ISSN: 0976-0369 VOL II No. 2 YEAR 2017

JOURNAL ON GOVERNANCE

[Volume II, Issue 2]

Special Edition on Corporate Law and Governance and focuses on the theme *"RBI and SEBI: The evolved gatekeepers to the Indian Financial system post 2014"*

FOREWORD

MR. RISHI ANAND, Cyril Amarchand Mangaldas

ARTICLES

MR. ARMAAN PATKAR, *Insider Trading: When does information become UPSI?*

MR. ARPIT GUPTA, *Listing of stock exchanges in India: Understanding the motivation behind 'going public'.*

MR. SHASHANK CHADDHA, *Merger and Acquisition in India: Trends on Squeeze Outs and Rights of Minority Shareholders.*

MR. ANURAG GUPTA AND MS. SUSHMA REDDY, *SEBI's Brightline Test on Control: The Right Way to Move Forward'.*

MS. ISHANI NARAIN AND MS. GARIMA, *A New Perspective on Dealing with Stressed Assets in India: An Insight into RBI's Role in Stressed Assets Management post 2014'.*

MS. LAKSHMI DWIVEDI AND MR. PRANAV AWASTHI, *P2P Lending: Regulating the New Kid on the Block.*

TABLE OF CONTENTS

MR. RISHI ANAND, *Foreword* 3

MR. ARMAAN PATKAR, *Insider Trading: When Does Information Become UPSI?* 7

MR. ARPIT GUPTA, *Listing of stock exchanges in India: Understanding the motivation behind 'going public'* 28

MR. SHASHANK CHADDHA, *Merger and Acquisition in India: Trends on Squeeze Outs and Rights of Minority Shareholders.* 42

MR. ANURAG GUPTA AND MS. SUSHMA REDDY, *SEBI's Brightline Test on Control: The Right Way to Move Forward'* 50

MS. ISHANI NARAIN AND MS. GARIMA, *A New Perspective on Dealing with Stressed Assets in India: An Insight into RBI's Role in Stressed Assets Management post 2014'.* 69

MS. LAKSHMI DWIVEDI AND MR. PRANAV AWASTHI, *P2P Lending: Regulating the New Kid on the Block* 87

FOREWORD

An academic write-up or an article is aimed at exchanging and disseminating knowledge with peers, both locally and internationally. While an author seeks a publisher best suited for circulating his work, a publisher or a journal has an ever more arduous task of selecting a handful of manuscripts from amongst the many received for publication. The Journal of Corporate Law and Governance ("**JCLG**") has the responsibility to ensure that each article published on the JCLG offers a new insight on a particular subject, while conforming to the basic theme and objectives of the Journal itself.

The composition of an article is the last leg of an author's journey starting from a thought, winding through rigorous research and culminating into a manuscript fit for publication. A few such journeys have been carefully picked and ensembled in this issue of the JCLG, on the central theme of '*RBI and SEBI: The evolved gatekeepers to the Indian Financial system post 2014*'. The Reserve Bank of India ("**RBI**"), which regulates the Indian banking sector, and the Securities and Exchange Board of India ("**SEBI**"), which regulates the money market and the stock markets, had all eyes upon them and they were to live up to the expectations of multiple stakeholders in their relevant areas. The burden of maintaining an economic growth rate of over 7% and the tag of fastest growing economy had brought these two institutions into limelight whereby their policies were not only discussed at several platforms, but were also subjected to careful scrutiny both within and without India. The year 2014 turned out to be an important one not only from the viewpoint of electoral politics but also from the aspect of societal aspirations towards realization of economic potential. Consequently, the developmental agenda and economic growth at both micro and macro level took centre stage of the political dialogue. The sudden twists in the tale and the electoral promise of ushering a new dawn of economic reforms have made the two regulators extremely pro-active and vigilant and have brought various positive and strong changes at both the legislative and policy level.

On account of the changed dynamics and given the importance attached to these two crucial financial regulators in India, the present edition of the JCLG squarely fits within the broader objective of kick-starting the academic discourse on the newly discovered path, spearheaded by these two regulators. JCLG is indeed playing an exceptional role in continuing its tradition of maintaining an active discourse in area of such niche importance and deserves commendation for having established itself as a lighthouse of the publication world (specifically in the area of corporate law and governance). JCLG has worked consistently towards identifying and promoting top quality manuscripts, which emphasize originality, coherence and clarity backed by deep and thought-provoking research. It gives me immense pleasure to introduce Volume II,

Issue 2, 2017 of the Journal of Corporate Law and Governance, a publication which has made great progress and received well-deserved recognition from the legal research community. Now, with a hope that an informed reader will benefit from the wide array of articles covered in this year's issue, I have attempted below to briefly highlight the works of each of the authors covered in the present issue of the JCLG.

The article on '*Insider Trading: When does information become UPSI*' by *Mr. Armaan Patkar* offers a well researched and deep insight into the controversial, tricky and often debated issue of when does an information start qualifying as an UPSI. The article's focal point is that UPSI may not only arise during formal corporate process but may also arise during negotiations or even informal discussions initiated for a proposed M&A or restructuring. While analyzing the above question in view of the SEBI (Prohibition of Insider Trading) Regulations, 2015 ("**2015 Regulations**"), an attempt has been made by the author to draw a comparative analogy with the SEBI (Prohibition of Insider Trading) Regulations, 1992. The author also draws strength for his conclusions by scrutinizing several cases from different geographies of the world, involving UPSI related aspects and in the process illuminates upon an otherwise ambiguous position of law. The article acts as a strong pedestal to analyze the evolved approach taken by SEBI and the Securities Appellate Tribunal, with the release of 2015 Regulations, aimed at the greater objective of transparency and elimination of corrupt rudiments in corporate culture.

When the stock exchanges of our country namely NSE and BSE decided to go public with their own IPO, several questions were raised as to the need and the mechanics of such a listing. In such a scenario, the role of financial watchdog transferences from merely being a supervisory body to a participatory body where the actions require both command and execution with equal balance of aspiration and caution. Being a leading corporate law journal, sticking to its principle theme of this year, a discussion of this important development could not have been missed.

'*Listing of stock exchanges in India: Understanding the motivation behind going public*' by *Mr. Arpit Gupta* discusses the significant development of initial public offering by BSE and NSE. The author takes a critical view of the decision and suggests the possible reasons behind such a choice. The article analyses the existing legal framework in context of ownership of stock exchanges in India and the possible risks and concerns involved. The prime issue of corporatization and demutualization is discussed comprehensively through the course of this article along with plethora of other regulations such as, Securities Contracts (Regulation) (Manner of Increasing and Maintaining Public Shareholding in Recognized Stock Exchanges) Regulations, 2006 and Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012 among others. The article aims at providing the reader a bird's eye view of the legal

framework for ownership and listing of stock exchanges which collectively address all concerns of the relevant stakeholders facilitating them with an informed decision making.

The critical aspects of M&A deals is touched upon by the next article titled *'Merger and Acquisition in India: Trends on Squeeze Outs and Rights of Minority Shareholders'* by *Mr. Shashank Chaddha* which analyses the meaning of the term 'minority shareholders'. The author does not mince his words in suggesting that it is not a legislative term *per se* and judicial deliberation over the same is essential for examining the trends in India. The author carefully proceeds with the judicial analogy which is developed on the sensitive issue over the years and intends to elucidate the cautious approach adopted by courts favoring the minority shareholders in M&A deals citing issues of oppression. The reader not only gets a sense of the problem underlying M&A deals but is also informed about various options available to majority shareholders to avoid the *catch 22* situation of oppression and mismanagement. The author further highlights the recourse available to minority shareholders under both the Companies Act, 1956 and the new act of 2013. The article culminates by stating that a holistic settlement with regard to minority protection is essential and only after all sections of the new Act are notified, will we understand the true governance status in numerous companies *vis-a-vis* the principles of good governance and accountability.

As a step towards investor protection, the SEBI, on March 12, 2016, proposed a policy framework to set out the '*Brightline Test'* for acquisition of 'control' under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. SEBI has suggested two options for determining the exercise of 'control': a list of protective rights not amounting to control and a numerical threshold of 25% amounting to control. In their article *'SEBI's Brightline Test on Control: The Right Way to Move Forward'*, *Mr. Anurag Gupta* and *Ms. Sushma Reddy* lucidly analyse SEBI's discussion paper, focusing on the problems with the existing concept of 'control' and questioning the need for a Brightline Test to determine the trigger for a mandatory bid requirement. The authors have given a very interesting critique, pointing out the flaws and issues in adopting the Brightline Tests in exclusion of a subjective approach. Some of these include the suitability of a 25% threshold, and the ripple effect of the definition of 'control' on other regulations. However, the article concludes on a positive note, as the authors believe that the Tests may bring more certainty to the law of takeovers in India, provided it is adopted cautiously and supplemented by the *de facto* approach.

Stressed assets are a powerful indicator of the health of the banking sector. RBI has periodically set out guidelines and policies, in order to regulate Non-Performing Assets (NPA), but unfortunately they failed to nip the problem in the bud as they offered temporary solutions to

long-term issues. In their article, '*A New Perspective on Dealing with Stressed Assets in India: An Insight into RBI's Role in Stressed Assets Management post 2014*', *Ms. Ishani Narain* and *Ms. Garima* examine the latest guidelines by the RBI, "Scheme for Sustainable Structuring of Stressed Assets (S4A)", which aim to mitigate the earlier defects. The article also examines provisions in the Insolvency and Bankruptcy Code, 2016, and the amendments to the SARFAESI Act, which are in relation to stressed asset management. The detailed analysis of the impact of the S4A Scheme, and its benefits over the Bankruptcy Code, makes this article an interesting read.

The last article, *'P2P Lending: Regulating the New Kid on the Block'* by *Ms. Lakshmi Dwivedi* and *Mr. Pranav Awasthi*, touches upon the growth of the peer to peer ("**P2P**") lending platform, which is a result of the booming e-commerce market. This financial mechanism entails the borrowing and lending of money to individuals and businesses in an online marketplace. The platform is a mere facilitator between the borrowers and lenders, and does not service the loan itself. P2P lending platforms are increasingly gaining popularity over banks and other financial institutions, as they yield higher returns and are cheaper to the borrower. The authors have discussed in detail the concept, advantages and risks involved in P2P lending, and why it is imperative to have unique regulations instead of subjecting these platforms to securities or banking laws. The "Consultation Paper on Peer to Peer Lending" by the RBI has been analyzed in this context, and the authors have pointed out the conundrum of how the RBI designates these platforms as NBFCs despite recognizing them as financial intermediaries. The article concludes on the note that the unique characteristics of P2P platforms should be acknowledged in framing rules and regulations, instead of trying to pigeon-hole them into the existing framework.

I congratulate Astt. Prof. (Dr.) Manoj Kumar Singh, Chief Editor of JCLG, all the authors, reviewers and editorial committee members on the successful publication of this issue of the JCLG.

Mr. Rishi Anand
Cyril Amarchand Mangaldas

INSIDER TRADING: WHEN DOES INFORMATION BECOME UPSI?

ARMAAN PATKAR

Listed mergers and acquisitions (M&A) are usually complex and have to be carefully threaded through securities law. One of the key regulations to be considered in such deals, are SEBI's regulations on Insider Trading. These regulations seek to prevent trading in listed securities by persons who have asymmetric access vis-à-vis public investors to information relating to such securities. In furtherance of this objective these regulations prohibit trading by persons in possession of unpublished price sensitive information (UPSI) about a listed company, unless they disclose their intention to trade in a trading plan. In this regard, whenever restructuring and M&A activity is proposed, discussed or negotiated, it needs to be considered whether such proposals, discussions and negotiations are UPSI or not; this is not simple as they keep progressing and evolving and do not unfailingly crystallize into deals. This uncertainty, coupled with SEBI favouring an expansive construction of these regulations, causes unease to those who wish to obey the law.

This article seeks to give guidance to such persons in such situations, based on a review of applicable law, regulatory trends and jurisprudence. It highlights that UPSI does not only arise on the occurrence of formalized corporate action; it can arise much earlier. In this light, this article intends to act as practical guide in such situations. It gives readers a sense of when uncertain or preliminary information becomes UPSI, or is likely to be treated by SEBI as UPSI.

TABLE OF CONTENTS

I. INTRODUCTION

II. INSIDER TRADING LAW IN INDIA

III. SEBI & SAT ORDERS

IV. GUIDANCE AND GOOD PRACTICES

V. CONCLUDING REMARKS

I. INTRODUCTION

The SEBI (Prohibition of Insider Trading) Regulations, 2015[1] ("2015 Regulations") prohibit persons from trading in listed securities whilst in possession of unpublished price-sensitive information (UPSI) in relation to such securities. This seeks to ensurea level-playing field in the capital markets.Ostensibly to best meet this policy objective, the 2015 Regulations define UPSI in wide terms underscoring the fear that ring-fenced definitions may provide reverse guidance on how to avoid statutory prohibition.[2] This wide definition, coupled with mere possession of UPSI triggeringInsider Trading prohibitions,[3]indicates that SEBI's regulatory policyis to cast as wide a net as possible.This forces lawyers to advise clients to err on the side of caution and to avoid trading when in doubt.For example, lawyers commonly advise non-designated persons to avoid trading while the trading window is closed; instead, theyshouldtrade immediately after the opening of trading window, as this is when UPSI is least likely to exist.[4]

Keeping this in mind, woulduncertain or inconclusivefacts or circumstances, especially in the case of early stage M&A proposals or negotiations, amount to "*information*"?As rightly observed by the Securities Appellate Tribunal (SAT),"*negotiations are negotiations*"; they sometimes fail and sometimes come to fruition.[5]In such situations, lawyers and businessmen would hope that SEBI only treatsconcrete information as UPSI. However, given appreciable regulatory concern for misuse, SEBI takesa flexible view of what constitutes information. This flexible view would be justifiedhad SEBI provided sufficient guidance in this regard. Unfortunately, this guidance is missing in the 2015 Regulations.

In this light, this article is intended to act as a practical guide for lawyers and businessmen as to the point in time when information becomes "*information*" for the purpose of UPSI.Part II introduces the relevant provisions of the 2015 Regulationsand discusses key concepts. Part III extensively analyses orders of the SEBI and the SAT, to give readers a sense of regulatory and judicial approach. This part also discusses learnings from securities regulators and

---

[1]The 2015 Regulations replaced the 1992 Regulations based on the recommendations of the Justice N.K. Sodhi Committee; Report of the High Level Committee to Review the SEBI (Prohibition of Insider Trading) Regulations, 1992, Justice N.K. Sodhi, 10 (Dec. 7, 2013). [Justice Sodhi Report]

[2] *See* Jill Fisch, Start Making Sense: An Analysis and Proposal for Insider Trading Regulation, Faculty Scholarship, Paper 1036, foot note 7.

[3] §4(1), SEBI (Prohibition of Insider Trading) Regulations, 2015 ("2015 Regulations").

[4] Schedule B, 2015 Regulations; The Minimum Standards for the Code of Conduct to Regulate, Monitor and Report Trading by Insiders contained in Schedule B of the 1992 Regulations requires compliance officers of listed entities to institute a notional trading window during which designated persons (these are persons who are designated in the listed entities internal insider trading code of conduct, as persons who are likely to be in possession of UPSI) cannot trade. This trading window is to be closed when the compliance officer determines that designated persons can be reasonably expected to possess UPSI and is to be reopened not less than 48 hours from such UPSI becoming generally available.

[5] Rakesh Agarwal v. SEBI, Appeal No. 33 of 2001.

enforcement agencies in other jurisdictions.Part IV highlights the key findings from Part III and distils guidance from it. Part VI contains concluding remarks.

II. INSIDER TRADING LAW IN INDIA

Insider Trading was prohibited for the first time in India in 1992, with the enactment of the Securities and Exchange Board of India Act (the "SEBI Act") and the SEBI (Prohibition of Insider Trading) Regulations 1992 (the "1992 Regulations").[6]These regulations initially prohibited trading "*on the basis*" of UPSI;[7] this is known as the "*use*" prohibition i.e. only persons who *use* UPSI commit Insider Trading. SEBI moved towards the "*possession*" prohibition through an amendment in 2002, which prohibited trading "*when in possession*" of UPSI;[8]this assumes that any person who possesses UPSI would find it difficult to trade without using such information.[9]The 2015 Regulations continued the "*possession*" prohibition but also provided defences to the charge of insider trading, such as Chinese walls.[10]The import of the "*possession*" prohibition was explained by the SEBI in 2015 Regulations through a drafting note to Regulation 4(1) which clarifies that trading whilst in possession of UPSI is presumed to have been motivated by such UPSI; the reasons for trading are irrelevant.

Regulation 2(1)(n) of the 2015 Regulations defines UPSI, as follows:

"*(n) "unpublished price sensitive information" means any information, relating to a company or its securities, directly or indirectly, that is not generally available*[11] *which upon becoming generally available, is likely to materially affect the price of the securities and shall, ordinarily including but not restricted to, information relating to the following: (i) financial results;(ii) dividends;(iii) change in capital structure;(iv) mergers, de-mergers, acquisitions, delistings, disposals and expansion of business and such other transactions;(v) changes in key managerial personnel; and(vi) material events in accordance with the listing agreement.*

---

[6] Securities and Exchange Board of India (SEBI) Act of 1992, §30 empowers SEBI to make regulations to carry out the purposes of the Act, with the prior approval of the Central Government. [SEBI Act, 1992]

[7] §3(1), SEBI (Prohibition of Insider Trading) Regulations, 1992 [1992 Regulations].

[8]*Id.* Amended by the SEBI (Insider Trading) (Amendment)Regulations, 2002.

[9]Christopher Gorman,*Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?* 2004 FJCFL Vol. IX 480 at foot note 24. In 2012, the SAT endorsed the pre-amendment "use" position in Mrs. Chandrakala vs. SEBI Appeal No. 209 of 2011, by holding that the (amended) 1992 Regulations prohibit trading on the basis of such UPSI i.e. the trade must be motivated by the UPSI, which is a rebuttable presumption,C.f. *with* Rajiv B. Gandhi and Others v. SEBI, Appeal No. 50 of 2007 (the SAT holding that making *mens rea* essential sets the stage for market players violating the law with impunity and subsequently pleading lack of *mens rea* in Court) *and* SEBI v. Shriram Mutual Fund, AIR 2006 SC 2287*and*Union of India v. Dharmendra Textiles Processors and others (2008) 2008 SCC (13) 369 (Three-judge bench of the Supreme Court holding that Supreme Court holding that *mens rea* is irrelevant for Insider Trading).

[10]*supra* note 1.

[11]§2(1)(e), 1992 Regulations; "*generally available information*" means information that is accessible to the public on a non-discriminatory basis.

***NOTE**: It is intended that information relating to a company or securities, that is not generally available would be unpublished price sensitive information if it is likely to materially affect the price upon coming into the public domain. The types of matters that would ordinarily give rise to unpublished price sensitive information have been listed above to give illustrative guidance of unpublished price sensitive information.*"

Whether any information is amounts to UPSI is necessarily a mixed question of fact and law.[12]Unfortunately, there is noclear guidance on how to approach this question in any of the 2015 Regulations, the Justice Sodhi Report, SEBI FAQ's or any informal guidances issued under the SEBI (Informal Guidance) Scheme, 2003.[13]The only guidance is contained in Schedule A of the 2015 Regulations which sets out minimum standards to be adhered to by every listed company and which need to be incorporated into a code of practices and proceduresfor fair disclosure of UPSI by listed companies.[14]Paragraph 1 of this Schedule requires prompt public disclosure of material information that would impact price discoveryno sooner than credible and concrete information comes into being,in order to make such information generally available.To the extent that information that is not credible and concrete(and therefore, need not be made generally available), can such information be excluded from the scope of UPSI?

To my mind,such information should be excluded though there is nothing to hold SEBIto the position that only "*concrete and credible information*" meets the UPSI test; it is likely to treat this as a measure solely aimed at preventing premature disclosure of price-sensitive information (to prevent market speculation) and which is not co-extensive with UPSI and the prohibition on trading. However, I do note that SEBI has considered linkages (though neither cogently nor conclusively) between materiality of information for disclosure and the scope of UPSI. In Re: DSQ Holdings Limited, the SAT referred to US case law which considered that even preliminary merger negotiations can be material;[15] these heldthat is not necessary that pricing and structure has to be agreed on to render information material. Further, if the possibility of the merger has an immediate importance to the Company's stakeholders, it should be disclosed even if no merger ultimately takes place.[16] Whilst on this point, the David Jones

---

[12]Justice Sodhi Report, *supra* note 1.

[13] These contain sufficient guidance as to the meaning of the words unpublished, price sensitive and generally available, but not "*information*".

[14]Schedule A sets out '*Principles of Fair Disclosure for purposes of Code of Practices and Procedures for Fair Disclosure of Material Information*', required under Regulation 8(1) of the 2015 Regulations which provides that every listed company shall formulate and publish on its official website, a code of practices and procedures for fair disclosure of UPSI.

[15] Order dated February 27, 2003, upheld in DSQ Holdings Limited v. SEBI 2005 60 SCL 156 SAT.

[16]*Id.* at ¶6.2.3 referring to *Basic incorporated* 485 US 224 (1998); unfortunately, SEBI has failed to appreciate this case actually proceeded on a completely different point. It held while there was no general duty to disclose discussions, any *voluntary* statement could not be "*so incomplete as to mislead.*",quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d

Casein Australia deserves brief mention: In 2011, the Australian Securities and Investments Commission (ASIC) investigated the acquisition of shares of David Jones Limited (DVL) by 2 of DVL's directors; these shares were acquired one day after receipt of an initial confidential 3 Billion USD merger of equals proposal.[17] The acquisition was within the permitted trading window under DVL's trading policy and the Chairman of DVL was given prior notification. It was argued that the merger proposal "*was just not going to fly*", though DVL did not formally reject the merger proposal for almost a month. In these proceedings, ASIC considered whether DVL should have disclosed the merger proposal in accordance with its continuous disclosure obligations (equivalent to the continuous disclosure requirements in SEBI's Listing Regulations[18]); these require listed entities to immediately disclose to the ASX any market sensitive information, subject to certain exceptions. These exceptions include information concerning an incomplete proposal of negotiation or matters of supposition or which is insufficiently definite to warrant disclosure.[19]To my mind, such carve-outs should be incorporated into the defences in Regulation 4(1) of the 2015 Regulations. However, this is highly unlikely.

III. SEBI & SAT ORDERS

This Part analyses relevant SEBI and SAT orders in detail and highlights the facts and circumstances that SEBI and SAT take into consideration in such cases. This forms the crux of this article given the lack of guidance from the regulatory framework. These orders relate to the 1992 Regulations, since jurisprudence under the year old 2015 Regulations has yet to develop:

833, 862 (CA2 1968).SEBI failed to note that a statement had been made that no negotiations were taking place and that the company did not know of any corporate developments to account for heavy trading activity in its shares. This statement was misleading. In this context, the court rejected the argument that preliminary merger discussions are immaterial as a matter of law, and held thatonce a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial, are material because they make the statement made untrue.; *and* at ¶6.2.4 referring to TSC Industries Inc. v/s. Northway Inc.426 US 449; here too the case revolved around the materiality requirement of Rule 10b-5 (which provides that it is unlawful for a person to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading) with respect to contingent or speculative information or events.In this case, as to materiality of information for the purpose of disclosure, the Court noted thatmergers were important events for companiesand therefore, information regarding mergers can become material at an earlier stage than would be the case as regards lesser transactions. This is despite the mortality rate of mergers in such formative stages being quite high.

[17]Michael Hansel and Katherine Hammond, *Seven Corporate Governance Lessons from David Jones*, FindLaw Australia, http://www.findlaw.com.au/articles/5416/seven-corporate-governance-lessons-from-david-jone.aspx. ASIC eventually dropped its investigation as it was reportedly unable to gather enough admissible evidence to establish that the Merger Proposal was "*Market Sensitive Information*", which is a necessary element for a successful insider trading prosecution, and issued a "*No Further Action*" letter.

[18]SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

[19]§3.1, ASX Listing Rules, Chapter III, Continuous Disclosure,http://www.asx.com.au/regulation/rules/asx-listing-rules.htm.

A. RAKESH AGARWAL V. SEBI[20]

This case is well known for introducing a *mens rea* based exception in the 1992 Regulations to the offence of Insider Trading i.e.if the trade had a legitimate corporate purpose. This order of the SAT contains *obiter* relevant for the purposes of this article and therefore, this order deserves detailed examination:

- In February 1996,Bayer AG (Bayer)approached ABS Industries Limited (ABS), a listed Indian company, with an offer to enter into a joint venture to synergize their expertise. Thereafter up to September, 1996, Bayer and ABS had a series of discussions for a proposed investment by Bayer in ABS;
- Sometime in the first week of September, Rakesh Agarwal, the Managing Director of ABS travelled to Germany to continue these discussions in person. Allegedly in this meeting, Rakesh Agarwal and Bayer made a decision to enter into the transaction, subject to the caveat that the proposed transaction should result in Bayer reaching a minimum of 51% shareholding in ABS;
- On October 1, 1996, the details of the transaction were disclosed to the stock exchanges in accordance with the erstwhile exchange listing agreement;
- Between October 2, 1996 and October 3, 1996, the legal consultants of both parties prepared a share subscription agreement and shareholders agreement detailing the terms and conditions of the transaction. The subscription agreement was executed on October 5, 1996 under which ABS made a preferential allotment of shares representing 31% of ABS's total share capital to Bayer. This was subject to a covenant that ABS's board and Rakesh Agarwal co-operate with Bayer to ensure that Bayer is able to acquire an additional 20% of the shares of ABS in the open offer made by Bayer under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (the "Takeover Code"). This requirement was a condition precedent to the completion of the proposed transaction, including the execution of the shareholder's agreement;
- Rakesh Agarwal's version of the story is as follows: On September 29, 1996 he travelled to Germany along with legal Counsel to "*work out legal modalities*".The counterparties legal advisers and merchant bankers were also present in these meetings, where <u>all modalities, valuations and the offer price were finalized</u>, subject to board approvals. It was only on October 1, 1996, after the above events, did a "*commercial understanding*" to proceed with the transaction and certainty regarding the transaction arise. At no point of time prior to October 1, 1996 was the fact of proposed joint venture between the said companies

[20]Order dated November 3, 2003, Appeal No. 33 of 2001.

certain or definite, that this fact became certain and definite only on 1st October 1996.

- The SEBI Adjudication Officer(SEBI AO) notedthat between September 9, 1996 and October 8, 1996, Rakesh Agarwal's brother-in law, IP Kedia acquired 1,82,500 shares of ABS. Further, Rakesh Agarwal lent money to his brother-in-law IP Kedia between September 12 and September 28, 2016, ostensibly for the purposes of the acquisition. Rakesh Agarwal claimed before the SEBI AO and in appeal before the SAT that his actions were to ensure thatthe deal with Bayer goes through(i.e. by ensuring that Bayer's condition of reaching a minimum of 51% of the equity of ABS is met).

Following the letter of the law, Rakesh Agarwal and IP Kedia clearly violated the 1992 Regulations. However, the SAT absolved Rakesh Agarwal on the basis that the acquisitions had a legitimate corporate purpose and were not made to misuse insider information. It did so despiteRegulations 3, 4 of the 1992 Regulations being "*pure vanilla*" sections (i.e. which do not require subjective determinations of motive or intention to establish a violation).It ruled that a motive requirement comes built-in to these regulations and effectively recognized that *mens rea* is a requirement, if not at least a key factor, in testing potential offences of Insider Trading.[21]Since, Rakesh Agarwal was frantically trying to complete the deal with Bayer to strengthen the position of thecompany in times of difficult industry conditions, his actions were focused on meeting Bayer's conditions which was for the betterment of the company and its other shareholders, employees etc. This was despite IP Kedia profiting from subsequently tendering his shares at a higher price in an open offer made by Bayer than his acquisition price.

While the proceedings were disposed on this basis, the SAT judgement contains *obiter* relevant to this article, as follows: "*But negotiations are negotiations. Negotiations may sometimes fail. It may some times fructify. Till the negotiations are concluded, and a decision is taken, it is not possible to conclude the ultimate result of the negotiations.*"Additionally, the SAT recognized (against the backdrop of preliminary negotiations with Bayer fromFebruary 1996 onwards), that itmay be possible that a matter may not be '*crystallized*' and "*may be in a fluid stage*'.At this point in the narration of facts, the SAT noted that the board of ABS considered Bayer's proposal in the June meeting; but it did not take a decision andresolved to examine the matter further. Therefore, UPSI did not arise in the negotiations between February and June, 1996.

---

[21] However, in *SEBI v. Cabot International Capital Corporation, Appeal No. 7 of 2001, Order dated March 3, 2004,* the Bombay High Court held that Section 15-G of the SEBI Act, 1992 deals with defaults or failure of statutory civil obligations under the SEBI Act, 1992 and SEBI Regulations (and not criminal offences), and there is no question of imposing *mens rea* as an essential requirement. This was upheld by the Supreme Court inSEBI v. Shriram Mutual Fund and Anr. Civil Appeal Nos. 9523-9524 of 2003, Order dated May 23, 2016.

❖

Given that a Company is said to act only through its board of directors, could it be said that there was UPSI in relation to the proposed transaction before the board of ABS approved the definitive documents? This case and the orders discussed hereafter, demonstrate that the answer to this question is yes. To Rakesh Agarwal's argument(thatUPSI came into existence only upon crystallization of the proposed transaction), the SAT held that there was UPSI in relation to the proposed joint venture in existence much before the board of ABS approved the transaction and disclosed it to the exchanges; even before negotiations were officially concluded. In this regard, the SAT caveated that during negotiations, "*some times half way through a shrewd negotiator would be in a position to see the would be outcome of the negotiation.*" It held thatABS's negotiation with Bayer is in no way different. Therefore, while negotiations officially continued till October, Rakesh Agarwal a.k.a the shrewd negotiator knew the eventual outcome of the negotiations in the first week of September, 2016. According to the SAT, it was at this point that Rakesh Agarwal and Bayer arrived at the decision to enter into the proposed transaction. Countering Rakesh Agarwal's defence that the modalities/formalities of the proposed transaction were still being worked out, the SAT held that the modalities/ formalities were being worked out in relation to a decision already made i.e. essentially disregarding that the modalities could have been a deal breaker.

B. THE SATYAM CASES

These cases arose out of the acquisition of Maytas Infra Limited (MIL) and Maytas Properties Limited (MPL)by Satyam Computer Services Limited (SCSL). The facts of this case are as follows:

- On December 6, 2008, Ramalinga Raju, the chairman of SCSL proposed the acquisition of MIL and MPL, to avoid a takeover threat. Instead of making this proposal to SCSL's board, Ramalinga Raju informed SCSL's company secretary, senior finance team members and M&A Head of the proposal. These persons were requested to maintain confidentiality till the next board meeting, to be held on December 16, 2008. Ramalinga Raju also requested the M&A Head to prepare a presentation on the acquisitions for the board meeting, for which Ramalinga Raju provided the M&A Head with further data.
- In the meanwhile, SCSL engaged lawyers and financial advisors and obtained an equity valuation report on MIL and MPL and a third party opinion on investment limits u/s 372A of the erstwhile Companies Act, 1956.
- BetweenDecember 11 and December 15, 2008, further internal discussions were held,the board presentation was finalized and Ramalinga Raju travelled to the U.S. to brief the directors of SCSL.

- On December15, 2008 Ramalinga Raju informed the M&A head regarding the final purchase price and told him that the acquisitions would be financed through cash and debt in a ratio of 7:3.
- SCSL madeon announcement on December 16, 2008 regarding the acquisition of MIL and MPL and the trading window was closed from December 17, 2008 till January 9, 2009.

SEBI initiated an investigation against SCSL's compliance officer for failing to close SCSL's trading window when UPSI relating to the proposed acquisitions was allegedly in existence. The respondentalleged that Ramalinga Raju's discussions and meetings on December 6, 2008 contained a mere proposal, subject to board discussion and approval, and therefore did not constitute UPSI. In this regard, theSEBI AOobserved that the definition of price sensitive information under the 1992 Regulations was very wide in nature and scope and was not limited to only concrete decisions/steps.The indicative items in the definition are broad enough to cover any information related to these items, which if published is likely to materially affect the price of listed securities. This could even be information in the nature of a proposal and therefore, the argument that information is not UPSI till a proposal attains finality through a decision of the board cannot be accepted.Applying this principle, the SEBI AO[22]held in that the meetings on December 6, 2008 gave rise to UPSI, rejecting the argument that the proposal was premature, improbable or ordinary. Instead, he found that it was a significant proposal with vast implications for SCSL. Thus, it held that the ambit of insider trading law cannot be restricted only to decisions and a proposal having implications on the price of the securities would be UPSI.To arrive at this finding, the SEBI AOrelied on the following:

- that SCSL, MIL and MPL were controlled by the same family and the proposal was made by Ramalinga Raju, who belonged to the family promoters;
- discussions were held with top management, with the intention to "*appraise the Board of directors of SCSL regarding the acquisitions*";
- that the events of December 6, 2008 itself gave rise to UPSI and SCSL completed all exercises such as valuation and legal opinion in a very short span of time;
- the support of the board had been obtained before the meeting; and
- the manner in which the proposal was initiated and accepted indicates the level of preparation done by SCSL and shows that that the proposal was final in all aspects and

[22]In re: G Jayaraman: In the matter of Satyam Computer Services Limited, Adjudicating Officer Order No. PG/AO/AB/45/2012.

obtaining the approval from the board was merely a formality.

This Order was confirmed by the SATwho noted that the seriousness with which Ramalinga Raju disclosed the proposal to high ranking officials of SCSL and called upon them to maintain secrecy, while taking necessary steps to complete the transaction, leaves no doubt that the acquisition was to be implemented expeditiously.[23]Further, the agenda and draft resolution show that all minute steps were undertaken with a view to obtain final approval and not in principle approval from the board. They also contained the acquisition price and proposed to authorize two persons to sign the transaction documentation. All of the above and the fact that the acquisitions were effected within 10 days of the meeting at Ramalinga Raju's residence demonstrate that all of the steps taken between December 6 and December 16, 2008 were only preparatory steps to implement a decision taken on December 6, 2008. The acquisitions were a foregone conclusion.[24]

C. RELIANCE PETROINVESTMENTS LIMITED V. SEBI[25]

Reliance Petroinvestments Limited (RPL), a subsidiary of Reliance Industries Limited (RIL) bought shares of Indian Petrochemicals Corporation Limited (IPCL) from February 27, 2007 to March 2, 2007. On March 7, 2007, Indian Petrochemicals Corporation Limited (IPCL) declared its intention to consider and recommend amalgamation of the company with Reliance Industries Limited (RIL) in a board meeting to be held on March 10, 2007. SEBI alleged that the acquisition of shares of IPCL by RPL, prior to the announcement of the amalgamation of IPCL with RIL was trading whilst in possession of UPSI in relation to the proposed amalgamation.

RIL claimed that RIL's senior management had a meeting on March 4, 2007 to discuss the possibility of a merger between RIL and IPCL. Intermediaries were appointed on March 5, 2007 and the process of deciding the merger ratio between RIL and IPCL started on March 5, 2007.SEBI alleged that data collection begun prior to March 5, 2007 for the valuation exercise. RPL admitted that UPSI came into existence on March 4-5, 2007 but not earlier. The SAT agreed since SEBI could not provide any material or a specific date before March 5, 2007 to demonstrate that UPSI had come into existence. Similarly, the SAT held that SEBI did not prove

[23]Mr. G. Jayaraman v. SEBI, Appeal No. 182 of 2012.

[24]In an investigation against SCSL's head of investor Relations, the SEBI noted that the respondent received multiple emails on December 14, 2008. These emails contained MIL and MPL's financials, a presentation on the acquisitions, etc. which gave the respondent sufficient information to identify that MIL and MPL were the targets. This was so despite code words being used for MIL and MPL, since it was still possible to identify the targets. In respect of T.A.N Murthi, In re: Satyam Computer Services Ltd. Adjudication Order No. PG/AO/SPV/76/2012; The noticee in these proceedings traded in SCSL securities prior to the announcement of the acquisition.

[25]Adjudication Order No. AO/SG-AS/EAD/15/2016.

that the process of data collection started before March 5, 2007. This case suggests that the appointment of intermediaries to undertake valuation and the process of data collection for the valuation exercise, may be considered as UPSI. However, to sustain a charge of insider trading, SEBI would have to adduce positive evidence in support.

D. IN RE: SHRI K.K. MAHESHWARI AND ANR.[26]

This case related to allegations of insider trading against a non-executive independent director of Wyeth Limited (Wyeth), a listed pharmaceutical and healthcare company. The facts of this case are as follows:

- Wyeth was the subsidiary of Wyeth LLC, an American company. On February 15, 2006, Wyeth informed the stock exchanges that Wyeth LLC had incorporated a wholly owned subsidiary in India to launch its new vaccine 'Prevenar', instead of launching Prevenar through Wyeth who had the right to market Wyeth LLC's pharmaceutical products in India.
- Wyethagreed to relinquish its rights to marketPrevenar to the new subsidiary for fair compensation, which was determined by KPMG to be 226 Million Rupees.
- The SEBI AOfound that this matter was discussed in the Wyeth's board meetings held on December 22, 2005 and January 25, 2006, and the SEBI AO, found that UPSI came into existence on December 22, 2006, despite the board not having made a final decision in these meetings and the ultimate would be subject to and contingent on Wyeth accepting KPMG's valuation of the fair compensation.

In interpreting the meaning of unpublished price sensitive information, the SEBI AO noted that information includes "*any information*", which includes not only a final decision but also a "*probable and most likely event*". The SEBI AObased his decision on the fact that the minutes of the December meeting demonstrated that Wyeth had more or less decided to relinquishits right to Prevenar only subject to determination of reasonable compensation. The minutes reveal that Wyeth's directorsdiscussed the matter in detailand resolved to issue a NOC to the Drug Controller General of India in favour of the new subsidiary (subject to reasonable compensation).

E. SAMIR ARORA V. SEBI[27]

In this case, the fund manager of Alliance Capital Mutual Fund (ACMF) liquidated ACMF's investment in Digital Globalsoft Limited (DGL). This was effectedfour days prior to a board

---

[26] Adjudication Order No. SKV/SA/AO–01/2010.
[27] *Appeal No. 83/2004, Order dated October 15, 2004.*

meeting of DGL on May 12, 2003, which was called to consider "*integration relateditems*". In June 2003, DGL announced a merger with the HP ISO Division of Hewlett Packard, with a swap ratio considered by the market to be adverse to DGL. The SEBI AO held that this sale was motivated by UPSI that the swap ratio for the merger was adverse to DGL.In appeal before, the SAT the appellant was absolved of Insider Trading violations.

The SAT rightly found that while it may be difficultto prove Insider Trading (as argued by SEBI), mere suspicion, conjecture and hypothesis cannot take the place of evidence.With regard to the facts of this case, it held that SEBI had asked perfectly legitimate questions; however, the appellant had provided more than adequate answers to each question. One of these answers was that the USPI (i.e. that an adverse swap ratio would be announced on May 12, 2003) "*did not materialize*"; the merger was announced in June 2003.[28] In this regard, the SAT noted that information which finally turns out to be false or at least uncertain cannot be labelled as "*information*".

F. IN RE: CHIRANTAN MUKHERJI AND ANR. IN THE MATTER OF SHELTER INFRA PROJECTS LIMITED[29]

This was an investigation into trading in securities of Shelter Infra Projects Limited (SIPL) between May 21, 2009 and August 6, 2009, by its Managing Director and Chairman, and his wife. The Managing Director was a party to negotiations for a proposed sale of shares of SIPL by its promoter which would trigger an open offer under the Takeover Code. The parties appointed consultants on May 21, 2009 to assist in the finalization of transaction documents. Pursuant to negotiations, a share purchase agreementwas signed on July 31, 2009 and the managers to the open offer issued a public announcement to the equity shareholders of SIPL on August 7, 2009. Despite this, the SEBI AOheld that May 21, 2009 was the date when UPSI relating to the acquisition came into existence.

The SEBI AObased his decision on the fact that the consultant was appointed on May 21, 2009 and forwarded the first draft of the share purchase agreementto the promoters on May 28, 2009, "*after the price deal was finalized*". Taking into consideration when the mandate was given and the time to prepare the draft, this date was fixed. This was despite fact that the exact date of fixation of share price was not known and the board of SIPL only approved the share purchase agreement on July 30, 2009.[30]

[28]*Id. On May 2, 2003, DGL appointed consultants to recommend a merger ratio, which was finalised on May 7, 2003 and discussed in the board meeting on May 12, 2003. However, the boarddid not announce the merger and decided to seek a fairness opinion from a third party. The ratio was finally announced on June 6/7, 2003.*
[29]Adjudication Order No. EAD-2/DSR/KM/PU/71-72/2014.
[30] It should be noted that the date of May 21, 2009 was not contested or denied by the noticees.

G. IN RE: BALA REDDY GOPU AND ORS. IN THE MATTER OF ICSA (INDIA) LIMITED[31]

In this case, the promoter group of ICSA (India) Limited (IIL) traded in IIL's securitiesprior to making a corporate announcement on March 18, 2010 that it had secured work orders worth INR 464.17 Crores. It argued that when the trades were made, the company had only been declared as the lowest bidder and that definitive contracts remained subject to negotiations. Further, it was possible for the lowest bidder not to receive the contract and that such work orders are generally treated as having been awarded only after receipt of the final letter of award.The SEBI AOtreated the work orders as UPSI, observing that while it was still subject to negotiations, IIL was generally awarded the contract upon becoming the lowest bidder. However, the SEBI AOnoted that since the tender process was long and involved multiple steps, it would be difficult to pin point the point at which information would become UPSI. Therefore, the SEBI AOemphasized that the determination of when UPSI came into existence would depend on the facts and circumstances of each case.

H. V.K. KAUL V. SEBI[32]

In this case, the SAT confirmed that circumstantial evidencecan be relied on to establishinsider trading.The facts of this case are as follows:

- ❖ Rexcel Pharmaceutical Limited (Rexcel) and Solus Pharmaceutical Limited (Solus), both subsidiaries of Ranbaxy Laboratories Limited (Ranbaxy), entered into a joint venture and incorporated Solrex Pharmaceuticals Limited (Solrex). On March 20, 2008, the board of Rexcel and Solus passed a resolution to open a joint demat account in the name of both the companies on behalf of Solrex;
- ❖ On March 28, 2008. Ranbaxy's board of directors authorized the provision of INR 151 Crores to Solrex. Prior to this deposit, the account had a balance of INR 10,000;
- ❖ On March 31, 2008 Solrex acquired shares of Orchid Chemicals and Pharmaceuticals Limited (OCPL) using funds from the account;
- ❖ On March 27-28, 2008, B. Kaul, the wife of non-executive director of Ranbaxy i.e the respondent V.K. Kaul, purchased shares of OCPL and sold them on April 10, 2008; she made significant profits from these transactions and SEBI alleged that acquisitions were based on the UPSI provided by the respondent.

The SEBI AOtreated the board resolution passed by Rexcel and Solus to create a demat

[31] Adjudication Order No. BM/AO-1-14/2015.
[32] Appeal No. 55 of 2012, Order dated October 8, 2012.

account, as the date when UPSI came into existence (i.e. relating to the acquisition of shares of OCPL by Solrex).[33] It was held that the decision to open the demat account and deposit 151 Crores into it, was taken in furtherance of the decision to acquire OCPL's shares, which must have been taken at least on March 20, 2008. This order was upheld by the SAT since the sequence of events (including other circumstantial factors such as telephone calls between V.K. Kaul and the management of Ranbaxy)lead to the irresistible conclusion that V.K. Kaul was guilty of insider trading.

I. IN RE: DSQ HOLDINGS LIMITED[34]

In this case, the promoters of DSQ Holdings Limited (DSQ) acquired shares of DSQ, during six month period prior to DSQ making a rights issue. The promoters claimed that they were not aware of the precise details of the rights issue such as the issue ratio, price, etc. and therefore, did not possess UPSI. However, the SEBI AOheld the promoters to have committed Insider Trading, by treating early stage discussions relating to issuance of capital as material. It held that the respondents, being promoters and having common promoter directors, were in an advantageous position in respect of the rights issue, including by having knowledge of the ratio, pricing, etc. ahead of others.

J. IN RE: SABERO ORGANICS GUJARAT LIMITED, IN RESPECT OF MR. A. VELLAYAN AND ORS.[35]

On May 30, 2016, Coromandel International Limited (Coromandel) executed a share purchase agreement to acquire shares of Sabero Organic Gujarat Limited (Sabero), and made a public announcement the next day. It was alleged that persons acting in concert with the management of Sabero/Coromandel, traded whilst in the possession of UPSI to make unfair gains. The date of UPSI coming into existence was taken as May 15, 2011; on this date, a meeting was held to discuss and negotiate the acquisition. This was despite the fact that; (a) legal due-diligence and initial financial assessments began after May 15, 2016; and (b) that between May 18, 2011 and May 30, 2011 discussions on "*major aspects*" of the proposed acquisition also continued.

---

[33]In Re: V.K. Kaul in the matter of Orchid Chemicals Pharmaceuticals Ltd, Adjudication Order No. ID-6/OCPL/BK/AO/DRK/AKS/EAD-3/302/68-11.
[34]AdjudicationOrder dated February 27, 2003, upheld by the SAT in DSQ Holdings Limited v. SEBI, 2005 60 SCL 156 SAT.
[35]Order No. WTM/SR/SEBI/EFD/26/05/2016.

K. HINDUSTAN LEVER LIMITED V. SEBI[36]

This case was set aside by the Ministry of Finance on procedural grounds and therefore does not have any precedent value. However, it highlights a common problem faced by promoters in restructuring. Often the proposed restructuring activity can result in the promoter's shareholding being reduced below the desirable threshold of 51%.In such situations, to prevent such a reduction promoters consider strategies such as pre-transaction stake increases, selective capital reduction squeeze outs, etc. to ensure their shareholding remains above 51%.In 1996, this was attempted by Hindustan Level Limited(HLL), whoacquired shares of Brooke Bond Lipton India Limited (BBLIL) (another common subsidiary of Unilever) from the Unit Trust of India, two weeks before HLL and BLLIL announced that they would merge.In its defence, HLLpleaded that it purchased BBLIL's shares so that its parent company, Unilever, could maintain a 51% stake in the merged entity. SEBI ruled in 1998 that HIL was guilty of Insider Trading by holding that HLL and BBLIL were well on the way towards a merger and that the directors of Unilever, HLL and BBLIL were actively involved in the exercise. This resulted in asymmetric access to UPSI relating to BBLIL's securities between HLL and UTI, who had no knowledge of the proposed merger.

HLL argued the information about the merger discussion was generally available and that UTI would have accounted for this in the sale price. SEBI rejected this on the ground that a fundamental difference between the general information in the market and the specific information available to HLL.[37]In this regard, SEBI pointed out that a core team comprising of directors of BBLIL and HLL was formed in January 1995 and that Unilever had granted "*in-principle*" approval to the merger proposal in January 1996. This teammet between March 6 and March 10, 1995 and decided to announce the merger on April 29. In the meanwhile,on March 25, 1996 HLL acquired BBLIL shares from UTI.[38]

L. LEARNINGS FROM OTHER JURISDICTIONS

Other Jurisdictions have also treated determinations of Insider Trading violations as a mixed question of fact and law; these have rejected the straight forward formalist approach to only include formal and final decisions of companies as constituting UPSI. For example, in the Murakami casein Japan, atrial Court held that the expectation that an acquisition would unfailingly occur is not required to constitute a decision of the Company;the degree of feasibility

---

[36](1998) 18 SCL 311 (AA); *See also* V. Sridhar, Setback to the market regulator, Frontline, Vol. 15, No. 16, Aug. 1-4, 1998, available at http://www.frontline.in/static/html/fl1516/15161070.htm.

[37]*Id.* Ultimately, the appellate authority absolved HLL of all liability, due to "*prior market knowledge of the merger*."

[38] While exonerating HLL of the charges of insider trading, the Appellate Authority says: "*At the same time, it would have been desirable if at the time of purchase of shares, HLL had informed UTI that the core committee is considering the proposal of amalgamation*.".

or the certainty of the acquisition is irrelevant. However, to constitute a decision, the proposal must be reasonably detailed, backed by serious intent to execute it and therefore, reasonably feasible. This would not include a plan with negligible prospects of being realized.[39]This formulation hinges on two points, which are in-principle acceptable;

(i) one is that the detail of the proposal reflects preparation and readiness to enter into the transaction (leaving relatively little room for surprises that may lead a party to walk away); and

(ii) that once the '*directing mind and will*' of the Company has decided to go ahead with the transaction, Insider Trading obligations should kick-in: in this regard, the Japanese Supreme Court in the Nippon Orimono Kako (NOK) case rejected the argument that no decision can be said to be made if the governing body of the company had not taken a decision; as such the decision was still uncertain. The Court broadly interpreted the term "*governing entity*"to include entities able to make decisions effectively equivalent to corporate decisions. Therefore, the Court refused to limit the scope of Insider Trading to formal decisions or where a certain expectation of the transaction is in place.[40]

While the Japanese approach was focused more on the directing mind and will approach, in Canada both the Ontario Securities Commission (OSC) and the Alberta Securities Commission (ASC) focused on the facts and circumstances of each case to determine whether the information is material or not; decisions of these regulators have treated early stage M&A activity as a material fact (initiating insider trading prohibitions), thereby preferring to uphold the spirit rather than the letter of Insider Trading law.[41]For example, in Re: AiT Advanced Information Technologies Corporation and Ors.[42] the OSC held that, in appropriate circumstances, a material change can occur in advance of the execution of a definitive binding agreement, and therefore, the determination of whether a material change has occurred is not a

[39]Nomura Research Institute Limited, *Problematic Supreme Court Decision in the Murakami Fund Case*, Vol. 113, July 5, 2011, available at https://www.nri.com/global/opinion/lakyara/2011/pdf/lkr2011113.pdf.

[40]Nippon Orimono Kako Co. Limited, Supreme Court judgment, 10 June 1999, Keishu 53-5, p. 415. In this case, NOK, a listed company entered into a transaction with a company which would underwrite the issuance of fresh securities of NOK. Before this agreement was made public, the auditor and legal advisors of NOK acquired shares of NOK. The respondents argued before the Japanese Supreme Court that no decision had been made by NOK's governing body, at the time when the respondents acquired shares of NOK; *see*Sadakazu Osaki*, The Murakami Fund Incident and the Regulation of Collective Investment Schemes*, Nr./No. 25 (2008), ZJAPANR / J.JAPAN.L 92-93, http://www.zjapanr.de/index.php/zjapanr/article/viewFile/213/220.

[41]Genevieve Pinto and Matthew Griffin, *Insider trading in the context of M&A activity part 2*,McCarthy Tétrault LLP, October 4, 2013, available athttp://www.lexology.com/library/detail.aspx?g=c6ce2967-a316-43a3-a843-e10410c356ff.

[42] (2008) 31 O.S.C.B. 712.

"*bright-line*" test. Instead, this would depend on the specific facts and circumstances of each case.In this case, a non-binding letter of intent was received, where the price was subject to due-diligence and significant internal review. Although the allegations of Insider Trading were eventually dismissed, this case demonstrates that other regulators are also ready and willingto commence enforcement proceedings in such cases.[43]Further, the order quoted the following paragraph of an expert report:

> "…*in a negotiation for a merger transaction, such negotiations may be material at a very early stage and for the purpose of insider trading laws, persons aware of such "material facts" should be prohibited from trading on this information. However, this may be well before the negotiations have reached a point of commitment to be characterized as a change in the issuer's business, operations or capital, and therefore, before public disclosure of the information would be appropriate*."

In the Australian Lambert Case; the ASC entered into a settlement agreement with Anthony Lambert the (then) President and CEO of Daylight Energy Limited (DEL).[44] It was alleged in this case that Lambert acquired DEL securities, knowing that DEL had received an unsolicited expression of interest on August 5, 2011 from Sinopec International Petroleum Exploration and Production Corporation (SIPC). This expression of interest discussed the possibility of "*a major strategic investment transaction*" in DELby SIPCand indicated that SIPC is interested in acquiring the whole company.[45]Pursuant thereto, on August 5, 2011, Anthony Lambert sought legal advice from its internal and external legal advisors and the chairperson of DEL's governance committee.He was advised unanimously that the receipt of the letter was not material and that a trading blackout was not necessary; this advised was based on the fact that DEL had previously received such letters and none had proceeded beyond early stages. Further, the SIPC letter was unsolicited and did not include the price, terms or specifics of the potential transaction. Further, tooDEL had not even hired financial advisors to explore the merits of this proposal.On August 8, 2011Lambertsent a letter to SIPC on behalf of DEL stating that DEL was interested in exploring potential business opportunities with SIPC and on the same day, acquired shares of DEL. On December 23, 2011, DEL announced the completion of a Plan of Arrangement with SIPC, under which SIPC indirectly acquired all DEL's outstanding securities,

---

[43] c/f. *Weiqing Jane Jin,* Jin (Re), 2014 BCSECCOM 194 (CanLII),where (i) the price was fixed; and (ii) the bidder wanted to complete a transaction "*as soon as possible*". http://www.lexology.com/library/detail.aspx?g=3f29a119-0166-4b76-91c4-64a8c1804f53

[44] Based on the agreed facts contained in ASC's order. *See* Alberta Securities Commission, Settlement Agreement and Undertaking, Lambert**,** Re, 2013 ABASC 338 Date: 20130731.

[45]*Id.* The financial advisors to DEL had general discussions with SIPC regarding the proposals. These advisors informed Lambert of these discussions and Lambert indicated that he would be receptive to considering any proposals from SIPC.

at a substantial premiumto the pre-announcement trading price, from which Anthony Lambert profited. The ASCalleged that all the facts related to SIPC's interest in DEL were separately and collectively material facts.[46]The investigation was settled and Lambert was fined under the Settlement Agreement for breaching his position of high responsibility and trust (as the then President and CEO of DEL). Unfortunately, this settlement did not make a clear finding on the issue of Insider Trading. However, what the ASC did not say in the Settlement Agreement, it said in a news release in the following terms:

> "*It is important that senior company officials – insiders - understand that insiders cannot trade while in possession of undisclosed material information; whether or not that material information must yet be disclosed under our continuous disclosure regime. Additionally, if in doubt, insiders should always err on the side of caution and not trade.*"[47]

Similarly, in Re: *Weiqing Jane Jin*[48]the British Columbia Securities Commission (BCSC) in Canadaheld an expired non-binding offer to be a material fact. In this case,a legal consultant of Hathor Exploration Limited (HEL) acquired shares of HEL, with knowledge that it had received an unsolicited proposal from Cameco Corporation (Cameco)to acquire HEL, as follows:"*We are pleased to submit this letter setting out the basis (the "Proposal") on which Cameco … offers to acquire all of the outstanding common shares...of Hathor* …". The BCSC treated the receipt of the offer to be a material fact, despite the offer being non-binding and having expired.[49] The BCSC found that it was clear that Cameco would make a hostile offer to acquire HEL once the offer expired[50] and that the bidder "*was ready, willing, and able to acquire*" HEL, for the following reasons:

- Pricing and transaction structure were specified;[51]
- The offer was not conditional on securing financing;
- Confirmatory due diligence was not required (as Cameco, working with its financial and

---

[46]Genevieve Pinto and Matthew Griffin, *Insider trading in the context of M&A activity part 1*, McCarthy Tétrault LLP, October 2, 2013, available athttp://www.canadianmergersacquisitions.com/2013/10/02/lambert-settlement-part-1/.

[47] ASC, *ASC settles case against former Daylight Energy CEO Anthony Lambert*, August 11 2013, available at http://www.albertasecurities.com/news-and-publications/Pages/customdisp.aspx?pi=1210.

[48]Jin (Re), 2014 BCSECCOM 194 (CanLII)

[49]*Id.* The Cameco offer remained open till August 21, 2011.Cameco stated that if Hathor did not respond by that time, Cameco would assume Hathor was not interested and Cameco would proceed accordingly. The BCSC determined that the offer was "*highly indicative*" of the bidder's intention to go hostile if its offer was not accepted. Therefore, the offer did not cease being a material fact after its expiry.

[50]*Id.* Five days after expiry of the offer, Cameco announced its intention to make an offer for all of the outstanding shares of HEL. A few weeks later, HEL's board unanimously recommended that HEL shareholders reject Cameco's offer and ultimately the proposed acquisition did not go through.

[51]*Id.* C/f. *Agrium Inc. v. Hamilton* [2005] A.J. No. 83 (Q.B.) (insider trading was not established because the defendant was only aware that potential acquirers had expressed interest in the target, but was not aware of the price being offered).

legal advisors, had already conducted an extensive review of Hathor's publicly-available information);

- ❖ conditions typical of acquisition transactions of this kind; and
- ❖ The bidder was prepared to invest considerable resources in any negotiations and analysis required to complete a transaction as soon as possible.[52]

In addition to the U.S. Case law cited by the SAT (discussed in Part II above), these orders should be noted by M&A practitioners as they may have persuasive value in Insider Trading proceedings.

IV. GUIDANCE AND GOOD PRACTICES

The SEBI and SAT orders discussed above do not give a clear or conclusive picture on when uncertain or preliminary information can be said to have become UPSI.However, these cases are a clear reminder that Insider Trading analysis is intrinsically fact specific. At each instance, a risk-assessmentneeds to be carried outwhich should take into consideration the following:

- ❖ Pricing and transaction structure:Trends in India and overseas indicate that if there is reasonable certainty relating to pricing and transaction structure, information regarding such information is UPSI, *eg*. SEBI treated the finalization of the "*price deal*" as UPSI.[53]
- ❖ Likelihood of the information becoming certain: If transaction modalities are still being worked out but these modalities are not deal breakers, SEBI may still treat the matter as if a decision has been made. If transaction documentation has substantially progressed, even if there is no price certainty, it is possible to constitute UPSI. In some cases, SEBI has treated the appointment of financial and legal advisors and the sharing of first drafts of transaction documentation as the date on which UPSI came into place. This was despite the exact date of fixation of share price not being known.[54]

  In this regard, SEBI treats "*information*" to include not only final decisions but events that are "*probable*", which will "*most likely*" happen.[55]Accordingly, meetings, discussions and negotiations have been considered to give rise to UPSI even before legal and financial due-diligence started.[56]This indicates SEBIs willingness to use circumstantial evidence in grey area situations. This effectively adopts the "*directing mind*

[52]*Id.*These factors were highly indicative of Cameco's ultimate intentions, including that the offer stated that it would "*proceed accordingly*" if HEL did not respond before August 21, 2011.
[53]In Re: Chirantan Mukherji, *supra* note 29.
[54]*Id.*
[55] The case law from other jurisdictions discussed in Part III.L, also adopts a similar likelihood approach.
[56]In Re: Sabero, *supra* note 35.

and will' approach; the idea being that when persons who control a company have decided to act, they cannot stand behind technicalities of corporate law. In such cases, the degree of control over the listed entitiesis also to be considered as increases the probability of the event becoming certain.[57]

- Manner of implementation: This points arises from the point above, as the manner of implementation of a proposal may demonstrate the likelihood of the event occurring.[58] If the company acts in a matter which demonstrates urgency and the facts and circumstances of the case (such as speedy initiation and completion of preparatory steps such as appointing advisors, obtaining advice, valuation reports, etc.) would be a red flag.[59]Therefore, transaction implementation should be carefully thought through to ensure that the proposal does not seem final before it reaches the board for approval.[60]
- Board procedure: If the agenda and minutes show that all minute steps were undertaken with a view to obtain final approval and not seeking in-principle approval, SEBI will likely treat such meeting as UPSI; for example, in the Wyeth Case, since the minutes of an initial board meeting demonstrated that the event was almost certain, the SAT disregarded the fact that no final decision was taken at this meeting.Therefore, in case of preliminary discussions, agenda and minutes should be carefully drafted. These should be drafted in broad terms being careful not to include specifics relating to the proposed transaction. If possible, also propose alternative options for the consideration of the board, which can be used to demonstrate that the proposed transaction has not yet crystallized.Further, if the discussions are to continue after the meeting, the minutes should clearly record that the board has not accepted the proposal and resolved to examine the matter further.[61]
- Circumstantial evidence: SEBI has liberally accepted circumstantial evidence to penalize persons for Insider Trading. In the cases discussed in Part III above, control within family promoters, preliminary discussions, opening of bank accounts, telephone calls, etc. have been considered by SEBI. In fact, SEBI recently considered the fact that two

---

[57]*eg*. The Satyam Cases; *See* Part III.B above.
[58]In Re: Bala Reddy Gopu, *supra* note 31.
[59]*eg*. The Satyam Cases; *See* Part III.B above.
[60]In this regard, the timing of the appointment of advisors should also be kept in mind; SEBI has in the past tried appointment of intermediaries and data-collection as the point in time when UPSI came into existence, though the SAT rightly treated such information as insufficient by itself to demonstrate that UPSI had come into existence; *supra* note 25.
[61]Rakesh Agarwal, *supra* note 1;This was one of the factors which led to the SAT not holding that UPSI arose in the negotiations between February and June, 1996.

persons were friends on Facebook in an Insider Trading investigation.[62]

V. CONCLUDING REMARKS

Unfortunately for listed M&A, certainty and clarity is missing from the 2015 Regulations with respect to the determination of when UPSI comes into existence.As far as possible, M&A practitioners should follow the guidance in Part IV above. However, it should be kept in mind that SEBI generally adopts a "*smell test*" approach; it prosecutes and penalizes any activity that smells fishy.[63]Thankfully, though the 2015 Regulations are silent on the standard of proof, the SAT has upheld a high burden of proof.[64]It has held that despite SEBI stating that it is difficult to gather evidence to establish Insider Trading offences, meresuspicions, conjectures and hypothesis cannot take the place of evidence.[65]Regardless, despite the limited possibility of circumstantial vindication in appeal, my recommendation is to err on the side of caution and avoid trading when in doubt.

****

[62] In re: Mr. Palem Srikanth Reddy and Ors. WTM/PS/152/IVD/FEB/2016.

[63]This practice is not uncommon other commission have also sought to uphold the spirit rather than the letter of the law; *supra* note 41.

[64] Dilip S. Pendse v. SEBI, Appeal No. 80 of 2009; It held that the charge of Insider Trading is one of the most serious charges in the securities market, requiring a higher preponderance of probabilities to establish Insider Trading. For example, in Reliance Petroinvestments Limited,*supra* note 25, the SAT refused to accept the date claimed by SEBI to be the date when UPSI came into existence since SEBI could not provide any material or specifics to demonstrate that UPSI had come into existence on this date.

[65]Samir Arora v SEBI Appeal No: 83/2004.

LISTING OF STOCK EXCHANGES IN INDIA: UNDERSTANDING THE MOTIVATION BEHIND 'GOING PUBLIC'

- Arpit Gupta*

I. ABSTRACT

One of the biggest recent developments in the Indian capital markets has been the initiation of the process of listing of the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE), with both of them filing their draft red herring prospectus with the Securities and Exchange Board of India. This development has led to a debate as to the positive and negative implications of listing of a stock exchange, which is what this article has sought to explore. This article highlights the various concerns that are generally associated with such a listing process, and possible reasons for the BSE and NSE to 'go public' even after the presence of these concerns.

The article is divided into two parts. The first part discusses the development of the legal framework governing ownership of stock exchanges in India, starting from demutualisation itself, and also includes a section on the legal framework governing listing of stock exchanges. The second part deals with the issues that have arisen specifically with respect to the listing of the Bombay Stock Exchange and the National Stock Exchange. The article tries to bring out the possible motivations behind such a big step, which has been pending for quite some time, considering the number of times the regulatory authorities have sought to address the issues concerning listing of stock exchanges in India.

II. INTRODUCTION

The listing of a stock exchange is not a phenomenon unheard of in different countries in the world. The first instance of a stock exchange 'going public' was in 1998, when the Australian Stock Exchange demutualised and became a listed stock exchange.[1] It was also the first stock exchange to 'self-list' on its own market. Similarly, the New York Stock Exchange also became a listed company in 2006.[2] Most of the major stock exchanges across the world have undergone listing,[3] and it has been recognized as a mostly positive trend.

* Associate, Shardul Amarchand Mangaldas. The views expressed are solely those of the author.

[1] *History*, AUSTRALIAN STOCK EXCHANGE, www.asx.com.au/about/history.htm (last visited Jan. 8, 2017).

[2] Stephen D. Simpson, *Who owns the stock exchanges*, INVESTOPEDIA, Mar. 9, 2011, www.investopedia.com/ financial-edge/0311/who-owns-the-stock-exchanges.aspx

[3] *Privatisation and Demutualization of MENA Stock Exchanges: To Be or Not To Be?*, ORGANISATION OF ECONOMIC COOPERATION AND DEVELOPMENT, 2014, p. 10, https://www.oecd.org/corporate/Privatisation DemutualisationMENAStockExchanges.pdf.

There are many benefits that are associated with publicly traded stock exchanges. Listing allows the stock exchange to raise money for maintaining state-of-the-art technology, which is one of the biggest requirements of any stock exchange in today's time. It also results in better decision making and governance, as ownership and management are separated, and the stock exchange has to ensure compliance with a host of laws including, *inter alia*, corporate governance laws.[4]

In India, both the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE), which are the two major stock exchanges of the country, are unlisted, though both of them are demutualised. The only stock exchange in India which is currently listed is the Metropolitan Stock Exchange of India Limited (formerly known as MCX Stock Exchange Ltd.), which was permitted to become a listed stock exchange in 2012.[5] However, both the BSE and NSE had filed their draft prospectus with the Securities and Exchange Board of India (SEBI) in 2016, and are on their way to becoming listed stock exchanges.[6] It is noteworthy that NSE is the world's fourth largest stock exchange in terms of equity trading volume,[7] whereas both BSE and NSE are ranked eleventh and twelfth respectively, in terms of market capitalisation.[8]

This article seeks to discuss the events that have led to the much-awaited listing of the BSE and NSE, and the various concerns that surround this event. Part-I of the article elaborates on the legal framework governing ownership of stock exchanges in India, which also discusses the legal position on listing of stock exchanges in India. Part-II specifically discusses the issues arising from the listing of the BSE and NSE. Finally, the article concludes that while the listing of BSE and NSE is certainly a positive development in some respect, there are certain issues surrounding the same which are yet to be addressed properly.

III. LEGAL FRAMEWORK GOVERNING OWNERSHIP OF STOCK EXCHANGES IN INDIA

[4] Andreas M. Fleckner, *Stock Exchanges at the crossroads: Competitive Challenges-Reorganization-Regulatory Concerns*, Discussion Paper No. 6, 10/2005, HARVARD JOHN. M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS FELLOWS' DISCUSSION PAPER SERIES, pp. 33-4, http://www.law.harvard.edu/programs/olin_center/ fellows_papers/pdf/Fleckner_6.pdf.

[5] *Listed stock exchanges*, THE ECONOMIC TIMES, Sept. 9, 2016, http://economictimes.indiatimes.com/listed-stock-exchanges/slideshow/54302097.cms.

[6] *BSE gets Sebi go-ahead to launch IPO, may raise Rs. 1,500 cr*, MONEYCONTROL, Jan. 3, 2017, http://www.moneycontrol.com/news/ipo-issues-open/bse-gets-sebi-go-ahead-to-launch-ipo-may-raise-rs-1500-cr_8202021.html; *NSE files draft IPO papers, investors to divest 22.5% stake*, LIVEMINT, Jan. 1, 2017, http://www.livemint.com/Money/Bxvfp9u1d1C0Vxe37dCPtM/NSE-files-draft-IPO-papers-investors-to-divest-225-stake.html.

[7] *About NSE*, NSE, https://www.nseindia.com/global/content/about_us/about_us.htm (last visited Jan. 6, 2017).

[8] *The 17 most valuable stock exchanges in the world*, THE ECONOMIC TIMES, Sep. 5, 2016, http://economic times. indiatimes.com/markets/stocks/news/the-17-most-valuable-stock-exchanges-in-the-world/articleshow / 54013184.cms

1. CORPORATISATION AND DEMUTUALISATION OF STOCK EXCHANGES:

Traditionally, stock exchanges used to operate like 'clubs', wherein the members of the stock exchange were the owners as well as the traders on the stock exchange. However, with the growing role of stock exchanges as an important component of the economy, this 'traditional' model of stock exchanges was found to be problematic due to various problems such as conflict of interest, lack of transparency, inefficient functioning etc. This resulted in a growing recognition of the need for stock exchanges to undergo 'corporatisation' and 'demutualisation'.

SEBI had released a circular in 2003 titled 'Corporatisation and Demutualisation of Stock Exchanges', which contained a report submitted by a committee formed under Justice Kania. [9] Recommendations were made in the report to make it compulsory for all stock exchanges to be 'demutualised', and to be incorporated as a company under the Companies Act, 1956.[10] Pursuant to the recommendations contained in this report, amendments were made to the Securities Contracts (Regulation) Act, 1956 ('SCRA') in 2004,[11] which, *inter alia*, introduced the following changes:

(a) Insertion of definitions of 'corporatisation' and 'demutualisation';[12]

(b) Insertion of a provision making it mandatory for all stock exchanges recognized under the SCRA to be corporatised and demutualised;[13]

(c) Insertion of a provision laying down the process of corporatisation and demutualisation.[14]

Demutualisation essentially means segregation of the ownership of a stock exchange, from the trading rights of its members. Corporatisation refers to the incorporation of a stock exchange as a 'company', thereby meaning that it becomes an entity separate from its owners, with its own shareholders and management. Therefore, the combined effect of these two changes was that the ownership of stock exchanges became more diversified, with different stakeholders representing different interests. This allowed the stock exchanges 'to operate as an entity in its own right, rather than as an extension of its members/users business'.[15] Hence, BSE became the first stock exchange in India to undergo demutualisation

---

[9] Annexure-A, *Corporatisation and Demutualisation of Stock Exchanges*, SMD/Policy/Cir-3/03, SEBI, January 30, 2003.
[10] *Id.*, ¶ 4, p. 20.
[11] Securities Laws (Amendment) Act, 2004 (No. 1 of 2005).
[12] Sections 2(aa) and 2(bb), Securities Contract (Regulation) Act, 1956 (hereinafter 'SCRA').
[13] SCRA, Section 4A.
[14] SCRA, Section 4B.
[15] BJC Report, ¶ 2.2, p. 37.

after the introduction of the aforementioned amendments to the SCRA, as the NSE was demutualised since its inception.[16]

2. **SEBI REGULATIONS GOVERNING OWNERSHIP IN STOCK EXCHANGES:**

(a) **Securities Contracts (Regulation) (Maintenance of Increasing and Maintaining Public Shareholding in Recognised Stock Exchanges) Regulations:**

In 2006, the Securities Contracts (Regulation) (Maintenance of Increasing and Maintaining Public Shareholding in Recognised Stock Exchanges) Regulations ('MIMPS Regulations') were introduced by SEBI,[17] which was the first set of regulations that imposed, *inter alia*, certain shareholding restrictions on stock exchanges, which were as follows:

(i) At least fifty one per cent of the equity share capital must be held by the public;[18]

(ii) Subject to the following conditions, a person can hold more than one per cent, up to a maximum limit of five per cent of the paid-up equity capital:

- The person must be a 'fit and proper' person as per the regulations;
- The person must have taken prior approval of SEBI.

If the above conditions are not fulfilled, then a person cannot hold more than one per cent of the paid-up equity capital.

Thus, any individual could hold up to five per cent of the paid up share capital, subject to the fulfilment of the above conditions, failing which an individual could hold one per cent.

In 2008, SEBI released a discussion paper wherein it considered relaxing the aforementioned shareholding restrictions for stock exchanges.[19] The discussion paper had highlighted the following key concerns raised by various stakeholders: [20]

(i) The limit of five per cent prevented anchor/strategic investors form investing in the stock exchanges;

[16] *BSE demutualisation complete*, BUSINESS STANDARD, May 19, 2007, http://www.business-standard.com/article/markets/bse-demutualisation-complete-107051901004_1.html.
[17] Securities Contracts (Regulation) (Maintenance of Increasing and Maintaining Public Shareholding in Recognised Stock Exchanges) Regulations, 2006 (hereinafter 'MIMPS Regulations').
[18] *Id.*, Regulation 4.
[19] *Discussion paper on relaxation of shareholding restrictions in recognised stock exchanges*, SEBI, September 2008 (the exact date has not been provided), http://www.sebi.gov.in/commreport/relaxation.pdf.
[20] *Id.*, ¶ 8.

(ii) Five per cent of the equity paid-up capital represented an insignificant share for any investor to take a long term interest in the progress of the stock exchange;

Consequently, the discussion paper made certain recommendations, which were incorporated in the MIMPS Regulations through an amendment in 2008.[21]

These amendments introduced a new provision in the MIMPS Regulations, wherein the following institutions were allowed to hold up to fifteen per cent of the paid up equity share capital of the stock exchange:[22]

(i) A depository
(ii) A clearing corporation
(iii) A banking company
(iv) An insurance company
(v) A public financial institution

Additionally, the conditions which were earlier required to be fulfilled by any person holding more than one per cent, but less than five per cent of the paid up equity share capital, were now made applicable to persons holding more than five per cent of the paid up equity share capital i.e. the above mentioned institutions.[23]

Thus, the previous limit of one per cent was removed, and any person could now hold up to five per cent of the paid up share capital.[24] The above mentioned institutions could hold a maximum of fifteen per cent.[25] It must be noted that this limit of fifteen per cent was recommended in order to ensure that while anchor/strategic investors should remain sufficiently motivated to contribute to the development of the stock exchange, at the same time, there should not be any dominant shareholder/class of shareholders.[26]

(b) Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012

In 2010, a committee formed under Bimal Jalan, a former Governor of the Reserve Bank of India, submitted its report to SEBI on 'review of ownership and governance of

---

[21] Securities Contracts (Regulation) (Maintenance of Increasing and Maintaining Public Shareholding in Recognised Stock Exchanges) (Amendment) Regulations, 2008.
[22] MIMPS Regulations, Proviso to Regulation 8(1).
[23] MIMPS Regulations, Regulation 9(1).
[24] MIMPS Regulations, Regulation 8(1).
[25] *Supra* note 21.
[26] *Supra* note 9, ¶¶ 8, 9.

market infrastructure institutions' ('Bimal Jalan Committee Report').[27] One of the recommendations made in the Bimal Jalan Committee Report was to replace the MIMPS Regulations, as the Committee felt that its purpose had been served.[28] Thus, in 2012, SEBI notified the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012 ('SECC Regulations').[29]

The SECC Regulations have prescribed the following conditions for shareholding in a stock exchange:

(i) Every person must satisfy the criteria prescribed for a 'fit and proper person', in order to be able to acquire or hold shares of a stock exchange, irrespective of the extent of shareholding;[30]

(ii) No person shall acquire, either individually or together with persons acting in concert, more than five per cent of the paid up equity share capital;[31]

(iii) The following institutions can have a shareholding of up to fifteen per cent:[32]

- A stock exchange
- A depository
- A banking company
- An insurance company
- A public financial institution

However, each of these institutions must have prior approval from SEBI, if they are acquiring more than five per cent of the paid up equity share capital of the stock exchange;[33]

(iv) Where a person's shareholding exceeds two per cent of the paid up equity share capital, then the same shall be subject to SEBI's approval within fifteen days of acquiring the shares;[34]

---

[27] *Report of the Committee on 'Review of Ownership and Governance of Market Infrastructure Institutions'*, SEBI, Nov. 2010, http://www.sebi.gov.in/commreport/ownershipreport.pdf.
[28] *Id.*, ¶ 5.5, p. 66.
[29] Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, June 20, 2012 (hereinafter 'SECC Regulations').
[30] SECC Regulations, Regulation 19(1).
[31] SECC Regulations, Regulation 18(2).
[32] SECC Regulations, Proviso to Regulation 18(2).
[33] SECC Regulations, Regulation 19(3).
[34] SECC Regulations, Regulation 19(2).

(v) Every person who holds more than two per cent of the paid up equity share capital has to file a declaration within fifteen days from the end of every financial year, stating that he/she has complied with the criteria for a 'fit and proper' person prescribed in the SECC Regulations.[35]

3. FOREIGN INVESTMENT IN STOCK EXCHANGES:

The MIMPS Regulations, which was the first instance of the codification of regulations governing shareholding in stock exchanges, did not contain any specific provisions with respect to foreign investment in stock exchanges.

On December 22, 2006, both the Reserve Bank of India and SEBI came out with circulars specifying the limits for foreign investment in stock exchanges.[36] Overall foreign investment was capped at forty nine per cent, with twenty six per cent limit for foreign direct investment (FDI), and twenty three per cent for foreign institutional investment (FII). FII was allowed only through purchases in the secondary market. However, where the shares of a stock exchange were unlisted, then the same could be purchased for the purposes of FII through transactions made outside the stock exchange, provided that it was not an initial allotment. Interestingly, these limits were specifically included in the MIMPS Regulations quite later, through amendments made in 2008.[37]

In the Bimal Jalan Committee Report, one of the observations made was that there was no justification for imposing the requirement for FIIs to purchase shares of an unlisted stock exchange from outside a stock exchange through means other than initial allotment. It was observed that such a restriction implied that whereas an FII could not hold shares in an entity that is currently at the stage of applying for setting up a new exchange, the FII could directly acquire 5% shareholding from any of the promoters of such a group, once SEBI approves the exchange. Thus, the Committee recommended that 'an FII should be allowed to acquire the shares through off market transactions including through initial allotment, as allowed for other shareholders, subject to the limits specified by the Government from time to time.'[38]

---

[35] SECC Regulations, Regulation 19(6).

[36] *Foreign investment in Infrastructure Companies in Securities Markets- Amendment to the Foreign Investment Scheme*, RESERVE BANK OF INDIA, RBI/2006-07/218, A.P. (DIR Series) Circular No. 25, Dec. 22, 2006, https://rbidocs.rbi.org.in/rdocs/notification/PDFs/74809.pdf.

[37] *Supra* note 21.

[38] *Supra* note 27, ¶ 2.5, p. 49.

While FII was removed as a separate route of foreign investment with the introduction of the SEBI (Foreign Portfolio Investors) Regulations, 2014,[39] the foreign investment regime for stock exchanges under the MIMPS Regulations was retained even under the SECC Regulations, and remains so even today.

The most recent change with regard to the shareholding of foreign investors came in January 2017, when the shareholding of foreign investors was increased from 5% to 15%.[40]

The following table briefly summarises the shareholding limits for stock exchanges, both for domestic and foreign investment:

Investor	**Shareholding limit**	**Other conditions**
Domestic Investors	All investors have to qualify as 'fit and proper persons' as per the criteria given in the SECC Regulations.[41]	
	Up to 5% of the paid up equity share capital, in case of a person, or persons acting in concert.[42]	Where the shareholding is more than 2%, then SEBI's approval has to be obtained within 15 days of acquisition of shares.[43]
	Up to 15% of the paid up equity share capital, in case of the following investors:[44] ▪ A stock exchange ▪ A depository ▪ A banking company ▪ An insurance company ▪ A public financial institution	Prior approval of SEBI is required, in case the investor seeks to acquire more than 5% of the paid up equity share capital.[45]
Foreign Investor	Overall investment limit: 49% of the paid up equity share capital.[46]	Foreign portfolio investors can acquire shares only through the secondary market. In case the

[39] Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, Jan. 7, 2014. The proviso to regulation 2(h), which defines 'foreign portfolio investor', states that a foreign institutional investor will be deemed to be a foreign portfolio investor.
[40] Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) (Amendment) Regulations, 2017, Jan. 12, 2017, http://www.sebi.gov.in/cms/sebi_data/attachdocs/1484304686250.pdf.
[41] SECC Regulations, Regulation 20.
[42] SECC Regulations, Regulation 17(2).
[43] SECC Regulations, Regulation 19(2).
[44] SECC Regulations, Proviso to Regulation 17(2).
[45] SECC Regulations, Proviso to Regulation 19(3).
[46] SECC Regulations, Regulation 17(4).

	Up to 15%, in case of a foreign investor, whether acting individually or together in concert with other individuals.[47]	stock exchange is not listed, then the shares can be acquired through transactions outside of the stock exchange, provided that it is not an initial allotment.[48]
A declaration has to be filed with SEBI within fifteen days from the end of every financial year by all persons who acquire shares representing more than 2% of the paid up equity share capital, stating that they are compliant with the 'fit and proper person' criteria prescribed in the SECC Regulations.[49]		

4. LEGAL FRAMEWORK GOVERNING LISTING OF STOCK EXCHANGES:

One of the first recommendations on listing of stock exchanges was made in the report annexed to SEBI's circular on corporatisation and demutualisation of stock exchanges.[50] The report, submitted by a committee headed by Justice Kania, stated that while it would be desirable for a demutualised stock exchange to list its shares on itself or on any other stock exchange, the same should not be mandatory.[51]

Accordingly, the MIMPS Regulations merely stated that listing of securities of a stock exchange on the same stock exchange must be in compliance with such conditions as specified by SEBI.[52] However, the MIMPS Regulations were otherwise silent about the listing of stock exchanges.

In 2010, the Bimal Jalan Committee Report stated that it was not in favour of permitting listing of stock exchanges. It cited the following reasons for the same:[53]

(i) Considering that the functions performed by stock exchanges are in the nature of a 'public institution', they should not become a 'vehicle for attracting speculative investments'. They should have long term investors, who take sufficient interest in the growth and development of the stock exchange.

(ii) Any downward movement in the share price of the stock exchange may lead to a 'loss of credibility' and may have a negative impact on the economy.

47 SECC Regulations, Regulation 17(3).
48 SECC Regulations, Explanation to Regulation 17(4).
49 SECC Regulations, Regulation 19(6).
50 *Supra* note 9.
51 *Id.*, ¶ 1, p. 16.
52 MIMPS Regulations, Regulation 5(3).
53 *Supra* note 27, ¶ 5.1, Chapter V, p. 61.

However, when the SECC Regulations were notified in 2012, they contained an exclusive chapter titled 'listing of securities',[54] which lays down the following conditions for listing of securities of a stock exchange:

(i) A stock exchange may apply for listing of its securities on any stock exchange, except for self-listing or for listing on its associated stock exchange.

(ii) It must comply with the SECC regulations

(iii) It must have completed three years of continuous trading operations immediately preceding the date of application of listing

(iv) It must have obtained the prior approval of SEBI

(v) SEBI has the right to impose any additional conditions in the interest of the securities market.

On January 1, 2016, SEBI released a circular detailing the compliance procedure for listing of stock exchanges, in accordance with the provisions given in the SECC Regulations.[55]

IV. ISSUES ARISING FROM THE LISTING OF THE BSE AND NSE

On September 9, 2016, BSE filed its draft red herring prospectus ('DRHP') with SEBI for its IPO through the 'offer for sale' option, whereby it will make available 27.43% of its shares in the IPO.[56] On December 28, 2016, NSE filed its DRHP with SEBI, also for an IPO through an 'offer for sale', whereby its existing shareholders will make available 22.5% of its shares for sale to potential investors.[57] The listing of these two stock exchanges has been in the works for quite some time, as is evident from the various developments vis-à-vis the regulatory landscape governing listing of stock exchanges:

(a) Release of the circular detailing the procedure for compliance with SECC Regulations by SEBI in January 2016;[58]

---

[54] SECC Regulations, Chapter VII.

[55] *Procedures for ensuring compliance with Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012 (SECC Regulations) by Listed Stock Exchanges*, CIR/MRD/DSA/01/2016, SEBI, Jan. 1, 2016.

[56] *BSE files draft prospectus for public offer*, BUSINESS STANDARD, Sept. 9, 2016, http://www.business-standard.com/article/markets/bse-files-draft-prospectus-for-public-offer-116090900995_1.html

[57] *NSE files draft IPO papers, investors to divest*, LIVEMINT, Dec. 29, 2016. http://www.livemint.com/Money/Bxvfp9u1d1C0Vxe 37dCPtM/ NSE-files-draft-IPO-papers-investors-to-divest-225-stake.html

[58] *Supra* note 54.

(b) Proposal given in the Budget Speech for 2016-2017, to increase investment limit for foreign entities in stock exchanges to fifteen per cent, from the existing five per cent; this will bring the foreign investment limits at par with the domestic limits;[59]

(c) Amendments made to the SECC Regulations in March 2016;[60]

(d) Approval of the increase in the foreign investment limit for stock exchanges from five to fifteen per cent by the Union Cabinet of the Government of India;[61]

(e) Proposed amendments to the SECC Regulations by SEBI, to give effect to the proposed change in foreign investment limits for stock exchanges;[62]

(f) Notification of amendments to the SECC Regulations, increasing the foreign investment limit from 5% to 15%.[63]

All the above developments are suggestive of a strong push towards ensuring that the listing process for BSE and NSE is carried out in a smooth manner, along with creating opportunities for both entities to derive the maximum benefit out of the listing exercise. However, the need for this 'push' arose from the increasing pressure on both the stock exchanges to provide their shareholders with an exit option.

1. RISING NEED FOR THE LISTING OF BSE AND NSE:

While access to better technology, improvement in corporate governance standards etc. have been cited as reasons for the BSE and NSE to undergo listing, the one factor that increased the pressure on the BSE and NSE to 'go public' was the need for providing its investors with an 'exit option'.

An exit option allows the investor to liquidate their investment in a financial asset (or any other asset), thereby allowing them to 'exit' from the investment made by them. Such an exit option may be exercised both in case of a negative contingency, such as where a financial asset becomes non-performing, or a positive contingency, where the intended objective of

[59] *Proposed Changes/Reforms in FDI and related policies*, *Budget Speech: 2016-17*, MINISTRY OF FINANCE, GOVT. OF India, ¶ (iii), Annex No. 1 to Part-A, p. 34, http://indiabudget.nic.in/ub2016-17/bs/bs.pdf.

[60] Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) (Second Amendment) Regulations, March 7, 2016.

[61] *Cabinet increases the limit for foreign investment in Stock Exchanges from 5% to 15%*, PRESS INFORMATION BUREAU, GOVT. OF INDIA, July 27, 2016, http://pib.nic.in/newsite/PrintRelease.aspx?relid=147855.

[62] *Increase in limit of foreign investment in Indian Stock Exchanges- Amendments to Regulations*, Board Memorandum no. 56/2016, SEBI, Sept-Oct. 2016, http://www.sebi.gov.in/cms/sebi_data/boardmeeting/ 1476337840788-a.pdf. (The exact date of this memorandum cannot be determined, as the same has been excised for reasons of confidentiality.)

[63] *Supra* note 40;

making an investment is achieved.[64] In either situation, the investor would want to exercise an 'exit option'.

In the past, both BSE and NSE shareholders have expressed their frustration over the lack of an exit option for them. NSE has been termed as the 'worst portfolio investment for private equity players', as it has deprived many of its shareholders of handsome returns by refusing to list itself.[65] Similarly, shareholders of BSE have expressed a lot of resentment with respect to the uncertainty over exit options, with some of them making direct written representations to the Ministry of Finance in this regard.[66] Other than reasons such as price discovery and better transparency, the need for listing of these exchanges also rises from corporate governance issues that have arisen in the past. For example, NSE didn't publish the appointment and remuneration of managerial personnel in its annual report for 2014-15 on its website for a very long time.[67] Shareholders believe that such issues could also be addressed through the listing of the stock exchanges.

However, the listing of BSE and NSE has also raised certain concerns, which have been associated generally with listing of stock exchanges in the past also.

2. ISSUES OF CONCERN IN LISTING OF STOCK EXCHANGES:

(a) Clash between the regulatory and economic functions of a stock exchange:

The primary concern in such an exercise is the clash between operating the stock exchange as a business entity motivated by profit maximization, and its role as a market regulator, ensuring market integrity and protecting the interests of investors. In the Justice Kania Committee Report, instances of foreign stock exchanges have been cited wherein the regulatory functions of a listed stock exchange have been separated, allowing the stock exchange to function as a business entity, such as in the case of the Australian Stock Exchange and the London Stock Exchange.[68]

(b) Concentration of control:

Another issue of concern in case of listing of stock exchanges is that it may result in a particular stakeholder amassing a significant control in terms of shareholding, allowing it to influence the decision making in its interest. In the Bimal Jalan Committee Report,

---

[64] *Exit Strategy*, INVESTOPEDIA, http://www.investopedia.com/terms/e/exitstrategy.asp (last visited Jan. 8, 2017).
[65] *No way out*, BUSINESS TODAY, June 19, 2016, http://www.businesstoday.in/magazine/features/no-way-out/story/233124.html.
[66] *No exit for investors as India dithers on stock exchanges' IPO*, BLOOMBERG, July 14, 2015, https://www.bloomberg.com/news/articles/2015-07-13/no-exit-for-investors-as-india-dithers-on-stock-exchanges-ipos
[67] *Supra* note 63.
[68] *Supra* note 9, ¶ 5.12-5.15, p. 5.

imposition of restrictions on shareholding has been highlighted as an effective way to tackle this issue.[69]

(c) Self-listing:

In certain countries, the listed stock exchanges have been listed as companies on those stock exchanges itself, such as the London Stock Exchange, Singapore Exchange and Hong Kong Stock Exchange.[70] However, self-listing poses a risk with respect to ensuring compliance with listing requirements, as the stock exchange will be responsible for monitoring itself. However, this issue is purely academic in India, as the SECC Regulations do not allow for self-listing.[71]

This prohibition may prove to be problematic for the BSE and NSE, since it leaves them with no other option but to list their shares on their respective rival stock exchanges, which may result in loss of confidentiality and transparency. NSE has stated in the past that it will go public subject to being allowed to self-list its shares, as 'listing NSE on BSE is like…Coca Cola being regulated by Pepsi in terms of products and strategy'.[72] However, the Chairman of NSE has confirmed that it will now be listing its shares on the BSE.[73]

V. CONCLUSION

Listing of any stock exchange has generally been seen as a practice that brings about positive changes in the administration of the stock exchange. This is not only evident from the number of exchanges around the world that have undergone listing, but also from the various issues that plague mutualised, non-listed exchanges. For instance, the Shanghai Stock Exchange (SSE) is one of the few stock exchanges today that is completely regulated by a government agency, the China Securities Regulatory Commission, which makes self-regulation a mere formality for the

[69] *Supra* note 27, ¶ 1.10(1), p. 26.
[70] *Supra* note 3.
[71] SECC Regulations, Regulation 45(1).
[72] *Supra* note 63.
[73] *Listing should not be hostage to NSE restructuring: Ashok Chawla*, THE ECONOMIC TIMES, Dec. 27, 2016, http://economictimes.indiatimes.com/opinion/interviews/listing-should-not-be-hostage-to-nse-restructuring-ashok-chawla/articleshow/56192147.cms?from=mdr

SSE.[74] This 'old-fashioned' approach has made SSE an unattractive option for even big Chinese companies, such as Alibaba.[75]

Thus, there is a general sentiment that the listing of the BSE and NSE will bring with it certain positive changes in the exchanges. Access to latest technology, global recognition etc. are some of these positive changes. However, there are still concerns that are yet to be addressed. For instance, in its forensic audit report, NSE was found to have made available unfair preferential access to certain brokers, before others.[76] NSE had also ostensibly made a representation to the Ministry of Finance, Government of India, with respect to the proposal to increase foreign investment limit, stating that they want to ensure that the control should rest with domestic investors only.[77] Hopefully, SEBI will address these concerns before the final approval for the listing of these exchanges is given.

It must be mentioned here that BSE and NSE have already availed most of the 'benefits' of listing through demutualisation and corporatisation, which NSE has followed since its inception. This is evident from the global standing of these exchanges as well. Thus, 'listing' is not a requirement for BSE and NSE in the same way as it is for a stock exchange like the SSE. What has mostly motivated the 'listing' of BSE and NSE is the increasing demand of the investors to be provided with an exit option, who have gone to the extent of writing to the Ministry of Finance, Government of India.[78] As far as technological benefits are concerned, the launch of the International India Exchange ('India INX') as the fastest stock exchange in the world is testimony to the fact that listing or increase in foreign investment is not the key to accessing better technology.[79] Whether any other substantial benefits will actually accrue from this listing exercise in terms of technological or managerial development, is something which remains to be seen.

---

[74] Cally Jordan, *Success and failure in stock exchange consolidations: Implications for markets and their regulation*, RESEARCH WORKING PAPER SERIES, CENTRE FOR INTERNATIONAL FINANCE AND REGULATION, p. 199, http://www.cifr.edu.au/assets/document/WP118-2016%20Cally%20Jordan%20Success%20and%20 failure%20in%20stock%20exchange%20consolidations-Implications%20for%20markets% 20and% 20their % 20regulation.pdf.

[75] *Id.*, p. 220.

[76] *NSE IPO papers: Audit found unfair access for brokers*, LIVEMINT, Dec. 29, 2016, http://www.livemint.com/Money/RTVs9RWYL9ERlknQYpGxjM/NSE-IPO-papers-Audit-found-unfair-access-for-brokers.html

[77] *NSE bypasses SEBI, writes to finance ministry on listing stand-off*, LIVEMINT, Feb. 1, 2016, http://www.livemint.com/Politics/K9hPfyQ4M1lC2tbO2GJ3lJ/NSE-bypasses-Sebi-writes-to-finance-ministry-on-listing-sta.html.

[78] *Supra* note 64.

[79] *Narendra Modi inaugurates India International Exchange*, THE ECONOMIC TIMES, Jan. 9, 2017, http://economictimes.indiatimes.com/markets/stocks/news/narendra-modi-inaugurates-india-international-exchange/articleshow/56425259.cms.

MERGER AND ACQUISITION IN INDIA: TRENDS ON SQUEEZE OUTS AND THE RIGHTS OF MINORITY SHAREHOLDERS

SHASHANK CHADDHA

Mergers and Acquisitions form a pertinent part of the corporate law field in today's times, for they are known for their complex transactions and considerations. These considerations can range from vital accounts and due diligence to voting and approvals. However, the first step of getting a merger or an acquisition is the proposal to the General Body of a company, which is dominated by the shareholders who have rights. For this, there has to be a consent on the part of shareholders and here, the problem begins. Very often, we get to hear about failed mergers because of the 'minority shareholders' objections'. This is what this article explores through a literature-based study analysis. These minority shareholders posses rights, however, are often out powered by the majority, which gives rise to Oppression and Mismanagement in a company dragging it to litigation. Often, majority shareholders look for prospects to squeeze out minority shareholders to get the deal approved, which is the scope of this article. The article discusses the brief term 'minority shareholders' and then goes on to state some judicial principles for guarding such shareholders' rights. The next section outlines the famous methods employed for driving out the minority shareholders and then, the article talks about the recourse the minority shareholders have and at last, concludes by giving recommendations to save such shareholders. Since, the complicated merger deals between two corporations are still regulated by the old Companies Act, 1956[1], therefore, for the purpose of this essay, the reference to the Company Law will be with 1956 Act. However, as the title suggests about trends, provisions of the new Companies Act, 2013[2], have been referred to for giving a better understanding of the theme.

Keywords: Minority; Squeeze Outs; Share Capital; Acquisition; Scheme of Arrangement; etc.

I. INTRODUCTION

Minority shareholders is not a legislative term, per se. It's a reference to the shareholders who hold less than 10% shares in a company. Theories have referred to this term as those having less than 50% of shares. The former concept holds more value, as the legislative intent of the 1956 Act points to that direction. This is a reflection from the wordings of the Section 397/398 of the 1956 Act, wherein the shareholders must have an at least 10% of the shareholding either by way of each such shareholder coming together, or either of them having the required percent

[1] Hereinafter referred to as, the 1956 Act.
[2] Hereinafter referred to as, the 2013 Act.

of shares.[3] The Merger-Acquisitions deal is a decision making process which is very crucial for a company. This complex process highlights the famous concept of "Corporate Democracy". This concept enumerates the philosophy that it is for the majority to decide as to what is in the interests of the company.[4] The interests of the shareholders and that of the company must always be preferred over the interests of anyone else, irrespective of the position occupied by him. However, at times, this concept comes in contravention with interests of the minority shareholders. Often, the argument posed from the majority shareholders is augmented from this concept, as can be seen in the famous case of *Life Insurance Corporation Ltd. v. Escorts Ltd.*[5] With reference to the scope of this essay, this concept is only relative in explaining the failed mergers and the role played by minority shareholders.

Past few decades have seen tremendous growth in mergers and acquisitions in India but under the light of the decisions of minority shareholders. Some of these deals have been successful and some of them have been rejected. The famous Vedanta merger is the highlight of the latter instance. Its subsidiary, Cairn India, whose one of the shareholders is Life Insurance Corporation, have opposed this deal. The opposition came with regard to an unprofitable share swap ratio for the minority shareholders. Other speculations have pointed out that the deal would have only been beneficial for Vedanta, which was debt laden, and the sufferer would have been the shareholders of Cairn India. A merger also merges the liabilities of two companies, which was again the issue here in Vedanta-Cairn Merger, that the various violations encrypted by the former would have an adversarial effect on the latter's reputation and costs.

II. KEY JUDICIAL PRINCIPLES

Although, the Courts are not that much inclined to interfere between the wisdoms of the businessmen[6], but minority or dissenting shareholders may still approach the Court claiming oppression and mismanagement.[7] It is worth noting here that it is on the Court to examine the Merger deal before imposing it on the dissenting members of the class.[8] The Court is not a mere rubber stamp and the fact that the majority has approved the scheme is not conclusive because it will not only bind the majority of the shareholders or creditors but also the dissenting minority of the shareholders or creditors. Thus, the scheme must be just and fair to all the shareholders.[9]

---

3 Section 397 of the 1956 Act.

4 BOYLE & BIRDS', COMPANY LAW, 673 (John Birds et al., 3rd ed., 1997).

5 (1986) 1 SCC 264 [*hereinafter referred to as, LIC v. Escorts*]

6 LIC v. Escorts *supra* note 5.

7 Miheer H. Mafatlal v. Mafatlal Industries Ltd., (1997) 1 SCC 579.

8 Bank of Baroda Ltd. v. Mahindra Ugine Steel Co. Ltd., [1976] 46 Comp Cas 227 (Guj); Bengal Hotels P. Ltd., In re, [1977] 47 Comp Cas 597 (Guj).

9 German Remedies Ltd., *In re*, [2004] 50 SCL 77.

Even if three-fourth majority have accepted the scheme of arrangement[10], the Court has to consider following circumstances before giving its approval: *(a)* the proposal for the scheme was made in good faith, *(b)* the scheme is fair and reasonable, *(c)* the scheme will yield to a smooth and satisfactory working *(d)* the scheme does not offend public or commercial morality, *(e)* the scheme is not detrimental to the interests of the creditors or members or public interest.[11]

Along the lines, it is submitted that in the issue of fairness of the scheme, if the Court is satisfied that the scheme is discriminatory and unfair, it can reject the scheme even after it has been approved by the required shareholders.[12]

When discussing the judicial principles relating to mergers, it is incumbent to highlight what the Supreme Court said in *Miheer H. Mafatlal v. Mafatlal Industries Ltd.*[13]:

- That the class was fairly represented by those who attended the meeting and that the statutory majority are acting *bona fide;*
- That the arrangement is such as a 'man of business' would reasonably approve;
- There should not be any lack of good faith on the part of the majority;
- Scheme not contrary to public interest or any other;
- Prudential Business Management Test.

However, there exists a grey area on this point of "fairness" while approving the scheme or merger deal. The latest trend is highlighted by a very recent case of *Matter of Kenneth Cole Productions, Inc., Shareholder Litigation*, 2016 WL 2350133 (N.Y. May 5, 2016), the New York Court of Appeals, on May 9, 2016, overruled the claim of the "entire fairness" rule and prioritised the "business judgement" rule. The judgement, authored by Judge Leslie E. Stein, applied the principle of *Kahn v. M & F Worldwide Corp.,*[14] and affirmed the dismissal of a shareholder's class action suit which challenged the company's purchase of the shares in Kenneth Cole Productions, Inc. This case marks the first time that New York's high court has explicitly addressed the standard of review that applies to challenges to going-private mergers by controlling

---

[10] The terms Merger or Amalgamation have not been defined in the Companies Act 1956, though this voluminous piece of legislation contains 69 definitions in Section 2. However, the provisions relating to M & A are contained in section 391 to 396A in Chapter V of the Companies Act, 1956. *See,* Scheme of Arrangement under the Companies Act, 1956 - ICSI *available at* http://www.icsi.edu/portals/2/icsihyd/ppt/ppt/Manoj%20-%20Presentation%20-%20Study%20Circle%20Meeting%20-%2016.02.2013.pptx (last visited, 19.07.2016).

[11] Sakamari Steel & Alloys Ltd., *In re*, (1981) 51 Comp Cas 266.

[12] State Bank of India v. Alstom Power Boilers Ltd., [2003] 43 SCL 449 (Bom); Tecumseh Products India(P.) Ltd., In re, [2000] 25 SCL 251 (Del); D.C.M. Ltd., In re, [2004] 50 SCL 585 (Del); De Beers India Minerals (P.) Ltd., In re, [2004] 53 SCL 421 (Bom.).

[13] Miheer H. Mafatlal *supra* note 7.

[14] Supreme Court of Delaware, in Kahn v. M & F Worldwide Corp., 88 A. 3d 635 (Del. 2014).

shareholders.[15] Similarly, the course of action can be seen right from the enactment of the 1956 Act, wherein the Court held that generally the Courts show a disinclination to interfere in business processes, or to modify the terms of the schemes.[16] The general rule is that a reduction is considered a domestic matter for the company, and the court will exercise its discretion only to examine whether the reduction is fair and equitable.[17]

III. OPTIONS AVAILABLE TO THE MAJORITY SHAREHOLDERS

After listing out some key judicial principles on the point of controlling a transaction to stall its effect, there are some options, which are not exhaustive, but are resorted to, in case, the scheme is not being approved. These may be classified as:

i. Compulsory Acquisition;

ii. Reduction of Share Capital; and

iii. Scheme of Arrangement.

i. Compulsory Acquisition

Section 395 of the 1956 Act and Section 235 of the 2013 Act provide for compulsory acquisition of shares. The former permits majority shareholders to do so to a limited extent but given the need for prior consent of majority shareholders whose transfer is involved along with dissenting shareholders' consent and other practical difficulties and ambiguities under this provision, the ability to compel a 'squeeze out' becomes redundant.[18] This provision did not help much to the majority shareholders in getting the scheme approved. Section 235, which is analogous to section 395, makes it mandatory for the majority shareholders to notify the company of their intention to buy the remaining equity shares the moment acquirer, or a person acting in concert with such acquirer, or group of persons becomes the registered holder of ninety per cent (90%) or more of the issued equity share capital of a company.[19] In other words, to give notice for compulsory acquisition of shares of dissenting shareholders, the offer, pursuant to which the notice is being given by the transferee company, has to be accepted by 90% of the

---

15 Jason M. Halper, Orrick, Herrington & Sutcliffe LLP, *Challenges to Going-Private Mergers in New York*, Harvard Law School Forum on Corporate Governance and Financial Regulation, *available at* https://corpgov.law.harvard.edu/2016/05/23/challenges-to-going-private-mergers-in-new-york/ (last visited, 19.07.2016).

16 Leela Mahajan v. T. Stanes & Co. Ltd., AIR 1957 Mad 225.

17 *See,* British and American Trustee, (1894) AC 399.

18 Tarunya Krishnan, Khaitan & Co., *New provision on minority buy-out | Is the buy-out a squeeze-out?,* Lexology Library, November 13 2014, *available at* http://www.lexology.com/library/detail.aspx?g=76064aa9-4fd5-4a9c-9430-be50e6fbd796 (last visited, 20.07.2016).

19 Akshat Sulalit, *Companies Act, 2013: Rise of the Minority Shareholder,* India Law Journal, *available at* http://indialawjournal.com/volume6/issue-2/article5.html (last visited, 20.07.2016).

shareholders.[20] However, it may be borne in mind that compulsory acquisition would apply only when the dissenting shareholders' shareholding is equal to or less than 10%. There is an additional provision in the 2013 Act for the dissenting shareholders, permitting an acquiring entity, holding at least 90% or more of the issued equity share capital of a company to buy out the minority shareholders at a determined exit price.[21]

Another aspect of section 395 of 1956 Act or section 235 of the 2013 Act, is the four months' time period, that is, the notice under this section can only be given after the lapse of four months period from the date of giving offer.[22] Judicial principles have become certain on the required time period. To mention for brief understanding, the case of *AIG (Mauritius) LLC v. Tata Televentures (Holdings) Ltd.*[23] Vikramjit Sen, J., after considering the contrary construction of the section in other jurisdictions[24], which he found to be obscure and unpersuasive, and relying on the construction of the section in Canada,[25] held that sufficient time is to be given to arrive at a sound conclusion. This was the intention of the legislature in this respect to avoid hiatus between the section's provisions.[26]

Although one may see this provision as a very easy option to acquire the shares of the dissenting minority shareholders, however, this provision does not have much practical use. The reason behind this is the humungous required of having an acceptance of 90% of the shareholders. In a case, where a controlling shareholder(s) holds around 60% in the company, now, for the compulsory acquisition, he will have to first make an offer to the 40% of the shareholders at a determined value and then, at least 90% of such 40%, that is, 36% of the shareholders.[27] Therefore, this tedious task of requisite percent of shares makes this, relatively less used option.

ii. Reduction of Share Capital

For being saved from the requirements relating to compulsory acquisition, shareholders may resort to the provision of reduction of share capital. Contemplated under Section 100 of the 1956 Act, this provision permits a company to reduce its share capital by way of a special resolution, that is, 75% approval of those present and voting. This is the most used way when it comes to minority squeeze out. Why is it beneficial for controlling shareholders is because, this

---

20 § 235(1), the 2013 Act.
21 § 236, the 2013 Act.
22 Ibid.
23 (2003) 43 SCL 22 (45) (Del).
24 Western Manufacturing (Reading) Ltd. Miles v. Adamant Engineering Co. (Luton), Ltd., [1955] 3 All ER 733.
25 Rathie v. Montreal Trust Company, [1953] 2 S.C.R. 204 (Canada).
26 AIG (Mauritius) LLC v. Tata Televentures (Holdings) Ltd., (2003) 43 SCL 22 (45) (Del).
27 Umakanth Varottil and Vikramaditya Khanna, *Regulating Squeeze Outs In India: A Comparative Perspective,* Working Paper 2014/009, National University of Singapore, Faculty of Law Working Paper Series, *available at* http://law.nus.edu.sg/wps/ (last visited, 20.07.2016).

section is opaque on the concept of minority shareholding and the special resolution required by it does not reflect the intention of the minority shareholders.[28] Herein, the law requires only a 75% approval from the shareholders, and therefore, a prospective controlling class will be in a better position to further a squeeze out. Regard must be had to the relatively lesser amount of legal requirements to effect this, as this being the pure domestic matter of the company.[29] Such exemptions, as compared to other options, does not entail that it shall be outside the purview of courts or regulators. It is only after the outstanding debt owed to the company's creditors, will the final approval be accorded.[30]

There might be a doubt regarding this back door method as being used unfairly, after all, the legitimate interests of the shareholders who represent the corporate as a whole are being compromised, even if it is just a percent. However, courts have, in recent years, acquainted this branch of law with the rigorous task of approvals and therefore, left the companies to their own domestic settings. Selective reduction[31] is what is being referred to here, making it to be a method of surpassing the compulsory acquisition of shares, as has been discussed in the last section.

iii. Scheme of Arrangement

A scheme of arrangement is another option which denotes a compromise between the shareholders and their creditors *vis-a-vis* their classes[32]. The process for this involves convening of meetings pursuant to an application to the respective High Court having jurisdiction. Such meetings will be held for different classes, and each class will have to vote at a high voting threshold, that is, more than 50% in number of shareholders and 75% in value of shares held.[33] The problem of meetings and votes arise only when such shareholders possess a different class

---

28 Akshat Sulalit, *supra* note 19.

29 Elpro Interational Ltd., In re, (2009) 149 Comp Cas 646 (Bom). *See*, Archi Agnihotri and Medha Srivastava, *Minority Shareholders' Position in case of Reduction of Capital — Judicial Development,* The Practical Lawyer, Eastern Book Company, *available at* http://www.supremecourtcases.com/index2.php?option=com_content&itemid=5&do_pdf=1&id=20968 (last visited, 20.07.2016).

30 Nishith Desai Associates, May 2015, *Mergers & Acquisitions in India, available at* http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/Mergers___Acquisitions_in_India.pdf (last visited, 21.07.2016).

31 *See*, Reckitt Benckiser (India) Ltd, *In re*, 122 (2005) DLT 612 (Del), at ¶26; Panruti Industrial Company (Private) Limited, *In re*, AIR 1960 Mad 537.

32 A company can have different classes of shares, for example, ordinary and preference shares, or "Class A" and "Class B" types of ordinary shares and ordinary and deferred shares. In *Bushell v Faith [1970] AC 1099*, it was held that, a company can legally have classes of shares, and consequently have weighted votes. The House of Lords held that such classification was valid. This was because Parliament had not sought to fetter a company's right to issue a share with such rights or restrictions as it thought fit. *See,* Wee Meng Seng, Assistant Professor of Law, *Shares and Debentures,* National University of Singapore, *available at* https://law.nus.edu.sg/cle/partA_bar/Lecture_8_CompLaw.pdf (last visited, 24.07.2016).

33 Umakanth Varottil and Vikramaditya Khanna, *supra* note 27.

of shares, such as, Class A Equity Shares, having a high voting values, otherwise, 75%[34] approval is required of all. Scheme, for getting approved by the High Court, also requires all the creditors to vote pursuant to the order of the High Court, and after this, the final order is passed approving the scheme.

IV. RECOURSE TO MINORITY SHAREHOLDERS

As we have seen, the provisions for getting a scheme approved or to get a merger approved can be tainted so as to drive out the minority shareholders. Therefore, for the upkeep of the principles of Corporate Governance[35], it is necessary that the interests of all stakeholders are accounted for. The 2013 Act has revamped the minority protection tool by permitting entrenchment provisions, to be incorporated into the Articles of Association of the company.[36] The powers and functions of NCLT[37], have been expanded so as to enable it to make orders for exit opportunity to such minority shareholders. In a major development, to safeguard the rights of the dissenting minority shareholders and to protect the interests of the company, "Class Action Suits" have a separate provision[38] in the 2013 Act. For a class action suit, the requirement is that, at least 100 members or members holding a certain percentage together can file a class action suit. Under this, a direct claim is permitted against third parties which will also include experts, auditors, directors, etc.[39]

V. CONCLUSION AND RECOMMENDATIONS

Although, there is law to protect the acts of the majority, however, Courts show a reluctance in interfering with the internal matters of the companies. Therefore, it is necessary to have a holistic settlement with regard to minority protection. For this, the presence of independent directors is needed. Since the law itself mandates independent directors, it also

---

34 § 391, the 2013 Act.

35 *See*, Rabindra Jhunjhunwala and Stuti Galiya, *Corporate governance - directors' duties and liabilities under Companies Act, 2013,* Lexology, (Sep 16, 2014) *available at* http://www.lexology.com/library/detail.aspx?g=aabc1dae-ab94-4f58-893d-f8f68b51c731 (last visited, 21.07.2016).

36 Ministry of External Affairs, Government of India, *Doing Business in India - Guide for Indian Diaspora, available at* https://www.mea.gov.in/images/pdf/DoingBusinessinIndiaGuide.pdf (last visited, 21.07.2016).

37 With effect from 1st June, 2016, the Ministry of Corporate Affairs, Government of India, vide F. No. A-45011/14/2016-Ad.IV, constituted National Company Law Tribunal, under § 419 of the 2013 Act. Refer to, http://www.mca.gov.in/Ministry/pdf/Notification_02062016_I.pdf; http://www.mca.gov.in/Ministry/pdf/Notification_02062016_II.pdf; (last visited, 24.07.2016, for both the links).

38 § 245, the 2013 Act.

39 Ministry of External Affairs, *supra* note 36.

facilitates good It is, however, necessary that such directors do not act under any sort of influence but uphold their fiduciary duties.

An internal agreement may also come to aid such acts on the part of majority shareholders. This means, having a specific provision relating to squeeze outs or buyouts requiring unanimous voting among the shareholders as well as the directors, so as to have a reflection of minority dissenting shareholders.

An independent financial review committee can also help in reviewing such transactions involving transfer of shares, or reduction of capital. However, it is important that the members of such committee are independent and do not act in concert with each other.

Along the lines, a veto vote, to be given to minority shareholders, is also an attractive option so as to curtail the misuse of the shareholdings' powers so that such activities, specially reduction of share capital which is attractive, does not escape the clutches of the law. However, the recommendations listed above are only indicative, and will largely depend on the practical efficiency and the size of the company. Although, most of the part with regard to minority protection is taken care of by the new provisions, such as, the 2013 Act has narrowed the process of share capital reduction by providing a notice to the Central Government and the SEBI as well.[40] It will be only after when all the sections are notified, will give a true picture of the governance status in various companies of the country *vis-a-vis* the principles of good governance and accountability.

[40] § 66, the 2013 Act.

SEBI'S BRIGHTLINE TEST: THE RIGHT WAY TO MOVE FORWARD?

ANURAG GUPTA & SUSHMA REDDY

I. ABSTRACT

Acquisition and takeover of companies have become an everyday phenomenon in the corporate world. However, the rights of shareholders, especially minorities, should not be prejudiced because of such hostile acquisitions or takeovers. In order to develop and regulate takeover activity, India's securities regulator the Securities and Exchange Board of India has enacted specific regulations for investor protection.Under the current regime of Indian takeover regulations, an acquirer who acquires 25% of the shareholding rights or obtains 'control' over a target company is obligated to make an open offer to buy the shares of the remaining shareholders. The latter part of exercise of 'control' is highly subjective and has led to lot of confusion in the market. Therefore, SEBI has proposed to move on from this subjective test of control to a more objective 'brightline' test and has proposed two options - a list of protective rights not amounting to control and a numerical threshold of 25%amounting to control. The goal of this paper is to critically examine the concept of 'control' and to evaluate the two options proposed by SEBI. It concludes with thedemonstration that an objective numerical threshold as the sole test for control even though looks bright, has to be taken with a pinch of salt.

II. INTRODUCTION

Securities and Exchange Board of India (Hereinafter referred to as '***SEBI***') is a statutory body established and mandated to protect the interests of investors in securities and to promote the development of, and to regulate the securities market by such measures as it thinks fit.[1]In furtherance of the same, SEBI brought to effect the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (Hereinafter referred to as **'Takeover Regulations'**or **'Regulations'**) applicable to public listed companies.[2]The Takeover Regulations aim to ensure that the shareholders are treated in a fair and equitable manner. The idea behind such regulations is to ensure that shareholders are not denied an opportunity to decide on the merits of an acquisition.[3]This is achieved by making it mandatory to give the shareholders an opportunity to exit the company in case of a substantial acquisition or a takeover.

The Takeover Regulations provide for a mandatory offer (open offer) to the existing shareholders of the target company. This is known as theMandatory Bid Requirement

---

[1] Securities and Exchange Board of India Act 1992, § 11(1).

[2] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011, Regulation 2 (z).

[3]Paragraph 2(a) of the City Takeover Code, United Kingdom.

(Hereinafter referred to as **'MBR'**).[4] Under the TakeoverRegulations, certain events such as substantial acquisition of shares or change of 'control' will trigger the requirement on an acquirer to make a mandatory bid to buy shares of existing shareholders of the target company. However, the change of 'control' provision is vague which has led to a lot of uncertainty for potential investors. Further, courts have given contradictory judgments leading to further ambiguities and confusion. Therefore, SEBI has released a discussion paper in an attempt to clarify the definition and scope of 'control'.

This article endeavorsto analyze the problems with the existing concept of 'control'and to find out if there is a need for a Bright Line Test to determine the trigger for MBR. In this context, the article will examine SEBI's discussion paper[5] on "Bright Line Tests for Acquisition of 'Control'under SEBI Takeover Regulations"(Hereinafter referred to as **'Discussion Paper'**) andcritically analyze the two options proposed by SEBI.

Part II of this paper outlines the various circumstances which trigger the MBR and the rationales behind MBR. Part III discusses the test of control under the SEBI Takeover Regulations in India.Part IV analyses the two options to determine 'control' as proposed by SEBI in its Discussion Paper namely, (1) Framework for Protective Rights and (2) Adopting a numerical threshold. Part V examines the extent to which a Bright Line Test would be feasible in the Indian jurisdiction. Part VI concludes.

III. WHAT IS MANDATORY BID REQUIREMENT (MBR)?

The Takeover Regulations are applicable to direct and indirect acquisitions of shares or voting rights or control over a target company.[6] An acquirer is defined as a person who directly or indirectly, acquires or agrees to acquire shares or voting rights or control over the target company.[7] Under these Regulations, an acquirer has to make an open offer to rest of the shareholders for buying their shares under the following provided circumstances:

Initial Trigger

According to the Takeover Regulations, every acquirer has to make an open offer to all the other shareholders if he acquires or agrees to acquire 25% of shareholding or voting rights in the company.[8] In the 1997 Takeover Code, the threshold for the MBR was 15%.[9] However, the

[4]Takeover Regulations, *supra* note 2, at Regulations 3, 4.
[5] SEBI Discussion Paper on "Bright Line Tests for Acquisition of 'Control' under SEBI Takeover Regulations" 2016 [hereinafter referred to as the "**Discussion Paper**"].
[6]Takeover Regulations, *supra* note 2, at Regulation 1(3).
[7]*Id*, at Regulation 2(1).
[8]*Id*, at Regulation 3(1).
[9]SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997, Regulation 10.

Bhagwati Committee Report[10] and the TRAC Report[11] observed that the threshold was too low in a country like India where pattern of shareholding is very concentrated. According to the latter, the mean and median of promoter shareholding in listed companies are at 48.9% and 50.5% respectively.[12] Therefore, it was suggested that the threshold should be increased to 25% as having 1/4th of the voting rights allows a person to block special resolutions.[13]

Control Trigger

The Takeover Regulations also provide that an acquirer is obliged to make a mandatory offer to other investors if he acquires 'control' over the target company, irrespective of his shares or voting rights in the company.[14] The definition of 'control' as provided in the Takeover Regulations is an inclusive one. It has been subject to a lot of debate, discussion and litigation which finally forced SEBI to come out with a DiscussionPaper in order to clarify the concept of 'control'. The next part of this article would address the concept of MBR and 'control'comprehensively.

Creeping Acquisitions

If any acquirer is an existing shareholder holding 25% or more shareholding or voting rights in the target company, then he has to make an open offer to other shareholders if he tries to acquire more than 5% of shares in a financial year.[15] The MBR requirement under creeping acquisition is meant to facilitate consolidation by persons already in control or holding substantial number of shares in the target company.[16] As the question of change of control does not arise in creeping acquisitions, itfalls out of the scope of this paper and wouldn't be dealt with further.

Indirect Acquisitions

If an acquirer holds shares or voting rights or has control over a certain company, which allows the acquirer to exercise such voting rights or control over the target company indirectly, then he has to make a public offer to investors of the target company.[17] Though indirect acquisitions are not within the scope of this paper, the author will discuss the impact on indirect acquisitions in relation to MBR and 'change of control'.

---

[10] Report of the Committee appointed by SEBI on Takeovers, Justice P.N. Bhagwati (Jan. 18, 1997) [hereinafter Justice Bhagwati Report].

[11] Report of the Takeover Regulations Advisory Committee, Mr. C. Achuthan (July 19, 2010) [hereinafter *TRAC Report]*

[12]*Id*, at 24.

[13]*Id*, at 25.

[14]Takeover Regulations, *supra* note 2, at Regulation 4.

[15]*Id*, at Regulation 3(2).

[16] TRAC Report, *supra* note 12, at 27.

[17]Takeover Regulations, *supra* note 2, at Regulation 5.

The triggers for MBR are mentioned in Regulation 3(1), 3(2), 3(3), 4 and 5 of the Takeover Regulations. For the purposes of this paper, only Regulation 3(1) and 4 are relevant. Under these sub-regulations, an acquirer, who either individually or together as persons acting in concert (PACs) acquires shares and voting rights crossing the threshold of 25%[18] or is in 'control' of the target company,[19] has to make a mandatory bid of at least 26% of the remaining shares in the company.[20]For the purposes of Takeover Regulations, persons who are acting or deemed to be acting in concert must have the common intention to acquire shares of a target company.It is the conduct of the parties that determines if they are acting in concert.[21]

IV. WHY IS THERE A NEED FOR MBR?

There are two major and popular rationales for the MBR. First, it supports the equal opportunity rule. It provides that the shareholders who sell their shares to the acquirer allowing him to cross certain prescribed thresholds must share their private benefits with all the other shareholders.[22]This means that in case of change of control, all the shareholders should be given an opportunity to exit the target company by selling their shares. The 'control' concept for the MBR, is principally aimed at providingequality of treatment to the minority shareholders of the target. Second, it takes into account thatwhen an investor buys shares in a company, he/she does the same on the basis of the existing management and policies of the company. Once a bidder acquires control over the company, the policies may or may not remain favorable to the interests of the existing shareholders.Thus, the MBR provides an option to the minority shareholders to exit in an eventof change of control over the company.

While the need for the MBR is emphasized, it is also widely criticized for its potential to prevent value enhancing takeovers and provide extra protection to existing controlling shareholders.[23]It increases the costs and expenses incurred during an acquisition and thereby discourages takeovers even if they are in the interests of the target company.[24]

The effectiveness of the aforesaid criticism depends on the ownership patterns of the corporate structures involved. In countries like India, the shareholding patterns tend to be concentrated

---

[18]Takeover Regulations, *supra* note 2, at Regulation 3(1).
[19]*Id*, at Regulation 4.
[20]*Id*, at Regulation 7(1).
[21] M/s Daiichi Sankyo Company Ltd v JayaramChigurupati and Ors, (2010) 7 SCC449.
[22]Lan LuhLuh, Ho Yew Kee& Ng See Leng*, Mandatory Bid Rule: Impact of Control Threshold on Take-over Premiums* [2001] Singapore Journal of Legal Studies 435, 433-452 (2001).
[23] Chao Xi, *The Political Economy of Takeover Regulation: What does the Mandatory Bid Rule in China Tell us?,* Journal of Business Law Issue 2, 158, 142-164 (2015); REINIERKRAAKMAN, JOHN ARMOUR, PAUL DAVIES, LUCA ENRIQUES, HENRY B. HANSMANN, GÉRARD HERTIG, KLAUS J. HOPT, HIDEKI KANDA, AND EDWARD B. ROCK**,** THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, 254 (2nd ed. 2009).
[24]UmakanthVarottil, *Comparative Takeover Regulation and the Concept of 'Control'*, Singapore Journal of Legal Studies, 213, 208-231 (2015).

due to prevalence of high promoter shareholding in most companies.[25]In such jurisdictions, the MBR is likely to work in favor of the controlling shareholders as opposed to the minority shareholders or the potential acquirer of the target company.[26] This contributes to perpetuationof concentration of shareholdings and might hamper the otherwise efficient takeovers beneficial to the interests of the shareholders.To this extent, it should be ensured that the MBR is not misused to prevent takeovers that are beneficial to the company's stakeholders as well as shareholders. It operates to grant equality of treatment to minority shareholders by conferring upon them an exit option in case of a change in control,[27]and should be used only to further this objective.

The major determining factor for the likelihood of the MBR to contribute to concentration of shareholdings in India is the level of threshold set to trigger control. These trigger levels were set based on the level at which the potential acquirer is likely to be able to get a majority of votes cast in a general meeting of the shareholders.[28] In order to ensure that the MBR is not misused, the threshold level for triggering control should be set right. If the trigger is set too high, then the acquirers would be able to exercise de facto control by staying just below the threshold level and deny exit option to minority shareholders. If it is set too low, it would include even insignificant acquisitions and would prevent value-enhancing takeovers thus proving the criticisms right. The threshold becomes important as it has a significant impact on the potential takeovers.

Apart from crossing a set numerical threshold, the MBR gets triggered even when the acquirer is able to exercise de facto 'control' over the target company. Such an event can occur when the acquirer is able to effect the management or policies of the target company by virtue of shareholder agreements, particular contractual rights, etc… Therefore, effectiveness of the MBR is also dependent on the change of control provision. MBR should be triggered when an acquirer is able to control the target company without crossing the numerical threshold (de facto control) giving minority shareholders an exit option. However, if the concept of control is not defined properly and is ambiguous, MBR may get triggered even where there is no de facto change of

[25]Individual data studies, combined with a view of some of the most popular stock exchange indices, show that average promoter shareholding in Indian companies is highly concentrated ranging from 48% to 54%. See: Shaun J Mathew, *Hostile Takeovers in India: New Prospects, Challenges and Regulatory Opportunities* (November 12, 2007). Columbia Business Law Review, Vol. 2007, No. 3, 2007; Balasubramanian, Bala N. and Anand, R. V*., Ownership Trends in Corporate India 2001-2011: Evidence and Implications,* IIM Bangalore Research Paper No. 419. (July 30, 2013).
[26]UmakanthVarottil, *The Nature of the Market for Corporate Control in India*, NUS Working Paper 2015/011, at 11.
[27]The MBR requires any person acquiring control of a public listed company to make an offer to acquire the shares of the remaining shareholders at no less favorable terms than that it offered to acquire control. See W.D. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, Harvard Law Review, 78 (1965), 505-63, pp. 515-6.
[28] TRAC Report, *supra* note 12, at 26.

control or it may not get triggered even when an acquirer has the de facto control without actually crossing the numerical threshold. Therefore, an unclear and vague definition of change of 'control' can be harmful to interests of the minority shareholders.

V. TEST OF CONTROL

The major controversy surrounding the MBR is the test of 'control'. According to this test, the MBR will be triggered even if the acquirer is below the 25% threshold, provided he has the *de facto*'control' over the affairs of the target company. According to the Takeover Regulations, 'control' has an inclusive definition:

"'control' includes the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner:
Provided that a director or officer of a target company shall not be considered to be in control over such target company, merely by virtue of holding such position;'[29]

Generally, the jurisdictions around the world have chosen either the quantitative or *de jure*(objective) test or the qualitative (subjective) to determine when the MBR is triggered. For example, Australia, Germany, New Zealand, Russia, Hong Kong, Singapore, South Africa and UK apply a numerical threshold to mandate a bid from the investor or the potential acquirer.[30] On the other hand, countries such as Canada, France, Ghana, Norway and Spain use the *de facto* control (subjective) test. Some jurisdictions such as India have moved forward to adopt a mixed approach, that is, a combination of objective and subjective approach.[31]

According to Regulation 2(e) of the Takeover Regulations, 'control' of a target company can be exercised if the acquirer has:

- The right to appoint a majority of directors.
- The right to control the management.
- The right to control the policy decision.

Right to appoint majority of the directors

The plain and ordinary meaning of 'control' is the '*power of exercising restraint or direction over something*'.[32]For the purposes of the Takeover Regulations, if 'control' includes the power of

[29]Takeover Regulations, *supra* note 2, at Regulation 2 (e).
[30]Discussion Paper, s*upra* note 6, at 4.
[31]Umakanth, *supra* note 24, at 221.
[32]WEBSTER'S ENCYCLOPEDIC UNABRIDGED DICTIONARY OF THE ENGLISH LANGUAGE 318-319, (1994).

direction over a company, it would include the power to determine the outcome of the meetings of the board of directors of the target company.[33]Therefore, it's easy to establish that an acquirer has control over the target company if he can appoint or remove majority of the directors. The composition of board of directors is a very important factor in the analysis of 'control' over the target company. SEBI and SAT have often looked at the composition of the board to determine 'control' over a target company.[34] In fact, control over a company is only evident in the manner in which voting rights are exercised by the board of directors.[35]

The SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 mandate that the board of a listed company with a non-executive chairman should have at least one-third of its directors to be independent directors. In case of an executive chairman, the board must have half of the directors to be independent. In the former case, it will be very difficult to appoint majority of directors. In the latter, it would be an impossibility. Therefore, the test of right to appoint majority of board of directors may become futile in certain cases.

To remedy this situation, SEBI has proposed to change this test from the right to appoint majority of directors to right to appoint majority of the "non-independent" directors of the company in its Discussion Paper.[36] The author believes that this was a logical and a correct move by SEBI and should be incorporated in the Regulations.

Right to control the management & Right to control the policy decisions

However, the other two criteria, namely controlling the management and policy decisions of the company are highly vague and fairly subjective.Such rights may be acquired by virtue of shareholding, management rights, veto rights, shareholder agreements or in any other manner. Despite the investor holding a very low amount of shares, he/she may be deemed to be in 'control' of the target company due to such special powers. This can happen even if the investor has no intention of taking control of the company.[37]Therefore, determining if a particular person or entity is in control of the target company is a question of fact and has to be determined by the relevant authority (for the purposes of the Takeover Regulations, SEBI) in each and every case.This has given rise to a multitude of opinions and led to various litigations.[38]Since the definition is so wide and inclusive and the law is not settled on what does or does not amount to control, the uncertainty negatively impacts willingness of potential investors. This is undesirable in equity and financial markets and impedes the growth of our economy.

---

[33]SHISHIR VAYTTADEN, SEBI'S TAKEOVER REGULATIONS 20(2010).

[34]For example: Sandip Save v SEBI (SAT Order Dated 27 November 2002, Appeal No 22/2002 and Application No 17/2002).

[35] Justice Bhagwati Report, *supra* note 11, at 2.21.

[36]Discussion Paper, s*upra* note 6, at 8.

[37]Umakanth, *supra* note 26, at 15.

[38]Discussion Paper, s*upra* note 6, at 2.

Since the concept of 'control' has become a controversial point of discussion[39], it necessitated SEBI to reconsider the determinative tests by bringing out its Discussion Paper on change of 'control'.

VI. DISCUSSION PAPER ON "BRIGHTLINE TESTS FOR ACQUISITION OF 'CONTROL' UNDER SEBI TAKEOVER REGULATIONS"

SEBI has finally decided to put to rest the perpetual controversy around the issue of 'control'. It felt the need to identify bright lines for control and has approved the proposal regarding Bright Line tests for acquisition of 'control'. It has issued a Discussion Paper on 14 March 2016, inviting public comments on the proposed policy framework.[40]In the DiscussionPaper, it has proposed two options to change or modify the existing definition of 'control'.[41]

1. LIST OF PROTECTIVE RIGHTS NOT AMOUNTING TO 'CONTROL' **(OPTION 1)**

Unlike strategic investors, financial investors invest to realize a return on their investments. In such a scenario, they are continually becoming vary of investing in listed companies due to the unintentional and unwarranted trigger of the MBR. The MBR can be triggered when a financial investor asks for additional protective rights in return for this investment. As majority of companies in India have a concentrated pattern of promoter shareholding, such new investors generally ask for certain veto rights and other contractual rights to protect their investments. Investors demand such rights to ensure that promoters don't abuse their power and take decisions that might not be in the interests of the investor. They may not have any intention to o0btain'control' over the companyor to be a part of its dailyaffairs. But due to the wide definition of term 'control' and unsettled jurisprudence on the matter, the MBR may be triggered and the investor might have to bear additional costs.[42]To improve this situation, many investors have been demanding SEBI to come up with a list of protective rights which would not amount to 'control'. However, for the longest time, SEBI refused to change its stance and continued to consider such protective rights as controlling rights for the purpose of triggering the MBR.[43]
Nonetheless, the tribunals and the courts did relax their stance towards investors and became more amenable to them. For instance, in the case of *Sandip Save v Securities and Exchange Board of India*,[44] a lending bank that was also a financial investor of the company had certain approval rights over significant decisions. These included appointment and removal of directors, changes

---

[39]Umakanth, *supra* note 24, at 221.
[40]Discussion Paper, s*upra* note 6.
[41]*Id*, at 5.
[42]Umakanth, *supra* note 24, at 224.
[43]*Ibid.*
[44]Sandip Save v. Chairman, SEBI, (2003) 41 SCL 47 (SAT - MUM.).

to projects and other key matters. The tribunal held that since the target company had promoters who were still in charge of the company's affairs and the nature of the rights conferred upon the lender investor were only protective, the bank could not be said to enjoy 'control'.

Finally, a change seemed imminent when the SAT in 2010, in the case of*Subhkam Ventures (I) Private Limited v. SEBI*,[45] observed:

"…Control, according to the definition, is a proactive and not a reactive power. It is a power by which an acquirer can command the target company to do what he wants it to do. Control really means creating or controlling a situation by taking the initiative. Power by which an acquirer can only prevent a company from doing what the latter wants to do is by itself not control. In that event, the acquirer is only reacting rather than taking the initiative. It is a positive power and not a negative power….The test really is whether the acquirer is in the driving seat….By no stretch of logic, can such an affirmative vote confer control over the day to day working of the company…Affirmative vote of the investor in these matters is necessary for protecting its investment….Such fetters fall far short of the existence of "control" over the target company. It must be remembered that every fetter of any nature in the hands of any person over a listed company cannot result in "control" of that person over that company…"

In addition to holding that negative rights are only protective in nature and not participative as to give control of the company to the investor, the Tribunal went on to lay down a list of protective and affirmative rights which would not amount to 'control'. This decision was well-received by the investors but their happiness remained sojourn as SEBI appealed to the Supreme Court. Instead of clarifying the matter, the Apex Court heldthat the SAT's decision would not have any precedential value and left the question of law open.[46]

After five years, in 2016, SEBI has finally moved on from its rigid stance and proposed a list of protective rights which if exercised, individually or collectively, wouldn't amount to 'control' over the target company and subsequently wouldn't trigger the MBR (Hereinafter referred to as "**Option 1**"). It has acknowledged that veto or affirmative rights do not give the investor any participative rights but allow him to protect his investments and wouldn't amount to 'control'. The list includes appointment of chairman or observer, granting of certain rights to lenders which is part of the business, certain veto rights, quorum rights etc.[47] These rights are subject to investor holding 10% of company's shares, shareholders' approval and incorporation of such rights in the Articles of Association.[48] Substantive analysis of the protective list given by the SEBI is not within the scope of this paper.

[45]Subhkam Ventures (I) Private Limited v. The Securities and Exchange Board of India, (2010) (SAT - MUM).
[46]Securities and Exchange Board of India v. Subhkam Ventures (I) Private Limited, MANU/SC/1587/2011.
[47]Discussion Paper, s*upra* note 6, at 6.
[48]*Id, at 7.*

This move by SEBI will receive a warm welcome from vary and distressed investors and lenders. If this suggestion is accepted, it will certainly create more certainty over the term 'control' and investors will be able to take a decision more confidently. However, this list will act only as a supplement to the existing definition of 'control' as defined in Regulation 2(e) of the Takeover Regulations. Whether a particular transaction amounts to 'control' would still be subjective and courts would have to decide the same on a case to case basis. Further, it is not possible for SEBI to lay down an exhaustive list of protective rights covering each and every case, and therefore tribunals and courts will retain certain amount of discretion. If Option 1 is adopted, then the objective or *de jure test* of 25% would still remain as an initial trigger, in addition to the control trigger and the negative protective list

Lastly, the requirement for the investor to have at least 10% of shareholding for granting of such affirmative rights seems to be unnecessary. This can be especially the case when a financial lending institution may want contractual affirmative rights from the borrowing company without any shareholding rights.

Nevertheless, introduction of such a list will be a step towards attaining certainty to the concept of 'control' in India.However, Option 1 suggested by SEBI is one half of the solution to the conundrum posed by the test of 'control'. Not only is it important to lay down what does not amount to 'control', but also what does amount to 'control'. There is a need for a positive test to determine change of control in the target company.

2. ADOPTING A NUMERICAL THRESHOLD (OPTION 2)

Unlike Option 1, which appears to be a negative definition of 'control',Option 2 suggested by SEBI defines the term positively. This is the quantitative approach to control.A certain numerical threshold of voting rights or shares in the target company is set to be the determinative element of the change of control in the company (Hereinafter referred to as the "**Bright Line Test**"). SEBI has followed the initial trigger threshold of 25% and made it a trigger for 'change of control'. If this test is adopted, it would practically amount to elimination of subjective test or de facto test of control as it seeks to merge the initial trigger with the control trigger.

The concept of 'control' did not have any set numerical threshold in its initial stages. Mandatory offer was triggered whenever a target company came under the *defacto* control of the acquirer giving way to too much discretion to the decision making panel.[49] Many jurisdictions have gradually shifted from qualitative to quantitative approach because of the ambiguity of the subjective definition.[50]

---

[49]Umakanth, *supra* note 24, at 214.

[50]*Id*, countries like Hongkong, Austria, Belgium, Italy.

The shift towards quantitative approach meant setting a particular trigger point, crossing which the acquirer would be deemed to be in control of the company and would have to make an open offer. These trigger levels were based on the level at which the potential acquirer is likely to be able to exercise de facto control over the company or simply put, get a majority of votes cast in a general meeting of shareholders.[51] In India, it was seen that most companies were controlled by shareholders holding 25-30% of the voting capital of the company and hence it was suggested that 25% be the threshold as the promoters would be able to exercise de facto control at around this point. In addition, a holding in excess of 25% would entitle the shareholders to block a special resolution according the Companies Act. Thus it was concluded that 25% would be an appropriate open offer trigger threshold as it was reasonable to expect a new shareholder to exercise positive control beyond this threshold.[52]

VII. IS THE BRIGHT LINE TEST RIGHT WAY TO MOVE FORWARD?

In 2010, the Takeover Regulations Advisory Committee (**TRAC**) constituted under the chairmanship of Mr. C. Achuthan emphasized on the need for subjective or *de facto* approach to control. It observed irrespective of *de jure* control, acquisition of *de facto* control must trigger an obligation to make an open offer and that the existence of such control should be decided on a case to case basis giving discretion to the concerned authority. It has emphasized on including the 'ability' to control the management or policy decisions or to appoint majority of the directors in addition to the 'right' to do so, within the definition of 'control'.[53]

In this section, the author discusses various problems and issues posed by the Bright Line test or the numerical approach, when adopted to the exclusion of the subjective approach. This paper intends to make a case for the subjective or *de facto* approach to 'control' by identifying problems and flaws with the objective or the numerical approach. First, the author will argue that adopted threshold of 25% is not suitable in the Indian jurisdiction. Second, I will examine situations where the numerical approach can lead to arbitrariness and defeat the basic rationale of the MBR. Third, the author discusses how creating a new definition of control may create confusion with respect to companies and their activities. Fourth, general inefficiency of the numerical approach, when used without any subjective element, would be identified with a help of a few examples of both Indian and foreign jurisdictions. Lastly, I would discuss the ripple effects of change of this definition of control over other regulations and concepts.

[51] TRAC Report, *supra* note 12, at 26.
[52]*Ibid.*
[53] TRAC Report, *supra* note 12, at 30.

1. **Is 25% a suitable threshold for Indian companies?**

In many jurisdictions, the threshold that triggers mandatory open-offer requirement is usually between 30% and 33%.[54] To determine this numerical threshold, one has to look at the general shareholding pattern within the jurisdiction.Jurisdictions with more concentrated shareholding would impose higher thresholds and those with dispersed shareholding would impose lower thresholds.[55] The underlying rationale for this proposition is that when the shareholding in a company is dispersed, each individual shareholder would have less percentage of shares or voting rights (for example, 5%) and the acquirer seeking to obtain control over the company would be successful in doing so even by acquiring lower percentage of shares (in this example, around 20%). Similarly, if the shareholding is concentrated, with each individual shareholder having around 30% of shares then change of control is not likely to occur with acquisition of lower percentage of shares and the threshold has to be set higher.[56]

Presently, the threshold provided by the Takeover Regulations is 25%.[57]. A study by Balasubramainan and Anand[58] shows that the shareholding pattern in Indian companies during 2001 to 2011 has moved towards concentration rather than dispersion. Empirically, there is predominance of concentrated ownership and control in India and the extent of such concentration has been increasing over the years.[59]Therefore, triggering of the MBR whenever an investor acquires 25% shareholding rights would impose an unnecessary burden on him even if the investor has no interest in a takeover. In this light, it seems perplexing that India hasn't increased the quantitative threshold for change of control.

2. **Arbitrariness of the Quantitative approach**

The quantitative approach has its own set of challenges. For example, in a situation where a company in distress may sell a part of its shares to an investor due to starvation of funds. Such an investor may have less than 25% but may still have affirmative votes on important decisions of the company.He would be able to effectively exercise de facto control over the company but would still not come within the definition of 'control' and hence would not be obligated to give an open offer. Such situations demonstrate the problems associated with the total exclusion of the qualitative approach to trigger the MBR.Setting a numerical threshold and making it a standalone approach to determine control can have an adverse effect on the minority

[54]Marc Goergen, Marina Martynova& Luc Renneboog, *Corporate Governance Convergence:Evidence from Takeover Regulation Reforms,* 23, Working Paper No 33/2005, European CorporateGovernance Institute, (2005).

[55]Umakanth, *supra* note 24, at 215.

[56]*Ibid.*

[57]Takeover Regulations, *supra* note 2, at Regulation 3(1).

[58]Bala N. Subramanian, R.V. Anand, *Ownership Trends in Corporate India 2001-2011: Evidence and Implications*, Research Paper no. 419, IIM Bangalore.

[59]*Ibid.*

shareholders whose rights are jeopardised by a hostile takeover. This would in effect negate the major purpose of the Takeover Regulations and the MBR.

The quantitative or the *de jure*approach is thus criticized for bringing in arbitrariness by substituting the *de facto* control with shareholding percentage thresholds.[60] The further the MBR tends to move away from *de facto* control, the more it negates the philosophy of equality of opportunity for minority shareholders which is the crust of the MBR. The rights of the minority shareholders are sacrificed in favor of the acquirer. The main advantage of a setting a particular numerical threshold is to bring certainty to the acquirers and shareholders in the market. But this pragmatic approach is also criticized as it is believed that the availability of a Bright Line Test will enable the parties to work their way around those rules by using clever structuring to skip the trigger of the MBR.[61] For example, a company may acquire voting rights up to a percentage just below the threshold set and may still be in position to have *de facto* control over the target if there is no other shareholder with similar rights, without triggering the rule or being obligated to incur any additional economic costs.This would go against the interests of the minority shareholders as they won't be given an opportunity to exit from the target company, even when there is a *de facto* change in control. Hence as much as the quantitative approach brings in certainty and predictability into the market, it undermines the very rationale of the MBR by moving away from *de facto* control.

Further, SEBI's proposal to have a Bright Line to trigger control comes at a time when it is being demonstrated by several technology sector companies that voting rights and the ability to derive economic benefits through dividends are completely dissociated. This is because most of the technology or IT companies follow dual class share structure whereby the general shareholders will reap the economic benefits but the control will remain with the other class of shares-management shares. So there are shareholders who enjoy control rights disproportionate to their economic rights.[62] Hence, the objective approach of looking at the substantial acquisition of shares wouldn't be the correct approach in such dual class share structures.

3. Definition of Control under other Statutes

The Companies Act 2013, the Insurance Laws (Amendment) Act 2015 and Consolidated FDI Policy Circular of 2015 define 'control' in the same way as the present Takeover Regulations. The definition of 'control' is inclusive in nature and includes:

- The right to appoint a majority of directors.

---

[60]Umakanth, *supra* note 24, at 216.

[61]Luca Enriques,*The Mandatory Bid Rule in theTakeover Directive: HarmonizationWithout Foundation?,*European Company and Financial Law Review, 452(2004).

[62]Paridhi Srivastava, *Sebi's evolving regime on acquisition of control: From Subhkam Ventures to the Brightline Test*, Journal on Contemporary Issues of Law Vol. 2 Issue 6, 11 (2016).

- The right to control the management.
- The right to control the policy decision.[63]

The basis of this definition is the factual determination of control, whatever the numerical shareholding percentage may be on a case to case basis by the regulating authority. It is a principle-based approach taken to define control and has stood the test of time. The Option 2 proposed by SEBI, i.e. the objective approach is on the other hand, a rule-based approach to mark out a BrightLine in order to define control. Therefore, creating a new definition of 'control' may create confusion in courts about which definition should be used for purposes of companies and their activities.

4. Ineffectiveness of the objective or numerical approach

The Bright Line Test proposed by SEBI attempts to define 'control' as acquisition of 25% voting rights. There will be cases where one shareholder may have 26% of the shares and has the power to veto special resolutions and the other shareholder might have 74% voting share and he can control the appointment or removal of directors as it needs only a simple majority vote. In this case, it is obvious that the investor with 74% shareholding would be the one in control as opposed to the one holding 26%. Though 25% voting rights threshold may be usedtrigger the MBR but to define 'control' in this manner would be problematic, especiallywhen other laws depend on the definition given by Takeover Regulations.

To understand this better, a recent decision of the Delaware Chancery Court on the concept of 'control' may be looked at. The study of this can help us analyse options proposed by SEBI. It is the case of *Calesa Associates L.P. v. American Capital Ltd.*[64] In this case, company A was a shareholder of 26% of the shares of the company B. A was going to increase its shareholding in B through contractual agreements which would dilute the shares of the other shareholders of B. One such shareholder, C initiated action against A, the controlling shareholder for breach of its duties towards minority shareholders of B. The point of contention was whether A exercised control over B. According to Delaware law, 'control' could be achieved either through acquiring majority interest or by virtue of exercising control over the business affairs of the company. The court held that as A only had 26% shareholding in B, it had to be established that it exercised 'actual control' over B. The court went on to hold that the contractual agreements between A and B giving rights to A were insufficient to establish 'control'. It analysed whether A had control over majority of the board of directors of B and observed that such determination has to be done on a case to case basis. It was held that merely because a director was appointed by a

[63]Companies Act 2013, Insurance Laws (Amendment) Act 2015 and Consolidated FDI Policy Circular 2015.
[64] C.A. No. 10557-VCG, decided on February 29, 2016.

shareholder, the latter would not be deemed to be exercising control over the company. In the end, the court took a very fact-specific approach and analysed how four out of seven directors of B were influenced by A and hence established 'control'.

More often than not, question of 'control' turns out to be a factual onewhich has to be decided on the basis of specific circumstances of a case. It is consistent with the present definition of 'control' under the Takeover Regulations which is inclusive in nature. Thus, it shows that subjective factors cannot be ignored in determination of exercise of 'control'.

Though a numerical threshold brings certainty and predictability in the market, subjective factors cannot be ignored while determining if an entity exercises control over the target company. There has to be some discretion left to the regulating authority to decide on the question of exercise of control. Despite an existence of a dispersed shareholding pattern in USA[65] where the numerical threshold may be more effective, the Delaware court went on to rely on the subjective test to make a determination. The need for this kind of approach is amplified in jurisdictions such as India where shareholding is generally concentrated and the *de jure* test can be often misleading.

5. Ripple effects of the Bright Line definition

There are other regulations which draw the definition of 'control' from the Takeover Regulations. For example, the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 imports the definition of 'control' from the Takeover Regulations. Even definition of a 'promoter' is dependent on definition of 'control' in the Takeover Regulations. This implies that if there is an investor with more than 25% shareholding and regarded as having 'control' over the company, he will also be deemed to be the 'promoter' of the company. These definitions are in turn depended up on by various SEBI Regulations. Hence there will be a substantial ripple effect with the change of definition of 'control' in the Takeover Regulations.

a. Indirect Acquisitions

Under Regulation 2 (1) (a) of the Takeover Regulations,[66] an acquirer is any person who directly or *indirectly* acquires control of the target company. Indirect acquisition refers to acquisition of a target company by virtue of acquisition of another listed company.[67] For example, in *Re Sterling Investment Corporation Private Limited*[68]Shapoorji group acquired 67.75% of shares of FGL, which in turn held 31.64% shares in another company, FAL. As Shapoorji had acquired a 'controlling

[65] Dennis Leech, *Shareholder Voting Power and Ownership Control of Companies*, Warwick Economic Research Papers, 1 (2002).
[66]Takeover Regulations, *supra* note 2, at Regulation 2(1)(a).
[67]Takeover Regulations, *supra* note 2, at Regulation 5(1).
[68]SEBI Order dated 31st August 2003, WTMN/195/CFD/8/04.

interest' in FGL, it had indirectly acquired control over FAL and was found liable for not following the MBR.

Further, the Takeover Regulations do not distinguish between accidental and intentional takeovers. Even if an acquirer doesn't intend to take control over the target company, MBR will be triggered as soon as it acquires 25% shareholding rights or 'control' over the company.[69] Therefore, altering the definition of 'control' and excluding the subjective approach completely may have an adverse effect on *indirect* acquisitions.

In the case of *NRB Bearings,*[70]the acquirer bought a French body corporate which held 26% of equity in NRB Bearings. The latter, in turn, held 63.98% of shares in SNL Limited. If shareholding of the acquirer was measured on a pro-rata basis,[71] then its shareholding in SNL Limited would have crossed the threshold (then 15%) and MBR would have been triggered. However, SEBI concluded that the acquirer wasn't obliged to make a mandatory offer in the target company because it didn't have any 'controlling interest' in SNL Limited. Therefore, SEBI took recourse to the subjective test and factually analyzed the issue to hold that an indirect acquisition cannot take place unless the acquirer has *de facto* control over the target company.

If Option 2 of SEBI is adopted, and subjective test is completely eliminated from the Takeover Regulations, then it would amount to overturning the rationale of the above decision. Investors or acquirers who acquire shares in a company may become liable to provide a mandatory bid to shareholders of another company because it may accidently cross the numerical threshold of 25% in the latter. This can have a negative impact on investor's willingness to trade in securities. On the other hand, companies may also take advantage of elimination of the subjective test and try to indirectly acquire a target company through an intermediate buying of shares without triggering MBR.

Therefore, eliminating the *de facto* or the subjective test from the Takeover Regulations by replacing the same with a numerical threshold can have an adverse impact on indirect acquisitions.

b. Different definition of 'promoters'

The definition of promoter for the purposes of the Takeover Regulations is imported from the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (Hereinafter referred to as "**ICDR Regulations**").[72] According to R. 2(za) of ICDR Regulations, a promoter includes a

---

[69]NagrajGaneshmal v. SEBI(SAT Order dated 17 August 2001, Appeal No 1212001); Re Ondeo Nalco(SEBI Order dated 9 April 2003); Rhodia SA v. SEBI(SAT Order dated 7 November 2001, Appeal No 36 of 2001).

[70]SEBI Order dated 29st May 2003,CO/33 /TO/05/2003.

[71] This is a method to calculate equity of a shareholder in a company. For example, in the case of NRB Bearings, the pro rate equity shareholding of the acquirer was 26% * 63.98% = 16.63%.

[72]Takeover Regulations, *supra* note 2, at Regulation 2(1)(s).

person who is in 'control' of the issuer.[73] If SEBI's Option 2 is adopted, then if an investor buys or agrees to buy 25% of equity or voting shares of the target company, then he would be deemed to have 'control' over the company. As a promoter includes a person who is 'control' of the target company, the acquirer would become a promoter for the purposes of the Takeover Regulations. Therefore, for an investor to become a promoter from a public shareholder, he would have to acquire 25% of equity shareholding or voting rights.

To retain the status of a public listed company, promoters are mandated to reduce their shareholding rights to reach the minimum public shareholding threshold, that is, 25%.[74] One of the methods which are often adopted by an issuer companies to achieve the same is to reclassify a promoter or group of promoters as public shareholders. In wake of the *Gilette's case,*[75]SEBI introduced Regulation 31A to Listing Obligation & Disclosure Requirements Regulations, 2015 which provides certain procedures for a promoter to be re-classified as a public shareholder.[76]Sub-Regulation 31A (5) states:

"(5) When a new promoter replaces the previous promoter subsequent to an open offer or in any other manner, reclassification may be permitted subject to approval of shareholders in the general meeting and compliance of the following conditions:

(a) Such promoter along with the promoter group and the Persons Acting in Concert shall not hold more than ten per cent of the paid-up equity capital of the entity.

(b) Such promoter shall not continue to have any special rights through formal or informal arrangements. All shareholdingagreements granting special rights to such entities shall be terminated.

(c) Such promoters and their relatives shall not act as key managerial person for a period of more than three years from the date of shareholders' approval"[77]

Therefore, according to above sub-regulation, in case of any open offer under the Takeover Regulations or any other method, a promoter can be classified as a non-promoter public shareholder provided, *inter alia,* that his shareholding falls below 10%. It means that an acquirer would become a promoter if he acquires 25% of shares in the target company but a promoter wouldn't become a non-promoter by reducing his shareholding below 25%. The existing promoter, among other things, would have to reduce his shareholding below 10% to be re-classified as a public shareholder. This creates two different bright lines for determination of a promoter.

---

[73] SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009, at Regulation 2(1)(za).

[74] Securities Contracts (Regulation) Rules, 1957, at Regulation 19(2)(b).

[75]M/s. Gillette India Limited v. SEBI (SAT Order dated 3rd July 2013, Appeal No: 65 of 2013).

[76] SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, at Regulation 31A.

[77]*Id.*

VIII. CONCLUSION

The Mandatory Bid Requirement has gained significant importance in the wake of mass demutualization and corporatization of business firms. It is an important tool to safeguard interests of minority shareholders in case of a hostile takeover of the target company. However, the concept of 'control' remains contentious, especially in the context of its application as a trigger for the MBR.

To clarify the controversy around the 'control' trigger, SEBI has proposed two alternate options with differing rationales. Option 1 of SEBI's Discussion Paper provides for a framework of protective rights whereby it gives a list of rights which would not amount to 'control'. This is a supplementary list in addition to the existing definition of 'control' under the Takeover Regulations, which provides for both a numerical threshold of 25% and subjective discretion of the regulating authority. This is a progressive approach to protect potential investors but is lacking in the sense that the list cannot be exhaustive, thus not solving the problem of uncertainty in the market.

On the other hand, Option 2 provided by SEBI is to adopt a numerical threshold of 25% voting rights for shareholding rights as the definition of 'control'. This definition of 'control' is problematic and may create more problems than it will solve because:

- 25% would be too low a threshold for change of control in the Indian scenario of concentrated shareholding patterns.
- Even though a purely rule-based quantitative test brings with it the much needed certainty and predictability, it would not be desirable to ignore any subjective factors or principles whatsoever in the process. The numerical approach, standing on its own, can create more arbitrariness in the takeover process defeating the basic rationale of the MBR.
- Creation of a new definition of 'control' which differs from the existing definition in the Companies Act, Insurance Act and FDI policy may create confusion and uncertainty.
- It has been observed that strictly adopting a numerical approach and excluding the subjective approach altogether can lead to situations with absurd outcomes. For example, when an acquirer holds 26% of shareholding rights and the promoter still owns the remaining shares, the latter would still be in 'control', but it would lead to triggering of a mandatory bid.
- Finally, changing the definition of 'control' can have a ripple effect on other regulations and concepts such as indirect acquisitions and definition of a promoter under a Companies law.

This paper has sought to critically examine both the options given by SEBI and it can be seen that both have their merits and demerits but both represent a step forward in providing clarity to the concept of 'control'.The Bhagwati Committee was of the view that 'control' was the 'very quintessence' of the takeover law. After careful analysis, the author believes that though Bright Line Test may bring more certainty under the takeover law, it needs to be adopted carefully and cautiously, and should be supplemented by the *de facto* approach.

A NEW PERSPECTIVE ON DEALING WITH STRESSED ASSETS IN INDIA: AN INSIGHT INTO RBI'S ROLE IN STRESSED ASSETS MANAGEMENT POST 2014

ISHANI NARAIN & GARIMA

I. ABSTRACT

Stress in the priority sectors has permeated into the accounts of lending institutions, resulting in a significant rise in loss-making receivables. Inefficient project evaluations, extensive project delays, lackluster monitoring and cost overruns, and the effects of global overcapacity on prices have plagued these sectors, raising the cost of insolvency and bankruptcy. RBI is one of the primary regulatory bodies which facilitate friction-less functioning through their guidelines. Mechanisms in the recent past attempted to target stress in assets but were unsuccessful in doing so as they provided short-term reliefs to a long-term issue. The latest guidelines aim to mitigate these defects by appropriately classifying and adequately provisioning the NPAs. Further, adherence to Basel III norms by establishing internal models for constant review of stressed assets would go a long way in improving lenders' balance sheets. The enactment of legislations like the Insolvency and Bankruptcy Code, the objectives of which though are laudable, require structured implementation for efficient operation. However, to harness a positive result these regulations must work in harmony with the existing legal framework. This cardinal issue requires a comprehensive study and analysis not only by the RBI but by all banks in order to develop a mechanism for effective management of such assets. This paper aims to outline the problem of stressed assets, their management and recovery in the Indian asset market while analyzing RBI's present outlook on handling such assets. It also brings forth the implications of the new RBI guidelines on all stakeholders and identifies the altering focus in addressing the NPA problem. Additionally, it delineates the major issues with the Bankruptcy Code and highlights how the latest RBI guidelines offer a mechanism free of such shortcomings.

II. BACKGROUND

Stressed assets have plagued our economy since a very long time, even more so after the 2008 financial crisis. Rapid growth of stressed assets and restructured loans in banks – public and private – has the potential to severely stunt the development of our economy. This rise was predicted by former Governor Raghuram Rajan in 2014, citing the unusually high returns that Indian banks earned compared to banks in other economies including developed countries in the previous year despite the economy being sluggish, as a signal of the accounts hiding the true value of the loans.[1]The Reserve Bank has repeatedly come out with guidelines and policies on how to handlethese Non-Performing Assets (NPAs), working in tandem with the Finance

---

[1] Krishna Merchant, *Investors have ignored RaghuramRajan's warning on stressed assets*, MINT, (Nov. 27, 2014, 9:45AM), http://www.livemint.com/Money/pBFNqjpD9kxDdx2jKlzJMJ/Investors-have-ignored-Raghuram-Rajans-warning-on-stressed.html(last visited Sept.16,2016).

Ministry. Refinancing and restructuring were the primary methods adopted by the banks to improve debt recovery ratio and debtors' credit position. However, their effect was limited since the real cause was the non-performance of the assets and non-repayment of debts was an effect of this problem. The 5/25 Refinance Scheme and the Strategic Debt Restructuring (SDR) Scheme are evidence of this. Even legislations such as SARFAESI focused more on repayment without taking into account the extant economic considerations that were adversely affecting the priority sectors.

NPAs affect banks in two ways – loss of income and provisioning for the lost value of stressed assets.[2]The underlying weakness in banking sector is primarily due to absence of robust credit appraisal system, inefficient supervision post credit disbursal and ineffective recovery mechanism. Proper implementation of any regulation or guideline is contingent on a periodical review of asset quality and without such precautionary frameworks; lenders would suffer huge unprecedented losses. Recent measures taken by the RBI such as introducing the Scheme for Sustainable Structuring of Stressed Assets (S4A) and effecting changes in the prudential norms,target resuscitation of stressed assets through proper classification, alteration of accounting procedures, revamp of the management through change in equity structure and reduction in involvement of the courts. Reforms promulgated by the government through the Insolvency and Bankruptcy Code (IBC) along with amendments to the SARFAESI Act, ease loan recovery procedures, consolidate existing laws and simplify exit procedures for entrepreneurial ventures. However, the latest amendments as well as the Bankruptcy Code ignore a very basic flaw in the effectiveness of the law that is, the displacement of existing management will most likely be a disservice to revival and repayment, as neither the lenders and the insolvency professionals nor the newly appointed promoters (as in S4A) would have complete knowledge of the affairs of the company.

NPAs witnessed sudden spurt in the last four years, rising to 4.62% of the gross advances in March 2015.[3]Thus the statistics denote that the previous legislations and guidelines had a sub-optimal impact since theyaddressed the issue of NPAs peripherally. An analysis of the current legal framework would reveal whether or not the new banking norms and regulations would have a substantial impact on the NPA issue.

---

[2]Nikhil Shah & Khushboo Vaish, *Outlook For Stressed Assets Market In India,*(2014), https://www.alvarezandmarsal.com/sites/archive/files/sidebar-callouts/india-stressed-assets.pdf (last visited Aug. 25, 2016).

[3]R Gandhi, *Asset Reconstruction And NPA Management In India*,RESERVE BANK OF INDIA (Sept. 15, 2015), https://rbi.org.in/scripts/bs_speechesview.aspx?id=974(last visited Sept. 20, 2016).

RBI FRAMEWORK ON EFFECTIVE MANAGEMENT OF STRESSED ASSETS

Non-identification of bad debts does not allow proper provisioning, which could otherwise act as a buffer to potential losses. This is evident from the slippage of the PSBs which is a result of delayed recognition of stress. If a debt is recognized as a bad loan its treatment is different from the rest of the loans and revival mechanisms can be initiated.

1.1 ASSET QUALITY REVIEW

Since identification and recognition mechanisms were implemented in a lackluster manner, a different and intensive approach had to be adopted. In response to the problem of rising NPAs, the RBI began the procedure of Asset Quality Review (AQR). This procedure is aimed at classifying assets as stressed or sustainable in order to get a clearer picture of the volume of bad debts. Although Annual Financial Inspections (AFI) wereroutinely conducted, AQR was necessary as the routine checks did not reveal the true picturewhich raised the suspicion that the banks were postponing classification of assets.[4] This procedure used a larger sample than AFIs usually take into account, finding that the gross non-performing assets jumped from 5.1% to 7.6% between September 2015 to March 2016, with public sector banks (PSBs) having a stressed asset ratio 14.5% and private and foreign banks at 4.5%.[5] Gross non-performing assets stood at an unprecedented Rs.5.7 trillion for 38 out of the 39 listed banks, as on 31 March 2016.[6] The RBI helped banks identify loans having potential weaknesses, those that cannot be revived and those that can be brought back on track through collective action. However, identification and classification is only the first step. Time intensive measures must be taken to stabilize these assets instead of adopting a risk adverse stance which would be beneficial to neither the bank nor to the investor. Scheme for Sustainable Structuring of Stressed Assets (S4A) complements the AQR process by providing a better method of revival of stressed assets through deep financial restructuring over a flexible period of time. The scheme was developed in concert with the recommendations of lenders who sought to address the drawbacks of the 5:25 Refinance Scheme and Strategic Debt Restructuring Scheme (SDR), which were also formulated to stem the NPA problem.

1.2PRE-SCHEME FOR SUSTAINABLE STRUCTURING OF STRESSED ASSETS REGULATIONS

[4]ManojitSaha, *Asset Quality Review and its Impact on Banks*,THE HINDU, (July 17, 2016), http://thehindu.com/business/industry/asset-quality-review-and-its-impact-on-banks/article8862648.ece (last visited Sept. 15, 2016).

[5]*Financial Institutions: Soundness and Resilience*, RBI Financial Stability Report, (June, 2016),https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/6_CH264F22FA79FA64F798EEDB1EC37CF03A8.PDF (last visited Sept. 15, 2016).

[6]AparnaIyer, *Banks may continue to report bad loans issues for two more quarters*, MINT, (May 30, 2016),http://www.livemint.com/Industry/7twttFkiGD3nKApDMtxJoM/Worst-may-not-be-over-yet-for-banks.html (last visited Aug. 15, 2016).

Restructuring and refinancing are popular alternatives to a bankruptcy proceeding which is not only costly and time consuming but also often not fruitful since the liquidated assets do not discharge the entire debt by virtue of being NPAs. 5/25 and SDR are two such schemes which offers the lenders a less time consuming and more powerful mechanism to clean balance sheets. However, the following paragraphs will also delineate their shortcomings which will be addressed in the subsequent mechanism, that is, S4A.

1.2.1.5/25 Refinance Scheme

The Scheme addressed the concerns of capital intensive industries, such as infrastructure, by way of flexible refinancing. Refinancing is, simply put, extending a cheaper loan at better terms to pay off an existing loan taken at tougher terms.[7] It infuses the necessary financing to improve a stressed company's ability to repay the loan. The issue in the industry was that there is a mismatch between asset liability management and sustainable repayment tenures. Gestation periods for capital intensive priority sectors were long and did not correspond with repayment schedules – generally 12-15 years – due to slow generation of cash flow by the assets.[8] Hence, amortization was extended to the corporate debtor to increase the repayment tenure, recognizing the slow monetization of projects in priority sectors such as textile, infrastructure, iron and steel, mining etc.[9] The project would be refinanced after determining its viability and ability to service debts for a period of 5 years. The process would be repeated as and when required, the loaned amount being lower than the original, according to the Amortization Schedule.[10] It sought to reduce cash flow stress during the initial years of the project and minimize restructuring to enable banks to continue extending loans which would also reduce asset liability management and increase ability to loan.

The scheme will have a positive effect on startup ventures and new projects as it seeks to mitigate initial stress by relaxing repayment, easing the gestation period for better monetization. However, the major flaw in the Refinance Scheme was that banks were mandated to maintain the Net Present Value (NPV) of the refinanced amount, for a loan that was granted for a period of 25 years[11], which is clearly detrimental to the creditors and would result in loss of receivables. Further, the scheme does not benefit either stakeholder for its narrow view of the problem, striking at loan default instead of the cause of that default, that is, non-performance of assets.

[7]Dr. RaghuramRajan, *Issues in Banking Today*, RESERVE BANK OF INDIA (Feb. 11, 2016), https://rbi.org.in/scripts/bs_speechesview.aspx?id=992 (last visited Aug. 28, 2016).

[8]*Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries*, RESERVE BANK OF INDIA (July 15, 2014), https://rbi.org.in/scripts/notificationuser.aspx?id=9101&mode=0 (last visited Sept. 29, 2016).

[9]*Id.*

[10]*Id.*

[11]*S4A Can Curb Fresh NPA Slippages But Has Limited Applicability*, CRISIL (2016),https://www.crisil.com/Ratings/Brochureware/News/Note-on-S4A.pdf(last visited Aug.26,2016).

Such myopic focus provides only temporary relief without a long-standing solution to the increasing stress on the assets. Another issue with this scheme is that it does not allow appropriate classification of stressed assets as, refinancing implies that the project is viable, placing it in a category better than it deserves.

1.2.2 Strategic Debt Restructuring Scheme

The SDR scheme functions on the premises that the responsibility of the state of affairs lies with the management of the company and therefore, revamping the control and management would put it on a path to recovery. The consortium of lenders converts part of the debt in astressed company into equity, holding atleast 51% of stake in the said company. This reduces the amount of debt in the company and improves its position. Further the majority stake allows the lenders to exercise control over the management of the company until their stake is divested to a new promoter.[12]A significant feature of SDR is that its invocation would not constitute as restructuring under the prudential norms.[13] Also, the restructured loans are granted a benefit by the RBI by not treating them as NPAs while reducing the provisioning to a low 5% in most cases. In other words, income in the lender's balance sheet is shown through accrual basis and not receivable basis, enabling them to report lower NPAs and higher profits for a period of 18 months.[14]Lenders have to find a suitable buyer within the said 18 months,failing which; the assets would be classified as NPAs.[15] The drawback of this mechanism is that of the time limit prescribed, i.e, 18 months, which is insufficient to find and vet a buyer. Therefore, there is very little clarity on the subsequent step to be taken after conversion of debt to equity. Another detail worth noting is the reluctance of lenders to take serious haircut in the recoverable debt which leads to most deals with buyers falling through.[16]This scheme adopts a rather misguided and simplistic approach to a largely economic problem. In fact, a study by KPMG showed that at least 50% of the banks (both public and private sector) support retaining the existing management and feel that the Board should play a pro-active role in managing risk.[17] In light of such evidence a scheme like SDR ought not to be relied upon as a mechanism for revival as it goes against what makes perfectly good business sense. The ideal approach would be for the existing management to keep the lenders in the loop and periodically update them on the current

---

[12]*Framework for revitalizing distressedassets in the economy- Guidelines on Joint Lenders forum and corrective action plan*, RBI/2013-14/503, (Feb. 26,2014).

[13]*Id.*

[14]VishwanathNair,*Has the strategic Debt Restructuring experiment run aground*, LIVE MINT, (Aug. 20, 2016), http://www.livemint.com/Industry/jlQ90MUEd8nVVEf9O3brDI/Has-the-strategic-debt-restructuring-experiment-run-aground.html (last visited Aug. 25, 2016).

[15]*Supra*note 12.

[16]*Supra* note 14.

[17]*Managing Model Risk: Perspectives from the Indian Banking Industry*, KPMG (2016), https://assets.kpmg.com/content/dam/kpmg/pdf/2016/04/managing-model-risk.pdf (last visited Sept. 20, 2016).

economic and regulatory scenario. Such a concerted approach would create an atmosphere of transparency, benefitting all involved parties.

1.3SCHEME FOR SUSTAINABLE STRUCTURING OF STRESSED ASSETS REGULATIONS

While the other initiatives skirt around the crucial issue of NPA revival, S4A addresses it head on. It provides for a detailed procedure in congruence with the Prudential Norms on how to handle NPAs. Resuscitation of stressed assets creates a win-win situation for both the lenders and debtors – the debtor is pulled out from insolvency while the prospects of recovering the entire principal amount substantially improve for the lenders. Large borrowal accounts facing severe financial problems need deep surgery to revive them and often write downs and provisioning are required to do so. The advantage of this scheme over the previous ones is that it does not mandate takeover of management and control of an affected company. Under this scheme a debtor company's assets are classified as sustainable or unsustainable and are treated accordingly. Since sustainable assets can be revived and the debts on these assets can be serviced through existing cash flows, neither moratorium is given on these loans nor are the rates reduced. The unsustainable portion of the debt can be converted to equity or convertible securities in order to service the debt. The bank can then[18] –

1. Acquire majority shareholding and choose to manage the company or allow the existing management to continue, or;
2. Sell the converted debt to a new promoter or in any other manner contemplated by the RBI Prudential Norms on Change in Ownership of Borrowing Entities.

1.3.1 Classification of Receivables

The classification is done on the basis of the degree of credit weakness and dependence on collateral security for realization of dues into Standard, Sub-standard, Doubtful and Loss Assets.[19] Determination of these variables will depend on the record of recovery[20] and not on the net worth of the borrower, except in cases of fraud or net-value of security being lower than 50% since the last inspection.[21]

1. Sub-standard Assets: Stressed assets may be classified under this category if they have been non-performing for at least 12 months. Such assets have well defined credit weaknesses and if the deficiencies are not rectified, the assets could slip into the loss category.

[18]*Scheme for Sustainable Structuring of Stressed Assets*, RESERVE BANK OF INDIA (June 13, 2016), https://www.rbi.org.in/scripts/notificationuser.aspx?id=10446&mode=0 (last visited Sept. 1, 2016).
[19]*Master Circular-Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances*, RESERVE BANK OF INDIA (July 1, 2015), https://www.rbi.org.in/scripts/bs_viewmascirculardetails.aspx?id=9908 (last visited Sept. 1, 2016).
[20]*Id.* at¶ 4.2.4.
[21]*Id.* at¶ 4.2.9(i)(a).

2. Doubtful Assets: When assets have been non-performing for 12 months, they may be classified as doubtful; provided they are not only sub-standard but the full recovery of debt is almost impossible.

3. Loss Assets: Though there may be some salvage value, a loss asset is considered wholly unredeemable. They are such assets which have been identified by the RBI but haven't been written off as uncollectible debts.

Banks must set up adequate and efficient identification mechanisms, such a minimum cut-off, for timely identification of stressed assets. Routine AFIs are insufficient to penetrate the lender's accounts and AQRs are few and far between which places the onus on the lender banks to lay down intravenous guidelines and accounting measures for better management as well as transparency.

1.3.2 Provisioning Requirements

Once the assets have been determined and properly classified, provisioning norms come into play. Proper provisioning would cushion the impact of the default, especially in recessionary or unstable economic conditions. Sub-standard assets should ideally be provisioned for 15% unless there are certain unsecured exposures for which an additional 10% should be put aside.[22] In case the bank has a proper mechanism in place to escrow cash flows, the provisioning can be a total of 20%.[23] Loss assets should either be provisioned for 100% of the outstanding debt or completely written off since these assets cannot be revived. Doubtful assets are provisioned depending on the period for which they remain classified under the category – 25% for one year, 40% for three years and 100% for more than three years.[24] However, unsecured doubtful assets must be provisioned for 100% of the outstanding debt. With respect to Standard Assets the provisioning requirements range from 0.25% to 0.75% with a contingency for extra provisioning in case of shifting credit exposure.[25]Up gradation to a more solvent category may be done after one year of satisfactory performance.[26]

The fact of the matter remains that banks must be prepared to write down substantial portions of the debt, 40-70%, to enable recovery of stressed assets. This will reduce the burden on the insolvent project/company, allowing them to repay part of the loan. Unlike the SDR scheme, S4A provides for the banks to enjoy the upside of the recovered asset by not stipulating a time frame for the disposal of debt-equity, thus not only raising the possibility of the full debt to be

[22]*Id.* at¶ 5.4.
[23]*Id.* at¶ 5.4(ii).
[24]*Id.* at¶ 5.3.
[25]*Id.* at¶ 5.4(iii).
[26]*Supra* note 18.

recovered in the long run, but also in a way giving the necessary moratorium to capital intensive projects. Therefore, the problem of loaning to capital intensive long term projects that usually take close to 25 years to take off, sought to be solved by the 5:25 Refinance Scheme has also been dealt with.

1.4EFFICIENCY OF NEW MECHANISMS REGARDING DEALING WITH STRESSED ASSETS

1.4.1 Identification of NPAs

The identification procedure developed by the RBI through AQR and S4A proposes classifying liabilities and determining which can be revived through insolvency resolution by conversion to equity or redeemable cumulative optionally convertible preference shares. This not only helps in hedging risk and securing provisioning, but the set time frame of six months[27] also urges the lenders to work in a time bound manner, thus mitigating the delay which could be detrimental to revival of stressed assets.

1.4.2Retention of existing management

The S4A restructuring scheme is an out-of-court mechanism providing for existing promoters of the borrower company to retain their shareholding in certain cases, as may be deemed fit for the benefit of the company. The promoters not only have the option of retaining management rights but also have the right of first refusal during the liquidation of assets, in case they are not sold at the predetermined price.[28] Proportionate loss sharing by promoters and accrual of the upside of sale of equity to the lenders in lieu of the debt[29] benefit the company as well as the lenders since both parties have stakes in the venture and a revival is highly likely through such concerted efforts. Fairness of this mechanism is evident from the mandatory submission of resolution plan to the Overseeing Committee which would render its advisory opinion on its viability and check whether there has been compliance with the Prudential Norms, including provisions under which the value of assets should not be compromised to service the debts.[30] The scheme allows lenders to change or retain the management when necessary unlike the previous un-amended SDR scheme where a new promoter had to be appointed within 18 months.[31]

Separate procedures have been envisaged for operational and financial creditors, and one excludes the other. In an insolvency resolution process one class of creditors would inevitably be ignored. This is a major fallacy of the law which could inhibit the ease of doing business with respect to quick liquidation and winding up proceedings. While safeguards have been provided

---

[27]*Supra* note 19.
[28]*Supra* note 18.
[29]*Id.* at¶7.3, 7.4.
[30]*Id.* at¶ 8.
[31]Nupur Anand, Abhijit Lele & Anup Roy, *RBI's new debt restructuring scheme may not be a game changer*, BUSINESS STANDARD, (June 15, 2016),http://www.business-standard.com/article/finance/rbi-s-new-debt-restructuring-scheme-may-not-be-a-game-changer-116061401120_1.html (last visited Sept. 16, 2016).

by way of a priority list, implementation would be difficult since the entire endeavor depends on the existence of a robust network of IRPs which does not at present. Further, no criteria have been laid down in the Code for the appointment of IRPs besides the requirement that there be no pending disciplinary proceedings against him. Therefore, it is a law with no teeth.

GOVERNMENTAL FRAMEWORK

2.1THE INSOLVENCY AND BANKRUPTCY CODE, 2016

The recent RBI guidelines on NPAs and the Insolvency and Bankruptcy Code deal with two different aspects of the same problem. While RBI has made stress detection simpler, the Code has made compliance with regulations and litigation easier and expeditious.The Code has been conceptualized as a consolidation of the laws related to insolvency resolution, promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment.[32] Akin to the UK Insolvency law, a new set of professionals have been introduced to handle insolvency and bankruptcy, who will be governed by the Insolvency and Bankruptcy Board ('the Board'), possessing legislative, administrative and quasi-judicial power.[33] A limited duration of 270 days has been prescribed under the Code to form and implement the insolvency resolution mechanism, failing which automatic liquidation would take place. These insolvency professionals, licensed as quasi-administrators, will not only exercise control and management over the stressed company, but also the power to form resolutions subject to approval by the creditors' committee and proceed with liquidation of assets. This introduction of third-party IPs as intermediaries will replace the existing management and operate the company as a going concern, with the safeguard that they will preserve the quality of the assets and not solely focus on realizing their value.[34] The IPs will be registered with the Insolvency Professional Agencies (IPAs) which set performance standards and cater to the overall governance of all the registered professionals. The agencies will also redress consumer grievances against such IPs, in the capacity of a disciplinary and adjudicating body. The Code intends to establish two sets of adjudicating bodies to handle insolvency and liquidation processes. The intention of the Code is to provide an incentive to corporate borrowers to improve asset recovery and avoid loan defaults. Therefore, the provision to replace existing management is likely to disincentivize massive loan defaults.[35]

2.2AMENDMENTS TO SARFAESI

---

[32]The Insolvency And Bankruptcy Code Of 2016.

[33]*Id.*

[34]*Moody's: India's new bankruptcy code to boost significantly bargaining power of creditors as against large debtors*, MOODY'S (May 26, 2016), https://www.moodys.com/research/moodys-indias-new-bankruptcy-code-to-boost-significantly-bargaining-power--pr_349676 (last visited Sept. 29, 2016).

[35]*Id.*

Enforcement of Security Interest and Recovery of Debts, Laws and Miscellaneous Provisions (Amendment) Bill, 2016 which was cleared in both Houses on9 August 2016 seeks to amend the SARFAESI and Recovery of Debts due to Banks and Financial Institutions Act, 1993 among others. The amendment bill has extended the scope of RBI's powers to audit and inspect the statements and information of ARCs, at an attempt to increase transparency and promote efficiency.According to a credit analysis report by India Rating, the problem with SARFAESI was that lender banks expected asset reconstruction companies (ARCs) to sell the stressed assets without taking a major haircut, which became tough as the assets had lost much of their value. This resulted in the ARCs suffering huge losses due to banks being unwilling to writedown substantial portions of the debt.[36]Although the proposed amendments seek to consolidate and synchronize the laws while making debt recovery processes more expeditious, only effective implementation would ensure the trickle down of benefits. Whether the amendments would actually make a difference can be judged once the bill receives Presidential assent.

2.3SHORTCOMINGS OF THE INSOLVENCY AND BANKRUPTCY CODE

2.3.1 Equal Involvement of all Stakeholders

The flipside of the provision empowering corporate debtors is that they will have no incentive to file for insolvency as their management is being displaced. Neither does the company have a say in the appointment of the insolvency professional nor in the operations after appointment. While the Code also empowers the corporate debtor to file for insolvency[37], it is highly unlikely that it would do so since the existing management would be displaced under any circumstance, as there is no provision for its retention. The major concern is that lenders focus more on recovering their debt and less on how that will affect the health of the company. The decision to liquidate the assets of the borrower company is also the decision of the creditors without consideration of the opinion of the suspended Board of Directors, who not only have a stake in the company but are also answerable to their shareholders.[38] The sole remedy of the borrower company lies in S.61(3) which allows appeal against the resolution plan on certain grounds [39]–

- Resolution plan is in contravention of any existing law in force
- There has been material irregularity in the exercise of powers by the insolvency professional during the resolution period
- Debts owed have not been provided in the manner prescribed by the Board

---

[36] Tara Khandelwal, *Indian Banks Need to take a Haircut to Shelve Bad Loans*, BLOOMBERG QUINT, (July 19, 2016), http://www.bloombergquint.com/business/2016/07/19/indian-banks-need-to-take-a-haircut-to-shelve-bad-loans-india-ratings (last visited Sept. 25, 2016).

[37]The Insolvency And Bankruptcy Code Of 2016 § 6.

[38]*Id.* at§ 33(1).

[39]*Id.* at§ 61(3).

- Costs of the process of insolvency have not been given priority over the other outstanding amounts
- Resolution plan does not comply with the other criteria specified by the Board

Therefore, although there are provisions such as S.25 and S.28 which are aimed at protecting the interests of the borrower by attempting to ensure that the insolvency resolution professional does not act against the interests of the company and treats it as a going concern, their proper implementation would be difficult.

The corresponding Chapter XI of the US Bankruptcy Code does not do away with the management of the company. In fact, the creditors and the Courts are empowered to appoint a trustee to manage the affairs of the company while the existing management exercises effective control and management from the sidelines.[40]Although the Indian insolvency and bankruptcy law is inspired from the US law, it has not incorporated this essential provision where the existing management retains its stake in the company. It is a well-known fact that the management is not only aware of the real state of affairs in the company, but also has a substantial stake in the company which ensures that they do not indulge in asset stripping. India ought to have made provision for retention of the management, in whatever capacity, such that their opinion is considered during everyday decision-making, insolvency resolution and liquidation.

2.3.2 Mitigation of Delays

The judicial recourse for operational and financial lenders under the Insolvency and Bankruptcy Code, 2016 prescribes a period of fourteen days within which the adjudicating authority must determine whether the plea for insolvency resolution is based on concrete grounds and facts and confirm the appointment of the interim insolvency resolution professional.[41] Further, a limit of 180 days has been set for the insolvency resolution plan to be formulated and approved[42] which can be extended by a further 90 days[43] provided the adjudicating authority is satisfied regarding the necessity of the extension. However, no time limit has been provided for liquidation or implementation of the insolvency resolution which could be a positive development and a lesson from the previous mechanisms which prescribed 18 months, if a reasonable period is considered. Another issue is that the provision for disputing the debt could result in companies avoiding

---

[40]MandarKadage, *Flaws in the Bankruptcy Code*, LIVE MINT(May 10, 2016), http://www.livemint.com/opinion/wovamcdlzzk0blefjb030m/flaws-in-the-bankruptcy-code.html (last visited Sept. 20, 2016).

[41]The Insolvency And Bankruptcy Code Of 2016 § 7(3),9(5).

[42]The Insolvency And Bankruptcy Code Of 2016 § 12(1).

[43]*Id.* at§ 12(3).

liability for a longer period.[44] Since filing a suit is expensive, they would dispute the debt through an arbitral reference without intending to pursue it. The adjudicating authority is not authorized to judge the validity or sufficiency of the dispute and therefore the operational creditors would be disabled from pursuing insolvency measures.[45]

2.3.3 Ease of Doing Business

India is currently ranked 136 among 189 countries with respect to resolution of insolvency, and it takes more than four years to resolve a case of bankruptcy, according to the World Bank.[46] Its rank pertaining to starting of a business moved up 4 positions since 2015 and is now 130.[47] The Insolvency and Bankruptcy Code is aimed at improving the ease of doing business in India and fulfilling the government objective of promoting entrepreneurial ventures. The nature of startups is such that returns on their assets are uncertain, which implies that repayment of any loans taken is risky. It is the duty of the regulators to prevent failure from dampening entrepreneurial spirit by providing requisite safeguards. While transferring the control and management of the debtor company to the lenders will definitely ease recovery, the time limit of 180 days (extendible to 90 days) will ensure an expeditious and smooth exit of unviable entities. However, since effective implementation has always been a concern, provision delineates the duties of an insolvency professional to treat the insolvent company as a going concern and actively attempt to rescue the stressed company instead of solely focusing on recovery of the loan, may not have the desired effect. CRISIL's analysis shows that currently recoveries by Asset Reconstruction Companies (ARCs) are very low at 36%, with each averagely taking five years.[48] Optimists predict better figures two years down the line, but the gain will most likely be marginal. According to the Minskyan model of financial instability, banks exhibit a profit seeking behavior as a result of the enormously risky decisions that could possibly lead to financial fragility.[49] Being traditional lenders, they are not equipped to handle high-risk entrepreneurial ventures, unlike venture capitalists.[50] Therefore, while the code does make exit from the market easier,

2.4 OTHER MECHANISMS

44*Id.* at§ 8(2)(a).

45LVV Iyer, *Is the Bankruptcy Code flawed?,* THE HINDU(May 28, 2016), http://www.thehindu.com/business/industry/is-bankruptcy-code-flawed/article8660821.ece (last visited Sept. 17, 2016).

46*Ease of Doing Business in India,*http://www.doingbusiness.org/contributors/doing-business (last visited Sept. 18, 2016).

47*Id.*

48*Is India's new Bankruptcy Law a game changer?*,KNOWLEDGE@WHARTON (2016), http://www.knowledge.wharton.upenn.edu/article/indias-new-bankruptcy-law-game-changer (last visited Aug. 24, 2016).

49VigneswaraSwamy, *Basel III: Implications of Legal Banking*, INDIAN INSTITUTE OF BANKING AND FINANCE, http://www.iibf.org.in/documents/reseach-report/report-25.pdf (last visited Sept. 24, 2016).

50V A Avadhani, Investment And Securities Market In India 184 (9th ed. 2011).

The Central Repository of Information on Large Credits (CRILC) has been authorized by RBI to collect and disseminate information on red flagged accounts, fraud accounts, updates on special mention accounts (SMA), non-cooperative borrowers etc.[51] Other industry specific measures have also been adopted to reduce the stress on priority sectors. Import duties have been raised, additional safeguard duty imposed and a minimum support price was stipulated for the steel industry; takeover of 75% of the debt of electricity distribution companies (Discoms) by the respective state governments, improving the process of providing coal linkages and auctioning of coal blocks, providing funding support through power system development fund (PSDF) were envisaged for the power sector etc.

ANALYSING IMPACT OF THE NEW RBI REGULATIONS AND THE BANKRUPTCY CODE

The new regulations indeed adopt a different approach from the past mechanisms by targeting the problem areas instead of penalizing the borrower companies and clearly distinguish between insolvency and bankruptcy. While insolvency is a temporary phase in a going concern, bankruptcy is a stage where the company is most likely to shutdown.[52] The fiscal cost of the 2008 financial crisis is the increase in the NPA portfolios in public sector banks due to lending to players in priority sectors, which were suffering the effects of recession. This led to a situation where a number of assets suddenly became unviable leaving banks high and dry. The primary reasons for the negative impact are improper risk management and lackadaisical attitude towards provisioning. In order to remedy this, in addition to the schemes RBI formulated, the Insolvency and Bankruptcy Code 2016 sought to make recovery procedures easier.

3.1 ALTERING FOCUS OF THE RBI

There can be two approaches to resolve NPAs- Short term measures, having a temporary effect, such as refinancing, and long term deep surgical measures aimed at revival and re-monetization of the loss making assets.[53]While short term measures are effective when the stress is superficial, a result of lackadaisical management or other reasons, they become ineffective when the stress is a result of an economic downturn, recessionary forces in the relevant industry or supply-demand dichotomy. Right after the 2008 financial crisis the RBI hoped that certain priority sectors in the industry were under would be temporary and therefore introduced short term measures to deal

---

[51]*RBI Financial Stability Report*, RESERVE BANK OF INDIA(June, 2016),https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/0FSR2316BB76DB39BF964542B9D1EBE2CBC273E7.PDF (last visited Aug. 27, 2016).

[53]Dr. Raguram Rajan, *Issues in Banking Today*, RESERVE BANK OF INDIA (Feb. 11, 2016), https://rbi.org.in/scripts/bs_speechesview.aspx?id=992 (last visited Sept. 28, 2016).

with the existing NPAs.[54] However, growth has eluded these sectors and the stress has acquired near permanence. Recognizing this problem, RBI began reforming the existing schemes and amended the prudential guidelines to address this issue more efficiently. A proactive approach was adopted by creating a Joint Lender's Forum(JLF) to formulate a joint corrective action plan for early resolution of stress in the account, which aimed at early identification of distressed assets.[55] Another concern addressed was lack of sufficient information sharing by establishing a Central Repository of Information on Large Credits (CRILC), which would collect, store and disseminate such data to lenders.

3.1.1 SDR and 5:25

Strategic debt restructuring (SDR) and 5:25 refinance schemes are also part of this imitative. The crux of SDR is converting a part of the debt into equity to reduce the stress on the projects and give lenders a substantial say in the functioning of the project. No matter howpath breaking this may seem, the limitations outweigh its benefits, especially if the market price is less than the face value, which is the case with most NPAs because they lack the required institutional mechanism to steer the operation and financing.[56]A number of other factors can be responsible for the distress of a company/project, otherthan the inefficiencies of the existing management. Therefore replacing the existing management is not ideal as lenders by virtue of their specializations are less capable to manage a company about which they know nothing. A cue must be taken from the US Bankruptcy Code where the existing management shadow-manages through a trustee, appointed by the lenders. On the other hand the 5:25 refinance scheme aimed at easing repayment schedules focused on necessary financing to improve the ability of stressed projects to repay the loans. The primary aim of this scheme was to improve debt recovery, to further which 'sops' such as non-classification of the accounts as the NPAs during the 18 month period were also given. The effect of this is that the real nature of the assets in hidden for quite some time allowing banks to represent them as profit making when they are actually not. Refinancing is a short term measure and is usually ineffective on long standing NPAs. In response to such limitations the Scheme for sustainable structuring of stressed assets (S4A) was formulated which seeks to pointedly target revival by proper classification, adequate provisioning

---

[54]*Id.*

[55]*RBI Discussion Paper on Early Recognition of Financial Distress: Framework For Revitalizing Distressed Assets in the Economy*, RESERVE BANK OF INDIA (Jan. 30, 2014),https://rbidocs.rbi.org.in/rdocs/content/pdfs/npa300114rff.pdf (last visited Sept. 30, 2016).

[56]B Sambamurthy, *For Banks to be Good, Some Have To Be Bad*, BUSINESS LINE(Jan 19, 2016), http://www.thehindubusinessline.com/opinion/for-banks-to-be-good-some-have-to-be-bad/article8124251.ece (last visited Sept. 1, 2016).

and transparent accounting methods.[57]Asset quality review is an intensive mechanism used by the RBI in sparse circumstances to identify bad loans and assist lender banks in categorizing them appropriately. This measure is quite intrusive as it looks into the accounts of the lender banks and alters them to such an extent that many of them slip into losses. In the fourth quarter of 2016, 13 of 38 lenders suffered deep losses, with public sector banks faring the worst with a loss of Rs. 15,064 crore, the worst since March 2001.[58]

3.1.2 Scheme for Sustainable Structuring of Stressed Assets

AQR is only a prelude to S4A but is highly significant in solving the identification problem leading to next step of categorization based on which provisioning requirements are determined. The detailed provisioning requirementsunder prudential norms in consonance with S4A will help banks create a cushioned fund in the event of heavy write-down, unlike the previous norms. Further, the existing promoters will be allowed to continue to manage the company in the capacity of a minority shareholder by divesting part of their shareholding in favor of the lenders, i.e, converting debt into equity. Therefore all stakeholders have a say in insolvency resolution process. Such shares are in the form of *Redeemable Cumulative Optionally Convertible Preference Shares/Debentures*, thereby enabling the lenders to take benefit of the upside, once the borrowing entity revives.[59]S4A also provides for a continuous reviewing of the NPAs on Marked to Market Basis thus promoting exactitude and preventing the stressed assets from losing more value.[60]

It is quite evident that the previous mechanisms had more loopholes than advantages, being based on a utopian premise of only the existing promoters and management being responsible for the default in repayments, with no regard to the economic conditions prevailing in the sector. The new guidelines adopt a more pragmatic approach by prescribing an achievable time limit and realizing the importance of the existing management as well as incompetence of banking professionals in running the company. However, a limitation of the guidelines that can be identified is that banks with a meager equity share would neither have the incentive to independently assess the resolution proposal nor the necessary weight to influence decision making in the consortium.[61]

3.2 EFFICIENCY OF S4A OVER THE BANKRUPTCY CODE

[57]*Scheme for Sustainable Structuring of Stressed Assets*, RESERVE BANK OF INDIA (June 13, 2016), https://www.rbi.org.in/scripts/notificationuser.aspx?id=10446&mode=0 (last visited Sept. 18, 2016).

[58]AparnaIyer&Vishwanath Nair, *Banks may continue to report bad loans issues for two more quarters,*LIVE MINT (May 30, 2016), http://www.livemint.com/industry/7twttfkigd3nkapdmtxjom/worst-may-not-be-over-yet-for-banks.html (last visited Oct. 1, 2016).

[59]*Supra* note 18, at ¶ 7.4.

[60]*Id.* ¶ 7.2.

[61]*Supra* note 3.

The Code presumes that promoters' of the debtor company pushing for retaining the existing management has a chilling effect on the credit availability to new businesses as the banks become more cautious as to who they lend to. While the remedy of giving the creditors a say in the management of the company through IRPs[62] is laudable, a balance must be established between the interests of all stakeholders. S4A recognizes this and has made provisions for retention of the existing management in a restricted way, upon the discretion of the consortium of lenders.[63]The Bankruptcy Code, however, provides for an internally flawed blanket rule to entirely exclude the existing management out of the resolution process.[64] On a close examination, it can be inferred that the establishment of the institution of IRPs is leap of faith asthere is no conclusive evidence of increased recovery rates. The UK law has a similar set up for insolvency resolution through IRPs and the statistics suggest that though the bankruptcy reforms there have resulted in increased recovery rates, the benefits are negated due to the increased bankruptcy cost.Additionally, any benefits that have accrued in the UK are due to effective implementation which remains a grave challenge in India.

Section 17 and 20 of the IBC lay down the powers of the insolvency professionals, which include entering into and modifying contracts, exercising all the powers of the board of directors or partners, full access to the books of account and inventory of assets owned or in possession. The exercise of such extensive powers without managerial oversight has the potential to push the project/company into further losses as the professionals are likely to be unaware of the internal state of affairs of the project/company.

With respect to unsecured creditors, IBC has introduced tremendous reforms in their favour. However, certain inherent limitations may inhibit them from enjoying the benefits. The provision excluding operational creditors from the creditors' committee, which is the primary decision-making body during insolvency resolution, will adversely affect their interestsas they would remain unrepresented.[65]Also, section 8(2) of the IBC allows the corporate debtor to dispute the debt made out by the operational creditor through arbitration. No court has the jurisdiction to determine the validity of these arbitration proceedings, implying thereby that unless the dispute is resolved the operational creditors cannot file for insolvency.

3.3 EFFECT OF BASEL III NORMS ON REGULATION FRAMING

[62]*Supra* note 32, at§ 7(3(b),9(4).

[63]*Supra* note 18, at¶7.2.

[64]Mandar Kadage, *Flaws in the Bankruptcy Code*, LIVE MINT (May 10, 2016), http://www.livemint.com/opinion/wovamcdlzzk0blefjb030m/flaws-in-the-bankruptcy-code.html (last visited Sept. 20, 2016).

[65]The Insolvency And Bankruptcy Code Of 2016.

Inadequate capital buffers which led to the 2008 financial crisis are major reasons for rise in NPAs.Basel III is a new accord in response to the financial stress in the economy and aims to raise capital base, enhancing risk coverage, supplement Risk-Based Capital Requirements with Leverage Measure, reduce pro-cyclicality through counter-cyclical buffers. This enables write downs where necessary, while putting the lender in a more viable position to assist revival of the debtor and improving the probability of an upside in the concerned assets benefitting them. These norms are to be implemented in a phased manner by 2019. It identifies the need for banks and other financial institutions to develop internal controls, systems and procedures to maintain capital buffers to provision for losses and conduct regular reviews of the bank's liquidity risk management functioning to quickly identify issues requiring immediate attention.[66]The implementation of this framework would help in reducing the risk of crises and subsequent losses from severely impacting the banks, by creating capital and liquidity buffers to absorb economic and financial shocks.[67]The capital conservation and counter-cyclical buffers are to be increased from the present value of 8% to 10.5% by 2019.[68]The only repercussion of stringent regulatory norms is that it could result in a reduced pace in the working of banks and other financial institutions.RBI has taken these norms as a guideline in formulating schemes to address the problem of NPAs and working towards implementing them. In the past as well, adherence to Basel I and II shielded our economy from the full impact of the 2008 financial crisis which practically crippled the economies of other countries. Therefore, we would in a better position to handle stressed assets if the framework is adequately implemented.

III. CONCLUSION

In April last year, Moody's changed India's rating outlook to 'positive' from 'stable' citing reform momentum and said that it could consider India for an upgrade in next 12-18 months.[69] The reforms that have been brought forth by the RBI through its new insolvency mechanisms and the legislations passed by the government aim at consolidating existing laws, easing recovery measures and attempt to include all stakeholders in the process. This was essential since the existing mechanisms were formulated for short term insolvency resolution and were therefore, unsuitable in a situation that demanded long term measures. The latest reforms are aimed at core asset revival, refinance and restructure of loans. 5/25 andSDR are not supremely ineffectiveand

---

[66]*Interim Report of the Bankruptcy Law Reform Committee*, (Feb, 2015), http://finmin.nic.in/reports/interim_report_blrc.pdf (last visited Oct. 2, 2016).

[67]*Id.*

[68]*Id.*

[69]Press Trust of India, *Moody's flags bad loan concern at Finance Ministry meeting*, BUSINESS STANDARD (Sept. 21, 2016) http://www.business-standard.com/article/finance/moody-s-flags-bad-loan-concerns-at-finance-ministry-meeting-116092100970_1.html(last visited Sept.29 2016).

can operate with much greater impact in the short term for temporary relief. The major issue plaguing the entire system of NPA management is the lack of an adequate structure to identify and categorize them, thereby drastically reducing the efficiency of these guidelines. The international standards laid down in Basel III, focus on self-creation of internal models by lenders to manage liquidity risk and capital risk among others. The requirements of capital buffers and counter-cyclical measures mentioned in the Basel III guidelines have been adopted by RBI in terms of category based provisioning, which keeps on changing when an asset moves an up or down a category. These constitute the out of court mechanisms. The in-court procedures laid down in the Bankruptcy Code, are touted to be path breaking and a boon for startups. However on close examination, it becomes evident that the Code is largely utopian and leaves a lot of questions with respect to structural implementation unanswered. Moreover, the substitution of corporate management of stressed assets with insolvency professionals based on a presumption that the existing management is responsible for the state of insolvency. It also omits to account for the lack of competency of the lenders and IPs to manage a company as a going concern, by virtue of being unaware of the actual state of affairs and the existing resources to handle them. The key to effectiveness is compromise and these schemes would have no positive effect in isolation. For there to be such a positive impact it is imperative for all stakeholders, the RBI and the government to act in sync with each other, with the RBI overseeing the entire procedure in the capacity of a prime regulatory body.

P2P LENDING: REGULATING THE NEW KID ON THE BLOCK

- LAKSHMI DWIVEDI & PRANAV AWASTHI

E-commerce's growth has led to the rise of Peer to Peer lending platforms. P2P platforms, similar to Flipkart, provide an online marketplace to individuals to borrow or lend. They are not a party to the loan contract but facilitate the contract and intermediate by determining the interest rate and borrower's creditworthiness. These platforms act as alternative to banks since loans via such platforms yield more return to the lender and are cheaper to the borrower. However, in absence of any regulation, China being an example, these platforms raise concerns of fraud, default by and privacy of parties. Various countries subject these platforms to securities or banking laws but such regulation has crippled industry growth. To effectively regulate the platforms, one must grasp the unique relationship of the parties involved. A P2P loan reflects a C2C tripartite relationship in which lenders and borrowers are consumers and are dependent on the platform, being a third party to the contract, for the loan transaction's successful completion. This relationship makes the traditional B2C consumer protection approach based on disclosure regime inadequate and calls for a more interventionist consumer protection approach going beyond mere disclosure and establishing a licensing system with prudential norms along with disclosures. United Kingdom and New Zealand follow such approach and have seen P2P industry thrive. The approach adopted In the RBI consultation paper seems confusing since the paper recognises them as financial intermediaries and incorporates few consumer protection methods but designates them as NBFC making them subject to banking regulations and does not expressly impose a duty of care on them. It is suggested that the way forward, inter alia, can be to recognize a new regulatory activity of use of electronic platform in relation to lending and expressly impose a duty of care on the platforms.

I. INTRODUCTION

Internet's exponential growth has tremendously influenced the way people conduct business. E-commerce websites are major economic players and have emerged as alternative marketplaces to access various consumer goods and services like groceries and taxis. It is interesting to note that the biggest taxi company, Uber owns no taxi, one of the biggest retailer Amazon owns no stock.[1] These companies "control the interface between the consumer and provider of goods and services."[2] The profit lies in the interface since they don't carry the traditional cost of provision of services, but take commission from the users.[3]

[1] Hamish Mcrae, *Facebook, Airbnb, Uber, and the Unstoppable Rise of the Content Non-Generators*, THE INDEPENDENT, http://www.independent.co.uk/news/business/comment/hamish-mcrae/facebook-airbnb-uber-and-the-unstoppable-rise-of-the-content-non-generators-10227207.html. (last visited September 24, 2016).
[2] *Id.*
[3] *Id.*

E-commerce has now entered even banking industry, by provision of cost effective alternatives to banks in the form of Peer-to-Peer (*P2P)* lending. In its most general form, P2P lending can be defined as "any transaction arranged using the Internet in which one or more individuals lend money to one or more other individuals."[4] Here, the platform is not servicing the loan request, unlike banks, but merely facilitates the transaction between individual lender and borrower. A P2P platform matches individual borrowers and lenders who create a profile on the P2P platform. The lenders can screen the borrowers profile and then enter into a loan agreement. Lending from friends and family has been a prevalent practice however; P2P lending platforms have modernized the same by providing "searchable electronic marketplaces, standardized loan contracts, borrower creditworthiness data, and loan servicing." [5]

Part II of the paper begins with by discussing the concept of P2P lending and the reasons behind its emergence and growth. It evaluates the benefits and risks of this model. Part III analyses the two most popular operational models used globally by P2P platforms, namely, notary model and client segregated model. It further analyses the regulatory regime across countries for different models. Part IV suggests a theoretical framework of an ideal regulatory approach to regulation of P2P lending and argues for a more interventionist consumer protection approach. Part V analyses the current legal framework in India in relation to P2P lending. Finally, it then analyses the consultation paper released by the Reserve Bank of India (*RBI)* to regulate P2P platforms as financial intermediaries in light of Part IV. Part VI concludes the paper.

II. WHAT IS P2P LENDING?

A. EMERGENCE & CONCEPT

Earlier, those unable to get loans from banks could raise funds through community based financing, chit funds and cooperative societies etc. all of which required physical interface.[6] However, with the rise of crowdfunding, funds can be directly raised online without any need for physical interface. Crowdfunding is the use of small amount of capital, obtained from a large

---

[4] Eric C. Chaffee & Geoffrey C. Rapp, R*egulating Online Peer-to-Peer Lending in the Aftermath of Dodd–Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry*, 69 WASH. & LEE L. REV. 485, 491, (2012).

[5] Tara Evans, *Peer-To-Peer Lending: Everything You Need to Know About the Leading Websites*, TELEGRAPH, http://www.telegraph.co.uk/personal-banking/savings/peer-to-peer-lending-everything-you-need-to-know-about-the-leadi/ , (last visited September 24, 2016).

[6] Nidhi Bothra & Shruti Agarwal, *Is Peer-to-Peer Lending Too Futuristic in India?,* MONEYLIFE,, http://www.moneylife.in/article/is-peer-to-peer-lending-too-futuristic-in-india/43545.html, (last visited September 24, 2016).

number of organizations or individuals to raise funds for a personal loan or business project through an online platform.[7] P2P Lending is an example of online crowd-funding.

P2P lending is based on the idea of simplifying the lending process, where people with surplus funds can lend directly to needy people.[8] The interest rate, for lender, is usually higher than the saving rate of a bank but lower than interest on a traditional loan to be paid by a risky borrower.[9] However, it comes with its sets of concerns and so if left unregulated, it can pose systemic risks due to possibility of fraud or defaults.

The growth and emergence of P2P lending has been due to the credit market contraction following the financial instability of 2008 when liquidity crises at several major financial institutions led to widespread fear that credit markets and global economy would collapse and cause an unparalleled economic catastrophe.[10] In the wake of the crisis, consumer credit remained elusive and small businesses were forced to seek alternative means.[11] P2P lending emerged as an alternate finance options for higher-risk borrowers turned away by increasingly risk-adverse traditional lending institutions.

The P2P lending industry is experiencing significant growth in developed financial markets. For instance, USA saw creation of $6.6 billion of loans in 2015[12], up 128% and UK shall witness ten fold growth to £ 12.3 billion in 2020.[13] Europe saw lending of $3.9 billion in 2014, a 144% jump, with France having a growth of 4,000% last year, to reach $10.6 million.[14] An indicator of the growth of this industry is the public issue of world's largest P2P platform Lending Club in 2014.[15]

India too has seen the emergence of P2P platforms like Faircent.com, I-cent.com, Easy Rupaiya.com. Though there is no survey available as to the size of the market in India, however Faircent claims that it has 5,000 registered lenders and 20,000 borrowers, and has distributed

---

[7] Gustav Claesson & Marcus Tengvall, *Peer-To-Peer Lending The Effects Of Institutional Involvement In Social Lending,*, JONKOPING UNVIERSITY, https://www.diva-portal.org/smash/get/diva2:812631/FULLTEXT01.pdf , (last visited September 24, 2016).

[8] Kathryn Judge, *The Future of Direct Finance: The Diverging Paths of Peer-To-Peer Lending and Kickstarter* , 50 WAKE FOREST L. REV. 603, 609, (2015).

[9] *Id.*

[10] ERIC, *supra* note 4.

[11] *Id.*

[12] Evan Bakker, *Top Peer-To-Peer Lending Markets: The Leading Countries for Alternative Finance and the Next High-Growth Markets*, BUSINESS INSIDER, http://www.businessinsider.in/TOP-PEER-TO-PEER-LENDING-MARKETS-The-leading-countries-for-alternative-finance-and-the-next-high-growth-markets/articleshow/47302668.cms, (last visited September 24, 2016).

[13] Tim Wallace, *Peer-to-Peer Business Loans to Hit £12bn in 2020* , THE TELEGRAPH, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11891965/Peer-to-peer-business-loans-to-hit-12bn-in-2020.html , (last visited September 24, 2016).

[14] EVAN, *supra* note 12.

[15] GUSTAV, *supra* note 7.

loans worth Rs 2.5 crore from 2014.[16] Faircent also notes that the average loan size being disbursed is of Rs 1.5 Lakhs with loans ranging from Rs 30,000 to Rs 5 Lakh for personal needs and upto Rs 15 Lakhs for business purposes[17]. It is expected that India's market can attain a size of $4-5 billion in the next five to six years. However, there is no regulatory framework in place in India unlike few western countries.[18]

B. BENEFITS

There are various benefits one can reap from availing the services of a P2P platform. *First,* it helps potentially riskier borrowers like small and medium enterprises and startups to meet their funding requirements by providing access to lending services in the face of possible rejection by commercial banks.[19] *Second,* it provides cheaper funds due to reduction in transaction costs. This is because of elimination of bank as an intermediary, which obviates the need to have a physical location, a in-person loan processing, and vast underwriting staff[20]. Costs are further decreased due to cheaper evaluation of counterparty risk since the P2P platform itself provides verified creditworthiness data, provides a standard contract, making negotiations unnecessary and also helps enforces the contract, thereby obviating the need for individuals to perform these tasks.[21]
Third, it offers higher interest to the lenders than the interest earned on bank deposits while at the same time ensures that such rate is lower than the rate at which the bank lends to unsecured borrowers. This is due to reduction in overhead costs because of less intermediation. Thus, larger parts of the profits go to the individuals rather than to large institutional intermediaries.[22]
Fourth, P2P lending channels funds into economically deprived section of the society and thus creates new avenues for economic growth and recovery.[23] It thus increases competition in the lending market and incentivizes traditional lenders to innovate and provide lending to all efficiently at lower costs.[24]

---

[16] Press Trust of India , *Start-Up Sees Peer-To-Peer Lending Market Growing Big in India*, , BUSINESS STANDARD, February 7, 2016, http://www.business-standard.com/article/pti-stories/startup-sees-peer-to-peer-lending-market-growing-big-in-india-116020700125_1.html, (last visited September 24, 2016).
[17] Shailesh Menon, *Faircent.Com, Lendbox.In and Other Peer-To-Peer Lending Platforms Gain Popularity, Draw RBI Gaze* ,ECONOMIC TIMES, January 28, 2016, http://articles.economictimes.indiatimes.com/2016-01-28/news/70150353_1_peer-to-peer-lending-moneylenders-borrowers, (last visited September 24, 2016).
[18] PRESS TRUST, *supra* note 16.
[19] Jack Magee, *Peer-to-Peer Lending in the United States: Surviving After Dodd-Frank,* 15 N.C. BANKING INST. 139, 141, (2011).
[20] Paul Slattery, *Square Pegs in a Round Hole: SEC Regulation of Online Peer-to-Peer Lending and the CFPB Alternative*, YALE J. ON REG. 30, 39, (2013).
[21] *Id.*
[22] GUSTAV, *supra* note 7.
[23] Eleanor Kirby & Shane Worner, *Crowd-funding: An Infant Industry Growing Fast*, http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf, (last visited September 24, 2016).
[24] Eugenia Macchiavello, P*eer-To-Peer Lending and the "Democratization" of Credit Markets: Another Financial Innovation Puzzling Regulators*, 21 COLUM. J. EUR. L. 521, 525, (2015).

Fifth, P2P lending creates a new asset class, allowing investors to diversify their portfolios and thus diversify their risk exposure.[25] *Sixth,* it reduces information asymmetry between contracting parties by screening potential borrowers diligently. The recommendation of a particular borrower based on such screening, provides positive signal and thus facilitates access to credit[26].

Seventh, P2P lending also facilitates socially motivated lending. It has been found that various lenders on the platform gain emotional utility from lending to small businesses or to people with certain attributes like race or gender or with compelling personal circumstances.[27] For instance, Prosper, a leading P2P platform in USA, hosts groups for veterans, environmental projects, and graduates of educational institutions etc. and offers better rates to members of high-performing groups and thus group membership increases the likelihood of securing a loan.[28]

C. RISKS

P2P lending comes with its share of risks. *First,* contracting parties face strong privacy risks since P2P platforms require substantial personal information and such data can be hacked, sold to someone else, or exploited by an unscrupulous employee of the platform.[29] This might be the case when platforms lack sufficiently robust data handling policy or effective implementation of the same and thus is vulnerable to cyber -attacks.[30]

Second, Parties face the risk of fraud. By their very design, P2P platforms allow lenders to connect with borrowers, who may provide false information[31] and very few platforms can completely verify the information or identify disclosed by the parties.[32] Further, if there is absence of any legal regime requiring registration and disclosures by platforms, parties are unable to find independent legal information on the safety and regulation of the platform and thus face the risk of being defrauded by the platform itself.[33]

Third, parties face the risk of incorrect or incomplete assessment of information by the platform. Borrowers face the risk that their creditworthiness could be assessed incorrectly and so attract less interest from potential lenders.[34] Further, Lenders might be enticed to lend on unworthy

---

[25] JACK, *supra* note 19.

[26] Sven Berger & Fabian Gleisner, *Emergence of Financial Intermediaries in Electronic Markets: The Case of Online P2P Lending*, BUR BUSINESS RESEARCH JOURNAL, VOL. 2, NO. 1,(2009).

[27] SLATTERY, *supra* note 20.

[28] *Id.*

[29] *Id.*

[30] KIRBY, *supra* note 23.

[31] Andrew Verstein , *The Misregulation of Person-to-Person Lending* , 45 U.C.D. L. REV. 445, 466, (2011).

[32] KIRBY, *supra* note 23.

[33] NIDHI, *supra* note 6.

[34] *Opinion Of the European Banking Authority on Lending-Based Crowdfunding*,, EUROPEAN BANKING AUTHORITY https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+(EBA+Opinion+on+lending+based+Crowdfunding).pdf, (last visited September 24, 2016).

borrowers, and also due to illusion of assured return created also by platform advertising the lending fallaciously as investment deposits.[35]

Fourth, there is a risk of possible default by borrowers since banks, on their risk assessment, might have rejected them.[36] Lenders also suffer because of absence of any security or at times, any compensation scheme of the platform to cover defaults.[37] Further, when borrowers default on loans extended based on false information submitted by them, P2P platforms disclaim responsibility for the content of information even ostensibly verified by the platforms.[38] This in turn harms the lenders ability to recover the amount lent.

The problem of default is compounded by the conflict of interest of the P2P platform. Such conflict emerges since the loan origination fee charged by the platform is calculated as a percentage of the loan amount and so the platforms have an incentive to encourage larger loans, unlike traditional commercial banks who despite, default of the borrowers, remain liable to the depositors to repay the depositors.[39] Further, due to lack of any corporate governance norms regulating the platform, conflict also arises if a platform or its shareholders, managers or key employees have financial interests in the borrower's business.[40]

Fifth, Lenders also face the risk of closure of platform, which leaves them with no recourse against the borrower to recover the loan since the platform assumes the responsibility to recover loans from the defaulter.[41] For instance, in 2011, Quackle closed suddenly and left no information on the borrowers or lenders leading 100% loss on the loans.[42]

Sixth, Borrowers also face the risk that their business project might be undermined if funds are not received on time from the lender.[43] They run the risk that their business ideas, which they might be required to disclose as part of the purpose for which loan is to be raised, might be stolen.[44] Also, some risky borrowers may access P2P platform however, to attract lenders, P2P platforms may offer return to lenders greater than that offered by banks, which can also be in

---

[35] *A Review of the Regulatory Regime for Crowdfunding and the Promotion of Non-Readily Realisable Securities by Other Media,* FINANCIAL CONDUCT AUTHORITY, 3, https://www.fca.org.uk/static/documents/crowdfunding-review.pdf (last visited September 24, 2016).

[36] Rongxin Zeng, *Legal Regulations in P2p Financing in the U.S. and Europe,* 10 US-CHINA L. REV. 229, 236, (2013).

[37] *Consultation Paper on Crowdfunding in India*, SECURITIES & EXCHANGE BOARD OF INDIA, 34, http://www.sebi.gov.in/cms/sebi_data/attachdocs/1403005615257.pdf , (last visited September 24,2016).

[38] SLATTERY, *supra* note 20.

[39] SLATTERY, *supra* note 20.

[40] EUORPEAN BANKING AUTHORITY, *supra* note 34.

[41] KIRBY, *supra* note 23.

[42] *Id.*

[43] EUORPEAN BANKING AUTHORITY, *supra* note 34.

[44] *Id.*

potential violation of usury laws and would nullify borrower's aim to secure cheap loans from a source other than banks.[45]

III. P2P MODELS AND REGULATION- INTERNATIONAL FRAMEWORK

This part discusses the two major operational models followed by P2P platforms globally. It then analyses regulatory structures of various countries and examines how the platforms and regulations in those countries have mutually shaped each other.

A. NOTARY MODEL

There are, broadly, two types of models: notary and client segregation account model, but many companies have finetuned it as per the regulations. The two differ mainly on account of role played by the P2P platform and on the factum of source of origination of loan. The Lender directly originates the loan in client segregation account model while a bank originates the loan in notary model.[46] Prosper and LendingClub are the two most prominent P2P platform in the USA, relying on the notary model.[47] The funds for the borrower are arranged from a bank, which disburses the loan amount to the borrower after receiving promissory note from the borrower.[48] The platform then provides the bank with aggregate funding received from multiple lenders and in return purchases the borrower's note.[49] The platform then collects monthly payments from borrowers and distributes it to the lenders based on their pro rata investment in the loan, after deducting origination and servicing fees from the loan.[50]Further, they have developed a secondary market for selling and reselling of loans that can provide liquidity at an earlier stage.[51] The default rate has been around 4-5% for both the platforms. [52]

Such a method raised the hackles of securities regulator, who termed the note as a security and required it to be subject to securities framework..[53] This affected the entry of other platforms since the regulatory costs became exponential.[54] Till date, apart from securities law, there is no other law governing P2P platforms in USA.[55]

B. CLIENT SEGREGATED ACCOUNT MODEL

---

[45] *The Regulation of Marketplace Lending A Summary of the Principal Issues (2015 Update)*, CHAPMAN & CUTLER LLP, 14, https://www.aba.com/Tools/Offers/Documents/ChapmanRegulationofMarketplaceLendingWhitePaper040815.pdf, (last visited September 24, 2016).
[46] KIRBY, *supra* note 23.
[47] GUSTAV, *supra* note 7.
[48] *Ibid*
[49] *Id.*
[50] *Id.*
[51] Simon Cunningham, *Default Rates at Lending Club & Prosper: When Loans Go Bad*, LENDING MEMO, http://www.lendingmemo.com/lending-club-prosper-default-rates/ (last visited September 24, 2016).
[52] ANDREW *supra* note 31.
[53] *Ibid.*
[54] *Id.*
[55] *Id.*

The second model is the client segregation account model involving less participation of the platform. The platform matches the lenders with the borrowers and transfers all funds from lenders to a separate legally segregated client account and then transferred to the borrowers. [56] The platform has no claim over the account in case of its closure and so the contractual obligation between borrower and lender still applies in the event of the platform's failure and money can be recovered from the account in such event. [57] Most P2P platforms rely on this on this model; however, variants of the model can be found. Some platforms like Babyloan and MicroWorld in France or Funding Circle in the United Kingdom provide detailed information about the borrowers and let the lenders freely choose while others like RateSetter, Zopa in U.K., and Smartika in Italy provide little information and allow little freedom of choice to the lenders and diversify the risk by splitting each lender's investment across a large number of borrowers. [58]
Countries like Germany, Italy and France regulate the P2P platforms as banks or payment institutions under banking laws due to their credit intermediation function.[59] Germany and Italy had mandated banking licenses for these platforms primarily because of the business model.[60] Zopa Italia used to collect money from lenders and keep it in an account for an average of 45 days before transferring it to the borrower, which was treated as deposit.[61] Further, the lenders could ask for reimbursement of the fund, making it repayable deposit.[62] Italian authorities considered this to be banking activity and closed down the website.[63] The platform came with a new name and limited itself to purely payment services.[64] Another website, opened a bank account in name of the lenders and managed it as a trust for them, thus creating contractual relationship between trust and borrowers.[65]

In Germany, regulations requires a bank to originate loans and so a P2P platform has to partner with a bank which formally originates the loan and a split second later sells the rights to proceeds to the investors via the platform.[66] This involves no direct contractual relationship between lender and borrower, though the platform assigns credits score, sets the interest rates and also provides for few loans secured by assets.[67]

[56] KIRBY, *supra* note 23.
[57] *Id.*
[58] EUGENIA, *supra* note 24.
[59] KIRBY, *supra* note 23.
[60] EUGENIA, *supra* note 24.
[61] *Ibid.*
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Review of Crowdfunding Regulation 2014 – Germany*, OSBORNE CLARKE, http://www.osborneclarke.com/connected-insights/publications/review-crowdfunding-regulation-2014-germany/ , (last visited September 24, 2016).
[67] *Id.*

While the growth in Europe has been restricted, UK and New Zealand have seen boom due to their regulation as financial intermediaries, making the market conducive for this industry. Many commentators have noted that Securities[68] and Banking Regulation[69] is inappropriate for governing P2P lending. Probably taking lessons from USA's encounter with Securities Law, and Europe's encounter with Banking Laws, platforms in India play a minimal role in managing funds, only transferring them and purely act as the facilitator of the transaction. SEBI has explicitly mentioned it has no jurisdiction[70] and RBI's consultation paper seeks to regulate them as NBFCs, which shall be discussed in Part VI.

IV. REGULATORY APPROACH TO P2P LENDING- THEORATICAL FRAMEWORK

A. NEED FOR REGULATIONS: CASE OF CHINA.

P2P lending has quickly grown in China with more than 2,000 P2P platforms. [71] However, neither the central bank nor China Banking Regulatory Commission currently regulate this industry.[72] The exponential growth with no appropriate regulation has adversely affected the lenders with large numbers of false or self- fund raising by the platforms and closure of platforms.[73] For instance, WangWang Dai, where people had lent up to 60,000,000 RMB, suddenly closed its operations even though it marketed itself as the biggest and safest platform in China guaranteeing 100% payment.[74] Another example is that of Ezubao's Ponzi scheme which robbed lenders of $ 7.6 billion, appropriated by the top executives of the platform.[75] Hence, to prevent fraud and systemic risk to the economy, P2P industry ought to be regulated.

B. C2C NATURE OF P2P WARRANTS MORE INTERVENTIONIST CONSUMER PROTECTION APPROACH

---

[68] JACK, *supra* note 19; ANDREW *supra* note 31; EUGENIA, *supra* note 24; SLATTERY, *supra* note 20.; *Report to Congressional Committees Person-To-Person Lending New Regulatory Challenges Could Emerge as the Industry Grows*, UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, 48, http://www.gao.gov/new.items/d11613.pdf, (last visited September 24, 2016).

[69] EUGENIA, *supra* note 24; GUSTAV, *supra* note 7; NIDHI, *supra* note 6.

[70] SEBI, *supra* note 37.

[71] Jing Bian, *Internet Finance in China: Half Lava? Half Ocean,* JOURNAL OF INTERNATIONAL BANKING LAW & REGULATION, VOL. 29 ISSUE 12, 743, 746, (2014).

[72] Shen Hu, *China's Brave New World of P2P Credit*, http://www.marketwatch.com/story/chinas-brave-new-world-of-p2p-credit-2011-09-18 , (last visited September 24, 2016).

[73] JING, *supra* note 71.

[74] *Id.*

[75] Neil Gough, *Online Lender Ezubao Took $7.6 Billion in Ponzi Scheme*, *China Says,* http://www.nytimes.com/2016/02/02/business/dealbook/ezubao-china-fraud.html?_r=2, (last visited September 24, 2016).

A more interventionist consumer protection approach is called for since the traditional consumer protection approach focusing on Business to Consumer (B2C) is inadequate in light of peculiar Consumer to Consumer (C2C) nature of the P2P lending transaction.

An ideal regulation should grasp the unique features of the transaction and the relationship of the parties involved and strike a balance between the interests of the borrowers and lenders while not overburdening the P2P industry with heavy regulation.[76]. A typical P2P transaction reflects a tripartite C2C relationship involving the intermediation by P2P platform which plays a facilitative role but is not party to the transaction.[77] The traditional consumer protection approach based on the B2C relationship reflects the need to protect the weaker party, ie. the consumer, against the stronger party i.e., the business since the idea of powerlessness underlies the approach.[78] Thus, a traditional lender is not a consumer since it is not seen as being powerless.

A P2P lender, however, is a consumer since it is powerless against the platform which plays an active role in the transaction and without whom the transaction is incomplete since it assesses the creditworthiness, sets the interest rate and assists in loan repayments and recovery of loan in case of default, based on the information it asks both the parties to share anonymously.[79] This makes independent identification of the parties difficult thereby increasing the parties dependency on the platform to conclude the transaction.[80] Thus, parties' trust and not control over the platform becomes the key factor for their participation on P2P platform, making them vulnerable against the platform[81]. Thus, both parties are consumers being powerless against the platform for successful transaction and so P2P transaction involves tripartite C2C relationship involving intermediation by P2P platform, a third party to the contract..

This peculiar relationship has two implications. *First,* the platform owes a duty to exercise reasonable care or due diligence. It has been noted in *Anil Bandopadhyay* and followed subsequently that a situation when one person trusts the faithful integrity of another, who as a result gains superiority or influence over the first represents a fiduciary relationship.[82] Such a relationship of trust contemplates good faith, rather than legal obligation, as the basis of the transaction.[83] Further, in the context of duty of care owed by financial intermediary, *Keynote*

[76] JACK, *supra* note 19.
[77] Onyeka Osuji & Ugochi Amajuoyi, *Online Peer-To- Peer Lending: Challenging Consumer Protection Rationales, Orthodoxies and Models?,* 6 JOURNAL OF BUSINESS LAW 485, 496, (2015).
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] Central Board of Secondary Education and Anr. v. Aditya Bandopadhyay and Ors, 2011 8 SCC 497; Reserve Bank of India and Ors. v Jayantilal N. Mistry and Ors, 2016 3 SCC 525.
[83] *Id.*

observed that on the faith that intermediary has conducted due diligence with utmost sincerity, public decides to invest in a particular company.[84] Thus, a financial intermediary ought to owe a duty to exercise due diligence or a duty to exercise reasonable care since the public put their faith on the platform's assessment of the information of the parties for successful conclusion of the transaction. However, such duty would not make the intermediary liable in case of fraudulent or concealed information since it does not require the intermediary to proceed in a manner of trying to detect a fraud or lie unless such information ought to arouse suspicion of a reasonable professional.[85] Thus, in such cases, only the concerned individual would be liable.

Second, the C2C relationship makes the traditional consumer protection approach inadequate for regulation of P2P lending. The traditional consumer protection relies on disclosure regime based on the rational consumer choice theory[86] which advocates that people being rational economic beings, will always choose that which maximizes their welfare.[87] However, this rationale would not be applicable for regulating P2P market. *First,* while disclosure improves quality and extent of consumer information but offers no help to consumers to comprehend the information.[88] *Second,* excessive information becomes too complex to understand for ordinary consumers using P2P platform for personal gain and not for business purpose and do not possess the expertise to comprehend such information.[89] *Third,* consumer decisions are often irrational, impulsive and influenced by emotions. *Fourth,* a P2P lender is primarily concerned about the performance of loan contracts, including prompt loan repayments and unlike banks, is mostly incapable of establishing and operating its own debt recovery arrangements.[90] Traditional disclosure based consumer approach is thus inadequate to guard P2P lender's interest. This calls for a more interventionist approach for consumer protection on P2P platforms.

C. *WHAT SHOULD SUCH AN INTERVENTIONIST CONSUMER PROTECTION APPROACH INCORPORATE?*

Such an approach, based on the assumption that P2P business models vary and a P2P platform better placed than regulatory authority to identify the risks in its operations and its consumer's needs, should refrain from prescribing form and content of specific disclosures but require

[84] M/s. Keynote Corporate Services Ltd. v. The Securities and Exchange Board of India, 2014 SCC OnLine SAT 17.
[85] Imperial Corporate Finance and Services Pvt. Ltd. v. SEBI, 2004 SCCOnline SAT 42.
[86] ONYEKA, *supra* note 77.
[87] *Id.*
[88] *Id.*
[89] *Id.*
[90] *Id.*

disclosure of appropriate and accurate information to consumers after identifying their needs and investment risks inherent in or relevant to their business models.[91]

To go beyond mere disclosure regime, such an approach can adopt various measures for the post contractual side of P2P transaction to ensure smooth functioning of the platform and recovery of loans. *First,* it can establish a licensing regime having minimum capital requirements to ensure efficient and continuous running of the platforms and inspire confidence among prospective consumers.[92] *Second*, P2P platforms being allowed to engage in activities outside of the primary P2P lending business to increase revenues, like selling advertisement spaces on their websites, would strengthen the financial stability of platforms thereby reducing insolvency risks and increasing lender confidence.[93] *Third,* platforms must provide a standard written contract to all parties to clearly provide their rights and obligations and the financing process and all costs and other features applicable to them.[94] *Fourth,* out of abundant caution, duty to exercise reasonable care should be expressly imposed by the regulatory framework. *Fifth,* lending caps should be imposed on certain categories of lenders to restrict their lending upto a certain amount in a time frame.[95] *Sixth,* a platform must have arrangements in place, like, setting up a compensation scheme or insurance coverage for default for lenders who took reasonable steps to evaluate platforms and borrowers before lending, to ensure recovery of loans in case of platform's closure or borrower's default.[96] A platform must also have arrangements with third parties to recover loans upon borrower's default[97] and must formulate business continuity plans to ensure the continued management and administration of loans in case of platform's closure.[98] *Seventh,* a platform should also take steps to avoid conflict of interest with parties and disclose the steps undertaken.[99] *Eighth,* platforms should also establish a complaints handling mechanism to redress consumer grievances.[100]

V. P2P REGULATION IN INDIA

This part discusses that P2P platforms in India fall outside the jurisdiction of securities and banking jurisdiction and argues against the applicability of moneylending and usury laws. In light of the framework discussed is Part IV, this part analyses the consultation paper released by RBI regarding regulation of P2P lending.

---

[91] *Id.*
[92] *Id.*
[93] JACK, *supra* note 19.
[94] EBA, *supra* note 34..
[95] *Id.*
[96] ONYEKA, *supra* note 77.
[97] SLATTERY, *supra* note 20.
[98] ONYEKA, *supra* note 77.
[99] EBA, *supra* note 34.
[100] *Id.*.

Some of the well- known P2P platforms in India are Faircent, LendBox, I-Lend and Easy Rupaiya. These platforms rely on the client segregation account model and so play a minimal role and act only as third parties facilitating the loan contract and charge fees for their facilitation services.[101] Some provide a standard loan agreement[102]. Some expressly disassociate themselves from collecting and transferring funds[103] while others play a role in disbursement of loan[104] or repayment of loan by collecting cheques and depositing them in the lender's account.[105] Some help in recovering loans, as lender's agent, in case of default, including initiating action to report defaulters to a recovery agency.[106]

A. *SECURITIES AND BANKING REGULATIONS ARE INAPPLICABLE TO P2P PLATFORMS*

P2P platforms are excluded from SEBI's jurisdiction since there is no issuance of a security by the platforms. The term security has been generally understood to connote an instrument which is marketable[107] in nature and thus freely transferable.[108] Since, Indian platforms do not follow the notary model, they do not provide any secondary market for the loans, thus making the loans non-marketable and thus not a security.

Further, the transactions via P2P platforms do not constitute a Collective Investment Scheme which, based on *Howey*[109]*,* connotes, pooling of money for any arrangement for the purpose of making profits from the investment managed on behalf of the investors.[110] However, there is no pooling of funds or common enterprise between the platform and lenders since there is no investment by lenders in the P2P platform itself and thus they are not entitled to the profits generated by the platform; rather the transactions resemble issuance of bonds and not investments..[111] Thus, loans issued via P2P platforms are not Collective Investment Scheme

---

[101] *Terms of Use*, LENDBOX, https://www.lendbox.in/terms-of-use, (last visited September 24, 2016); *How it Works*, I-LEND, https://www.i-lend.in/how-it-works, (last visited September 24, 2016); *How Faircent Works*, FAIRCENT, https://www.faircent.com/how-faircent-works, (last visited September 24, 2016).

[102] *Sample Contract between the Lender and the Borrower*, FAIRCENT, https://www.faircent.com/sites/default/files/lender_borrower.pdf, (last visited on September 24, 2016); *Loan Agreement Between Borrower and Investor*, I-LEND, https://www.i-lend.in/legal-agreements/loan-agreement-between-borrower-and-investor, (last visited on September 24, 2016).

[103] *Terms of Use*, LENDBOX, https://www.lendbox.in/terms-of-use, (last visited September 24, 2016).

[104] *Loan Agreement Between Borrower and Investor*, I-LEND, https://www.i-lend.in/legal-agreements/loan-agreement-between-borrower-and-investor, (last visited September 24, 2016).

[105] *Id.*; *What does Faircent not do*, FAIRCENT, https://www.faircent.com/what-does-faircent-not-do, (last visited September 13, 2016).

[106] I-LEND, *supra* note 104.

[107] The Securities Contracts (Regulation) Act, 1956, §2(h).

[108] Bhagwati Developers Pvt. Ltd. v. Peerless General Finance and Investment Company Ltd. and Anr, 2013 9 SCC 584 ¶ 22.

[109]

[110] The Securities & Exchange Board of India Act, §11AA(2) (1992).

[111] JACK, *supra* note 19.

.Moreover, SEBI itself notes that securities regime excludes P2P lending since it does involve issuance of securities for financial return, and may fall under the purview of RBI.[112]

P2P platforms are not subject to banking regulations since they do not constitute a bank or a Non-Banking Financial Company (NBFC). Banking is "the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, or otherwise." [113]Thus, a P2P platform is not a bank since it only acts as an intermediary to facilitate the loan between two parties. Further, NBFC denotes a financial institution being a company or a non- financial institution having its principal business the receiving of deposits, under any scheme or arrangement, or lending in any manner[114]. A financial institution is one which is engaged in certain financial activities.[115] Since the principal business of a P2P platform is not to engage in funding the borrower, it does not carry out any financial activity and hence is not an NBFC.

B. *MONEYLENDING AND USURY LAWS SHOULD NOT BE EXTENDED TO P2P PLATFORMS*

Money lending envisages only those classes of persons whose regular business is to advance moneys and not those who advance money casually.[116] Such an understanding of moneylenders excludes from its ambit P2P platforms since they do not themselves provide loans or advances.[117] Even so, platforms might incur liability under the moneylending laws while acting as agents of lenders to recover loans on default since various state moneylending statutes include agents and other legal representatives as moneylenders.[118] Further, Tamil Nadu and Andhra Pradesh deem a person resident in the state, being an agent of moneylender resident outside the state extending loans to people in the state, as the moneylender under the state law.[119] Considering P2P's online nature, in case of inter- state loans , a P2P platform, having its office in Andhra, which is used by person in Delhi to give loan in Andhra, would be deemed the moneylender.

---

[112] SEBI, *supra* note 37.
[113] The Banking Regulation Act, §5(b) (1949).
[114] The Reserve Bank of India Act, §45I(f) (1934).
[115] NIDHI, *supra* note 6.
[116] Vivek Kumar Verma, *Requirement Of Registration for Private Money Lending in India,* https://indiancaselaws.files.wordpress.com/2014/04/requirement-of-registration-for-private-money-lending-in-india.pdf, (last visited September 24, 2016).
[117] NIDHI, *supra* note 6.
[118] The Andhra Pradesh Money Lenders Act, §2(10) (2000); The Assam Money Lenders Act, §2(1) (1934); The Bihar Money Lenders Act, §(2)(n) (1974); The Punjab Registration of Money-Lender's Act, §(2)(9) (1938); The Madhya Pradesh Money Lenders Act, §(2)(v) (1934), The Tamil Nadu Money Lenders Act, §(2)(8) (1957).
[119] The Tamil Nadu Money Lenders Act, §(2)(8) (1957); The Andhra Pradesh Money Lenders Act, §(2)(10) (2000).

Moreover, unregistered money lenders, coming within the purview of state laws, might try to access the platform. However, any loan advanced by an unregistered moneylender is non recoverable.[120] Money lending statutes also prescribe maximum interest to be charged and if money lenders accessing P2P platform charge more than prescribed interest, loan would be invalid and would attract penal provisions under state laws.[121]

Further, P2P loans may still be subject to Usurious Loans Act 1918, which gives power to the court to set aside interest rate which in the court's opinion is excessive.[122] Since the P2P platforms also suggest the interest to be charged, they have to be mindful of this statute since P2P lending, as discussed, involves high interest due to the risks involved.

Moneylending and usury laws however should not be extended to P2P platforms due to certain factors. *First,* moneylending laws being framed a long time back envisage only simple B2C relationships within a state wherein a borrower would go to lender's office to request for a loan. For instance, many states require a physical place of business, grant of license only for a particular area etc.[123] P2P lending however is an innovation relying on the internet and represents C2C relationship and also envisages inter- state transactions. Therefore, the old framework of moneylending laws should not be extended to this innovation.

Second, the moneylending laws' rationale is to protect unwary debtors from moneylender's malpractices[124] while that of Usurious Loans Act was only to save agriculturist debtors from moneylender's oppression.[125] P2P's rationale however, is to provide access to cheap finance to people. It is agreed that the same problem of exploitation and setting up of excessive interest rates might arise on the platform. However, this can be met by framing of RBI guidelines to regulate determination of interest rates by the platforms, instead of extending moneylending or usury laws considering that such laws have a different rationale. For instance, Banks are currently exempt from Usurious Loans Act, 1918[126] and are not considered moneylenders under state laws. The concern of excessive interest is met by RBI guidelines based on which banks charge interest and the court can intervene if banks violate the guidelines.[127] There seems no reason why a similar provision cannot be made for P2P platforms.

---

[120] Kaloji Talusappa Gangavathi v. Khyanagouda and Ors. AIR 1970 SC 1420.
[121] VERMA,*supra* note 116.
[122] Usurious Loans Act, §3 (1918).
[123] The Andhra Pradesh Money Lenders Act, §3(2) (2000); The Goa Money Lenders Act, §(5) (2001); The Gujarat Money Lenders Act, §(7)(2) (2011); The Kerala Money Lenders Act, §3(2) (1958); Bombay Money Lenders Act, §(5) (1946).
[124] KALOJI *supra* note 120.
[125] Indian Bank, Tiruvannamalai v.V.A. Balasubramania Gurukal, AIR 1982 Mad 296.
[126] The Banking Regulation Act, §21A (1949).
[127] Corporation Bank v. D.S. Gowda & Anr, 1994 5 SCC 213; Central Bank of India v. Ravindra and Ors, 2002 1 SCC 367.

Third, extension of usury and moneylending laws would unduly cripple the industry. To attract lenders to lend to high risk borrowers, P2P platforms have to offer return to lenders greater than that offered by banks. Further, higher risk entails higher returns. Extending the usury laws thus disable the platforms from attracting potential lenders and would thus cripple the industry. Moneylending laws as mentioned might include P2P platforms when acting as agents of lenders to recover loans. However, considering the inter state nature of loans on P2P platform, a platform would then have to register itself as moneylender in practically every state while acting as agent thus imposing great costs and thus harming the fledgling industry.

Any uncertainty towards applicability of these laws and legal challenge to violation of these laws by P2P platforms might harm the industry and so it is imperative that legal position ought to be clarified soon and in favour of exempting platforms from these laws. A case in point is the current law suit filed in USA alleging violation of usury laws. This law suit was a result of recent ruling in *Madden v Midland Funding*[128]. This case dealt with preemption of National Bank Act over state usury laws. Madden opened an account with a national bank, Bank of America which sold the account to another national bank which also sold it to a third-party debt purchasing company, Midland and did not retain any interest in the account after such sale.[129] The appeal was decided in favour of Madden on the ground that Midland, acting on its own, not being a national bank or an agent of a national bank, could not claim an exemption under the National Banking Act from the application of state usury laws.[130] This ruling potentially can apply to the notary model of P2P lending since the originating bank in the model has no interest in the notes, similar to *Madden* and so has made the investors in P2P industry skittish due to which P2P platforms have started shelving their expansion plans in USA.[131] A broad application of usury law in the law suit against Lending Club could reduce interest rates charged on platform or could make the loans void and non recoverable, thereby making the industry unattractive.[132] Any other similar lawsuits filed would further impose unnecessary costs on the platform and would distract

[128] Madden v. Midland Funding, 2015 U.S. App. LEXIS 8483 (2nd Cir. May 22, 2015).

[129] Nicholas Giuliano & Christopher Murray, *Legal Brief: Madden v. Midland Funding*, DEBANKED, http://debanked.com/2015/06/legal-brief-madden-v-midland-funding/ , (last visited September 24, 2016).

[130] Greg Stohr & Elizebeth Dexheimer, *Lenders Rejected by Supreme Court on State Interest Caps*, BLOOMBERG, http://www.bloomberg.com/politics/articles/2016-06-27/lenders-rejected-by-u-s-supreme-court-on-state-interest-caps , (last visited September 24, 2016).

[131] Kevin Wack, *Supreme Court Throws Curveball in Big Case for Online Lenders*, AMERICAN BANKER, http://www.americanbanker.com/news/marketplace-lending/supreme-court-throws-curveball-in-big-case-for-online-lenders-1080015-1.html , (last visited September 24, 2016).

[132] Sean Murray, *Could The Debt You Bought on a Lending Marketplace be Null and Void?,* DEBANKED, http://debanked.com/2015/08/could-the-debt-you-bought-on-a-lending-marketplace-be-null-and-void/ , (last visited September 24, 2016).

the management of P2P platform and slowing down the industry.[133] Consequently, Lending Club has altered its relationship with the originating bank to ensure that bank has an economic interest in the note[134]; however, this is unlikely to eliminate investors concerns over looming ruling in the lawsuit.[135]

To avoid such a scenario in India, it is imperative that law ought to be clarified soon and in favour of exempting platforms from these laws.

C. PLATFORMS' VOLUNTARY PRACTICES ARE INSUFFICIENT AND QUESTIONABLE

Presently, P2P platforms adopt certain voluntary practices to guard parties' interests and to attract more people. Before allowing anyone to open account, the platforms adopt KYC norms of RBI to counter money laundering.[136] To recover loans, some undertake to follow RBI guidelines for the same.[137] Further, some attempt to ensure veracity of their determination of creditworthiness and interest rates by relying on borrower's credit ratings issued by Credit Information Companies.[138] Banks and other credit institutions share their information with Credit Information Companies set up under the Credit Information Companies (Regulation) Act, 2005(*CIC Act)* who use this information to determine an individual's credit worthiness.[139] There are four such entities in India[140] and all credit institutions must be members of all the four entities.[141] The CIC Act eliminates the need to take consent of borrowers before a credit institution submits the information to a CIC.[142] The CIC work on the system of reciprocity and currently only members i.e. credit institutions, can contribute to, and get access to borrower's credit scores.[143] Faircent however currently has a tie up with TransUnion, majority shareholder of Credit Information Bureau of India Limited (*CIBIL*), to obtain data.[144] This potentially violates of the *CIC* Act since, only specified user i.e. a credit institution or insurance company or

---

[133] J.D. Alois, *Moody's Calls Class Action Lawsuit Against Lending Club a Negative for Entire Sector*, CROWDFUND INSIDER, http://www.crowdfundinsider.com/2016/05/85254-moodys-calls-class-action-lawsuit-against-lending-club-a-negative-for-entire-sector/ , (last visited September 24, 2016).
[134] GREG, *supra* note 130.
[135] ALOIS, *supra* note 133.
[136] *Supra* note 101.
[137] FAIRCENT, *supra* note 105.
[138] SHAILESH, *supra* note 17.
[139] The Credit Information Companies (Regulation) Act, §17 (2005).
[140] *RBI Nod for 4 Credit Information Companies*, LIVEMINT, April 18, 2009, http://www.livemint.com/Companies/xV99ISCymGQYcfQWueR8mN/RBI-nod-for-4-credit-information-companies.html, (last visited September 24, 2016).
[141] *Id.*
[142] The Credit Information Companies (Regulation) Act, §14 (2005).
[143] The Credit Information Companies (Regulation) Act, §§14-15 (2005).
[144] SHAILESH, *supra* note 17.

the borrower himself or any other institution as specified by RBI can access the data.[145] Further, the existence of platform's obligation to submit information to a CIC on the transaction it facilitates is unclear. More clarity is needed on this since the system works on reciprocal basis.

Thus, the platforms do not incur any liability under the current legal framework and the voluntary practices which are not adopted uniformly by all platforms raise questions of legality. It is thus essential that regulations be formulated to ensure smooth and efficient growth of this innovation. It is thus welcome that the RBI has recently released a consultation paper on regulation of P2P lending.

D. *CONSULTATION PAPER BY RBI- FIRST STEP TOWARDS REGULATION OF P2P LENDING*

Section 45I of the RBI Act authorises the RBI to declare any entity as a NBFC[146]. Accordingly, RBI proposes to treat P2P platforms as NBFC and seeks to put in place various registration and prudential norms to regulate these platforms. P2P platform can only be registered as a financial intermediary with a limited purpose of bringing the borrower and lender together without reflecting the loans on its balance sheet.[147] It can opine on a borrower's creditworthiness and suitability of a lender, is prohibited from giving any assured return and is banned from allowing cross border transactions.[148] Further, funds must move directly between the bank accounts of the parties to negate possibility of money laundering.[149] Prudential requirements include a minimum capital of Rs 2 Crore, a minimum leverage ratio, and lending cap on lenders or for a particular sector.[150] To ensure efficient functioning of the platform, fit and proper person criteria is proposed for promoters and key managerial personnel of platforms along with the requirement of experience of board members in financial sector.[151] The platforms also must have a business continuity plan and adequate risk management systems to ensure smooth operations.[152] Further, fair practices code is proposed mandating confidentiality of the customer data, transparency in operations, and minimum disclosures to borrowers and lenders.[153] The current regulations applicable to other NBFCs will be made applicable to the P2P platforms as

---

[145] The Credit Information Companies (Regulation) Act, §14 (2005) .
[146] The Reserve Bank of India Act, §45I(f)(iii) (1934).
[147] *Consultation Paper on Peer To Peer Lending*, RESERVE BANK OF INDIA, 11, https://rbidocs.rbi.org.in/rdocs/Content/PDFs/CPERR280420162D5F13C3A2204F4FB6A2BEA7363D0031.PDF , (last visited September 24, 2016).
[148] *Id.*
[149] *Id.*
[150] *Id.*
[151] *Id.*
[152] *Id.*
[153] *Id.*

well regarding recovery practices and the platforms would be mandated to have a proper grievance redress mechanism to deal with complaints from the parties.[154]

1. *Do the proposed regulations adequately address C2C relationship of P2P lending?*

Part IV had advocated a more interventionist consumer oriented approach relying not merely on pre contractual disclosures but also on post contractual measures like registration and prudential requirements. In this backdrop, the measures as discussed above are a welcome move by RBI since they propose to put in place registration and various prudential requirements to ensure smooth functioning of P2P platforms and to take care of consumer's concerns.

Primarily, there are six measures which reflect the understanding of P2P as a tripartite C2C relationship warranting consumer protection. *First* is prohibition on platform to offer any assured returns, directly or indirectly. It has been discussed earlier that since platforms do not have any repayment obligation, it is in their interest to originate as many loans as possible to make profit without considering creditworthiness of borrowers. To do so, they might offer assured returns to entice uninformed individuals who would then face loss of their money doe to default.[155] Thus, banning assurance of return is a welcome move to protect lenders from getting enticed[156]. *Second,* caps have been proposed to be imposed on amount lent by a lender or lent to a certain sector or activity. This would protect lenders from excessive credit exposure since unwary, inexperienced creditors might lend recklessly in hopes of making profits. *Third,* the requirement of having a business continuity plan reflects the need to protect lenders in case of closure of platform on which they are dependent for completion of transaction. *Fourth,* to effectively address concerns of consumers on the platform, P2P platforms are required establish a proper complaint redressal mechanism and report the same periodically to the RBI. *Fifth,*, *fit and proper person* criteria for key managerial personnel reflects the need to avoid conflict of interest of the platforms with consumers accessing the platforms. This would take care of conflict of interest since as held in *Sahara,* this test is applied not just on the concerned entity but also on people in a position to influence decision making.[157] In the context of P2P lending, this would mean borrowers or lenders themselves or any person likely to be influenced by lenders or borrowers cannot be a key managerial personnel of the platform, thereby avoiding exploitation of other innocent consumers *Sixth,* allowing P2P platforms to engage in advertising would also

---

[154] *Id.*

[155] SLATTERY, *supra* note 20.

[156] Vishwanath Nair & Vivina Vishwanathan , *RBI Proposes P2P Lending Regulations*, LIVEMINT, April 29, 2016, http://www.livemint.com/Industry/Vx9iwySoYwxHxfIsPq2r1L/RBI-proposes-regulatory-framework-for-P2P-lending-platform.html , (last visited September 24, 2016).

[157] *In Re Sahara Asset Management Company Private Limited,* SECURITIES & EXCHANGE BOARD OF INDIA, www.sebi.gov.in/cms/sebi_data/attachdocs/1425032596373.pdf, (last visited September 24, 2016).

increase consumer confidence by strengthening the financial stability of P2P platforms and reducing the insolvency risks and thus attract more consumers to borrow and lend.

It is felt that such consumer friendly provisions will bring respectability to this fledgling sector and would attract people to lend and borrow.[158] However, there are two proposals which go against the consumer oriented approach advocated in Part IV.

First is the designation of platforms as NBFC. On one hand, RBI recognises their role as financial intermediary only but on the other hand treats them as NBFC which is an essential part of banking laws in the country. This appears ludicrous since NBFCs function is much wider in scope including deposit taking etc., while a P2P platform primarily plays an enabling role[159] which the RBI itself recognises in the paper.[160] Further, platform's source of income lies not in interest income but in arrangement fees.[161] It is proposed that it is appropriate to regulate platforms only as intermediaries without imposing the onerous requirements applicable to NBFCs[162] and by following UK in recognizing a new regulatory activity of "*use of electronic platform in relation to lending*".[163]

A necessary implication of designating as NBFC's is regarding access to credit information held by CIC's. RBI has declared that designation of P2P platforms as NBFC would enable integration with the CIC's which would make reporting cases of defaults easier.[164] However, it is proposed that the platforms can be designated as specified users u/s 15 entitled to credit ratings of CIC u/s 14 of CIC Act due to inappropriateness of designation as NBFC. [165]

Second, the RBI seems totally confused regarding imposition of duty of care, which as discussed in Part IV, is a necessary implication of the tripartite C2C relationship. It proposes to apply the Fair Practices Code of NBFC's to P2P platforms. However, considering designation of NBFC being misleading in nature, extending a code which deals with fair practices of a lender to an intermediary not involved in lending seems inappropriate because the Fair Practices Code itself

---

158 NAIR, *supra* note 156.

159 Harini Subramani, *Is RBI over-regulating by allotting online platforms additional responsibilities?*, YOURSTORY, https://yourstory.com/2016/08/rbi-regulations-online-platforms/ , (last visited September 24, 2016).

160 RBI, *supra* note 147.

161 Jitendra Soni & Kanad Bagchi , *RBI Paper on Peer-to-Peer Lending: A Case of Unmindful Contradictions*, THEWIRE, http://thewire.in/37842/rbi-paper-on-peer-to-peer-lending-a-case-of-unmindful-contradictions/, (last visited September 24, 2016).

162 Trilegal, *India: RBI Seeks to Regulate Peer To Peer Lending*, MONDAQ, http://www.mondaq.com/india/x/492876/Financial+Services/RBI+Seeks+to+Regulate+Peer+to+Peer+Lending , (last visited September 24, 2016).

163 FCA, *supra* note 36.

164 Pratik Bhakta, *RBI Keeps a Watch, Demands P2P Lending Only Via Bank Accounts,* ECONOMIC TIMES, May 27, 2016, http://economictimes.indiatimes.com/industry/banking/finance/banking/rbi-keeps-a-watch-demands-p2p-lending-only-via-bank-accounts/articleshow/52457529.cms, (last visited September 24, 2016).

165 The Credit Information Companies (Regulation) Act, §§ 2(l),14-15 (2005).

needs to be evolved to take into account new types of intermediaries like P2P platforms.[166] The RBI further complicates the situation by proposing that platforms are not responsible for carrying out KYC exercise since it can be done by the concerned banks, in which the lender and the borrower hold the account.[167] This leads to a conflict with the Fair Practices Code which if made applicable would obligate the platforms to carry out due diligence, like carrying out KYC exercise, of the borrowers.[168] The way out of this conflict could be not extending fair practices code and instead imposing explicitly a duty to exercise reasonable care or due diligence on the platforms, especially regarding credit worthiness, to avoid any ambiguity.

There are certain other lacunae in the proposals which if addressed would strengthen consumer protection on P2P platforms and would improve financial stability of the platform. With individual lenders being involved, it is possible that they might be unaware of the risks involved and would be misled. However, imposing a lending cap is insufficient since the proposals are silent about the eligibility criteria and norms applicable to the lenders and the borrowers.[169] Further, imposing Rs 2 crore as the minimum capital required to enter presently a small market seems excessive and would act as a barrier to the entry of new firms, especially since such a company may not hold tangible assets.[170] UK in contrast, which has a thriving P2P market, requires just Rs 50 lakh as the minimum capital for starting the business and then requires minimum capital calculated as a percentage of the total outstanding loans on the platform.[171] Another concern is the requirement of maintaining a leverage ratio or debt equity ratio by the platforms. It seems excessive since they are not involved in extending credit and do not have repayment obligation. A better alternative could be to require the P2P platforms to create a compensation or insurance to cover for default with access restricted to lenders who took reasonable steps to evaluate platforms and borrowers before lending.[172] The consultation paper is silent on platform mandatorily providing a standard written agreement detailing out the rights and duties of both parties. Its absence would lead to legal uncertainty and would deter consumer from using P2P platforms. The paper further proposes minimum disclosure which a platform must make. However, instead of prescribing a set of disclosures to be made, it is better to adopt a principles based approach to disclosures, as adopted by UK, which is based on the assumption

---

[166] Linda George, *Response to the Reserve Bank of India's Consultation Paper on Peer To Peer Lending*, IFMR TRUST, http://www.ifmr.co.in/blog/2016/06/17/response-to-the-reserve-bank-of-indias-consultation-paper-on-peer-to-peer-lending/ , (last visited September 24, 2016).

[167] RBI, *supra* note 147.

[168] *Id.*

[169] TRILEGAL, *supra* note 162.

[170] Mandar Kagade, *RBI and Peer-To-Peer Lending: One Step Forward, Two Steps Back*, LIVEMINT, May 2, 2016, http://www.livemint.com/Opinion/utm4O8XY1rcxx8I2lVBC7O/RBI-and-peertopeer-lending-One-step-forward-two-steps-ba.html , (last visited September 24, 2016).

[171] *Id.*

[172] NAIR, *supra* note 156.

that a P2P platform is in a better position than the regulatory authority to know the risks in its operations and its consumer's needs, and so should disclose all relevant information to its consumers based on its analysis of operational risks and needs of consumers.[173]

Further, the proposal to make it mandatory for P2P platforms to set up a physical place of business presence, to enable the regulator to visit and scrutinize records periodically, may also go against the viability of this sector since it may lead to operational inefficiencies because P2P platforms employ cloud-based servers for reducing costs.[174]An alternative could be requiring disclosures on their websites which would increase the platforms' efficiency and improve transparency and would enable lenders and borrowers to transact in a stable environment. For instance, Atom Bank in the UK has no brick-and-mortar presence at all.[175]

Another proposal is that the funds should only flow from the lender's bank account to those of borrowers. However, this practice could result in an operational complexity or delay since the platform might diversify loan request of one borrower and grant loan from funds from several lenders.[176] In future, if such diversification happens, it must not be brought under the securities regime. A better approach would be mandating creation of an escrow account to pool funds of all lenders from where loan can be granted. Lastly, secured loans have not been allowed via platforms.[177] An unsecured loan being riskier would increase costs for consumers and thus as long as existing norms are not violated, and customer protection requirements are met, secured loans must be allowed in the interests of consumers since it would help in reducing costs of borrowing.[178]

VI. CONCLUSION & SUGGESTIONS

P2P lending has emerged alongside the growth of internet and after the 2008 financial crisis and has grown by leaps and bound ever since. It acts as an alternative to traditional lending institutions like banks by providing access to cheap funds to individuals seen as risky borrowers by banks at lower cost than banks and by offering a higher interest rate to lenders than those offered by banks. If left unregulated, it can pose systemic risks to the economy in the future due to possibility of fraud on unsuspecting lenders or defaults by unworthy borrowers.

Keeping in mind the two models followed globally by p2p platforms, notary and client segregated, various countries either subject P2P lending to securities regulation, banking

---

[173] ONYEKA, *supra* note 77.

[174] Naresh Makhijani, *P2P Lending: Finding the Right Balance*, LIVEMINT, June 20, 2016, http://www.livemint.com/Opinion/uTEgEvIOKQV4YdRd7apAkN/P2P-lending-Finding-the-right-balance.html, (last visited September 24, 2016).

[175] *Id.*

[176] *Id.*

[177] RBI, *supra* note 147.

[178] LINDA, *supra* note 166.

regulation or regulation as a financial intermediary who just acts as a facilitator between lender and borrower. Based on International experience, it is concluded that the best approach to regulation of P2P lending is treating them as financial intermediary since securities regulation and banking regulations fundamentally misunderstand the transaction and harm the industry by imposing excessive costs.

A typical loan via P2P platform represents a C2C tripartite relationship in which lenders along with borrowers are also seen as consumers since both are dependent on the platform which is not a party to the loan contract but is necessary for completion of the transaction and thus owes a duty of care. Traditional consumer protection approach is based on B2C relationship and is therefore inadequate to regulate P2P platforms since it relies mainly on disclosures to protect consumers. Thus, a more interventionist consumer protection approach is needed which goes beyond mere disclosure and imposes certain registration and prudential requirements to ensure that lender's main concern of successful recovery of loans on platforms after entering into the contract is addressed.

In India, P2P platforms currently fall outside the framework of securities and banking regulations and even though they might incur liability under moneylending and usury laws, it is concluded that such laws should not be extended to P2P platforms because such laws were framed to prevent exploitation in a pre- internet era and envisaged only B2C relationships. The issue of exploitation by charging excessive interest on platforms can be met by RBI laying guidelines to be followed by platforms, similar to how banks have been exempted from usury and moneylending laws. Voluntary practices followed by platforms to address consumer concerns, remain questionable and at best, voluntary.

In this context, RBI's consultation paper for regulation of P2P lending was much needed but seems a mixed bag. It treats a P2P platform as an intermediary and lays down certain registration and prudential requirements. Some of these like ban on assured returns, lending caps, formulating a business continuity plan, compliant redressal mechanism, avoiding conflict of interest undoubtedly would be beneficial for consumers using the platforms. However, designation of platforms as NBFC is not appropriate and extension of NBFC's Fair Practices Code to platforms, which requires due diligence, is conflicting and confusing since paper also requires only the banks to carry out due diligence for KYC norms.

It is suggested that the way forward can be to incorporate certain provisions like recognizing a new regulatory activity of "use of electronic platform in relation to lending" and expressly imposing duty of care or due diligence on the platforms instead of extending the fair practices code. Platforms should be designated as specified users under the CIC Act to ensure access

CIC's credit rating to enable better determination of creditworthiness. Eligibility criteria of lenders and borrowers must be laid down and platforms must be required to provide for a compensation scheme or insurance coverage in case of default. Minimum capital requirement must be toned down by following UK and platforms must provide a standard written agreement to both parties to avoid legal ambiguity. Instead of prescribing specific disclosures to be made, it should be left to the platforms' discretion to best judge the relevant information to be disclosed. Lastly, secured loans should also be allowed on platforms since that would help to reduce costs of borrowing and would thus attract more borrowers thereby attracting more lenders to fulfill the demand.