CFTC and SEC (although prudential regulators, such as the Federal Reserve Board, also have an important role to play for swap entities that are banks – similar to the RBI's role in India).[108] While the SEC has regulatory authority over security-based swaps,[109] the CFTC has primary regulatory authority over all other swaps, including energy swaps.

> as may be notified by the Central Government, in consultation with the Board, but does not include securities as referred to in sub-clauses *(A)* and *(B)* of clause *(ac)*;"

[108] See §§ 45U(a) (definition of "derivative") and 45V ("Transactions in derivatives") of the RBI Act, 1934, as amended

[109] "Security-based swaps" are defined as swaps based on a single security or loan or a narrow-based group or index of securities (including any interest therein or the value thereof), or events relating to a single issuer or issuers of securities in a narrow-based security index. Security-based swaps are included within the definition of "security" under the Securities Exchange Act of 1934 and the Securities Act of 1933. In addition, the SEC has anti-fraud enforcement authority over swaps that are related to securities but that do not come within the definition of "security-based swap." These are called "security-based swap agreements." Further, Dodd-Frank provides the SEC with access to information relating to security-based swap agreements in the possession of the CFTC

VPPA transactions in the US can also be structured as commodity forward contracts (where RECs are priced at the difference between a floating and a fixed price). In this scenario, however, VPPAs are not considered swaps. The CFTC originally proposed to regulate environmental commodities – such as RECs – as swaps. Eventually, however, the CFTC found that intangible environmental commodities that are capable of physical delivery and 'can be consumed' qualify as 'non-financial commodities'. Accordingly, sales of environmental commodities settled by transfer, such as RECs, are not swaps, but rather, constitute excluded forward contracts.

### F. OTHER POSSIBILITIES

The right to receive EACs might be treated as a standalone contract, distinct from a VPPA.[110] During the sale of bundled EACs, for example, a 'hybrid' VPPA structure ("**Hybrid VPPA**") might be deemed to include: (i) a non-financial host contract (*i.e.,* the right to receive EACs), as well as (ii) an embedded price adjustment feature (*i.e.,* a swap derivative). However, in India, since the transfer of RECs from a genco (or other eligible entity) to a buyer (who might be a VPPA counterparty) is ultimately intended, and designed, to occur through CERC-approved platforms/persons/procedures only, such REC-related aspects of VPPA transactions may continue to remain under the purview of the CERC.

On the other hand, in the US, the power market related to RE is voluntary – essentially representing a free market economy with little regulatory oversight, driven by consumer preferences articulated via supply and demand. Certificate tracking systems account for REC issuances and transfers (rather than either FERC or CFTC). Such tracking systems are typically electronic databases that register basic information

and certain CFTC-regulated entities, such as derivatives clearing organizations, designated contract markets, and swap data repositories.

[110] Essentially, a Forward REC Purchase Agreement.

about each MWh of RE generated in a specific region of the US. Accordingly, they issue RECs to the generator, signifying that an MWh of RE has been delivered to the grid. Thus, not one, but several U.S.-based tracking systems register and track generation from RE. The Center for Resource Solutions' Green-e Energy program certifies green power products and independently verifies such products on an annual basis.

## VI. LESSONS FOR INDIA

### A. REVISITING THE 2021 POWER MARKET REGULATIONS

The 2021 Power Market Regulations apply to the OTC market,[111] specifically, to contracts transacted in the OTC market.[112] Further, the price and other terms of such contracts can be determined, *inter alia*, through mutual agreement between the buyer and the seller directly.[113] Thus, customized bilateral agreements directly between sellers and buyers (*i.e.,* outside of power exchanges) – such as VPPAs – appear to correspond with such characterization. However, the settlement of OTC-market contracts under the 2021 Power Market Regulations can only be done through the *physical* delivery of electricity.[114]

Nevertheless, the delivery of RECs (as opposed to electricity) could be expressly provided for under the 2021 Power Market Regulations, along with applicable changes made to the 2022 REC Regulations in parallel. For instance, within a Hybrid VPPA, one component of the overall contractual matrix could include a delivery-based forward contract (or a purchase agreement) in respect of RECs alone – since delivery-based contracts in the OTC market are included within the 2021 Power Market Regulations already.[115] In addition, agreements between sellers and buyers

[111] Regulation 3(3) of the 2021 Power Market Regulations.
[112] *See* Regulations 7 and 4(2) of the 2021 Power Market Regulations.
[113] Regulation 7(1) of the 2021 Power Market Regulations.
[114] Regulation 7(3) of the 2021 Power Market Regulations.
[115] Regulation 4(2) of the 2021 Power Market Regulations.

for the sale and purchase of RECs are included within the definition of a 'contract' under such regulations.[116]

However, at present, the 2021 Power Market Regulations require contract settlement for OTC transactions to be done under the physical delivery of electricity only.[117] Nonetheless, if RECs are considered 'electricity' by appropriate authorities and exchanged by sellers and buyers through electricity traders (and *not* via power exchanges),[118] such forward contracts or purchase agreements involving RECs (and RECs alone) might be possible – *i.e.*, these contracts may then fall within CERC's jurisdiction, remaining consistent with the SC Order.

### B. AN INDIAN DODD-FRANK?

In addition, the Necessary Specification contained in the 2010 Power Market Regulations (before such specification was declared inoperative) bore the necessary language to provide both precision and clarity in respect of allocating regulatory jurisdiction over financially settled electricity derivative contracts transacted in the OTC market (such as VPPAs). Pursuant to the SC Order, SEBI, as the domestic equivalent of both the CFTC and SEC, may want to issue regulations containing provisions similar to the Necessary Specification, as well as include record-keeping, registration, and reporting requirements – similar to Dodd-Frank – within such newly-issued regulations.

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[116] *See* Regulation 2(r) of the 2021 Power Market Regulations: "Contract" means an agreement between seller and buyer for sale and purchase of electricity or Renewable Energy Certificate or Energy Savings Certificate or any other product as may be decided by the Commission".

[117] Regulation 7(3) of the 2021 Power Market Regulations.

[118] Pursuant to Regulation 2(an) of the 2021 Power Market Regulations, OTC contracts are those which are transacted outside of power exchanges.

### C. VPPAs WITHOUT RECs

Notwithstanding any arguments or discussions as presented above, it is possible that the MoP will eventually decide against, or retract, a bundled REC regime in respect of the Indian power market (on account of concerns related to double counting, certification/tracking issues, 'greenwashing', or otherwise). Even then, however, VPPAs may be useful in light of India's ambitious climate-related targets, pursuant to which domestic RE capacity-addition and procurement both need significant scaling up, including through increased private sector participation. In case the government wishes to retain greater oversight in respect of the entire VPPA process, it could designate and/or require state bodies/nodal agencies to act as VPPA counterparties with private RE gencos. In this model, such designated bodies/agencies can be empowered to conduct auctions to determine the strike price in respect of a proposed VPPA, while also, in parallel, requiring the selected bidder (a genco) to enter into a physical PPA with a discom. Meanwhile, consistent with VPPA dynamics, the discovery of market prices related to the sale of electricity can continue to occur on power exchanges.

Such an arrangement may produce distinct advantages, other than producing greater 'additionality'.[119] For example, it may help cash-strapped discoms to distribute RE more easily among retail customers (thereby promoting renewables consumption across the country, and leading to greater RPO compliance among obligated entities). At the same time, this arrangement can protect discoms against procurement, price, and supply-related risks (which are typically associated with RE) – since the state body/nodal agency will be the one bearing such risks, and not the discom. Instead, the concerned discom can remain a beneficiary (albeit *only* a beneficiary) under the VPPA.

[119] The RE so generated is directly attributable to a new 'additional' RE project, which adds clean energy to the grid by displacing fossil equivalents: thus, in effect, such RE project would not have happened 'but for' the VPPA.

Designated government bodies/agencies can also enter into similar arrangements with C&I customers (instead of with discoms). That way, while continuing to provide price and offtake assurance to RE gencos (*i.e.,* gencos with which VPPAs are entered into), the government bodies/agencies may transfer the benefit of the fixed price in the VPPA to a C&I customer for a fee.[120] Further, this arrangement may alleviate government concerns about VPPA-related risks, including those associated with a lack of familiarity among (smaller) C&I buyers in respect of the wholesale power market generally, as well as more specific concerns related to accounting complexities and RE variability. In addition, regulatory tussles may be more easily avoided, since it is likely that such an arrangement will be subsumed entirely within CERC's jurisdiction.

A similar arrangement has already been proposed by the CERC under its MBED[121] mechanism related to the 'Day-ahead Market' ("**DAM**").[122] At any rate, the 2021 Power Market Regulations already contemplate bilateral transactions[123] in respect of OTC contracts related to the *physical* delivery of electricity.[124] More specifically, a system of settlement in respect of bilateral contracts ("**BCS**"), *i.e.*, refunding the difference between the market clearing price and the contracted price – similar to CFD – has been contemplated under MBED, although the details are yet

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[120] This arrangement may be somewhat similar to a 'sleeved' PPA. Other than as integrated bilateral agreements between a genco and a consumer, physical PPAs can be structured as tripartite agreements as well – between the customer, the genco, and a discom. This tripartite agreement is known as a 'sleeved' PPA, where the power produced by the genco is delivered from the grid to the customer through a discom.

[121] Market Based Economic Dispatch.

[122] *See* CERC, DISCUSSION PAPER ON MARKET BASED ECONOMIC DISPATCH OF ELECTRICITY: RE-DESIGNING OF DAY-AHEAD MARKET (DAM) IN INDIA, 2018, https://cercind.gov.in/2018/draft_reg/DP31.pdf (the "**MBED Discussion Paper**").

[123] For example, day-ahead bilateral transactions under Regulation 7(2)(i)(c), and bilateral transactions in a contingency under Regulation 7(2)(i)(d) of the 2021 Power Market Regulations.

[124] *Generally see* Regulation 7 of the 2021 Power Market Regulations.

to be finalized.[125] The discussion paper prepared by the CERC staff in this regard (the "**MBED Discussion Paper**")[126] clarifies that BCS is: (i) a mechanism to provide hedging to both contracting parties against price volatility; and (ii) purely a non-tradable bilateral arrangement, meant to grandfather existing contracts (typically, long-term physical contracts entered into between discoms and gencos). Replacing the proposed BCS mechanism under MBED with a non-REC-based VPPA arrangement might further ensure that existing/future physical PPA counterparties derive the maximum benefit from their *inter se* power purchase/sale arrangement, while a government-designated body/agency absorbs intermediate shocks if any. Further, patching such non-REC-based VPPA arrangement with the pre-existing DAM template might help parties with respect to interval accounting under CERC's supervision.

## VII. CONCLUSION

Despite the SC Order, it remains unclear as of date whether the physical and financial aspects of VPPA-based transactions can be clearly addressed by SEBI and CERC. In light of such persisting uncertainties, the appropriate regulatory jurisdiction in respect of VPPAs could be jointly clarified by both such authorities, including through the issuance of separate regulations in this regard, if necessary.

In the future, VPPAs could also be instrumentalized through the use of 'smart' legal contracts.[127] For instance, blockchain technology[128] can

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[125] See CERC MINUTES OF THE COMMISSION MEETING ON IMPLEMENTATION OF MARKET BASED ECONOMIC DESPATCH (MBED), Paragraph 2(vi), (August 25, 2022) https://cercind.gov.in/2022/Minutes/MBED-Commission-Meeting-25-Aug-2022.pdf

[126] The MBED Discussion Paper.

[127] A smart contract is usually a computer code, which, upon the occurrence of a specified condition, is capable of running automatically according to pre-specified functions. Smart contracts can be used in various contexts, but they are an integral part of blockchain and distributed ledger technologies. A smart *legal* contract is a smart contract that articulates, and is capable of self-executing, on a legally-enforceable basis, the terms of an agreement between two or more parties. See, e.g., Lu, Jing, et al. *Smart contract for distributed energy trading in virtual power plants based on blockchain*, COMPUTATIONAL INTELLIGENCE, 37.3, 1445-1455, (2021)

assist in: (i) automating the issuance and trading of RECs based on actual energy consumption, (ii) ensuring payments using smart contracts, and (iii) streamlining energy accounting. Various initiatives in India related to a 'smart grid'[129] in collaboration with the MoP, such as the National Smart Grid Mission (NSGM)[130] and the India Smart Grid Forum (ISGF),[131] may significantly contribute towards this formulation.

[128] Blockchain technology directly connects the procurer to the seller, eliminating the need for a third party, consequently reducing transaction costs. See, e.g., Kirli, Desen, *et al. Smart contracts in energy systems: A systematic review of fundamental approaches and implementations*, RENEWABLE AND SUSTAINABLE ENERGY REVIEWS, 158, 112013, (2022); CENTRE FOR ENERGY FINANCE (CEF), THE COUNCIL ON ENERGY, ENVIRONMENT AND WATER (CEEW), THE ROLE OF BLOCKCHAIN TECHNOLOGY IN THE POWER SECTOR, (January 31, 2022), https://www.ceew.in/cef/masterclass/explains/the-role-of-blockchain-technology-in-the-power-sector

[129] A 'smart grid' is an electricity grid vested with automation, communication, and information technology (IT) systems that can monitor power flows from points of generation to points of consumption, as well as control the power flow or curtail the load to match generation in real time.

[130] See https://www.nsgm.gov.in/en/smart-grid.

[131] See https://indiasmartgrid.org/.

# CHARACTERIZING SPACS: THE CHALLENGES TO INDIAN REGULATION

*Piyush Raj & Sahil Agarwal**

**ABSTRACT**

*SPAC companies offer an alternative to Initial Public Offerings (IPOs) by raising capital to acquire a company instead of going through the traditional IPO process. They are sometimes known as 'shell companies' because they do not have any operating assets or business activities at the time of their IPO. A private or unlisted company may go public by raising cash via an acquisition, buyout, or reverse merger. Once the target company has been acquired by the SPAC, it becomes a publicly traded company, avoiding the lengthy process required for a traditional IPO. Therefore, a SPAC can be an attractive option to purchase a commercially viable business that may generate significant returns for investors since it can be simpler and faster than a traditional IPO. Given the popularity of SPACs in India, regulatory authorities have taken steps to promote and regulate this investment vehicle. However, it is important to consider the characteristics of SPACs and how they have been regulated in the US to determine the best approach for regulation in India. This paper will argue that we need to step-back a little and contemplate the characteristics of a SPAC in light of its development in the US. The questions like whether it is a regulatory arbitrage (which requires it to be treated on par with an IPO) or whether it is a pure alternative to the IPO process goes to the heart of how SPAC regulation should be structured. Thus, this article proposes that a more balanced approach to SPAC regulation should be considered on the question whether it should be treated as a regulatory arbitrage or as a pure alternative to the IPO process.*

**Keywords:** Special Purpose, IPO, Board Structure, Germany.

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## I. INTRODUCTION

The market of securities provides various kinds of investment vehicles including private equity funds and venture capital funds. In recent times, another investment vehicle has garnered much attention in India and even globally, namely, the Special Purpose Acquisition Companies ("**SPACS**"). SPAC is a company which has minimal or almost non-existent operating business and assets, that seeks to launch an initial public offering (hereinafter, IPO) in order to raise capital. Thereafter, it effects a merger, asset acquisition or any other form of business combination with a 'target' company, benefitting from such listing without going through the formalities and rigours of an IPO.[1]In March 2021, the Securities and Exchange Board of India (SEBI) formed a group of experts to examine the feasibility of bringing regulations for SPAC as it can substantially increase the prospects of domestic listing of startups.[2]

Recently, concerns were raised as to the regulatory domain of SEBI, and the potential of some future SPACs to be outside its regulatory

[1] Abir Roy and Vyapak Desai, *What's special about special purpose acquisition vehicles?,* ECO. TIMES, (June 4, 2008) http://www.nishithdesai.com/fileadmin/user_upload/pdfs/What-s_special_about_special_purpose_acquisition_vehicles-.pdf.

[2] Team, *SEBI's Expert Group to Study SPAC Potential for Indian Startups*, INC42, (Mar 11, 2021) https://inc42.com/buzz/sebis-expert-group-to-study-spac-potential-for-indian-startups/

jurisdiction. The suggestion was that we need clarity as to the role of the SEBI and the NCLT when it comes to reverse mergers and mergers, as currently, this issue is a subject matter of the NCLT.[3] Since, under Section 232 of the Companies Act, 2013,[4] the NCLT has the power to sanction a scheme of merger or amalgamation, it effectively allows the 'target' companies to go public without the scrutiny of eligibility under the SEBI Regulations.[5] This is one preliminary example of regulatory challenges that SPAC, as an investment vehicle, faces in India. However, we argue that this issue pertains to a much foundational inquiry as to the nature of SPAC as a regulatory arbitrage or an innovative investment avenue. The notion of regulatory arbitrage implies that SPAC is an attempt to avoid the SEBI's scrutiny and thus requires a strict regulatory overview, similar to the case of an IPO, if not stricter. On the other hand, the approach towards SPAC as a novel investment avenue requires a fresh look at it without any presumptive inhibitions of regulatory arbitrage, posed theoretically. Accordingly, throughout this paper, we intend to show that the characterization of SPAC as a regulatory arbitrage or novel investment avenue for India will eventually influence the drafting of regulations around it. Therefore, we attempt to delineate those regulatory considerations, in detail, to show that the conception of SPAC is as complex as it is innovative. This paper will attempt to provide a suggestion as to the reorientation of the approach we should observe towards SPAC regulation in order to fill the gaps in the current regulatory framework.

In Part II, we shall briefly dwell on the rise and mechanism of SPACs in the US, in order to determine the causes of its coming into being, and determine whether from its inception, SPAC was meant to be a regulatory

[3] PTI, *SEBI in no rush to come out with SPAC policy: Tyagi*, THE HIN. BUS.LINE, (December 29, 2021) https://www.thehindubusinessline.com/markets/sebi-in-no-rush-to-come-out-with-spac-policy-tyagi/article38060374.ece.
[4] The Companies Act, No. 18 of 2013, §232 (Ind.).
[5] Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, SEBI, Reg. 6 (Feb. 07, 2023).

arbitrage or an innovative approach of investment. In Part III, we shall initially investigate the regulatory hurdles for SPACs in current Indian regulatory framework in order to highlight that, *firstly*, the choice of orientation towards SPAC regulation would decide its efficacy in the Indian scenario and *secondly*, that in making such choice, the regulators need to reach a balance between the broader goals of securities law namely, investor protection, and the growth of investment and economy. Moving further, we will explore the idea of 'economic substance' approach, as proposed by Halbhuber,[6] which has been used to argue in favour of considering SPAC, as a workaround for an IPO. In contrast, we will argue that such a steadfast approach to regulating SPAC is not favourable in the context of India. Thus, we shall argue that in order to regulate SPACs properly, we need to conceptually reorient ourselves and shall provide clarity on regulatory aspects which have so far been identified. This will also provide a leverage to SEBI to deal with the challenges which may arise in future SPAC regulations.

## II. SPECIAL PURPOSE ACQUISITION VEHICLES: BACKGROUND

### A. REGULATORY WORKAROUND: HISTORY OF SPAC

In the 1980s US, the capital market was replete with something called 'blank check offerings' which refers to a type of IPO of a company, that did not yet have a specific business plan or purpose. These offerings were also known as "blank check companies" or "blank check IPOs." After the IPO process, the funds raised through the investors were used to pursue an acquisition or merger with another company that had a specific business plan or purpose. The essential attraction of such companies was to offer 'penny-stock'[7] which tempted a large mass of retail investors.[8]

[6] Harald Halbhuber*, Economic Substance Approach to SPAC Regulation*, 40 YALE J. ON REG.: BULLETIN 2022, 45, 45 (2022). (hereinafter, Halbhuber)
[7] Securities Exchange Act of 1934 §3(a)(51), 15 U.S.C. §78a.

However, such strategy resulted in a serious abuse of market and investors.[9] The primary reason for such abuse was that penny-stocks were not approved or registered and were also not traded on security exchange platforms.[10] Realizing the gravity of the situation, the Congress passed the 'Securities Enforcement Remedies and Penny Stock Reform Act of 1990'[11], ("**PFRA**") with the objective of preventing the use of blank check companies as a tool for fraud. However, it seemed that the legislation was so restrictive, that it was extremely difficult to attract investors for them. As a solution, the SPAC structure was developed which avoided the regulatory binds of the PFRA by using exceptions in the definition of 'penny-stock'.[12]For instance, one exception to the definition was that a company with post-issue capital of more than $5 Million was not covered under the PFRA. Accordingly, the SPAC were shaping their offering in such a way that it left the company, with greater than $5 million in net tangible assets, post-IPO.[13]

Nonetheless, this new structure, abided by the requirement of the Act as to not attract the regulatory glare of Securities Exchange Commission (SEC). For instance, requirements such as deposit of the funds raised in IPO in an escrow account, and to retain investor funds without completing an acquisition for not more than 18 months, were adequately followed.[14]Such provisions ensured that the funds raised by reincarnated

[8] Karen Richardson and Peter Lattman, *Financiers Now Say 'Trust Us',* THE WALL STREET JOURNAL, (Feb. 1, 2007). https://www.wsj.com/amp/articles/SB117029862200094571.
[9] Gerald V. Niesar and David M. Niebauer, *The Small Public Company after the Penny Stock Reform Act of 1990*, 20 SEC. REG. L.J. 227, 239 (1992).
[10] Derek K. Heyman, *From Blank Check To SPAC: The Regulator's Response to The Market, and The Market's Response to The Regulation*, 2 ENTREPRENEURIAL BUS. L.J. 531, 533 (2007). (hereinafter, Derek K. Heyman)
[11] Securities Enforcement Remedies and Penny Stock Reform Act of 1990, §508, 15 U.S.C. §78a, (1990).
[12] Derek K. Heyman, *supra* note 10 at 540.
[13] Derek K. Heyman, *supra* note 10 at 541.
[14] Daniel S. Riemer, *Special Purpose Acquisition Companies: SPAC and SPAN, or Blank Check Redux?.* 85 Wash. U. L. Rev. 931, 946 (2007).

blank check structures, or SPACs in a public offering could not be misused by the company's management.

However, it is notable that the growth of SPAC was not just reincarnation of blank-check companies; it was fundamentally an investment vehicle which wanted to avoid the regulation of traditional IPOs. Yet its utility from business perspective must not be overlooked.[15] Generally, the investment banks only provide underwriting service to large IPOs, it is difficult for small companies and startups to successfully go public. SPACs are uniquely situated to counter this problem[16] however, as we shall see in case of India, it seems that SPAC itself gets restricted because of multiple regulatory hurdles.

### B. SPAC: A MECHANISM FOR POOLING FUNDS

#### 1. Issuance of an IPO

A SPAC, just like any other public company intending to get listed, must go through the typical IPO process of filing prospectus in order to raise public capital. However, such a SPAC IPO is much quicker than a traditional IPO process, since the details which are to be disclosed are much shorter. A SPAC does not have any prior financial statement to disclose or any assets to be described, and the risk factors associated with the IPO are also minimal. This is because crucially, investors are essentially betting on the ability of the SPAC's management team to find a suitable acquisition target, rather than the success of an unproven business.

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[15] Iqbal Tahir, Dua Associates, *Supportive SPAC Regulations Can Unlock Significant Value For Indian Companies*, MONDAQ (May 26, 2021)https://www.mondaq.com/india/corporate-and-company-law/1072796/supportive-spac-regulations-can-unlock-significant-value-for-indian-companies.

[16] *Id.*

### 2. Allotment and Apportionment of Pooled Funds

The capital raised from an IPO is, thereafter, held in a trust or escrow account until it gets released to fuel the acquired target company or redeem investors for an exit. Since, the '*management*' or '*sponsor*' had, with their private equity, established the SPAC, they continue to hold nominal stock in the SPAC after the IPO. The remaining stake in the holdings is allotted to the public who subscribed to the common stock of SPAC and a proportional warrant of future fund utilization.[17] A portion of the proceeds collected is not held in the escrow account and is used for paying insurance, legal, and accounting expenses related to the SPAC processes.

### 3. Negotiation and Acquisition

After the identification of target acquisition, the sponsor declares the target company which must be approved by majority shareholders. The finalization of a SPAC acquisition must be made within the stipulated time otherwise it will be terminated, moreover the management cannot collect salaries for finalization of the deal.[18] Once approved, the SPAC acquires the target company through consolidation/merger commonly referred to as reverse-merger or "De-SPAC" transactions. In such transactions, a private company may ensure more certainty as to pricing and control terms as compared to conventional IPOs.[19] This is because, during the reverse-merger, the target company negotiates the price and

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[17] Ramey Layne and Brenda Lenahan, *Special Purpose Acquisition Companies: An Introduction,* HARVARD L. SCHOOL FOR. ON CORP. GOVERNANCE (July 6, 2018) https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/.

[18] OFFICE OF INVESTOR EDUCATION AND ADVOCACY, WHAT YOU NEED TO KNOW ABOUT SPACS – UPDATED INVESTOR BULLETIN, U.S. Securities And Exchange Commission, (2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin#:~:text=Similar%20to%20an%20escrow%20arrangement,a%20certain%20period%20of%20time.(hereinafter, USEC Investor Bulletin)

[19] *Id.*

terms of the deal directly with the SPAC sponsor, rather than relying on market demand to set the price (as done in conventional IPO). This can give the target company more control over the transaction and ensure that it receives a fair value for its shares.

## III. SPAC V. TRADITIONAL IPOS

### A. PURPOSE AND TIMING

As noted above, the use of a SPAC structure can provide a quicker and more efficient path to going public for both the SPAC sponsor and the target company, while also providing investors with an opportunity to invest in a potentially high-growth company. This is because, *firstly*, the SPAC being a shell company, does not require providing extensive information or undergoing strict scrutiny of regulator. *Secondly,* it may already have a target identified, which means that the extensive process of identifying a suitable target company, performing due diligence, and negotiating terms can be completed before the SPAC goes public.

### B. MORE LUCRATIVE THAN TRADITIONAL IPOS

A SPAC offers lucrative and easier alternatives to investors and private equity firms without resorting to the hurdles of typical IPO transactions. In terms of the Sponsor, they generally hold about 20% equity in the SPAC. However, post the de-SPAC transaction, if the acquisition has substantive returns and growth, then the final stakes of the new entity have much higher value in comparison to nominal price for which the equity was purchased initially.[20]This equates to a massive return for sponsors which fuels them for taking such risks. For instance, In February 2021, Lucid Motors announced that it had agreed to merge with CCIV, with the resulting company named Lucid Group Inc. The deal valued Lucid at $11.75 billion, and was one of the largest SPAC mergers

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[20] Lola Miranda Hale, *Special Purpose Acquisition Companies: A Financing Tool with Something for everyone,* 18(2) Journal of Corporate Accounting & Finance, 67, 68 (2007).

at the time. After the completion of the merger, shares of Lucid Group Inc. began trading on the Nasdaq under the ticker symbol LCID. The stock saw a surge in price in the months following the de-SPAC transaction, reaching an all-time high of $64.86 per share in early September 2021.[21] This is because in a traditional IPO, the price per share is typically set by the underwriters based on the demand from investors. In contrast, the price of a SPAC's share is determined by the market after the de-SPAC transaction is completed, and can be influenced by various factors such as market conditions and the performance of the target company.

### C. LESS COSTLY THAN A TRADITIONAL IPO AND ELIMINATION OF INTERMEDIARIES

In addition, as suggested above, the SPAC presents an excellent opportunity to circumvent the costs and time associated with traditional IPOs. Traditional IPOs have implied costs and fees which may amount to 5-7% of the total IPO proceeds.[22] Most of all, SPAC provides an opportunity to startups and small businesses to circumvent the stringent listing requirements which they otherwise may not be able to fulfil. SPAC also helps companies to go public without getting involved in hurdles such as multiple investor negotiations, underwriter negotiations, valuation uncertainty and overwhelming documentations/filings.

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[21] Chavi Mehta and Niket Nishant, *EV maker Lucid rises in Nasdaq debut after merger with Klein-backed SPAC*, THOMSON REUTERS,(July 27, 2021) https://www.reuters.com/business/autos-transportation/ev-maker-lucid-rises-nasdaq-debut-after-merger-with-klein-backed-spac-2021-07-26/.

[22] Michael D. Klausner, Michael Ohlrogge, and Emily Ruan, *A Sober Look at SPACs*, 39(1) YALE J. ON REG., (2022) 1, 48.; (Stanford Law and Economics Olin Working Paper No. 559, NYU Law and Economics Research Paper No. 20-48, European Corporate Governance Institute – Finance Working Paper No. 746/2021).(hereinafter Michael Klausner).

### D. RISKIER THAN A TRADITIONAL IPO

Nonetheless, a SPACs is a risky venture too. Underlying each regulatory requirement of traditional IPOs is the primary aim of regulators, namely, investor protection. In that sense, SPAC primarily relies on the expertise and experience of the management to attract investors (instead of concrete business plans, generally) to invest in the profitable target company, which is a contingent matter. Consider this, in a traditional IPO issuance, SEBI relies on intermediaries like merchant bankers, banker to an issue, etc. to enhance disclosure and other compliances by a primary actor that is the company intending to get listed.[23] But, in a business combination deal, the merchant bankers are not required to act as disclosure gatekeepers with the responsibility of ensuring that the information flowing from the company to the retail investors is true, adequate or correct. Additionally, SPACs often have complex structures and arrangements that can create conflicts of interest or result in dilution of shareholder value. Therefore, given the mechanism of SPAC, there is much scope, regardless of the effectivity of regulations, of fraud and misrepresentations at each stage of the process.

## IV. REGULATORY HURDLES: A SCOPE FOR CONTEMPLATION

Presently, the Indian capital market does not have any uniform regulations to govern the operation of SPACs and the subsequent transaction they undertake. However, given that in the entire SPAC mechanism, the retail investors are inevitably the most vulnerable parties as due diligence is not as strict or rigorous in de-SPAC transactions as in an IPO; a higher degree of caution is required on the part of the investors as well as the regulators. The limitations with respect to information and uncertainty of the markets together create an undesirable affair for both SPAC and investor protection in India.

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[23] See, Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 82-83, 94-100 (1986).

### A. BROAD REGULATORY HURDLES TO SPAC IN THE INDIAN CONTEXT

The regulatory hurdles for the SPACs can be attributed to the strong resentment to "shell companies" by the Indian legal regime. De-SPAC transactions are still technically prohibited in India as it is in contravention to various provisions of Indian law such as SEBI Regulations, FEMA, RBI Master Directions, and the Income Tax Act, 1961.[24] In this part, we shall look at some of these hurdles to argue that *firstly*, SPAC structure of investment comes with its own individual challenges which force us to question its characteristics from the perspective of a regulatory arbitrage and an independent avenue. Secondly, we have tried to highlight regulatory challenges, which have not yet been considered in Indian scholarship in order to argue that if India adopts SPAC structure in its current mature state, it will create complex challenges for Regulators to ensure its promotion as an investment avenue, and its regulation for investor protection.

To begin with, for instance, Regulation 6 of SEBI ICDR Regulation[25] stipulates the minimum eligibility conditions for an IPO to be permissible for listing, including a net tangible asset of at least INR 3 crore in each of the preceding three years, minimum average consolidated pre-tax operating profit of INR 15 crore during any three of the last five years of operating, and net worth of at least INR 1 crore in each of the previous three years. These requirements go against the fundamental model of SPAC, which is meant for accessing public money within a shorter period. However, SPACs in India may still go public through a book-building process, but this mandates that 75% of the IPO must be allotted to

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[24] See, Anant Roy & Aviral Deep, *Skipping the Rigmarole of Listing: Critical Analysis of Indian Regulations and Tax Provisions Related to SPACs*, 9 RGNUL FIN. & MERCANTILE L. REV. 24 (2022).

[25] SEBI ICDR Regulations, *Supra* note 5, Reg. 6.

qualified institutional buyers, limiting investment opportunities for retail investors who can only invest for a few percentage of stakes of the entity.

Further, a SPAC merger is likely to be a cross-border merger, making it subject to FEMA regulations. The Foreign Exchange Management (Cross Border Merger) Regulations 2018[26] states that in an inbound merger, the transferee company can issue or transfer securities to persons outside India according to RBI guidelines[27] and sectoral caps.[28] However, as SPAC companies do not have a specific business object, determining the maximum foreign shareholding is difficult, and RBI guidelines impose intensive reporting requirements for cross-border mergers. This creates higher compliance requirements for SPAC entities, lengthening the time required to complete SPAC listings.

In this context, as noted earlier, the SPACs do not necessarily have tangible assets or an identifiable business objective. For instance the SEC notes that "*a SPAC may identify in its IPO prospectus any industry or business that it will target as it seeks to combine with an operating company, but it is not obligated to pursue a target in the identified industry.*"[29] Given this, the Section 4(1)(c) of the Companies Act, 2013[30] ("**the Act**") mandates the stipulation of definitive objective of the company in its memorandum for incorporation. This seems to restrict the liberty with which the SPAC can operate and identify targets. Similarly, as per Sections 248(1)(a) and 248(5) of the Act,[31] the Registrar has been given the power to remove a Company's name from the register of companies, if it fails to initiate "*its business within one year of its corporation.*" This acts as the biggest roadblock to

[26] Foreign Exchange Management (Cross Border Merger) Regulations 2018, Notification No. G.S.R. 244(E), Reg. 4 (March 20, 2018).
[27] Reserve Bank of India Master Direction - Liberalised Remittance Scheme (LRS), Notification No. RBI/FED/2017-18/3.
[28] Reserve Bank of India Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004, Gazette of India, pt. II sec. 3(i) (July 07, 2004).
[29] USEC Investor Bulletin, *supra*note18.
[30] The Companies Act, *Supra* note, §4(1)(c).
[31] *Id.* §§248(1) and 248(5).

SPAC, as a typical acquisition timeline of SPACs in itself is 18 to 24 months until which it has no existing business structure.

### B. COMPLEXITIES OF SPAC: AN INDEPENDENT ALTERNATIVE TO IPO MECHANISM

#### 1. SPAC as an 'Entity': Private Equity Structure

Moving beyond, and this is where we are reminded of the fundamental difference between a conventional IPO and SPACs. That is, an IPO is a *transaction* where the issue is selling stock against purchasers' money, and to that extent, "*the issuing corporation owes no fiduciary duty to IPO purchasers*."[32] However, the SPAC is an *entity* which makes significant decisions for its future by deciding on business combinations. It is notable here that the legal commentators have time and again, emphasized on the similarities between private equity funds and SPACs.[33] Essentially, in the "Private Equity Fund" Structure of SPAC, it is the sponsor who exercises' significant control rights, which saps the limited avenues available to the public holders to exercise influence.[34]

Moreover, one recent study notes that the SPAC sponsors tend to fare much better than SPAC shareholders.[35] For instance, the 'sponsors', generally constituted by institutional investors, formulate the strategy of

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[32] Minor Myers, *The Corporate Law Reckoning for SPACs*, HARVARD L. SCHOOL FOR. ON CORP. GOVERNANCE (Aug. 17, 2022). https://corpgov.law.harvard.edu/2022/08/17/the-corporate-law-reckoning-for-spacs/.

[33] See generally, Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 849, 851 (2013) (hereinafter, Usha Rodrigues).and Steven Davidoff Solomon, *Black Market Capital*, 1(1) COLUM. BUS. L. REV. 173, 224-28 (2008).

[34]. Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 849, 851 (2013).

[35] Michael Klausner, *supra* note 23. See also, Minmo Gahng, Jay R. Ritter & Donghang Zhang, *SPACs*, The Review of Financial Studies (Forthcoming) (Jan 26, 2023) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3775847 (hereinafter, Minmo Gahng).

acquisition post-IPO, subject to the shareholder's approval. Further, the SPAC structure allows the investors to redeem their investment before the proposed merger, sometimes regardless of the fact that they might have voted in favor of it as a shareholder. However, this has led to the problem of opportunistic 'hold-out rights'[36] by sophisticated investors in the SPAC mergers. In response to which, Sponsors have started to follow two trends in contractual formulations:

1. SPAC sponsors have started to design contracts where they have put higher threshold for the redemption rate in order to cancel an acquisition, and thus have effectively dissolved the purpose of voting on an acquisition.[37]Further, in order to compete for targets with hundreds of similar SPACs in the market, the terms of the De-SPAC contract are further diluted against the interests of the unredeemed shareholders.[38]This means that the unsophisticated investors who do not generally redeem their money are left with no influential rights on the choice of acquisition the SPAC will make.

2. There is a recorded tendency of the shareholders to 'approve and redeem' their shareholding, by exercising the exit option after approving the acquisition of a particular target. While these investors (majorly constituted by sophisticated institutional investors with ample information about strategies of investment)[39] redeem their shares for their pro rata value in the trust/escrow account, holding the IPO proceeds plus accrued interest, the non-redeeming shareholders (generally, these are less sophisticated retail investors and

[36] See generally, Thomas Friedmann & D. Chad Larson, *Special Purpose Acquisition Companies: A SPAC Evolution*, THE HEDGE FUND J. (May 2008) and Usha Rodrigues, *supra* note 34 at 857.
[37] See, Usha Rodrigues, *Supra* note 34 at 894.
[38] Holger Spamann and Hao Guo, *The SPAC Trap: How SPACs Disable Indirect Investor Protection*, 40 YALE J. ON REGUL, 75, 78 (2022). (hereinafter, Holger Spamann.)
[39] Michael Klausner, *Supra* note 23 at 232-36.

institutions)[40]are left with shares with value less than the share price they paid.[41]

This is extended to show that the retail investors may fare poorly in comparison to the 'sponsors' and other institutional investors in a De-SPAC transaction.[42] Similar issues have been raised as to the governance structure, provisions of bylaws, compliance with formalities, existing under the company law.[43] In that context, the regulators must also be conscious of these possibilities while considering regulation of SPACs. But this also brings us to the foretasted confusion, whether securing the interests of stockholders of SPAC come in the domain of NCLT or SEBI. Should we consider them stockholders of an *entity* or investors in a *transaction*?

## 2. Forward Looking Statements: A Challenge to SPAC

The SPAC structure of investment also necessitates another consideration. Unlike a public company aiming for conventional IPO, SPACs do not have business operations or assets which can be disclosed to initial investors. Therefore, when SPAC narrows down on a prospective small target company, it sends a statement to the stockholders which often include ""*forward-looking statements" regarding anticipated performance or financial projections of the post-merger company.'*[44] In India, the liability for making forward looking statements is intermingled with the jurisprudence on misstatements in general.[45] Given that a SPAC would inevitably rely on forward looking statements to project an attractive

[40] Holger Spamann, *Supra* note 39 at 80.
[41] See, Holger Spamann, *Supra* note 39 at 81-82.
[42] Michael Klausner, *Supra* note 23 at 246-51.
[43] Minmo Gahng, *Supra* note 36.
[44] Roger E. Barton and Michael C. Ward, *SPACs and speculation: the changing legal liability of forward-looking statements*, THOMSON REUTERS (July 2, 2021) https://www.reuters.com/legal/legalindustry/spacs-speculation-changing-legal-liability-forward-looking-statements-2021-07-07/.
[45] Mini Gupta*, Liability For Forward Looking Statements - Discussion Of Indian Law,* 55(2)Journal of the Indian Law Institute 228, 235 (2013).

avenue for investment during De-SPAC transactions, it is potentially an area of considerable need for regulation[46] and litigation.[47] Consider this, the Regulation 6 of SEBI Issue of Capital and Disclosure Requirements Regulations, 2018[48] provides a reasonable eligibility threshold (that is, for investor protection only) which restrict the entry of budding startups to go public. Currently, Schedule VI of the same Regulations prohibits use of forward looking statements which cannot be substantiated. Considering that, SPAC will act as a saviour for private companies to avoid these requirements about which the retail investors basically would know nothing but the claims that SPAC makes, it would be very complex to determine stringency of this regulation.[49] In the US, SPACs have enjoyed the 'safe harbor' exemption, which protects them from liabilities in private litigation for making forward-looking statements in good faith and with cautionary language.[50]But if a similar exemption is adopted in the case of India, it would not favor the retail investors, as it will burden them for proving that a particular SPAC made some false and misleading statement, while knowing that the statements were false and misleading. In a sense, we find that any regulation must enhance the gatekeeping role of SEBI to protect investors, otherwise it will get compromised in case of shell companies such as SPAC. Therefore again, a jurisdictional question arises – whether SEBI can have authority to govern a De-SPAC

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[46] Yaxuan Wen and Mengnan Zhu, *Is Going Public via SPAC Regulatory Arbitrage?: A Textual Analysis Approach,* Brandeis University 9-10(2022)https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4066641.

[47] Wendy Gerwick Couture, *Top Ten Issues in De-SPAC Securities Litigation,* 44 UA LITTLE ROCK LAW REVIEW, University of Arkansas (2022).(hereinafter, Wendy Couture).

[48] SEBI ICDR Regulations, *supra* note 26, Reg. 6.

[49] John Coates (Acting Director, Division of Corporation Finance), *SPACs, IPOs and Liability Risk under the Securities Laws,* Statement on U.S. Securities Exchange Commission (April 8, 2021) https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws. (hereinafter, John Coates)

[50] Roger E. Barton and Michael C. Ward, *SPACs and Speculation: The Changing Legal Liability of Forward-Looking Statements*, THOMSON REUTERS (July 07, 2012) https://www.reuters.com/legal/legalindustry/spacs-speculation-changing-legal-liability-forward-looking-statements-2021-07-07/.

transaction which is essentially a business combination deal where a public company acquires a private company.

In this light, we see that there are an umpteen number of considerations which are required to be given to SPAC structures in Indian regulatory regime. In this part, we saw that the governance structure in SPAC may suggest that since it is an *entity,* it should be treated differently from an IPO, yet some challenges like the possibility of forward looking statements, makes it similar to an IPO and therefore warrants protection of SEBI. This is to show that in categorizing SPAC as a regulatory arbitrage, we effectively argue that it must be regulated as strictly as an IPO. That would mean curtailing the freedom of contract of the parties involved in De-SPAC transactions. On the other hand, if we categorize it as an independent alternative, we run the risk of failing in investor protection efficiently. Similarly, there has been much discussion around other regulatory hurdles like cross border or taxation considerations to SPAC as well.[51]

Given these challenges have already arisen in evolved jurisdictions like the US and the EU, it is not implausible that Indian regulators will also have to account for them at this stage of the economy when they are trying to promote the SPAC structure of investment in the country. Therefore, it becomes a serious challenge for them to allow is sufficient flexibility to the sponsors to attract SPAC while securing investor/shareholder protection simultaneously. Thus, underlying each regulatory hurdle discussed herein, we see ourselves staring at a single problem: How to characterize SPAC? That is, is it merely an investment structure that is truly and inherently a regulatory arbitrage, or does it represent scope for certain reconsiderations?

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[51] See generally, Medha Pandey & Adarsh Choubey, *Regulatory Challenges Arising due to the Emergence of Special Purpose Acquisition Companies (SPAC) in the Indian Corporate Environment*, 4 INT'l J.L. MGMT. & HUMAN. 1094 (2021) and Sireesha Mamidenna, *Special Purpose Acquisition Companies: An Overview of Their Structure and Legal Status in India*, 21(1) IUP Journal of Accounting Research & Audit Practices; 56, 61 (2022).

### C. A SCOPE FOR REGULATORY CONTEMPLATION IN INDIA

Understandably, the conception of SPAC will come with its own challenges. But this has led many scholars as well regulators to treat SPACs as an '*alternative*' or a run-around to a conventional IPO regulation. Therefore, the prevalent positions with respect to the character of SPAC are that it should be treated as a functional equivalent of IPOs, and thus be subjected to a regime as restrictive as an IPO regulation.[52]On the other hand, some have argued in the context of recent regulatory proposals[53] released by the SEC that,

"*The SEC proposed a series of regulations that promised to apply some of the lessons of history, by forcing SPACs into some of the old regulatory boxes, that SPACs initially purported to escape through the shiny packaging of novelty.*"[54]

However, it must be noted that India is uninitiated in context of SPAC and the challenges accompanying it as a conception in other jurisdictions have matured significantly. While these challenges will require a well-drafted regulatory regime, which ensures that the goal of investor protection does not get undermined, it will also dissuade the investors to opt for SPAC when it is treated in an identical manner as the traditional IPOs.[55]

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[52] See, Minmo Gahng, *Supra* note 36 and Wendy Couture, *Supra* note 48.

[53] Securities Exchange Commission, *Special Purpose Acquisition Companies, Shell Companies, and Projections*, SEC Release Nos. 33-11048; 34-94546; IC-34549 (Proposed Rules) (Mar. 30, 2022) https://www.sec.gov/rules/proposed/2022/33-11048.pdf.

[54] John Morley, *How SPACs Made Old Things Old Again*, 40 YALE J. ON REGUL, 13, 16 (2022). (hereinafter, John Morley).

[55] Gillian Tan, *Citi to Pause New SPAC Issuance as SEC Signals Crackdown*, BLOOMBERG (Apr. 4, 2022,) https://www.bloomberg.com/news/articles/2022-04-04/citi-said-to-pause-new-spac-issuance-as-sec-signals-crackdown. See also, Lauren Mosery, *YTD 2022 Saw Dramatic Slowdown in Global IPO Activity from a Record Year in 2021*, EY GLOBAL (June 30, 2022)https://www.ey.com/en_gl/news/2022/06/ytd-2022-saw-dramatic-slowdown-in-global-ipo-activity-from-a-record-year-in-2021.

### 1. **Economic Substance Approach**

The SPAC structure, when located in the context of its history and functionality, represents a sale of stock for cash.[56]Essentially, in a SPAC structure, the target company is enabled to raise capital from the public, but not from the primary market but the secondary market. Nonetheless, the role of SPAC has been described as follows,

"*SPACs act as intermediaries in this sale process, effectively selling target stock to public investors for a fee. They advertise target shares as an investment, validate target quality, and receive compensation only if the transaction closes.*"[57]

And because of the absence of this conception, there are still existing regulatory gaps in the US regime. Halbhuber argues that when SPAC shareholders decide to invest their escrowed cash without redeeming their shares at the time of combination deal, it translates into a purchase of stock for cash. On a similar note, but in the context of liabilities for making forward-looking statements, the then Acting Director of the S.E.C.'s Division of Corporate Finance, John Coates, suggested that an IPO is where we most typically need protection to overcome the information asymmetries, and if this fact of "*economic and information substance*" about IPO drives our understanding, then it is a De-SPAC transaction which shall be treated as "Real-IPO".[58]

The idea here is that such a conceptual reorientation towards SPAC will ensure that the regulatory gaps are filled in context of strong investor protection. For instance, Companies that use a SPAC merger to effectively sell their shares to the public for cash do not have to disclose as much information to investors as those who do so through a conventional IPO. In fact, practically, the same liability criteria for financial predictions that apply in IPOs do not apply to businesses that

[56] Halbhuber, *supra* note 6, at 61.
[57] *Id.*at 46.
[58] John Coates, *Supra* note 50.

receive public capital via SPAC mergers. And here is the reason why we cannot equate an IPO with De-SPAC transaction as, practically, there should be different liabilities for making projections, or any statement in case of SPAC as there is relatively less information and track record in SPAC's possession than a company fulfilling conditions of ICDR Regulations of SEBI.[59]As Halbhuber notes,

"*The pressure to embellish projections may be especially pronounced in SPAC mergers because SPACs and their sponsors have incentives that are quantitatively and qualitatively different… from an IPO.*"[60]

Regardless, for now the argument of economic substance, that is treating De-SPAC as a sale of stock for cash, still holds strong.

Moving forward, in the case of considering De-SPAC as a mere business combination deal distinct from an IPO, the intermediaries like Merchant or investment bankers are also not provided with the same incentives "*to act as disclosure gatekeepers"* in case of De-SPAC transactions as in case of IPOs. That is, a De-SPAC merger cannot be dealt by similar rules as other intermediaries in an IPO. For instance, Clause 12 of the Code of Conduct for Merchant Bankers[61] provide that the Merchant Banker should avoid conflict of interest by taking reasonable steps to ensure truth and fairness of information. On a similar note, Halbhuber argues that, as a regulatory gap, SPACs are not subject to the conflict of interest rules, that govern conventional underwriters in IPOs. However, this proposition is practically impossible in the context where it is given that SPAC and their controlling person have aligned special financial interests in the merger. That is, even if in the real world, data shows that a median sponsor contributed no cash at all to the target practically,[62] this does not mean that the intention of the sponsors to make profits out of

[59] SEBI ICDR Regulations, *supra* note 26, Reg. 6.
[60] John Morley, *Supra* note 56.
[61] Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992, SEBI Notification No. LE/11112/92, Sch. III, Cl. 12.
[62] Michael Klausner, *Supra* note 23 at 241.

the SPAC structure dissolves. In that sense, the fact that "*SPACs offer public investors a way to co-invest side-by-side with sponsors,*" holds true.[63]Therefore, the economic substance approach conceptualized by proponents fails on different practical grounds given the innovative structure of a SPAC.

Nonetheless, there are several implications of such approach. First, the economic substance approach can be instrumental in clarifying the jurisdictional confusion for SEBI. In history and structure, a SPAC essentially represents an investment vehicle which enables the public to invest in a private company or start-up. To that extent, the notion that a De-SPAC transaction may be equated with a conventional IPO, though at the stage of secondary market, can be helpful. Since, through a De-SPAC transaction, the investor's money is being invested in a business venture, it aligns with the underlying economic and financial substance of an IPO. Although, in terms of regulation, liabilities and implications, a De-SPAC merger and IPO differ significantly, therefore, SEBI has to be mindful of that.[64] Secondly, this approach also enables the regulator to locate the SPAC corporate structure as distinct from the transactional dynamic between the investors and the target company. In that, the SPAC corporate governance structure can be strictly governed by Company law separately, to ensure that the representation of retail investors does not get overwhelmed by the seeming influence of the sponsors. Similarly, the regulation of disclosure and compliance requirements can be oriented to treat De-SPAC transaction as an IPO issue, however, while being conscious of the practical distinction between them.[65] For instance, a special guideline as to the scope of forward-looking statements (& ensuing

[63] NASDAQ, *SPACs: Special Purpose Acquisition Companies*: *Listing a SPAC on Nasdaq*, https://www.nasdaq.com/solutions/listings/markets/americas/ways-to-list/spac.

[65] UshaRodrigues, and Michael A. Stegemoller, *Redeeming SPACs,* Research Paper No. 2021-09, University of Georgia School of Law Legal Studies Research Paper Series,(2021) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=39061964.

liabilities different from an IPO) and the misuse of the language can be provided to the SPACs in the interest of investor protection.[66]

### 2. Economic, Functional and Strategic Utility: A Case for Relaxed Regulation

It is important here to take a pause and remind ourselves of the sudden surge of SPAC as an investment vehicle in the market.[67]Forgetting for the moment that the SPAC represents a regulatory arbitrage, it essentially propels us to ask that why do we need to look for an alternative to traditional IPO or whether the IPO process can be improved? Consider this, if a De-SPAC and an IPO are subjected to identical regulation and liability, what would a target company prefer? The likely answer is that it will prefer an IPO, this is because

"*A de-SPAC, if coupled with a low conversion threshold, introduces contingency. A target cannot be certain that the deal will close until the redemption date has passed.*"

In a SPAC market, the risk to the investors categorically changes its nature. In that, SPACs generally become a fundraising vehicle for the budding start-ups with interesting business plans. Given the aforementioned uncertainty that a deal may not go through, such start-ups will either dissolve before reaching the post-IPO stage or will become public while losing out on strategic[68] and functional utility of SPACs. For instance, in 2020, the surge of SPAC was partly attributed to the

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[66] Michael Klausner, Michael Ohlrogge and Harald Halbhuber, *Net Cash Per Share: The Key to Disclosing SPAC Dilution*, 40 YALE. J. ON REGUL. BULLETIN 18, 20 (2022).

[67] See, Matthew Goldstein, *SPACs Were All the Rage. Now, Not So Much*, N.Y. Times (June 2, 2022) https://www.nytimes.com/2022/06/02/business/spacs-inflation-regulation.html. (hereinafter, Mathew Goldstein).

[68] Editorial, *What is a SPAC?,* CBInsights (April 2022). https://www.cbinsights.com/research/report/what-is-a-spac/. See also, Usha Rodrigues, and Michael A. Stegemoller, *Why SPACs: An Apologia*, Research paper No. 2022-04, University of Georgia School of Law Legal Studies Research Paper Serieshttps://ssrn.com/abstract=40728342.

prominent financial firms and venture capitalists embracing the SPAC process as a prompt and an easier route to public markets than an IPO.[69]

On the other hand, SPACs increase the public's access and exposure to these companies which is not possible in venture capital funds which are generally limited to institutional or wealthy investors, or mutual funds where retail investors participate indirectly.[70]Effectively, the argument here is that by harping on investor protection too much and equalizing the SPACs and IPOs, the regulator runs the risk of excluding the retail investors from the market and the gap between the private companies and the investors widens.[71] The idea here is that SPAC holds utility other than being a regulatory arbitrage or a pseudo IPO. In that sense, its implications on the capital markets must be governed differently from an IPO.

## V. CONCLUSION

This paper has made the case that the development of SPAC in India must be looked from a different orientation while keeping in mind the incumbent challenges it faces in other jurisdictions. India, being a developing economy finds itself in a different position than other countries where it wants to promote economic growth by increasing flow of money in the market through investment, and at the same time it faces challenges from a matured investment structure like a SPAC. Thus, the regulation of SPAC in India requires a scope for contemplation as to strike the balance between encouraging SPACs as well as protecting investors simultaneously. And, the current debate surging in the US provides an important case study for that.

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[69] Mathew Goldstein, *Supra* note 69.

[70] Bob Zider, *How Venture Capital Works*, 1998 HARV. BUS. REV. 131 (1998). See also, Usha Rodrigues, and Michael A. Stegemoller, *Why SPACs: An Apologia*, Research paper No. 2022-04, University of Georgia School of Law Legal Studies Research Paper Series https://ssrn.com/abstract=4072834.

[71] See, C. P. Chandrasekhar, Sarat Malik and Akriti, *The elusive retail investor: How deep can (and should) India's stock markets be,* SEBI. https://www.sebi.gov.in/sebi_data/DRG_Study/elusiveretailinvestor.pdf.

In this article, we looked at the history of the SPAC structure in order to show that its invention was a response to the IPO regime in the US. In that limited sense, we see it as an attempt to bypass the existing laws and scrutiny of the regulators. However, when we look at the diversity of challenges it poses to the regulators in India, we are reminded of its characteristics which makes it difficult to regulate it with an IPO *transaction.* In that sense, the economic substance approach which promotes the idea of equating IPOs and SPACs, by arguing that they essentially represent a transaction of stock sale and purchase only, represents only a limited understanding. This paper has tried to argue that we cannot reduce the regulation of SPAC to a mere intermediary in the investment transaction because such an approach will *firstly,* ignore the economic, function and strategic utility of SPAC which it has over IPO transactions. *Secondly,* such an approach ignores the dimension of '*entity*' which SPAC carries beyond its IPO and thus requires regulation in that domain too. For instance, we noted that after the IPO process, Sponsors and institutional investors, while leveraging their freedom of contract (which represents an entirely different challenge)and information asymmetry may enter into transactions which are not beneficial to the retail investors (who become shareholders afterwards). Further, they may profit unethically at the cost of the unaware shareholders.

Therefore, we argue that SPAC cannot be squarely placed in categories of a regulatory arbitrage or a new independent alternative to IPO. That the proposal that the De-SPAC transaction must be regulated and treated on par with an IPO is impracticable yet not completely dispensable. Rather, a creative regulatory structure is required to contextualize the SPAC structure in India. In this structure, the economic substance of the SPAC as being an investment vehicle (and not a regulatory arbitrage) must be realized without undermining the investor protection. One way of doing this is to ensure that the information asymmetry between institutional investors and the retail investors is cured through regulatory means. Again, such an approach must not be so stringent that it demotivates the sponsors and institutional investors from

even considering SPAC as an investment avenue, and thus limiting the scope of market in India.

# PROXY ADVISORY FIRMS AND CORPORATE GOVERNANCE IN INDIA & UNITED STATES: REGULATORY FRAMEWORK AND EMERGING ISSUES

*Priyansh Singh & Palak Yadav*[*]

## ABSTRACT

*Proxy Advisory Firms are the newest entrants in India's corporate governance landscape, bringing with them the tools for enhancing the participation of institutional investors while establishing greater corporate accountability through their recommendations on corporate proposal and governance consultancy. In this light, the present paper recognizes the various trends responsible for the advent of the proxy advisory industry such as increased institutional ownership of public stocks, diversified portfolios and shareholder activism. While analyzing the mushrooming of various proxy advisory firms, the paper then undertakes to identify and study the key market players such as "Institutional Shareholder Services" and "Glass, Lewis & Co." in more developed and matured jurisdiction such as the United States and "InGovern Research Services", "Institutional Investor Advisory Services India Limited" and "Stakeholders Empowerment Services" in the context of developing jurisdiction such as India.*

*The paper then undertakes to analyze the existing regulatory framework of proxy advisors in India, United States and also embarks upon the oversight of International Regulatory Organizations concerning the proxy advisory industry. The paper furthers by elucidating the emerging issues with proxy advisory firms such as bearing heavy influence on institutional investors, non-transparency and inaccuracy involved in its research methodologies and conflicts of interest through self-dealing and bias. While addressing these criticisms of corporate lobbyists, the paper puts forth both practical implications for the proxy advisory industry worldwide and the policy implications in relation to India and United States. The paper concludes by identifying the importance*

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*of independence and equitability in the present proxy advisory industry for paving the way towards greater corporate governance and accountability in future.*

**Keywords**: Corporate Lobbyists, International Regulatory Organizations, Proxy Advisory Firms, Regulatory Framework, Shareholder Activism.

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## I. INTRODUCTION

The aim of corporate governance has always been to improve the outcomes of decision making for the stakeholders involved in corporations and their functions. With the dawn of shareholder activism through the rise in investors attaching significance to their activism, the landscape for corporate governance has dramatically changed. The higher collective emphasis on the large majority of shares, huge investment portfolios, fiduciary obligations, and voting in all these corporations gave birth to a logistical problem. Here is when, Proxy Advisors, which are firms that specialize in research and analysis of corporate data and issue recommendations to guide managers and institutional investors of all stripes tapped into this market niche.

Proxy Advisory Firms are governance intermediaries that are engaged in the function of analyzing corporate proposals and making recommendations to intuitional investors for exercising their votes on

such proposals.[1] The retail investors also utilize these recommendations, which are public in nature, for exercising their votes.[2] These firms provide independent consultancy by producing significant research on corporate governance practices of investee firms and assist the inventors with voting recommendations at the shareholder meetings on various issues.[3] These issues range from the election of the board of directors, compensation design, corporate transactions such as mergers and acquisitions as well as governance policies and procedures.[4]

The word "proxy advisory" is derivative of the notion of "proxy votes"[5] which bases the shareholder with the right to authorize another person for voting on resolutions on his behalf on such prime corporate resolutions,[6] While internationally, Proxy Advisory Firms have become an emerging and powerful driver of corporate governance with the industry leader, "Institutional Shareholder Services" controlling about 61% of the market[7] and runner up being "Glass, Lewis & Co." in the United States. India only saw these proxy advisory firms dotting its landscape in the last decade, with the first proxy advisory, "InGovern Research Services" mushrooming in 2010 with the addition of "Institutional Investor Advisory Services India Limited" and "Stakeholders Empowerment Services" and in the next two years. The paper discusses these firms and their establishments in detail.

Although their role has earmarked the notions of proper governance in the landscape of corporate law, there is a chorus of issues relating to

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[1] Paul Rose, On the Role and Regulation of Proxy Advisors, 109 Mich. L. Rev. First Impressions 62 (2010).
[2] *Id.*
[3] D. F. Larcker, A. L. McCall & G. Ormazabal, Proxy advisory firms and stock option repricing, 56(2) J. Accounting and Econ., 149, 169 (2013).
[4] *Id.*
[5] Companies Act, 2013 No. 18 of 2013, § 105 (Ind.).
[6] S. Subramanian, Proxy Advisory Industry in India, 13(2) Corp. Ownership & Control 371, 375 (2016).
[7] James R. Copland, Yevgeniy Feyman & Margaret O'Keefe, Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism, 22 (2012).

their working and business model which has also gained the attention of regulators across the globe. Some of the key issues can be identified as unresponsiveness to corrections for corporate demands, inaccuracy in the analysis, lack of transparency in formulation of these recommendations, conflicts of interest for offering consultancy services to corporations whose investors are its proxy clients and unnecessarily raising the bar of good governance for continued employment.[8] This paper identifies the existing regulatory oversight and further suggests implications for these issues.

## II. BACKGROUND

The proxy advisory industry is a specialized sector within the financial services industry that provides research, analysis, and recommendations to institutional investors regarding shareholder votes in publicly traded companies. These advisory firms help investors navigate complex corporate governance issues, executive compensation plans, and environmental, social, and governance (ESG) factors that may have an impact on their investments. In the early era of the corporate management industry, the prevalent practice amongst professional investors was either to vote with the management or sell their equity[9] also referred to as the "wall street rule"[10] or "wall street walk"[11]. This method of voting with their feet or simply quitting the company by selling their shares kept these passive investors out of the decision-making process which led to lacking an incentive for these investors to monitor the performance of these corporations.[12] Passive investors in the context of the proxy advisory

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[8] Yvan Allaire, The Troubling Case of Proxy Advisors: Some policy recommendations, Policy Paper N°7, Institute for Governance of private and public organizations, 2013.
[9] Alan R. Palmiter, Mutual Fund Voting of Portfolio Shares: Wy Not Disclose?, 23 *Cardozo L. Rev.* 1419 (2002).
[10] *Id.*
[11] Jayne Elizabeth Zanglein, From Wall Street Walk to Wall Street Talk: The Changing Face of Corporate Governance, 11 *DePaul Bus. L. J.*43 (1998).
[12] M. Cappucci, *The proxy war against proxy advisors*, 16(3) N.Y.U. J. L. and Bus. 579, 632 (2020).

industry refer to those who invest in index funds or exchange-traded funds (ETFs) that track specific market indices, rather than actively picking individual stocks. These investors generally adopt a "buy and hold" strategy, seeking to mirror the performance of the underlying index. Passive investors also have a role in proxy voting as they hold shares in a broad range of companies through their index fund investments. Although these investors do not actively manage their portfolios, they still have voting rights as shareholders. Various trends such as diversified portfolios to shareholder activism can be associated with the emergence of the proxy advisory industry.

### A. EMERGING TRENDS FOR PROXY ADVISORY FIRMS

The following trends can be identified for tracing the emergence of the proxy advisory industry:

#### 1. Increased Institutional Ownership of Public Stocks

At one point of time in history, the majority of the stocks were predominantly controlled or held by a few leading business houses and wealthy individuals. In India, the equity share markets were noticeably shallow and retail investment was almost insignificant.[13]

Institutional investors are organizations that invest on behalf of their members. They can include entities like pension funds, insurance companies, mutual funds, hedge funds, endowment funds, and commercial banks. They have large amounts of money to invest and often hold substantial stakes in a wide array of companies. Because of their size and the amount of capital they control, institutional investors can have significant influence on the markets and individual companies in which they invest. Although institutional investors such as Unit Trust of India (UTI) and development financial institutions (DFIs) held considerably

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[13] John Armour & Priya Lele, Law, Finance, and Politics: The Case of India, 43 *Law & Society Rev.* 491, 496 (2008).

large stakes,[14] their participation was heavily subjected to bureaucratic and governmental influence[15] which contributed to their passivity in the governance process.

However, most of the shares of public companies, today, are controlled and owned by institutional investors which comprise professional investment managers and asset owners like pensions and endowments.[16] In the United States, this control is as high as 70% of market value on United States stocks.[17] The greater presence of institutional investors contributes in various shades to the corporate governance mechanism and proxy industry as they not only control a larger percentage of one company but also a broader segment of market as well. A 20% share of S&P 500 companies is collectively held by index fund managers giants namely "Vanguard", "BlackRock", and "State Street Global Advisors".[18] Also, these investors are more likely to vote their shares regarding recent corporate discrepancies and scandals, forcing them to have a higher threshold for monitoring and governing these corporations. For instance, the Big Three discuss above control 25% of votes of S&P 500 company given to the fact that not all shareholders vote their shares.[19]

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[14] Jayati Sarkar & Subrata Sarkar, Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India, 8 (2000), http://www1.fee.uva.nl/fm/Conference/cifra2000/sarkar.pdf.
[15] Omkar Goswami, The Tide Rises, Gradually: Corporate Governance in India, OECD Development Centre, Harv. Bus. Rev. on Corp. Governance, Harv. Bus. Sch. Press (2000).
[16] *Id.*
[17] Chuck Callan & Paul DeNicola, 2019 Proxy Season Review, *The Harv. L. Sch. Forum on Corp. Governance* (2019).
[18] Lucian A. Bebchuk & Scott Hirst, The Specter of the Giant Three, 99 B.U. L. Rev., 721, 741 (2019).
[19] *Id.*

## 2. Shareholder Activism and Regulation

Shareholder activism is a way that shareholders can influence a corporation's behavior by exercising their rights as owners. These rights include voting on matters at annual meetings, proposing new corporate governance rules, or publicly expressing their views to apply pressure on management.[20] These are often the shareholders who have incurred some dissatisfaction with certain aspects of management of the company and wish to bring changes to these aspects without changing the control.[21] There are various shades of shareholder activism such as participative shareholder activism where the role of shareholder broadens by assuming responsibility by participating in shareholder meetings and exercising votes.[22] There is also interactive shareholder activism which confers direct engagement and strategizing for enhancing shareholder value[23] and combative shareholder activism where the shareholder is involved in hostile takeovers and proxy fights for changing the control of management.[24] The combative has been prevalent in the United States undertaken by pension funds and hedge funds activists.[25]

In the United States, regulatory changes over the past several decades have empowered shareholders and have fostered an environment

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[20] Bernard Black, Shareholder Activism and Corporate Governance in the United States, *The New Palgrave Dictionary of Economics and The Law* (1998).

[21] Stuart L. Gillan & Laura T. Starks, The Evolution of Shareholder Activism in the United States, 19 J. Applied Corp. Fin., 55, 73 (2007).

[22] Umakanth Varottil, The Advent of Shareholder Activism in India, 1(6) *J. On Governance* 582, 639 (2012).

[23] Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 *U. Pa. L. Rev.*1021 (2007); Thomas W. Briggs, Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis, 32 *J. Corp. L.* 681 (2007).

[24] Brian R. Cheffins & John Armour, The Past, Present and Future of Shareholder Activism by Hedge Funds 37 *J. Corp. L.* 51 (2011).

[25] Stephen J. Choi & Jill E. Fisch, "On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance" 61 *Vanderbilt L. Rev.* 315 (2008); Randall S. Thomas, The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation, 61 *Vanderbilt L. Rev.* 299 (2008).

conducive to shareholder activism. The Securities and Exchange Commission (SEC) has enacted rules that make it easier for shareholders to nominate directors to the boards of companies, allowing activist investors a clearer path to influence corporate decision-making. Disclosure requirements have been enhanced to improve corporate transparency, making it easier for shareholders to hold companies accountable.

Although participative shareholder mainly comprises of institutional investors, various countries have come up with soft laws and self-regulation for greater participation of shareholders in decision making.[26] In the Indian corporate landscape, there is a significant predominance of controlling shareholders or promoters. These individuals or families often hold a substantial stake in their companies, which allows them to maintain control over the business's decision-making process and strategic direction. This concentration of ownership is commonly observed in both public and private companies across various sectors in India Various regulatory reforms in the Indian context involve the voting rights such as the appointment of a proxy,[27] electronic voting,[28] approval of related party transactions,[29] director for minority shareholders,[30] relief against oppression and mismanagement,[31] and class actions suit.[32]These reforms have given shareholders a stronger voice and more rights, such as the right to participate in major decisions via special resolutions, increased voting rights, and better access to information.

In the United States, such regulatory reforms involve the Securities and Exchange Commission (SEC) rules in the mid-1980s for shareholders

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[26] Lisa M. Fairfax, Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power, 3 *Va. L. & Bus. Rev.* 1 (2008).

[27] Companies Act, No. 18 of 2013, § 105 (Ind.).

[28] Companies Act, 2013 No. 18 of 2013, § 108 (Ind.).

[29] Companies Act, 2013 No. 18 of 2013 § 188 (Ind.).

[30] Companies Act, 2013No. 18 of 2013 § 151 (Ind.).

[31] Companies Act, 2013 No. 18 of 2013 § 213 (Ind.).

[32] Companies Act, 2013No. 18 of 2013 § 245 (Ind.).

to use voting to bring corporate changes[33] It allows activist investors a clearer path to influence corporate decision-making. Disclosure requirements have been enhanced to improve corporate transparency, making it easier for shareholders to hold companies accountable. Further, the Dodo-Frank Act, 2010 provides for various other regulations such as the decision on executive compensation, nominating directors, proxy access and changing the corporate bye-laws.[34]

### 3. Diversified Portfolios

With institutional investors holding a more diversified portfolio, this has added further to the mushrooming of the proxy advisory industry.[35] This arrives in the backdrop of modern portfolio theory (MPT) which contributed to the mathematical extension for the notion that larger holding in the portfolio with fewer stocks is riskier than holding well-diversified portfolios of more assets[36] and thus making the latter more preferable in nature. Modern Portfolio Theory (MPT) is an investment theory developed by Harry Markowitz in 1952. It argues that it's possible to construct an "efficient frontier" of optimal portfolios, offering the maximum possible expected return for a given level of risk. This theory emphasizes the benefits of portfolio diversification. This extension led to institutional investors dramatically increasing their returns by lowering the risk and holding a larger number of diversified issues. This however contributes to the logistical problem of voting on all these issues and the larger number of proxy ballot each investor has to process and vote. For

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[33] Séan Patrick O'Brien, The 1983 Amendments to SEC Rule 14A-8: Upsetting a Precarious Balance, 19 *Valparaiso U. L. Rev.* 221-281 (1984).

[34] Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 78n-1 (2018); Holly J. Gregory, Rebecca Grapsas & Claire Holland, "The Latest on Proxy Access" *Harv. L. Sch. Forum on Corp. Governance* (2019).

[35] *Supra* note 12.

[36] Harry M. Markowitz, "Portfolio Selection" 7 *J. of Fin.* 77-91 (1952).

instance, the number of stocks in average mutual funds has marked an increase of about 100% from 54 in 1979 to 126 in 2014.[37]

### 4. **Race to Lower Fees**

Another trend is lowering of the advisory fees and expenses for tracking and analyzing a greater number of stocks. Although managing more stocks and trades should have added to these costs, however, the opposite has taken place given to the economies of scale captured by these firms.[38] Managing a portfolio of 125 stocks is cheaper to manage a portfolio of 100 stocks as a percentage of assets managed.[39] Another reason is the inclusion of investment in passive index funds which becomes another derivative of the modern portfolio theory (MPT)[40] and has forced the managers to put in less talent and creativity, which are two highly compensated skills.[41] With Vanguard being the first to arrive at this approach, many have followed, marking the estimate of more than 80% of all assets divested to index funds from investments funds.[42] For instance, This shift from active to passive management has forced the managers to do more in less and thus leading to the allocation of lesser resources for non-core functions such as analyzing and researching proxy votes. Active management involves making individual investment decisions with the goal of outperforming a specific benchmark index. On the other hand, passive management involves replicating an index, aiming to match its performance rather than outperform it. The increasing popularity of passive strategies, such as index funds and ETFs, has been driven by their lower fees and comparable, sometimes even better, long-term performance.

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[37] Lubos Pastor, Robert Stambaugh & Lucian A. Taylor, "Fund Tradeoffs" *(Nat'l Bureau of Econ. Rsch. Working Paper 23670*, Nat'l Bureau of Econ. Rsch., Inc. (2017)).
[38] *Supra* note 12.
[39] *Supra* note 37.
[40] *Supra* note 36.
[41] *Supra* note 12.
[42] Supra note 23

All these trends have scoped towards the creation of a market niche for the proxy advisory industry and their use as a gradually attractive option for institutional investors. Even the Big Three supplement their internal proxy research with external research and related support.[43] For reducing their expenses, the investment managers have a robust incentive to approach these proxy advisors.[44] It is therefore pertinent to analyse its birth and development from these perspectives.

### B. HISTORY

The origination of Proxy Advisory Firms dates back to the changes brought forward for the inclusion of institutional investors in the decision-making process, for instance, through enaction of the ERISA ("Employee Retirement Income Security Act") in 1974.[45] The act led to establishing duty for voter proxies to vote in a reasonable manner. Due to such regulatory reforms worldwide, the institutional investors began to analyse and monitor the board composition, shareholder proposals and their implementation and other matters of prime importance due to their fiduciary duties.[46] However, due to the large number of portfolios that were to be governed, it was difficult to review all necessary information at the same time.[47]

This marked the birth of the first proxy advisory firm, "Institutional Shareholder Services" in the United States in 1985, which was created for "promoting good corporate governance and raising the level of active and informed proxy voting among institutional investors"[48] and is currently

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[43] Lucian Bebchuk, Alma Cohen & Scott Hirst, "The Agency Problems of Institutional Investors" 31 *J. of Econ. Perspectives* 89-100 (2017).

[44] Tamara Belinfanti, "The Proxy Advisoiy and Corporate Governance Industry: The Case for Increased Oversight and Control" 14 *Stan. J. of L., Bus. & Fin.* 384-409 (2009).

[45] Ctr. on Executive Compensation, "A Call for Change in The Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight" (2011).

[46] Michael R. Levin, Proxy Advisors, http://www.theactivistinvestor.com/The_Activist_Investor/Proxy_Advisors.html.

[47] *Id.*

[48] ISS History, http://www.issgovernance.com/about/iss-history/.

the globe's largest proxy advisory firm. Further, more such firms like "Glass, Lewis & Co." entered the corporate landscape.[49]

India saw mushrooming of these firms only in the last decade, with the establishment of "InGovern Research Services" in 2010 marking the birth of its indigenous proxy advisory industry[50] with the addition of two more firms, namely "Institutional Investor Advisory Services India Limited" and "Stakeholders Empowerment Services" entering the picture in less than half a decade.[51] These firms are analyzed in detail in the subsequent part.

## III. DRAMATIS PERSONAE

Proxy Advisory Firms have dotted the corporate governance landscape with various firms such as "Institutional Shareholder Services", "Glass, Lewis & Co.", "ProxyVote Plus", "Segal Marco Advisors", "Egan-Jones Proxy Services" in the United States, "Minerva Analytics", "PIRC" (United Kingdom) and "Proxinvest" (France) in Europe.[52] However, in the United States, ISS and Glass Lewis rule the proxy advisory industry by a share of 97%.[53] Similarly in India, "InGovern Research Services", "Institutional Investor Advisory Services India" and Stakeholders' Empowerment Service dominate the proxy advisory industry.

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[49] Company Overview, Glass Lewis, http://www.glasslewis.com.

[50] Priya Garg, "Ripple, If Not the Waves Effect: Analysing the Way(s) in Which Proxy Advisory Firms Can Affect Corporate Governance in India, in the Long Run" 5 Nat'l L. U. Delhi Student L. J. 111 (2018).

[51] Bhuma Shrivastava, Proxy Advisory Firms Give a Boost to Shareholder Activism, http://www.livemint.com/companies/ heug8 spsw3 zxe4 suyhecqn/proxy-advisory-firms-give-a-b 00 st-toshareholder-activism.html.

[52] *Supra* note 12.

[53] James K. Glassman & Hester Peirce, How Proxy Advisory Services Became So Powerful, Mercatus Center Geo. Mason U.(June 18, 2014), . https://www.mercatus.org/research/policy-briefs/how-proxy-advisory-services-became-so-powerful.

### A. INDIA

#### 1. InGovern Research Services ("InGovern")

This is the first proxy advisory firm that came up in India in June 2010, started by Mr Shriram Subramaniam. Starting with its "Government Radar", a proprietary framework for analysis of corporate governance structure, it offers various services in the governance landscape such as Corporate Governance Score Cards, Vote Recommendations, Risk Monitoring Services, Corporate Governance Consulting and Education Services.[54] It was approached by Broadbridge for a business tie-up which was finalized in 2011, following which the ProxyEdge voting platform was incorporated in the InGovern's proxy research and voting.[55] It has also been joined by various notable corporate personnel as angel investors and advisors such as Mohandas Pai and Shankar Jaganathan.[56]

#### 2. Institutional Investor Advisory Services India ("IiAS")

Promoted by Amit Singhvi, ex-CEO, Gujarat Ambuja Cements with Amit Tandon, ex-managing director, Fitch Ratings, IiAS is the second proxy advisory firms that started in India in July 2011.[57] It is the largest among the three in terms of volume of business and has equity participants as "Fitch Group Inc.", "ICICI Prudential Life Insurance Ltd.", "Tata Investment Corporation Ltd." and "HDFC Ltd".[58] In addition to voting advisory, it assists investors with proxy voting, maintains the history of votes case, providing value advisory services and

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[54] *Supra* note 6.
[55] S. Subramanian, Proxy Advisory Industry In India, Vol. 13, Issue 2, Corp. Ownership & Control, 371, 375 (2016).
[56] *Supra* note 6.
[57] *Id.*
[58] *Id.*

legal assistance to company management and developing governance scorecards.[59]

### 3. Stakeholders' Empowerment Services ("SES")

Founded in 2012 by J. N. Gupta, a former senior officer at Securities and Exchange Board of India (SEBI) with Arjun Gupta, formerly at "Ernst & Young" and Amarendra Singh, formerly at "Deutsche Bank", SES has been registered as a non-profit organization and avoids any kind of association with listed companies and denies all possible conflict of interest.[60] Operating with very few employees,[61] it analyses the corporate governance practices of various companies and provides voting recommendations on the same. Further, it also administers corporate governance reports as per client requirements on listed companies.[62]

## B. UNITES STATES

### 1. Institutional Shareholder Services ("ISS")

"Institutional Shareholder Services" founded in 1985, is the largest and most dominant proxy advisory firm around the world and influences the corporate governance industry through coverage of around 40,000 annual meetings in more than 115 countries with around 1,600 institutional clients.[63] Its client includes the top twenty-five asset managers, top twenty-four mutual funds and seventeen of the world's largest public pension funds.[64] Owned by Genstar Capital, a private equity

[59] IiAS, http://www.iias.in/.
[60] Interview with J. N. Gupta, Founder and MD, SES, *Business Standard,* January 24, 2013.
[61] N Sundaresha Subramanian & Indulekha Aravind, Proxy Warriors, Bus.Standard, (Mar. 09, 2013), https://www.business-standard.com/article/companies/proxy-warriors-113030800504_1.html
[62] SES, http://www.sesgovernance.com/.
[63] Nadya Malenko & Yao Shen, "The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design" 29 *Rev. of Fin. Stud.* 3394 (2016).
[64] James Cotter, Alan Palmiter & Randall Thomas, "ISS Recommendations and Mutual Fund Voting on Proxy Proposals" 55 *Villanova L. Rev.* 88 (2010).

firm, ISS holds an estimated market share of over 61% of the proxy advisory industry.[65] It has defended the proxy advisory industry its business model.[66] Other than the standard proxy advisory, it also advises client on social responsibility initiates[67] known as Social Advisory Services and for public funds, boards structure, performance-based awards, corporate social responsibility and other issues with impact of public good, known as Public Fund Advisory Services.[68] It also offers international proxy voting,[69] Mergers and Acquisition Analysis Services[70] and Proxy Voting Services[71]. On a case-to-case basis, it also provides research on various international[72] and social[73] issues for its clients.

**2. <u>Glass, Lewis & Co. ("Glass Lewis")</u>**

Glass Lewis was launched in 2003, despite being a latecomer to the industry, it has over 1,300 instructional clients, covering proxy matters for 20,000 company meeting each year and representing asset management of $35 trillion.[74] Similar to ISS, Glass Lewis provides research and analysis to

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[65] James R. Copland, A Report on Corporate Governance and Shareholder Activism, Proxy Monitor, (2014),. https://proxymonitor.org/Forms/pmr_09.aspx

[66] Letter from Gary Retelny, President & Chief Exec. Officer, ISS, to Brent J. Fields, SEC (Mar. 10, 2019) https://www.issgovernance.com/file/ publications/iss-roundtable-comment-letter.pdf..

[67] Institutional Shareholder Services, Social Advisory Services, http://www.issproxy.com/institutional/research/sirsresearch.jsp.

[68] Institutional Shareholder Services, Public Fund Advisory Services, http://www.issproxy.com/institutional/research/publicfund.jsp.

[69] Institutional Shareholder Services, International Proxy Advisory Services, http://www.issproxy.com/institutional/research/globalresearch.jsp.

[70] Institutional Shareholder Services, M&A Insight, http://www.issproxy.com/institutional/research/mainsight.jsp.

[71] Institutional Shareholder Services, Custom Proxy Advisory Services, http://www.issproxy.com/institutional/research/customresearch.jsp.

[72] Institutional Shareholder Services, US and International Governance Research Services, http://www.issproxy.com/institutional/research/globalgovemanceresearch.jsp.

[73] Institutional Shareholder Services, Social Advisory Services, http://www.issproxy.com/institutional/research/socialissues.jsp.

[74] Company Overview, Glass, Lewis & Co., https://www.glasslewis.com/company-overview/

institutional investors through various products. It also supplements research on governance, which is subjective and does not incorporate numerical rating.[75] Except in rare circumstances, it does not provide consulting services.[76] It also administers and provides previously published research to rated companies for fees.[77] Glass Lewis also publishes the "Board Accountability Index" (BAI) which involve adjusting the company's weight estimated through the presence and absence of 5 "critical corporate governance features" through a market-cap weight algorithm to all S&P 500 companies.[78] These factors involve the staggered boards, poison pills, limitations on shareholder bylaw amendments, merger and acquisitions requirements and golden parachutes which have a very strong and significant statistical relationship with the performance of the stock in the long term.[79]

## IV. REGULATORY FRAMEWORK

### A. INDIA

The functioning of Proxy Advisory Firms in India is regulated under the Securities and Exchange Board of India (Research Analyst) Regulations, 2014. As stated under sub-clause 2(p), proxy adviser means "any person who provides advice, through any means, to institutional investor or shareholder of a company, to exercise of their rights in the company including recommendations on public offer or voting

[75] Glass, Lewis & Co., In-Depth Analysis of Unrecognized Risks, http://glasslewis.com/downloads/overviews/yellowcard.pdf.
[76] Glass, Lewis & Co. (Glass Lewis), Conflicts of Interest Disclosure, http://www.glasslewis.com/company/disclosure.php.
[77] *Id.*
[78] Glass, Lewis, & Co., Board Accountability Index, http://www.glasslewis.com/solutions/bai.php.
[79] *Id.*

recommendation on agenda items."[80] All such firms are under compulsion to abide by these regulations. As stated under these regulations, such firms are required to first register themselves with SEBI (Securities and Exchange Board of India) and comply with some threshold provisions like the formation of internal policies and procedures, disclosures about the entities in reports, maintaining record about the voting recommendations etc. According to the latest procedural guidelines brought out following regulation 24(2) read with regulation 23(1) these firms are to abide mandatorily by the code of conduct.[81] Further, regulation 23[82] read with regulation 19[83] deals with disclosures to be made by PAF.

The Securities and Exchange Board of India in regulations issued by it to the mutual funds obliges them to provide disclosure regarding general policies and procedure regarding voting rights of the members and how the number of shares held by them affects the same. All these particulars ought to be disclosed in the AMC's annual reports and on their website.[84] In addition to this, AMCs are needed to unveil genuine exercise of proxy votes corresponding to specific issues viz. Corporate Governance matters, changes to capital structures, arrangement/evacuation of Directors, ESOP and whatever other issues that may influence the revenue of the investors and premium of unitholders specifically.

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[80] Sec. & Exch. Board of India (Research Analysts) Regulations, 2014, Gazette of India pt. III sec. 4, (Sept. 01, 2014), https://www.sebi.gov.in/sebi_data/commondocs/RESEARCHANALYSTS-regulations_p.pdf

[81] Sec. & Exch. Board of India, Procedural Guidelines for Proxy Advisors, (Aug. 03, 2020), https://www.sebi.gov.in/legal/circulars/aug-2020/procedural-guidelines-for-proxy-advisors_47250.html.

[82] Securities and Exchange Board of India (Research Analysts) Regulations, 2014, Gazette of India pt. III sec. 4 (Sept. 01, 2014), Regulation 23.

[83] Securities and Exchange Board of India (Research Analysts) Regulations, 2014, Gazette of India pt. III sec. 4 (Sept. 01, 2014), Regulation 19.

[84] Sec. & Exch. Board of India, Master Circular for Mutual Funds, (Sept. 14, 2016), https://www.sebi.gov.in/sebi_data/attachdocs/apr-2018/1523337972677.pdf.

Insurance companies were urged to step up and play an important role in the general meeting of investee companies and improve their governance by engaging with managements at a greater level. Thus, in March 2017, Insurance Regulatory and Development Authority had implemented a code for stewardship for the insurer vide.[85] The stewardship code applicable for all the insurers comprising seven principles modelled on the UK stewardship code.[86]

In November 2018, working groups were formed keeping in mind to review the working of proxy advisory firms and for keeping a tab on their provisional and functional areas.[87] In addition to recommendation put forward by these working groups, the reports propose to mandate FPIs, Portfolio Managers, AIFs, REITs, InvITs etc. to ascertain if such proxy advisors have appropriate capacity and capability.[88]

The SEBI circular dated August 03, 2020, codified the various business practices of the firms involved in proxy advisory and these firms need to follow these regulations from 1st Sept. 2020 for ensuring compliance with the SEBI circular.[89] Various aspects of the same include code of conduct for voting suggestion policy, which incorporates conditions of when such proposal will not be given (to be evaluated yearly); communication policy, which is the expressed cycle to speak with customers and friends, and timetable to get remarks from the organization; sharing policy, in order of guarantee sharing of their analysis

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[85] IRDAI, Guidelines on Stewardship Code for Insurers in India, *(Mar. 22, 2017)*,https://www.irdai.gov.in/ADMINCMS/cms/whatsNew_Layout.aspx?page=PageNo3096&flag=1.
[86] *Id.*
[87] Sec. & Exch. Board of India, Report of Working Group on Issues Concerning Proxy Advisors-seeking public comments, Jul. 29, 2019, https://www.sebi.gov.in/reports/reports/jul-2019/report-of-working-group-on-issues-concerning-proxy-advisors-seeking-public-comments_43710.html.
[88] *Id.*
[89] Sec. & Exch. Board of India, Procedural Guidelines for Proxy Advisors,: (Aug. 03, 2020), https://www.sebi.gov.in/legal/circulars/aug-2020/procedural-guidelines-for-proxy-advisors_47250.html.

report with investors and investee simultaneously; and conflict of interest policy, to accommodate strategies to unveil, oversee/moderate any possible irreconcilable situation, including from strife emerging from different business exercises embraced by the proxy adviser.[90]

Further, the disclosure requirements include disclosure of policies of voting recommendation to clients, publication of such sharing policies on its website, explicit mention of the following in the advisory documents, including recommendations issued to the client:

I. Methodologies and procedure followed by the proxy adviser in the advancement of the research and relating proposals in regard to a company;

II. Lawful prerequisites or better standard (which is past the fundamental legitimate necessity) applied for reaching up at the recommendations, alongside reasoning for the reception of better quality, rather than the use of the prerequisite by law; and

III. Statement on the irreconcilable situation, explicitly referencing territories of likely conflict of interest with the relief proposal organized as protection for guaranteeing that there is no contention.[91]

IV. Material revisions or factual errors in the recommendations, already shared with the client, to be disclosed to the client within 24 hours of the reception of such information.

Further, it mandated the Proxy Advisory Firms to ensure the exactness of data depending on the recommendations provided by the

[90] Jayshree P. Upadhyay, SEBI issues disclosure standards for proxy advisory firms, mint (Aug. 03, 2020), https://www.livemint.com/news/india/sebi-issues-disclosure-standards-for-proxy-advisory-firms-11596457774523.html.

[91] Indian Bus. L. J., SEBI prepares guidelines for proxy advisers, L. Asia Dot., (Sept. 10, 2020), https://law.asia/sebi-guidelines-proxy-advisers/ (.

proxy advisory firms regarding a given company by accepting remarks/explanations from the investee and presenting their report, as well as revising the recommendations initially made to clients.[92]

### B. UNITED STATES

The U.S. Securities and Exchange Commission (SEC) has adopted the long-awaited requisite amendments to keep a check on proxy advisory firms addressing the issues related to proxy advisory voting. This has been a never-ending decade long battle that seems to be finally put to bed by the adoption of these amendments.[93] There has been two major concern which the SEC tried to deal with, *first*, the requisite amount of accountability that is required for statistical accuracy needed in the area of developing and applying the voting standards and *second*, the conflict of interest as not properly managed and disclosed insufficiently.[94] The amendments suggested by the SEC included. SEC, included –

I. Putting proxy advisory firms under the check of regulations that govern the solicitation of proxy votes.

II. Rule 12a-2(b)(3), Securities Exchange Act, 1934 ("Exchange Act") was suggested to be amended to contain the important provision related to addressing proxy advisory firms.[95]

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[92] Rabidndra Jhunjhunuwala & Saranya Mishra, India: Tightening the Noose on Proxy Advisors (Influencers of India Inc), Mondaq, (Aug. 07, 2020), https://www.mondaq.com/india/shareholders/973894/tightening-the-noose-on-proxy-advisors-influencers-of-india-inc.

[93] U.S. Sec. & Exch. Comm., Exemptions from the Proxy Rules for Proxy Voting Advice,17 C.F.R. Prt. 240.14a-2 ("Rule 14a-2") Release No. 34-89372, https://www.sec.gov/rules/final/2020/34-89372.pdf

[94] U.S. Sec. & Exch. Comm., Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, 17 C.F.R. Prt. 271 & 276, Release No. IA-5325, https://www.sec.gov/rules/interp/2019/ia-5325.pdf

[95]Jason Comerford & Andrew MacDougall, SEC finalizes amendments to proxy rules applying to proxy advisory firms, OSLER, (Aug. 20, 2020),:

III. Investment Advisers Act of 1940[96] (the "Advisers Act") to be amended to require compulsory registering by proxy advisory firms.[97]

The Investment Company Act of 1940 was passed in order to establish and integrate a more stable financial market regulatory framework following the Stock Market Crash of 1929. It is the primary legislation governing investment companies and their investment product offerings.

In 2003, a rule was passed under the Investment Company Act, 1940 by the SEC, which put an obligation on the registered mutual funds to adopt proper policies and procedures to make sure that the best interest of the clients is taken care of when the proxies are voted and voting records are disclosed in public.[98]

Several questions were left unanswered like how much can investment advisers rely on when it comes to the topic of third-party proxy advisors during completing their fiduciary duty? what are the boundaries under which reliance on the third-party proxy is acceptable? what procedures are there to keep in check conflict of interest? These questions were collectively answered in what came to be known as *Egan-Jones and ISS* no-action letters.[99] These letters provided a solution that institutional investors and asset managers can rely on the recommendation of third

https://www.osler.com/en/resources/governance/2020/sec-finalizes-amendments-to-proxy-rules-applying-to-proxy-advisory-firms.

[96] Investment Advisers Act, 1940 (Title 15 of 1940) (United States).

[97] U.S. Sec. & Exch. Comm., Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, 17 C.F.R. Prt. 240.14a-9 ("Rule 14a-9"), Release No. 34-87457, https://www.sec.gov/rules/proposed/2019/34-87457.pdf.

[98] U.S. Sec. & Exch. Comm., Final Rule: Disclosure of Proxy Voting Policies Voting Records by Registered Management Investment Companies, https://www.sec.gov/rules/final/33-8188.htm.

[99] Sec. & Exch. Comm. Staff Letter to Kent S. Hughes, Egan-Jones Proxy Services (Washington, D.C.: May 27, 2004); and SEC Staff Letter to Mari Anne Pisarri, on behalf of Institutional Shareholder Services (Washington, D.C.: Sept. 15, 2004).

party proxy advisers when it comes to discharging their fiduciary duties provided that this was not an outcome of the conflict of interest and the pre-determined policies were followed when the proxies were voted.[100] Keeping in check what all critics and blames were put up against these after a series of events and legal battles, the commission finalised the adoption of regulations governing proxy voting advice presented through proxy advisory firms on July 22, 2020.[101]

An amendment was made to the Exchange act Rule 14(a)-1(l)[102] for the codification of the decade-old notion about the definition of solicitation that when a proxy voting advice is sought by a person or entity, that generally constitutes up as "solicitation". The SEC demonstrates that a proxy voting advice firm should qualify for depending on the exemption through such data and recording necessities for their proxy voting advice, "yet just to the degree that such exemption is fittingly custom-made to their unique function in the proxy cycle and encourages the transparency, accuracy, and fulfilment of the data accessible to those making voting choices."[103]

The SEC amended Rule 14a-1(l)(1)(iii)[104] by adding paragraph A to make a clearer statement that the terms "solicit" and "solicitation" incorporate any proxy voting advice which prepares a recommendation to an investor concerning its approval on a particular issue for which investor assent is requested, and which outfitted using an entity which sells its expertise by providing such advice and recommendations, independently from different types of venture advice

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100 *Id.*

101 Release No. 34-62495, Concept Release on the U.S. Proxy System, https://www.sec.gov/rules/concept/2010/34-62495.pdf.

102 General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C C.F.R. §§ 240.14a-1(l)(1).

103 *Id.*

104 General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C C.F.R. §§ 240.14a-1(l)(1)(iii)

and sells such advice for an expense.[105] To the degree a business which gives proxy advisory services is practising delegated voting authority given to them by the clients, such service, for the most part, won't comprise 'proxy voting advice'— and, in this way, not be a 'solicitation'— under Rule 14a-1(l)(1)(iii)(A)[106]." [107] Rule 14a-1(l)(2) [108] was also amended by the addition of paragraph (v), which stipulated that the terms "solicit" and "solicitation" in no sense involve any proxy advisory regarding shareholder voting, served by an individual or firm who provides such advice only in reply to an unforced demand. [109]

Further, proxy advisory firms must fit the bill for an exemption to try not to hide away from the need for complying with the filing and reporting prerequisites of the government proxy regulations while giving proxy voting advice. Any individual taking part in a proxy advisory and solicitation is commonly dependent upon the filling of data requisites of the government proxy rules except if an exemption applies. In particular, certain exemptions made accessible to a proxy advisory firm are:

I. Rule 14a-2(b)(1)[110], that usually relieves solicitations from individuals who don't pursue the power of acting as a proxy for

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[105] Bank and Corp. L. Rep., ISS Updates Voting Policies for the 2012 Proxy Season, http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.21546.12.pdf.

[106] General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C C.F.R. §§ 240.14a-1(l)(1)(iii)(A)).

[107] Robyn Bew & Richard Fields, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers, Tapestry Networks, IRRC Inst., June 2012, http://www.irrcinstitute.org/pdf/Voting_Decisions_at%20US_Mutual_Funds.pdf.

[108] General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C C.F.R. §§ 240.14a-(1)(2).

[109] Kelly Simoneaux, Hope Spencer & Carley Tatman, SEC Adopts Rules to Regulate Proxy Advisory Firms, Vol. XIII, No. 143, Nat'l. L. Rev., (May 23, 2023), https://www.natlawreview.com/article/sec-adopts-rules-to-regulate-proxy-advisory-firms.

[110] General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C C.F.R. §§ 240. 240.14a-2(b)(1)

the other shareholders and who don't have any great interest in the ongoing subject area.[111]

II. Rule 14a-2(b)(3) [112], that relieves proxy voting advice to a person by a financial advisor with whom the proxy advisory firm already has a business association.[113]

For addressing the issue of conflict of interest, SEC paid equal weightage to comments that pointed out pros and cons related to disclosure to the presence of conflicts of interest. Amendment to rule 14a-2(b) [114] was made which it is compulsory for the person who provides any proxy voting advice keeping in consideration either rule 140-2(b)(1) or (b)(3), they were put under the obligation to provide disclosure about as specified in new rule 14a-2(b)(9)(i).[115] According to this, there should be a disclosure of:

I. All significant information for the transaction, interest or relation of such proxy voting advisory firms is considered as material for understanding the purpose of the proxy voting advice keeping in view that particular transaction, interest, or relation.

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[111] *Id.*
[112] General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C §§ 240.14a-2(b)(3) (United States).
[113] SEC Tightens Regulations on Proxy Advisory Firms, *available at:* https://corpgov.law.harvard.edu/2020/08/18/sec-tightens-regulations-on-proxy-advisory-firms/ (last visited on November 24, 2020).
[114] General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C C.F.R. §§ 240.14a-2(b)
[115] General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C C.F.R. §§ 240.14a-2(b)(9)(i); Priya Cherian Huskins, Esq.,Aug. 19, 2020, SEC Final Rule: Regulating Proxy Advisory Services, https://woodruffsawyer.com/do-notebook/sec-final-rule-regulating-proxy-advisory-services/

II. Steps that can be taken or the policies implemented for identifying and addressing, any concerning conflict of interest arising from transaction, or relation.[116]

Therefore, the proxy advisory industry was put under an obligation to disclose conflicts of interest. Nonetheless, these businesses were given an option to either make the disclosures through any medium including electronic medium to their proxy voting advisory. For electronic medium platforms such as voting platforms for clients can be used which allows the firms to separate the data so that the access as is necessary and intended to be given to each person can be limited based exclusively on the client.[117]

For supplement guidance, as according to this latest amendments, suitable steps should be taken by the investment advisers to make sure that they take into consideration responses of the issuer about the proxy advisory firm's voting to such a degree that when served with advance notice, it would highly be expected out of it that it will affect the adviser's voting determination.[118] Also, a recommendation was put forward by the SEC, under which advisers were expected to disclose the use of extent of their automated voting features of a proxy advisory firm, to which extent they are put in use and what policies are there to have a strong grip on this feature.

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[116] Gaffen, David. Proxy Issues, The Wall Street Journal Blogs, May 21, 2007, *available at:* http://blogs.wsj.com/marketbeat/2007/05/21/proxy-issues/ (last visited on November 23, 2020).

[117] ISS FAQs Regarding Recent Guidance from the U.S. Securities and Exchange Commission Regarding Proxy Voting Responsibilities of Investment Advisers (Oct. 17, 2019) ("ISS FAQs"), *available at:* https://www.issgovernance.com/file/faq/ISS_Guidance_FAQ_Document.pdf. (last visited on November 24, 2020).

[118] Release No. IA-5547, Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers (Jul. 22, 2020), *available at:* https://www.sec.gov/rules/policy/2020/ia-5547.pdf. (last visited on November 24, 2020).

Proxy advice business need not ensure compliance with amendments to rule 14a-2(b)(9) until 1st December 2021. This extended period is inapplicable to amendments to rule 14a-1(l) and Rule 14a-9[119] as they will become effective 60 days post they are published in the Federal register.[120]

### C. INTERNATIONAL REGULATORY ORGANIZATIONS

In recent years, international regulatory organization such as "Canadian Securities Administrator" and "European Securities and Markets Authority" have taken several actions for promoting the increased engagement of proxy advisory firms in the market and inclusion of transparency in their work.[121] These institutions have previously prepared reviews of the proxy advisory industry and have argued for non-intervention of regulatory norms evidencing the lack of market failure in their interaction with institutional investors and corporations.

The 2013 report of European Securities and Markets Authority put out recommendations for creating an industry code of conduct[122] after which a group of proxy advisory firms including the market holders, "ISS" and "Glass Lewis", came up with a set of best practices principles which disclosed, *first*, their general voting policies and research methodology and *second*, policies for communicating with the corporate management, shareholders and other stakeholders such as media and public.[123] A follow-up report by European Securities and Markets

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119 Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, (effected Sept. 10, 2019) 17 C.F.R.pt. 241.).
120 SEC Adopts 2019 Proxy Voting Amendments, Minus the Bite, Aug. 4, 2020https://www.velaw.com/insights/sec-adopts-2019-proxy-voting-amendments-minus-the-bite/.
121 Rep. to the Chairman, Subcomm. on Econ. Pol'y, Comm. on Banking, Hous., and Urb. Affairs, U.S. S., Proxy Advisory Firms' Role in Voting and Corp. Gover. Practices, S. Rep. No. at 17- 47, (Nov. 2016). https://www.gao.gov/assets/690/681050.pdf.
122 ESMA, Final Rep. 84 , (Feb. 19, 2013).https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-84.pdf.
123 Best Practice Principles for Shareholder Voting Research, (2022): https://bppgrp.info/.

Authority concluded that this establishment of best practices principles has let to a positive impact on the market.[124] Similarly, the Canadian Securities Administrators has also come up with a policy for promoting transparency in the process, developing guidelines for proxy voting and fostering synergy amongst market stakeholders regarding the proxy advisory industry.[125]

## V. EMERGING ISSUES WITH PROXY ADVISORY FIRMS

Although the proxy advisory firms have blossomed in the last few decades, they have encountered several grievances from all quarters, and especially the corporate lobbyists. The most common issues include, *first*, that the proxy advisory firms have a large influence; *second*, that proxy advisory firms are inaccurate in their research; *third*, that proxy advisory firms lack the required transparency; and *fourth*, those proxy advisors have a considerable conflict of interest in their functioning.[126] These are further discussed as below:

### A. HEAVY INFLUENCE

With the rise in institutional investors, the demand for proxy advisory services has also grown and so has its influence in corporate decisions and voting. This influence has been referred to as unaccountable and problematic for corporate governance functioning.[127] Unaccountable influence can significantly hinder the effectiveness of corporate governance. It can undermine key principles like fairness, accountability,

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[124] Eur. Sec. and Mkt. Authority, Follow-up on the Development of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis (Paris, France, December 2015).

[125] Canadian Securities Administrators, Guidance for Proxy Advisory Firms, National Policy 25-201 (Montreal, Canada, April 30, 2015), https://www.osc.ca/sites/default/files/pdfs/irps/csa_20150430_25-201-proxy-advisory.pdf.

[126] *Supra* note 12.

[127] *Supra* note 44.

and transparency by enabling opaque decision-making processes. Such influence often serves personal or business interests, potentially leading to decisions that are not in the company's or shareholders' best interests. A lack of oversight can allow financial mismanagement and unethical behavior to go unchecked, thereby subverting shareholder rights, especially those of minority shareholders. Further, this argument is guided by strong evidence as 70% of the market shares in United States corporations are controlled by institutional investors[128] and the two proxy advisory giants, "ISS" and "Glass Lewis" holding 97% of the market of proxy advisory services to institutional investors.[129] This strong control by proxy advisors has further contributed to the practice of robot voting, where institutional investors automatically vote their shares in line with the recommendations of proxy advisory firms, without necessarily conducting their own analysis or considering the specific circumstances of each individual vote. This adds to the power of tremendous sway in corporate boardrooms.

### B. INACCURACY

Although, influence is not necessarily bad in nature and heavy influence might also lead to better governance practices, however, the critics have strongly argued that the research produced and recommended by these proxy advisory firms are often inaccurate, leading to poor recommendations and misinformed votes.[130]Given the substantial amount of data to be analyzed and the resource limitations these firms face, they often involve seasonal employees and offshore contractors. This approach, however, can contribute to higher error rates.[131] Further given the similar time frame for holding all annual meetings, these advisors have

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[128] Chuck Callan & Paul DeNicola, "Proxy Season Review" *Harvard Law School Forum on Corporate Governance* (2019).

[129] Timothy M. Doyle, "The Realities of Robo-Voting" *Harvard Law School Forum on Corporate Governance* (2018).

[130] *Supra* note 12.

[131] *Supra* note 45.

only a few weeks at hand for processing and analyzing the majority of all voting recommendations each year. As reported by COEC's (cost of equity capital) survey of corporate officers, 53% of reports were made for proxy advisors making one or more errors in their final recommendation reports.[132]

### C. NON-TRANSPARENCY

Other than inaccuracy, corporate lobbyists also criticized the opacity of methodologies adopted by the proxy advisory industry for the determination of their voting recommendations.[133] Non-transparency in corporate governance can have serious implications for accountability and potentially hide conflicts of interest. Transparency is a cornerstone of accountability, as it enables stakeholders, including shareholders, to understand and assess a company's actions, performance, and decision-making processes. When transparency is lacking, it hinders the ability of stakeholders to scrutinize and hold those in power accountable, which may lead to unchecked authority and possible misuse of resources. Additionally, a lack of transparency can conceal conflicts of interest. This argument presented has two dimensions, *first*, the "case-by-case" approach followed by the proxy advisory industry that adds to inconsistent recommendations and *second*, the "one-size-fits-all" approach where these firms fail to identify considerable differences between companies.[134] This is problematic especially in the case of executive compensation which has been criticized as delusional and destroying the value of "say-on-pay" assessment.[135] This non-transparency criticism also leads to the weakening of accountability of such firms and raises concerns about undisclosed conflict of interest.

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[132] *Id.*
[133] *Supra* note 12.
[134] *Supra* note 45.
[135] *Supra* note 8.

### D. CONFLICTS OF INTEREST

Corporate lobbyists have severely accused proxy advisory firms of being compromised due to conflicts of interest by focusing on favouritism and self-dealing.[136] "Self-dealing" is a term used to describe situations where individuals or entities in a position of trust or responsibility use that position to further their own interests, often at the expense of the parties they are supposed to represent or serve. For example, a director of a company engaging in transactions with the company that are more beneficial to the director than to the company could be considered self-dealing. This practice is generally frowned upon, as it can lead to conflicts of interest and undermine the trust that shareholders and other stakeholders place in these individuals or entities.

Although, proxy advisors hold a fiduciary duty to not substitute their personal preferences the temptation for enhancing its reputation at the expense of the interests of its clients are too high.[137] Further, ideological bias is discoverable in issues relating to the environment, social and governance (ESG) with evidencing from ISS being more inclined towards proposals of labour unions.[138] Another issue is offering corporate governance consultation to corporate management while at the same time advising their shareholders on voting recommendations. This is the high mark of conflict of interest with research supporting the bias of proxy advisory firms towards the corporations who use its consulting services.[139] This puts to question the independence of recommendations presented by the proxy advisors.

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[136] *Supra* note 12.
[137] George W. Dent, Jr., "A Defense of Proxy Advisors" 8 *Michigan State Law Review* 1289 (2014).
[138] Tao Li, "Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry" 64 *Management Science* 2951-2962 (2018).
[139] *Id.*

## VI. IMPLICATIONS AND WAY FORWARD

In light of these issues, various implications can be put forth for addressing and inculcating the independence and efficiency of the proxy advisory industry and securing the best practices in the corporate governance landscape. By identifying both the practical implications to the above-stated issues argued by corporate lobbyists and policy implications to the regulatory oversight governed by SEBI (India) and SEC (United States), the creation of a herd-like shareholder voting with proxy advisors being the shepherds can be discarded.

### A. PRACTICAL IMPLICATIONS

Various practical implications can be identified for empowering institutional investors in the proxy advisory industry. Following prominent solutions can be implemented in this regard:[140]

I. Mandatory registration for all proxy as investment advisor while establishing their fiduciary duties.

II. Requirement for mandatory issuer research comment and review.[141]

III. Incorporating regulations for credit rating agencies to proxy advisory industry.

IV. Modelling Public Accounting Oversight Boards for overviewing the industry and the voting structure of institutional investors.

V. Increasing disclosure requirements for research methodology used by these proxy advisors for drafting ratings or

[140] *Supra* note 12.

[141] Charles Nathan, "Proxy Advisoiy Business: Apotheosis or Apogee?" *Harvard Law School Forum on Corporate Governance* (2011).

recommendation and further policies for disclosure of easement and interaction with its client base.[142]

VI. Setting up a new self-regulatory firm for the industry, with its mandatory rulebook and code of conduct. [143]

While introducing regulations can lead to enhanced outcomes in the industry, it's crucial to monitor for over-regulation, as it may have negative consequences and potentially exacerbate distress.[144]

### B. POLICY IMPLICATIONS

#### 1. India

In India, although SEBI has come out with a comprehensive procedural guideline,[145] a few loose ends that remain to be dealt with are whether proxy advisory firms can charge fees from the organization by putting forth the recommendations to the company along with time limit for giving additions to its report with modified or underscored proposal if the proposal isn't changed or there is no real blunder. Different things that may get petulant in resolving grievances could be the better quality standard wise for recommending and reasoning.

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142 Brian Croce, SEC commissioner takes agency lead on proxy-voting efforts, Pensions and Investments, (Mar.19, 2019), https://www.pionline.com/article/20190319/ONLINE/190319842/sec-commissioner-takes-agency-lead-on- proxy-voting-efforts.).

143 Meagan Thompson-Mann, *Voting Integrity: Practice for Investors and the Global Proxy Advisory Industry*, Colum. L. Sch.Policy Briefing No. 3, Millstein Ctr. for Corp. Governance and Performance, 2009.

144 Comm'n Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Exchange Act Release No. 86,721, 84 Fed. Reg. 47,416 (Sept. 10, 2019).

145 Chamber of Com. Of the U.S., Public Company Initiatives in Response to the SEC Staff's Guidance on Proxy Advisory Firms, available at: (Nov. 20,2020), https://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/021874_ProxyAdvisory_final-1.pdf

Another point that grabs the eyeball is that the SEBI Circular disclosure requirement is the same as that of amendment to rules for Proxy Voting Advisory firms adopted by the US Securities and Exchange Commission on 22 July 2020[146], which mainly deals with the conflict of interest with well-written policies and procedures.[147] The conflict is that the dissemination to the client and at the same time[148], companies also have access to the advice given by these advisors which influence both client and companies in their decision making.[149]

Huge hopes are pinned on these proxy advisers as they are projected to be the major stakeholders of this modern and effective shareholder democracy, and in this light, the data and information sources given by such firms to the investors must be bona fide and inculcate impartiality and reliability. The circulars issued by SEBI end up being a milestone for setting up a mark for transparency, reliability, and independence that is expected out of these proxy advisory firms to discharge their duties and responsibilities which being fiduciary in its nature.

### 2. United States

Similarly, in the United States, the recommendation put forward by the SEC magnifies the positive steps taken in the right path by inculcating more rationality and transparency to the present system governing proxy voting advisory. Now the hot question that is to be answered is whether proxy advisors shall be able to capture the opportunity for improving and inculcating transparency and adequacy in their business tasks so that the interest of these shareholders are served properly as that is the main

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146 US. Sec.and Exch.Comm'n, SEC Adopts Rule Amendments to Provide Investors Using Proxy Voting Advice More Transparent, Accurate and Complete Information, (July 22, 2020),https://www.sec.gov/news/press-release/2020-161

147 General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C C.F.R §§ 240.14a-2(b)(9)(i)

148 General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C C.F.R §§ 240.14a-2(b)(9)(ii)(A)).

149 General Rules and Regulations, Securities Exchange Act, 1934 17 U.S.C C.F.R §§ 240.14a-2(b)(9)(ii)(B)).

objective. Public organizations in this manner have a major and significant task to carry out to accomplish a more desirable working system of proxy voting advice. Therefore, high hopes should be pinned that these corporate governance houses will be able to use these amendments as a valuable scale for realising the potential of the SEC staff guidance.[150]

## V. CONCLUSION

The present regulatory oversight in the proxy advisory industry, is without a doubt, not the last, given the changes in a long-running fight between corporate executives and investor activists. It is the current state of a deliberate, long-term exertion by corporate interests to persuade people who control the functioning to reign in the effect of proxy advisors who contribute to the efficient governance process.

Taking the above research into deeper analysis, the idea behind such a vast expansion of proxy advisor firms and increase in regulations for proxy access is not only about levelling the playing field or by getting the maximum value of shareholders but is also based on the notion of reducing or diminishing the unwanted influence of the controlling shareholders on corporate decision making. The main strength for institutional investors in this battle between shareholders and corporate managers. The disagreement with the voting value of shareholders shows the presence of proxy advisors. Shareholder voting is an effective manner for holding these managers accountable for mismanagement and oppressive approaches. One share, one vote, is the idea on which this widely accepted and supported the argument is based. [151] However, voting rights are only effective if voters can vote independently. Thus, the presence of proxy advisors is as important as the presence of equitability and independence in their approach while upholding the best interests of

[150] Chamber of Com. Of the U.S., Public Company Initiatives in Response to the SEC Staff's Guidance on Proxy Advisory Firms, *(Nov. 20,2020),* https://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/021874_ProxyAdvisory_final-1.pdf ).

[151] Grant M. Hayden Maurice A. Deane School of Law at Hofstra University & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity* 30 Cardozo L. REV. 445 (2008).

institutional investors. With these goals turning into reality, the road towards greater corporate governance and accountability can be cemented with ease.

# FRACTIONAL SHARE INVESTING IN INDIA: A STEP IN THE RIGHT DIRECTION?

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## ABSTRACT

*Indian company law has always been averse to fractional shareholding since its very incidence. The Indian securities market is also characterized by its conservative approach and minimal participation of private players in its operational framework. In such a situation, the question arises about the feasibility of implementing fractional shareholding in India. Even if it is feasible, what would be the way forward in implementing the framework? The recommendation of the recent report of the Company Law Committee, 2022 to permit fractional shareholding is definitely a step in favour of its implementation. This calls for an analysis of the merits and demerits of fractional shareholding, as well as the need to propose a feasible method for its implementation.*

*The given essay adopts a stance in favor of fractional shareholding. It is aimed at proposing the key aspects that need to be considered while implementing the framework. It proceeds to achieve the same by analyzing the law in other jurisdictions like the USA, Japan and Canada which permits fractional shareholding. Further, it aims to justify fractional share trading in India by understanding the pros and cons and proposing a method of implementation that can overcome the drawbacks. It concludes by analyzing the best practices from various jurisdictions and further suggesting their adaptation to the Indian scenario.*

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**Keywords**: fractional shareholding, securities market, Canada,

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## I. INTRODUCTION

The Report of the Company Law Committee, 2022 has proposed that the issuance, holding and transfer of fractional shares be permitted owing to the rise in retail shareholders in India.[1] Fractional shares are parts of one share unit of the company's share capital. The right to hold fractional shares enables investors to invest a certain sum of money, irrespective of the value of the share, thus entitling them to a fraction of the share of the company. In India, the Companies Act, 2013 has expressly barred the issuance of fractional shares. In the prevailing position of law, companies usually sell the fractional shares generated because of bonus issue, rights issue or any other corporate action to an intermediary and further distribute the proceeds amongst its shareholders.[2] Thus, the

[1] MINISTRY OF CORPORATE AFFAIRS GOV'T OF IND., REPORT OF THE COMPANY LAW COMMITTEE (2022), https://www.mca.gov.in/bin/dms/getdocument?mds=bwsK%252FBEAFTVdpdKuv5IR5w%253D%253D&type=open

[2] *Share in Parts,* THE HINDU BUSINESSLINE (April 22, 2022) https://www.thehindubusinessline.com/opinion/editorial/the-idea-of-fractional-shares-while-interesting-from-the-investor-viewpoint-may-not-excite-companies/article65345517.ece

recommendation reflects a serious consideration of permitting fractional shareholding in India.

Permitting trade in fractional shares has several benefits. Not only does it benefit investors who would be able to invest smaller sums of money, which would otherwise prove to be unaffordable, but it also provides a wider array of investing options to household investors, enabling them to invest in high value companies. However, developing a legal framework would envisage several modifications to both legal as well as infrastructural frameworks. Further while there are countries like USA, UK, Canada and Japan that have permitted fractional shares, however, the question arises whether, given the infrastructural differences, permitting fractional shares is a right step to be taken in the Indian context.

The given essay aims to analyze the potential effects of permitting fractional share trade in India. The second section aims to briefly touch upon the current provisions restricting fractional trade in India. The third part gives an overview of the law relating to fractional shares in other jurisdictions that have been referred to in the report. The fourth section aims to highlight the possible merits and drawbacks of permitting fractional shareholding in India. The fifth section aims to propose a way forward for India, taking into consideration, both the positives and negatives of permitting dealings in fractional shares.

## II. HISTORY AND CURRENT POSITION OF LAW IN INDIA

India is a fairly conservative market as compared to other markets in other jurisdictions such as USA. What we mean by this is that the Indian Government exercises substantial control over the securities market. Even the demat accounts are only permitted to be held with depositories NSDL and CDSL, the role of private brokers being limited to that of intermediaries between the stock exchange and the client.

The legislative history of company law, dating back to 1866, has always expressly prohibited the issuing of fractional shares by Indian Companies. The Companies Act, 1866 provided that no subscriber to the Memorandum of Association of a Company Limited by shares shall take *less than one share.*[3] Section 14 of the 1866 act, which governed the Articles of Association of the company also prescribed that each subscriber should take at least one share.[4] The Indian Companies Act, 1882 also restricted subscribers from holding less than one share.[5] The Indian Companies Act, 1913 on a similar note restrained the subscriber to the memorandum from holding a fraction of the share.[6]

Post-independence, even after the enactment of the Companies Act, 1956, the stance of the government regarding fractional shareholding remained unchanged. The Companies Act, 1956 which was borrowed heavily from the UK Companies Act, 1948 maintained its restriction on holding and trading fractional shares.[7]

The present and the most recent 2013 companies' law also has similar restrictions. Section 4(1)(e)(i) of the Companies Act, 2013[8] which lays down the provisions concerning the Memorandum of Association (MoA), provides that –

"the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount and the number of shares which the subscribers to the memorandum agree to subscribe, which **shall not be less than one share.**"[9]

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[3] The Companies Act, No. 10 of 1866, §8 (Ind.).
[4] The Companies Act, No. 10 of 1866, §14 (Ind.).
[5] The Companies Act, No. 10 of 1866, §8 (Ind.).
[6] The Companies Act, No. 7 of 1913, §6 (Ind.).
[7] UK Companies Act 1948, 11 & 12 Geo. 6 c. 38, §2(4)(b) (Eng.); The Companies Act, No. 1 of 1956 §13(4)(b) (Ind.).
[8] The Indian Companies Act, No. 18 of 2013, §4(1)(e)(i) (Ind.).
[9] *Id.*

Even Schedule I of the Companies Act 2013, restricts any person from holding a fractional part of a share.[10]

SEBI has issued a master circular[11] for stock brokers which emphasizes on the clear separation and non-fungibility of the transactions undertaken by brokers/stockbroker firms as principals and as agents of the client. It also stipulates regulations as to other underlying aspects such as delivery of securities to clients, payment timelines, etc. In India, stock brokers can act merely as agents of clients as far as trade over the stock exchange is concerned. This is particularly a concern as fractional share dealings across the world take place through brokerage firms, who own entire share units and enable retail investors to hold fractions of share units.[12]

As per the SEBI (ICDR) Regulations,[13] corporations are required to notify SEBI as to how they would be dealing with fractional shares arising out of various activities such as rights issues, stock splits, etc. However, the shares cannot be issued directly to the shareholders. Thus, an enactment permitting fractional shareholding and trading would necessitate several changes to the existing legal framework in India.

## III. LAW IN OTHER JURISDICTIONS

### A. USA

USA has one of the most liberal and the oldest set of laws pertaining to fractional shareholding; laws relating to fractional shares date back to as

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[10] The Indian Companies Act, No. 18 of 2013, para. 4 Table F – sched. I (Ind.).

[11] Securities and Exchange Board of India (hereinafter SEBI), Master Circular for Stock Brokers SEBI/HO/MIRSD/DOP1/CIR/P/2018/87 (Issued on June 1, 2018).

[12] *Fractional Share Investment: A step towards inclusive Securities Market*, TAXMANN (June 30, 2022) https://www.taxmann.com/post/blog/opinion-fractional-share-investment-a-step-towards-inclusive-securities-market/.

[13] SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018, Gazette of India, pt. III sec. 4, B [4 (XIX)], B-1 [(18)] of sched. VI (Sept. 11, 2018).

old as 1927.[14] Further, the US legal framework encourages fractional share trading. The US Securities Commission published guideline on fractional share investing for the benefit of household investors titled- *"Fractional Share Investing – Buying a Slice Instead of the Whole Share"*.[15] In USA fractional share holding and trading takes place through brokerage firms as fractional share trading cannot take place directly over exchanges such as the NASDAQ or New York stock exchange, i.e., fractional shares fall outside the ambit of the National Market System.[16] While the household investors own the fractional units of the share/ shares, the brokerage firm owns full units of the shares.[17]

Shareholders are permitted to participate in corporate action such as stock splits and reverse stock splits and are also entitled to receive dividends on the shares. In fractional shares, however the exercise of direct voting rights is not possible, although proxy voting rights may be exercised based on the brokerage firm's policy.

All states in USA permit trading in fractional shares, although each state has its own set of laws governing the subject. The laws differ in certain aspects such as the issuance of scrip instead of fractional shares.

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14 Anon, *Uniform Business Corporation Act and the Uniform Stock Transfer Act*, 5 WASH. L. REV. 170 (1930).

15 SECURITIES EXCHANGE COMMISSION, US SEC INVESTOR ALERTS AND BULLETINS, FRACTIONAL SHARE INVESTING – BUYING A SLICE INSTEAD OF THE WHOLE SHARE (2020), https://www.sec.gov/oiea/investor-alerts-and-bulletins/fractional-share-investing-buying-slice-instead-whole-share.

16 Robert P. Bartlett, Justin McCrary, Maureen O'Hara, *Tiny Trades, Big Questions: Fractional Shares* (Oct. 19, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4248449.

17 *What is Fractional Share Investing*, NASDAQ (July 26, 2021) https://www.nasdaq.com/articles/what-is-fractional-share-investing-2021-07-26.

### B. CANADA

In Canada, several aspects of fractional share lending have been discussed in section 49 of the Canada Business Corporations Act, 1985.[18] Section 49(15)[19] of the act in particular legitimizes the issue of fractional shares in Canada and provides for the rights of the fractional shareholder. Unlike USA, Canadian law on fractional shares is more restrictive. According to section 49 (17),[20] fractional shareholders are not entitled to voting rights or dividends on fractional shares.

This is however subject to two exceptions, *firstly*, if the fractional shares are resultant from a consolidation of the shares or *secondly*, if the articles of the particular corporation whose fractional shares are being dealt with, provide otherwise. Thus, unlike USA which permits voting rights subject to the broker's policy, the Canada Business Corporations Act vests this discretion with the corporation.[21]

### C. JAPAN

Japan also permits shareholders to hold fractional shares. Section 234 of the Japanese Companies Act clearly provides how the fractional shares need to be treated. It lays down that in case of any acquisition, merger, allotment of shares, acquisition of share options or any other item provided in section 234, if the shares to be delivered to the persons includes a fractional share, then the company shall sell the equivalent number of fractional shares by auction and deliver the proceeds gained from the auction, to such persons in proportion of the fractional shares attributed to them.[22]

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[18] Canada Business Corporations Act, R.S.C., 1985, c. C-44, §49 (Can.).
[19] Canada Business Corporations Act, R.S.C., 1985, c. C-44, §49(15) (Can.).
[20] Canada Business Corporations Act, R.S.C., 1985, c. C-44, §49(17) (Can.).
[21] Canada Business Corporations Act, R.S.C., 1985, c. C-44, §49(17)(b) (Can.).
[22] Companies Act, No. 86 of 2005, art.234. (Japan).

The section also provides an alternative mechanism where in lieu of the auction the Stock Company may sell the fractional shares at a predetermined market price, which will be calculated as per the method prescribed by the Ministry of Justice. To protect the interest of the fractional shareholders, the section further provides for the determination of market price with the permission of the court.

Section 235 of the Japanese Companies Act lays down the treatment of fractional shares created by share split or consolidation of shares. It provides for a similar mechanism as prescribed under section 234 to dispose of fractional shares.

In case the Stock Company is consolidating its shares and the fractional shares are included in such consolidation, then the dissenting shareholders have the right to demand a fair price from the Stock Company for the number of fractional shares they hold.[23] If the dissenting shareholders and the Stock Company are not able to reach an agreement determining the price of the shares, then either the shareholders or the Stock Company may file a petition in the court[24] to determine the price within thirty days after the expiration of the thirty days from the Effective Day (effective day is the day when the consolidation of shares will become effective).[25]

The Japanese Law does not allow the shareholder holding less than one unit of share to cast vote at a shareholders' meeting.[26]

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[23] Companies Act, No. 86 of 2005, art.182(4) (Japan).
[24] Companies Act, No. 86 of 2005, art.182(5) (Japan).
[25] Companies Act, No. 86 of 2005, art.180(2)(ii) (Japan).
[26] Companies Act, No. 86 of 2005, art.189 (Japan).

## IV. BENEFITS AND DRAWBACKS OF INTRODUCING FRACTIONAL SHAREHOLDING IN INDIA

### A. BENEFITS OF FRACTIONAL SHARE TRADING

#### 1. Increases retail investor participation

Globally there has been an increase in retail investor participation, post the pandemic, induced by Covid as well as advancements in technology.[27] This trend has also been reflected in India. According to SEBI, the ten-month period ending in January 2022 culminated with three crores more Demat accounts as compare to those opened in the financial year ending 2022.[28] This indicates that there has been an increase in retail participation. The issuance of fractional shares would serve two purposes, *firstly* to meet the growing demand of retail investor participation in stock trading and *secondly*, to further increase such participation.

Increased retail participation is one of the main reasons in favor of fractional shareholding. This has been evidenced in USA, where trading in fractional shares is known to have led to a spur in retail activity.[29] The fractional shareholding will provide an opportunity to small retail investors to participate in the stock market as it will be easy for them to purchase shares even with budgetary constraints. The increase in retail trading is more for higher-value shares as compared to lower-value shares.[30] Choice-based trading will incentivize people to venture into the market and help curb investor fatigue.

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[27] Pedra Gurrola-Perez, Kaitao Lin, Bill Speth, *Retail trading: an analysis of global trends and drivers*, WORLD FEDERATION OF EXCHANGES (Sept., 2022) https://www.world-exchanges.org/storage/app/media/WFE-Retail-Investment%20Sep%2020%202022.pdf

[28] SEBI, *SEBI Bulletin March 2022* [2022] 20(3) https://www.sebi.gov.in/sebi_data/commondocs/mar-2022/SEBI%20Bulletin%20-%20March%202022.docx

[29] Zhi Da and Vivian W. Fang, *Fractional Trading* (2022), https://www3.nd.edu/~zda/FT.pdf.

[30] *Id.*

#### 2. Construction of a balanced portfolio

Investors struggle to prepare a balanced portfolio as the prices of the stocks keep on fluctuating. The fractional shareholding will promote dollar-cost averaging i.e., retail investors will keep purchasing the fractional shares of stocks which are expensive when their prices will be comparatively low, facilitating less expenditure per share. Investing an equal amount of money over regular intervals will help investors mitigate losses in case of high market volatility. Further, purchasing small fractions of various stocks will lead to a more diverse and balanced portfolio.

### B. DRAWBACKS OF FRACTIONAL SHARE INVESTING

#### 1. Likelihood of inflationary pricing of fractional shares

One of the key drawbacks of fractional share investing is that increased participation of retail investors would push the demand for fractional shares. A disparity between the demand and availability of the shares would increase the price of the fractional shares, resulting in inflation, which defeats the purpose of issuing fractional shares in the first place. This may prove true, especially for high-value corporate shares. Although, fractional shares may individually seem small, when coordinated and consolidated, they may lead to price fluctuations and may cause an increase in the price.[31]

#### 2. Existing legal framework

If we consider the model of fractional shareholding in countries like USA, a lot of power is vested with private players, i.e., brokerage firms. However, in India, the role of brokerage firms is limited to being mere intermediaries between the shareholder and the corporate. Further, the

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[31] *Id.*

SEBI Master circular expressly prohibits any intermingling of transactions between the broker and the client, thus preventing brokerage firms to hold shares on behalf of investors. Permitting fractional shareholding envisages a lot of changes to the existing legal framework, which might be a tedious process.

#### 3. Lack of liquidity

Fractional shareholding routed through brokerage firms, depends on time taken to accumulate fractional shares till the whole unit of shares is reached. Further, this time period may be even longer for lesser preferred corporations. This makes fractional shares more illiquid compared to regular shares, i.e., there is a lack of asset liquidity.

## V. THE WAY FORWARD

It cannot be denied that permitting fractional shareholding has several benefits accruing to the economy. However, it is opined that while there are drawbacks, the negative effects can be circumvented, the key being a way forward that assuages the negatives of fractional lending.

### A. REGULATION OF BROKERAGE FIRMS

The first step toward implementing fractional shareholding in India is the alteration in the brokerage rules in India. Stockbrokers in India merely act as agents of the client limited to placing orders of shares. However, in other countries, brokerage firms act as dealers to the extent that they own the shares on behalf of the clients. Further, unlike India, where securities are held in accounts maintained with depositories, in countries like USA, securities are maintained with the brokerage firm's books of account. In USA, they are known as broker-dealers.[32]

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[32] Neelanjit Das, *Why Indian Stock Brokers Don't Follow The US 0% Brokerage Trading Model,* OUTLOOK INDIA, (Feb.17. 2022) https://www.outlookindia.com/business/why-do-indian-stock-brokers-don-t-follow-the-us-0-brokerage-trading-model--news-182748

While it is not advocated that freedom to such an extent be provided to brokerage firms in India, enabling fractional shareholding would necessitate the relaxation of certain provisions of Regulation 25 of the SEBI Master Circular for Stock Brokers.[33] Since India presents a more conservative market, this also has to be mirrored with a set of guidelines governing fractional shareholding by brokers on behalf of clients, considering that the fractional shares may not be conventionally held in accounts with the national depositories- CDSL or NSDL. A plausible solution to ensure brokerage firms do not have unnecessarily high markups or commissions, and to ensure that they do not engage in other unfair practices, is to establish a regulatory body solely for overseeing the brokers.

In USA, FINRA or Financial Industry Regulatory Authority is a not-for-profit organization, authorized by the government to oversee and regulate broker-dealers in the USA to ensure their honest and fair operation. Currently, fractional shares are required to be reported in accordance with FINRA guidance.[34] Further, broker-dealer firms are also required to comply with various set of FINRA rules that are operational in the marketplace.[35]

India being a more conservative market, the non-interventionist approach like that of the US cannot be implemented. However, a similar model of law can be implemented in India, by the government instead of a private entity, to prevent the misuse of powers by brokerage firms and broker-dealers. Implementing such a step would help mitigate the risk accruing from vesting too much power in the hands of brokerage firms and allow them to maintain accounts for the purpose of fractional shares.

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[33] SEBI Master Circular for Stock Brokers SEBI/HO/MIRSD/DOP1/CIR/P/2018/87 (Issued on June 1, 2018), regn. 25.

[34] Financial Industry Regulatory Authority (hereinafter FINRA), 2023 REPORT ON FINRA'S EXAMINATION AND RISK MONITORING PROGRAM, H.R. DOC. NO. 118, at 60 (Jan. 2023) https://www.finra.org/sites/default/files/2023-01/2023-report-finras-examination-risk-monitoring-program.pdf

[35]FINRA Rules, FNRA.org https://www.finra.org/rules-guidance/rulebooks/finra-rules

Further, to ensure better regulation, a phased approach can be used to implement fractional share trading in India. Designated stocks like Nifty 50 or Top 100 stocks as per the market capitalization can be identified for this purpose and brokers can be authorized to deal in fractional shares only from these stocks. A similar approach has been adopted by the NSE-IFSC while allowing trading in the US Stocks. It has designated 50 popular US stocks in which trading can be done through the NSE IFSC platform.[36] The introduction of fractional share trading in such a phased manner will enable better monitoring and regulation of fractional shareholding.

### B. VOTING RIGHTS

Voting Rights is one of the major concerns following the introduction of fractional shareholding. Voting is considered the most important right of any shareholder as it not only provides decision-making authority to the shareholders, but also helps in keeping the management of the company in check. However, in the case of fractional shareholders, it will be a herculean task to grant voting rights and facilitate the process of voting as there would be many small units of a single share with different shareholders. The Companies Act, 2013 which embodies the principle of 'one share-one vote'[37] by granting voting rights in proportion to the share in the paid-up equity share capital,[38] further complicates the aspect of granting voting rights to every fractional shareholder.

It is submitted that the right of voting on every resolution placed before the shareholder's meeting should not be extended to fractional shareholders. This has been suggested taking into consideration the

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[36] NSE International Exchange, 'NSE IFSC Receipts on US Stocks (in the form of Unsponsored Depository Receipts) permitted to trade and admitted to dealings on the Exchange', 007/2022 (Issued on Feb.26 2022) https://static.nseifsc.com/s3fc-public/content/circulars/NSEIFSC_REG_792.pdf

[37] Simon C.Y. Wong, *Rethinking "One Share, One Vote"*, HARVARD BUSINESS REVIEW, (Jan.29 2013) https://hbr.org/2013/01/rethinking-one-share-one-vote

[38] The Indian Companies Act, No. 18 of 2013, §47(2) (Ind.)

practices in Canada and Japan (discussed above). However, the Japanese and Canadian Companies Laws do not completely curtail the rights of fractional shareholders, rather they vest the power in the hands of the concerned corporation to decide the rights of the fractional shareholders in accordance with their articles of incorporation.[39] A similar model can be implemented in India as well.

Further, the treatment provided to preference shareholders in terms of voting rights in India can also be considered as a model framework while determining the issue of voting rights to fractional shareholders. Preference shareholders are allowed to exercise their voting right only on the resolutions- a) which directly affect the rights attached to their preference shares, b) for the winding up of the company or c) affecting the repayment or reducing the preference or equity share capital of the company.[40] The voting rights of fractional shareholders should also be restricted to such specific situations, further providing scope for the corporations to grant additional rights as per their articles of association.

### C. DIVIDEND

Payment of dividends helps the company improve its market perception. Fractional shareholders should also be entitled to the dividend in proportion to their holding in the share capital. Though the dividend paid on the fractional share will be negligible considering the average dividend payout in India,[41] payment of dividend on fractional shares will incentivize the investors to invest more. The dividend payout will also provide an opportunity for dividend reinvestment schemes to grow. Using the dividend received, investors can repurchase the shares of the

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[39] Companies Act, No. 86 of 2005, art. 189-(2) (Japan); Canada Business Corporations Act, R.S.C., 1985, c. C-44, §49(17)(b) (Can.)

[40] The Indian Companies Act, No. 18 of 2013, §47(2) (Ind.)

[41] Pooja Sitaram Jaiswar, *Top 10 dividend yield stocks' 5-year average returns are better than FDs*, LIVEMINT (Dec.6, 2022) https://www.livemint.com/market/stock-market-news/top-10-dividend-yield-stocks-5-year-average-returns-are-better-than-fds-11670314477250.html

company, which can help them further strengthen their portfolio in the Company.

### D. COMBATING INFLATIONARY PRICING OF FRACTIONAL SHARES

A USA-based study has shown that fractional share trading leads to an increase in the stock price of high-value shares. However, this price increase is temporary in nature and is subsequently reverted.[42]

The study analyses the Fractional trading data of Robinhood, one of the top brokerage firms operating in the USA. The study concludes that fractional trade induces price fluctuations; as a result of retail herding, the high-price or high-value companies face a price overshot, followed by a reversal. This reversal is attributed to negative returns on the stock that is subsequently faced. Hence, while there is an initial inflationary trend, studies reveal that this is a temporary change and that eventually this effect would be reversed.

## VI. CONCLUSION

Permitting fractional shareholding is a double-edged sword. On one hand, it has largescale economic benefits, such as it increases retail investor participation, meets the growing demand for retail investment, increases the affordability of shareholding and also enables investors to diversify their portfolio and minimize their risk by investing smaller amounts. On the other hand, fractional shareholding also faces drawbacks such as incompatible brokerage regulations, risk of stock price inflation and issues of liquidity. The paper submits that the drawbacks of fractional shares, though important considerations, can be circumvented through various legal frameworks and proper implementation.

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[42] Zhi Da and Vivian W. Fang, *Fractional Trading* (2022), https://www3.nd.edu/~zda/FT.pdf.

Although the recommendation of the company law report permitting the issuance of and trade in fractional shares is a major step towards fractional shareholding, there has been no further action by the government in this direction. The probable reasons for not permitting fractional shareholding could be the conservative approach of India and its reluctance to adopt a non-interventionist policy which may be required for fractional shareholding. However, it is opined that India need not adopt a completely "hands-off" approach when it comes to fractional shareholding. Models adopted in countries like Japan and Canada can be adopted, wherein, although dealings take place through brokerage firms, the power vested with these firms are limited. Further, a government body can be established solely for the monitoring and regulating the activities of the stock brokers. This would ensure that fractional shareholding is carried out in line with the objective of safeguarding shareholder's interests.

# INCORPORATING SHAREHOLDER RATIFICATION IN THE COMPANIES ACT, 2013: RELEVANCE FOR CORPORATE GOVERNANCE

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## ABSTRACT

*Corporate Governance is concerned with the way a company conducts its internal business mainly focusing at this level on the interaction of the various organs of the complex corporate entities which issue securities on such regulated markets and their debt and equity investors. It seeks to provide equal rights to all the stakeholders of a corporation, including the minority shareholders. On the other hand, Corporate Democracy emanates from majority rule and provides primary rights to shareholders inclusive of ratification. Shareholder ratification is the adoption of the unauthorized actions of the directors by the majority of the shareholders. This paper analyses the concepts of shareholder ratification, corporate governance, corporate democracy, and shareholder activism to delineate a lacuna in Indian corporate law. This lacuna can be attributed to the lack of provisions on shareholder ratification in the Companies Act, 2013. This lacuna and the consequential necessity for statutory incorporation of shareholder ratification has become all the more relevant considering a recent judgment by the Securities Appellate Tribunal, wherein it was held that shareholders can post-facto ratify an unauthorized action by the director. This paper demonstrates that this judgment sets a dangerous precedent for corporate governance by allowing unrestricted power to be given to shareholders in the corporation or by over (shareholder) activism. It provides possible roadblocks and opportunities, apart from suggestions for the incorporation of shareholder ratification in the Companies Act, 2013.*

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**Keywords:** Corporate Governance, Corporate Democracy, Shareholder Ratification, Shareholder Activism, Memorandum and Articles of Association.

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## I. INTRODUCTION

Stephen Bainbridge argues that any contract entered by corporate constituents is with the corporation and not with the shareholders or directors of the corporation.[1] He argues that this *"entity-based"* understanding of the corporation is necessary since there are no mechanisms available for corporate constituents to communicate or contract with each other. The corporate constituents can only engage in contracts with the corporation which is a separate legal entity after incorporation. For example, an employment agreement is a contract entered into by the employee with the corporation, not with the directors or shareholders of the corporation. The constituents claim compensation from the contracts that they enter with the corporation and are paid before the shareholders receive profit. Therefore, the shareholders are the *"sole residual claimants"* of the corporation's profit. As residual claimants, their benefits are tied to the profit made by the corporation: if profit increases, the shareholder's benefit as a part of profit increases. The shareholder's benefit as a part of the profit made by the corporation is

[1] *The Means and Ends of Corporate Governance, in* STEPHEN BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE (Oxford University Press 2008).

dependent upon the director's ability to make sound business decisions. This dependency is because of the separation of ownership and control between the shareholders and directors in a public corporation.[2] Since external mechanisms cannot regulate complex interactions between the factors of production, internal mechanisms are responsible for management decisions. Consensus-based decision-making is largely inefficient because of a difference in knowledge, information, and interests in a corporation. Therefore, in the corporation, a centralized internal mechanism with relevant information and relative independence is authorized to make decisions.

This centralized decision maker is the Board of Directors (**"BOD"**) or the directors within. For entity-based understanding, the BOD is the 'nexus of the corporation'. The shareholders enjoy discretion to elect the BOD, but their discretion is limited to this decision. The BOD elected by the shareholders represents their interests in other business decisions that they make. Given that the director has better and more relevant information than the shareholders, the latter are vulnerable to the losses of the corporation arising from the discretion of the director. They cannot ensure that the director's performance is exactly what was promised, while the interests of other corporate constituents are protected by the contracts that they enter into with the corporation. This may motivate the director to act opportunistically and provide a service of lower quality to the shareholder causing an agency problem between the shareholder as the principal and the director as an agent.[3] The resolution of agency problems causes agency costs, for the reduction of which, a corporate governance framework is developed.

In the opinion of Palmer, corporate governance rules *"are concerned with the manner in which a company conducts its internal business mainly focusing at this*

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[2] ADOLF A. BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Transaction Publishers 1932).
[3] John Armour, Henry Hansmann, Reinier Kraakman, *Agency Problems, Legal Strategies and Enforcement,* 644 HARV. LAW AND ECON. RESEARCH PAPER SERIES, (2009).

*level on the interaction of the various organs of the complex corporate entities which issue securities on such regulated markets and their debt and equity investors"*.[4] Corporate governance includes the principles of corporate democracy, ethical conduct of business, running corporations on a trusteeship model instead of an ownership model and transparency and accountability.[5] The Indian corporate governance framework incorporates these principles into the Companies Act, 2013,[6] (**"Act"**) whereby the director is statutorily obligated to exercise a duty of care and skill towards the corporation. The director must act in good faith to promote the objects of the corporation. He must exercise due and reasonable care, skill, and diligence without causing conflicts of interest to the corporation or any undue advantage to himself or his relatives.

There is little participation by the shareholders and their interests are represented by the directors in the decision-making process. Every shareholder enjoys a limited right to participate in decision-making by voting on resolutions. This is known as the principle of corporate democracy which emanates from majority rule, whereby an individual shareholder cannot initiate legal action against the corporation for a breach of his rights.[7] Corporate democracy assumes that the shareholders are the actual owners of the corporation and should receive an opportunity to take part in the decisions that will affect them as sole residual claimants of the corporation. The members of the company may file an application with the National Company Law Tribunal if, *inter alia,* they hold more than one-tenth of the issued share capital.[8] This remedy caters to 'minority shareholders' who do not enjoy majority rule and

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[4] *Supra* Note 2.
[5] *Id.*
[6] No. 18, Acts of Parliament, 2013 (India), §166.
[7] Simran Jha, *Analysis Of Tata – Mistry Feud: A Quest For Balancing The Stakes And Upholding Corporate Democracy,* LEXFORTI (Aug. 13, 2021), https://lexforti.com/legal-news/analysis-of-tata-mistry-feud/.
[8] *Supra* Note 7, §244.

remain at a disadvantage in the decision-making process. It may be employed subject to the condition that the affairs of the company are *"oppressive and prejudicial"* to any member or the interests of the company. The winding up of the company should prejudicially affect the members, an order for which would have otherwise been *"just and equitable"*. Evidence demonstrates that this conditional limb imposes a high standard notwithstanding the nature of the offending shareholder's behaviour.[9] The high standard narrows the scope of the oppression remedy for the minorities against the opportunistic behaviour of the directors and increases the significance of a developed corporate governance framework.

In the emerging market of India, which is recovering from the Covid-19-induced economic downturn, the employment of quality governance practices by corporations is likely to increase shareholder value and protect the corporation against systemic shocks.[10] It has been found that companies with better governance index scores generate higher returns.[11] Companies with better governance are more likely to receive loans from development financial institutions.[12] If quality governance practices are not followed, shareholder rights are affected which increases agency costs and decreases investment appeal overall. To solidify India's position as a *"preferred destination"* for international investments,[13] corporate governance principles of transparency and accountability can help avoid investment scandals like that of the Sahara Group. Transparency and accountability can be secured by the mechanisms of, *inter alia*, independent directors,

[9] Devika Bansal and Naina Bora, *Analysing the Oppression Remedy in India: Is it "Just and Equitable"?,* INDIACORPLAW (May 16, 2021), https://indiacorplaw.in/2021/05/analysing-the-oppression-remedy-in-india-is-it-just-and-equitable.html.
[10] Dr. Preetha S. and Manjula R. S., *Corporate Governance in Securities Fraud Prevention, Control and Firm Value,* 5(1) J. GOV. 44, 46-49 (2022).
[11] Pitabas Mohanty, Institutional Investors and Corporate Governance in India, SSRN (2003), https://papers.ssrn.com/abstract=353820 (last visited Dec 11, 2021).
[12] Id.
[13] *Infra* Note 77.

periodic disclosures, compliances and vetting to regulators and prohibition of insider trading. These mechanisms are regulated by the Securities and Exchange Board of India (**"SEBI"**). Since SEBI's inception in 1992, India has adopted disclosure-based regulations to foster transparency and accountability in the capital market which requires corporations to disclose offer documents and annual reports to stock exchanges under a Listing Agreement.[14] An Agreement was entered into between Terrascope Ventures Limited (**"Terrascope"**) then Moryo Industries Limited – and the Bombay Stock Exchange which required the corporation to furnish details on a quarterly basis indicating the variations between the projected utilization of funds raised and the actual utilization. Since details of the variation were not furnished, SEBI imposed a penalty upon Terrascope Ventures for violating the Agreement between the corporation and the Stock Exchange.[15] In appeal, the Securities Appellate Tribunal (**"SAT"**) quashed SEBI's order to hold that a post-facto ratification of the violation by the shareholders had absolved the corporation of the liability to disclose a variation in utilization of funds.[16] In allowing post-facto ratification of the violation, the SAT's order "junked" the disclosure-based regulatory framework of corporate governance.[17] This move was especially alarming since the corporate governance framework in India does not provide for the ratification of statutory reporting requirements.

This paper demonstrates that for years Indian courts have been assessing the validity of shareholder ratification through the lens of an agency relationship. However corporate law has recently experienced a shift away from the principal-agent analysis of the shareholder-director relationship, which necessitates corporate law reform. The absence of a

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[14] Sucheta Dalal, *Does This SAT Order Junk the Very Basis of SEBI Regulations?,* MONEYLIFE (Aug. 05, 2022), https://www.moneylife.in/article/does-this-sat-order-junk-the-very-basis-of-sebi-regulations/67943.html.
[15] SEBI Adjudication Order No. Order/PM/NK/2020-21/7578.
[16] Appeal No. 116/2021.
[17] *Supra* Note 15.

principal-agent relationship between the shareholder and director creates a lacuna for shareholder ratification in India. The shareholder ratifies or adopts the directors' unauthorized action as a stranger, in the absence of an agency relationship. Undefined shareholder ratification can cause corporate democracy to exacerbate into shareholder activism where the directors become mere instruments of the majority shareholders. If majority shareholders are allowed to make business decisions, minority shareholders will be unable to exercise their rights and corporate governance will be undermined. Considering growing investment in India, there is a need to develop a provision on shareholder ratification in the Act which can help assess the validity of shareholder ratification. Part II of the paper defines the shareholder-director relationship as understood by the Memorandum and Articles of Association. Part III of the paper considers the discussion on shareholder ratification in India. This part goes into the statutory provisions, judicial discussion and the principles employed in the judicial discussion. Part IV goes into the confusion that exists about the agency nature of the shareholder-director relationship and seeks to resolve it by employing the Business Judgment Rule and Stakeholder Primacy. Lastly, Part V considers the information discussed and the way ahead for the legislature to develop a provision on shareholder ratification.

## II. SHAREHOLDER-DIRECTOR RELATIONSHIP BOUNDED BY CHARTERED DOCUMENTS

Corporate law provides that any action which a corporation - whether private, public, or one-person - undertakes is governed by the specific act, Memorandum of Association (**"Memorandum"**) and the Articles of Association (**"Articles"**) adopted on incorporation.[18] The object clause in the Memorandum provides the purpose of the corporation, for which it has been incorporated while the act provides for the bounds of legality within which the Memorandum of Association must operate. The Articles

[18] H. Fillunger & Co. Pvt. Ltd. & Ors. v. Ajit Arvind Marathe, 2017 SCC OnLine Bom 7233.

regulate the company's operations and provide authority to the directors. An action which is beyond the scope of the object clause in the Memorandum is ultra vires against the corporation. An action which is beyond the authority of the director in the Articles is intra vires. This was recognized in the seminal judgment of *Ashbury Railway Carriage & Iron Co. v. Riche* wherein the House of Lords found that the object clause in the Memorandum of Ashbury Railway Carriage and Iron Company Ltd. did not allow the corporation to provide loans to build a railway.[19]

Any action beyond the objects clause of the Memorandum of Association would be ultra vires, and consequentially null and void or without legal validity. A void action cannot be enforced against, or by, a third party even if it is accepted by every shareholder of the corporation. The acceptance of an unauthorized action by the shareholders through a resolution is known as ratification. Ratification can be defined as the approval, by act, word, or conduct, of an action which was done without authority in the first instance.[20] For an action to be ratified, it must be authorized by the Memorandum since ratification cannot legitimize an action which is without legal validity. If an action is beyond the authority of the director as delineated within the Articles but within the scope of the Memorandum, it can be ratified by the shareholders by a special resolution passed in a general meeting.[21] If the ratification is effective, the shareholder is bound as if the director had acted with authority at the time of action.

Like the shareholder-director relationship, ratification is recognized by a principal and agent. In other words, ratification can be understood as the unilateral expression of assent by the principal to be bound by a prior unauthorized action of the agent.[22] It must be understood within the

[19] (1875) LR 7 HL 653.
[20] Hartman v. Hornsby, 142 Mo 368: 44 SW 242.
[21] *Supra* Note 15.
[22] Deborah A. DeMott, *Ratification: Useful But Uneven,* 7 EUR. REV. OF PRIV. L. 987, 987 (2009).

limits and defining principles which have come to form a set of pre-conditions for valid ratification.[23] For example, the first principle says that the one undertaking the ratification (assuming, principal) must be an *"identifiable individual",* on whose behalf the other purports to perform the unauthorized action (assuming, agent). The principle must be in existence to ratify at the time when the action is performed.[24] If a principle was not in existence at the time of the action, he cannot subsequently ratify it since he lacked contractual capacity at the time of the action.[25] According to jurisdiction, ratification of an unauthorized action may or may not be barred by limitation.[26] Ratification is a jural act and has the consequences of forming a contract where it did not exist.[27] It can be done by a party that has the authority, in the form of the capacity to contract in the first instance. Privity of contract allows those who are parties to a contract, either themselves or through an authorized agent, to sue or be sued on the contract.[28] A contract cannot be enforced by or against a stranger. Neither can a contract entered by a party on his own behalf be enforced by another by ratification because ratification cannot be done by a stranger or an individual who has no relation to the contract.[29] Therefore, the ratification of an agent's unauthorized actions can be done only by the principal. The principal must have knowledge of material facts through readily accessible information and is expected to make inquiries about the contract he is ratifying.[30] The ratification must be an uncoerced expression of will on behalf of the principal.[31] For it to be valid, the action itself must be valid since a ratification cannot legitimize an action which was not

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[23] Robert Schultz, *Principles without Principals: Reconsidering Unauthorised Agency on the Boundary of Contract: Implied Warranty of Authority and Ratification,* 20 AUCKLAND U. L. REV., 20, 29 (2014).
[24] *Id.*
[25] Philip Mechem, *Rationale of Ratification,* 100 U. PA. L. REV. 649, 652 (1952).
[26] *Supra* note 23.
[27] *Supra* note 24.
[28] Tweddle v Atkinson, [1861] EWHC J57 (QB).
[29] *Supra* note 26.
[30] *Id.*
[31] *Supra* note 23.

legally valid.[32] Then how did the SAT allow Terrascope's post-facto ratification of an action which was violative of the listing agreement?

## III. SHAREHOLDER RATIFICATION IN INDIA

### A. STATUTORY FRAMEWORK

There is no statutory recognition of shareholder ratification in India. The word *"ratification"* has been employed five times in the text of the Act itself, but only two of these instances are relevant. In one instance, Section 173 allows for any decision taken in board meetings to be enforceable only when it is ratified by an independent director if the director was absent at the meeting. In the other, Section 188 authorizes the shareholders to ratify the unauthorized actions of the director in a limited context. Under Section 188, if a contract or arrangement is entered into by a director or employee with a related party without the prior consent of the board or shareholders by a resolution at a general meeting, it must be ratified either by the board or shareholders. Within this limited context, a shareholder can only ratify the action of the director or employee if he is not a related party himself. *Inter alia,* the Act defines a related party as a director or key managerial personnel or any of their relatives.

While the Act makes references to shareholder ratification, there is no explicit provision for shareholder ratification of an unauthorized action of a director. In fact, the legislature recently reduced the statutory scope of shareholder ratification by erasing the requirement of shareholder ratification of an auditor's appointment.[33] Under the Act, the discretionary power to absolve a director – or any officer of the corporation – of his negligence, default, breach of duty and misfeasance rests solely with the court after due consideration of material circumstances.

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[32] *Supra* note 26.

[33] No. 1, Acts of Parliament, 2018 (India).

### B. JUDICIAL FRAMEWORK

It is conceded that courts in India have devised rules to decide the validity of different shareholder ratification. For example, the doctrine of ultra vires as enumerated by Ashbury has been reiterated by the Indian Supreme Court in the landmark judgment of *Lakshmanaswami Mudaliar v. Life Insurance Corporation of India.*[34] In this judgment, the United India Life Assurance Co. Ltd. was set up with the principal object of carrying on the life insurance business. A shareholder resolution was passed to donate shareholder dividend to a charity which promoted technical or business knowledge in insurance. It was decided that an action which is impermissible by the objects clause and provides some *"indirect or remote benefit",* would be ultra vires against the corporation and could not be enforced even if all the shareholders provide their assent to be bound by the action. Similarly, in *Banaji v. Manilal,*[35] the Bombay High Court held that the directors cannot take recourse to ratification of their breach of duty, where they are the sole shareholders themselves. The same High Court has also provided that the validity of shareholder ratification is subject to transparent disclosure of material facts and the true nature of the breach of duty to the shareholders. The disclosure of material facts would enable shareholders to make an informed decision for ratification.[36] The Privy Council in this judgment held the ratification invalid because there was no knowledge of the transaction. There could be no ratification without an intention to ratify, and there could be no intention to ratify the illegal action without knowledge of the illegality. For knowledge of illegality, there must be a notice to the shareholders that the action was done without authority.[37] Thus, the unauthorized action must be notified in a manner which would attract the attention of persons of ordinary care. There must be adoption of the unauthorized action by acquiescence or an

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[34] 1963 AIR 1185.
[35] AIR 1956 Bom 681.
[36] Smt. Premila Devi & Others v. Peoples Bank of Northern India Ltd., (1939) 41 BOMLR 147.
[37] T. R. Pratt (Bombay) Ltd. v. E.D. Sassoon And Co. Ltd. And Anr., AIR 1936 Bom 62.

overt act which would allow the action to continue with authority. If it is demonstrated that shareholders were willfully not informed or consulted about the illegal action, the ratification of the action will be vitiated by mala fides.[38] If the action itself was valid or authorized or it could be subsequently ratified, the court will not interfere.[39] There must be distinct proof that the ratification was done in accordance with the statutory formalities and a mere presumption of assent on behalf of the shareholder is insufficient for a valid ratification.[40] Therefore, an action will not be invalid because the exercise of authority is irregular when the manner of performance is different from that directed by authorization.[41] This must be distinguished from actions where there is a complete execution of an authority, but the director has done more than the authority. The action will be bad only as to the excess authority. If there is not a complete execution of authority, or the boundary between excess authority and rightful execution cannot be distinguished, the action will be ultra vires. An ultra vires action cannot be ratified.[42]

### C. ANALYSING TERRASCOPE VENTURES LIMITED V. SECURITIES AND EXCHANGE BOARD OF INDIA

Recently, the SAT enjoyed the opportunity to further develop the Indian framework for shareholder ratification of unauthorized actions of the director. This opportunity arose in *Terrascope Ventures Limited v. Securities and Exchange Board of India*.[43] To elaborate on the limited facts discussed above, the struggle between SEBI and Terrascope began in 2012, when Terrascope obtained shareholder approval for issuing 63,50,000 preference shares. Shareholder approval was obtained for the

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[38] C. D. S. Financial Services v. B. P. L. Communications Limited, 2004 121 CompCas 374 Bom.
[39] Shanta Genevieve Pommeret v. Sakal Papers Pvt. And Ors., 1990 69 CompCas 65 Bom.
[40] The New Fleming Spinning v. Kessowji Naik And Ors., (1885) ILR 9 Bom 373.
[41] Deonarayan Prasad Bhadani v. Bank Of Baroda Ltd., (1956) 58 BOMLR 1056.
[42] *Supra* note 20.
[43] *Supra* note 17.

proceeds of this preferential issue to be used for *"capital expenditure including acquisition of companies/business, funding long-term working capital requirements, marketing, setting up of offices abroad and for other approved corporate purposes"*. However, the proceeds from the preferential issue were used for purchasing shares of other companies and extending loans and advances to other companies and entities. Five years after the preferential issue, the majority shareholders of Terrascope passed a shareholder's resolution for the ratification of the unauthorized actions of the directors, of utilizing the proceeds from the preferential issue for purposes different than what was agreed to by the shareholders. The validity and effect of the ratification was not accepted by the regulatory authority. Terrascope argued before SEBI that the Memorandum of Association had been amended by way of a special resolution in a general meeting to include financing, investment and share trading. However, SEBI, through its Adjudicating Officer, did not agree with this reasoning for a post-facto amendment could not legitimize the illegality of an *"earlier exercise"* by the directors. SEBI applied a similar reasoning when deciding the contentions on ratification. Terrascope submitted that its shareholders had provided their approval to *"all acts, deed and things done by the corporation in entering into and giving effect to the utilization of proceeds in the said preferential issue which is in variance to the objects as stated out in the Notice of the EOGM"* by a special resolution passed in a general meeting. The regulatory authority decided that subsequent ratification could not legitimize a past illegal action of the directors. Therefore, the objects of the issue were not true and consequentially, the applicants of the preferential issue had been misled, while Terrascope was in violation of the Listing Agreement as it had not made a disclosure of the variance discussed above.

In a complete reversal, the SAT struck down SEBI's order. The SAT found that the shareholders of Terrascope had ratified the actions of the directors in utilizing proceeds towards investment and loans to other companies, investment and loans to other companies had become the object for utilization of the proceeds. It relied upon the judgment of

*National Institute of Technology v. Pannalal Choudhury,*[44] which explained the meaning of ratification as the *"making valid of an act already done"*. The judgment discussed the Latin maxim of *"ratihabitio mandato aequiparatur"*, which means *"a subsequent ratification of an act is equivalent to a prior authority to perform such act"*. The SAT concluded that ratification means making valid an act already done, and the shareholder ratification by a special majority in a general meeting had corrected any violation by providing the directors with authority that they had previously lacked. Therefore, it was incorrect of SEBI to conclude that the past illegal acts or deeds could not be legitimized by subsequent ratification. Since there could be no variation after shareholder ratification, there was no question of disclosure under the listing agreement by non-disclosure of variation.

This judgment justified the violation of the disclosure-based regulatory framework adopted by the Indian corporate governance regime. Further, the SAT's reasoning raises questions of legitimacy. The judgment of *NIT v. Pannalal Choudary,* which forms the crux of the SAT's reasoning, discusses ratification by a Board of Governors akin to a board of directors rather than shareholders of the university. In this judgment, the respondent, Pannalal Choudary, functioned as the Registrar and Deputy Registrar of Accounts at the National Institute of Technology at Silchar, Assam. It was noticed in the audits of the university, that the respondent had committed several financial and administrative irregularities while functioning in the position. Because of these irregularities, the respondent was dismissed from the services of the university by a decision of the Principal and Secretary of the Board of Governors. The respondent filed a writ petition before a single judge bench of the High Court, on the ground that the dismissal order was passed by the Principal and Secretary without authority. The respondent alleged that the authority to dismiss was with the Board of Governors, who had not delegated this authority to the Principal and Secretary. The respondent argued that the dismissal order was against the Assam Services

[44] Civ. App. 5070/2008.

(Discipline and Appeal) Rules, 1964. In opposition, the university argued that the dismissal order was within the Rules since the action against the respondent was *"proposed, initiated and eventually taken"* by the Board of Governors. The Board of Governors had approved the dismissal as well. The Board of Governors had not only delegated their authority to the Principal and Secretary but also approved the entire action including the dismissal order. Any action taken by the Principal and Secretary stood ratified and became legal and proper from the date they were conducted. The court considered the issue from two perspectives, one of the authority of the Principal and Secretary in passing the dismissal order, and the other of the effect of ratification by the Board of Governors. For the present discussion, the latter perspective is of relevance. In this perspective, the court depended upon its reasoning in *Parmeshwari Prasad Gupta v. Union of India,*[45] wherein the Chairman of the board had terminated the services of the General Manager after a resolution of the board. It was accepted that the resolution was invalid since the meeting of the board was improperly held. Subsequently, the board convened a meeting where it ratified the earlier resolution of terminating the services of the General Manager. The court held that the earlier resolution was invalid, and the Chairman's action of termination was unauthorized. However, the board could subsequently ratify the termination since the Chairman had acted *"on behalf of the company"*. The ratification would date back to the unauthorized action and the termination of the General Manager would be valid. The court in *Pannalal Choudary* also went on to discuss the judgment in *Maharashtra State Mining Corporation v. Sunil,*[46] wherein the respondent was an employee of the Maharashtra State Mining Corporation and was dismissed therefrom by the Managing Director. It was contended by the respondent that at the relevant time, the Managing Director did not have the authority to dismiss him. The court decided that an action by an incompetent authority would not be valid, but the act could be retrospectively validated by way of ratification by the board. In

[45] [9740] 44 Comp Cas 1 (SC).
[46] (2006) 5 SCC 96.

these judgments, the Supreme Court looks at ratification as the adoption of the director's unauthorized actions by the shareholder which is traditionally employed in agency law.

## IV. AGENCY NATURE OF THE SHAREHOLDER-DIRECTOR RELATIONSHIP

DeMott argues that it seems natural to think that the shareholders are principals and directors are their agents.[47] An agency relationship arises when the principal agrees to be bound by the actions done by the agent on his behalf which are done according to the principal's control. The shareholder-director relationship arises out of consensual association, and the decisions of the directors affect the shareholders. The director of a corporation enjoys the apparent authority to bind the corporation to any transaction which he is permitted to enter into by way of the Memorandum and authorized by the Articles.[48] Like an agent, he owes a fiduciary duty to the corporation. While actions beyond the Memorandum are null and void, shareholder ratification plays a significant role by retrospectively adopting the action of the director which is beyond his authority. Shareholder ratification retrospectively authorizes the director to act, subsequently binding the corporation by his actions. The director's authority is dragged back to the date on which the action was done, better known as *ratihabitio mandato aequiparatur* in the judgments discussed. An expanded form of this doctrine of *"Omnis ratihabitio retrotrahitur et mandato priori aequiparatur"* can be found in discussions on ratification. The adoption or affirmation of the director's unauthorized actions by the shareholders must be distinguished from the exoneration or release of the director from personal liability by ratification. The two views of ratification are distinct, and the adoption of the director's unauthorized action does not imply impunity from a subsequent personal action by the

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[47] Deborah A. DeMott, *Shareholders as Principals,* KEY DEVELOPMENTS IN CORPORATE LAW AND EQUITY: ESSAYS IN HONOUR OF PROFESSOR HAROLD FORD 105 (2002).

[48] Pearlie Koh, *Directors' Fiduciary Duties: Unthreading the Joints of Shareholder Ratification,* 5 J. CORP. L. STUD. 363, 367-368 (2005).

shareholders.[49] If the director breaches his fiduciary duty by an unauthorized action, the shareholders may adopt the action, but the adoption does not extinguish the shareholder's claim against the director on grounds of negligence. The extinguishment of a claim against the director arises from the trust concept of release. While adoption of an unauthorized action can be done after a breach of a legal obligation, the director can be released retrospectively or prospectively in anticipation of a breach. The shareholders who released the director from personal liability by ratification are estopped from subsequently bringing a claim against the director. The employment of the adoption of unauthorized actions by the Supreme Court demonstrates the view that the directors are the agents of the shareholder and are subject to their *"superior control"*. This view has seen a fundamental shift in recent years in the persistence of business judgment and stakeholder primacy.

In contrast to the fiduciary duty owed by the directors to the corporation, the relationship between the shareholders and the corporation can be of two kinds: actual and legal relationship.[50] The actual relationship between the shareholders and the corporation extends to the money invested into the corporation for the purpose of benefit as a part of the profit. The shareholder is not concerned with how the corporation is able to generate money, as long as it does. The shareholder's lack of concern is not a product of incompetency but rather that of the division of control between the shareholders and management. The shareholders are assumed to lack time, expertise, and incentive to participate in the management and remain dependent upon the experienced and skilled BOD to take management decisions. Because of directorial discretion - in true republican fashion - these directors are in the nature of representatives of the shareholders, and the latter enjoys the authority to elect the BOD as per discretion. The absence of shareholder control,

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[49] Id., 370-373.

[50] Paula J. Dalley, *Shareholder (and Director) Fiduciary Duties and Shareholder Activism,* 8 HOUS. BUS. & TAX L. J. 301, 306-314 (2008).

juxtaposed against control by the directors arranges the corporation as a republic rather than a corporate democracy, where every shareholder plays a role in decision-making. This is the sole legal relationship that subsists between the shareholders and the corporation, in contrast to the fiduciary duty of the directors.

### A. BUSINESS JUDGMENT RULE

There is some debate as to whom the director owes this fiduciary duty. Agency is the fiduciary relationship that arises when the principal manifests assent to the agent that the agent shall act solely on the principal's behalf. If it is assumed that the director owes a fiduciary duty to the shareholder and acts on his behalf, it is of relevance whether the agency relationship between the director and shareholder is individual. DeMott argues that the problem with considering majority shareholders as one body instead of considering the individual relationships between directors and shareholders since the body of majority shareholders does not remain constant and escape the definition.[51] Under agency law, the principal can be made liable for the actions of the agent done on behalf of the principal. This limitation of agency law is avoided by incorporation since a shareholder cannot be made liable for the obligations entered into by the director, nor can his assets be claimed by a third party because of the director's actions. The actions of the director cannot be on behalf of the shareholder since the shareholder cannot be personally bound by the actions of the directors. The shareholders do not exercise any real control over the directors beyond their selection. The directors are obligated to exercise their expertise and judgment in coming to management decisions and their decisions are not subject to the directions of the shareholders. Business judgment prevents shareholders from challenging the decisions of the directors. If the directors are not dealing with themselves and have

[51] *Supra* note 48.

provided the shareholders with material information before the decision, their decision cannot be challenged before a court.[52]

The limitations of the doctrine have been elaborated in *Cede v. Technicolor,*[53] wherein the court provided that the action must be performed with good faith, due care, and loyalty to qualify as business judgment. In India, the court will not interfere if the director's conduct was *"just, fair and reasonable, according to a reasonable businessman, taking a commercial decision beneficial to the company"*.[54] Under the Act, an officer of the corporation may enjoy impunity in proceedings for negligence, default, breach of duty, misfeasance, or breach of trust, if the court is of the opinion that he acted honestly and reasonably with due regard to the circumstances.[55] The Act makes provision for an interested director to disclose his interest in the transaction at the board meeting.[56] Section 179 empowers the BOD to do all such acts as the company is empowered to do. It does not distinguish between the powers of the non-executive/independent directors and the executive directors. It has been argued that this provision has been misconstrued to impose liability upon the non-executive/independent directors notwithstanding their limited involvement in the decision-making of the company.[57] For example, a director *"in charge"* of the business of the company and responsible to the company for the business of the company can be held vicariously liable for the offences committed by the company.[58] A director would be *"in charge"* if he is in overall control of the daily business of the company. A

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52 Dhvani Shah, *Analyzing the Business Judgement Doctrine in the Indian Context,* INDIACORPLAW (Aug. 3, 2022), https://indiacorplaw.in/2022/08/analyzing-the-business-judgement-doctrine-in-the-indian-context.html.

53 634 A. 2d 345 (Del. 1993).

54 Miheer H. Mafatlal v. Mafatlal Industries Ltd., JT 1996 (8) 205.

55 *Supra* note 7, §463(1).

56 *Supra* note 7, §184.

57 Bharat Vasani, *Vicarious Liability of Non-Executive Directors: A Case for Reform of Law,* CYRIL AMARCHAND MANGALDAS (Nov. 11, 2020), https://corporate.cyrilamarchandblogs.com/2020/11/vicarious-liability-of-non-executive-directors-a-case-for-reform-of-law/#_ftn2.

58 KK Ahuja v. V.K Arora, 2009 10 SCC 48.

director cannot be held vicariously liable for the offences of the company on the basis of merely holding a designation or office in a company.[59] To avoid the imposition of liability upon the non-executive/independent directors, the Act adds another layer of protection for them by way of Section 149(12). Under this section, non-executive and independent directors will not be held liable for *"omissions or commissions"* by a company unless it was done with his knowledge, consent and connivance or because of his negligence. The Ministry of Corporate Affairs has issued a circular providing that civil or criminal proceedings should not be instituted against independent directors unnecessarily.[60] The burden of proof is on the regulatory authority to demonstrate that the independent director had breached his fiduciary duty.[61] Even though the director's discretion is limited by objects in the Memorandum and authority in the Articles, he enjoys the authority to make business decisions without interference by shareholders. Business judgment protects the director against frivolous litigation which may hamper his ability to make business decisions efficiently; corporate law avoids dilution of this authority of the director. If it is assumed that the director is an agent of the individual shareholder, the latter would be empowered to revoke the director's authority at any time even if there exists a contract to the contrary effect.[62] Such an assumption conceptualizes a situation, where the directors would have the authority to contract with any third party subject to confirmation by the shareholders. This assumption would affect directorial discretion and consequentially retard business growth.

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[59] S.M.S. Pharmaceuticals Ltd. v. Neeta Bhalla, 2005 8 SCC 89.

[60] Ministry of Corporate Affairs, *Clarification on Prosecutions filed or internal adjudication proceedings initiated against Independent Directors, non-promoters and non- KMP,* Mar. 2, 2020, https://www.mca.gov.in/Ministry/pdf/Circular_03032020.pdf.

[61] Id.

[62] *Supra* note 48.

### B. STAKEHOLDER PRIMACY

Apart from the shareholder, fiduciary duty is owed to stakeholders including the employees, creditors, and customers of the corporation. The shift from shareholder to stakeholder primacy undermines the principal-agent analysis of the shareholder-director relationship. While agency law assumes that the agent will act on behalf of the principal, stakeholder primacy provides that the director's decisions affect every stakeholder of the corporation. The director is expected to act in the best interests of all stakeholders of the corporation. In his New York Times essay, Milton Friedman theorized that the social responsibility of a business is to increase its profits.[63] He referred to the shareholders as owners of the corporation and corporate assets of the corporation. Contractarian corporate scholars like Easterbrook and Fischel assume that the shareholders are the actual owners of the corporation while control is exercised by the directors who are the agents of these shareholders.[64] They have argued that a corporation is a *"nexus of contracts"* between the corporation and several participants who look to profit from their contribution to the corporation. What Friedman and the contractarian scholars fail to acknowledge is that the shareholders neither control the assets of the business nor are they entitled to dividends. They cannot make a direct claim on the corporation's earnings because, in contrast to the theory of the sole residual claimant, shareholders are not the only group affected by the decisions made by the director.

Managers and employees make large investments in the firm in the form of human capital. They invest their effort and time to benefit the firm with the expectation of rewards in the form of benefits and remuneration in the long run. These rewards are dependent upon the profits of the corporation from sound business decisions. Their

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[63] Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board,* 79 WASH. U. L. Q. 403, 409 (2001).
[64] FRANK H EASTERBROOK & DANIEL R FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

expectations are not enforceable against the director, and the managers and employees depend on the director to act in good faith to achieve the best interests of the corporation. Since there are multiple groups affected by the decisions of the director, it is impossible for the shareholder/stakeholder debate to satisfactorily rest on either end. No corporation can continue its operations in the long term without providing shareholder value.[65] In the absence of shareholder value, the corporation will be unable to attract investors. On the other hand, no corporation can simply ignore the interests of the corporation's stakeholders to increase shareholder value. Realistically, when a corporation shows concern for the interests of its stakeholders, its profitability and shareholder value are likely to experience an increase. Boeing is a famous example of the limitation of shareholder primacy. Boeing was threatened by its European competitor, Airbus.[66] To meet competition, Boeing's management pushed aggressively for premature approval for a faulty jet. Since the United States regulatory system allowed the Federal Aviation Administration to shift the responsibility of safety inspections to Boeing itself, the faults in the jets went ignored. Boeing's focus on shareholder primacy led to 737 crashes in Indonesia and Ethiopia causing 642 deaths and losses of approximately (USD) 86 billion. These losses included the expenses of fixing the aircraft, compensating the company's customers, and lost or cancelled orders for the aircraft. An additional two and a half billion was spent to settle a criminal probe by the Justice Department.

Recognizing the relevance of stakeholder primacy, Indian corporate law has moved away from shareholder primacy to stakeholder primacy with the introduction of Section 166(2) in 2013. Placing reliance on legislative debate and history, Varotill concludes that a director governed by Indian corporate law and Section 166(2) of the Act, has a duty to act in

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[65] *Supra* note 51.

[66] Peter Georgescu, *Boeing and Business Governance,* FORBES (Apr. 17, 2019), https://www.forbes.com/sites/petergeorgescu/2019/04/17/boeing-and-business-governance/?sh=65e1de477d98.

good faith to promote the objectives of the corporation which is in the interests of the corporation and all the stakeholders.[67] Under the Act, there is no independent duty of the directors to the stakeholders, but the directors must promote the objectives of the corporation which will further the interests of the stakeholders. Therefore, it can be said that there has been a fundamental shift in recent years, away from the assumption of a principal-agent relationship between the shareholder and director (**"the shift"**). The shift is a result of the persistence of business judgment and stakeholder primacy.

### C. IMPLICATIONS OF THE SHIFT & THE WAY AHEAD

Privity of contract tells us that a stranger cannot act upon an agency contract or appropriate an agency contract. Privity of contract, coupled with the shift, creates a lacuna in the ratification of unauthorized actions of the director by the shareholder. The shift or the absence of a principal-agent relationship between the shareholder and director creates a situation where the shareholder adopts the unauthorized actions of the director as a stranger (to a contract). The shift or the absence allows courts to validate a form of over (shareholder) activism, where the majority shareholders exploit their majority rule in the corporation to manipulate directorial discretion. In the absence of a principal-agent relationship between the shareholder and director, there are no recognized limits to shareholder ratification. Thus, when regulatory authorities such as SEBI raise questions about the unauthorized actions of the directors, the actions can be post-facto ratified to escape penalization. Over-activism undermines the Arrowian model of the corporation discussed by Bainbridge by shifting managerial discretion from the directors to the shareholders.[68]

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[67] Mihir Naniwadekar and Umakanth Varottil, *'The Stakeholder Approach towards Directors' Duties under Indian Company Law: A Comparative Analysis'*, in MAHENDRA PAL SINGH (ED.), THE INDIAN YEARBOOK OF COMPARATIVE LAW 2016 (Oxford Academic 2019).

[68] Supra note 2.

The Arrowian model centralizes decision-making power in the directors to maximize efficiency. There is dependence upon the experience, judgment, and knowledge of the directors after separating the shareholder's rights from the responsibilities of the directors. While corporate democracy requires participation by the members of the corporation, there is mob rule if the decision-making authority of the directors is undermined, and it is turned into an instrument under shareholder control. Owing to the power dynamic within a company, such a BOD may result in oppression and mismanagement of the minority shareholders. A BOD which has been reduced to an instrument under shareholder control, cannot be independent or representative of stakeholder interests including minority shareholders, employees, or managers. A corporation operating without directors who enjoy the authority to make decisions, not only undermines the corporate governance framework but is beyond the boundaries of the Act which requires directors to consider stakeholder interests.

Other common law countries including the United States have incorporated shareholder ratification in their corporate statutes, which has allowed for greater transparency and accountability. In Delaware, the ratification of an action must be followed by the filing of a certificate with the Secretary of State.[69] Similarly, Nevada requires such filing within ten days of approval of ratification of an unauthorized action. Both corporate legislations provide for a fixed limitation for filing an appeal against the ratification and a fixed quorum for passing a resolution for ratification. In the United Kingdom, the U.K. Companies Act, 2006 expressly provides for the exclusion of directors and their connected parties in the relevant votes for passing the ratification resolution.[70] While other common law countries have statutorily recognized the power of the shareholders to

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[69] Nate Emeritz, *The Development of Statutes for Ratification and Validation of Defective Corporate Acts,* HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Jul. 28, 2019), https://corpgov.law.harvard.edu/2019/07/28/the-development-of-statutes-for-ratification-and-validation-of-defective-corporate-acts/.

[70] United Kingdom Companies Act 2006, c. 46, §239.

ratify unauthorized actions of the directors and provide guidelines for ratification, the Act is devoid of these provisions. In fact, ratification has been upheld by Indian courts even with underdeveloped judicial discussion. In the absence of statutory or developed judicial recognition of shareholder ratification, there are no mechanisms to determine the legal validity of any ratification. Indian courts have moved towards the disinterested shareholder model in shareholder ratification, where the directors that hold sole shareholding cannot ratify their wrongdoing.[71] Under the Act, only the disinterested shareholder can ratify a material-related party transaction.[72] This move is to ensure that the ratifying shareholders will act for the benefit of the corporation. However, it cannot be guaranteed that the minority shareholders will act in the best interests of the corporation, as the shareholders may be motivated by the impact of litigation on the value of their shares.[73] This can be prevented by adopting mechanisms including rules and institutions to ensure that the shareholders are well-informed, independent and acting in the best interests of the corporation.

## V. CONCLUSION

In India, there has been a fundamental shift away from the principal-agent analysis of the shareholder and director relationship. This shift has been because of the persistence of business judgment and stakeholder primacy. While earlier it was understood that the director, as an agent, acts according to the wishes of the shareholder, it has been realized that efficient decision-making of the director requires otherwise. The court will not interfere in the decision-making of the director if his actions are just, fair, and reasonable, according to a reasonable man taking a commercial decision which is beneficial to the company. The director has a fiduciary duty to make the best decisions for the corporation, but what about the shareholders? Stakeholder primacy addresses this question: the director

[71] *Supra* note 36.
[72] *Supra* note 7, §188.
[73] Ji Lian Yap, *Reforming Ratification,* 40(1) COMM. L. WORLD REV. 1, 4 (2011).

does not owe a fiduciary duty to the shareholder, but to the stakeholders of the company in achieving the best interests of the company. This absence of a principal-agent relationship between the shareholder and director, coupled with the privity of contract allows shareholders to ratify the unauthorized actions of the directors as a stranger (to the contract). There are no defining limits to shareholder ratification; the Act is silent on shareholder ratification while judicial discussion is underdeveloped. Owing to the lack of statutory guidelines, the SAT employed a reasoning in *Terrascope* which will set a dangerous precedent for minority shareholders claiming oppression and mismanagement. The shareholders can utilize the directors to do their bidding, who depend upon the shareholders for their selection. If the director acts beyond the Articles but within the Memorandum, the shareholder can post-facto ratify the action. The process subdues the authority of the developed body of corporate law and the Act. If shareholder ratification is not appropriately incorporated into the Act, it may result in oppression and mismanagement of minority shareholders and class actions which would affect the shareholder value of the corporation.

Even in the absence of statutory guidelines for shareholder ratification, the Indian corporate sector continues to expand with an inflow of $80 billion of foreign direct investment in 2021-22.[74] This number is the result of reforms introduced by the Indian government to boost domestic and international investment after the Covid-19-induced economic downturn in the country. These reforms include *inter alia,* the promotion of the Make-In-India campaign, which was launched in 2014 to facilitate investment, foster innovation, and build high-quality infrastructure. These reforms have caused total investment proposals

[74] *FDI inflows to India may cross $100 billion in 2022-23: Government,* THE TRIBUNE (Sep. 24, 2022), https://www.tribuneindia.com/news/business/fdi-inflows-to-india-may-cross-100-billion-in-2022-23-government-434980.

since the reopening of the economy to steadily increase.[75] In June 2022, India was labelled a *"preferred investment destination"* with a *"liberal and transparent"* FDI policy that makes it an *"attractive and investor-friendly"* destination.[76] This increase in corporate investment makes it imperative to incorporate shareholder ratification and accompanying guidelines in the Act. In the development of a provision, consideration of stakeholder views may be difficult, especially for widely held corporations. India has seen its fair share of investor scams because of the failed implementation of corporate governance, but restricting the role of shareholders may affect the value of the corporation. The development of a provision would be a fine balance between ensuring the progress of the Indian corporate sphere and ensuring effective corporate governance. However, the Act has well-developed provisions on the fiduciary duties of a director and the enforceability of the Memorandum and Articles. The development of a provision for shareholder ratification in the Act is not only possible but imperative.

[75] George Mathew, *New investment proposals up 71% in 2022 as economy strengthens*, INDIANEXPRESS (Jan. 9, 2023), https://indianexpress.com/article/business/economy/new-investment-proposals-up-71-in-2022-as-economy-strengthens-8369225/.

[76] *India emerging as preferred destination for foreign investments: Govt,* THEBUSINESSSTANDARD (June 26, 2022), https://www.business-standard.com/article/economy-policy/india-emerging-as-preferred-destination-for-foreign-investments-govt-122062600035_1.html.

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