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TABLE OF CONTENTS

ARTICLES

EDITORIAL

Tamanna Bansal & Dr. Ankit Srivastava, *A Critical Study Of Provisions Under The Insolvency And Bankruptcy Code,2016 With Special Reference To Decisions Of The National Company Law Tribunal, Chandigarh Bench*, 11 (2) SCHOLASTICUS 1 (2024).

A CRITICAL STUDY OF PROVISIONS UNDER THE INSOLVENCY AND BANKRUPTCY CODE,2016 WITH SPECIAL REFERENCE TO DECISIONS OF THE NATIONAL COMPANY LAW TRIBUNAL, CHANDIGARH BENCH

Tamanna Bansal & Dr. Ankit Srivastava**

ABSTRACT

In India, there was a lot of pendency of the matters in the Hon'ble Supreme Court of India and High Courts. There was a need for setting up of the Tribunals as the quasi-judicial bodies to lower the burden of the judges and the judicial authorities. As per Articles 323A and 323B of the Constitution of India by virtue of the 42nd Amendment gives special power to set up these tribunals and to adjudicate upon the subject related issues within a time-bound manner. The tribunals aim to provide speedy justice thereby reducing the pendency of the cases. The National Company Law Tribunal was set up for the company matters specifically. The paper will discuss the role and functions of the National Company Law Tribunal. Moreover, the paper will focus on the landmark decisions of the National Company Law Tribunal, Chandigarh Bench and its impact on the judicial system.

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I. INTRODUCTION

The Tribunals are set up in India to deal with the subject-specific cases. The need for the development of the Tribunals in India arose due to the pendency of the matters in the High Courts and the Supreme Court. There was a need for the setting up of the Tribunals across the country for the speedy disposal of the matters with expert opinions in the relevant field. For that very purpose, tribunals were set up including:- the Company Law Board, the National Green Tribunal, the Debt Recovery Tribunal, the Income Tax Appellate Tribunal, the Armed Forces Tribunal, Telecom Disputes Settlement and Appellate Tribunal, the Railway Claims Tribunal, Securities Appellate Tribunal, Central Administrative Tribunal, etc under Article 323-A of the Indian Constitution[1] by the 42nd Amendment gives special power to set up these tribunals and power to the tribunals to adjudicate upon the subject related issues within a time bound manner. The tribunals aim to provide speedy justice thereby reducing the pendency of the cases.

The Company Law Board was set up in India earlier to deal with the company matters. However, there were certain loopholes in the law as well as the Board was established with limited powers. Hence, there was a need for the reform of the Company Law Board. In view of the same, there was a shift from the Company Law Board to setting up of the National Company Law Tribunals and its appellate authority, i.e. National Company Law Appellate Tribunal. The National Company Law Tribunals and National Company Law Appellate Tribunal were set up under Section 408 of the Companies, Act, 2013 which provides that,

> "*408. Constitution of National Company Law Tribunal.— The Central Government shall, by notification, constitute, with effect from such date as may be specified therein, a Tribunal to be known as the National Company Law Tribunal consisting of a President and such number of Judicial and Technical members, as the Central Government may deem necessary, to be appointed by it by notification, to exercise and discharge such powers and functions as are, or may be, conferred on it by or under this Act or any other law for the time being in force*"[2].

Currently, there are 11 benches all over India including the principal bench at New Delhi and regional benches at Ahmedabad, Allahabad, Bangalore, Chandigarh, Chennai,

[1]India Const. art. 323-A.
[2]The Companies Act, 2013, §408.

Gauhati, Jaipur, Hyderabad, Kolkata, and Mumbai. Further, there are more benches have been set up at Cuttack, Jaipur, Kochi, Amravati and Indore.

II. ROLE OF NATIONAL COMPANY LAW TRIBUNAL IN INSOLVENCY AND BANKRUPTCY LAW MATTERS

The role of the National Company Law Tribunal and the National Company Law Appellate Tribunal is to provide speedy dispute resolution and also to maintain the business environment in a well-regulated manner. The National Company Law Tribunal is a two-tier structure that is a primary forum for the company law disputes to be settled between the parties. The jurisdiction of the National Company Law Tribunal and its appellate authority includes company matters (including- mergers, acquisitions, oppression and mismanagement, winding up, reduction of share capital) and Insolvency and Bankruptcy law (including passing up the resolution plans under the insolvency laws, personal guarantee of the corporate debtor, pre-packed insolvency, liquidation of the company, dissolution of the company, initiation of the Corporate Insolvency Resolution Process etc). The quasi-judicial body has the power same as the power of the Hon'ble High Court in order to provide the decision on the specified subject i.e. corporate disputes. Any appeal shall lie to the appellate authority that is the National Company Law Appellate Tribunal and any appeal from the appellate authority shall lie directly to the Hon'ble Supreme Court of India. The National Company Law Appellate Tribunal serves as the appellate authority which is relevant for reviewing the orders passed by the lower authority. The parties can approach the National Company Law Appellate Tribunal on passing of the judgement by the National Company Law Tribunal within the 30 days of passing of the judgements.

III. POWERS AND FUNCTIONS OF NATIONAL COMPANY LAW TRIBUNAL IN INSOLVENCY AND BANKRUPTCY LAW MATTERS

The National Company Law Tribunal acts as an Adjudicating Authority with the vested powers of the liquidation and winding up of the Company. The NCLT has the power to initiate the Corporate Insolvency Resolution Process (CIRP) under Sections 7 and 9 of the Insolvency and Bankruptcy Code, 2016 wherein once the debt and default are proved. In Section 7 of the Insolvency and Bankruptcy Code, 2016 matters the NCLT has the power to examine the debt amount which has to be above the threshold limit of rupees one crore and the date of default[3]. The NCLT considers the documents attached

[3]The Insolvency and Bankruptcy Code, 2016, §7.

with the Section 7 petition including- Loan agreements, bank statements, Income Tax Returns, notice issued under Section 13(2) of the SARFAESI Act, 2002[4] etc. Once all the documents are examined, debt is proved, and the CIRP is initiated. Moreover, Section 9 Insolvency and Bankruptcy Code, 2016 provides the CIRP to be initiated by the bench wherein there is an exchange of goods or services, and the payment is to be made by the corporate debtor to the operational creditor[5]. The NCLT examines the date of default which should be within three years of the limitation period, the debt amount which has to be above the threshold limit of rupees one crore, the service of demand notice to the corporate debtor before the filing of the petition under Section 9 of the Insolvency and Bankruptcy Code, 2016. There should be no pre-existing dispute between the parties[6].

Moreover, in either of the cases, the Interim Resolution Professional is appointed by the Adjudicating Authority after checking the antecedents and wherein no disciplinary proceedings are pending against the said Interim Resolution Professional for carrying out the CIRP after its admission.

Further, the Adjudicating Authority, once the CIRP is initiated against the corporate debtor, it has the power to impose moratorium and orders the Interim Resolution Professional to make the Public Announcement in Form-A inviting all the claims. Moreover, once the moratorium is imposed the initiation of the suit, proceedings are prohibited. The ongoing litigation stops.

The Adjudicating Authority has the power to initiate the liquidation of the company and has the power to appoint a liquidator who would take care of the liquidation of the assets. Under Section 59 of the Insolvency and Bankruptcy Code, 2016 provides for the voluntary winding up of the company[7]. The Adjudicating Authority has the power to order the voluntary winding up of the company.

The NCLT has the power to proceed with the Fast Track Corporate Insolvency process wherein the CIRP is to be completed within 90 days. The fast Track Corporate Insolvency process is different from the normal CIRP as the time limit provided under the Fast Track Corporate Insolvency process is less as compared to the normal CIRP.

[4]The SARFAESI Act, 2002, §13(2).
[5]The Insolvency and Bankruptcy Code, 2016, §9.
[6]The Insolvency and Bankruptcy Code, 2016, §9.
[7]The Insolvency and Bankruptcy Code, 2016, §59.

IV. THE LOOPHOLES IN THE INSOLVENCY AND BANKRUPTCY LAWS WHICH ARE CATERED BY THE ARENA OF LANDMARK DECISIONS PASSED BY THE CHANDIGARH BENCH

The most basic loophole in the Insolvency and the Bankruptcy Code, 2016 is with respect to the limitation period. Section 238A of the Insolvency and the Bankruptcy Code, 2016, specific provision that provides the limitation period applicable for the initiation of the Corporate Insolvency Resolution Process and its appeal. Although, the Limitation Act, 1963 provides that the application be filed within three years from the date of filing of the application. This said period is governed by the Article 137 of the Limitation Act,1963. Section 433 of the Companies Act, 2013 makes the provision of the Limitation Act applicable to proceedings or appeals which are to be filed before the National Company Law Tribunal or National Company Law Appellate Tribunal. In case the default has occurred beyond three years from the date of filing of the application before the Adjudicating Authority, the default will said to be time-barred. Further, Section 5 of the Limitation Act may be made applicable to condone the delay in filing the application. However, the loophole in the law is that it does not provide the specific grounds or essentials for consisting the date of default applicable for initiating the Corporate Insolvency Resolution Process under Sections 7 and 9 of the Insolvency and Bankruptcy Code,2016. The Chandigarh bench passed the judgment in regard to the limitation period when the default would have been said to take place in the matter of ***Edelweiss Asset Reconstruction Company Limited v. M/s Winsome Yarns Ltd. CP (IB) No. 291/Chd/Chd/2018*** wherein the petition was filed under Section 7 of the Insolvency and Bankruptcy Code, 2016 and Rs. 2,37,49,54,804.29/- (Rupees Two Hundred and Thirty-Seven Crores Forty-Nine Lakhs Fifty-Four Thousand Eight Hundred and Four and Twenty-Nine Paise) was the amount in default. The issue involved in the present case was whether or not the present petition was filed within the limitation period. For the purpose of the limitation period, the petition is to be filed within three years from the date of default. In this case, the date of default was 17.01.2014. The corporate debtor contended that the present petition is time-barred as it has been filed beyond the period of three years of limitation. However, the Adjudicating Authority held that for the purpose of calculation of the date of default, the last transaction between the parties can be considered or when the last payment was made by the corporate debtor to the financial creditor. The payments were received by the financial creditor for the period 31.03.2016 upto 01.02.2018. Therefore, it extended the date of default to 01.02.2018 which also amounts to the acknowledgement of the debt by the financial creditor. The petition was filed well within the period of limitation of three years[8].

Therefore, after the passing of the judgment, it has been clarified that the date of default can be considered from the date of last transaction between the parties or when the last payment was made by the corporate debtor to the financial creditor. This is applicable under Sections 7 and 9 of the Insolvency and the Bankruptcy Code, 2016. Now, the benches have a criteria to ascertain the limitation period which will be applicable while considering the applications under the Insolvency and the Bankruptcy Code, 2016 i.e. 3 years which can be considered from the date of last transaction between the parties.

The second loophole in the Insolvency and Bankruptcy Code,2016 is with respect to the threshold limit. It does not specify whether the threshold limit is solely applicable to the principal amount or threshold limit is to be determined by adding the interest component in it. The threshold limit has been changed as earlier it was more than Rupees one lakh and after the amendment the threshold limit is rupees one crore which has been notified vide notification No. S.O.1205(E) dated 24.03.2020. Therefore, as per the Insolvency and the Bankruptcy Code, 2016 provides that the debt amount ascertained under Section 7 or 9 of the Insolvency and the Bankruptcy Code, 2016, the threshold limit for initiation of the Corporate Insolvency Resolution Process should be above one crore. However, neither the code nor the notification provides whether the threshold limit includes the interest component on the principal amount or not. Therefore, the question lies is whether the interest component and principal amount can be clubbed together to achieve the threshold limit. Moreover, it gives rise to another question i.e. whether the Corporate Insolvency Resolution Process can be solely initiated on the grounds of the interest component or not in case the principal amount under Section 7 or 9 of the Insolvency and the Bankruptcy Code, 2016 stands paid off. The Chandigarh bench decided in the case of ***Oswal Cable Products v. Jindal Speciality Textiles Limited 2023 SCC Online NCLT 179*** regarding the interest component**.** The petition was filed under Section 9 of the Insolvency and Bankruptcy Code, 2016 wherein the issue regarding the payment of the interest component was involved when the principal amount stood paid by the corporate debtor to the operational creditor. The court held that the interest component cannot be paid by solely relying on the fact that

[8]Edelweiss Asset Reconstruction Company Limited v. M/s Winsome Yarns Ltd. CP (IB) No. 291/Chd/Chd/2018 (2023) (India).

the same is mentioned in the bill or the invoice. To ascertain the interest component, there should be an exclusive clause in the agreement between the parties in the payment terms. In the absence of the agreement or the clause of interest in the payment terms, the corporate debtor is not liable to pay the interest. Moreover, in case the principal amount is already paid, the Corporate Insolvency Resolution Process cannot be only initiated for the interest component under the Insolvency and Bankruptcy Code, 2016. The code does not provide any provision for the same[9].

Further, in the case of ***M/s Gokal Iron & Hardware Traders (LDH) v. M/s Ahio Overseas LLP CP (IB) No.168/Chd/Pb/2021***, the bench decided with respect to the clubbing of the principal amount along with the interest component to reach the threshold limit of rupees one crore. The present petition was filed under Section 9 of the Insolvency and Bankruptcy Code, 2016 wherein the issue was involved whether or not the interest component can be clubbed with the principal amount to meet the threshold limit of rupees one crore prescribed under the Insolvency and Bankruptcy Code, 2016 for filing of the petition. In this case, the Adjudicating Authority held that the principal amount due is Rs.84,88,307/- and interest due upto 30.06.2020 @ 18% amounting to Rs.86,39,865/-. Hence, the total amount Rs.1,71,28,172/- (Rupees One Crore Seventy One Lakhs Twenty Eight Thousand One Hundred and Seventy Two Only). The interest component can be clubbed with the principal amount for ascertaining the threshold limit of rupees one crore for the purpose of filing of the petition under Section 9 of the Insolvency and Bankruptcy Code, 2016. The reliance was placed on the judgment passed by the Hon'ble National Company Law Appellate Tribunal in the case of ***Netafirm Agricultural Financing Agency Private Limited v. Baliraja Sakhar Karkhana Limited***[10] wherein it was held that both principal and interest amount has to be computed for the purpose of the threshold limit. The court relied on the case of ***Mr. Prashant Agarwal v. Vikash Parasrampuria*** [11] wherein it was held that, "*Since, interest on delayed payment was clearly stipulated in the invoice and therefore, this will entitle for "right to payment" (Section 3(6) IBC) and therefore will form part of "debt" (Section 3(11) IBC), (vi) It is, therefore, clear from these facts that the total amount for maintainability of claim will include both principal debt amount as well as interest on delayed payment which was clearly stipulated in the invoice itself. It is noted that the total principal debt amount of Rs. 97,87,220/- along*

[9]Oswal Cable Products v. Jindal Speciality Textiles Limited 2023 SCC Online NCLT 179 (2023) (India).
[10]Netafirm Agricultural Financing Agency Private Limited v. Baliraja Sakhar Karkhana Limited Company Appeal (AT) (Ins) No. 408 of 2023 (2023) (India).
[11]Mr. Prashant Agarwal v. Vikash Parasrampuria Company Appeal (AT) (Ins) No. 690 of 2022 (2022) (India).

with interest the total debt makes total outstanding as Rs. 1,60,87,838/-. Thus, the total debt outstanding of OC is above Rs. 1 crore as per requirement of Section 4 IBC read with notification No. S.O 1205 (E) dated 24.3.2020 (Supra), and meets the criteria of Rs. 1crore as per Section 4 of IBC and Application is therefore maintainable in present case. We concur with the orders of Adjudicating Authority on this issue also".

Therefore, in the present case, the interest amount was clubbed with the principal amount which was beyond the threshold limit of rupees one crore[12].

The third loophole in the Insolvency and Bankruptcy Code,2016 is that Section 9 of the Code, states that there should be no pre-existing dispute between the parties before the issuance of the demand notice under Section 8 of the Insolvency and Bankruptcy Code,2016 and whether the communication in the form of email or letter amount to pre-existing dispute or not. The pre-existing dispute with respect to the quality of the goods or with respect to the deficiency in services due to which the outstanding demand was not paid. In case there is pre-existing dispute between the parties then the Corporate Insolvency Resolution Process cannot be initiated against the corporate debtor as the corporate debtor had given the notice of the dispute with respect to the quality of the goods supplied or with respect to the deficiency in services provided, therefore the corporate debtor is not liable to pay for the same. However, the Code is silent on whether communication in the form of an email or letter between the parties amount to a pre-existing dispute or not. The Chandigarh bench in the case of ***Indo Pack Ltd. Vs. M SEA Pharmaceuticals Pvt. Ltd. (2023) ibclaw.in 141 NCLT*** decided the question related to pre-existing dispute on the basis of the letter and email exchanged between the parties before the issuance of the demand notice under Section 8 of the Insolvency and Bankruptcy Code,2016. In this case, the question of law involved was whether the communication through email and letter issued by the corporate debtor before the issuance of the demand notice amounts to a pre-existing dispute or not under Section 9 of the Insolvency and Bankruptcy Code,2016. In the present case, the operational debt was disputed by the corporate debtor as the corporate debtor had already sent a communication to the operational creditor with respect to the dispute regarding the quality of the goods supplied by the operational creditor. Moreover, the operational creditor admitted the same in their communications. The letter and communication sent before the issuance of the demand notice by the operational creditor amounts to a

[12]M/s Gokal Iron & Hardware Traders (LDH) v. M/s Ahio Overseas LLP CP (IB) No.168/Chd/Pb/2021 (2024) (India).

dispute between the parties. The demand notice should be issued by the operational creditor and no notice of the dispute between the parties should be given by the corporate debtor before the issuance of the demand notice. The intimation regarding the quality of the goods or the deficiency in the services by the operational creditor before the issuance of the demand notice amounts to a pre-existing dispute between the parties[13]. Moreover, the National Company Law Tribunal is not a recovery forum and this matter is to be adjudicated by the civil court[14].

The fourth loophole in the Insolvency and Bankruptcy Code,2016 is under Section 94 IBC, 2016 where the petition is filed by the personal guarantor. As soon as the petition under Section 94 is filed, the interim moratorium is imposed from the date of filing of the application. Moreover, there is a prohibition on the Institution of suits or continuation of pending suits, execution of any judgment, decree, or order, recovery of property and enforcement of security interest. Therefore, banks cannot initiate or continue recovery proceedings against the corporate debtor under the SARFEASI ACT,2002. A petition under section 94 of IBC, 2016 is often filed to defeat the action initiated by the bank under section 14 of SARFEASI Act, 2002. Moreover, because of Section 94 petition bank cannot file their counter in the Section 95 petition as the interim Moratorium of Section 94 petition will bar another petition under Section 95 in view of the decision passed by the ***Hon'ble NCLAT in the case of Company Appeal (AT) (Ins.) No. 721 of 2022 Kishan Kumar Basai vs SBI***[15] decided on 14.07.2022. Moreso, sometimes there is a lot of gap in filing a petition under Section 94 beyond 3 years of limitation even after the invocation of the guarantee. Further, as soon as the interim moratorium is imposed, there is a stay on enforcement of security interest. Thus, the balance of the assets and liabilities of the Banks is adversely affected, which may have an impact on the cash flow and liquidity in the market due to the non-realization of debts by the Banks. However, banks can participate in the CIRP and have voting rights. Lastly, the banks can only recover their dues through the resolution plan by participating in the CoC meetings. The loophole in the Insolvency and Bankruptcy Code, 2016 is that it does not provide any clause which would specify the limitation period and moreover, the code is silent on whether the personal guarantor can take advantage of Section 96 for initiation of the interim moratorium or not. In some matters, the deed of guarantee

[13]Indo Pack Ltd. Vs. M SEA Pharmaceuticals Pvt. Ltd. (2023) ibclaw.in 141 NCLT (2023) (India).
[14]Indo Pack Ltd. Vs. M SEA Pharmaceuticals Pvt. Ltd. (2023) ibclaw.in 141 NCLT (2023) (India).
[15]Kishan Kumar Basai vs SBI Company Appeal (AT) (Ins.) No. 721 of 2022 (2022) (India).

is executed much prior and the application is filed after the lapse of the three years of period of the limitation based on the deed of guarantee which was executed before three years. The Chandigarh Bench in the case of ***Punjab National Bank and Anr. Vs. Mohita Indrayan (2024) ibclaw.in 704 NCLT*** decided on this particular aspect. In the present case, the issue involved is in case the personal guarantor has filed an application under Section 94 of the Insolvency and Bankruptcy Code, 2016 prior to the filing of the application under Section 95 of the Insolvency and Bankruptcy Code, 2016, therefore, the personal guarantor whether or not is entitled to the benefit of the interim moratorium under the Code, 2016. As per Section 95 of the Insolvency and Bankruptcy Code, 2016, the interim moratorium starts from the date of the filing of the application with the Adjudicating Authority. In the present case, it was held by the Adjudicating Authority that under Section 94 of the Insolvency and Bankruptcy Code, 2016 itself provides the shield to the personal guarantor against the insolvency process for which the application is initiated by the financial creditors. Therefore, the advantage of the interim moratorium cannot be taken by the personal guarantor under Section 96 of the Insolvency and Bankruptcy Code, 2016 in the interest of justice. Moreover, when the application is filed under Section 94 of the Insolvency and Bankruptcy Code, 2016, the insolvency is initiated by the personal guarantor himself, therefore, Section 96 of the Insolvency and Bankruptcy Code, 2016 will not be applicable[16].

The fifth loophole in the Insolvency and Bankruptcy Code, 2016 is with respect to the issue of whether the Adjudicating Authority can entertain any application after the approval of the Resolution Plan or not and moreover, the another question on which the Insolvency and Bankruptcy Code, 2016 is silent is with respect to the fact that can the Adjudicating Authority decide on the issue related to the issuance of the share capital and its reduction. The Chandigarh Bench in the case of the ***Vineet Gupta Vs. Monitoring Committee Through Shri Kumar Gaurav (2023) ibclaw.in 483 NCLT*** decided on both issues. In the present matter, there were three issues raised- first, whether the guarantor has a locus standi to file the application, second, whether the Adjudicating Authority has to restriction to entertain any application after the approval of the resolution plan and third, whether the Successful Resolution Applicant can increase the authorised share capital or not, and a lot the same share capital to the lenders in proportion to their debt or not. The court held that the applicant being the ex-director

[16]Punjab National Bank and Anr. Vs. Mohita Indrayan (2024) ibclaw.in 704 NCLT (2024) (India).

of the corporate debtor who was also the personal guarantor in the present case has substantial interest in the Corporate Insolvency Resolution Process of the corporate debtor and moreover, the implementation of the resolution plan can only be considered once the steps to implement the plan, including the terms and conditions of the approved plan, are executed. Further, the authority had not taken certain steps to implement the plan in totality. Therefore, the authority can entertain any application that will execute or modify the plan by issuing the necessary directions that are related to the plan. Moreover, in case there is an increase in the share capital with respect to the issuance of the shares and also the reduction of the shares which was not as per the statutory provisions of the Companies Act 2013, therefore, no such exemption was claimed by the authorities under the Companies Act,2013. Thus, the resolution applicant was directed to approach the authorities to seek necessary leave and concessions[17].

The sixth loophole in the Insolvency and Bankruptcy Code, 2016 is with respect to the liquidator's fee. Under the Insolvency and Bankruptcy Code, 2016 and the notification issued by the Insolvency and Bankruptcy Board of India, the liquidator is paid according to the time and the total number of the sale during his tenure, the percentage of the amount as fee is fixed by the Insolvency and Bankruptcy Board of India. However, the Insolvency and Bankruptcy Code, 2016 and the notification issued by the Insolvency and Bankruptcy Board of India, both are silent on the fact that the fee should be paid to the liquidator for the time period which is excluded in the Corporate Insolvency Resolution Process or not. In the case of ***The Mr. Sanjay Kumar Aggarwal Liquidator of Punjab Basmati Rice Ltd. Vs. Canara Bank (2023) ibclaw.in 593 NCLT***, the issue before the Chandigarh Bench, Adjudicating Authority under Section 60(5) of the Code was in case there is an exclusion of time period in the liquidation process, will it also exclude the calculation of the liquidator fees for the period excluded in the liquidation process or not. In view of the same, it was held by the Adjudicating Authority that in the present case despite the fact that the liquidator carried out all the functions and the role assigned to him with due diligence and proper responsibility. Therefore, he not is entitled to the fees of the liquidation for the period excluded. The authority also relied on the case of ***SIDBI v. Shri Virender Sharma***[18] when it was held

[17]Vineet Gupta Vs. Monitoring Committee Through Shri Kumar Gaurav (2023) ibclaw.in 483 NCLT (2023) (India).
[18]SIDBI v. Shri Virender Sharma (2022) ibclaw.in 879 NCLAT (2022) (India).

that the exclusion of the period in the liquidation process of the corporate debtor will also be excluded for the computation of the liquidator's fee for that said period[19].

V. IMPACT OF THE DECISIONS ON THE JUDICIAL SYSTEM

The decisions of the Adjudicating Authority have impacted the decisions which were pending at the different forums of the National Company Law Tribunals. The precedents set up by one Adjudicating Authority are adopted by the other Adjudicating Authority for the decision-making in complex matters. The judgment of the Oswal Cables has been referred in many cases by the other benches of the National Company Law Tribunals wherein the interest cannot be granted unless and until there is a specific clause in the agreement executed between the parties even though there is a condition of interest on the bill or invoice itself. Moreover, the interest cannot be granted in case the principal amount stands paid by the corporate debtor to the operational creditor, thus, the Corporate Insolvency Resolution Process (CIRP) cannot be initiated. Another judgment passed by the Chandigarh bench with respect to the liquidator’s fee has been upheld by the Hon’ble National Company Law Appellate Tribunal and the appellate authority stated that the fee is not to be paid for the period which is excluded by the Adjudicating Authority from the liquidation process. Furthermore, the bench rightly held in the case of Gokal Iron that the interest component can be clubbed with the principal amount for meeting the threshold limit of rupees one crore as prescribed under the law. Therefore, the law set up by one bench is followed by the other as the precedent in accordance with the law.

VI. CONCLUSION

The National Company Law Tribunal and its appellate authority are the quasi-judicial bodies dealing solely with corporate law matters related to companies. The tribunal is aimed at the speedy disposal of the matters in a time-bound manner. The paper discussed the powers, and rules of the National Company Law Tribunal and its appellate authority, the landmark judgments under the Insolvency and Bankruptcy Code, 2016 by the Chandigarh Bench and further the impact of the judgments. However, despite the setting up of the different tribunals across the nation and implementation of the new law i.e. the Insolvency and Bankruptcy Code, 2016, still there is a requirement for the law to be more stringent with respect to the companies and their functioning in order

[19]Mr. Sanjay Kumar Aggarwal Liquidator of Punjab Basmati Rice Ltd. Vs. Canara Bank (2023) ibclaw.in 593 NCLT (2023) (India).

to ensure the transparency, accountability in their working. Moreover, even if in case the company is undergoing the Corporate Insolvency Resolution Process still it should be sold as a going concern. The research in this paper provides the landmark decisions of the Chandigarh bench which has set out the precedent in the Insolvency and Bankruptcy law and is followed by the different benches across India in the cases where the Code is silent on certain issues. As the country is moving towards the introduction of MNCs in the country and economic growth, the National Company Law Tribunal is acting as a pillar in safeguarding the interests and rights of the company, its employees, shareholders etc and promoting the economic progress in the country.

Aman Karan, *Taxability Of Escrowed Funds In Earn-Out M&A Deals In India: Lessons From Foreign Jurisdictions*, 11 (2) SCHOLASTICUS 14 (2024).

TAXABILITY OF ESCROWED FUNDS IN EARN-OUT M&A DEALS IN INDIA: LESSONS FROM FOREIGN JURISDICTIONS

Aman Karan[*]

ABSTRACT

The prevailing confusion around taxing of escrow funds in earn-out M&A deals and the consequent flow of litigations arising from both the lack of clarity around this concept and the language of Section 45 r.w. Section 48 of the Income Tax Act, 1961, have compelled the courts and tribunals to engage in the exercise of the establishing the tax jurisprudence regarding the taxability of escrow funds in earn-out M&As. Whereas, some notable observations have been made in cases like Modi Rubber vs. Dy. Commissioner of Income Tax, Dinesh Vazirani vs. Principal Commissioner of Income Tax, Commissioner of Income Tax vs. Hemal Raju Shete, and other such cases mentioned in the paper, there is still an air of uncertainty. Some of these uncertainties, for example, include questions like how should the deferred consideration spread over several years should be taxed? Or how should the interest that accrues on the amount put in escrow should be taxed? This paper seeks to address these uncertainties, including other such contingencies, through a comparative analysis of tax jurisprudence of UK and US regarding deferred consideration and taxability of escrow funds in earn-out M&As. Before indulging in the comparative analysis, the paper endeavors to explain the jurisprudence of deferred consideration and how the tax regime of India treats escrow funds in earn-out M&A deals through a series of judgements. Finally, drawing from the tax regimes of UK and US, this paper seeks to recommend the adoption of certain concepts for developing a more robust tax framework to handle the taxability of escrow funds in earn-out M&A

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I. INTRODUCTION

The legal landscape surrounding the concept of taxing escrowed funds in M&A deals with earn-out arrangements or deferred considerations has become an issue of contention over the last few years. The contention arises due to the nature of consideration put in escrow funds and the statutory treatment of income from capital gains by virtue of Section 45 and 48 of the Income Tax Act, 1961. Section 45 of the Income Tax Act, 1961 provides for taxation of Capital Gains, stating that *"any profits or gains arising from the transfer of a capital asset effected in previous year shall… be chargeable to income-tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place"*.[1] Section 48 of the Income Tax Act provides for the mode of computation of income tax charge on capital gains. It states that *"the income chargeable under the head "Capital gains" shall be computed, by deducting, from the full value of the consideration received or accruing as a result of the transfer of the capital asset, the following amounts, namely – (i) expenditure incurred wholly and exclusively in connection with such transfer; and (ii) the cost of acquisition of the asset and the cost of any improvement thereto"*.[2] It is the language of this section that gives rise to numerous litigation. The "full value of consideration" talked about in section 48 and the concept of deferred consideration, i.e. consideration that is contingent of fulfilment of certain conditions, often clash in regards to whether the deferred consideration should be included while computing the tax liability of the assessee on income from transfer of capital gains. When a part of sale consideration in a M&A deal is put in the escrow, and the discharge of such sum is made contingent on certain conditions agreed upon by the buyer and the seller, such part of sale consideration takes the nature of deferred consideration.

Deferred consideration refers to the consideration that is/will be payable in the future, depending on the fulfilment of certain conditions agreed upon between buyer and seller, rather than at the time of transfer of an asset.[3] Deferred considerations are contingent on conditions like performance of the company, profits accrued, and other factors in the future years. Deferred consideration in M&A comes in the form of earn-out arrangements. Earn-out arrangements and deferred consideration are synonymous in the context of M&A, referring to a scenario where after the acquisition or merger, the consideration for the transfer of shares and other assets are contingent on the fulfilment of certain

[1] Income Tax Act, 1961, § 45, No. 43, Acts of Parliament, 1961 (India)
[2] Income Tax Act, 1961, § 48, No. 43, Acts of Parliament, 1961 (India)
[3] Shruti K.P., Gaurav Goyal, Nupur Jain, *The Elusive Clarity on Taxation of Deferred Consideration Under the Indian Income Tax Act*, LEGAL500 (May 22, 2024, 11:47 PM), https://www.legal500.com/developments/thought-leadership/the-elusive-clarity-on-taxation-of-deferred-consideration-under-the-indian-income-tax-act/

conditions that is agreed upon by the buyer and the seller or the transferee and the transferor company. Here, the role of escrow comes in. The companies put away these deferred payments in escrow funds using escrow agents, usually a bank. Then upon fulfillment of contingent conditions, or to meet the contingent costs, such as that of any litigation, the funds are discharged accordingly.

The bone of contention in the taxability of escrow funds in earn-out M&A deals in India lies in determining at what stage the income from these deals should be taxed – whether the receipt should be taxed at the time of transfer or at the time of accrual? A plethora of judgements help us to understand this issue and have gone ahead to resolve the intricacies surrounding tax jurisprudence with regards to taxability of escrow funds in earn-out M&As. But before jumping to understand these judgements, the initial thing to do would be to understand the jurisprudence of deferred considerations.

II. THE JURISPRUDENCE OF DEFERRED CONSIDERATIONS

Deferred consideration in simple terms refers to the payment for a sale that is paid in the future, contingent upon fulfilment of certain conditions. These conditions can be based on the performance of a company, such as its profits, earnings, revenue, etc. or any future uncertain events, such as litigation, the joining or leaving of a new key managerial person, etc., The significant thing in deferred payment to note is that it is contingent upon a condition that is agreed upon by the buyer and the seller. For example, company A is taking over company B. The shares of company B are transferred to A. However, a part of the consideration that B is supposed to get will be deferred or postponed and will be made dependent on a certain condition that is agreed upon by both A and B. Escrow accounts are usually kept by companies where the deferred consideration is transferred and from this escrow fund, the consideration is discharged accordingly.

The deferred consideration recourse is taken due to various advantages for both buyers and sellers alike. For instance, one such advantage that a seller is subjected to is higher total consideration for their business. Sellers may be able to close the difference between their pricing estimates and the buyers' valuation by taking a portion of the payment in the future, which could result in a better deal outcome.[4] Similarly, deferred consideration allows buyers to bridge the valuation gap by offering a lower upfront payment and deferring a portion of the consideration. Deferred consideration ensures the vested interest of the seller in the merged entity post-transaction.[5] The seller is involved in the integration process and growth of the business. Deferred consideration also proves beneficial from a risk allocation perspective. By deferring payment, buyers can protect themselves from potential underperformance or unforeseen liabilities that may arise post-transaction. On the other hand, deferred consideration provides a safety net for sellers, ensuring they receive fair compensation based on the actual performance of the business.

However, there are some challenges that come with this mechanism. Defining clear and measurable performance metrics is crucial to ensure transparency and avoid disputes. Buyers and sellers must agree on the specific criteria that will determine the payment of deferred consideration, such as revenue targets, profitability thresholds, or market share goals.[6] The structure of deferred consideration should be carefully designed to balance the interests of both parties. It can be in the form of earn-outs, milestone payments, or contingent payments based on specific events or achievements. The payment schedule and timeline should be clearly defined to avoid ambiguity and potential conflicts. And last but not least, deferred consideration may have legal and tax implications that need to be carefully considered. Parties should seek professional advice to ensure compliance with relevant regulations and optimise the tax treatment of the deferred payments.

The jurisprudence of deferred consideration centres around one major issue, the accrual of such consideration to the assessee. One question that is often repeated in this domain is whether the consideration has been accrued to the assessee or not? The decisions of tribunals and courts concern themselves with answering this question and explaining deferred consideration in the backdrop of accrual of income. The Bombay High Court in *Commissioner of Income Tax vs Hemal Raju Shete*[7] has made notable observations regarding this. In this case, the appeal was filed against the order of the Tribunal,

[4] Monica Macheng, *Deferred Consideration in M&A Transactions,* DEFERRED CONSIDERATION IN M&A TRANSACTIONS (May 22, 2024, 9:20 PM) https://www.hilldickinson.com/insights/articles/deferred-consideration-ma-transactions
[5] *Id.*
[6] Monica Macheng, *Deferred Consideration in M&A Transactions,* DEFERRED CONSIDERATION IN M&A TRANSACTIONS (May 22, 2024, 9:20 PM) https://www.hilldickinson.com/insights/articles/deferred-consideration-ma-transactions
[7] Commissioner of Income Tax vs Hemal Raju Shete [2016] 239 TAXMAN 176 (Bom).

upholding the decision of the Commissioner accepting the assessee's mode of paying capital gains tax on a receipt basis for various assessment years. This was due to the fact that the assessee was to receive deferred consideration in the concerned four years, which was contingent on the profits made by the M/s Unisol in each of the years and that if M/s Unisol does not make a net profit in a year under consideration, then no amount as deferred consideration would be payable to the assessee. The Court said that *"the consideration of 20 crores is not an assured consideration to be received by the Shete Family"*. The observations of the court based on this can be elucidated in the following points:

1. Taking reference from the Supreme Court's decision in *Morvi Industries vs CIT*,[8] the Court explained that the income is said to be accrued when it becomes due to the assessee. The assessee gets a right to claim the amount the minute the income is accrued. In this regard, the consideration of 20 crores or any part of it does not accrue to the assessee unless conditions contingent get fulfiled. Therefore, in the concerned assessment year, no right to claim any amount gets vested in the assessee and hence, the entire amount of 20 crores that was sought to be taxed has not accrued to the assessee-respondent.
2. The test of accrual, as observed by the court, was whether there is a right to receive the amount and that right is legally enforceable, even though the amount may be received by him later.
3. This amount that is to be received as deferred consideration is contingent upon certain conditions, and therefore it cannot be said to have accrued to the assessee-respondent. The Tribunal is correct in holding that the amount that is to be taxed is the amount that should be received or accrued and not any notional or hypothetical income.

The Court, while dismissing the appeal, held that the amount of Rs. 20 crores that is to be received as deferred consideration cannot be subjected to tax in the concerned assessment year as it has not accrued to the assessee-respondent.

The notable observation that was made in this case was that since deferred consideration is contingent upon certain conditions and since the assessee is not entitled to this type of consideration until the conditions contingent get fulfilled, it cannot be said that such consideration has been accrued to the assessee. The assessee gets a right to claim the deferred consideration amount only when the

[8] Morvi Industries vs CIT [1971] 82 ITR 835

conditions contingent get met with and the test of accrual says that income is accrued only when there is a right to claim that amount and that right is legally enforceable, even though the amount gets in the hands of the assessee much later. Considering all this, the Court held that the deferred consideration cannot be taxed unless it is accrued to the assessee.

The same line of jurisprudence has been followed in numerous decisions like *CIT vs. Ashokbhai Chimanbhai,*[9] *CIT vs Bharat Petroleum Corporation Limited*[10] and Authority of Advance Ruling in *Re: Anurag Jain*[11]. All of these decisions contended that a sum is said to accrue only when the legal right to receive it has come into existence.

Further, in the case of *Commissioner of Central Excise, Mysore vs. TVS Motors Company*[12], the Supreme Court of India, while adjudicating on "assessable value", noted that what cannot be regarded as a deferred consideration. The Court observed:

"It is true that the Owner's Manual specifically indicates that if the PDI (pre-delivery inspection charges) and said services are not availed of, then the customer would not be able to claim the benefit of the warranty. This will go to show that the Petitioners undertake responsibilities so far as the warranty aspect is concerned provided the customer takes the benefit of PDI and said services. It has no bearing on the assessable value as it is abundantly clear that to perform PDI as well as render said services is on the dealer's obligation on account of dealership agreement and not on any other count. Once it is held that the PDI and said services are not provided by the dealer on behalf of the Petitioners, it cannot be treated as consideration for sale. It also cannot be treated as a deferred consideration."

It is evident that the jurisprudence regarding deferred consideration has been adequately established through judicial precedents. Even the statutes in India do not bar these types of transaction. The relevant sections of the Income Tax Act, 1961 that pertains to the taxing of earn-out M&As and escrowed funds are in Chapter 4 Part E of the Act, that is Capital Gains. The transfer of shares in M&A deals is taxed under the head of income from capital gains. Section 45 of the Income Tax Act, 1961, states that any profits or gains from the transfer of capital assets effected in the previous year shall be chargeable to income tax under the head of Capital Gains and shall be deemed to be the

[9] CIT vs. Ashokbhai Chimanbhai [1965] 56 ITR 42 (SC)
[10] CIT vs Bharat Petroleum Corporation Limited [1993] 202 ITR 492 (Cal)
[11] In Re: Anurag Jain [2005] 277 ITR 1 (AAR)
[12] Commissioner of Central Excise, Mysore vs. TVS Motors Company [2015] INSC 921

income of the previous year in which the transfer has been effected.[13] Section 48 of the Act states that the income chargeable under the capital gains head shall be computed by deducting (i) expenditure incurred on transfer of capital asset; and/or (ii) the cost of acquisition and the cost of improvement of the asset, from the full value of the consideration received or accrued from transfer of capital assets.[14] In both of these sections deferred consideration has not found any mention or exception, due to which the pandora box of litigation was opened. However, by virtue of the words "full value of the consideration received or accrued" in section 48, one can deduce that only full consideration value shall be taken into account while computing tax on income from the transfer of capital gains and deferred consideration would not be included while computing this tax.

III. TAXABILITY OF ESCROWED FUNDS IN EARN-OUT M&A DEALS IN INDIA

Earn-out arrangement or deferred consideration M&A has been becoming a new popular trend where the sale consideration from the acquisition of a company is put in an escrowed fund and is discharged accordingly to meet the conditions that are agreed upon by the buyer and seller beforehand, or is discharged when these conditions are fulfilled. This type of consideration is deferred consideration since it is contingent upon certain conditions that a buyer and a seller agree upon beforehand, such as performance of the merged business. These contingent conditions are sometimes stipulated in the Share Purchase Agreement (SPA). The consideration is diverted to escrowed funds so that if any potential liabilities in the future arise, such as any potential litigation, then the funds from the escrow would be used to cover those costs. It provides security to the buyer from any uncertainties.

The legal issue that frequently arises in these types of M&A is how the escrow funds should be taxed. One line of jurisprudence says that the income should be taxed in the year in which the transfer of capital assets took place. Another line of thought suggests that the income should be taxed when it is actually accrued to the assessee. For instance, in the case of *Universal Medicare Pvt. Ltd. vs DCIT*,[15] where the assessee sold its market division for the consideration of Rs. 567.07 crores, out of which Rs. 477 crores were shown by the assessee as Capital Gains and the rest, Rs. 89.73 crores, were kept in an escrow account. The assessee asserted that the amount kept in escrow would accrue to the assessee in

[13] Income Tax Act, 1961, § 45, No. 43, Acts of Parliament, 1961 (India)
[14] Income Tax Act, 1961, § 48, No. 43, Acts of Parliament, 1961 (India)
[15] Universal Medicare Pvt. Ltd. vs DCIT [2020] 185 ITD 250 (Mum)

five yearly equal instalments of Rs. 17.89 crores on fulfilment of certain obligations and achieving of performance targets. The Assessing Officer rejecting this reply took recourse to Section 50B of the Income Tax Act, 1961, to contend that, as per the provisions, any profit or gain arising from the slump sale effected in the previous year shall be chargeable to income tax as capital gains arising from the transfer of long-term capital assets and shall be deemed to be the income of the previous year in which the transfer took place.[16] The Assessing Officer further contended that the capital gains cannot accrue in instalments and that the amount kept in escrow has no relation with the transfer of market division, it is only related to the supply agreement between the buyer and the seller. Under these contentions, the Assessing Officer brought the remaining amount kept in escrow to tax as income of the assessee.

The Income Tax Appellate Tribunal, Mumbai (Tribunal), observed that although the maintenance of the escrow account was of no significance to the Business Purchase Agreement (BPA) between buyer and seller, the escrow account agreement was executed in furtherance of the BPA. Also, the conditions stipulated in the supply agreement cannot also be delinked to the BPA. It was observed that if the conditions mentioned in the supply agreement are not fulfilled, then the BPA will be terminated and therefore, the deposit in the escrow account is *"intrinsic and integral to transfer of marketing division under BPA without it, the sale shall be incomplete"*.

Moving on to the issue of accrual of income, the Tribunal observed that the remaining amount from escrow funds would accrue to the assessee in the subsequent years and hence are not liable to be taxed in the year under consideration. While taking reference from a plethora of judgements explaining the jurisprudence of accrued income and deferred consideration, the Tribunal noted that such considerations are to be taxed in the year of accrual. The Tribunal observed:

"No doubt, the Income Tax Act takes into account two points of time at which the liability to tax is attracted, viz., the accrual of the income or its receipt; ***but the substance of the matter is the income*****.** ***If income does not result at all, there cannot be a tax****, even though in bookkeeping, an entry is made about a 'hypothetical income', which does not materialize. Where income has, in fact, been received and is subsequently given up in such circumstances that it remains the income of the recipient, even though given up, the tax may be payable.* ***Where, however, the***

[16] Income Tax Act, 1961, § 50B, No. 43, Acts of Parliament, 1961 (India)

income can be said not to have resulted at all, there is obviously neither accrual nor receipt of income*, even though an entry to that effect might, in certain circumstances, have been made in the books of account."*[17]

A different approach was taken by the High Court of Madras in the case of *Carborandrum Universal Ltd. vs The Assistant Commissioner of Income Tax,*[18], where the High Court upheld the decision of the Tribunal to tax the income from capital gains, kept in an escrow account, in the year of transfer. In this case the assessee sold a plant machinery for Rs. 31.146 crores and considered only Rs. 27.89 crores as sale consideration for computation of capital gains tax. The assessee contended that the remaining amount of Rs. 3.25 crores was retained in an escrow account to meet the future contingencies. The Tribunal brought this amount under consideration for tax by asserting that the entire amount of Rs. 31.146 crores has been accrued to the assessee based on the Business Sale Agreement between assessee and the buyer and the retention of amount in the escrow is just an application of income. The High Court upholding this decision of the Tribunal observed:

"...the assessee has received the entire amount of Rs. 325,000,000/- without any deduction. Even going by the case as projected by the assessee, the amount of Rs. 3.25 Crores is retained in an Escrow account and the right of the assessee has not been disputed and that amount was retained to cover four contingencies which are part of the indemnity clause and assuming certain payoffs were to be made from the retention money that will not in any manner alter the full and total consideration received by the assessee pursuant to the Business Sale Agreement and if such is the factual position, undoubtedly, the entire sale consideration had accrued in favor of the assessee during the assessment year under consideration. Even assuming that certain payments have been made from the amount retained in the Escrow account, it will not make or in any manner reduce the cost of acquisition."[19]

A recent case has firmly established the tax jurisprudence of escrow funds in M&A deals. The High Court of Bombay, in the case of *Dinesh Vaziirani vs The Principal Commissioner of Income Tax,*[20] held that the amount kept in an escrow fund to meet future liabilities and contingencies would be regarded as accrued to the assessee and therefore would not be considered while computing the full value of consideration for capital gains under Section 48 of the Income Tax Act. The factual matrix of the case was simply that the promoters of a company entered into an SPA with purchasers to sell 51% of their

[17] Universal Medicare Pvt. Ltd. vs DCIT [2020] 185 ITD 250 (Mum)
[18] Carborandrum Universal Ltd. vs The Assistant Commissioner of Income Tax [2021] 283 TAXMAN 312 (Mad)
[19] *Id.*
[20] Dinesh Vazirani vs The Principal Commissioner of Income Tax [2022] 445 ITR 110 (Bom)

shares in the company and a second subsequent SPA (Second SPA) was entered into between promoters and the purchasers for the purchase of remaining equity shares owned by the promoters on the satisfaction of certain conditions under the Second SPA. The SPA provided that of the Rs. 155 crores to be payable as sale consideration, a sum of Rs. 30 crores would be kept in escrow. Subsequent to the sale of shares, some liabilities and contingencies arose for which Rs. 9,17,04,240/- was withdrawn from the escrow account and never accrued to the promoters. The assessment was already done and the whole of Rs. 155 crores were taxed as capital gains without reducing the amount that was used for liabilities from escrow. The petitioner requested the PCIT reduce the long-term capital gain and also direct the assessing officer to refund the excess tax paid. The PCIT ruled against the petitioner, to which the petitioner approached the High Court of Bombay.

The Bombay High Court made meticulous observations in this case regarding the taxability of the escrow funds. It held that the amount of Rs. 9,17,04,240/- that was discharged from escrow to meet the liabilities neither accrued to the petitioner-promoter nor received by them and when the amount has not been received by or accrued to the assessee, the same is not to be taken as full value of consideration while computing capital gains. The Court, while ordering to refund the excess tax paid by the petitioner on the excess capital gains, held that respondent no. 1 (PCIT) erred in their ruling and observed that:

*"In the present case, the real income (capital gain) can be computed only by taking into account the real sale consideration, i.e., sale consideration after reducing the amount withdrawn from the escrow account. Respondent no. 1 has proceeded on an erroneous understanding that the arrangement between the seller and buyer which results in some contingent liability that arises subsequently to the transfer, cannot be reduced from the sale consideration as per Section 48 of the Act. We say this because the **liability is contemplated in SPA itself and certainly the same should be taken into account to determine the full value of consideration.** Therefore, i**f sale consideration specified in the agreement is along with certain liability, then the full value of consideration for the purpose of computing capital gains under Section 48 of the Act is the consideration specified in the agreement as reduced by the liability.** For respondent no. 1 to say that from the sale consideration only cost of acquisition, cost of improvement and cost of transfer can be reduced and the subsequent contingent liability does not come within any of the items of the reduction and the same cannot be reduced, is erroneous because full*

value of consideration under Section 48 would be the amount arrived at after reducing the liabilities from the purchase price mentioned in the agreement."[21]

Furthermore, very recently the Income Tax Appellate Tribunal, New Delhi Bench, has reiterated this jurisprudence and established once again that the amount kept in escrow would not be regarded as the full value of consideration while computing tax on income from the transfer of capital gains. The ITAT, New Delhi bench in the case of *Modi Rubber Ltd. vs Dy. Commissioner of Income Tax,*[22] observed that the taxability of an amount retained in an escrow fund which is neither received nor accrued or likely to be received or accrued by the assessee is contrary to the provision of law enunciated in Section 45 r.w. Section 48 of the Income Tax Act and that the amount kept in an escrow forms a part of consideration, however, it does not necessarily form a part of the full value of consideration received or accruing from the transfer of a capital asset. The Tribunal further held that *"realization of escrow amount depends on fulfilling specific conditions, with liabilities exceeding earmarked amount. As funds haven't been released to assessee yet, subsequent events post filing of Return of Income (ROI) deem escrow deposits as not constituting sale consideration accrued to Assessee for purpose of calculating capital gains chargeable under Section 45 of ITA."*[23]

The observations made in the case laws mentioned above have adequately settled the disputes regarding the taxation of escrowed funds in earn-out M&As. The bone of contention that was poking, that at what stage should the consideration from transfer of capital gains, which are transferred to escrow funds, should be taxed is resolved by stating that (i) the amount put in the escrow funds should not be regarded in the full value of consideration from transfer of capital gains while computing tax liability when the discharge of such amount is contingent on certain conditions and (ii) when the agreement effectuating the transfer stipulates that full consideration shall be transferred to the assessee, then the tax liability would arise in the year of transfer and when the such agreement does not stipulates the same, the consideration from transfer of capital assets shall be liable to be taxed in the year of accrual.

IV. COMPARATIVE STUDY OF TAXABILITY OF ESCROW FUNDS IN EARN OUT M&AS

[21] *Id.*
[22] Modi Rubber Ltd. vs. Dy. Commissioner of Income Tax MANU/ID/0131/2024
[23] *Id.*

Earn-out M&As have become a recent trend and have been made a preferred method of transaction due to the fact they are secure and mindful of any future inconsistencies that may arise post-transaction. These future inconsistencies are handled by putting a portion of the consideration in an escrow account and these funds would only be discharged on or for contingent conditions that would be stipulated in the agreement between the buyer and seller for the transfer of capital gains. As discussed earlier, it has also become a task to deduce the tax liabilities on these types of transactions and deals. From the observations made by the Courts and Tribunals in numerous cases, the intricate web of tax incidence has been resolved. However, to understand where such an approach by Indian courts and tribunals stands in the domain of tax jurisprudence in case of taxing escrow accounts and capital gains, a comparative analysis of how these earn-out M&As are taxed in other countries is necessary. For the purposes of this, the treatment of deferred consideration or earn-out M&As and escrow accounts under the tax laws of the United Kingdom (UK) and United States of America (US) has been taken for the analysis.

A. Taxability of Escrow Funds in Earn-Out M&As in the UK

Before going into the tax incidence of escrow funds M&As, let us understand the tax laws surrounding deferred consideration in the UK. The principal national taxing authority that collects both direct and indirect taxes in the UK is known as His Majesty's Revenue & Customs (HMRC). The HMRC publishes manuals that contain guidance for HMRC staff and tax professionals.[24] The guidelines are not all-inclusive and do not offer a conclusive solution in every situation. Its foundation is the law as it existed at the time these were published. If the law or the department's view of it changes, HMRC releases updated or amended guidelines. The principal statute that governs the taxation of capital gains in the UK is the Taxation of Chargeable Gains Act, 1992.

The technicalities surrounding the taxation of deferred consideration have been given in the HMRC manual. The deferred consideration in the UK is computed based on whether it's ascertainable or unascertainable. CG14850 of the HMRC Manual (Manual) says about deferred consideration that there are many situations where purchasers do not want to pay the full

[24] GOV.UK, https://www.gov.uk/government/collections/hmrc-manuals (last visited on May 29, 2024)

amount of consideration at once.[25] They may wish to spread the payments by an instalment plan. Very often the amount which they are willing to pay will depend on future events, for example, the future profits of a business or obtaining planning permission for land. The particular circumstances will be specified in the contract. CG14881 of the Manual explains that the deferred consideration is ascertainable if, at the date of disposal, the amount of future payments is "known" or ascertainable by calculations or "ascertainable by making up an account AND all of the events which establish the AMOUNT have occurred by the date of the disposal."[26] The date of disposal referred here is explained in Section 28 of the Taxation of Chargeable Gains Act, 1992 (TCGA) as *"*where an asset is disposed of and acquired under a contract the time at which the disposal and acquisition is made is the time the contract is made (and not, if different, the time at which the asset is conveyed or transferred)."[27] Clause 2 of the same section states that if the contract is conditional (and in particular if it is conditional on the exercise of an option), the time at which the disposal and acquisition is made is the time when the condition is satisfied. This provides some insights into the way deferred consideration is treated usually in the UK. Further, CG14940 of the manual talks about unascertainable deferred payments. It says that the consideration will be unascertainable if events that establish the amount do not occur till after the date of disposal.[28]

Essentially, the additional consideration will be "ascertainable" on the disposal date if it has a definite or known amount at that time. This implies that the liability owing on the entire amount at the time of disposal will be determined by including the amount to be received in the future in the CGT calculation. The deferred and/or conditional character of the consideration is reflected by no discount.[29] Consequently, the capital gains tax computation includes all proceeds, which include both the initial cash consideration and the future consideration.[30] On the other

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[25] HM Revenue & Customs, *CG14850 - Deferred consideration: introduction*, CG14850 DEFERRED CONSDERATION: INTRODUCTON (May 29, 2024, 6:50 PM) https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg14850
[26] HM Revenue & Customs, *CG14881 - Deferred consideration: what is ascertainable*, CG14881 - DEFERRED CONSIDERATION: WHAT IS ASCERTAINABLE (May 29, 2024, 6:50 PM) https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg14881
[27] Taxation of Chargeable Gains Act, 1992, § 28, c. 12, Acts of Parliament, 1992 (UK)
[28] HM Revenue & Customs, *CG14940 - Deferred consideration: unascertainable deferred payments*, CG14940 - DEFERRED CONSIDERATION: UNASCERTAINABLE DEFERRED PAYMENTS (May 29, 2024, 7:24 PM) https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg14940
[29] *Earn-Outs and Deferred Consideration,* EARN-OUTS AND DEFERRED CONSIDERATIONS – CLARITAS TAX (May 29, 2924, 7:28 PM) https://claritastax.co.uk/knowledge/earn-outs-and-deferred-consideration/
[30] *Id.*

hand, the right itself is considered to be part of the consideration when a vendor is granted the right to receive unascertainable deferred consideration. This asset is known as a "chose in action" in legal terms.[31] Thus, in addition to the cash profits given upon completion (and any other ascertainable consideration), the earn-out right's value is included in the consideration for the sale and becomes taxable at that time. This means the taxpayer is paying tax now on something of which they are not yet certain of the value.

A significant principle regarding right to a future unascertainable sum for CGT purposes was established in the case of Marren (Inspector of Taxes) Vs. Ingles.[32] In this case, the taxpayer sold shares in a private limited business. A portion of the selling revenues was paid out right away, and more consideration would come due if the business was later quoted on the Stock Exchange and the price on the first day of trading went beyond a certain amount. Given that the aforementioned conditions were satisfied, the taxpayer was granted additional deferred consideration. HMRC imposed capital gains tax assessments, arguing that the deferred consideration right of the taxpayer fell under the definition of an asset under TCGA 1992, s21(1), and that any additional consideration obtained from it would be considered the asset's disposal for CGT purposes. The taxpayer appealed, arguing that the delayed consideration was a debt that qualified for exemption under TCGA 1992, s251(1), and that as the payer of the deferred consideration did not acquire an asset, there was no disposal for the purposes of capital gains tax.

Since the taxpayer's right to receive the delayed consideration was a "chose in action" (i.e., an asset) and the payment of the further consideration was a capital sum derived from this asset, it was decided that there had been a disposal for capital gains tax purposes. Due to the fact that the amount of the deferred consideration was uncertain and contingent on future occurrences, it was not considered a debt under s251(1). It was decided that the right to receive future consideration must be valued and taken into account as part of the sale proceeds on the initial disposal when a chargeable asset is being disposed of and there is a chance that additional

[31] *Earn-Outs and Deferred Consideration,* EARN-OUTS AND DEFERRED CONSIDERATIONS – CLARITAS TAX (May 29, 2924, 7:28 PM) https://claritastax.co.uk/knowledge/earn-outs-and-deferred-consideration/
[32] Marren (Inspector of Taxes) Vs. Ingles [1980] 3 All ER 95

consideration will be received, contingent on future events. The value of that right may then be used as the allowable base cost in calculating the chargeable gain (or allowable loss) on any future consideration received.

In the UK, the taxation of escrow funds in an earn-out arrangement during a merger and acquisition (M&A) transaction can be complex, depending on several factors. In an M&A transaction, earn-out payments received by the seller are typically treated as part of the consideration for the sale of shares or assets. These payments are subject to Capital Gains Tax (CGT). When part of the consideration is held in escrow, it is generally treated as part of the overall sale consideration.[33] The tax point (the time when the tax is payable) depends on when the funds are deemed to be received by the seller. This could be when the funds are released from escrow, not when they are initially placed into escrow. The timing of taxation can depend on when the seller becomes entitled to the escrowed funds. If the entitlement is contingent on future events (e.g., achieving certain performance targets), the CGT might only be payable when those conditions are met and the funds are released.[34] For example, suppose a seller agrees to sell their company for £1 million, with £800,000 paid upfront and £200,000 held in escrow contingent on the company achieving specific performance milestones over the next two years. The £800,000 is immediately subject to CGT (or Corporation Tax if the seller is a company). The £200,000 held in escrow will be taxed when it is released, assuming the performance milestones are met. The tax treatment (CGT or Income Tax) will depend on the specifics of the agreement and the seller's circumstances.

B. Taxability of Escrow Funds in Earn-Out M&As in the US

In the United States, deferred consideration in business transactions is subject to specific tax rules and treatments. Deferred consideration refers to a portion of the purchase price that is paid after the closing of a transaction, often based on future performance or events. The tax treatment of deferred consideration can vary depending on the structure and terms of the transaction. The primary legislation that governs taxation in the US is the Internal Revenue

[33] HM Revenue & Customs, *CG14805 - Contingent liabilities: the effect of TCGA92 S49*, CG14805 - CONTINGENT LIABILITIES: THE EFFECT OF TCGA92 S49 (May 29, 2024, 7:31 PM) https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg14805
[34] *Id.*

Code of 1986 (IRC). For the seller, the tax treatment of deferred consideration depends on whether the transaction is treated as a sale or exchange and the type of consideration received. If the deferred consideration qualifies for instalment sale treatment under Section 453 of the IRC, the seller can recognise gain over the period in which payments are received.[35] This can provide a deferral of tax liability.

If the deferred consideration is structured as an earn-out, the seller recognises gain as payments are received, and the timing and amount of income recognised depend on the performance criteria met.[36] IRC Section 483 and the Original Issue Discount rules can apply to deferred consideration, requiring the imputation of interest if the deferred payments do not include adequate stated interest.[37] For example, consider a business sale where the buyer agrees to pay $1 million upfront and an additional $500,000 in three years, contingent on the business meeting certain performance targets. If this transaction qualifies as an instalment sale, the seller recognises a portion of the gain upfront and the remaining gain as the contingent payment is received. Interest on the deferred payment might need to be imputed and reported.

As has already been reiterated various times, in earn-out M&A transactions, an escrow fund is often established to hold a portion of the purchase price contingent on certain future events or performance metrics. The tax treatment of the amounts placed in escrow can be complex and depends on several factors, including the terms of the escrow agreement and the actual disbursement of the funds. For the seller, generally the income is not recognised at the time the escrow is funded because the seller does not have full control or rights to the funds. The funds are considered contingent and are not recognised as income until the seller has an unconditional right to receive them.[38] The amount is recognised as income when the funds are released from escrow and become available to the seller and if the transaction qualifies as an instalment sale, the release of escrow funds can be treated as part of the instalment payments, allowing for

35 Internal Revenue Code, 1986, § 453, 26 U.S.C (US)

36 Catherine Gannon, *Deferred Consideration on Business Sales,* DEFERRED CONSIDERATION ON BUSINESS SALES – GANNONS SOLICITORS (May 29, 2024, 7:40 PM) https://www.gannons.co.uk/insights/deferred-consideration-on-business-sales/

37 Internal Revenue Code, 1986, § 483, 26 U.S.C (US)

38 Christopher Letang, *M&A Escrows and Payments – What to Know*, M&A ESCROWS AND PAYMENTS (May 29, 2024, 7:47 PM) https://www.srsacquiom.com/our-insights/escrows-ma/

deferral of gain recognition under Section 453 of the IRC.[39] Furthermore, any interest or earnings on the escrowed funds are typically taxable to the seller as ordinary income in the year they are earned, even if the funds have not yet been disbursed.[40]

For example, suppose a business is sold for $10 million, with $2 million placed in escrow contingent on the business meeting certain performance targets over the next two years. The $2 million in escrow is not immediately recognised as income by the seller. If $1 million is released from escrow after the first year based on performance, the seller recognizes this $1 million as part of the sales proceeds (capital gain or ordinary income, depending on the nature of the sale). The amount released would be taxable and if the transaction comes under instalment sale as per the standard of Section 453 of the IRC, then it will allow for deferral of taxability on the gain. Any interest earned on the $2 million while in escrow is taxable to the seller as ordinary income.

The difference between Indian tax laws and UK and US tax laws is clear and evident from the above observations. Concepts like choice in action, ascertainable and unascertainable deferred considerations, or instalment sales even, have not found their way into the Indian tax jurisprudence. Although the Indian tax regime in the context of deferred consideration and taxing escrow funds in earn-out M&As, has evolved through numerous judicial pronouncements, to make this mechanism more robust and handle the taxing of amounts put in escrow efficiently, the tax regimes of the US and UK can provide an appropriate direction to the same.

V. RECOMMENDATION AND CONCLUSION

The taxability of escrow funds in earn-out M&As is becoming a popular recourse in M&A transactions. This is due to their security and calculation of any future inconsistencies. The tax incidence on these types of transactions is treated differently in different jurisdictions, as we observed above. Moreover, the taxing of deferred consideration is different in different jurisdictions. Therefore, it is imperative to understand this tax jurisprudence exhaustively by comparing it with regimes of

[39] *Id.*
[40] *Taxation of Interest Earned on the M&A Escrow Account: Actual vs. Imputed*, THE COMPLEX TAXATION OF M&A ESCROW INTEREST (May 29, 2024, 8:02 PM) https://www.srsacquiom.com/our-insights/taxation-of-interest-earned-on-the-escrow-actual-vs-imputed/

different jurisdiction. Let us see what the difference is between the tax regimes of the UK, US and India in their treatment of taxing escrow funds in earn-out M&As.

A. Regarding Deferred Consideration

In the United Kingdom, the deferred consideration is divided into ascertainable deferred consideration and unascertainable deferred consideration. Ascertainable deferred consideration and unascertainable deferred consideration attract different types of tax liability. Ascertainable deferred considerations have to be included in the CGT calculator at the date of disposal and the liability is due on the whole amount. In the case of unascertainable deferred consideration, the right to receive unascertainable deferred consideration itself is also treated as a part of consideration.

In the US, the taxation of deferred consideration depends on the type of transaction. If the deferred consideration qualifies as an instalment sale, then Section 453 of the Internal Revenue Code would apply. If the deferred consideration gives rise to interests, then the principles of section 483 of the Internal Revenue Code would apply.

In India, through judicial pronouncements, it is established that deferred consideration cannot be said to accrue to the assessee as only after satisfying the contingent conditions, such consideration becomes accessible. However, sometimes the assessee receives full consideration and diverts a part of it for deferral. In such cases, the deferred consideration would be taxable. Therefore, the Indian jurisdiction has established the principle that deferred consideration cannot be taxed unless it is accrued to the assessee.

B. Regarding Earn-Out M&A and Escrow Funds

In the UK, when a part of consideration is held in escrow, it is regarded as the overall sale consideration. The time when the seller is entitled to the escrowed amount may affect when taxes are due. In cases where the entitlement is subject to future events, such as meeting specific performance targets, the Capital Gains Tax may only become due upon the fulfilment of those conditions and the release of the funds. For example, where the assessee agrees to sell their company for £8 million, with £5 million paid upfront and £3 million transferred to escrow contingent on the company achieving specific performance milestones over the next two years. The £5 million is immediately subject to CGT (or Corporation Tax if the seller is a company). The £3 million held in escrow will be taxed when it is released, assuming the performance milestones are met.

In the US, the concept of instalment sale and interest on escrow amounts come into picture. The funds put in escrow are not recognised as the income of the assessee/seller because such funds are contingent on conditions. The funds are regarded as income when the assessee gets an unconditional right to the amount and the amount is released from the escrow and becomes available to the seller. It is at this stage that the amount from escrow is liable to be taxed. Moreover, if the amount qualifies as an instalment sale under Section 453 of the Internal Revenue Code, its taxability can be deferred to when each of the gains from instalments becomes available to the seller. Also, if any interest accrues on the escrowed funds, such interest would be chargeable to tax by the virtue of Section 483 of the Internal Revenue Code.

In India, the case of *Modi Rubber vs Dy. Commissioner of Income Tax,* settled the disputes surrounding the taxability of escrowed funds in earn-out M&As. It held that the amount put in the escrow funds should not be regarded in the "full value of consideration" from transfer of capital gains while computing tax liability (as per Section 48 of the Income Tax Act, 1961). The court further held that the tax liability would arise in the year of transfer when the agreement of the transfer stipulates that full consideration shall be transferred to the assessee and when such agreement does not stipulate the same, the consideration from the transfer of capital assets shall be liable to be taxed in the year of accrual.

The purpose of comparing the tax jurisprudence of the UK and US regarding the taxability of escrow funds in earn-out M&As was to understand at what stage India's tax laws stand in treating this type of M&As and to excavate learnings from other tax regimes. The plethora of judgements in the Indian tax law regarding taxability of escrow funds is a clear indication of the evolution of the Indian tax regime. The judicial interpretation of tax laws by the judges has worked hard to resolve the complex webs of tax law surrounding earn-out M&As and escrow funds. However, in analysing the taxability of escrow funds in earn-out M&A deals in India, and comparing the treatment of these funds under the tax laws of the UK and the US, several key observations and recommendations emerge. Both jurisdictions offer distinct approaches that could inform and improve the Indian tax framework for M&A transactions, particularly concerning escrow funds.

Indian tax laws, in an attempt to explicitly address the treatment of escrow funds in earn-out arrangements and provide clarity and reduce litigation, draw from the UK and US frameworks clear guidelines on when and how these funds are taxed. This could involve specifying the tax point as when the funds are released from escrow or become unconditional, similar to the UK approach. Furthermore, the introduction of provisions similar to the US "installment sale rules" to address situations where payments are contingent and spread over several years, ensuring a fair tax treatment without undue deferral or acceleration of tax liabilities, can also prove to be beneficial for the Indian tax regime. Another important aspect of the US tax regime in regards to its treatment of escrow funds that can prove to be beneficial for India is adopting provisions to implement tax on the interest accumulated on amounts sitting in escrow funds.

By incorporating these recommendations, India can develop a robust tax framework for handling escrow funds in earn-out M&A deals, aligning with international best practices and fostering a more predictable and investor-friendly tax environment.

Akash Nath, *Capital Market Manipulation Through Social Media,* 11 (2) SCHOLASTICUS 34 (2024).

CAPITAL MARKET MANIPULATION THROUGH SOCIAL MEDIA

Akash Nath[*]

ABSTRACT

The convergence of social media influence and the intricate dynamics of financial markets has given rise to a notable trend known as 'finfluencers'—individuals wielding significant online followings who leverage their platforms to share financial insights. This investigation delves into the phenomenon of social media-driven manipulation within stock markets, examining deceptive tactics like pump-and-dump schemes and strategies involving short selling and the dissemination of misinformation. Drawing from case studies spanning across regions including India, the United States, and Singapore, this study sheds light on regulatory frameworks aimed at addressing the challenges posed by finfluencers. It highlights proactive measures taken by regulatory bodies such as the Securities and Exchange Board of India, United States Securities and Exchange Commission and the Monetary Authority of Singapore, outlining strategies to combat market manipulation facilitated by social media. The suggested recommendations put forward advocate for the implementation of accreditation standards for finfluencers, the enforcement of rigorous regulations on social media platforms, and the integration of advanced technologies such as artificial intelligence and natural language processing in market surveillance endeavours. Through a meticulous examination of this complex phenomenon and the proposition of practical solutions, this paper contributes to the scholarly discourse surrounding the oversight of finfluencers and the maintenance of market integrity in an increasingly digitized and interconnected global landscape.

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I. INTRODUCTION

In recent times, the expansion of various social media platforms has brought about a significant change in how people communicate, access information, and conduct financial activities globally.[1] Concurrently, the rise of influencers, individuals who wield significant influence over their followers online,[2] has reshaped marketing strategies and consumer habits. While this digital shift offers remarkable prospects for connection and interaction, and might seem inconsequential in trivial matters such as choosing skincare products, it also harbours a darker underbelly. The potential for manipulation, particularly within the stock markets is of grave concern.[3]

This paper explores the role of social media and *fin*fluencers in stock market manipulation.[4] With sizable online audiences, influencers wield a distinct ability to influence perspectives, drive trends, and impact consumer actions. Yet, their influence transcends conventional product promotions, as influencers increasingly use their platforms to spread false financial data, leading to significant consequences for the stock market dynamics. Finfluencers have also taken guise to "educational courses" to make people invest in certain stocks. The confluence of social media influence and stock market activity introduces a host of complexities and challenges. Notably, the rapid dissemination of inherently decentralized information on these platforms can amplify market volatility and catalyse the spread of misinformation.[5] Moreover, the lack of regulatory oversight and transparency exacerbates susceptibility to manipulation tactics, ranging from pump-and-dump schemes to coordinated trading strategies orchestrated by influential figures. The ramifications of such manipulation are far-reaching, spanning from individual investors experiencing financial losses to broader systemic implications for market integrity and investor confidence. Consequently, ascertaining the intricacies of market

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[1] Jingjing Gu, *Social Media Affects the Way of Communication*, BCP EDUCATION & PSYCHOLOGY (2022); Shakerin Ismail, R. K. Nair, Rohana Sham, S. N. Wahab, *Impacts of online social media on investment decision in Malaysia*, INDIAN JOURNAL OF PUBLIC HEALTH RESEARCH AND DEVELOPMENT; Safa Khalil Abu-Taleb, Fredrick Nilsson, *Impact of Social Media on Investment Decision A quantitative study which considers information online, online community behaviour, and firm image*, DEPARTMENT OF BUSINESS ADMINISTRATION, UMEA UNIVERSITET (2021)

[2] *Guidelines for Influencer Advertising in Digital Media Definitions (2023),* ADVERTISING STANDARDS COUNCIL OF INDIA

[3] *How Trading Has Evolved & How Trading Systems Adapt*, NASDAQ, Dec. 6, 2023, available at: https://www.nasdaq.com/articles/how-trading-has-evolved-how-trading-systems-adapt.

[4] Lisa-Marie Voneshen, *Finfluencers: what they do and how to avoid bad advice*, UNBIASED, Feb. 06, 2024, https://www.unbiased.co.uk/discover/personal-finance/savings-investing/finfluencers-what-they-do-and-how-to-avoid-bad-advice.

[5] Maria Cristina Arcuri, Gino Gandolfi, Ivan Russo, *Does fake news impact stock returns? Evidence from US and EU stock markets*, 125 JOURNAL OF ECONOMICS AND BUSINESS (2023).

manipulation driven by social media requires a comprehensive strategy involving regulatory adjustments, technological advancements, and increased awareness within market actors.

This paper seeks to delve into the intricate workings of this phenomenon, outlining its mechanisms, evaluating associated risks, and suggesting practical measures to uphold market integrity in today's digitized and interconnected landscape. Through a thorough examination of this multifaceted issue, I aim to enrich discussions on the convergence of technology, finance, and regulation, aiming to cultivate a stronger and fairer financial environment.

II. FRAUDULENT MEANS

A. Pump and Dump Schemes

Pump-and-dump scheme stands as a nefarious stratagem designed to artificially inflate the value of a given stock or security through the dissemination of false, deceptive, or egregiously exaggerated information.[6] Operatives orchestrating such schemes strategically acquire positions in said securities prior to disseminating the misleading information, subsequently divesting themselves of their holdings once the price has been artificially inflated, thereby precipitating significant financial losses for unsuspecting investors. This deceitful practice predominantly targets stocks of micro- and small-cap stature owing to their susceptibility to manipulation.[7]

The evolution of pump-and-dump tactics has seen a transition from traditional cold calling methods to contemporary digital platforms such as spam emails and social media messages, facilitating a wider reach and greater efficacy in ensnaring potential investors.[8]

Pump-and-dump schemes entail deliberate manipulation rather than the natural ebbs and flows of market dynamics.[9] While they do have similarities with Ponzi schemes, they remain distinguishable in terms of their modus operandi, duration, and underlying intentions.[10] These

[6] Rajeev Dhir, *Pump-and-Dump: Definition, How the Scheme is Illegal, and Types*, INVESTOPEDIA, Mar. 13 2022, https://www.investopedia.com/terms/p/pumpanddump.asp.
[7] *"Pump and Dump" Schemes*, U.S SECURITIES AND EXCHANGE COMMISSION, Aug. 7, 2006, https://www.sec.gov/rss/your_money/pump_and_dump.htm.
[8] FINRA Staff, *Wake Up and Smell the Pump-and-Dump* Nov. 24 2015, FINANCIAL INDUSTRY REGULATORY AUTHORITY.
[9] Janet Austin, *Stock Markets Play 'Whack a Mole' with Pump and Dump Schemes*, 23 UC DAVIS BUSINESS LAW JOURNAL 1 1-24 (2023)
[10] CFI Team, *Pump and Dump*, CORPORATE FINANCE INSTITUTE, https://corporatefinanceinstitute.com/resources/career-map/sell-side/capital-markets/pump-and-dump/.

schemes are typically executed with alacrity over the span of weeks or even hours and aim to yield rapid profits before the inevitable collapse of the artificially inflated stock prices.

B. Short and Distort Schemes

Short and distort is a form of securities fraud wherein investors undertake short selling of a stock while concurrently disseminating adverse rumours concerning the respective company, all with the aim of precipitating a downturn in stock prices.[11] This deceptive practice unfolds without the requisite borrowing of stock, thereby instigating a plummet in stock valuation.[12] Following the orchestrated decline, the investor acquires more shares than initially sold, utilizing a portion to fulfil the short-selling agreement and offloading the remainder to perpetuate the downward trajectory of share prices.

While short selling in itself represents a lawful speculation on the potential decline of a stock,[13] the "short and distort" stratagem entails the dissemination of falsified information to accrue personal gain from the ensuing depreciation, thereby constituting illicit market manipulation. In essence, this deceitful practice entails the exploitation of stocks through short selling and the propagation of fabricated data to induce a devaluation, thereby embodying illegal market manipulation.

III. RELEVANT CASE STUDIES

A. SEBI'S Orders on Sadhna Broadcast Limited

In early 2023, the Indian regulatory body Securities and Exchange Board of India (SEBI) passed an order barring 31 market entities, including actor Arshad Warsi and his wife Maria Goretti, along with YouTuber Manish Mishra, and promoters associated with Sadhna Broadcast, from the securities market for uploading false and misleading videos on YouTube.[14] SEBI's investigation delved into the purported dissemination of misleading information via Sadhana

[11] Rick Wayman, *Short and Distort: Bear Market Stock Manipulation*, INVESTOPEDIA, Feb. 17, 2022, https://www.investopedia.com/articles/analyst/030102.asp.
[12] Florian Hauser & Jürgen Huber, *Short-selling constraints as cause for price distortions: An experimental study*, 31 JOURNAL OF INTERNATIONAL MONEY FINANCE 5 (2012).
[13] Rick Wayman, *Short and Distort: Bear Market Stock Manipulation*, INVESTOPEDIA, Feb. 17 2022 https://www.investopedia.com/articles/analyst/030102.asp.
[14] ENS Economic Bureau, *Sebi bars Arshad Warsi, others for stock manipulation via YouTube*, THE INDIAN EXPRESS, Mar. 3, 2023, https://indianexpress.com/article/business/companies/sebi-ban-sadhna-broadcasts-promoters-arshad-warsi-securities-mkt-8474861/.

Broadcast's YouTube channels, which influenced stock prices and trading activity. This investigation was initiated due to concerns raised regarding price manipulation and share dumping by specific in the scrip of Sadhna Broadcast.

SEBI's investigation revealed that during the latter part of July 2022, deceptive videos regarding Sadhna Broadcast were uploaded on two YouTube channels – "The Advisor" and "Moneywise".[15] These videos advocated for purchasing Sadhna stocks with promises of remarkable returns, consequently inflating the stock's price and trading volume. One instance of deceptive content disseminated through YouTube channels suggested an impending acquisition of Sadhna Broadcast Ltd by the Adani group, purporting that such an acquisition would result in amplified profit margins for the company. Subsequent to the circulation of these misleading videos, there ensued a surge in both the price and trading activity of Sadhna's shares. This surge in trading volume notably comprised a significant proportion of retail investors, ostensibly swayed by the deceptive content disseminated via YouTube. Evidently, the company experienced a remarkable escalation in its shareholder base, soaring from a mere 2,167 to an impressive 55,343.

SEBI has categorized the entities involved into various roles including creators of YouTube channels, net sellers/promoters, profit makers, volume creators, and information carriers. Arshad Warsi and Maria Goretti were identified as volume creators who engaged in both buying and selling Sadhna shares during the investigation period.[16]

SEBI's interim order from early May was reaffirmed with certain adjustments. As part of this, the regulator prohibited 15 individuals from engaging in transactions involving the shares of Sadhna Broadcast until the investigation concludes. Furthermore, SEBI has impounded illicit gains amounting to Rs 41.85 crore acquired by the implicated entities through the "pump and dump" scheme.[17] In response, SEBI has directed all 31 individuals involved to establish an escrow account with a designated commercial bank and deposit the impounded sum accordingly.

B. Other Cases

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[15] *Id.*
[16] Explained Desk, *Why SEBI barred actor Arshad Warsi and others from the securities market*, THE INDIAN EXPRESS Mar. 4, 2023, https://indianexpress.com/article/explained/explained-economics/sebi-banned-actor-arshad-warsi-8476020/.
[17] ENS Economic Bureau, *supra* 14.

SEBI has delved into various other instances where influencers were discovered to have artificially inflated both the price and trading volume of certain securities by engaging in coordinated manipulative trades. Subsequently, these influencers disseminated buy recommendations through channels as rudimentary as bulk SMS messaging.[18] The regulatory body has issued warnings to the public, advising vigilance against fraudulent practices facilitated through SMS messages, online platforms including websites, and popular social media platforms such as Telegram, Instagram, and YouTube.

SEBI conducted an inquiry into Telegram accounts where the modus operandi involved initial acquisition of shares from relevant companies, succeeded by issuing favourable recommendations on these stocks via the Telegram platform.[19] This strategy aimed to entice numerous subscribers into trading these shares. Subsequently, subsequent to disseminating such recommendations, the individuals behind the scheme would sell off the accumulated shares in the market, yielding a profit. Consequently, SEBI noted that upon the issuance of recommendations on the channel, there was a noticeable surge in price volatility for the specific stocks. The trio identified as administrators of the Telegram channel also propagated manifestly false assertions, suggesting the presence of a four-member research analyst team purportedly in the process of SEBI registration. SEBI determined that the perpetration of such deceptive activities by these individuals, through the outlined scheme, with an evidently dubious intention to profit at the expense of unsuspecting investors in the securities markets, prima facie constitutes flagrant breaches of the SEBI Act and the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 (PFUTP Regulations).

IV. EDUCATIONAL COURSES

In October 2023, SEBI took action against Mohammad Nasiruddin Ansari, popularly known as "Baap of Chart", barring him from participating in the securities market and imposed a hefty fine of 17.2 crores.[20] Ansari, operating across various social media platforms including YouTube, Instagram, WhatsApp, and Telegram, was alleged to have dispensed unregistered investment advice disguised as

[18] Securities and Exchange Board of India, SEBI PR No.9/2023, Interim Order-cum-Show Cause Notice in case of market manipulation of shares of five small cap companies through circulation of Bulk SMSs to induce Investors.
[19] Securities and Exchange Board of India, WTM/SKM/54/201-22, Interim Order in the matter of Stock Recommendations using Social Media channel Telegram.
[20] BS Web Team, *Fined Rs 17 crore by Sebi: All you need to know about 'Baap of Chart'*, BUSINESS STANDARD, OCT. 26, 2023, https://www.business-standard.com/markets/news/fined-rs-17-crore-by-sebi-all-you-need-to-know-about-baap-of-chart-123102600383_1.html.

educational guidance. SEBI's investigation uncovered Ansari's accumulation of Rs 17.2 crore through deceptive practices, enticing investors with assurances of guaranteed returns and persuading them to engage in securities transactions.[21]

In its findings, SEBI unveiled Ansari's establishment of 'Baap of Chart' as a platform for offering stock recommendations and profiting substantially from courses, workshops, and unregistered investment advisory services. Accusing Ansari of fraudulent conduct, SEBI asserted his exploitation of individuals' capital in pursuit of swift gains within the securities market. It noted:

"[t]he theatrics and showmanship in the trailer videos on YouTube issued by Md. Nasir/ BoC appear to be aimed at creating illusion of unnatural returns by drawing in gullible and uninformed viewers to join his 'classes' thereby inducing them to trade in the securities market."[22]

It even found that Ansari actually incurred losses for the period when he made claims about earning profits.[23] Consequently, SEBI mandated Ansari to desist from acting as an investment advisor and instructed him to remit Rs 17.2 crores.[24]

This punitive action against Nasiruddin Ansari is an extension of SEBI's ongoing endeavours to oversee *fin*fluencers who dispense financial guidance devoid of requisite registration and supervision. By undertaking such measures, SEBI seeks to safeguard investors' interests and uphold the integrity of the securities market against the backdrop of deceptive practices.

V. REGULATORY FRAMEWORK IN INDIA

As per *V Natarajan v SEBI*, "planting false or misleading news which may induce the public for selling or purchasing securities would also come within the ambit of unfair trade practice in securities."[25] The

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21 Ashutosh Joshi, *Indian 'Finfluencer' to Refund $2.1 Million to Followers in Latest Crackdown*, BLOOMBERG, Oct. 26, 2023 https://www.bloomberg.com/news/articles/2023-10-26/india-sebi-bans-baap-of-chart-from-market-tightens-surveillance.

22 Interim Order cum SCN in the matter of unregistered investment advisory activities of Mohammad Nasiruddin Ansari/ Baap of Chart 45WTM/AN/MIRSD/MIRSD-SEC-6/29693/2023-24.

23 Nasiruddin Ansari, *the influencer called 'Baap of Chart', who was banned by SEBI and fined Rs 17 crore*, Oct. 26, 2023, ECONOMIC TIMES, https://economictimes.indiatimes.com/news/new-updates/meet-nasiruddin-ansari-the-influencer-called-baap-of-chart-who-was-banned-by-sebi-and-fined-rs-17-crore/articleshow/104722661.cms.

24 Interim Order cum SCN in the matter of unregistered investment advisory activities of Mohammad Nasiruddin Ansari/ Baap of Chart 45WTM/AN/MIRSD/MIRSD-SEC-6/29693/2023-24.

25 V Natarajan v SEBI, SAT Order dated June 29, 2011, in Appeal No. 104 of 2011.

following subsections entail the specific rules and regulations corresponding to the manipulative practices undertaken in the securities market.

A. Securities and Exchange Board of India, 1992

Chapter VA of the SEBI Act 1992, prohibits manipulative and deceptive devices, insider trading and substantial acquisition of securities or control. [26] Section 12A (a)(b)(c) delineates prohibitions regarding the utilization of manipulative or deceptive tactics in relation to securities transactions on recognized stock exchanges.[27] It stipulates that individuals are prohibited from employing any form of deceitful device, contrivance, or scheme in connection with the issuance, acquisition, or disposal of listed or proposed securities.[28] Furthermore, it expressly prohibits engaging in activities that would perpetrate fraud or deceit upon any party, thereby violating the regulations outlined in the Act or its associated rules and regulations.[29] Section15HA entails the penalty for fraudulent and unfair trade practices.[30]

B. Prohibition of Fraudulent and Unfair Trade Practices, 2003

The regulatory framework outlined by the Securities and Exchange Board of India (SEBI) under the Prohibition of Fraudulent and Unfair Trade Practices (PFUTP) Regulations serves as a bulwark against deceptive and inequitable practices within financial markets.[31] This encompassing mandate includes the prohibition of activities such as market manipulation and price manipulation, safeguarding the integrity and fairness of market operations. Section 4 of the PFUTP regulations define what constitutes a manipulative, fraudulent or unfair trade practice,[32] with “fraud” definied in Section 2(1)(c). In Section 4, within the long list of activities related to trading, some which are relevant in the context of the finfluencers includes creating a false trading appearance,[33] dealing in order to inflate or otherwise fluctuate the market,[34]

[26] The Securities and Exchange Board Of India Act, 1992, Chapter VA.
[27] The Securities And Exchange Board Of India Act, 1992, Chapter VA, §12(a)(b)(c).
[28] The Securities And Exchange Board Of India Act, 1992, Chapter VA, §12(a)(b)(c).
[29] The Securities And Exchange Board Of India Act, 1992, Chapter VA, §12(a)(b)(c).
[30] The Securities And Exchange Board Of India Act, 1992, §15HA.
[31] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 [Last amended on January 25, 2022].
[32] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 [Last amended on January 25, 2022] §4.
[33] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 [Last amended on January 25, 2022] §4(2)(a).
[34] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 [Last amended on January 25, 2022] §4(2)(b).

publishing information such as financial statements or merger approvals etc., which is not true,[35] and disseminating misleading information to influence the decision of influencers.[36]

VI. SEBI (STOCK BROKERS AND SUB-BROKERS) REGULATIONS, 1992

The SEBI (Stock Brokers and Sub-brokers) Regulations, 1992 entail a code of conduct for stock brokers in Schedule II. Regulation 9 of said code categorically prohibits market manipulation. Clause A(3) states:

> "a stock-broker shall not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumo[u]rs to distort market equilibrium or make personal gains"[37]

Clause A(4) discusses malpractice and prohibits brokers from manipulating the market through deceptive practices or in collaboration with others. It brings rumours within the meaning of malpractice, stating that

> "A stock-broker shall not create false market either singly or in concert with others or indulge in any act detrimental to the investors interest or which leads to interference with the fair and smooth functioning of the market. A stock-broker shall not involve himself in excessive speculative business in the market beyond reasonable levels not commensurate with his financial soundness."[38]

VII. REGULATORY RESPONSE TO INCREASING USE OF SOCIAL MEDIA BY FINFLUENCERS TO MANIPULATE THE STOCK MARKET

A. Consultation Paper on Association of SEBI Registered Intermediaries/Regulated Entities with Unregistered Entities

[35] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 [Last amended on January 25, 2022] §4(2)(f).
[36] Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 [Last amended on January 25, 2022] §4(2)(k).
[37] Securities and Exchange Board of India (Stock Brokers and Sub-brokers) Regulations, 1992 [Last amended on July 13, 2017] Schedule II Regulation 9 (A)(3).
[38] Securities and Exchange Board of India (Stock Brokers and Sub-brokers) Regulations, 1992 [Last amended on July 13, 2017] Schedule II Regulation 9 (A)(4)

SEBI's August 2023 "Consultation Paper on Association of SEBI Registered Intermediaries/Regulated Entities with Unregistered Entities (including Finfluencers)" notes that financial influencers, or finfluencers, are

"usually unregistered entities providing catchy content, information, and advice on various financial topics to their several followers".[39]

SEBI notes further that those influencers lacking registration with the pertinent financial regulatory bodies may lack the necessary qualifications or expertise in the field. Moreover, their exemption from adherence to the financial sector's ethical standards may result in the non-disclosure of potential conflicts of interest, such as affiliations with or interests in the products, services, or securities they endorse.

Two Regulations are relevant in this regard, the SEBI (Investment Advisors) Regulations, 2013 and the SEBI (Research Analysts) Regulations, 2014. Amongst others, academic qualifications, and other requirements such as at least five years of experience in "activities relating to advice in financial products or securities or fund or asset or portfolio management" is essential to be an Independent Advisor.[40] Similar requirements are mandated for a Research Analyst.

In matters of remuneration, Investment Advisors refrain from accepting compensation from sources other than the client they are advising. Similarly, Research Analysts are barred from receiving any form of remuneration such as royalties or referral bonuses from the organization engaging them for research. Furthermore, the compensation of RAs must undergo an annual review by either the Board of Directors or a designated committee.

SEBI has stipulated that SEBI-registered intermediaries and regulated entities, along with their agents or representatives, are prohibited from engaging in any form of association or relationship, whether monetary or non-monetary, with unregistered entities, including finfluencers, for the promotion or advertisement of their services or products.[41] Furthermore,

[39] Securities and Exchange Board of India, Consultation Paper on Association of SEBI Registered Intermediaries/Regulated Entities with Unregistered Entities (including Finfluencers)
[40] Securities and Exchange Board of India, (Investment Advisors) Regulations, 2013, Regulation 7.
[41] Securities and Exchange Board of India, Consultation Paper on Association of SEBI Registered Intermediaries/Regulated Entities with Unregistered Entities (including Finfluencers) ¶4.2.

entities registered or regulated by SEBI, stock exchanges, or AMFI are forbidden from disclosing any confidential client information to unregistered entities.[42]

Finfluencers who are registered with SEBI, stock exchanges, or AMFI are required to prominently display their registration number, contact details, investor grievance redressal helpline, and provide appropriate disclosures and disclaimers on any posts.[43] They are also obligated to fully adhere to the code of conduct prescribed under their respective registrations as comply with the advertisement guidelines issued by SEBI, stock exchanges, and SEBI-recognized supervisory bodies.[44] Additionally, SEBI-registered intermediaries and regulated entities are prohibited from offering trailing commissions based on referral numbers as referral fees.[45] However, limited referrals from retail clients and the payment of fees for such referrals by stockbrokers are permissible.[46] Finally, SEBI-registered intermediaries are required to actively dissociate themselves from any unregistered entity that utilizes their name, product, or service.[47]

VIII. MARKET RUMOUR AMENDMENTS (POST-LODR)

In June 2023, SEBI by virtue of an amendment introduced a mandatory requirement under Regulation 30 read with Schedule III of the LODR Regulations or the market rumours amendment, requiring the top 100 listed companies from October, 2023, and the top 250 listed entities from April, 2024 to

"confirm, deny or clarify any reported event or information in the mainstream media which is not general in nature and which indicates that rumours of an impending specific material event or information in terms of the provisions of this regulation are circulating amongst the investing public,

[42] Securities and Exchange Board of India, Consultation Paper on Association of SEBI Registered Intermediaries/Regulated Entities with Unregistered Entities (including Finfluencers) ¶4.3.
[43] Securities and Exchange Board of India, Consultation Paper on Association of SEBI Registered Intermediaries/Regulated Entities with Unregistered Entities (including Finfluencers) ¶4.4.
[44] Securities and Exchange Board of India, Consultation Paper on Association of SEBI Registered Intermediaries/Regulated Entities with Unregistered Entities (including Finfluencers) ¶4.4, ¶4.5.
[45] Securities and Exchange Board of India, Consultation Paper on Association of SEBI Registered Intermediaries/Regulated Entities with Unregistered Entities (including Finfluencers) ¶4.6.
[46] Securities and Exchange Board of India, Consultation Paper on Association of SEBI Registered Intermediaries/Regulated Entities with Unregistered Entities (including Finfluencers) ¶4.7.
[47] Securities and Exchange Board of India, Consultation Paper on Association of SEBI Registered Intermediaries/Regulated Entities with Unregistered Entities (including Finfluencers) ¶4.8.

as soon as reasonably possible and not later than twenty four hours from the reporting of the event or information..”[48]

This is a result of a SEBI Consultation Paper and a Board Note,[49] proposing the mandatory verification of rumours in addition to the general provision in Regulation 30(11) which permits listed entities to confirm or deny information on its own initiative.[50]

However, in a noteworthy development in SEPTEMBER 2023, SEBI sought to alter a few regulations pertaining to the verification of market rumours. In its consultation paper SEBI aimed to substitute the “material events” parameter for validating market rumours with a “material price movement in shares” criterion.[51] Furthermore, SEBI aims to introduce a mechanism to ensure that, upon confirmation of rumours, the unaltered price will be factored in for transactions involving the securities of a listed entity. This is in response to a suggestion by the Industry Standards Forum which suggested that defining materiality in terms of price movement allows for verification of rumours that “results in a sudden movement in the price of the scrips of the listed entity,” and is more relevant for the purpose of the regulation.[52]

IX. Regulatory Frameworks In Other Jurisdictions

Finfluencers mostly form part of regulatory gray areas in most jurisdictions. Some people believe that finfluencers should be unregulated in order to not “inhibit progress and innovation in the financial aspect of an economy.[53] For the purpose of this paper, I have discussed the regulatory frameworks in the US and Singapore, for equitable representation across different jurisdictions.

A. United States

[48] SEBI LODR (Second Amendment) Regulations, 2023.
[49] SEBI Board Meeting Note, *Extension of timeline for verification of market rumours by listed entities Amendment to the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015*, Dec. 7 2023 Securities and Exchange Board of India https://www.sebi.gov.in/sebiweb/about/AboutAction.do?doBoardMeeting=yes.
[50] SEBI Consultation Paper on Review of disclosure requirements for material events or information under SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.
[51] Securities and Exchange Board of India, SEBI Consultation Paper On Amendments To SEBI Regulations With Respect To Verification Of Market Rumour Dec 28. 2023.
[52] S Securities and Exchange Board of India, EBI Consultation Paper On Amendments To SEBI Regulations With Respect To Verification Of Market Rumour Dec 28. 2023.
[53] Jassmyn Goh, *Finfluencers not to be banned*, Money Mgmt, Sept. 21, 2021, https://www.moneymanagement.com.au/news/financial-planning/finfluencers-not-be-banned-hume.

The U.S has witnessed similar stock manipulation schemes. Recently for example, the Securities and Exchange Commission (SEC) in the U.S, unveiled allegations against eight individuals involved in a securities fraud scheme valuing $100 million. This scheme involved leveraging social media platforms such as Twitter and Discord to manipulate the trading of exchange-listed stocks. The accused parties purportedly engaged in the purchase of specific stocks and subsequently urged their significant social media followers to invest in these stocks through various means such as setting price targets or implying acquisition or retention of stock positions. However, the complaint posits that during the period of heightened share prices and trading volumes in the promoted securities, these individuals systematically dumped their shares without prior disclosure of their intentions to divest while promoting said securities.

In a separate incident, the SEC took legal action against public figure Kim Kardashian for allegedly engaging in the unlawful promotion of a cryptocurrency security. Kardashian opted to settle these charges, agreeing to remit $1.26 million in fees and penalties.[54]

SEC has released various investor alerts and bulletins to educate investors to not rely on social media for investing related information.[55] The Securities Exchange Act prohibits individuals fromeither directly or indirectly, with the intent, knowledge, or recklessness, to engage in fraudulent activities related to buying or selling securities. This includes employing fraudulent devices, schemes, or strategies, making false statements of material fact, or omitting material facts necessary for statements to not be misleading. Additionally, it encompasses engaging in actions or business practices that deceive certain individuals, or alternatively, aiding and abetting such violations.[56]

Section 206(4) of the Advisers Act bars investment advisors from participating, either directly or indirectly, in any activity, practice, or pattern of conduct that is deceitful, fraudulent, or manipulative.[57] Meanwhile, Rule 206(4)-8(a)(1) specifically bars advisors to pooled investment

[54] Saptaparno Ghosh, *Why did the U.S. SEC charge Kim Kardashian for 'touting' cryptocurrency?*, THE HINDU, Oct. 9, 2022 https://www.thehindu.com/business/markets/explained-why-did-the-us-sec-charge-kim-kardashian-for-touting-cryptocurrency/article65975497.ece.

[55] *Social Media and Investment Fraud – Investor Alert*, U.S SECURITIES AND EXCHANGE COMMISSION, Aug. 29, 2022 https://www.sec.gov/oiea/investor-alerts-and-bulletins/social-media-and-investment-fraud-investor-alert; U.S Securities And Exchange Commission, *Investor Bulletin: Social Sentiment Investing Tools —Think Twice Before Trading Based on Social Media*, INVESTOR.GOV Apr. 3 2019 https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-18.

[56] Exchange Act [15 U.S.C. § 78j(b)] Section 10(b) and Rule 10b-5 [17 C.F.R. § 240.10b-5].

[57] Advisers Act [15 U.S.C. § 80b6(4)] Section 206(4).

vehicles from disseminating any false statement of significant fact or neglecting to disclose a significant fact essential for ensuring that the statements made, considering the context in which they were made, do not mislead any investor or potential investor in the pooled vehicle.[58]

Interestingly, in the U.S, much like the united Kingdom, the Federal Trade Commission (FTC) has issued directives pertaining to the conduct of social media influencers when promoting products.[59] These guidelines underscore the critical significance of transparency and disclosure in sponsored content.

B. Singapore

In response to the increasing trend of security trading being influenced by online discussion forums and social media, the Monetary Authority of Singapore (MAS) and Singapore Exchange Regulation (SGX RegCo) have issued cautionary advisories to the investing public.[60] This advisory, prompted by SGX RegCo's warning on SEPTEMBER 10, 2020, regarding the prevalence of pump and dump" schemes facilitated through platforms such as Telegram chats and other social media outlets, underscores the imperative for heightened vigilance.[61]

In Singapore, the regulatory framework governing the activities of influencers primarily falls under the purview of the Singapore Code of Advertising Practice (SCAP), overseen by the Advertising Standards Authority of Singapore (ASAS). In 2016, ASAS introduced specific *Guidelines on Interaction Marketing Communication & Social Media*, a collaborative effort involving input from social media agencies, governmental bodies, multinational corporations, and the general public. These guidelines, intended to complement existing provisions within the SCAP, emphasize the importance of clear differentiation between marketing communication and personal opinions or editorial content. The overarching aim is to mitigate the risk of confusion or misrepresentation in advertising.

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[58] Rule 206(4)-8, Advisers Act [17 C.F.R. § 275.206(4)-8].

[59] FTC, *Disclosures 101 for Social Media Influencers (Federal Trade Commission)*, https://www.ftc.gov/business-guidance/resources/disclosures-101-social-media-influencers; Guides Concerning Use Of Endorsements And Testimonials In Advertising, 8 Stat. 717, as amended; 15 U.S.C. 41–58, 88 FR 48102, July 26, 2023.

[60] *MAS and SGX: Beware of risks related to trading incited by online discussions*, MONETARY AUTHORITY OF SINGAPORE, Feb. 2, 2021.

[61] *SGX RegCo warns public of pump and dump activities exploiting Telegram chats and other social media channels*, Dec. 10, 2020, SGX GROUP.

The key provisions under these Guidelines are the identification of commercial messages,[62] the distinction of all marketing communications from editorial or personal opinions,[63] and the disclosure of connections endorsers and product/service marketers that could significantly influence the endorsement's credibility or impact.[64] Guideline 3.5 further elucidates explicit mandates pertaining to disclosure. The differentiation between commercial content and personal expressions holds significance, enabling social media content to reflect the authentic sentiments of its creator.[65]

Although the Guidelines are officially not binding,[66] ASAS does have the power to request offenders to rectify or retract their promotional materials. ASAS further holds the authority to administer penalties, including the denial of advertising placements or the revocation of commercial privileges for violators. Additionally, ASAS may opt to disclose investigation outcomes, thereby publicly "naming and shaming" the advertiser and the transgression, consequently subjecting them to adverse publicity. Furthermore, ASAS may refer the case to pertinent authorities for potential legal action under the Consumer Protection (Fair Trading) Act.

Typically, actions aimed at deliberately, knowingly, or negligently distorting the genuine state of active trading, market dynamics, or prices of securities are proscribed under the Securities and Futures Act (SFA).[67] Other prohibited acts include but are not limited to the making or dissemination of false or misleading statements under Section 199,[68] fraudulent inducement to deal in securities under Section 200,[69] and the employment of manipulative and deceptive

[62] Advertising Standard Authority of Singapore, Guidelines on Interaction Marketing Communication & Social Media, Guideline 3.1.
[63] Advertising Standard Authority of Singapore, Guidelines on Interaction Marketing Communication & Social Media, Guideline 3.1(a).
[64] Advertising Standard Authority of Singapore, Guidelines on Interaction Marketing Communication & Social Media, Guideline 3.1(c).
[65] Advertising Standard Authority of Singapore, Guidelines on Interaction Marketing Communication & Social Media, Guideline 3.5.
[66] See Advertising Standard Authority of Singapore, Annex B – Guidance Notes for Interactive Marketing Communication & Social Media.
[67] Securities and Futures Act 2001 (Cap 289, 2006 Rev Ed) (Singapore).
[68] Securities and Futures Act 2001, §199 (Cap 289, 2006 Rev Ed) (Singapore).
[69] Securities and Futures Act 2001, §200 (Cap 289, 2006 Rev Ed) (Singapore).

devices under Section 201.[70] Investors should make sure they refrain from conduct that could infringe the SFA.

X. Discussion and Recommendations

A. On the rumour verification standard

Legal scholars have observed that while aligning the obligation for rumour verification with material price movements, as seen in SEBI's recent initiative, represents a positive stride, the current breadth of mainstream media definition presents concerns. They argue that the encompassing scope presently encompasses all newspapers registered with the registrar of newspapers in India, all news channels sanctioned by the Ministry of Information and Broadcasting, content published under IT rules, and analogous newspapers, content publishers, and news channels from overseas. Moreover, they state the presumption that material price movements arise from market rumours necessitates companies to conduct exhaustive scans across these outlets, potentially numbering in the thousands, to pinpoint the source of any rumour. Proposing a more delimited definition of "mainstream media" specifically tailored to recognized financial newspapers and news channels could alleviate the compliance burden on companies.[71] However, such a stance is perhaps unwarranted as this would once again remove social media platforms and chat platform such as telegram or WhatsApp groups from the ambit of scrutiny, thereby allowing finfluencers to continue exploiting in these forums.

B. Guidance & Certification, not prohibition?

Another aspect that SEBI could consider, is to provide the right guidance and support to finfluencers, instead of trying to regulate them out of the financial sector. A significant proportion of finfluencers in India lack the necessary qualifications to be recognized as advisors within the current regulatory framework. Consequently, they operate within a nebulous legal space. It is within the purview of the Securities and Exchange Board of India (SEBI) to contemplate the implementation of a regulatory structure that mandates finfluencers to undergo registration with pertinent financial regulatory entities and attain certification prior to dispensing

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[70] Securities and Futures Act 2001, §201 (Cap 289, 2006 Rev Ed) (Singapore).

[71] Manshoor Nazki, Anjali Menon & Neha Sharma, *Guardians Of Gossip: Analysing Sebi Consultation Paper On Market Rumour Verification*, INDUSLAW INFOLEX NEWSLETTER, https://induslaw.com/publications/pdf/alerts-2024/guardians-of-gossip-analysing-sebi-consultation-paper-on-market-rumour-verification.pdf.

financial advice or endorsing securities. Such regulations could be less stringent compared to those imposed on IAs and RAs, yet they would still guarantee that finfluencers possess the requisite expertise and credentials to provide reliable financial counsel to their audience, or at the very least, foster a sense of accountability. This would allow individuals genuinely providing their opinions on stocks etc., to continue to do within a regulatory safety.

In various legal jurisdictions, for instance, regulatory bodies have taken proactive steps to offer guidance to individuals creating content on social media platforms regarding financial matters, aiming to differentiate between such content and formal "financial advice." For instance, the Financial Market Authority (FMA) in New Zealand has published a comprehensive guide titled "Guide to Talking About Money Online," aimed at assisting both consumers and social media influencers in navigating associated risks effectively.[72] Similarly, the European Securities and Markets Authority (ESMA) has issued a notable statement addressing "Investment Recommendations on Social Media," wherein they elucidate the concept of investment recommendations, appropriate methodologies for disseminating them via social media channels, and delineate the repercussions of contravening the EU Market Abuse Regulation.[73] dopting a parallel stance, regulatory bodies in the Asia Pacific region, such as the Australian Securities and Investments Commission (ASIC), have embarked upon analogous initiatives. ASIC's information sheet (INFO 269) targets social media influencers discussing financial products and services, emphasizing compliance with pertinent legislation and regulations.[74] Furthermore, it furnishes practical illustrations and case studies to underscore potential breaches, thereby serving as a deterrent to unlicensed financial influencers from engaging in finance-centric content creation, given the stringent penalties stipulated under the Corporations Act 2001. And as already discussed before, it is pertinent to revisit the MAS'S warnings against the dissemination of misleading statements or engaging in activities tantamount to market abuse

[72] *A guide to talking money online*, FINANCIAL MARKET AUTHORITY, Jun. 28 2021, https://www.fma.govt.nz/library/articles/guide-to-talking-about-money-online/

[73] *ESMA's Statement on Investment Recommendations on Social* Media,EUROPEAN SECURITIES AND MARKET AUTHORITY, Oct. 28, 2021, https://www.esma.europa.eu/sites/default/files/library/esma70-154-2780_esmas_statement_on_investment_recommendations_on_social_media.pdf; Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC Text with EEA relevance.

[74] *Discussing financial products and services online, Information Sheet 269,* AUSTRALIAN SECURITIES & INVESTMENT COMMISSION, https://asic.gov.au/regulatory-resources/financial-services/giving-financial-product-advice/discussing-financial-products-and-services-online/

under prevailing securities laws, reinforcing the imperative for conscientious content creation practices across digital platforms.[75]

At the same time, it is imperative to enlighten investors regarding the hazards linked with stock speculation fuelled by social media and underscore the significance of conducting comprehensive research prior to investment commitments. Through advocacy for financial literacy and proactive awareness initiatives, regulatory bodies can furnish investors with the tools to make discerning decisions and counteract the impact of deceptive strategies.

C. Stricter rules for Social-Media Platforms

Should SEBI choose to impose certification standards on financial influencers at a level lower than those applicable to IAs and RAs, it could potentially instruct social media platforms to designate accounts created for discussing financial matters, particularly stocks, and necessitate these accounts to register with evidence of the requisite certification. Without such categorisation, social media platforms could implement AI-driven mechanisms to remove posts regarding stocks from accounts not designated for such discussions. This approach would alleviate the necessity for human review of such content. Social media platforms could be compelled to adhere to these directives, with the possibility of facing legal consequences and losing their safe harbour protections if they fail to comply.

D. Strengthening Market Surveillance

The potential of finfluencers to manipulate stock markets has become a significant concern for regulators, corporates, and investors alike. Surveillance cells play a pivotal role in detecting any suspicious or manipulative activities in the stock market. With the increasing use of social media platforms for stock recommendations and market speculation, it’s essential for surveillance teams to be equipped with the necessary tools and technologies to identify potential instances of market manipulation promptly. Once suspicious activities are flagged, it's imperative for surveillance teams to investigate them promptly. Timely investigation can help mitigate the impact of fraudulent activities on the market, thereby reducing trading risks and restoring investor confidence. By closely monitoring trading activities and enforcing regulations, surveillance cells help maintain market integrity and level the playing field for all investors. This,

[75] *MAS and SGX: Beware of risks related to trading incited by online discussions*, MONETARY AUTHORITY OF SINGAPORE, Feb. 2, 2021.

in turn, fosters a more transparent and fair market environment. Ultimately, fostering responsibility and accountability within surveillance cells serves to safeguard the interests of investors..

To achieve this goal, sophisticated AI and machine learning algorithms into SEBI's surveillance framework is crucial. These algorithms can continuously monitor various digital platforms, including social media and news outlets, to detect any signs of suspicious activities or market manipulation. By analysing vast datasets in real-time, such systems can uncover patterns indicative of market manipulation, enabling timely regulatory action.

Furthermore, the adoption of advanced Natural Language Processing (NLP) techniques can empower SEBI to extract sentiment, context, and intent from discussions on social media and news articles related to stocks. This enhanced understanding of language nuances used by influencers and traders enables regulatory bodies to identify potential instances of market manipulation with greater precision and accuracy.

E. Conclusion

This paper has delved into the intricate interplay among social media, influencers in finance, and potential market manipulation, shedding light on the evolving challenges and regulatory responses across India, the United States, and Singapore. By reinforcing the core argument that the emergence of financial influencers presents considerable regulatory hurdles, this examination underscores the critical need to address the risks associated with market manipulation driven by social media. The discourse has amalgamated crucial insights, encompassing the prevalence of schemes like pump-and-dump, the regulatory frameworks across different jurisdictions, and suggestions for bolstered oversight and surveillance of markets. The importance of this subject matter resides in its implications for safeguarding investors, maintaining market integrity, and sustaining the broader financial ecosystem.

Looking ahead, collaborative endeavours involving regulators, industry participants, and technology providers are indispensable for effectively mitigating risks and nurturing a transparent and fair financial environment. With the ongoing digital transformation reshaping financial landscapes, sustained vigilance and proactive regulatory interventions are vital for navigating the intricacies of market dynamics influenced by social media.

Aishwarya Mathanan, *Using Vostro Accounts To Internationalize The Rupee And Decrease Trade Risk: An Analysis Of Indo-Russian Trade Through The Lens Of Banking Relationships,* 11 (2) SCHOLASTICUS 54 (2024).

USING VOSTRO ACCOUNTS TO INTERNATIONALIZE THE RUPEE AND DECREASE TRADE RISK: AN ANALYSIS OF INDO-RUSSIAN TRADE THROUGH THE LENS OF BANKING RELATIONSHIPS

Aishwarya Mathanan[*]

ABSTRACT

The financial world has become staggeringly dependent on the U.S. dollar for international transactions, with most nations using the currency to carry out trades to which the United States is not even a party. The same holds true for the vast majority of Indo-Russian trade. However, in light of the sanctions placed on Russia by the United States for the former's actions against Ukraine, the dominance of the dollar carries negative implications for the economic relationship between India and Russia. Though the Reserve Bank of India has promoted the decentralisation of the dollar and the use of Vostro Accounts to carry out Indo-Russian trade without fear of secondary sanctions, these accounts present a host of practical difficulties which act as deterrents to their use. This work analyses the significance of the trading relationship between India and Russia, the impact Western sanctions could have, and the issues posed by Vostro Accounts to propose a viable way forward.

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I. Chapter 1: Introduction and Research Design

A. Introduction

Dollar dependency is at the core of present-day international trade. The majority of international trade occurs and is invoiced in certain "dominant currencies".[1] This is now known as the Dominant Currency Paradigm, with the most dominant currency globally being the U.S. Dollar USD, which accounted for over 98% of all exports as of 2017[2]. However, with the dominance of the U.S. Dollar (USD) comes the dependence of the international community on USD when it comes to invoicing international transactions, even when these transactions do not involve the United States of America.[3]

In the case of India, 86% of its imports are invoiced in USD, despite only 5% of these imports originating in the United States. Conversely, 86% of India's exports are invoiced in USD, despite only 15% of these exports being made to the United States.[4] This leaves a total of 81% of Indian imports and 71% of exports being invoiced in USD despite not involving the United States at all. The same holds true for bilateral trade between India and Russia.

As per the Indian Embassy in Moscow, both countries aim to increase bilateral investment to $50 billion USD and bilateral trade to $30 billion USD by the year 2025.[5] However, the case of India and Russia in the contemporary context is unique. As of the 2022/23 financial year, Russia was the biggest exporter of fertiliser to India, exporting a record 4.35 million tonnes of fertiliser at high discounts. Though this may decrease due to tightening global

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[1] Gita Gopinath, *'The International Price System',* in *Jackson Hole Symposium*, Federal Reserve Bank of Kansas City (2015), 2015-jackson-hole-gopinath-the-intl-price-system.pdf (hereinafter 'Gopinath').

[2] Camila Casas, Federico J. Díez, Gita Gopinath and Pierre-Olivier Gourincha,*Dominant Currency Paradigm: A New Model for Small Open Economies*, IMF Working Paper (2017)(hereinafter 'Casas').

[3] L. Goldberg, and C. Tille, *The International Role of the Dollar and Trade Balance Adjustment*, NBER Working Paper No. 12495, National Bureau of Economic Research (2006), (hereinafter 'Goldberg and Tille').

[4] Gopinath, G. *Dollar dominance in trade: Facts and implications*, India ExImBank, https://www.eximbankindia.in/blog/blog-content.aspx?BlogID=9&BlogTitle=Dollar+Dominance+in+Trade%3A+Facts+and+Implications#:~:text=Dollarization%20of%20International%20Finance%3A%20The,global%20currency%2C%20such%20as%20euros (last visited on 18 January 2024).

[5] *Tea Board of India, Moscow: Brief on Russia-India Economic Relations*, Embassy of India, Moscow (Russia), https://indianembassy-moscow.gov.in/overview.php (last visited on: 18 January 2024).

supply of fertiliser and Russian companies returning to par values with the market[6], Russia remains a vital supplier of fertiliser to India's vast farming sector.[7]

The issue then stems from the sanctions imposed on Russia by the West for its invasion of Ukraine. US Secondary Sanctions prohibit trading in USD with countries, organisations, and individuals under the US Sanctions Regime.[8] If and when Western sanctions against Russia become stricter, the transactions between India and Russia cannot be settled in US Dollars. It is for this reason that the RBI identified the internationalisation of the Rupee as the need of the hour.[9]

One mechanism which the RBI has permitted as a means of allowing the internationalisation of the Rupee is the opening of "Vostro Accounts", which a domestic bank holds in the name of a foreign bank with denominations in the currency of the domestic bank, in order to help facilitate trade. The RBI allowed banks in multiple partner countries, including Russia, to open such Vostro Accounts with 14 Indian banks, including the State Bank of India, HDFC Bank, Canara Bank, UCO Bank, and Yes Bank.[10] However, reluctancy to use Vostro Accounts on the part of Russian entities as well as concerns regarding repatriation of the rupee amounts in Vostro Accounts without attracting penalties as a result of sanction are crucial issues to be addressed.

This paper uses a doctrinal methodology of research to achieve three main objectives. The first is to understand the trading relationship between India and Russia in the context of the U.S. Dollar as a dominant currency and the effects of dependency on the U.S. dollar. The second is to critically analyse the scheme of internationalisation of the Rupee adopted by the Indian government and how this aids in circumventing Western sanctions to protect the economic interests of India and Russia. The third is to evaluate the regulations balancing the

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[6] Rajendra Jadhav & Polina Devitt, *Exclusive: Russian sellers stop fertiliser discounts to India*, Reuters (12 September 2023), https://www.reuters.com/world/india/russian-sellers-stop-fertiliser-discounts-india-sources-2023-09-12/#:~:text=India's%20fertiliser%20imports%20from%20Russia,DAP%2C%20urea%20and%20NPK%20fertilisers (last visited on 18 January 2024).

[7] Rajendra Jadhav, Nupur Anandand Aftab Ahmed, *India Explores Setting up Rupee Trade Accounts With Russia to Soften Sanctions Blow*, The Wire (25 February 2022), Available at: https://thewire.in/world/india-explores-setting-up-rupee-trade-accounts-with-russia-to-soften-sanctions-blow (last visited on 18 January 2024) (hereinafter 'Jadhav *et al.*').

[8] Rawi Abdelal and Aurèlie Bros, *The End of Transatlanticism?: How Sanctions Are Dividing the West*, 16 Horizons: Journal of International Relations and Sustainable Development 114, 114–135 (2020).

[9] V.B. Sharma, *'Explainer: How Feasible Is RBI's Push to Settle International Trade in Rupees?'*, The Wire (10 January 2023), https://thewire.in/economy/explainer-rbi-rupee-settlement-international-trade (last visited on18 January 2024).

[10] Amit Sen, *RBI speeds up bank approval for Russian rupee trade but exporters face issues*, The Hindu Business Line (20 SEPTEMBER 2022), https://www.thehindubusinessline.com/economy/rbi-speeds-up-bank-approval-for-russian- rupee-trade-but-exporters-face-issues/article66285696.ece#:~:text=To%20give%20a%20boost%20to,with%20correspondent%20banks%20in%20Russia (last visited on 18 January 2024).

role of Indian and Russian banks in bilateral trade and the prevention of violation of Western sanctions against Russia.

II. CHAPTER 2: DOLLAR DEPENDENCY IN INDO-RUSSIAN TRADE

The relationship between India and Russia is one of significant political and economic importance. In October of 2010, the Declaration on the India-Russia Strategic Partnership was signed, and this was further elevated to a Special and Privileged Strategic Partnership in SEPTEMBER 2010.[11] Russia is one of India's most crucial trade partners, rising from India's 25th largest trading partner in 2020- 2021 to 7th largest in 2021-2022[12] to 4th largest in 2022-2023[13].

A. Beneficial Ties In Global Politics

While the United States is currently the only superpower country in the world,[14] Russia[15] and India[16] have consistently been discussed among the handful of countries discussed academically as possessing the potential to attain superpower status. Many scholars argue that Russia already is a superpower.[17]

The partnership between India and Russia is based on mutual benefit and trust. A sort of alliance between the two countries allows for India to enjoy the leverage that comes with having the support of a major global power and gives Russia a foothold to go toe-to-toe with American and Chinese dominance in Asia.[18] Russia has taken the stance that India's abrogation of Article 370 of the Indian Constitution and the bifurcation of the Jammu and Kashmir into Jammu and Kashmir as well as Ladakh is a "purely internal matter" which need to be resolved as per the Shimla Agreement of 1972 and the Lahore Declaration of

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[11] *Bilateral Relations: India-Russia Relations,* Embassy of India, Moscow (Russia),https://indianembassy-moscow.gov.in/bilateral-relations-india-russia.php (last accessed on 18 January 2024).
[12] Hariah Sharma, *India-Russia trade soars to record high as imports of oil and fertiliser drive surge*, The Indian Express (21 October 2022), https://indianexpress.com/article/india/india-russia-trade-soars-to-record-high-as-imports-of-oil-and-fertiliser-drive-surge-8221831/ (last visited on 19 January 2024).
[13] *Russia becomes India's fourth-largest trading partner, imports jump 5-fold*, Business Standard (12 January 2023),. https://www.business-standard.com/article/economy-policy/russia-becomes-india-s-fourth-largest-trading-partner-imports-jump-5-times-123011700291_1.html (last visited on 19 January 2024).
[14] George C. Herring, *From Colony to Superpower: U.S. Foreign Relations Since 1776 Vol 1* (Oxford University Press 2011).
[15] Steven Rosefielde, *Russia in the 21st Century: The Prodigal Superpower* (Cambridge University Press 2005).
[16] Ruth Meredith, *The Elephant and the Dragon: The Rise of India and China and What it Means for All of Us* (WW. Norton 2008).
[17] Robert Steel, *A Superpower is Reborn*, The New York Times (24 August, 2008), https://www.nytimes.com/2008/08/24/opinion/24steel.html?_r=0 (last visited on 20 January 2024).
[18] Saurav Sen, *Why is India standing with Putin's Russia?*, Al Jazeera (14 March, 2022), https://www.aljazeera.com/opinions/2022/3/14/why-is-istandwithputin-trending-in (last visited on 20 January 2024) (Hereinafter 'Sen').

1999. It has vetoed UN Security Council Resolutions seeking UN intervention in Kashmir in 1957, 1962, and 1971, thereby preventing the internationalisation of the matter.[19]

Similarly, rather than condemn the war between Russia and Ukraine like many other major democracies and major allies of the United States, India has "adopted a studied public neutrality toward Russia".[20] India was joined only by China and the United Arab Emirates in abstaining from voting on a Draft Resolution of the UN Security Council submitted by Albania and the United States, which aimed at ending the military offensive of Russia in Ukraine.[21]

B. Trade AND Economic Cooperation

A strong economic relationship helps maintain a strong political relationship, and *vice versa*. Thus, the Indo-Russian relationship can also be examined in economic terms. Apart from political strategy, bilateral cooperation and collaboration on economic matters are one of the key underpinnings of the alliance between India and Russia.[22]

Trade with Russia amounted to $7.5 billion USD in 2009 and has now seen a tremendous increase to approximately $50 billion USD in 2023.[23] Between April and September of 2023, Indian imports from Russia rose by a staggering 67%, largely due to the import of crude oil and fertilisers. This put Russia in the position of being India's second-largest importer during the first half of that Fiscal Year.[24]

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[19] D.R. Chaudhury, *Russian support to India on Kashmir is rooted in history*, The Economic Times (20 January, 2020), https://economictimes.indiatimes.com/news/politics-and-nation/russian-support-to-india-on-kashmir-is-rooted-in-history/articleshow/73411150.cms?from=mdr (last visited on 20 January 2024).

[20] A.J. Tellis, *"What Is in Our Interest": India and the Ukraine War*, Carnegie Endowment for International Peace (Apr. 25, 2022), https://carnegieendowment.org/2022/04/25/what-is-in-our-interest-india-and-ukraine-war-pub-86961 (last visited on Jan. 20, 2024).

[21] *India Abstains in U.N. Vote Underscoring Need for Just, Lasting Peace in Ukraine*, The Hindu (Feb. 24, 2023), https://www.thehindu.com/news/international/india-abstains-in-un-vote-underscoring-need-for-just-lasting-peace-in-ukraine/article66546740.ece (last visited Jan. 20, 2024).

[22] Sen, *supra* note 18.

[23] Sandeep Mattoo & Rishabh Kundu, *India-Russia Trade Doubled to Nearly $50 Billion in Jan-Sept: Russian Ambassador*, The Mint (Dec. 8, 2023), https://www.livemint.com/news/india/indiarussia-trade-doubled-to-nearly-50-billion-in-jan-sept-russian-ambassador-11702044475944.html (last visited Jan. 20, 2024).

[24] *Imports from Russia Up 67% in Apr-Sep on Higher Shipments of Oil: Govt Data*, Business Standard (Oct. 13, 2023), https://www.business-standard.com/economy/news/imports-from-russia-up-67-in-apr-sep-on-higher-shipments-of-oil-govt-data-123101301366_1.html (last visited on Jan. 20, 2024).

According to the Export Import Data Bank of the Indian Ministry of Commerce, Russian imports to India grew by 368.21% from the 2021-2022 Fiscal Year to the 2022-2023 Fiscal Year. As of 2023, Russian imports alone constitute a massive 6.45% of all Indian imports.[25]

C. USD And The Dominant Currency Paradigm

The precursory Mundell-Fleming Model put forth the assumption of Producer Currency Pricing in international trade.[26] However, the majority of international trade occurs and is invoiced in certain "dominant currencies", the most dominant currency globally being the U.S. Dollar (USD).[27] Studies have shown that the value of the currency of a country relative to the U.S. Dollar is one of the key drivers of the prices and quantities of imports in that country, regardless of where the goods being imported originate from.[28]

The USD generally has had the deepest and most liquid market in the past few decades. This means that the transaction costs will be lesser when invoicing in USD as opposed to invoicing in other currencies, making the USD a superior invoicing currency in terms of the Theory of Invoice Currency Selection.[29] Further, some currencies such as the USD are used in particular industries where homogenous goods are traded in specialised markets such that the selected currency will carry minimal transaction costs.[30] This is what causes the USD to act as a "vehicle currency". This means that even non-dollar economies will transact in the USD indirectly rather than through their own currencies in the form of direct bilateral trade as this will help mitigate transaction costs of exchange.[31]

The same holds true in the case of trade effected between India and Russia. The biggest exports coming to India from Russia are crude oil and fertiliser. These were originally traded in USD due to the specialised markets in which crude oil and fertiliser were traded as well

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25 *Export Import Data Bank – Russia*, Dept. of Commerce, Ministry of Commerce & Industry (2024), https://tradestat.commerce.gov.in/eidb/iecnt.asp (last visited Feb. 16, 2024).

26 Robert A. Mundell, *Capital mobility and stabilization policy under fixed and flexible exchange rates*, 29(4) Canadian Journal of Economics and Political Science 475,. 475-485 (1963); James M. Fleming, *Domestic financial policies under fixed and floating exchange rates*, 9 IMF Staff Papers369,369-379 (1962).

27 Gopinath, *supra* note 1.

28 Casas, *supra* note 2.

29 Goldberg and Tille, *supra* note 3.

30 Robert McKinnon, *Money in International Exchange: The Convertible Currency System* (Oxford University Press, 1979)
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31 M.B. Devereaux & S. Shi, *Vehicle Currency*, 54 Int'l Econ. Rev. 97, 97-133 (2013).

as owing to the low transaction costs associated with trading in the USD.[32] This created a dollar dependency within Indo-Russian transactions.

III. CHAPTER 3: THE IMPACT OF WESTERN SANCTION

The criticality of Indo-Russian economic ties paired with the dependency of transactions on the US Dollar culminated in a dire situation for India and Russia's trade relations in the wake of the Russia-Ukraine war.

A. Russia-Ukraine War

The war between Russia and Ukraine is an international conflict that started on February 20, 2014, with the Russian annexation of Crimea.[33] For a long time, the war consisted mainly of political tension, naval incidents, and cyber warfare. In early 2021, Russia began building up its military presence at the border of Russia and Ukraine.[34] However, it was in February of 2022 that Russia launched a full-scale invasion of Ukraine and began to occupy Ukrainian territory as part of a "special military operation" to "demilitarise and denazify" Ukraine.[35]

B. Global Reaction

The actions of Russia were condemned by a host of countries, particularly those in the West. This led to the imposition of sanctions on Russia, which in turn had far-reaching effects on the Russian economy and the global economy as a whole.

While there were already sanctions that had been in place since the annexation of Crimea, these sanctions became harsher in the wake of the Russian invasion of Ukraine. The United States, the European Union, and other countries, which form the Western Bloc, imposed various economic sanctions on Russia.

i. Expulsion Of Russian Banks From SWIFT

SWIFT is a network where over 11,000 financial institutions in over 200 countries and territories around the world communicate with each other on financial transactions and

[32] S.G. Chortane & D.K. Pandey, *Does the Russia-Ukraine War Lead to Currency Asymmetries? A US Dollar Tale*, The Journal of Economic Asymmetries, 26 (2022)
[33] John Cosgrove, *The Russian Invasion of the Crimean Peninsula 2014–2015: A Post–Cold War Nuclear Crisis Case Study*, Johns Hopkins National Security Report (2020)
[34] Shuster, Simon, *The Untold Story of the Ukraine Crisis*, TIME (Feb. 2, 2022), https://time.com/6144109/russia-ukraine-vladimir-putin-viktor-medvedchuk/ (last visited Jan. 20, 2024).
[35] A. Osborn & P. Nikolskaya, *Russia's Putin Authorises 'Special Military Operation' Against Ukraine*, Reuters (Feb. 24, 2022), https://www.reuters.com/world/europe/russias-putin-authorises-military-operations-donbass-domestic-media-2022-02-24/ (last visited on Jan. 20, 2024).

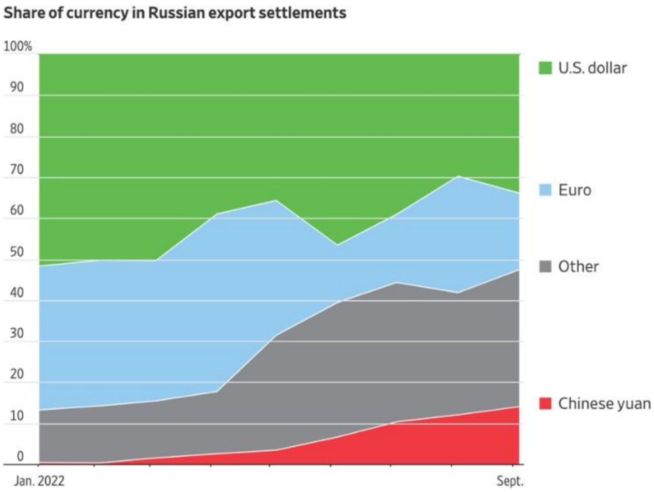
carry out payments.[36] Sanctions expelling select Russian Banks from SWIFT (Society for Worldwide Interbank Financial Telecommunications) have been implemented as a way to cut Russia off from the international financial system and harm their global operations.[37] This makes it significantly more difficult for Russia to obtain foreign currency and transfer assets abroad cost-efficiently. It also makes it harder for Russia to export oil and gas.[38]

ii. CBR Freeze

The sanctions have also hit the Central Bank of the Russian Federation (CBR). After the first set of sanctions came into place in 2014, Russia has been shoring up $630 billion USD in international reserves consisting of assets such as currency and gold.[39] The sanctions prevent the CBR from accessing the assets and reserves it has stored in the Central Banks and private institutions of various places, such as the US, the UK, and the European Union. This could have a significant effect on the Russian currency exchange rate's stability as well as Russia's ability to use foreign assets to mitigate the effect of other sanctions.[40]

C. Ramifications of Sanction

Due to the sanctions imposed by the West, Russia began to find ways to cut its dependence on the dollar. Though this began in 2014, Russia started selling its U.S. Treasury Bonds in 2018 and started looking into trading in other currencies. After the latest set of sanctions, particularly with regard to SWIFT and the CBR freeze on foreign reserves, Russia began its process of de-dollarization in earnest. This is an



Note: 'Other' category is primarily made up of Russian ruble settlements.
Source: Central Bank of Russia

[36] *About Us*, Swift, https://www.swift.com/about-us (last visited on 21 January 2024).
[37] Katherine Collins, Peter Mattingly, Kirsten Liptak, & Jeremy Judd, *White House and EU Nations Announce Expulsion of 'Selected Russian Banks' from SWIFT*, CNN (Feb. 26, 2022), https://edition.cnn.com/2022/02/26/politics/biden-ukraine-russia-swift/index.html (last visited Jan. 21, 2024)
[38] M. Thompson, A. Chernova & V. Cotovio, *Russia Faces Financial Meltdown as Sanctions Slam Its Economy*, CNN (Feb. 28, 2022), https://edition.cnn.com/2022/02/28/business/russia-ruble-banks-sanctions/index.html (last visited Jan. 21, 2024).
[39] *Id.*
[40] Carmine Girardone, *Russian Sanctions and the Banking Sector*, 33 British J. Mgmt. 1683, 1683–99 (2022)

extremely arduous process owing to the high share of the USD as currency in Russian export settlements.[41]

Though there is no explicit ban on the use of USD, and some banks that have not been sanctioned continue to operate using the USD and the Euro, Russian financial institutions have turned away from the USD as a means of protection from further damage to the economy. However, according to Daniel McDowell, while this may have a significant impact at the moment, this will lead to a more fractured system in the long term, making the U.S.'s ability to use financial sanction as a weapon less effective.[42]

However, de-dollarization does present challenges in the shortterm when it comes to finding alternative methods and boosting trade to counteract the effects of Western sanctions in Russia. Therefore, this has implications for all countries trading with Russia, including India.

IV. CHAPTER 4: VOSTRO ACCOUNTS TO MITIGATE SANCTIONS

A. Internationalisation Of The Rupee

While the rest of the world stopped buying oil from Russia, India (which has historically been a leader in the neutral "Non-Aligned Movement") started buying more at immense discounts, which saved India about $2.7 billion USD in the first 9 months of 2023 alone.[43] Despite the sanctions of the West not including oil, India faced severe international criticism for this move and Indian entities became apprehensive of being hit with secondary sanctions by the West.[44]

After sanctions were imposed on SPB, the second-largest Russian Stock Exchange, even the Moscow Exchange has said that it would halt trading in USD should sanctions be imposed

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[41] Christopher Dulaney, Evan Gershkovich & Veronika Simanovskaya, *Russia Turns to China's Yuan in Effort to Ditch the Dollar*, The Wall Street Journal (Feb. 28, 2023), https://www.wsj.com/articles/russia-turns-to-chinas-yuan-in-effort-to-ditch-the-dollar-a8111457 (last visited Jan. 21, 2024).

[42] David McDowell, *Bucking The Buck: US Financial Sanctions & International Backlash against the Dollar* (Oxford University Press 2023)

[43] N. Verma, *Russian Oil Shaves India's Import Costs by About $2.7 Bln*, Reuters (Nov. 9, 2023), https://www.reuters.com/business/energy/russian-oil-shaves-indias-import-costs-by-about-27-bln-2023-11-08/ (last visited on Jan. 22, 2024).

[44] Amit Sen, *With RBI Allowing Trade Settlement in Re, India, Russia Can Set Up Banking Structure*, The Hindu Business Line, (July 12, 2022), https://www.thehindubusinessline.com/economy/rbi-framework-in-place-india-russia-to-speed-up-banking-arrangement-for-rupee-denominated-trade/article65631845.ece (last visited on Jan. 22, 2024).

upon it.[45] This shows the possibly imminent need for some other way to trade. This is where India comes into the picture.

The problem of secondary sanction would only arise if foreign currency was used in these transactions. This is why India, specifically the Reserve Bank of India, has been pushing for the internationalisation of the rupee[46] by increasing its use in cross-border transactions of both export and import, using the rupee in capital account transactions, and using the rupee in other current account transaction. This would mitigate the currency risk faced by Indian businesses, reduce the need for India to hold foreign exchange reserves, reduce the dependence of India on foreign currency such as the dollar, and increase Indian bargaining power in global business.[47] The RBI has gone so far as to say that the internationalisation of the rupee is inevitable.[48]

B. Creation Of Vostro Accounts

One way in which India is promoting the internationalisation of the rupee is by permitting the invoicing, payment, and settlement of Indian exports and imports via rupee vostro accounts with overseas banks.[49]

The word "vostro" is derived from the Latin word meaning "your". In the case of India and Russia, this would act as a guarantee of payment when a trade was executed but it is too risky to used USD.[50] As per the 2022 RBI Circular authorizing the creation of Vostro Accounts, Authorized Dealer (AD) Banks which have been authorized by the Foreign

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[45] Reuters, *Moscow Exchange Would Halt USD Trading If Sanctions Imposed*, Reuters (Dec. 5, 2023), https://www.reuters.com/markets/currencies/moscow-exchange-would-halt-usd-trading-if-sanctions-imposed-2023-12-05/ (last visited Jan. 23, 2024).

[46] Shaktikanta Das, *Globalising Rupee Will Help Derisk Trade*, *The Times of India* (Jan. 17, 2024), https://timesofindia.indiatimes.com/business/india-business/globalising-rupee-will-help-derisk-trade-shaktikanta-das/articleshow/106911340.cms?from=mdr (last visited Jan. 22, 2024)

[47] T.R. Sankar, *Internationalisation of the Rupee: Is it Time to Shift Gears?*, Annual Day Event of the Foreign Exchange Dealers Association of India (FEDAI) at Mumbai (Oct. 21, 2022), https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1331 (last visited Jan. 22, 2024).

[48] Amit Roy, *Internationalisation of the Rupee is 'Inevitable,' Says RBI Report*, Business Standard (Feb. 26, 2021), https://www.business-standard.com/article/economy-policy/internationalisation-of-the-rupee-is-inevitable-says-rbi-report-121022601459_1.html (last visited Jan. 22, 2024)

[49] D. Vasudevan, *India's Rupee Trade Bid and the Math Behind It*, Mint (Jan. 22, 2023), https://www.livemint.com/news/india/indias-rupee-trade-bid-and-the-math-behind-it-11674411113278.html (last visited on Jan. 22, 2024).

[50] Jadhav *et al*., *supra* note 7.

Exchange Department of the RBI to open Rupee Vostro Accounts in India and Special Rupee Vostro Accounts of correspondent banks of partner trading countries.[51]

The mechanism can be explained as follows: Say a non-sanctioned Russian bank such as Gazprom opens a vostro account in an Indian Bank such as SBI. This means that Gazprom will maintain a certain amount in rupees in this account. When an Indian importer buys something from Russia, the payment made goes into the vostro account of Gazprom. When an Indian exporter sells something to Russia, Russia will pay the exporter from the vostro account of Gazprom. Thus, the entire set of transactions takes place in rupees and no currency exchange is required.

As there is no foreign currency such as USD which forms a part of this transaction, the Indian apprehension of facing secondary sanction by the West is eliminated.

As of early 2023, there were 20 Russian Banks (including Gazprom, Rosbank, and Credit Bank of Moscow) have opened rupee vostro accounts with AD banks in India such as SBI, Axis Bank, and UCO Bank.[52]

C. Practical Constraints

Though vostro accounts seem like a perfect solution, there are certain issues arising from the use of vostro accounts in practice.

i. Vostro Account Surplus Balance

Russia exports much more to India than it imports from India. This means that it's vostro accounts will have a Rupee surplus balance. However, as per the 2022 RBI Circular, this surplus balance can only be used for specific purposes such as projects and investments, export/import advance flow management, and investment in Government Treasury Bills or Securities in line with Indian law.[53]

Though this is a benefit for India, Russian counterparts may see it as less than ideal. India's tremendous amounts of oil imports in the time since these vostro accounts have

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[51] Reserve Bank of India, *International Trade Settlement in Indian Rupees (INR)*, RBI/2022-2023/90, A.P. (DIR Series) Circular No. 10 (July 11, 2022), https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12358&Mode=0 (last visited Jan. 18, 2024) (hereinafter *Circular No. 10*).
[52] Arvind Sen, *20 Russian Banks Open Rupee Vostro Accounts for Trade with India*, The Hindu Business Line (Feb. 15, 2023), https://www.thehindubusinessline.com/money-and-banking/hdfc-bank-uco-among-20-banks-to-open-special-vostro-accounts-for-trade-in-rupee/article66512538.ece (last visited Jan. 24, 2024).
[53] Circular No. 10, *supra* note 51.

been created essentially counteracts the vostro account system.[54] Over time, it will result in the accumulation of rupees in the vostro account of Russia. However, owing to the fact that the rupee is not yet an international currency, Russia stands to gain very little from this accumulation when its Indian exports are significantly higher than its imports and the rupee surplus cannot be spent beyond what is outlined in the RBI Circular. Russia would prefer payment in Yuan, which is still closer to an international currency than the rupee and would prove more useful if and when accumulated.[55]

ii. Repatriation of Amounts

In September of 2022, multiple banks reached out to the RBI to clarify concerns regarding issues such as:

- the repatriation of rupee amounts that were accumulated in the vostro account without penalty when the bank is from a country facing international sanction such as Russia
- the transfer of government securities which were purchased by the correspondent bank via the accumulated rupee surplus in the vostro account to buyers

The banks represented that, despite the RBI's assurances, they remained reluctant to open up vostro accounts for fear of getting hit by the sanctions on Russia. The banks stated that they "expect RBI to give some clarity so that there is a regulatory comfort before we implement this mechanism".[56]

V. CHAPTER 5: CONCLUSION AND SUGGESTIONS

The economic relations between Russia and India are extremely crucial, especially in the context of Russian imports to India such as oil and fertiliser without which the economy of India would suffer great losses. However, the dependency on the dollar as the currency used in trade between the two countries has the power to jeopardize both economies when viewed at in the context of Western sanctions against Russia in light of the Russia-Ukraine war.

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[54] *Why Russian Exporters Are Reluctant to Use Vostro Facility to Invest Rupees in Indian Markets*, The Wire (May 1, 2023), https://thewire.in/trade/russian-exporters-vostro-facility-rupees-indian-markets (last visited on Jan. 25, 2024)

[55] Nidhi Verma & Aftab Ahmed, *Exclusive: As India Frowns on Paying for Russian Oil with Yuan, Some Payments Held Up*, Reuters (Oct. 16, 2023), https://www.reuters.com/markets/commodities/india-frowns-paying-russian-oil-with-yuan-some-payments-held-up-sources-say-2023-10-16/ (last visited on Jan. 23, 2024).

[56] D. Tiwari & J. Rebello, *Re Vostro Accounts: Banks Move RBI, Flag Grey Areas*, The Economic Times (Sept. 16, 2022), https://economictimes.indiatimes.com/news/economy/finance/re-vostro-accounts-banks-move-rbi-flag-grey-areas/articleshow/94233388.cms?from=mdr (last visited on Jan. 25, 2024).

Economic sanctions, particularly with regards to the banking sector, are one very important form of sanction adopted by the Western bloc. This has included the expulsion of Russian banks from using SWIFT as well as freezing the foreign reserves of the Central Bank of the Russian Federation. This tactic has been employed because banks are at the heart of every economy, including that of Russia. Thus, it follows that the way to soften the effects of the sanctions imposed on Russia also lies in the hands of the banks.

India, being a close partner of Russia, also has to be wary of Western sanction. Thus, both countries have a mutual desire to find ways to avoid trading in USD, the use of which the Western bloc has the power to curtail. It is for this reason that the Indian government has been promoting the internationalisation of the rupee through the opening of vostro banks to protect from the risk of the economic effects of sanction on Russia. Though vostro banks to eliminate the threat of facing secondary sanction, they come with their own problems such as an accumulated rupee surplus balance in the vostro accounts of Russian correspondent banks and apprehension of secondary sanction when dealing with the repatriation of funds which accumulate in these accounts or when Russia sells Government Securities or Treasury Bonds which it purchases using this rupee surplus balance.

These issues can be solved by adopting a hybrid model.

Firstly, rather than making the entirety of the payment for exports to Russia in rupees, India can pay in a combination of rupees along with some other currency such as yuan, Euro, or even the dollar depending on the stability of the political requirement. This will still achieve the aim of reducing transaction costs while also helping ensure that rupee amounts do not unnecessarily accumulate to a level which is obscenely beyond that which Russia requires to pay for its imports from India.

Secondly, issue of repatriation and regulation of sale of Government Securities or Treasury Bonds lies entirely in the hands of the RBI. Banks are not opposed to utilizing these vostro accounts, they are merely looking for clarification on the regulatory mechanisms in place so that they can ensure they are not slapped with secondary sanctions and have to face hurdles in their own profitability. As the rupee is fully convertible in a Current Account and partially convertible in a Capital Account, a hybrid payment system for Indian imports from Russia alone and a purely rupee-based payment system for Indian exports to Russia would allow for the repatriation of the amount in the vostro account.

Thus, the vostro account mechanism implemented by India and Russia to facilitate trade even while Russia is under sanction is a good strategy to soften the blow of the sanctions. However, the key is to use the vostro accounts in such a way that their effects are not countered by the sheer volume of import and export of the two countries. This is where the role of the banks and the RBI comes in when effecting payments by the use of vostro accounts. A hybrid payment system for Indian imports alone would greatly reduce the practical issues caused by vostro accounts in the particular case of India and Russia. This would prove it a truly effective method for the internationalisation of the rupee as a way to reduce sanction-induced trade risk.

Devanshu Pareek & Divyanshi Sethi, *A Comprehensive Study On The 'IFs And BUTs' Of Tokenisation: Proposing The 'Malta' To Capitalise On The Initial Coin Offerings For India,* 11(2) SCHOLASTICUS 68 (2024).

A COMPREHENSIVE STUDY ON THE 'IFs AND BUTs' OF TOKENISATION: PROPOSING THE 'MALTA' APPROACH TO CAPITALISE ON THE INITIAL COIN OFFERINGS FOR INDIA

Devanshu Pareek[†] *& Divyanshi Sethi*[‡]

ABSTRACT

India's financial landscape stands at a crossroads. Tokenisation, empowered by blockchain and decentralisation, presents not just a challenge but a transformative opportunity to rewrite the rulebook. This paper delves into this revolutionary concept, exploring its potential to reshape the financial ecosystem from the perspectives of both issuers and investors.
'Initial Coin Offering' facilitates such tokenisation using Distributed Ledger technology, particularly Blockchains and smart contracts. This paper delves into unravelling its core principles to explain the technology and unveiling its multifaceted benefits of cost-effectiveness, Demand Assurance, Liquidity and Flexibility, alongside cautioning its risks of security, money laundering, 51% Attack, Ponzi scheme, and the challenges related to Monitoring. We meticulously analysed the advantages and potential risks in the lens of the Indian context, meanwhile drawing valuable insights from global pioneers.
Building upon an analytical understanding, we proposed a novel regulatory framework for India, prioritising jurisdictional aspects across both domestic and international domains by categorising the tokens on the basis of their practical aspects. This framework, while laying the groundwork for further research, paves the way for a future where tokenisation flourishes in harmony with Indian law.
This research project draws inspiration from disruptive models that redefined industries like transportation (Uber), tourism (Airbnb), and entertainment (Netflix). Just as these companies transformed their respective landscapes, tokenisation has the potential to rewrite the rules of the financial gameplay of India.

Keywords*- Blockchain, De-centralisation, Distributed Ledger Technology, Jurisdictional Aspect, Regulatory Framework, Tokenisation.*

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I. INTRODUCTION

Beyond traditional banking and capital market channels, corporations today have a diverse spectrum of options for raising capital, particularly for production purposes. This evolving landscape reflects the continuous interplay between innovation, technology, and market dynamics. The rise of new actors like mutual funds and private equity firms exemplifies this transformative trend by their disintermediation[1] and innovative financing instruments.[2]

Throughout history, technological advancements have often driven disruptive innovations, fundamentally reshaping existing structures.[3] In line with this trend, recent years have witnessed the emergence of a novel channel for capital formation: ***Initial Coin Offerings ("ICOs")***. ICOs leverage smart contracts, self-executing agreements on a blockchain, to facilitate direct fundraising without intermediaries. These transactions involve the issuance of tokens or coins on a distributed ledger powered by blockchain technology.[4]

The rapid growth of the token-offering market in advanced economies can be attributed to several factors. *Firstly*, the ease and speed of fundraising are unparalleled. Establishing an offering using readily available token standards like *"ERC-20"* can be done in minutes and at minimal cost.[5] *Secondly*, online-based fundraising opens up a global investors' pool, removing geographical barriers for both issuers and potential investors. The transaction records on the blockchain are apparently transparent and reveal the wallet addresses. However, the true identities of investors remain concealed. Thus, blockchain technology ensures a level of pseudo-anonymity for token holders.[6]

A. Tracing the Trajectory of Tokenisation

The year 2009 witnessed the dawn of a new era in decentralised finance with the birth of Bitcoin, the first cryptocurrency. Emerging from the vision of an anonymous personality, Satoshi Nakamoto, Bitcoin established a peer-to-peer digital cash system powered by its native token.[7] Its success paved the way for a multitude of alternative coins, each leveraging

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[1] C.K. Whitehead, *The Evolution of Debt Covenants, the Credit Market, and Corporate Governance*, 34 JOURNAL OF CORPORATION LAW, 101 (2009).
[2] Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARVARD LAW REVIEW, 561 (1981).
[3] Marco Dell'Erba, *Initial Coin Offerings: The Response to Regulatory Authority*, 14 NEW YORK UNIVERSITY JOURNAL OF LAW AND BUSINESS, 1109 (2018).
[4] Paul P. Momtaz, *Token Sales and Initial Coin Offerings: Introduction*, 22(4) THE JOURNAL OF ALTERNATIVE INVESTMENTS (2019).
[5] Paul P. Momtaz, and others, *Token Offerings: A Revolution in Corporate Finance?* S.S.R.M. 4 (2019), https://ssrn.com/abstract=3346964.
[6] Ibid at 6.
[7] Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN, 1 (2018), https://bitcoin.org/bitcoin.pdf.

its own blockchain technology.[8] This burgeoning ecosystem soon saw the emergence of the first-ever ICO in 2013. It was proposed by J.R. Willett in which MasterCoin raised roughly 5,000 Bitcoins, marking a historic turning point in venture financing.[9]

The launch of Ethereum in 2015 is the next pivotal moment in the tokenisation of finance.[10] Its revolutionary contribution lies in the integration of smart contracts as the cornerstone of its decentralised platform. This enables developers to build diverse applications directly on Ethereum's blockchain by designing and deploying their own smart contracts.[11]

It was in 2017 when ICOs' capitalisation soared from $18 billion USD in January to over $800 billion USD at the end of the year, showcasing the rapid rise of this innovative financial instrument.[12] India, too, witnessed a handful of early ICOs, primarily from startups like WandX and Cashaa.[13] Following the same, the *Reserve Bank of India* notified, in 2018, to ban crypto transactions by regulated banks due to the chilling shadow it casts.[14] However, the Supreme Court's landmark judgment in ***Internet & Mobile Association of India v. RBI***[15] reversed this ban, fostering the domestic cryptocurrency landscape.

The government's active promotion of startups fostered a fertile ground for FinTech and EdTech innovations. India has reached the position of one of the top cryptocurrency holders globally, which further underscores the potential for a crypto and ICOs boom.[16] At the current stage, India's nascent token market is poised to revolutionise the capital industry. However, it is susceptible to scams and fraud. Therefore, we require a comprehensive regulatory framework for India.

B. The driver of the innovation: Blockchain-DLT Technology

For effective regulation of tokenisation, a thorough understanding of its underlying technology and potential impacts is crucial. Decentralisation and disintermediation pose a

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[8] *The Market in Initial Coin Offerings Risks Becoming a Bubble*, THE ECONOMIST (April 27, 2017), https://www.economist.com/finance-and-economics/2017/04/27/the-market-in-initial-coin-offerings-risks-becoming-a-bubble.
[9] José Campino, and others, *Initial coin offerings (ICOs): Why do they succeed?*, 8(1) FINANCIAL INNOVATION (2022), https://jfin-swufe.springeropen.com/articles/10.1186/s40854-021-00317-2.
[10] Marco Dell'Erba, *Initial Coin Offerings: The Response to Regulatory Authority*, 14 NEW YORK UNIVERSITY JOURNAL OF LAW AND BUSINESS, 1115 (2018).
[11] *Supra* note 8.
[12] Hui-Ching Hsieh, Jonas Oppermann, *Initial Coin Offerings and their Initial Returns*, 26 ASIA PACIFIC MANAGEMENT REVIEW, 1 (2021).
[13] Chartered Secretary, *53rd ICSI Foundation Day Powering Atmanirbhar Bharat through Entrepreneurship and Innovation*, 51(10) THE JOURNAL FOR GOVERNANCE PROFESSIONAL, 104 (2021).
[14] Reserve Bank of India, Prohibition on dealing in Virtual Currencies (VCs) RBI/2017-18/154 (IND).
[15] Internet & Mobile Association of India v. RBI, 2020 SCC Online SC 275.
[16] *Supra* note 13.

significant challenge to traditional notions of financial institution operations, posing a need for re-evaluation of existing regulatory frameworks.[17]

If we were to trace the evolution, the ***2008 global financial crisis*** sowed the seeds of doubt in the centralised financial system dominated by sovereign governments and central banks. This scepticism fuelled the rise of Blockchain-based *Distributed Ledger Technology ("**DLT**")*, which provided a pathway for a decentralised and democratised financial landscape.[18]

Satoshi Nakamoto described this innovation for the first time as '*an electronic payment system based in cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party*.'[19] In simpler terms, this is an unconventional approach to record and share transactions and/or data across multiple participants in a decentralised way.

While Blockchain and DLT are often used interchangeably, there exists an insightful distinction. Blockchain represents a specific type of DLT architecture characterised by chronological blocks of data, cryptographically linked to form an immutable chain. This immutability significantly mitigates the risk of data fraud or manipulation.[20]

In the absence of a centralised authority, blockchain networks employ *'consensus mechanisms'* to establish trust and validate transactions. One such mechanism is *proof-of-work*, which involves a competitive process among network nodes to solve complex mathematical puzzles. This helps ensure the integrity of the shared ledger.[21]

Within the realm of cryptocurrencies and tokens, DLT leverages smart contracts, which are self-executing computer programs that autonomously process transactions when predetermined conditions are met on the ledger.[22] This novel blockchain economy has the potential to revolutionise traditional ledger systems.[23] However, this nascent technology faces significant challenges, which include:[24]

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[17] Randolph A. Robinson II, *The New Digital Wild West: Regulating the Explosion of Initial Coin Offerings*, 85 TENNESSEE LAW REVIEW, 905 (2017).
[18] id. at 907.
[19] *Supra* note 7.
[20] Harish Natarajan and others, *Distributed Ledger Technology and Blockchain*, WORLD BANK GROUP, 1 (2017), https://openknowledge.worldbank.org/server/api/core/bitstreams/5166f335-35db-57d7-9c7e-110f7d018f79/content.
[21] Paul Klimos, *The Distributed Ledger Technology: A Potential Revamp for Financial Markets?*, 13(2) CAPITAL MARKETS LAW JOURNAL, 194–222 (2018).
[22] MELANIE SWAN, BLOCKCHAIN BLUEPRINT FOR A NEW ECONOMY (O'Reilly 2015).
[23] Roman Beck and others, *Governance in the Blockchain Economy: A Framework and Research Agenda*, 19(10) JOURNAL OF THE ASSOCIATION FOR INFORMATION SYSTEMS, 1 (2018).
[24] RANDY PRIEM, CLEARING OTC DERIVATIVES IN EUROPE 502 (Oxford University Press 2023).

(a) **Barriers to Entry**: Transitioning from traditional and well-known systems to DLT-based systems can be hindered by technical complexities, integration costs, and possible friction from the regulators.

(b) **Unclear Regulations**: The lack of comprehensive and consistent regulatory frameworks across jurisdictions creates uncertainty for businesses and investors, potentially stifling innovation and its adoption.

(c) **Negative Perceptions**: The association of cryptocurrencies with illicit activities and market volatility has engendered scepticism and reputational risks for institutions involved in the crypto-asset space.

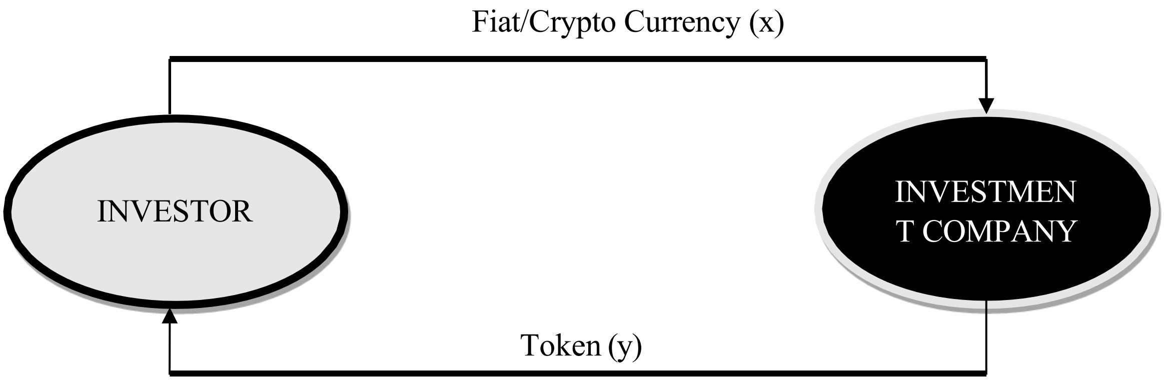

Figure 1

The illustrative Figure 1 portrays the working mechanism of the transaction between the investor and the issuer (the Investment Company). Here, x/y is the exchange rate fixed priori in the smart contract.[25]

C. Taxonomy of Tokens

The heterogeneous nature of tokens makes it crucial to categorise tokens into types. While the terminology of several types is often confused and used interchangeably, this lies in the discretion of each jurisdiction to divide all these hybrid tokens into various categories and govern them.

[25] Paul P Momtaz, *Token Sales and Initial Coin Offerings: Introduction*, THE JOURNAL OF ALTERNATIVE INVESTMENTS, 21 (2019).

This section combines a table of the most known categories of tokens. However, this list is not exhaustive, and each token is a different combination of functions. Hence, there can be various forms. Though the tokens can be categorised on several parameters, we have identified them on the basis of rights given to the user or investor.

Types of Tokens	Functions[26]	Rights Granted
Payment Token	These tokens are also known as coins, exchange tokens, or crypto currencies. The functionary is similar to money in a traditional financial system. Such a 'surrogate to money' can be easily transacted over the DLT without any limitations.	Monetary exchange rights.
Utility Token	This type of token is used as a medium for availing services or access to an application on the blockchain.[27] However, these usages are determined by the issuer. These can be referred to as '*Payment token with specific purpose*', as countries around the world have not made specific legislations that deal with utility tokens in a token sale.	Consumption rights like vouchers
Investment/ Security Token	These tokens are issued as a token holding ownership in the issuer's organisation, or provides dividend rights, or right over revenue, or any other right as an owner on the network.	Economic and ownership rights
Asset Backed Token	These are the security tokens that represents bonds, shares, derivatives, and assets. These tokens represent rights in tjereal physical underlyings of the issuer. Token holders may be entitled to dividends and interest payments.[28]	Rights from securities
Participation Token	These tokens are issued as a pass to take part in activities like voting.	Voting rights

[26] Thijs Maas, *Initial Coin Offerings: When Are Tokens Securities in the EU and US?*, SSRN ELECTRONIC JOURNAL, 21 (2019); Rishabh Periwal & Yajur Lath, *Initial Coin Offerings: An Analysis of the Potential Legal and Regulatory Challenges and Framework*, INDIAN JOURNAL OF LAW AND LEGAL RESEARCH 1, 7 (2021).
[27] Allexis Collomb and others, *From IPOs to ICOs: The Impact of Blockchain Technology on Financial Regulation*, BLOCKCHAIN PERSPECTIVES JOINT RESEARCH INITIATIVE, 10 (2018).
[28] S. GOTTSCHALK, FINTECH, PANDEMIC, AND THE FINANCIAL SYSTEM: CHALLENGES AND OPPORTUNITIES 145 (Emerald Publishing Limited 2023).

II. KEY ADVANTAGES OF TOKENISATION

The tokenised finance presents a compelling alternative to traditional financial methods and has the potential to revolutionise the entire industry. However, a critical evaluation is necessary to uncover its true merits from the mere hype. Distinguishing its potential benefits and drawbacks is crucial from the policymakers' point of view, who seek to craft effective regulatory frameworks tailored to the unique needs of each stakeholder. This section will delve into its four key advantages, which acknowledge the potential benefits of adopting the innovation.

A. **Cost-effectiveness**:

The technical flexibility of smart contracts offers several advantages, including reduced transaction costs compared to traditional financing methods.[29] It is facilitated by eliminating the intermediaries and automated execution of smart contracts. Furthermore, the use of cryptocurrency could further minimise the transaction fees for international token transfers.[30] Additionally, accepting both fiat and cryptocurrency expands the potential investor pool by allowing individuals to invest directly using government-backed legal tender and receive tokens in return.[31] Due to the fiat currency's association with traditional banking systems, its acceptance by the issuers gave trust to the potential investors. However, it also raises concerns about potential regulatory hurdles and investor confidence in cryptocurrency.[32] It furthers our objective of creating a comprehensive regulatory framework that fosters inclusivity and addresses these challenges that are crucial for maximising the benefits of tokenised finance.

A long-term benefit of adopting blockchain technology is its ability to foster decentralised networks. In traditional financial systems, intermediaries capture most of the value generated through their role in operating the network. Blockchain, however, offers an alternative, i.e., value to be accrued to token holders. This accrual would result in incentivising network participants, like validators who hold native tokens,[33] and providing fair compensation for

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[29] R. Amsden and D. Schweizer, *Are Blockchain Crowd sales the New 'Gold Rush'? Success Determinants of Initial Coin Offerings*, SOCIAL SCIENCE RESEARCH NETWORK (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3163849.
[30] Sabrina T. Howell and others, *Initial Coin Offerings: Financing Growth With Cryptocurrency Token Sale*, NATIONAL BUREAU OF ECONOMIC RESEARCH 23 (2019), http://www.nber.org/papers/w24774.
[31] Ryan Amsden and Denis Schweizer, *Are Blockchain Crowdsales the New "Gold Rush"? Success Determinants of Initial Coin Offerings*, SSRN ELECTRONIC JOURNAL 20 (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3163849.
[32] Id.
[33] *Supra* note 29, at 20.

initial developers but not granting them control beyond that of any other token holder.[34] This model shares similarities with open-source platforms like *Wikipedia*, where voluntary contributions are recognised and rewarded through various mechanisms.[35]

B. Assurance of Demand:

Tokenisation offers a unique model to raise funds from potential customers of the venture. This is similar to crowdfunding opportunities, where capital is raised by engaging future customers as initial investors. One of the key advantages is that while raising capital from users, the real value and opportunity of investment can be attributed to them instead of traditional investors. Such users aid the process by not merely seeing the investment from the view of making profits but also towards the cause of the investment. However, it is crucial to recognise that user-driven token purchases often reflect a commitment to utilise the tokens within the platform's ecosystem, as their value may be limited outside it.[36]

Notably, this differs from traditional investments, where funding is based on anticipated future cash flows, often without direct consumer involvement.[37] Conversely, tokenisation incentivises consumer engagement and brand promotion, providing issuers with valuable early insights into potential demand.[38]

C. Easy Liquidation:

One of the key advantages of tokenised financing is its inherent transferability of tokens, which fosters investor liquidity. Exchange listings enhance token liquidity by enabling trading for other cryptocurrencies or fiat. It helps to foster broader market participation and potentially increases the token valuations. However, a 2018 report revealed that only 53% of ICO tokens reached exchange listings, highlighting potential limitations in realising liquidity.[39] Thus indicating that successful listings can benefit the underlying aim by raising awareness and attracting potential users and investors.[40]

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[34] A. Canidio, *Financial incentives for open source development: the case of Blockchain*, MUNICH PERSONAL REPEC ARCHIVE (2018), https://mpra.ub.uni-muenchen.de/85719/.
[35] N. POPPER, DIGITAL GOLD: BITCOIN AND THE INSIDE STORY OF THE MISFITS AND MILLIONAIRES TRYING TO REINVENT MONEY (Harper Collins 2016).
[36] J. Li and W. Mann, *Initial coin offering and platform building*, SSRN ELECTRONIC JOURNAL, 1-56 (2018), https://ssrn.com/abstract=3088726.
[37] *Supra* note 29, at 20.
[38] C. Catalini and J. S. Gans, *Initial coin offerings and the value of crypto tokens*, NATIONAL BUREAU OF ECONOMIC RESEARCH (2018), http://www.nber.org/papers/w24418.
[39] *Supra* note 29, at 22.
[40] *Supra* note 30, at 2.

An ancillary economic benefit of easy liquidation is the '*rapid exit option*' for the initial innovators. This ensures lower commitment requirements for innovation and hence works as a mechanism to attract individuals who would otherwise be less likely to become innovators.[41] *For example*, Brendan Eich found a new browser, 'Brave,' by leaving his appointment as CEO of the Mozilla Corporation, with the help of ICO proceeds that reached $35 million within 30 seconds only.[42]

D. Flexibility:

The flexibility inherent in tokenised financing offers distinct advantages for both issuers and investors. *For Issuers*, it permits capital raising across all venture stages, unlike traditional methods, which are often restricted to a specific stage.[43] This wider access to capital is facilitated by the global reach of tokenised offerings and by the minimal transaction costs associated with blockchain technology.

For Investors, the benefit is derived from the concept of *"fractional token ownership."* This innovative approach involves dividing assets into smaller tokens, which lowers the minimum investment amount and reduces the entry barrier for participation, which is particularly relevant for high-cost assets like equities.[44] Additionally, fractional ownership can lead to increased trading activity, potentially enhancing liquidity in certain markets.[45]

III. THE POTENTIAL PITFALLS OF TOKENISATION

The above-stated benefits that came with the adoption of tokenisation also carry the risk of several potential threats. The following section delves into three key concerns that arose under the guise of tokenisation's effective capital acquisition, swift transactions and global investor reach.

A. Security Concerns:

The trade of virtual assets in tokenised financing is facilitated by smart contracts. The use of such smart contracts has a risk of getting hacked or other fraudulent practices due to their automatic and immutable nature. Considering that there are no universally standardised

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[41] Paul P. Momtaz, *Initial Coin Offerings*, 15(5) PLOS ONE (2020), https://journals.plos.org/plosone/article?id=10.1371/journal.pone.0233018.
[42] Mitchell Baker, *Brendan Eich Steps Down as Mozilla CEO*, THE MOZILLA BLOG (April 3, 2014), https://blog.mozilla.org/blog/2014/04/03/ brendan-eich-steps-down-as-mozilla-ceo.
[43] *Supra* note 40.
[44] Paul P. Momtaz, *How Efficient is Decentralized Finance (DeFi)?*, SSRN ELECTRONIC JOURNAL (2023), https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=4063670.
[45] Paul P. Momtaz, *Security tokens. In The Emerald Handbook on Cryptoassets: Investment Opportunities and Challenges* (EMERALD PUBLISHING LIMITED 68) (2023).

regulations, and only a few jurisdictions have governed the trade of virtual assets and tokens, it creates loopholes that give leeway for hackers to steal money.[46]

'***51% Attack***' is an attack on blockchain technology, wherein a particular group acquires more computing power than the rest of those on the network together. This attack gives certain holders the power to manipulate past transactions and alter or prevent new ones. Moreover, the attackers may exploit the smart contracts to replicate their particulars like design, implementation and execution, making such transactions vulnerable to other forms of crimes.[47]

The ***Ponzi Scheme***, which is a fraudulent means of attracting investments by promising high rates of return, can also be operated by issuing tokens by a company. An example could be when the regulators, namely the Texas State Securities Board and North Carolina Securities Division, declared the business of issuing tokens by *Bitconnect* in 2017, a model of the Ponzi scheme. This company issued digital tokens BCC by representing that their market was of $4.1 billion USD. They also assured that investors could lend back their tokens to Bitconnect and promised a monthly return of up to 40%.[48] Subsequently, after declaring that the promises made were fraudulent by the regional regulators, the Federal Bureau of Investigation also began investigating the company.[49]

B. Monitoring Challenges:

Digital assets, or tokens, often rely on underlying technological frameworks that meticulously track ownership transfers. Each transaction forms a link in a chain, tracing the asset's journey from initial investment to its eventual holder. This chain reflects not only the movement of the asset itself but also the associated rights granted to each investor at each stage. In essence, it provides a transparent and immutable record of ownership evolution and rights distribution within the digital asset ecosystem.

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46 Mike Orcutt, *Once hailed as hacked, blockchain are now getting hacked*, MIT TECHNOLOGY REVIEW (Feb. 19, 2019), https://www.technologyreview.com/2019/02/19/239592/once-hailed-as-unhackable-blockchains-are-now-getting-hacked/.

47 David Uzsoki, *Report of the International Institute for Sustainable Development on the Tokenisation of Infrastructure: A blockchain-based solution to financing sustainable*, INTERNATIONAL INSTITUTE FOR SUSTAINABLE DEVELOPMENT, chapter 3.2 (Jan. 17, 2019), https://www.iisd.org/publications/tokenization-infrastructure-blockchain-based-solution-financing-sustainable.

48 *$4 Billion Crypto-Promoter Ordered to halt Fraudulent Sales*, TEXAS STATE SECURITIES BOARD (Jan. 04, 2018), https://www.ssb.texas.gov/news-publications/4-billion-crypto-promoter-ordered-halt-fraudulent-sales.

49 *Seeking Potential Victims in Bitconnect Investigation*, FEDERAL BUREAU OF INVESTIGATION (Feb. 20, 2019), https://www.fbi.gov/contact-us/field-offices/cleveland/news/press-releases/seeking-potential-victims-in-bitconnect-investigation.

An example of such technology can be the Blockchain based on Distributed Ledger Technologies (DLTs).[50] Subsequently, to recognise the accurate placement of such assets and rights, smart contracts are used to verify the performance of such assets over time. Monitoring costs are incurred by the investor to evaluate the performance of assets invested.[51] In certain blockchains, such verification of the value of the source can be done automatically. However, some require an off-chain verification. Units on the blockchain are used to identify various particulars like economic asset value, technology used, and other determinants of growth attached to the token. These tokens hold value in the market, which is not static and, hence, subject to movements as per the changes in the market forces. When this value of the token is directly available on the technology that is blockchain, the verification can be done automatically. However, if the value of this token is off the chain of technology, verification is not automated, and hence, additional monitoring costs have to be incurred in order to decide a future course of action.[52]

One of the other challenges is monitoring the flow of such assets and cash by the regulatory bodies in order to prevent fraud, theft, money laundering and other similar crimes. Illegal proceeds can be found in the form of virtual assets. However, the extent of such misuse is still unclear.[53] This lack of clarity regarding the degree of potential harm from misuse highlights a major risk in the tracing of cash flow involved with such virtual assets. Consequently, we are witnessing a rapid increase in such misuse.[54]

Terror Financing is also channelled through virtual currencies and assets. A major reason is the pseudonymous nature of the virtual currency. The holder of a virtual currency is represented on the ledger technology through a virtual alphanumeric address associated with their wallet, like the blockchain wallet. So, despite the transactions being recorded by the technology, the actual user's identity is not.[55] These Virtual currencies and assets could be a possible leeway for terror activity funding as it is easy to avoid regulatory intermediaries. An

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[50] Pablo de Andres and others, *Challenges of the market for Initial Coin Offerings*, 79 INTERNATIONAL REVIEW OF FINANCIAL ANALYSIS 2 (2022).

[51] Reggie O'Shields, *Smart Contracts: Legal Agreements for the Blockchain*, 21 N.C. BANKING INST. 179, 181 (2018).

[52] Shlomit Azgad-Tromer, *Crypto Securities: On the Risks of Investments in Blockchain-Based Assets and the Dilemmas of Securities Regulation*, 68 AM. U. L. REV. 69, 95 (2018).

[53] *12-month Review of The Revised FATF Standards on Virtual Assets and Virtual Asset Service Providers,* FINANCIAL ACTION TASK FORCE, (June 2020), https://www.fatf-gafi.org/en/publications/Fatfrecommendations/12-month-review-virtual-assets-vasps.html.

[54] Regulation (EU) 2023/1114 of the European Parliament and of the Council of 31 May 2023 on markets in crypto-assets, and amending Regulations (EU) No 1093/2010 and (EU) No 1095/2010 and Directives 2013/36/EU and (EU) 2019/1937, OJ L150/40 (2023), art. 3.

[55] Policy (EU) PE 604.970 of the European Parliament of 14 May 2018 on Virtual currencies and terrorist financing: assessing the risks and evaluating responses, (2018), para 3.2.2.

example of the same is of early 2017, when the Indonesian Financial Intelligence Unit reported that a jihadist named *Bahrun Naim* planned attacks on Jakarta by using PayPal and Bitcoin to transfer funds to provide assistance to Indonesian terror cells based in that region.[56] In the recent clashes between Israel and Hamas, a new crypto angle has also emerged that aided the militants by financing fights.[57]

Money Laundering is another way criminals misuse virtual assets through the following means: (**a**) funds are raised for illegal activities by trading illegal goods or services, (**b**) illegally obtained virtual assets are also converted into fiat currencies within an economy, and (**c**) income obtained through illegal methods is also legitimised by formulation of crypto payments.[58] Moreover, potential risks exist with digital assets because the maiden buyer and subsequent traders might not have undergone any regulator checks and anti-money laundering verification processes. Since these transactions are fast and unceasing, it makes the verification of each participant by regulators tough without slowing down the process, thereby introducing friction into trading.[59]

C. Technology Risk:

The technology of distributed ledgers on which blockchains are based is vulnerable to various tech-based risks. Hence, the assets based on such blockchains could be immune to physical damages but are prone to other disruptions.

Smart contracts, which facilitate such transactions, are known to be immutable in nature. This means that these contracts are automatically enforced according to the terms laid down in the original contract without any ex-post directions or reservations based on renegotiations.[60] Hence, a downside to such transactions is that it gives scope for cyber-

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56 Wahyudi Soeriaatmadja, *Militant Bahrun Naim used PayPal, bitcoin to transfer funds for terror attacks in Indonesia*, STRAIGHTS TIMES (Jan. 14, 2017, 01:54 PM), http://www.straitstimes.com/asia/se-asia/militant-bahrun-naim-usedpaypal-bitcoin-to-transfer-funds-for-terror-attacks-in.

57 Angus Berwick and Ian Tallley, *Hamas Militants Behind Israel Attack raised millions in Crypto*, WALL STREET JOURNAL (Oct. 10, 2023, 3:34 pm ET), https://www.wsj.com/world/middle-east/militants-behind-israel-attack-raised-millions-in-crypto-b9134b7a.

58 *Report of International Federation of Accounts on the Anti Money Laundering: The Basics*, THE INTERNATIONAL FEDERATION OF ACCOUNTANTS, (2020), https://www.ifac.org/knowledge-gateway/ethics/publications/anti-money-laundering-basics-installment-1-introduction-anti-money-laundering-professional.

59 *Security token offerings: The next phase of financial market evolution?*, DELOITTE 18 (2020), https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/audit/deloitte-cn-audit-security-token-offering-en-201009.pdf.

60 Mary Juetten, *Legal Technology and Smart Contracts: Blockchain and Smart Contracts (Part IV)*, FORBES (Sept. 6, 2017, 08:00 am EDT), https://www.forbes.com/sites/ maryjuetten/2017/09/06/egal-technology-and-smart-contracts-blockchain-smart-contractspart-iv.

attacks, interventions and manipulations, and any mistake or bug cannot be reversed. Smart contracts are therefore called a "***one way train, technically unstoppable***."[61]

A well-known case study is the Cyber-attack on a Decentralised Autonomous Organization (DAO), in which the attacker removed one-third of DAO's Ethereum and placed them on their ethereum blockchain, which was controlled by him. This was a result of a bug in the software of the DAO's smart contract, though it was a mutual mistake on the part of both parties. Traditionally, contracts without 'consensus ad idem' or a meeting of the minds are void. However, in the case of smart contracts, the same was not technically possible.[62]

Risks with regards to the issuance of tokens, or virtual assets do not necessarily arise from the internal affairs of the company issuing them. However, External risks also exist wherein third parties are involved.[63] One such is the ***Pump-and Dump Scheme,*** which involves inflating the price of a token artificially in order to get a higher price for a token purchased at a lower price.[64] This can be done using phishing emails, fake social media accounts and hacking into the company's IT system. As discussed above, manipulation of smart contracts is an overt method of committing fraud in the context of tokens and virtual currencies. Exploiting bugs in these smart contracts is also used to inflate the prices of the tokens. A study shows that twenty-five percent of smart contracts are vulnerable to manipulation by attacks and bugs.[65]

IV. PROPOSING A REGULATORY FRAMEWORK FOR TOKENISATION

This research paper begins by introducing the concept of tokenisation for capital-raising, including a simplified explanation of the core technology involved. Further, the nature of rights associated with diverse types of tokens or coins has been identified. The significance of the advantages and risks accompanying this novel method has been discussed. In the following section, we will build on these particulars to propose the objectives India should adopt to regulate tokenised financing,

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[61] Jeremy Sklaroff, *Smart Contracts and the Cost of Inflexibility*, 166 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 263, 302 (2017).

[62] *Report of Securities and Exchange Commission on Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, SECURITIES AND EXCHANGE COMMISSION, para II(B) (July 25, 2017), https://www.sec.gov/files/litigation/investreport/34-81207.pdf.

[63] Lars Hornuf and others, *Initial Coin Offerings, Information Disclosure, and Fraud*, 58 SMALL BUS. ECON. 1741, 1743 (2022).

[64] JT Hamrick and others, *The economics of cryptocurrency pump and dump schemes*, CENTRE FOR ECONOMIC POLICY RESEARCH, 2 (2018); Tao Li and others, *Cryptocurrency Pump-and-Dump Schemes*, SSRN ELECTRONIC JOURNAL 5 (2018).

[65] Kai Sedgwick, *25% of all Smart Contracts contain bugs*, BITCOIN.COM (Aug. 29, 2018), https://news.bitcoin.com/25-of-all-smart-contracts-contain-critical-bugs/; Gabe Shepherd, *Auditing the unchained capital smart contract*, MEDIUM (May 24, 2018), https://medium.com/@hosho/auditing-the-unchained-capital-smart-contract-ac2d7ecea373.

alongside a briefing on the existing methods employed by other jurisdictions and their feasibility for the Indian landscape.

Regulators often navigate two distinct paths while framing market behaviour policies. These are the proactive Ex-Ante approach and the reactive Ex-Post approach. The former approach lays out clear guidelines and establishes pre-emptive regulations, aiming to prevent unwanted events before they occur. In contrast, the latter approach reacts to situations after they happen, taking corrective action to address the issue at hand. In this section, the proposed framework for India seeks to amalgamate the strengths of both approaches, tailoring its response to the needs of the market for the investor as well as the government and regulator. This hybrid model offers the flexibility to adapt to unforeseen circumstances while ensuring essential safeguards are in place.

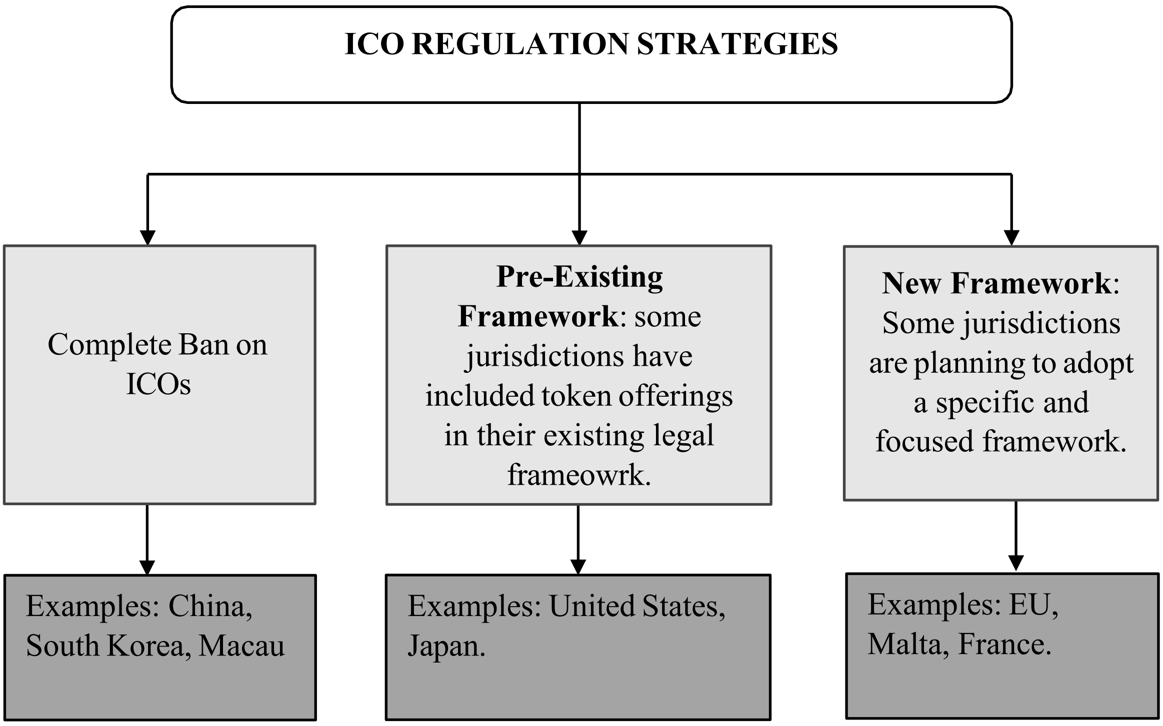

Figure 2

A. Token Categorization for India

With regard to the taxonomy of tokens, India should divide them into three categories: **(a)** Payment Tokens, **(b)** Security Tokens and **(c)** Utility Tokens. This model of categorisation is advantageous, as seen in other global jurisdictions:

The European Parliament has **Markets in Crypto-Assets Regulation** (MiCA), under which they have divided tokens into three categories: Asset-referenced tokens, electronic money tokens and utility tokens.[66] The European Parliament tried to create a framework that is friendly and attractive for both the investor and the investment company.

It is suggested that the tokens could be regulated and hence be allowed, disregarding the complete ban extremist approach of countries like China, South Korea, and Macau. China also threatened to cut off web access to sites that traded digital currencies.[67] South Korea also followed the path of China banning Crypto Assets,[68] the reason being the non-availability of information regarding the investment in ICOs to the regulator. The information requirements include business plans, investment strategy, financial statements, and investor protection policy. Moreover, due to the challenge of categorising all such token issues, South Korea decided not to govern them at all.[69] However, this approach fails to acknowledge a wide range of advantages that regulating Digital Assets and their access to people can help to capitalise for the betterment of the economy. This has been subsequently realised by South Korea and the said ban was constitutionally challenged. Hence, the country re-evaluated its stance and voted to change its financial laws in 2020.[70]

In contrast to the above two approaches, the United States of America has not banned them but has made a strict framework to govern them. They have made regulations to only include the security tokens under the existing securities law, i.e., the Securities Act of 1933. However, they have inadvertently neglected the other forms of tokens like Utility Tokens. Hence, there is no ICO-specific legislation or regulatory framework. If the tokens issued fall in the category of securities, they shall be governed, and the same shall not be true if the tokens are not.[71] However, until now, no legislation has been enacted, and only existing frameworks have been used to regulate those falling under the category of securities.[72]

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[66] *Supra* note 53.

[67] Stan Higgins, *Report: China Cutting Access to Overseas Crypto Trading*, COINDESK (Sep 13, 2021 at 1:01 p.m.), https://www.coindesk.com/markets/2018/02/05/report-china-cutting-access-to-overseas-crypto-trading/.

[68] Gregor Stuart Hunter, *South Korea Joins Cryptocurrency Crackdown*, WALL STREET JORNAL (Sept. 29, 2017, 1:26 am ET), https://www.wsj.com/articles/south-korea-joins-cryptocurrency-crackdown-1506661702.

[69] J. Lai and L. Whitlow, *The Spaghetti Effect of ICO Regulations: An Introduction to the Developing Regulatory Frameworks of Initial Coin Offerings Around The World*, CLCT WILLIAM & MARY LAW SCHOOL, (2020).

[70] Tim Alper, *Game On! South Korean Parliament Passes "Landmark" Crypto Bill*, CRYPTONEWS (June 26, 2023, 06:53 EDT), https://cryptonews.com/exclusives/breaking-south-korean-parliament-passes-landmark-crypto-bill-5948.htm.

[71] C. Bellavitis, C. Fisch and J. Wiklund, *A Comprehensive Review of the Global Development of Initial Coin Offerings (ICOs) and their Regulation*, 15 JOURNAL OF BUSINESS VENTURING INSIGHTS, (June 2020).

[72] Agata Ferreira, Ferreira, *Emerging regulatory approaches to blockchain based token economy*, (3)1 THE JOURNAL OF THE BRITISH BLOCKCHAIN ASSOCIATION 1, 4 (2020).

B. Jurisdictional Resolution

The issue of jurisdiction in the context of Initial Coin Offerings is two-folded. *One*, which national regime be given the jurisdiction, in case of cross-border transactions and offerings. *Second*, who should be authorised to regulate which type of token? These issues could be the probable reasons for the present lack of regulations.[73] This is coupled with the difficulty of the universal and virtual nature of the crypto asset.[74]

i. Cross-border Issue

It is a complex challenge to determine whose national regime's domestic laws are applicable in the case of cross-border ICO transfers. There are three primary approaches adopted worldwide in this regard.

The *first approach* focuses on the issuer's beneficial owners. It is a practical method that pinpoints the company's true location or, more nuanced, the actual beneficiaries behind the offering. This approach resonates with its simplicity but may struggle with identifying beneficial owners in complex ownership structures.

The *second approach* shifts the focus to the place of the crypto exchange. **Malta,** aptly dubbed the "blockchain island," exemplifies this approach with its Virtual Financial Assets Act.[75] While this method capitalises on the domestic tokenisation market, it faces significant hurdles in pinpointing the exchange's location due to blockchain's decentralised nature and reliance on smart contracts.

The *third approach*, or the purchaser's location approach, grants jurisdictional rights based on where the token buyer resides. However, this seemingly straightforward approach clashes with the disintermediated and decentralised nature of ICOs, where investors hail from diverse geographical locations. This impracticality overshadows its potential benefits of saving the ICO from money laundering.

In the face of a fragmented global landscape, the EU's upcoming **MiCA** stands as a pioneering attempt at cross-jurisdictional crypto-asset regulation. Aiming to achieve

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[73] Julianna Debler, *Foreign Initial Coin Offering issuers beware: the Securities and Exchange Commission is watching*, 51 CORNELL INT. L. J. 245, 253 (2018).

[74] O Marian, *Blockchain havens and the need for their internationally-coordinated regulation*, 20 NORTH CAROLINA JOURNAL OF LAW & TECHNOLOGY 529, 554 (2019).

[75] Virtual Financial Assets Act, Act XXX of 2018 (Malta), Chapter 590.

investor protection and market stability, MiCA offers a practical blueprint for harmonisation, yet its global applicability remains uncertain.

For India, emulating **Malta's** "Attraction Based Framework" presents a compelling option. Unlike nations with established ICO markets, India currently finds itself on the periphery. Malta, even being of size comparable to an Indian state, has successfully established itself as a "blockchain island," attracting token offerings through a conducive regulatory environment. By studying and adapting Malta's approach, India can foster domestic innovation and capture a share of the burgeoning global token economy.

Drawing an analogy from arbitration, where parties choose the favourable jurisdiction (seat) by taking into account its legal framework and efficient administration, India could establish itself as a "haven for token offerings" by building a robust regulatory environment. This framework ought to prioritise consumer protection, market integrity, and system stability while remaining adaptable to the diverse nature of token offerings. While India is careful about crypto-based financial products, it needs to find a balanced way to attract companies offering these tokens without loosening its norms.

ii. <u>Which Authority should Regulate the Tokens in India?</u>

For the purpose of deciphering the conundrum of authority checks on various types of tokens, India could implement a 'token registration system' to address the initial concern of domestic jurisdictional authority. Upon registration, tokens would be classified based on their characteristics and assigned to specific regulatory bodies empowered to frame regulations tailored to specified categories. This tiered approach would ensure targeted regulatory oversight while upholding the three core pillars, namely, consumer protection, market integrity, and system stability.

a) Security Tokens

This section proposes that tokens classified as security tokens should fall under the regulatory purview of the Securities and Exchange Board of India (SEBI). This aligns with a global trend towards securities regulators in major jurisdictions taking responsibility for overseeing security tokens. In India, the Supreme Court adopted the view that the term "marketable securities of a like nature" must be freely transferable.[76] Also, the term 'Marketable' under Section 2(h) of the Securities Contracts (Regulation)

[76] Bhagwati Developers Pvt. Ltd. v. Peerless General Finance, (2013) 5 SCC 455.

Act, 1956, means 'capable of being sold.'[77] Thereby, a conclusion can be drawn that marketable securities that can be freely traded will fall under the ambit of Indian securities law, and hence, tokens can be regulated under this act.

For instance, the U. S. Securities and Exchange Commission (SEC) adopts a principle-based approach, treating tokens with economic characteristics similar to traditional securities as such.[78] Similar recommendations can be found in the DAO (Decentralized Autonomous Organization) Report, which highlights the need for robust regulatory frameworks for security tokens.

> *"[Securities Act registration] requirements apply to those who offer and sell securities in the United States, regardless of whether the issuing entity is a traditional company or a decentralised autonomous organisation, regardless of whether those securities are purchased using United States dollars or virtual currencies, and regardless of whether they are distributed in certificated form or through distributed ledger technology."*[79]

This stance was further supported by referring the new financial instrument, tokens, to the well-known *Howey Test* established in the landmark case of ***SEC v. W.J. Howey Co***.[80] This test defines what constitutes an investment contract under federal securities laws. Its central elements include ***(a)*** an investment of money, ***(b)*** in a common enterprise, ***(c)*** an expectation of profit, and ***(d)*** to be derived from the efforts of others. Applying this test, the SEC determined that the DAO tokens fulfilled all prerequisites and, therefore, constituted investment contracts and, hence, securities.[81]

In alignment with the United States' approach, *Canada's* Security Administration regulates ICOs by applying existing securities regulations to tokens deemed investment contracts.[82] *Germany*, however, employs a token-specific approach, classifying those granting shareholder-like rights as securities subject to national financial regulatory oversight.[83] Similarly, *France* regulates security tokens through its financial market

[77] Securities Contracts (Regulation) Act, 1956, Act of Parliament 42 of 1956 (India), section 2(h).
[78] S. Holoweiko, *What is an ICO? Defining a Security on the Blockchain*, 87 GEO. WASH. L. REV. 1472, 1516 (2019).
[79] *Supra* note 61, at para IV.
[80] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).
[81] P. Maume and M. Fromberger, *Regulations of initial coin offerings: reconciling US and EU securities laws*, 19.2 CHICAGO JOURNAL OF INTERNATIONAL LAW 548, 566 (2019).
[82] *Cryptocurrency Offerings*, ONTARIO SECURITIES COMMISSION CANADA CSA STAFF NOTICE (Aug. 24, 2017), https://www.osc.ca/en/securities-law/instruments-rules-policies/4/46-307/csa-staff-notice-46-307-cryptocurrency-offerings.
[83] *Advisory letter on the classification of tokens as financial instruments*, FEDERAL FINANCIAL SUPERVISORY AUTHORITY GERMANY (March 28, 2018), https://www.bafin.de/SharedDocs/Downloads/EN/Merkblatt/WA/dl_hinweisschreiben_einordnung_ICOs_en.html.

regulatory framework, further distinguishing between equity and debt security tokens.[84] Likewise, *Singapore's Securities and Futures Act, 2001* encompasses offers of security, including tokenised offerings akin to traditional securities.[85]

While national security law frameworks employ a variety of terms, the underlying regulatory structures for instruments classified as "securities" exhibit significant convergence. This approach, though unpopular among issuers, prioritises investor protection through robust regulatory frameworks.[86]

b) Payment tokens

This section proposes that payment tokens be regulated by the Reserve Bank of India (RBI), India's central bank. This aligns with the Supreme Court's judgment in ***Internet & Mobile Association of India v. Reserve Bank of India***,[87] which affirmed the RBI's authority to regulate and take appropriate actions regarding cryptocurrencies based on their functional characteristics. Therefore, entrusting the RBI with the oversight of payment tokens, defined by their resemblance to traditional currencies, is a sound decision considering both legal precedent and the nature of these instruments.

A compelling justification for this approach lies in the potential for unchecked cryptocurrency circulation to foster a parallel economy. This unsanctioned sector operates independently and potentially contradicts the established financial system, jeopardising national economic stability and growth.[88] By facilitating tax evasion and illegal income generation, a parallel economy poses significant threats to the official financial system.[89] Therefore, in line with the Supreme Court verdict, payment tokens should be governed by the RBI.

c) Utility tokens

This section proposes that utility tokens be governed by regulatory sandboxes, designed as temporary frameworks to assess the characteristics of novel financial instruments.

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[84] *Discussion paper on Initial Coin Offerings*, AUTORITE DES MATCHES FINANCIERS FRANCE (Oct. 26, 2017), https://www.amf-france.org/sites/institutionnel/files/contenu_simple/consultations_publiques/AMF%20public%20consultation%20on%20Initial%20Coin%20Offerings%20(ICOs).pdf.

[85] Press Release, *MAS clarifies regulatory position on the offer of digital tokens in Singapore*, MONETARY AUTHORITY OF SINGAPORE (Aug. 01, 2017), https://www.mas.gov.sg/news/media-releases/2017/mas-clarifies-regulatory-position-on-the-offer-of-digital-tokens-in-singapore.

[86] *Supra* note 79, at 552.

[87] Internet & Mobile Association of India v. RBI, 2020 SCC Online SC 275.

[88] K. RAJARAM, INDIAN ECONOMY 577 (Spectrum Books Pvt. Ltd., 2006)

[89] S. Sarkar, *The parallel economy in India: causes, impacts and government initiatives*, 1-2 (11-12) ECONOMIC JOURNAL OF DEVELOPMENT ISSUES 124, 126 (2010).

Regulatory sandboxes have gained prominence across various sectors, notably in finance and legal services, often employing mechanisms to safeguard overarching regulatory objectives, including consumer protection.[90] These sandboxes operate on a case-by-case basis, embracing an *ex-post approach* to regulation that is tailored to the specific token type. Moreover, numerous national regulators have already established regulatory sandbox programs to foster innovation without imposing premature regulatory burdens.[91]

The inherent nature of utility tokens, circulating within the issuer's network and governed by smart contracts, suggests a prominent role for contract law and anticipated future legislation in regulating this domain. This aligns with the current reliance on private law principles as encoded within smart contracts.

V. CONCLUSION

The idea of tokenisation can prove to be a challenging but potentially fruitful endeavour for the Indian financial framework. The concept has stemmed from the trend of disruptive blockchain technology facilitated herein via Distributed Ledger technology and the immutability and automation of smart contracts. The story, which began with the inception of Bitcoin in 2009, with the first Coin Offering in 2013 to the 2017 boom, is knocking on the doors of the Indian Financial Market. Moreover, India has a green signal to play its part in the global crypto market after the *Internet & Mobile Association of India v. RBI* case.

The authors have observed the variety of rights being granted to the investors by the issuers. These are found to be dependent upon the function and the nature of the particular offered token. This analysis greatly helped to delve into the intricacies of inherent advantages, namely, ***(a)*** Cost-Effectiveness via minimising the transaction fees and enlarging the pool of investors, and the long-term benefit of fostering a decentralised network, ***(b)*** Demand Assurance by making the investors the future consumers of the issuer, ***(c)*** the Easy Liquidity by having exchange listings and facilitating 'rapid exit options', and lastly ***(d)*** the Flexibility via all stage capital raising for the issuer and fractional ownership for the investor.

This new idea is also posed with some serious challenges. There exist major threats like 51% Attack, the immutable nature of smart contracts making bugs irrevocable and phishing emails and

[90] A. Attrey, M. Lesher and C. Lomax, *The role of sandboxes in promoting flexibility and innovation in the digital age*, 2 OECD GOING DIGITAL TOOLKIT NOTE 4 (2020).
[91] Id. at 9.

hacking, which emanate from the technology over which crypto assets or tokens operate. However, other risks are common to different financial systems, like Terror Financing, Money Laundering and Ponzi Scheme. The exploitation of such crypto assets by the perpetrator is mainly due to the absence of regulation and a regulatory body to trace and oversee transactions. Therefore, the growth of the usage of crypto assets by corporations and individuals around the world necessitates the need for a framework to conquer these risks.

The proposed framework in the paper has approached the issue at hand in a very practical way by *firstly*, categorising the tokens on the basis of their nature, i.e., of Payment, Security and Utility, and *secondly*, providing a framework for jurisdiction resolution. In the realm of regulating the tokens, the most striking challenge and reason for the lack of regulations is the issue pertaining to jurisdiction, which is itself bifurcated in ***(a)*** cross-broader due to the decentralised and globalised nature of the token offering and ***(b)*** domestic jurisdictional authority due to the varied nature of tokens as security, utility and payment.

The researchers have comparatively analysed the existing framework adopted in various countries to resolve the issue at hand and proposed an "*Attraction-based framework*" to capitalise on the Initial Coin Offering Market. On the front of the domestic regime, the nature of the token has been analysed, and accordingly, the authority to frame the regulations has been proposed. Security tokens are proposed to be regulated by the Security Board of India because of the compelling concerns of consumer protection. Payment tokens are proposed to be regulated by the Monetary Authority of India, i.e., the Reserve Bank of India, due to the dangers of running a parallel economy in the financial market that has a number of loopholes of terror financing and money laundering, to name a few. The utility tokens are proposed to be regulated via 'Regulatory Sandboxes', giving way to an ex-post framework that emerged by taking into consideration the nature of these tokens to run on their network only.

Anshuman Srivastava & Pravit Vir Sarmah, *Strategic Frontiers: Exploring Foreign Direct Investment Within Umbrella Structures,* 11 (2) SCHOLASTICUS 89 (2024).

STRATEGIC FRONTIERS: EXPLORING FOREIGN DIRECT INVESTMENT WITHIN EMERGING UMBRELLA STRUCTURES

Anshuman Srivastava[*] & Pravit Vir Sarmah[†]

ABSTRACT

The editorial explores the evolving landscape of India's digital payment ecosystem, focusing on the proposed establishment of New Umbrella Entities (NUEs). Currently dominated by the National Payments Corporation of India (NPCI), the ecosystem faces challenges such as centralization, monopolistic tendencies, and technological stagnation. To address these, the Reserve Bank of India (RBI) introduced a framework for NUEs, which aims to foster competition, enhance infrastructure, and mitigate systemic risks.

Unlike NPCI, NUEs are envisioned as profit-driven entities capable of levying transaction fees, attracting private investment, and introducing innovative technologies. The editorial delves into the strategic potential of NUEs, particularly their role in fostering foreign direct investment (FDI) and boosting financial inclusion. India's burgeoning fintech sector, supported by government initiatives and relaxed FDI norms, positions NUEs as pivotal in integrating domestic and international markets. However, concerns over regulatory compliance, anti-competitive practices, and foreign influence on critical economic infrastructure necessitate a cautious approach.

The editorial critiques the RBI's decision to pause the NUE licensing process due to a lack of innovative proposals. It emphasizes the urgent need for NUEs to address infrastructural deficiencies, enhance global connectivity, and compete with international payment giants like Visa and MasterCard. The authors recommend a collaborative effort between the RBI and consortiums to refine proposals, targeting remittance-heavy markets and leveraging cross-border linkages. By addressing these gaps, NUEs could transform India's payment ecosystem, driving economic growth, fostering innovation, and ensuring global competitiveness.

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I. INTRODUCTION

The Indian payment system ecology, which is currently controlled by the National Payments Corporation of India **["NPCI"]**, has been examined by the Reserve Bank of India **["RBI"]**. Some of the most popular payment systems that are currently run by the NPCI are UPI, IMPS, CTS, BHIM, RuPay, NETC, BharatQR, and AePS. In order to reduce the risks associated with this concentration of operations, including monopolistic patterns, shortage of creativity, and single point failure, the RBI made the decision to promote entry in the retail payments sector **["RPS"]**.[1]

On SEPTEMBER 27, 2019, the 20th edition of the Financial Stability Report[2] was released, highlighting the establishment of a different market participant organisation with the goal of improving coordination and resource sharing. Known as an umbrella entity, this organisation would help the retail payments ecosystem.

In light of this, the RBI published a Draft Framework for the Authorisation of Pan-India New Umbrella Entity for Retail Payments **["Draft Framework"]**[3] on February 10, 2020. The creation of new umbrella entities **["NUE"]** with the responsibility of setting up, overseeing, and running new payment systems in the retail industry was its main objective. In addition to outlining the requirements that applicant businesses must fulfil, the Draft Framework described the scope of activities that an NUE would carry out.[4]

The fact that NPCI is the only organisation in charge of monitoring all retail payment systems in the nation has drawn criticism from industry participants. To increase competition in this market, the RBI is allowing other organisations to set up umbrella companies for payment systems. The objective of those aiming to establish these NUEs is to increase their share of the market for digital payments. Due to its non-profit status, NPCI has limited capacity to develop a more resilient and dynamic digital payment network or enhance and broaden its technological foundation. In all these years after UPI was established in India, not much technological advancement has been made pressing upon the need to let entities establish NUEs as a profit-making organisation which shall

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[1] *New umbrella entities explained: Why India has delayed their retail payment systems*, Financial Express (Sept. 13, 2021), https://www.financialexpress.com/business/banking-finance-new-umbrella-entities-explained-why-india-has-delayed-their-retail-payment-systems-2329445/.

[2] Yogesh Dayal, *20th issue of the Financial Stability Report (FSR)*, Reserve Bank of India (Dec. 27, 2019), https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR15309AF20CEFCBCC406FAD83BD7FBCCD2AEC.PDF

[3] Department of Payment, *Framework for authorisation of pan-India Umbrella Entity for Retail Payments*, Reserve Bank of India (2020), https://rbidocs.rbi.org.in/rdocs/notification/PDFs/FRAMEWORKCC3A86B01E974EB3BDD6930ED922B31C.PDF.

[4] *Framework for Authorisation of Pan-India Umbrella Entity for Retail Payments*, Trilegal (June 20, 2022), https://trilegal.com/knowledge_repository/framework-for-authorisation-of-pan-india-umbrella-entity-for-retail-payments/.

be authorised by the RBI under Section 4 of the Payment and Settlement Systems Act, 2007[5] **["PSS"]** to act as a pan-India NUE for retail payments.

II. New Umbrella Entity: Meaning and its Need

A. Meaning

Unlike NPCI, New Umbrella Entities are permitted to charge fees for transactions and may opt to register as Section 8[6] companies under the Companies Act of 2013 or operate as for-profit businesses. Additionally, they are able to collect interest on the sums that consumers maintain in their online accounts. An NUE license will enable businesses to create, administer, and run Aadhaar-based payment systems, White Label PoS, ATMs, and remittance services, as well as create novel methods of payment, criteria, and technologies, and monitor pertinent matters both nationally and internationally, in accordance with RBI guidelines.[7]

NUEs will be authoriseauthorised by the RBI in accordance with Section 4 of the Payment and Settlement Systems Act of 2007[8]. According to the Draft Framework, these organisations must keep a minimum balance of INR 300 crore at all times. Additionally, the only entities eligible to apply as promoters or members of a promoter group are those that are "owned and controlled by Indian residents" as per the definition in the Foreign Exchange Management Act **["FEMA"]** Regulations and possess a minimum of three years of experience in the payments ecosystem as a Technology Service Provider **["TSP"]**, Payment System Operator **["PSO"]**, or Payment Service Provider **["PSP"]**. This indicates a desire to restrict international participation while allowing foreign investment under certain restrictions.[9] The RBI would still have the power to authorise or select board members, and corporate governance guidelines will also be followed.

For the NUE to meet its capital requirements for handling risks, investing in technology facilities and running its operations, it must have a minimum paid-up capital of ₹500 crore. Less than 40% of the NUE's capital may be owned by any one promoter or promoter group and any organisation that owns more than 25% of the NUE's paid-up capital is considered

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[5] § 4, The Payment and Settlement Systems Act, 2007.
[6] § 8, The Companies Act, 2013. Act no. 18 of 2013.
[7] Komal Gupta, *RBI releases Draft Framework for authorisation of a pan-India New Umbrella Entity (NUE) for Retail Payment Systems*, Nasscom Community (Feb. 12, 2020), https://community.nasscom.in/communities/policy-advocacy/rbi-releases-draft-framework-for-authorisation-of-a-pan-india-new-umbrella-entity-nue-for-retail-payment-systems.html.
[8] Supra note 5.
[9] Supra note 3.

a promoter. [10] In order to establish the NUE, promoters must show that they have contributed at least ₹50 crore (10% of the minimum capital) up front. The shareholding of the promoter or promoter group must be lowered to a minimum of 25% following five years of operation. Another thing which must be present in such entities is the diversity in the pattern of shareholding.[11]

B. Need for NUEs

i. Non-Participation Of Nbfcs

According to the Framework, there are many possible advantages to establishing a second pan-India umbrella entity that focuses on retail payment systems. In a market that is currently controlled by a single organisation that is solely backed by banks, the main objective is to bring competition from non-banking firms. The framework allows non-banking entities to participate by requiring three years of expertise in the payment's ecosystem as a TSP, PSO, or PSP.[12] Despite the existence of prominent private e-wallet companies such as Paytm and PhonePe, the current retail payment ecosystem does not permit their inclusion in the NPCI framework, making this a significant shift.[13]

ii. Centralisation

Ten promoter banks currently make up NPCI, and by 2016, 56 banks from a variety of industries had increased their shareholding. The planned NUE allows non-banking companies to create their own payment systems that are not dependent on NPCI's offerings. Already, PSOs and TSPs like RazorPay and Billdesk have expressed interest, as has MobiKwik. Furthermore, the stability of the nation's financial system is anticipated to be enhanced by the introduction of NUEs, which are anticipated to mitigate the risks related to centralisation.[14]In a significant departure from the restrictions under Section

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[10] Pranav Mukul, *Explained: Why private companies are queueing up to set up NUEs*, The Indian Express (Mar. 8, 2021), https://indianexpress.com/article/explained/explained-why-nue-marks-next-inflection-point-for-indias-payments-ecosystem-7219168/.

[11] Our Bureau, *RBI tables draft framework for pan-India New Umbrella Entity for retail payment systems*, The Hindu BusinessLine (Feb. 11, 2020), https://www.thehindubusinessline.com/money-and-banking/rbi-tables-draft-framework-for-pan-india-new-umbrella-entity-for-retail-payment-systems/article30789684.ece.

[12] Economic Times, *New Umbrella Entity: Nothing innovative presented by applicants, says RBI*, The Economic Times (Apr. 6, 2023), https://economictimes.indiatimes.com/industry/banking/finance/banking/new-umbrella-entity-nothing-innovative-presented-by-applicants-says-rbi/articleshow/99300016.cms?from=mdr.

[13] *New Umbrella Entity to Refine India's Digital Payment Ecosystem*, (Aug. 18, 2020), https://www.counterpointresearch.com/insights/nue-india-digital-payment-ecosystem/.

[14] *Umbrella entities for retail payments: Game changer or perfunctory policy? – NLUJ LAW REVIEW*, (Oct. 13, 2020), http://nlujlawreview.in/banking-and-finance-law/umbrella-entities-for-retail-payments-game-changer-or-perfunctory-policy/.

4(2) of the Payment and Settlement Systems Act, 2007[15], the framework also permits non-banking companies to engage in clearing and settlement systems without the capital constraints normally placed on Public Sector Banks. Furthermore, the admission of competing companies is anticipated to spur innovation and uphold high service standards, given that NPCI already oversees the management of UPI, IMPS, Aadhaar Enabled Payment System, Bharat Bill Payment System, RuPay, FASTag, and other payment channels. The main goals of this project are to prevent monopolies, mitigate the dangers of a single point of failure in the payment ecosystem, and guarantee future operational security and efficiency.[16]

iii. <u>Anti-Competitive actions</u>

"Guidelines on volume cap for Third Party App Providers (TPAP)"[17] was published by NPCI. According to the Circular, which goes into effect on January 1, 2021, TPAPs must make sure that the total number of transactions made through their individual Unified Payment Interface (UPI) applications does not surpass 30% of all transactions made in the nation during the previous three months. Moreover, TPAPs that now exceed the 30% cap have been given two years to adhere to this new rule. The Standard Operating Procedure (SOP), which outlines the requirements for TPAPs to adhere to the volume cap, was also published by NPCI on March 25, 2021. When looked at from a regulatory perspective, the Circular might violate the Competition Act, 2002.

As per Section 4 of the Competition Act,[18] no business or organisation may misuse its position of dominance. Under sub-section (1), there is an abuse of dominant position if a business or group "*Limits or restricts the production of goods, the provision of services, or the market.*"

By restricting the number of transactions that each TPAPs can manage to 30%, NPCI has restricted service provision, which is considered an ***"abuse of dominant position"*** under the Competition Act.

As NPCI is the sole body looking after UPI transactions, its actions could be anti-competitive sometimes. If there are multiple players present in the market, then it will

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[15] § 4(2), The Payment and Settlement Systems Act, 2007 (51 of 2007).
[16] Id.
[17] *Guidelines on volume cap for Third Party App Providers (TPAPs) in UPI*, NPCI (Nov. 5, 2020), https://www.npci.org.in/PDF/npci/upi/circular/2020/OC-97-Guidelines-for-TPAPs-in-UPI.pdf.
[18] § 4, The Competition Act, 2002.

not only hone healthy competition amongst them but also enhance the quality of service being provided.

iv. Zero Merchant Discount Rates

Even in the case of low-value transactions, the cost is still significant for banks, leaving little to no motivation because the margins are small or non-existent and frequently even lesser than a rupee. To make matters worse, any tiny gains that banks might have made have been completely erased by the finance ministry's decision to stop using merchant discount rates **["MDR"]** on UPI and RuPay transactions from January 01, 2020.[19] The acquiring payment sector has effectively been hit hard by this zero-MDR regulation. There is currently no financial motivation for PSPs who provide the infrastructure for digital payments, to keep making investments in such an infrastructure.

Many times, people face the issue of delayed or non-payment through UPI. This issue could be attributed to the lack of digital infrastructure. Customers of banks are experiencing severe financial hardship as a result of the increase in UPI payment failures. Notably, during a market slump on June 4, many investors were unable to complete deals using UPI, which led to lost money possibilities.

Every UPI transaction undergoes a number of processes at the merchant's location. These include instantly establishing a connection between the customer's bank and the merchant's bank via the NPCI server. Therefore, the transaction would fail even if there was a single-second lag or delay in response from any of the participants, such as banks or the NPCI server. As a result, banks and NPCI need to make sure that their servers can process thousands of transactions simultaneously, and the NPCI needs to make sure that its servers can accurately identify and switch transactions. To build a robust system which is capable of handling multiple transactions simultaneously, while upholding the security of each such transaction, needs investment, which the institutions may not be in a position to make due to the zero MDR scheme. Hence, with the introduction of NUE, the intermediaries would also earn some profit which could be invested in advancing the technological infrastructure.

[19] Indranil Chakraborty, *The good, the bad, and the ugly of UPI transactions*, Payhuddle Solutions (July 9, 2024), https://www.payhuddle.com/post/bad-and-ugly-upi-transactions.

III. FOREIGN DIRECT INVESTMENT IN NUES

One of the FinTech markets with the quickest growth rate in the world is India. The Indian FinTech industry is expanding rapidly, with more than 2,000 FinTech companies formally registered by the Department for Promotion of Industry and Internal Trade (DPIIT). According to projections, the Indian FinTech industry's total addressable market is expected to grow to $1.3 trillion by 2025. Additionally, it is anticipated that revenue would reach $200 billion by 2030, while assets under administration will total $1 trillion. Without question, the Indian FinTech market is set to grow significantly over the next several years.[20]

The Indian government has been aggressively promoting foreign direct investment **["FDI"]** in the FinTech industry through programs like **"Start-up India"**, **"Digital India"**, and the **"Make in India"** campaign. The government has increased the FinTech industry's appeal to international investors by relaxing FDI requirements. By providing more convenient, accessible, and customised solutions, fintech companies—which range from online loan services to digital payment platforms—have upended established financial systems.[21] The rapid uptake of peer-to-peer financing platforms, electronic payment systems, and smartphone wallets suggests that Indian consumers are becoming more trusting of and accepting of FinTech services. FDI in the FinTech sector has had a major impact on the domestic economy. It has created new job opportunities, boosted adoption of newer technologies, and expedited economic growth. FDI in the FinTech sector has also helped to bridge the disparity that exists between urban and rural populations by facilitating the availability of financial services in remote places. Our FinTech sector has also improved economic inclusion by giving the unbanked a chance at banking and financial services. According to a World Bank estimate, almost 190 million Indians do not have access to formal financial services. Indian FinTech companies have been successful in providing financial services to this demographic through their online platforms and mobile apps.

The amount of money raised by FinTech startups in 2021 almost quadrupled from that of 2020. The top three firms, Pine Labs, OfBusiness, and CRED, raised a combined $2.3 billion, and 12 FinTech businesses became ***"unicorns"***. Investments in India's FinTech sector came to $1.2

[20] Giulio Cornelli, Jon Frost, Leonardo Gambacorta, Sonalika Sinha, Robert M. Townsend, *The organisation of digital payments in India- lessons fromm the Unified Payments Interface (UPI),* Suerf, The European Money and Finance Forum (Aug. 14, 2024), https://www.suerf.org/publications/suerf-policy-notes-and-briefs/the-organisation-of-digital-payments-in-india-lessons-from-the-unified-payments-interface-upi/.

[21] *Trends in Trade and Foreign Direct Investment in FinTech and FinTech Related Services: Challenges and Prospects from Digital Transformation of Financial Markets — Centre for Global Finance*, Centre for Global Finance (Aug. 16, 2023), https://www.centreforglobalfinance.org/cgf-events-list/2023/11/15/trends-in-trade-and-foreign-direct-investment-in-fintech-and-fintech-related-services-challenges-and-prospects-from-digital-transformation-of-financial-markets.

billion in the first quarter of 2023, a 55% decrease from the $2.6 billion raised during the same period in 2022. Nonetheless, this was a noteworthy 126% rise in contrast to the $523 million raised during the fourth quarter of 2022. There were six FinTech financing rounds totalling $100 million in the first quarter of 2023.[22] Over $100 million in funding was raised during this time by businesses like PhonePe, Mintify, Insurance Dekho, and KreditBee. In terms of total funding operation, we ranked among the top five countries of the world and were the ***"second-highest-funded"*** region in the global FinTech sector, closely following the US, according to Tracxn's Geo Quarterly FinTech India Report - Q1 2023[23].

Along with the structural features, strong private investment has been a key factor in the development of India's digital payment system, fostering more chances for innovation and market entry.

The above discussion highlights the importance of the digital payment sector in securing record FDI for the country, besides proving the fact that FDI for fintechs would be available and more so increase in the future. The money so earned helps the various entities enhance their services and products. Currently, as per the FDI policy of 2020[24], ***"other financial services"*** are entitled to get an FDI of 100% through an automatic route if such services are regulated by any financial sector regulator such as RBI, SEBI etc. As NUEs would be regulated by RBI under PSS, they would become eligible for 100% FDI through an automatic route, but the framework states that the foreign players can only have less than a 25% stake in the entity as a promoter.

As per Section 2(69) of the Companies Act, 2013[25], a promoter is someone who has direct or indirect control over the affairs of the company or whose advice the Board of Directors is used to act upon. Here, if the foreign player becomes a promoter, they would control the NUEs, which leads to them controlling a significant part of our economy.

This could be attributed to the fact that the NUE, in case it becomes popular, would become a strong pillar of our economy. This assertion could be made based on the fact that UPI's total transaction value by the end of 2022 was INR 125.95 trillion, growing 1.75 times YoY, which

[22] Yogesh Jhunjhunwala, *FDI in FinTech*, Invest India (May 29, 2023), https://www.investindia.gov.in/team-india-blogs/fdi-fintech.
[23] Textile Value Chain, *Tracxn Releases its Q1'23 India Tech Quarterly Report: Startup Funding Plunges by 75% Compared to Q1'22*, Textile Magazine, Textile News, Apparel News, Fash (Apr. 11, 2023), https://textilevaluechain.in/news-insights/finance-economy-news/tracxn-releases-its-q123-india-tech-quarterly-report-startup-funding-plunges-by-75-compared-to-q122.
[24] *Consolidated FDI Policy*, Department for Promotion of Industry and Internal Trade (Oct. 15, 2020), https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf.
[25] § 2(69), The Companies Act, 2013. Act no. 18 of 2013.

represented about 86% of our GDP.[26]If any foreign player manipulates a market as big as this, or does anything which affects the payment systems, a good chunk of the economy could crash.

Such a cautious approach is also seen in the amendments that were made to FEMA regulations around 2020, very close to the time when the draft framework was published, which kept residents of neighbouring countries away from investing in many sectors of the Indian economy. Such an approach is justified on the basis of the argument of National Security, however, the allowance of non-promoter shareholders to be foreign ensures that the technological transfer is not harmed.

IV. RBI'S CURRENT STANCE WITH RESPECT TO NUES

In order to allow the various entities, to come up with their payment systems, RBI invited applications for an NUE licence by February 26, 2021, which was extended to March 31, 2021. Several prominent consortia have formed in the race to establish New Umbrella Entities (NUEs). One consortium includes Amazon, Visa Inc., Indian private lenders ICICI Bank Ltd. and Axis Bank, along with financial-services startups Pine Labs and BillDesk. Another group is led by Reliance Industries, which has partnered with Facebook and Alphabet Inc.'s Google. Paytm has joined forces with ride-hailing startup Ola, IndusInd Bank, and Policy Bazaar, among others. The Tata Group has collaborated with Mastercard Inc., Airtel Digital, and Indian banks HDFC and Kotak. Financial Software and Systems is applying in partnership with India Post Payments Bank Ltd., RazorPay, and other players. Additionally, U.S.-based payments firm FIS has teamed up with Union Bank of India and Punjab National Bank.[27]

These applications represent the enthusiasm which is there in the market to start developing the NUE and provide its service to the customers. Despite such a response from various domestic and international firms, the RBI has decided to put the idea on hold. The reason given by RBI for this is that none of the applicants proposed anything novel or a great technology breakthrough that would have made RBI happy, and all applicants plans were similar to the model of NPCI. This poses a hindrance to the development of a competitive digital economy.

This step of the RBI could be analysed from two perspectives, first that if nothing new is being proposed, then there seems no need to find an alternative to our current NPCI and second, that such a stance would be detrimental to the future FDI that these NUEs could have raised. Letting

[26] *Digital Payments driving the growth of Digital Economy*, National Informatics Centre https://www.nic.in/blogs/digital-payments-driving-the-growth-of-digital-economy/.
[27] ET Bureau, *RBI shelves plan for NUE*, The Economic Times (Apr. 7, 2023), https://m.economictimes.com/news/economy/policy/rbi-shelves-plan-for-nue/articleshow/99305861.cms.

the idea go is a way to remain unconcerned about the issues and challenges raised by the UPI. There are many issues and challenges with the primary one being the inferior infrastructural setup leading to many failed transactions. To tackle this, funds would be required to upgrade the technology used and make it better suited for an economy dealing with the number of transactions as high as ours. In the month of September, 2024, we had 15,041.75 million transactions through UPI for a total of ₹ 20,63,994.71 crores. [28]

Currently, there are no transaction costs for personal transactions. Whether they are paying for groceries, sending money to pals, or conducting other private transactions, UPI is still totally free for them.[29] The cherry on the top is the Zero-MDR, which leaves no incentive for the PSP to invest in the infrastructure. Therefore, allowing paid UPI transactions via NUE could act as a driving force behind the boom in the making of state-of-the-art technological infrastructure which is appropriate for the transaction volumes.

V. CHALLENGES WITH NUE

Notwithstanding the need and advantages enumerated before, there do lie some challenges with NUE. Some of them have been enumerated below: -

A. Cost of Transaction

The RBI has given the NUEs an option to either remain a charitable institution under Section 8 of the Companies Act, 2013, or become a for-profit entity. Keeping in mind the fact that many private companies have formed consortiums to operate NUEs, it would be logical to assume that they are doing this in order to earn profits. Until now, UPI transactions have been absolutely free of cost. In case you transfer money to any other individual or merchant, you don’t have to pay any kind of extra amount. In case NUE comes up and becomes operational, one might have to pay some extra charges for using their platform.

This argument could be refuted by acknowledging the fact that NUE will not replace NPCI, rather it will complement it. Having said that, the scenario would be similar to today’s banking system where private and public entities operate. In the case of private banks, the services are better as compared to public banks, but that doesn’t come at no cost. Private banks such as ICICI. Mandate you to keep a minimum balance of ₹ 10,000, failing which a

[28] *UPI Product Statistics*, NPCI, https://www.npci.org.in/what-we-do/upi/product-statistics.
[29] Chidananda Vasudeva, *UPI Transaction Limit Per Day in 2024: UPI Transaction Charges and Rules*, (Oct. 11, 2024), https://razorpay.com/learn/upi-transaction-charges/.

hefty penalty is imposed immediately. Such is not the case with public banks, where they have very low minimum balance requirements and they don't penalise as quickly as a private bank, but in the end their services are poor. For example, the server of ICICI Bank will not be down as frequently as that of SBI.

Hence, in the case of digital payments as well, customers might not be left with a choice in case the servers are down or other technological issues occur. In such cases, they might have to use the NUEs, despite NPCI being present, and pay the extra amount that the entities will be charging.

B. Non-Acceptance by Customers

Another challenge which can arise for these NUEs is the non-acceptance by the customers. Contrary to what has been discussed in the previous point, in case the customers do not shift to these new NUEs, then the survival of such entities would be at stake. This non-acceptance could stem from the fact that there is no substantial difference between the NUEs and the current framework. If in terms of service time, quality of service and variety of services, the NEUs are similar to that of the current entities, there would be no incentive for people to switch.

For example, if out of 10 transactions done through NPCI, 7 are successful in one go and 3 either take more time to process or fail completely, and on a similar note out, of the 10 transactions made through NPCI, 6 are successful in one go and 4 either take more time to process or fail completely, then because the success rate of NUEs is not much different from that of NPCI, it wouldn't be prudent for the customers to switch when NPCI is anyways not charging any extra fee.

C. Lack of Innovation

As discussed in the previous challenge, the lack of innovation could be one of the reasons due to which the NUEs fail. The RBI, while putting the idea on a standstill, observed that the various consortiums didn't come up with any innovative idea which could differentiate them from the current NPCI framework. In case there is a lack of novelty in the NUEs, it would not be feasible for them to shake the market. The current regime has several problems, especially the lack of appropriate infrastructure and if the NUEs don't have any concrete plan for doing something new, it would neither get RBI's confidence nor the potential customers.[30]

VI. FUTURE IMPACT OF NUEs

The NUE being proposed this time is not being restricted to our country, and reports have shown that the Reliance-led consortium desires to create an NUE which would be operational globally through its foreign partners.[31] Other NUEs can also aim for the same thing and hence give a competition to global giants like MasterCard and Visa.

The NUEs, if they become operational, would provide a different platform to undertake all your digital transactions. This would include UPI payments as well as card payments. Currently, we have online banking services by Mastercard, Visa (international and domestic) and RuPay (domestic and some countries abroad). Since its launch in 2012, RuPay has gained a lot of attention and customers, giving a tough fight to MasterCard and Visa. Slowly and steadily, RuPay and UPI are becoming popular in countries other than India such as Mauritius, Sri Lanka, Singapore etc. which is also projected to give a tough competition to MasterCard and Visa **["the Duo"]**.

A. MasterCard and RuPay

A wider range of financial services would be provided by NUEs compared to the services provided by the Duo, which primarily concentrate on card-based transactions. This could give NUEs an advantage and broaden its service offering. Examples of this include electronic payments, transactions between peers, wallets, and domestic card schemes. When our domestic NUEs would be launched on a global scale, it would try to shake the market which is being dominated by the Duo.[32]

The Duo generally provides for card transactions to be made worldwide. We have had other regional or local payment systems but an entity which can compete with them is yet to be seen. In India, we have already put them on the backfoot with our RuPay cards and UPI. An NUE might establish itself as a rival to Mastercard and Visa on the international level as Indian digital payment systems become more well-known abroad. With more economical

[30] Joel Rebello, *Reserve Bank of India puts on hold NUE licensing*, The Economic Times (Jan. 7, 2023), https://m.economictimes.com/industry/banking/finance/reserve-bank-of-india-puts-on-hold-nue-licensing/articleshow/96803826.cms.

[31] Saikat Das, *RIL plans global payments play via NUE*, The Economic Times (Apr. 4, 2021), https://economictimes.indiatimes.com/industry/banking/finance/ril-plans-global-payments-play-via-nue/articleshow/81899596.cms?from=mdr.

[32] Rajan Shah, *India's RuPay Takes On Mastercard-Visa Duopoly*, The Case Centre (2019), https://www.thecasecentre.org/products/view?id=159208.

and effective transaction methods, it might extend its services into foreign markets with which India has solid trading ties. With advancements in digital payments, particularly in real-time payment systems, NUE may pose a global threat to the Duo.

B. SWIFT

SWIFT is a worldwide payment system that makes it easier to move money beyond boundaries. The Belgian-based system links 11,000 banks and other financial institutions in 200 nations. The only purpose of Swift is to notify customers whenever any amount is credited or debited. Here it is important to note that it is not a banking network. Daily it manages trillions of dollars in transactions.

The need to look for its replacement came up when SWIFT cut off Russia from its global network after the US and its European allies sanctioned Russia for attacking Ukraine. Such an action not only affected Russia's economy but also its international trade. As a result, nations like India were forced to look for SWIFT substitutes right once, which led to the creation of a rupee-based system for international trade settlements. The action taken by the RBI was perceived as an attempt to subvert the dollar's and euro's hegemony in international payments.

NUE could be an alternative to this system. Our homegrown UPI couldn't be an alternative due to the minute scale at which UPI functions and its inability to put a bar on fraud or mistakes in payments made in real time. With NUE as profits would be involved, it is expected that the system would be better than UPI in terms of the security of transactions and quality of service. Hence, with time NUEs could be an alternative to SWIFT for the world.[33]

C. Remittances and small-scale investment

An InterAmerican Development Bank (IADB) study conducted in 2003 revealed that depending on the type of financial institution, the cost of sending US$200 to India through a financial institution could range from 6% to 14% (with banks being more expensive than MTOs).[34] According to a 2003 study[35], the cost of sending money using the hundi was significantly lower, at 2.5 percent. According to a 2005 World Bank study and field survey,

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[33] Policy Circle Bureau, *Global payments system: Can India present UPI as alternative to SWIFT*, Policy Circle (Sept. 22, 2022), https://www.policycircle.org/industry/global-payments-upi-swift/.

[34] Gabi G., Afram, *The Remittance Market in India Opportunities, Challenges, and Policy Options*, (The World Bank) (2012).

[35] Orozco, *"Worker Remittances in International Scope."* Working Paper commissioned by the Multilateral Investment Fund of the Inter-American Development Bank, Washington DC (2003).

households in receiving countries earn more local currency when unofficial methods are used, even if the costs of remitting to India have been falling.[36] Such a huge cost of transfer inhibits remittances through legal means and also leads to a lesser amount coming to the country.

A lower cost of transmission can also allow for foreign investment in MSMEs to increase. MSMEs currently account for 49% of India's export market[37] and importers in foreign countries would be keen to have control over their supply chain by investing in such MSMEs.

UPI has proved to be a boon for NRI investment in Indian stock markets[38] and a modern and competent NUE can further take this forward. NRI deposits have seen a significant uptick in the recent years[39] and Indian stock markets would also stand to benefit from a global NUE as lower costs of transferring remittances would mean more money left for investment through the stock market or by other means.

An NUE could also facilitate easier corporate transfers and payments for foreign entities situated in IFSCs which would make such projects more viable and further attract investment into the country.

VII. SUGGESTIONS AND CONCLUSION

The expansion of India's digital payment industry has been greatly aided by FDI. India has emerged as a desirable location for foreign investors looking for FinTech innovation prospects due to its benevolent regulatory framework and growing digital penetration. In addition to speeding up economic expansion, FDI has helped close the access disparities between urban and rural residents in terms of financial services. The industry's potential and investors' faith are demonstrated by the record-breaking funding raised by Indian FinTech start-ups. The sector's trajectory indicates

[36] Maimbo, S. R. Adams, R. Aggarwal, and N. Passas, *Migrant Labor Remittances in South Asia*, Direction in Development Series, Washington, DC: World Bank (2005).

[37] India Briefing, *A Guide to the MSME Sector in India for Foreign Investors*, (Dec. 13, 2023), https://www.india-briefing.com/news/msme-india-guide-for-foreign-investors-classification-support-schemes-sector-opportunities-28455.html/.

[38] Arnav Grover, *NRI Investment in India via UPI: A Comprehensive Guide*, (Jan. 16, 2024), https://www.vance.tech/blog/unlocking-investment-opportunities-for-nris-upi.

[39] Economic Times, *NRI deposits surge, thanks to India's strong post-pandemic report card*, The Economic Times (June 14, 2024), https://economictimes.indiatimes.com/nri/invest/nri-deposits-surge-thanks-to-indias-strong-post-pandemic-report-card/articleshow/110995492.cms?from=mdr.

success and a revolutionary impact on financial inclusion as India continues to adopt digital payments and FinTech services.

The FDI in the fintech sector has been tremendous which showcases the trust that investors have in our companies and people. Therefore, if we want to give an alternative to the most dominant payment and financial transaction systems in the world, we would need the appropriate funds.

The RBI has put on hold all the proposals for an NUE, however, the same has been done due to the proposals not being as innovative as desired by the RBI[40]. Putting the process on hold is not the correct step as the need for an NUE is more evident than ever. Therefore, the authors suggest that the RBI must elucidate more upon these points so as to allow the various consortiums to redraft their proposals and come up with something found desirable by the RBI.

Further, the authors also suggest that the consortiums must focus their NUE more on the global interlinkage aspect of connecting markets. The current NPCI-operated payment system, although ridden with flaws and inefficient in dealing, is more or less able to handle the domestic demand in the country. Any NUE must target countries which send a lot of remittances to the country and/or attract Indian tourists. Linking their NUE with systems currently existing within such countries like the UAE, USA, Canada etc., would make the NUE more viable for the consumer as payment systems in these jurisdictions generally charge payments, making the NUE more viable for users in such countries.

Therefore, a combined effort by the RBI and the consortiums is warranted to initiate any new development towards an NUE which corrects all the existing flaws while attracting foreign investment and foreign exchange into the country.

[40] *'Didn't get any good plan for NPCI rival'*, Mint (Apr. 6, 2023), https://www.livemint.com/news/india/rbi-puts-nue-initiative-on-hold-as-industry-fails-to-offer-innovative-proposals-for-rival-to-npci-concerns-over-data-safety-cited-digitalpayments-npci-rbi-11680799432887.html.