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Printed, published and owned by the Registrar, Rajiv Gandhi National University of Law, Punjab, Bhadson-Patiala Rd, Sidhuwal, Patiala, Punjab, 147 006.

To our dear friends Ishaan, Reet, Ribhu and Kushagra.

You will be forever missed, but never forgotten.

IN MEMORIAM: Ms. Reet Kaur Virk

Ms. Reet Kaur Virk's tenure at the RFMLR was marked by exceptional dedication and an unwavering commitment to excellence. Her distinguished legal acumen and compassionate nature have left an indelible mark on all who knew her.

Over the past five years, Ms. Virk demonstrated a relentless pursuit of excellence, inspiring her colleagues with her fervent enthusiasm. Her leadership transcended traditional roles, fostering a collaborative and inclusive environment where every editor felt valued and empowered to contribute their best. Ms. Virk's genuine kindness and warmth created a collegial atmosphere that endeared her to all who had the privilege of working with her.

The void left by Ms. Virk's absence is deeply felt by our board. We extend our heartfelt condolences to her family and loved ones during this difficult time. Her memory will forever be treasured by the RFMLR family. May her soul rest in peace, and may her legacy of excellence and compassion continue to guide and inspire us all.

EDITORIAL NOTE

Dear Readers,

On behalf of the Editorial Board of the RGNUL Financial and Mercantile Law Review ("RFMLR"), we wish all the readers and patrons the best of health. We are pleased to present the RFMLR Volume XI Issue I. This Issue consists of manuscripts catering to a variety of laws such as corporate law, finance, insolvency, banking and finance, dispute resolution, telecommunication, and white-collar crimes.

The RFMLR stands as a premier academic and legal journal, renowned for its scholarly rigor and practical relevance. Embracing an interdisciplinary approach, it explores complex issues at the nexus of law, finance, and commerce. RFMLR publishes timely articles, case notes, and commentaries, addressing current and emerging topics in financial and mercantile law with an international perspective. It serves as a valuable educational resource, fostering dialogue among scholars, practitioners, and policymakers. RFMLR provides a platform for emerging scholars to contribute to the academic discourse, enriching understanding and informing decision-making in the global business community.

The Editorial Board has always made a stride towards achieving excellence and contributing to the existing legal discourse through publications and other academic initiatives. During this academic session, the Editorial Board organised 4th edition of the 'Demystifying Series' on the topic 'Navigating the Evolving Regulatory Landscape: Impact on Mergers and Acquisitions and Corporate Governance' on February 17, 2024. The session was a successful event wherein Mr. Pratika Shankar, Partner at Talwar Thakore & Associates (TT&A) discussed the evolving regulatory regime in India.

The Editorial Board also organised the RFMLR-CAM Blog Series Competition on the topic 'Emerging Trends and Developments in the Competition Law Regime' in March 2024 in collaboration with the reputed law firm, Cyril Amarchand Mangaldas. The same was followed by a virtual Expert Panel Discussion on the topic. Mr. Dhruv Rajain and Mr. Kirthi Srinivas, Partners at Cyril Amarchand Mangaldas discussed various sub-topics as the killer acquisition, leniency plus and hub-and-spoke cartel wherein students and attendants were able to understand these topics efficiently.

We are thrilled to unveil the First Issue of Volume XI, a testament to the professionalism and dedication of our Senior Editors, Associate Editors, Junior Editors, Citation Editors, Copy Editors, Digital Editors, and Assistant Editors. Our esteemed Peer Board, comprising distinguished Practitioners and Academicians from various fields such as Capital Markets, Intellectual Property Law, Arbitration, Insolvency, Mergers and Acquisitions, Banking and Finance, and Technology Law, played a pivotal role in this Issue's publication.

We assure our contributors and readers that the Board is continually enhancing the Journal's visibility and impact. We eagerly await your feedback and submissions for our forthcoming Issues.

Aryan Gupta

Managing Editor

(*On Behalf of the Editorial Board)*

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- Prof. (Dr.) Ritu Gupta and Siya Jangir*

ABSTRACT

India is a country with a young demographic enchanted and enticed by the digital world. Emerging within this context of increasing digitisation is the online gaming industry. Online games include real money games which may be games of skill or chance. The involvement of real money has become a cause of unease and even consternation for governments struggling to keep pace with the evolving nature of the industry. The Indian Government has also been scrambling to come up with effective models of regulation. Most recent moves include the imposition of GST at the rate of 28% and amendments to the Information Technology (Intermediary Guidelines and Digital Media Ethics Code) Rules, 2021. This paper seeks to analyse these initiatives in terms of their structure and consequences, as well as the rationale behind their implementation. The paper begins with a general introduction to the current scenario in India followed by a section distinguishing between online gaming and gambling. There is an in-depth discussion on the social ramifications of the industry and the moral dilemma it poses. The subsequent sections explore in detail the recent measures including the latest MeitY rules and increase in the rate of GST. Lastly, the paper consists of a cross-jurisdictional view on regulating the online gaming industry to compare the characteristics of various regulatory models.

* The authors are currently working as Professor of Law and student of B.A. LL.B. at National Law University, Delhi, respectively. Views stated in this paper are personal.

I. INTRODUCTION

The online gaming industry in India has been growing rapidly for the past decade. This growth has been fuelled by the expansion of high-speed internet access and affordable gadgets. Moreover, in a country with an ever-increasing young demographic, it harnesses extraordinary potential. With 15 billion installs in FY 2022, India had the highest share of game downloads globally.[1] Having already generated USD 1.5 billion, the industry is projected to exceed revenue figures of USD 5 billion by 2025, according to the BCG Sequoia Report.[2] The lucrative nature and massive revenue streams of this industry coupled with the emergence of new players in the market have brought it into the government's spotlight, which has finally taken cognisance of the need for uniformity in both regulation and taxation. This recognition has culminated in two key developments: the new online gaming rules[3] notified by the Ministry of Electronics and Information Technology ("**MeitY**"), and the implementation of a 28% rate of GST.[4]

For the purpose of this paper, emphasis is on the underlying rationale of morality and social concerns which guided the processes by which these measures came into effect. As online gaming grew popular, various state governments first sought to regulate the industry owing to concerns of

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1 Farhat Basir Khan, 'Skill, Not Chance, will be Needed to Differentiate Game of Skill from Chance' (*The Times Of India*, 18 January 2023) < https://timesofindia.indiatimes.com/blogs/voices/skill-not-chance-will-be-needed-to-differentiate-game-of-skill-from-game-of-chance/> accessed 20 September 2023.

2 'Online Gaming In India: Boon for Economy, Employment' (*India Corporate and Social Responsibility*, 16 November 2022) <https://indiacsr.in/online-gaming-in-india-boon-for-economy-employment/> accessed 21 September 2023.

3 The Information Technology (Intermediary Guidelines and Digital Media Ethics Code) Amendment Rules 2023.

4 The Central Goods and Services (Amendment) Bill 2023.

addiction and gambling.[5] Yet the lack of a unified regulatory framework was sorely felt and MeitY thus brought in the new online gaming rules[6] focusing on the roles of intermediaries and self-regulatory bodies ("**SRBs**"). The discourse surrounding these rules, in turn, also led to a more accelerated discussion on the rate of taxation for online gaming. Thus came the implementation of a 28% rate of GST.

Prior to the final implementation of this rate, the conundrum before lawmakers was the skill versus chance dichotomy. The primary argument from the industry was that these are in fact games of skill and should therefore be regulated accordingly and treated differently from games of chance. The previous GST regime acknowledged the distinction between games of chance and games of skill placing an 18% tax on games of skill but a 28% tax on games of chance.[7] This was primarily because the industry was operating on a much smaller scale at the time and the government, therefore, took a more lenient approach in taxation. Moreover, amidst this debate, the Indian judiciary also dealt with numerous cases[8] to determine the distinctions between games of chance and games of skill. Yet with no definite conclusion to this debate in sight, the urgency for uniform taxation remained.

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[5] The Telangana Gaming (Amendment) Act 2017; The Andhra Pradesh Gaming (Amendment) Act 2020; Tamil Nadu Ordinance No. 4 2022; Karnataka Police (Amendment) Act 2021.

[6] Information Technology (Intermediary Guidelines and Digital Media Ethics Code) Rules 2021 (IT Rules, 2021).

[7] Avani Maheshwari, 'The GST Conundrum of Online Gaming' (2023) 5(2) IJLLR < https://www.ijllr.com/post/the-gst-conundrum-of-online-gaming> accessed 21 September 2023.

[8] *Chandresh Sankhla v. The State of Rajasthan & Ors* (2020) SCC OnLine Raj 264; *Gurdeep Singh Sachar v. Union of India & Ors* (2019) SCC OnLine Bom 13059; *State of A.P. v. K. Satyanarayana* AIR (1968) SC 825.

In light of this came the report of the first Group of Ministers (“**GoM**”) constituted to deal with this issue. This report,[9] which was submitted in the 47th GST Council meeting, outlined a legislative intent which emphasised how the differentiation between games of chance or games of skill is irrelevant considering that the “chance to win” is an inherent feature in all such activities including online gaming. However, it must be noted that this distinction had been acknowledged as far back as the *Chamarbaugwala*[10] case in 1957 and as latest as in the case of *All India Gaming Federation v. State of Tamil Nadu*.[11] The Indian courts, while deciding the question of ”*skill* v. *chance*”, have adopted the test followed by the US Courts, known as the dominant factor test. As per the test, the primary question is whether skill or chance is the dominating factor in the determination of the outcome of the game.[12] This distinction is crucial in deciding whether or not a game comprises of gambling. It is also important to understand the difference between the kinds of players involved in a game. While games of skill may also be played by individuals sparingly as a recreational activity or to cultivate an additional source of small income,[13] players involved in gambling are almost always susceptible to addiction and debt traps.[14]

[9] Report of Group of Ministers on Casinos, Race Course and Online Gaming, 2022 (First Report of GoM).
[10] *State of Bombay v. R.M.D. Chamarbaugwala* 1957 SCC OnLine SC 12.
[11] WP.13203/2023.
[12] Precincts of Electronic Sports, Betting and Gambling, 2022 SCC OnLine Blog Exp 59.
[13] Megha Mandavia, ‘Gaming Fearing backlash, India's skill gaming startups ensure users don't get addicted playing (*Economic Times*, 27 July 2018) <https://economictimes.indiatimes.com/tech/internet/fearing-social-backlash-online-companies-go-for-counselling/articleshow/65157620.cms> accessed 11 January 2024.
[14] Luke Clark and others, ‘Pathological Choice: The Neuroscience of Gambling and Gambling Addiction’ (2013) 33(45) Journal of Neuroscience <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3858640/> accessed 11 January 2024.

Yet, despite the importance attached to this concept by judicial decisions, the distinction between skill and chance was deemed irrelevant by the GST Council and the initial report was followed up by a second report[15] at the 50th GST Council meeting post which a rate of 28% on full value of bets was imposed. This has finally rendered moot the debate on the skill versus chance dichotomy in so far as taxation is concerned. However, this development places online gaming in the same category as casinos, race courses and gambling, giving rise to a greater need to examine the relationship between gambling and online gaming.

II. ONLINE GAMING VERSUS GAMBLING

Gambling and online gaming have a convoluted relationship which is difficult to disentangle. Gambling refers solely to the act of placing bets in the hope of a favourable outcome dependent entirely on chance.[16] The issue of regulating gambling has existed since time immemorial. A crucial point to note here is the moral concern surrounding gambling ever since the colonial era. Gambling has always been considered to be a major social taboo and there has been little tolerance for it both pre- and post-Independence. The earliest legislations on gambling in India go as far back as the Public Gambling Act

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[15] Second Report of the Group of Ministers on Casinos, Race Courses, and Online Gaming, 2023.

[16] Public Gambling Act 1867 < https://file-rajshahi.portal.gov.bd/files/bera.pabna.gov.bd/page/3a656455_1ab0_11e7_8120_286ed488c766/THE%20PUBLIC%20GAMBLING%20ACT,%201867.pdf> accessed 8 November 2023; Dan Glimne, ‘gambling’ (2023) Encyclopedia Britannica <https://www.britannica.com/topic/gambling> accessed 11 January 2024; ‘gambling’ (2024) Oxford Advanced Learner’s Dictionary <https://www.oxfordlearnersdictionaries.com/definition/english/gambling?q=gambling+> accessed 11 January 2024; ‘gambling’ (2024) Cambridge Dictionary <https://dictionary.cambridge.org/dictionary/english-hindi/gambling?q=gambling+#google_vignette> accessed 11 January 2024.

of 1867.[17] In contrast, online gaming is an entirely new phenomena which has only gained prominence in the 21st century, and lawmakers across the globe are struggling to keep pace with the volatile nature of this industry. It is imperative to understand the vastly different contexts of both in order to recognise their similarities and dissimilarities.

The online gaming industry has several facets which differentiate it from gambling. In the past courts have even referred to games such as Blue Whale[18] and PUBG[19] as online games. However, this changed with the new IT rules which define an online game as a game that is offered on the Internet and is accessible by a user through a computer resource if he makes a deposit with the expectation of earning winnings.[20] This distinguishes online games from video games which may allow in-app purchases. In accordance with the new definition, online gaming consists of games which rely not only on chance but also on skill. Dream11 is an extremely popular online game in which the players must choose an ideal team based on the performance of a player in a particular cricket match. In the case of *Chandresh Sankhla v. The State of Rajasthan & Ors.,*[21] the High Court of Rajasthan declared that since the game involves the element of skill and judgement while choosing the players, it is a game of skill. A similar finding was also reached by the Bombay High Court in *Gurdeep Singh Sachar v. Union of India & Ors.,*[22] wherein the Court

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[17] Public Gambling Act 1867 <https://file-rajshahi.portal.gov.bd/files/bera.pabna.gov.bd/page/3a656455_1ab0_11e7_8120_286ed488c766/THE%20PUBLIC%20GAMBLING%20ACT,%201867.pdf> accessed 8 November 2023.
[18] *Sneha Kalita v. Union of India* 2018 12 SCC 674.
[19] *Rajesh Kishor Barman v. State of Maharashtra* 2022 SCC OnLine Bom 11328.
[20] IT Rules, 2021 (n 7).
[21] *Chandresh Sankhla v. The State of Rajasthan & Ors.*, (n 9).
[22] *Gurdeep Singh Sachar v. Union of India & Ors*., (n 9).

observed that the success in Dream 11 fantasy sports depends on the user's ability to exercise his skills based on superior knowledge, judgement, and attention. The Supreme Court in *State of A.P. v. K. Satyanarayana*[23] also held that rummy is preponderantly a game of skill and not of chance. Thus, online gaming, that include games such as fantasy sports, rummy, and poker among others, arguably involve an element of skill. This clearly distinguishes online gaming from gambling.

Nonetheless, moral concerns with respect to gambling also pervade the online gaming discourse as gambling infiltrates the online space, leaving only a thin line of distinction between online gaming and gambling which is drawn only by varied interpretations of "skill" and "chance." The overlap between the two primarily exist in two major areas: (a) the use of real money; and (b) their addictive nature. The use of real money in both gambling and online gaming obscures the line of differentiation between the two. Moreover, both have an addictive nature[24] as players have the tendency of getting addicted to the game, be it online or offline, or based on skill or chance. Both, the use of real money and their addictive nature, make it hard for lawmakers and jurists to differentiate between the two activities for the purposes of regulation and taxation as these give rise to substantial social concerns. However, whether these social concerns can be grounds for treating online gaming in the same manner as gambling in questions of regulation and taxation is a dilemma which remains.

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[23] *State of A.P. v. K. Satyanarayana,* (n 9).
[24] Daria J Kuss, 'Internet Gaming Addiction: Current Perspectives' (2013) National Library of Medicine (USA) < https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3832462/> accessed 7 November 2023.

III. SOCIAL RAMIFICATIONS AND THE MORAL DILEMMA

Law communicates and reinforces social values.[25] While the law may impose some sense of morality, moral concerns cannot be the sole factor guiding formulation and imposition of new laws. This is primarily because morality is neither a stagnant nor a scientifically definable concept. Morality cannot have a scientific definition because it is formed through public dialogue and interaction and affected by factors such as traditional norms which are neither quantifiable nor easily discernible. Moreover, morality is dynamic rather than stagnant, for social values and public morality are subject to changing times. The anomaly here, however, is that in so far as gambling is concerned, its social connotation has remained unchanged. It has always been and continues to be placed under taboo. Gambling remains a socially unacceptable activity and this is reflected in the laws formed to prevent the same. These concerns have translated into the regulation and taxation of the online gaming industry as well because of the overlap between online gaming and gambling outlined in the previous section.

This assertion is exemplified in the deliberations of the Group of Ministers formed to deal with issues concerning taxation related to casinos, horse racing and online gaming. The GoM submitted its first report to the 47th GST Council Meeting.[26]This report contained deliberations of the GoM while considering the issues at hand. One of the primary points highlighted was that "all these activities are to be uniformly taxed and because of their nature and negative externalities, should be levied a higher incidence of tax."[27] This sums

[25] Farrar and Dugdale, *Introduction to Legal Method* (first published 1990).
[26] Report of Group of Ministers on Casinos, Race Course and Online Gaming, 2022 (First Report of GoM).
[27] First Report of GoM (n 10).

up the narrative which shrouds the online gaming industry. The debate surrounding regulation, taxation and governance of the online gaming industry is marred by what has been termed by the GoM in its first report[28] as negative externalities. While the very same report acknowledges the sheer monetary scale of the industry, the social concerns substantially overpower the economic considerations.

The moral dilemma posed by the online gaming industry is very real. On one hand is the massive economic potential of the industry while on the other is its increasing social cost. In a country like India with a young demographic, it is hard to overlook the social costs of the industry which possibly include systematic psychological harm to young players. China recognised the threat from online gaming addiction as early as 2019 and issued a Notice on the Prevention of Online Gaming Addiction in Juveniles imposing legal obligations on online gaming service providers.[29] Delamere Health in its report on gaming addiction revealed that 3-4% of gamers worldwide were addicted to video games.[30] WHO has also in its 11th revision of the International Classification of Diseases included gaming disorder as a recognised disorder.[31] While addiction to video games is a threat to the mental health of the youth, addiction to online games involving real money can result

[28] First Report of GoM (n 10).
[29] Leon Y. Xiao, 'People's Republic of China Legal Update: The Notice on the Prevention of Online Gaming Addiction in Juveniles (*ResearchGate,* October 25, 2019 <https://www.researchgate.net/publication/337691033_People's_Republic_of_China_Legal_Update_-_The_Notice_on_the_Prevention_of_Online_Gaming_Addiction_in_Juveniles> accessed 8 November 2023.
[30] Gaming Addiction Report 2022 (*Delamere Health*, 2022) <https://delamere.com/blog/gaming-addiction-report-2022> accessed 7 November 2023.
[31] World Health Organisation, 'Addictive Behaviors: Gaming Disorder' (*WHO*, 2020) <https://www.who.int/news-room/questions-and-answers/item/addictive-behaviours-gaming-disorder> accessed 8 November 2023.

in severe financial stress as well. The best example of the same is found amongst those addicted to online fantasy gaming. Online fantasy gaming is hugely popular amongst the youth comprising of teenagers, college going graduates and work professionals too.[32] In India, fantasy gaming addiction poses great challenges. Young students receiving money for tuition and sustenance often find themselves in tricky situations having spent all their resources on fantasy gaming apps such as Dream11, My11Circle and MPL.[33]

Online gaming is a preferred form of entertainment for the newer tech-savvy generations. However, when this entertainment becomes an addiction, it causes immense psychological harm to the youth, beginning with social detachment issues. Moreover, when real money gets involved, this problem is exacerbated. There is a tendency for young players to get trapped in monetary debts as they often have no sources of income other than from their families. Moreover, unethical advertising (including advertisements of offshore gambling and betting websites targeting Indian users on these platforms) can lead players further down the rabbit hole, to even illegal websites, and in this context, cyber security and data privacy concerns become all the more tangible.

In the past few years, the negative social ramifications of online gaming have even led to bans in a few states. The power of the state governments to make laws on gambling is vested in Entry 34 of List II of the

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[32] Kayomard Irani & Samveda Hatwalkar, 'An Overview of Fantasy Sports: A Road to Entertainment or Addiction?' (2021) 3 IJLLR< https://www.ijllr.com/post/an-overview-of-fantasy-sports-a-road-to-entertainment-or-addiction> accessed 7 November 2023.

[33] Anil Kumar Tiwari, 'In India, fantasy gaming is causing addiction and financial ruin' (*Al Jazeera*, 2023) < https://www.aljazeera.com/economy/2023/7/20/in-india-fantasy-gaming-is-causing-addiction-and-financial-ruin> accessed 8 November 2023.

Seventh Schedule of the Indian Constitution.[34] Thus, the states have exclusive power to make laws on this subject including the power to prohibit or regulate gambling in their respective territorial jurisdiction. In 2017, Telangana banned all forms of online gaming and gambling through an amendment to the Telangana Gaming Act.[35] Further, the Karnataka government had banned all online games, both of skill and chance, by amending the Karnataka Police Act, 1963[36], in 2021. However, this was overturned by the Karnataka High Court in February 2022. The Court struck down sections 2, 3, 6, 8 and 9 of the Karnataka Police (Amendment) Act 2021 declaring these as ultra vires of the Constitution of India.[37] In this amendment, under sections 2 and 3, the differentiation between games of skill and chance had been set aside and the punishment for online gaming had also been increased. The Court, in line with the ongoing discourse where the distinction between skill and chance had been acknowledged, set aside these sections of the amendment. The Andhra Pradesh Legislative Assembly in 2020 passed by voice vote the AP Gaming (Amendment) Bill 2020[38] banning online gaming in the state after some youngsters committed suicide in the aftermath of being pushed into debts due to online games. Tamil Nadu went a step further in imposing a prison term that may extend to three months or a fine up to ₹5,000 or both on persons indulging in online games.[39] This decision of the Tamil Nadu government came in response to the report of the Justice Chandru Committee[40] which

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[34] Constitution of India, 1950, Schedule VII, List II (State List), Entry 34.
[35] The Telangana Gaming (Amendment) Act 2017.
[36] The Karnataka Police (Amendment) Act 2021.
[37] W.P No. 18703/21.
[38] The Andhra Pradesh Gaming (Amendment) Act 2020.
[39] 'Tamil Nadu bans online gaming, imposes fine up to 10 lakh, 3 year jail term' (*Livemint*, 2023) < https://www.livemint.com/news/india/tamil-nadu-bans-online-gaming-imposes-fine-up-to-rs-10-lakh-or-3-year-jail-11681195033226.html> accessed 28 September 2023.
[40] Tamil Nadu Ordinance No. 4 2022.

recommended that the state "bring in a legislation for a total ban on online card games, including the game of rummy, immediately." The committee further stated that at least 17 suicides had been reported in Tamil Nadu on account of people losing money in games like online rummy.

Several of these state legislations came prior to the decision of the GST Council and therefore shaped the discourse which led to the council imposing a 28% tax. These states have taken a particularly negative stance on online gaming keeping in mind its social impact. As a result, online gaming has been viewed in the same light as casinos, horse racing and offline betting or gambling. However, this is an erroneous categorisation on the part of legislators. Online gaming cannot be treated the same way because there are certain key factors which differentiate it. Firstly, online gaming is an industry which in India is still at a nascent stage.[41] It has the potential to be a major source of revenue for the country's economy[42], and a hostile stance will only alienate the stakeholders of the industry which include not only companies but also players[43]. Secondly, the online gaming industry has a multitude of facets which need to be dealt with via more individualised regulations as opposed to a blanket ban or a uniformly high rate of taxation. While the negative social effects of casinos, gambling and horse racing extend as far as their addictive

[41] Japneet, 'Gaming for the future: The growth potential of India's iGaming industry and how it can drive India's $5 trillion vision' (*Times of India*, 2023) <https://timesofindia.indiatimes.com/blogs/voices/gaming-for-the-future-the-growth-potential-of-indias-igaming-industry-and-how-it-can-drive-indias-5-trillion-vision/> accessed 12 January 2024.

[42] 'Big bang growth of India's gaming industry' (*The Economic Times*, 2022) <https://economictimes.indiatimes.com/news/international/business/big-bang-growth-of-indias-gaming-industry/articleshow/92053190.cms?from=mdr> accessed 12 January 2024.

[43] Naini Thaker, 'Will 28 percent GST kill the online gaming industry?' (*Forbes India*, 2023) <https://www.forbesindia.com/article/take-one-big-story-of-the-day/will-28-percent-gst-kill-the-online-gaming-industry/86565/1> accessed 12 January 2024.

nature is concerned, online gaming poses other challenges which include unethical content, sexual harassment[44], and cyber frauds[45] among others. A deeper analysis of the nature of the online gaming industry is required to bring in effective regulation of the industry. The MeitY's latest rules[46] citing the role of SRBs are a step in the right direction, but this is undercut by the GST Council's considerations on online gaming and the imposition of such a high rate of tax.

IV. REGULATION AND THE ROLE OF SELF-REGULATORY BODIES

In April 2023, MeitY notified amendments to the Information Technology (Intermediary Guidelines and Digital Media Ethics Code) Rules, 2021. These rules came in light of the fact that comprehensive, centralised rules specific to the industry were conspicuously absent from legal framework. Although separate state legislations did exist, there were no regulatory frameworks applicable nationwide. The newly amended rules have various aspects and most prominent among them is the emphasis on the role of intermediaries and self-regulatory bodies. Section 4 of the IT Rules 2021 now reads "additional due diligence to be observed by significant social media intermediary and online gaming intermediary."[47] This recognises the existence

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[44] Anuradha Gandhi and Isha Sharma, 'India: Sexual harassment in online games' (*Mondaq,* 2023) <https://www.mondaq.com/india/discrimination-disability--sexual-harassment/1347248/sexual-harassment-in-online-games> accessed 12 January 2024.

[45] Bhavin Vadera, 'Cybersecurity threats from online gaming' (*Observer Research Foundation*, 2023) < https://www.orfonline.org/expert-speak/cybersecurity-threats-from-online-gaming#:~:text=There%20has%20been%20a%20surge,percent%20of%20all%20such%20attacks.> accessed 12 January 2024.

[46] IT Rules, 2021 (n 7).

[47] IT Rules, 2021 (n 7).

and role of intermediaries in the facilitation of availability of online games to consumers. Intermediaries, which include social media platforms and app stores, are required to restrict surrogate advertising of online games not deemed permissible by online gaming self-regulatory body. Secondly, the intermediaries may not host, share, publish or make available to consumers an online game which has not been recognised as permissible.

An online gaming self-regulatory body or SRB, as required under Section 4B of the IT Act, must be a company incorporated under Companies Act 2013 or a society registered under the Societies Registration Act 1860. Most importantly, the Board of Directors of such a body must include an independent person from the field of online gaming or other relevant field; an individual who represents online gaming players; an individual from the field of psychology, medicine, or consumer education; an individual with practical experience in the field of public policy; and an individual from the field of information communication technology.[48]

A permissible online game must not involve 'wagering on any outcome,'[49] and must adhere to a framework developed by the SRB. The prerequisites of such a framework are to be mandatorily published on the SRB's respective website and are to include at least four measures already specified in the rules. Firstly, the online game cannot be against the interests of sovereignty and integrity of India, security of the State, friendly relations with foreign States and public order.[50] Secondly, there must exist additional

[48] IT Rules, 2021 (n 7).
[49] 'Government ushers in new era of responsible online gaming through strict guidelines for ensuring safety of digital nagriks and accountability of online gaming industry' (*PIB*, 2023) <https://pib.gov.in/PressReleasePage.aspx?PRID=1918383> accessed 5 October 2023.
[50] IT Rules, 2021 (n 7).

safeguards for the prevention of self-harm and psychological harm. This is a noteworthy requirement but exceedingly difficult to implement. This is because there have not been sufficient empirical studies in India to indicate the particular causes of psychological harm in online gaming, and problems that are unique to the Indian context. Relying on foreign or international case studies cannot help in solving the problems of online gaming addiction in India primarily because fantasy sports addiction is also fuelled by tournaments such as the Indian Premier League, which is a phenomenon unique to India. In the absence of a detailed analysis of specific causes, targeted solutions cannot be implemented. Therefore, there exists a pressing need to first determine the causes to start formulating solutions. Thirdly, there must exist age-rating mechanisms and parental controls to protect children in particular against the adverse impacts of online gaming. This is most significant as online gaming mostly attracts a younger consumer base and children are therefore greatly susceptible to potential harms. Lastly, the framework envisages protection against risks of gaming addiction through warning messages in long gaming sessions. While these are the primary requirements to be adhered to by all SRBs, additional safeguards may be listed by SRBs individually on their sites. The framework therefore consists of two essential categories of measures: (i) mandated by the online gaming rules; and (ii) created by the SRB. It is important to draw this distinction to observe that the government has in fact retained a commanding voice over the formulation of such a framework whilst simultaneously empowering the SRBs to tweak the system as they deem fit.

This also raises the question of role and functioning of SRBs, for under the new rules,[51] the SRBs will effectively be dictating the actions of

[51] IT Rules, 2021 (n 7).

intermediaries as well, by recognising a game to be permissible or not permissible. Section 4A[52] deals with the verification of online real money game. The emphasis here lies on the phrase "real money" which means that the SRBs ideally may only regulate online games involving transactions of monetary value. However, a provision has been inserted here to state that any non-real money online game if considered to have the potential to harm users, then such a game too could be regulated under these rules. This provision has inherent ambiguity as there are no measures defined against which a non-real money online game may be deemed harmful. Therefore, the SRBs will be playing a pivotal role in shaping the industry, with powers to regulate not only real-money games, but possibly also non-real money games.

Additional requirements such as the inclusion of an expert on psychology in the Board of Directors reflect the social concerns underlying the formulation of these rules. The government felt the need for supplementary frameworks of safeguards to protect the interests of consumers, mostly young and impressionable. While there was cognisance of social concerns in the formulation of these rules, it did not become an authoritative rationale dictating the entire consideration. There was adequate acknowledgement of the fact that members from within the industry would be in a better position to assist with regulation owing to their nuanced understanding of online gaming; something which the government agencies may not have been able to effectively implement on their own. A deeper understanding of the nature of the industry on the part of the SRBs will facilitate more effective measures to mitigate the social costs of online gaming. In the case of regulation of online gaming, some level of autonomy and representation has thus been granted to

[52] IT Rules, 2021 (n 7).

the industry in the form of SRBs. The glaring pitfalls of overregulation were also avoided here. The innovative role, constitution and functioning envisaged for SRBs exemplifies an adequate balance between social concerns and economic considerations of the industry.

V. TAXATION AS MEANS OF REGULATION

The rationale behind an increased rate of taxation was based on veritable social concerns yet it serves another imperative practical purpose as well. While MeitY's rules grant a degree of autonomy to the industry by encouraging self-regulation, the inadvertently high rate of tax also serves as a means of regulation absolutely within the ambit and prerogative of the government.

Taxation of any industry serves twin functions for the government- the primary being revenue-generation and the secondary being regulation. Taxation has a substantive regulatory aspect,[53] and this is particularly in the case of growing industries such as that of online gaming in India. The industry is growing at a breakneck pace and poses challenges that go beyond the online sphere resulting in tangible effects. In addition to the social concerns regarding the youth, there are larger threats for the government to counter, which include concerns relating to cyber security and fraudulent transactions through online gaming. It is difficult for the government to navigate the regulation of third-party servers used in online gaming as they may or may not be physically present in the territory of India, thereby making regulation extremely

[53] Reuven S. Avi-Yonah, 'Taxation as Regulation: Carbon Tax, Healthcare Tax, Bank Tax and Other Regulatory Taxes' Acct. Econ. (1)1 (2011) <https://repository.law.umich.edu/cgi/viewcontent.cgi?article=2643&context=articles#:~:text=In%20general,%20the%20choice%20between,achieve%20a%20specific%20regulatory%20goal.> accessed 4 October 2023.

complicated. Moreover, unlike casinos where offline betting can be regulated physically, online gaming is extremely individualistic. Online games are mostly played in the privacy, safety, and comfort of one's home. Regulating the actions of individuals playing from remote locations is practically impossible despite the existence of SRBs as mandated by MeitY's rules.[54] Therefore, the government's purpose in imposing such a high rate of tax is to regulate an industry which has been growing hitherto unchecked. Increased taxation places an immediate tangible burden on the stakeholders of the industry and checks the unprecedented growth of revenue by bringing a greater amount under the ambit of taxes.

While earlier an 18% tax was imposed on the gross gaming revenue, now a 28% tax is imposed on the full value of bets placed. Gross gaming revenue refers to the difference between the amount of money wagered by a player and the amount that they win. The new rate of 28 percent will be applicable not on this differentiated rate, but on the full value of a bet. This significantly increases the tax burden. Moreover, winnings from betting in online game are categorised under 'income from other sources' under the Income Tax Act.[55] Therefore, the winnings are subject to tax deducted at source under the Act at a rate of 30%.[56] While the previous threshold for the applicability of TDS was Rs. 10,000, this has now been removed as per notification of the CBDT.[57] Only net winnings below Rs.100 in a month are exempted from TDS under the new rule. It has been clarified that all bonuses

[54] IT Rules, 2021 (n 7).
[55] Income Tax Act 1961, s. 115B.
[56] Income Tax Act 1961, s. 194BA.
[57] Income Tax Notification (22 May 2023) Central Board of Direct Taxes.

or incentives provided by gaming intermediaries to users are considered taxable.

Hence, there is a considerable tax burden which has been added under the new regime. Even winnings below Rs. 10,000 have become taxable and this substantially reduces the gains for regular players but also creates a barrier for irregular players to become regular. This is because even a one-time player with meagre winnings will have to pay TDS applicable on the winnings. This is the effect of the TDS change. This reduces gains for the player and also revenue for the company. Thus, while the incentive is reduced for the player, the expansion capacity is reduced for the company. This serves to regulate the exponential growth of an industry which has a substantive negative social cost. However, high rate of taxation cannot be an adequate means of regulation but only an intervening measure, especially considering that an inadvertently high rate of tax could push players towards illegal betting sites in search of greater returns. Further effects of the higher rate of GST are discussed in detail in the following section.

VI. DISCORD BETWEEN INTENT AND OUTCOME

The intent of a uniform regulatory framework or a higher rate of taxation is to put checks on the online gaming industry. This intent stems from deep-rooted moral concerns. Therefore, instead of merely regulating an industry that has grown hitherto unchecked, the new measures put together threaten to altogether choke the industry's revenue generating capacity. The increased rate of tax has been met with much opposition from the industry's major stakeholders for it will greatly increase the operating cost for gaming companies. This is a growing industry in which smaller profit margins cannot withstand the blow of a 28% GST. Currently, most online gaming platforms charge a 10-15% commission which post the increased rate of taxation will not suffice to sustain these platforms. Companies looking to stay afloat under the new tax regime will have to increase their user base, which in turn will prove difficult because of the negative publicity surrounding the industry in light of MeitY's rules[58] and news of higher taxation. This therefore traps gaming platforms in a losing vortex.

The online gaming industry being a latest experiment in technology, does not enjoy much backing from institutional investors. The backbone of the industry is formed by venture capital funds[59] which evaluate a gaming platform's revenue-generating and growth potential to ascertain whether or not to invest. Ever since the first group of ministers was formed to deliberate on the issue of taxation of online gaming, the investments flowing into the industry have substantially reduced.[60] Prior to the decision, investments were reduced owing to ambiguity in regulations and fear of a higher rate of taxation, and post the decision, the revenue potential of the industry would diminish and therefore investments will also stand reduced. Thus, there are three major foreseeable outcomes of this higher rate of GST:

1. Diminishing profit margins

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[58] IT Rules, 2021 (n 7).
[59] Shivam Bajaj, 'Gaming Industry is Winning the Batlle of VC Funding' (*Times of India*, 2022) < https://timesofindia.indiatimes.com/blogs/voices/gaming-industry-is-winning-the-battle-of-vc-funding/> accessed 8 November 2023.
[60] Arushi Mishra, 'Investments in gaming start-ups nosedives amid tax worry, rising competition' (*Business Line The Hindu*, 2023) <https://www.thehindubusinessline.com/news/investment-in-gaming-start-ups-nosedives-amid-tax-worry-rising-competition/article67402534.ece#> accessed 7 November 2023.

2. Reduced user base
3. Limited capital investment

These three events threaten to altogether dismantle the industry in the long run. The distinction between games of skill and games of chance was not a sustainable measure as nature of individual games defined on ad hoc basis by courts was becoming an unnecessarily complex and long-drawn exercise. The discarding of such a system was therefore inevitable. However, the dilemma of taxation then continues to persist. According to the industry apex body (All India Gaming Federation), there are currently over 900 gaming (online) companies in India, a vast majority of which fall within the MSME sector.[61] These smaller companies will be disproportionately impacted by the new rules and taxation regime. Whereas key players within the industry will manage to stay afloat, the smaller start-ups may die out. This is likely to also exacerbate monopolisation tendencies within the industry. Regulation of online gaming is desirable, but it cannot be at the cost of choking the industry in its entirety. Moreover, this also hurts the government's vision of a Digital India and reduces ease of doing business. In conclusion, online gaming needs to be seen and treated differently from other forms of gambling, both in regulation and taxation, for the industry to survive.

[61] Mini Tejasvi, 'Indian Gaming Landscape Caught under Pressure, May Face an Early Shakeout Hints AIGF' (*The Hindu*, 2023) <https://www.thehindu.com/business/indian-gaming-landscape-caught-under-pressure-may-face-an-early-shakeout-hints-aigf/article67231642.ece#> accessed 10 October 2023.

VII. A CROSS-JURISDICTIONAL VIEW ON REGULATING ONLINE GAMING

Regulating the online gaming industry is a problem not unique to India but in fact a global concern. The United States has in the last two decades increased monitoring and regulation of the industry. It passed the Unlawful Internet Gambling Enforcement Act[62] in 2006 which prohibits any person engaged in the business of betting, as defined, from knowingly accepting credit, electronic fund transfers, checks, or any other payment involving a financial institution to settle unlawful internet gambling debts. Moreover, under the Wire Wager Act[63], interstate online gambling is deemed illegal. There are also other federal laws applicable to certain online gambling activities, such as the Wagering Paraphernalia Act[64]. However, their applicability depends substantially on the type of gaming activity, as well as the state law where the activity is occurring.[65] Individual states have their own laws pertaining to online gambling. This creates a highly complex system which is cumbersome to monitor at a large-scale systematic level. This is far from ideal as online gaming poses challenges even for country-specific regulations because it is an industry without borders. When the Gaming Treaty in Germany obligated state parliaments to ban commercial online gambling, German players' demand was satisfied by providers operating from offshore locations where they could not be monitored or even prosecuted by German

[62] Unlawful Internet Gambling Enforcement Act 2006.
[63] Interstate Wire Act 1961.
[64] Wagering Paraphernalia Act 1961.
[65] 'Online Gaming Overview: Basic information Regarding Online Gaming Law' (*Walters Law Group*, 2018) <https://www.firstamendment.com/online-gambling-information/> accessed 14 January 2024.

authorities.[66] This example clearly shows that an outright ban could never be the solution for online gambling. The need then is to effectively regulate the industry. While the regulatory framework under the new IT rules in India seeks to monitor both real money and non-real money games, most countries consider only the real-money online games for regulation. Therefore, these countries have exclusive "online gambling laws" (such as Finland and Netherlands which follow the "alibi model" and "risk model" for gambling regulation respectively)[67] as opposed to India which has "online gaming laws."

Online gambling laws in jurisdictions such as Macau are exceedingly lenient for they aim to become international hotspots for the industry.[68] However, these are exceptional cases and most countries, in fact, seek to regulate and tax this growing industry. In India it is clear that the legal frameworks are guided by addiction concerns in a young demographic, but this is not the case for countries in the west for whom the primary concerns are data privacy and money laundering. This shows the fundamental difference underlying the formulation of legal frameworks in Western countries and India. However, this difference does not mean that there is nothing to be imbibed from their legal frameworks for online gambling. While online gaming has become a major concern for India only in the last five years,

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[66] Joachim, 'Taxation of Online Gambling in Germany' (2013) 17 Gaming Law Review <https://www.liebertpub.com/doi/10.1089/glre.2012.1714> accessed 14 January 2024.
[67] Alan Littler & Johanna Jarvinen-Tassopoulos, 'Online Gambling, Regulation, and Risks: A Comparison of Gambling Policies in Finland and the Netherlands' (2018) 30 JLSP<https://digitalcommons.osgoode.yorku.ca/jlsp/vol30/iss1/6/> accessed 14 January 2024.
[68] Matthew Tingchi Liu and others, 'Macau gambling industry's quick V-shaped rebound from 2014 to 2019' (2020) Asia Pacific Journal of Marketing and Logistics <https://www.emerald.com/insight/content/doi/10.1108/APJML-08-2019-0489/full/html> accessed 12 January 2024.

EU adopted the Communication "Towards a Comprehensive European Framework on Online Gambling" as early as October 2012.[69] From this it is evident that there may be much for us to learn.

EU does not have a uniform legal framework for regulation of online gambling but proposes a comprehensive set of actions and common principles on protection. When Germany sought to differentiate from the trend of liberal regulation in EU through the "Gaming Treaty," it came under pressure from some judgements of the European Court of Justice.[70] Gambling laws in Germany then underwent reforms and the Interstate Treaty 2021 came into force on 1 July 2021 with provisions for the licensing of virtual slot machines and online poker with limited stakes and winnings.[71] Germany, under scrutiny from the EU, was compelled to adopt a more lenient approach to online gambling but established a strict licensing regime nonetheless to ensure that it can filter acceptable games. France also adopted a licensing regime for the online gambling sector. The sector is regulated by the French Gambling Act 2010 which has three types of licences for online gambling activities: (i) online sports betting; (ii) online horse race betting; and (iii) online poker games.[72] Netherlands also has a licensing system and seeks to channel 80 percent of demand to locally licensed online operators.[73] Thus, licensing is an important aspect of the various regulatory frameworks for online gambling in European

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[69] Sue Schneider, 'Towards a Comprehensive European Framework on Online Gaming' (2013) 17 Gaming Law Review.
[70] Case C-46/08, Carmen Media 2010 E.C.R. I-8149; Case C-316/07, Markus Stoß 2010 E.C.R. I-8069; Case C-409/06, Winner Wetten 2010 E.C.R. I-8015.
[71] Melchers Rechtsanwälte, 'A General Introduction to Gambling Law in Germany'(*Lexology*, 2023) < https://www.lexology.com/library/detail.aspx?g=a586d86a-41bc-443a-af92-099351ffd1af> accessed 9 November 2023.
[72] Sue Schneider, 'Online Gaming in France' (2013) 17 Gaming L Rev & Econ.
[73] Littler & Jarvinen (n 68).

countries. It also shifts the industry narrative away from government monopolies to private competitive markets.

Private competitive market is the norm in the Indian online gaming industry as well. And these policies of licensing can be seen to some extent as being analogous to the new IT rules which allow for games to be deemed as permissible subject to certain conditions. However, the key difference is that while licensing in the aforementioned European countries is undertaken by central or state government authorities, the IT rules delegate this prerogative to the SRBs thereby establishing a two-step system. It is a two-step system because first the SRB is approved by the government, and it is then the SRB which approves the online game. The SRBs will thus almost act as a mediating element wherein they have an understanding of the regulatory framework as well as working knowledge of the industry. While the SRBs are a significant addition, the guidelines established are merely to recognise a game as permissible or impermissible. Our framework may also benefit from categorisation following from the French example. Online gaming is a sphere which consists of several games of various types. Fantasy sports games in particular are distinct from other forms of online gaming because they are affected greatly by real time tangible factors such as sports tournaments. Once these distinctions are acknowledged and incorporated into an approval system, it will be easier to discern which type of game is permissible and which is not. As the skill versus chance delineation has been set aside by MeitY's current rules, this may be the right time to experiment with other forms of categorisation for online games to make regulation and control easier.

VIII. CONCLUSION

The line between online gaming and gambling may be murky but they are vastly different activities and need to be treated as such in laws relating to regulation and taxation. It is also evident that the social costs of this industry cannot be ignored. The Delhi High Court recently dismissed a petition seeking ban on multiple online gambling sites and directed the IT ministry to treat the petition as representation and settle the issue.[74] Moreover, the very fact that MeitY has recently deemed fit to ban nearly 22 apps for illegal betting[75] shows that there is much to be concerned about in regulation of the online gaming industry. Yet these social concerns cannot, in the present scenario, be reason enough to dismantle the industry altogether. The new GST policy heavily influenced by this moral dilemma uses taxation itself as a means of regulation, and ultimately threatens the existence of a veritable online gaming market in India. In contrast, the SRBs may be an ideal way forward. The rationale behind the creation of SRBs shows a completely divergent perspective from that causing an increase in the GST rate. While the former acknowledges the modern and dynamic nature of the industry, the latter is reducing it to the same category as casinos, horse racing and gambling. There is, therefore, still much confusion as to what may be the right path in dealing with online gaming and its social concerns. In formulating newer policies, it may help lawmakers in the country to take a page out of the handbook of other jurisdictions where online gaming laws were being formulated since much before. Online gaming

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[74] *Shaik Raheem v. Union of India and Ors.* W.P.(C) 16206/2023.

[75] PIB, 'MEITY issues blocking orders against 22 illegal betting apps and websites, including Mahadev Book Online on request from Enforcement Directorate', (2023) PIB <https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1974901#:~:text=Ministry%20of%20Electronics%20and%20Information,including%20Mahadev%20Book%20and%20Reddyannaprestopro.> accessed 9 November 2023.

essentially being an industry without borders, policymakers across the globe may benefit from coordinating, cooperating, and learning from one another in regulating this dynamic, complex, and rapidly growing industry

two specific circumstantial evidences – trading patterns and the timing of trades, to invoke the presumption of guilt against the defendant/accused. In contrast, the Courts have provided a non-exhaustive and comprehensive list of circumstantial evidence that SEBI can employ to establish access to MNPI or UPSI.

As a result, the proposed Regulations have limited the scope of circumstantial evidence, contrary to the original intent of the judiciary. Moreover, the proposed Regulations have elevated the presumption to a higher standard and have not considered the totality of the facts and circumstances surrounding the event. This raises concerns that not mandating SEBI to consider the complete chain of circumstances when declaring an individual as an insider may have a chilling effect on the market. Parties may be deterred from participating in the securities market, which runs counter to SEBI's fundamental mandate.

Furthermore, to arrive at an incontrovertible conclusion that an individual has access to UPSI, a cumulative analysis of all relevant facts and circumstances is indispensable. However, under the PSUTA Regulation, it is presumed that an individual has access to UPSI based solely on two circumstantial evidences – unusual trading patterns and MNPI. This approach lacks the cumulative analysis of all relevant facts and circumstances.

Consequently, the author proposes the inclusion of a "reasonable connection" requirement in addition to the two contemplated circumstantial evidences. SEBI can establish a reasonable connection based on several other circumstantial evidences, such as financial records, telephonic records, trade volume, trade timing, ability to access MNPI, and the timing of contact between tipper and tippee. This list is non-exhaustive, and SEBI can consider any other relevant facts and circumstances it deems appropriate to prove the requirement of a reasonable connection. This way, the introduction of the reasonable connection requirement allows SEBI to consider the totality of attending facts and circumstances to effectively discharge its burden of proving that an insider likely had access to MNPI or UPSI at the time of trading.

Ultimately, by introducing the reasonable connection requirement, SEBI can not only establish foundational facts but also meet the high burden of proof by cumulatively analysing all attending facts and circumstances. This approach aligns SEBI with existing judicial decisions and legal jurisprudence.

XI. NEED FOR ENHANCING THE INVESTIGATION POWERS OF SEBI

The Author commends the commendable initiatives undertaken by SEBI to safeguard the interests of investors. However, the Author also posits the argument that, alongside implementing specific regulations to combat insider trading, SEBI should consider a comprehensive overhaul of its investigative techniques.[67] As per the author, the following factors are contributing in SEBI's lower success rates in investigations and convictions -

- **SEBI's inability to wiretap phone calls** – According to the Indian Telegraph Act of 1885, both the state and central governments

[67] Souvik Ganguly, Renjith Nair, and Krishna Nair, 'Prove your innocence: Insights into the proposed securities trading regulations' (*Acuity Law,* 28 July 2023) <https://www.lexology.com/library/detail.aspx?g=6d3cf007-35b1-4f4c-8459-006c9c2b861a> accessed 08 September 2023.

possess the authority to intercept telephone communications.[68] Numerous investigative agencies, including the Central Bureau of Investigation ("**CBI**"), the Enforcement Directorate ("**ED**"), the Intelligence Bureau ("**IB**"), the Narcotics Control Bureau, and the National Investigation Agency, are granted prior permission by the Union Home Secretary to tap phone calls. However, SEBI has not been endowed with similar powers.[69] The Committee on Fair Market Conduct, in its report, recommended granting SEBI the authority to intercept phone calls, as such interceptions can serve as substantial evidence in establishing insider trading.[70] It is worth noting that SEBI's foreign counterparts, such as the SEC, possess the power to intercept calls. In the widely publicized Galleon insider trading case, wiretap recordings were admitted in court to substantiate the allegations of insider trading.[71] Therefore, the Author suggests that to enhance the rate of successful investigations, SEBI should be vested with the authority to intercept telephonic communications, provided that proper checks and balances are in place. An argument frequently raised in the context of wiretapping concerns the potential erosion of an individual's privacy. In the case of *K. S. Puttaswamy v. Union of*

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[68] Indian Telegraph Act 1885, §5(2).

[69] HT Correspondent, '10 government agencies can tap phones, Lok Sabha told' (*The Hindustan Times* 20 November 2019, 02:10 AM) <https://www.hindustantimes.com/india-news/10-govt-agencies-can-tap-phones-ls-told/story-oY1vlfevUwacGRJIC7jnCN.html> accessed 08 September 2023.

[70] Dr. T. K. Viswanathan, 'Report of Committee on Fair Market Conduct' (*SEBI*, 09 August 2018) <https://www.SEBI.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html> accessed 10 September 2023.

[71] Kenneth Herzinger, Amy M. Ross, and Katherine C. Lubin, 'Court allows use of wiretap evidence in Galleon insider trading case' (*Orrick, Herrington & Sutcliffe LLP*, 29 November 2010) <https://www.lexology.com/library/detail.aspx?g=1e3ef747-3fd2-46ab-beae-a20617d49529> accessed 13 September 2023.

India, the Supreme Court ruled that the Right to Privacy is a fundamental right, subject to reasonable restrictions. State intrusion can be justified if it meets a three-fold test: 1) the existence of a law, 2) the pursuit of a legitimate aim, and 3) restrictions that are proportionate to the objective being sought (a rational nexus).[72] Therefore, based on the aforementioned reasoning, the author contends that SEBI can encroach upon an individual's right to privacy only when it satisfies the three-fold test.

- **Dearth of human resources at SEBI** – As of March 30, 2022, SEBI had a total of 980 employees,[73] while its U.S. counterpart, the SEC, boasts a workforce of approximately 4,500 individuals.[74] Furthermore, in the financial year 2020-21, SEBI initiated only 30 investigations into insider trading cases, a number that decreased to 17 in the subsequent financial year, 2021-22.[75] These statistics imply that SEBI faces limitations in conducting a significant number of investigations related to insider trading, primarily due to a shortage of human resources. Considering the vast expanse of the Indian securities market, the quantity of investigations undertaken by SEBI is notably inadequate. Consequently, the author recommends that, in order to ensure effective and expeditious handling of investigations,

[72] *K. S. Puttaswamy v. Union of India,* (2017) 10 SCC 1.
[73] SEBI, 'Employee Profile In SEBI' (*SEBI*, 31 March 2022).
[74] U.S. Securities and Exchange Commission, 'About the SEC' (06 April 2023) <https://www.sec.gov/strategic-plan/about> accessed 13 September 2023.
[75] SEBI, 'Annual Report 2021-22' (*SEBI*, 10 October 2022) <https://www.SEBI.gov.in/reports-and-statistics/publications/oct-2022/annual-report-2021-22_63812.html> accessed 14 September 2023.

II. PROHIBITION OF UNEXPLAINED SUSPICIOUS TRADING ACTIVITIES IN THE SECURITIES MARKET: EFFECTIVENESS AND CHALLENGES OF SEBI'S PROPOSAL

- Mayank Gandhi*

ABSTRACT

In India, there has been a surge in the number of new retail investors participating in the securities market. This shift in the financial landscape of the Indian economy reflects a growing preference for investing in the securities market over traditional methods of saving. One of the primary factors contributing to this inclination towards shares as an investment option is the trust instilled in the system by the Securities and Exchange Board of India ("**SEBI**"), which ensures fairness. In a further stride towards safeguarding fairness and investor security, SEBI has introduced a consultation paper titled "SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023." This consultation paper includes a draft bill outlining a framework for addressing cases of insider trading based on suspicion. It seeks to increase the enforcement rate of SEBI in insider trading cases by reducing the burden of proof on SEBI. However, the proposed consultation paper does come with inherent limitations. These limitations include the absence of precise definitions, variability in materiality thresholds, and a reversal of the burden of proof onto the accused. In light of these issues, this article aims to accomplish several key objectives. Firstly, it seeks to identify the materiality threshold in India and compare it to other jurisdictions. Secondly, it examines the concept of burden-shifting and the use of circumstantial evidence in the "Prohibition of Unexplained Suspicious Trading Activities" ("**PUSTA**") Regulation, in comparison to existing Indian and other international standards. Finally, it puts forward practical and viable alternatives to address the shortcomings of tackling insider trading more effectively.

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I. INTRODUCTION

Securities market is a part of financial market which allows people to channelise their savings among a number of investments. In last few years, capital market is witnessing a rapid surge in number of retail investors participating in the market. Hence, in the best interest of retail investors, it is the duty of the SEBI to ensure symmetry of information because access to unpublished/non-public information in the securities market places genuine investors at a disadvantageous position.[1] The prime example of this is insider trading. Insider trading occurs when an individual trades a company's securities using non-public, price-sensitive, or material information to gain profit or avoid losse.[2] This practice not only erodes the interests of investors but also compromises the integrity of the market.[3] The problem of insider

[1] Cornell Education Blog, 'Asymmetric Information in the Stock Market' (1 December 2016) <https://blogs.cornell.edu/info2040/2016/12/01/asymmetric-information-in-the-stock-market/> accessed 24 July 2023.

[2] Merriam-Webster, <https://www.merriam-webster.com/dictionary/insider%20trading> accessed 24 July 2023.

[3] Julan Du and Shang-Jin Wei, *Does Insider Trading Raise Market Volatility,* IMF Working Paper, WP/03/51, (2003), <https://www.imf.org/external/pubs/ft/wp/2003/wp0351.pdf> accessed 24 July 2023.

trading has garnered increased attention from global securities watchdogs. In India, insider trading is regulated by the SEBI (Prohibition of Insider Trading) Regulations, 2015.[4] However, rapid technological changes and evolving insider trading methods have necessitated adjustments to SEBI's regulatory framework. These changes are essential to maintain governance principles that foster free and fair trading in line with the times.[5] In this context, SEBI recently introduced draft regulations for the Prohibition of Unusual Suspicious Trading Activities in the Securities Market through a consultation paper. The new regulation introduces significant changes, including a reversal of the burden of proof, a new materiality threshold, and recognition of circumstantial evidence in proving insider trading cases. However, it's important to note that the proposed regulation is not without its shortcomings. The proposed regulation contains several vague terms and appears to deviate from globally accepted materiality thresholds. It presumes that a person is guilty of insider trading solely based on two factors- trading patterns and the timing of the trade. This presumption has generated considerable discussion. In this paper, the author comprehensively addresses these key issues and seeks to provide viable solutions to mitigate potential future anomalies.

[4] N. K. Sodhi, 'Report of the High-Level Committee to Review the Sebi (Prohibition of Insider Trading) Regulations, 1992' *SEBI* (7 December 2013), <https://www.SEBI.gov.in/SEBI_data/attachdocs/1386758945803.pdf> accessed 25 July 2023

[5] SEBI, *Consultation paper on draft SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023,* SEBI, (May 18, 2023) https://www.sebi.gov.in/reports-and-statistics/reports/may-2023/consultation-paper-on-draft-sebi-prohibition-of-unexplained-suspicious-trading-activities-in-the-securities-market-regulations-2023_71385.html.

II. LEGISLATIVE FRAMEWORK OVER *"MATERIALITY"* IN FOREIGN JURISDICTIONS

United States - To safeguard investors against insider trading, Congress has implemented measures that prohibit trading in securities of the issuer based on material non-public information concerning that security or issuer. These provisions are outlined in Section 10(b) of the Securities Exchange Act of 1934 and, more specifically, Rule 10b5-1.[6] Materiality, a cornerstone of these regulations, has been legally defined as encompassing all particular facts or information that a prudent investor would deem pivotal in their decision-making process.[7] This principle was exemplified in the case of *Elkind v. Liggett & Myers*, where the Court ruled that information is material if its disclosure is likely to have a substantial impact on the market prices of the security.[8] This principle was subsequently reaffirmed in *Securities & Exchange Commission v. Texas Gulf Sulphur Co.*[9] A significant milestone in the U.S. Supreme Court's examination of materiality was the case of *TSC Industries, Inc. v. Northway, Inc.*[10] In this instance, the Court emphasized that *"an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it significant in deciding how to vote."*[11] This test, as articulated in the case, does not necessitate that the information had an actual effect on the investor's decision. Rather, it suffices

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[6] Rule 10b5-1 of the Securities and Exchange Commission Rule, codified at 17 CFR 240.10b-5.
[7] *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976); *Basic Inc. v. Levinson,* 485 U.S. 224 (1988).
[8] *Elkind v. Liggett & Myers Inc.,* 635 F.2d 156, 166 (2d Cir. 1980).
[9] *Securities & Exchange Commission v. Texas Gulf Sulphur Co.,* 258 F. Supp. 262 (S.D.N.Y. 1966).
[10] *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976); Basic, 485 U.S. at 231.
[11] ibid.

for the information to hold 'actual significance' in the investor's decision-making process.[12] Moreover, this case was followed by the *Basic case*, wherein Justice Blackmun viewed that the definition of materiality propounded in *TSC case* in respect of voting also applies to a shareholder deciding whether to buy or sell a security.[13] More specifically, the information will be material, if its disclosure would be *"viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."*[14] This notion was further adopted in the case of *Matrixx Initiatives, Inc. v. Siracusano,* where the Court held that information is material "*if it is substantially likely that a reasonable investor would have regarded this information as having significantly altered the 'total mix' of available information."*[15] Both these judgments underscore that the significance of undisclosed information is the determining factor for materiality.[16] It can be discerned from the approach adopted by the U.S. Judiciary that the test for materiality is objective and does not adhere to a strict formula.[17] Moreover, as per Rule 12b-2 of the SEC Act, the term 'material' refers to *"information to which there is a substantial likelihood that a reasonable investor would attach*

[12] Tommy Brennan, 'A Critical Analysis of New Zealand's Insider Trading Regime' University of Otago (2019) <https://www.otago.ac.nz/law/research/journals/otago734236.pdf>, accessed 25 July 2023, Page 15.
[13] *Basic Inc. v. Levinson,* 485 U.S. 224, 231–32 (1988).
[14] ibid.
[15] *In Matrixx Initiatives Inc. v. Siracusano,* 563 U.S. 27 (2011).
[16] Thomas M. Madden, 'Significance and the Materiality Tautology' (2015) 10 Journal of Business & Technology Law 2 <https://core.ac.uk/download/pdf/56359826.pdf> accessed 27 July 2023.
[17] Willkie Farr & Gallagher LLP, 'Supreme Court Reaffirms "Total Mix" Standard for Assessing Materiality in Federal Securities Actions' (*Willkie*, 24 March 2011), <https://www.willkie.com/~/media/Files/SupremeCourtReaffirmsTotalMixStandardpdf/FileAttachment/Supreme-Court-Reaffirms-Total-Mix-Standard.pdf> accessed 29 July 2023.

importance in determining whether to buy or sell the registered securities."[18] Materiality, in practice, is a fact-based determination that must be evaluated on a case-by-case basis.[19]

United Kingdom - The Companies Securities (Insider Dealing) Act 1985 is widely regarded as the inaugural statute in the United Kingdom aimed at criminalizing insider trading.[20] However, the application of this Act and the liabilities it outlined were rather narrow in their scope. Consequently, it was replaced by a more comprehensive legislation, the Criminal Justice Act of 1993.[21] Part V of the Criminal Justice Act of 1993 deals explicitly with insider dealing. One of the essentials for establishing the case of insider dealing is to prove that an insider is having inside information which if made public would be likely to have a significant effect on the price of any securities.[22] Furthermore, Section 118 of the Financial Services and Markets Act 2000, subsequently repealed by the UK Market Abuse Regulation, delineated the framework for civil liability concerning insider trading.[23] In accordance with the "Requirement to disclose inside information" as stipulated by the Financial Conduct Authority ("**FCA**"), information pertaining to several key aspects such as *"the issuer's assets and liabilities, the performance of the issuer's business, the financial condition of the issuer, and significant new*

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[18] Rule 12b-2 of the Securities Exchange Act of 1934, codified at 17 C.F.R. § 240.12b-2 (2020).
[19] J. Anthony Terrell, 'Materiality in Review' (*Bracewell*) <https://bracewell.com/sites/default/files/knowledge-center/Materiality%20in%20Review_0.pdf> accessed 02 August 2023.
[20] Company Securities (Insider Dealing) Act 1985, (United Kingdom).
[21] Kern Alexander, 'Insider Dealing and Market Abuse: The Financial Services and Markets Act 2000' ESRC Centre for Business Research, University of Cambridge Working Paper No. 222 (December 2001), <https://www.cbr.cam.ac.uk/wp-content/uploads/2020/08/wp222.pdf> accessed 03 August 2023.
[22] Criminal Justice Act 1993, §56 and §57 (United Kingdom).
[23] The United Kingdom Market Abuse Regulation [Regulation 596/2014 ("MAR")].

developments in the issuer's business" are deemed relevant.[24] These factors are crucial for a reasonable investor in making informed decisions about buying or selling securities associated with the company in question. Moreover, the FCA has also underscored that the size of the issuer, recent developments, and the prevailing market sentiment concerning the issuer and its sector can provide significant indicators of whether the information is likely to substantially impact the prices of the securities.[25]

Singapore - Section 218 of the Securities and Futures Act, 2001 pertains to insider trading.[26] It prohibits individuals connected to a corporation from trading in its securities if they possess non-public information that could materially affect the securities' price or value upon disclosure.[27] The Court of Appeal of Singapore, in the case of *Lew Chee Kevin v. Monetary Authority of Singapore,* has clarified the element of materiality in insider trading. They established that it's not necessary to demonstrate actual price fluctuations in the company's securities following the information disclosure.[28] They also noted that while market impact can serve as relevant evidence, it shouldn't be considered as conclusive proof.

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[24] Disclosure Guidance and Transparency Rules sourcebook, 'Chapter 2 - Disclosure and control of inside information by issuers' (*Financial Conduct Authority*) <https://www.handbook.fca.org.uk/handbook/DTR/2.pdf> accessed 04 August 2023.
[25] ibid.
[26] Securities and Futures Act, 2001 (Singapore).
[27] The Monetary Authority of Singapore, 'Guidelines on the Regulation of Markets' (*CFTC*, 1 July 2005), <https://www.cftc.gov/sites/default/files/groups/public/@otherif/documents/ifdocs/orgfbotapdxddsfamr160615.pdf> accessed 07 August 2023.
[28] *Lew Chee Kevin v. Monetary Authority of Singapore*, (2012) [SGCA] 12.

III. DICHOTOMY OVER MATERIALITY THRESHOLD IN INDIAN LEGISLATIVE FRAMEWORK

The term "Unpublished Price Sensitive Information" ("**UPSI**") is frequently used interchangeably with "Material Non-Public Information" ("**MNPI**"), as both convey similar meanings.[29] Generally, information that is not publicly disclosed would be classified as UPSI/MNPI if it holds material significance. In essence, materiality is understood as information that is likely to substantially influence the decision-making process of a reasonable investor. The SEBI regulations that directly or indirectly pertain to the concept of materiality are discussed below.

- **SEBI (Prohibition of Insider Trading) Regulations, 2015 -** As per Regulation 2(1)(n) of the PIT Regulation, 2015, the term UPSI refers to any information, relating to a company or its securities, directly or indirectly, that is not generally available which upon becoming generally available, is likely to materially affect the prices of the securities.[30] In accordance with the provided definition, information is deemed material if it has the potential to impact the prices of the company's stocks.
- **SEBI (Listing Obligations Disclosure Requirements) Regulations, 2015 -** Regulation 30(4) of SEBI (LODR) Regulations, 2015 set out total three disjunctive criteria for deciding materiality of

[29] Heena Ladji, Shreyas Bhushan and Ruchir Sinha, 'Private Funds: AIF Investors Holding UPSI in Breach of Insider Trading Norms for AIF's Investment Decisions' (*Mondaq*, 11 May 2022) <https://www.mondaq.com/india/fund-management-reits/1192024/private-funds-aif-investors-holding-upsi-in-breach-of-insider-trading-norms-for-aifs-investment-decisions> accessed 09 August 2023.
[30] Regulation 2(1)(n) of the Prohibition of Insider Trading Regulations, 2015.

an event/information.[31] The first two criteria are as follows – 1) *"the omission of an event or information, which is likely to result in discontinuity or alteration of event or information already available publicly"* and 2) *"the omission of an event or information is likely to result in significant market reaction if the said omission came to light at a later date"*.[32] Both these conditions are qualitative in nature. Also, these conditions are very much in line with the interpretation given by the U.S. Supreme court in *TSC case* which is considered to be one of the widely accepted cases across jurisdictions on materiality.[33]

- **SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023 -** The PUSTA Regulations, 2023, have also provided a definition for MNPI (which is synonymous with UPSI). Within these regulations, three distinct scenarios have been outlined, specifying when non-public information can be considered material. The condition pertinent to our discussion is as follows –

  Material Non-Public Information encompasses "*information about a company or security that was not generally available, and upon becoming generally available, had a reasonable impact on the price of the company's securities."*[34]

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[31] Regulation 30(4) of the SEBI (Listing Obligations and Disclosure Requirement) Regulations, 2015.
[32] ibid.
[33] *TSC Industries v. Northway, Inc.,* 426 U.S. 438, 449 (1976); *Basic Inc. v. Levinson,* 485 U.S. 224 (1988).
[34] Regulation 2(1)(f)(i) of SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023.

After a thorough analysis of the concept of materiality as defined in the three SEBI Regulations and in line with international practices for the determination of materiality, it becomes evident that the definition of materiality under the PUSTA Regulations is notably narrower in scope. The PUSTA Regulations specifically emphasise that information should be deemed material when it reasonably impacts the prices of a company's securities, while the other SEBI regulations consider information material if it is likely to affect the prices of the company's securities. Certainly, as opposed to the PUSTA regulations, other SEBI regulations do not necessitate an actual impact on the prices of the company's securities.

Consequently, it is strongly recommended that, in order to eliminate any ambiguity surrounding the definition of materiality within SEBI's regulations, a revision of the materiality definition is imperative. This revision is also warranted due to the significant deviation of the current definition under the PUSTA Regulations from the standards adopted by countries such as the United States, Singapore, Australia, and other comparable jurisdictions.

IV. MATERIAL NON-PUBLIC INFORMATION UNDER PUSTA REGULATIONS *VIS-À-VIS* INFLUENCERS

As per the proposed PUSTA Regulations, *"information about an impending recommendation, advice by name, in a security, by an influencer, to the public/followers/subscribers, and which when became generally available to the public/followers/sub-scribers, reasonably impacted the prices of that security"* will be considered as a material non-public information.[35] A

[35] Regulation 2(1)(f)(iii) of SEBI (Prohibition of Unexplained Suspicious Trading Activities in the Securities Market) Regulations, 2023.

genuine Finfluencer/Influencer analyses the already available information about a company, such as its financial statements, various accounting ratios, executed material contracts, and the potential growth of the sector in which the company operates. Based on this analysis, they offer advice or tips in good faith through their social media platforms, making their analysis accessible to the public. Subsequently, their subscribers often purchase the company's securities, which can reasonably impact the prices of those securities. However, according to the Proposed Regulation, advice given by Influencers that reasonably impacts the price of a security would fall under the ambit of Material Non-Public Information ("**MNPI**").

In this context, the author highlights that categorizing advice from Finfluencers as MNPI is problematic. The fundamental principle of materiality stipulates that information must not be generally available to the public. In the case of Finfluencers, their advice and tips are typically based on information that is already publicly accessible.[36] Therefore, the author expresses scepticism about including the recommendations of Finfluencers as material non-public information. Finfluencers do not provide advice based on non-public information about a company; rather, they analyse publicly available information about the company and its operating sector. They leverage their analytical and research skills when offering recommendations. The information upon which they base their advice is already accessible to the general public. Consequently, other market participants are not placed at an unfair or disadvantageous position, which is a prerequisite for declaring information as MNPI. Hence, it is essential to reconsider the inclusion of

[36] Sue S Guan, 'The Rise of the Finfluencer' (*Oxford Law Blog,* 22 May 2023) <https://blogs.law.ox.ac.uk/oblb/blog-post/2023/05/rise-finfluencer> accessed 13 August 2023.

advice and recommendations within the scope of MNPI from the perspective of SEBI.

V. STANDARD OF PROOF IN SECURITIES MARKET ABUSE CASES

After a thorough examination of the materiality issue under the PUSTA Regulations, we shall now delve into the matter of burden-shifting as stipulated by these regulations. To begin, the Burden of Proof refers to which party in a legal case or suit bears the responsibility of proving a fact that is in dispute and essential to the case, typically by adducing evidence.[37] In the United States, the courts have established that the Securities and Exchange Commission ("**SEC**") can meet its burden of proof in enforcement proceedings by a preponderance of evidence.[38] Moreover, in the case of *Roberts v. Woods,* it was determined that, in cases involving fraud, wrongdoing must be substantiated by "clear and convincing evidence," even when measured against the preponderance of probability.[39] Consequently, the burden of proof placed on the SEC in the violation of anti-fraud provisions is of a somewhat lower standard compared to the more rigorous "beyond a reasonable doubt" criterion. The preponderance of probabilities standard implies that, while both conflicting versions of events are possible, one is more

[37] Juhi Gupta, 'Interpretation of Reverse Onus Clauses' (2012) 5 NUJS Law Review 49 <http://nujslawreview.org/wp-content/uploads/2016/12/juhi-gupta.pdf> accessed 15 August 2023.
[38] 'High Court Backs S.E.C. on Fraud Proof Standard' *The New York Times* (26 February 1981) <https://www.nytimes.com/1981/02/26/business/high-court-backs-sec-on-fraud-proof-standard.html> accessed 16 August 2023. *See also,* Russell G. Ryan, 'The SEC's Low Burden of Proof' *Wall Street Journal* (14 July 2013) <https://www.wsj.com/articles/SB10001424127887323297504578582213820533922> accessed 17 August 2023.
[39] *Roberts v. Woods, 82 III App 630, 640 (1898); Woodby v. Immigration and Naturalization Service,* 385 US 276, 286 (1966); *Addington v. Texas,* 441 US 418, 433 (1979).

likely than the other.[40] The adoption of this standard of proof within securities laws serves to ensure that individuals with doubtful suitability do not continue trading in the market. It guarantees that only market participants with unquestionable suitability operate within the market. This, in turn, fosters fair trading and eradicates any form of unfair practices within the market. This standard of proof is also suitable for insider trading cases, as "beyond reasonable doubt" evidence is rarely available in such cases. Consequently, securities regulators may struggle to apprehend perpetrators of securities violations, allowing them to persist in the market, undermining the core objectives of market regulation.

From the perspective of the Indian judiciary, in the case of *Kishore Ajmera v. SEBI,* the Supreme Court established that the standard of preponderance of probabilities applies to civil proceedings under the SEBI Act, 1992, or the rules and regulations derived from it.[41] One of the early instances where the Securities Appellate Tribunal ("**SAT**") deliberated on the degree of preponderance of probabilities applicable in securities market violations was in the case of *Sterlite Industries (India) Ltd. v. SEBI*.[42] In this case, SAT emphasized that a higher degree of probability must be established when addressing offenses related to market manipulation.[43] Moreover, in 2009, in *Dilip S. Pendse v. SEBI,* the SAT ruled that *"the charge of insider trading is one of the most serious charges in relation to the securities market*

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[40] Dr. Rangin Pallav Tripathy, 'Standard of Proof in Inquiry Against Judges: A Case for a Lower Threshold' (2018) 5(2) National Law University Jodhpur Law Review 85, <http://nlujodhpur.ac.in/uploads/5%20(2)%20NLUJ%20Law%20Review%2085%20(2018).pdf> accessed 18 August 2023.
[41] *Kishore Ajmera v. SEBI, (2016) 6 SCC 368.*
[42] *Sterlite Industries (India) Ltd. v. SEBI (2001) SCC OnLine SAT 28*.
[43] ibid.

and having regard to the gravity of this wrong doing, higher must be the preponderance of probabilities in establishing the same."[44] This rationale was influenced by the case of *Mousam Singha Roy v. State of West Bengal*, where the Supreme Court established that in criminal jurisprudence, the seriousness of the offense dictates the stringency of the burden of proof. The same principle applies to civil cases, where the standard of proof for establishing a charge is a "preponderance of probabilities."[45] It is worth noting that within each standard of proof in both civil and criminal cases, there are varying degrees of probability.[46]

In 2010, in *R.K. Global Shares and Securities Ltd. v. SEBI,* the SAT reaffirmed its stance from the Dilip S. Pendse case, asserting that, when proving a serious offense, SEBI must meet a high degree of probability.[47] Similar view was further reiterated in *V.K. Kaul v. SEBI.*[48] Subsequently, in *DLF Ltd. v. SEBI,* the SAT emphasized that securities fraud and market manipulations are serious allegations and that, although these offenses must be established on the basis of a "preponderance of probabilities," the level of probability within this standard must be high. [49]

Based on the aforementioned judicial decisions, it is evident that under securities laws, even when violations may have penal consequences, the burden of proof is based on a preponderance of probabilities. This is because

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[44] *Dilip S. Pendse v. SEBI,* (2009) SCC OnLine SAT 177.
[45] *Mousam Singha Roy v. State of West Bengal,* (2003) 12 SCC 377.
[46] *Hornal v. Neuberger Products Ltd.,* (1956) 3 All E.R. 970. *See also, Bater v. Bater,* (1950) 2 All E.R. 458.
[47] *R.K. Global Shares and Securities Ltd. v. SEBI,* (2010) SCC OnLine SAT 285.
[48] *V.K. Kaul v. SEBI,* (2012) SCC OnLine SAT 203, *See also, Manoj Gaur v. SEBI,* (2012) SCC OnLine SAT 176; *Chandrakala v. SEBI,* (2012) SCC OnLine SAT 21.
[49] *DLF Ltd. v. SEBI* (2015) SCC OnLine SAT 54.

proving violations with direct evidence can be exceedingly challenging.[50] Moreover, it is now clear that a higher degree of probability is required for serious offenses concerning the securities market, including insider trading.[51]

However, in the present "PUSTA Regulations" under consideration, SEBI has significantly lowered the degree of preponderance of probabilities by only necessitating the trading pattern and timing of the trade to invoke a presumption of guilt. This approach deviates significantly from the positions taken by the SAT and the Supreme Court. Therefore, the author contends that, given the seriousness of insider trading charges, the preponderance of probabilities should be higher. The chilling effect of these proposed regulations could lead to innocent market participants being wrongly held accountable. To prevent such anomalies, the proposed regulations should adopt a higher standard of preponderance of probabilities.

VI. SHIFTING THE BURDEN OF PROOF ON ACCUSED *VIS-À-VIS* INSIDER TRADING

In insider trading cases, according to the Prohibition of Insider Trading ("**PIT**") Regulations, 2015, the onus lies with SEBI to establish a prima facie case against an insider who is not affiliated as a connected person. SEBI must demonstrate that this individual had possession of or access to Unpublished

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[50] Rajat Sethi, Misha Chandna, and Aditi Agarwal, 'Insider Trading: Circumstantial Evidence Is Evidence Enough?' (2020) 32 National Law School India Law Review, <https://repository.nls.ac.in/cgi/viewcontent.cgi?article=1083&context=nlsir> accessed 20 August 2023.

[51] Armaan Patkar and Diya Uday, 'Standard of Proof: Civil Securities Fraud, Market Manipulation, and Insider Trading in India' (2018) 8 SCC J-25 <https://www.scconline.com/blog/post/2018/10/08/2018-scc-vol-8-october-7-2018-part-4/> accessed 22 August 2023.

Price Sensitive Information ("**UPSI**") at the time of trading.[52] Whereas, under the proposed Prohibition of Unlawful Securities Trading Activities ("**PUSTA**") Regulations, SEBI can, merely by alleging suspicious trading activity, presume that a person has access to Material Non-Public Information ("**MNPI**"). Accordingly, SEBI can establish a case of insider trading. In contrast to the Prohibition of Insider Trading ("**PIT**") Regulations, where the primary burden of proving that a person has access to UPSI rested with SEBI, the PUSTA Regulations have relieved SEBI of this primary responsibility. Instead, SEBI can presume that a person has access to MNPI/UPSI based on unusual trading patterns and MNPI. This shift has, in essence, transferred the onus of burden.

VII. INDIAN JUDICIARY OVER REVERSAL OF BURDEN OF PROOF

India boasts a rich judicial history concerning the validity of reversing the burden of proof. In the case of *Noor Aga v. State of Punjab,* the Supreme Court ruled that the policy decision to reverse the burden of proof is constitutionally valid. The Court also clarified that burden of proof is shifted only after the *"prosecution has met the threshold of establishing the actus reus and foundational facts".*[53] Furthermore, in the case of *Sheikh Zahid Mukhtar v. State of Maharashtra,* the Bombay High Court held that a reverse onus clause under Section 9B of the Maharashtra Animal Preservation Act is ultra vires the constitution for failing to meet the criteria of being just, reasonable, and fair, which are fundamental prerequisites for a fair trial under Article 21

[52] SEBI (Prohibition of Insider Trading) Regulations, 2015.

[53] *Noor Aga v. State of Punjab,* (2008) 16 SCC 417. *See also, M/s. Seema Silk and Sarees v. Directorate of Enforcement,* (2008) 5 SCC 580.

of the Constitution.[54] The Court contended that the present Act overlooked the primary condition for the prosecutor to prove foundational facts before invoking the presumption of guilt, rendering the provisions under Section 9B of the Act unreasonable and unfair.

In the context of insider trading, the Supreme Court, in *Balram Garg v. Securities and Exchange Board of India,* determined that proving access to non-material public information constitutes a foundational fact.[55] The consultation paper for the PUSTA Regulations, while citing special statutes that impose a reverse burden of proof, has shifted the burden of proof to the accused in cases of insider trading and front running. However, even in special statutes like the NDPS Act, the prosecutor is still required to prove the prima facie case beyond a reasonable doubt against the accused.[56] Applying the aforementioned decisions of the Courts to SEBI's reversal of the burden of proof under the PUSTA Regulations, it is argued that SEBI has overlooked the requirement of proving foundational facts and has instead presumed them solely on the basis of two circumstantial pieces of evidence - trading patterns and the timing of trades. This constitutes a significant drawback of the proposed Regulations that needs rectification to align with the existing legal jurisprudence on the reversal of the burden of proof.

Based on existing legal theories and judicial precedents, it is established that before any presumption is raised, foundational facts must be

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[54] *Sheikh Zahid Mukhtar v. State of Maharashtra,* (2016) SCC OnLine Bom 2600.
[55] *Balram Garg v. Securities and Exchange Board of India*, (2022) 9 SCC 425.
[56] Livelaw News Network, 'Stringent Provisions Of NDPS Act Does Not Dispense With The Requirement To Establish A Prima Facie Case Beyond Reasonable Doubt: SC' *(LiveLaw,* 5 August 2020*)* <https://www.livelaw.in/top-stories/stringent-ndps-act-does-not-dispense-with-requirement-to-establish-prima-facie-case-161012> accessed 03 September 2023.

proven by the prosecutor. Recognizing the challenge of producing direct evidence to prove possession or actual access to UPSI or MNPI, the author proposes a balanced approach under the PUSTA Regulations. In this approach, SEBI's standard of proof should neither be as high as "proving beyond a reasonable doubt" nor as low as "based on mere suspicion." Instead, the standard of proof should be that which requires SEBI to demonstrate that a reasonable investor can logically infer that the defendant is likely to have access to MNPI.

The author suggests that, rather than presuming access to MNPI, the proposed Regulations should place a higher preponderance of probabilities on SEBI to prove that there is a reasonable likelihood that a person is likely to have access or possession of UPSI/MNPI. Therefore, in addition to repetitive unusual trading patterns and consequential material non-public information, SEBI should also demonstrate that a reasonable person can draw a logical inference from all the surrounding facts and circumstances that there is a reasonable likelihood that the accused is likely to have possession of UPSI/MNPI.

Further, the author proposes that, instead of proving the actual possession of MNPI, if SEBI can produce evidence showing that a reasonable investor can establish a connection between repetitive unusual trading patterns and MNPI, it should be considered sufficient to raise the presumption that the accused is likely to have access to UPSI/MNPI.

Thus, based on this reasoning, the proposed definition of suspicious trade activities should include unusual trading patterns, material non-public information, and a reasonable connection between repetitive unusual trading patterns and MNPI. Once all three conditions are met, SEBI can invoke the presumption that the person had access to or was in possession of MNPI, leading to a charge of insider trading. Moreover, by introducing a reasonable connection as an additional condition, a prudent investor can draw a logical inference that the defendant is likely to have access or possession of MNPI/UPSI, thereby aligning with the judicial precedent set by the Supreme Court of India.

VIII. INTRODUCING OF 'REASONABLE CONNECTION' REQUIREMENT *VIS-À-VIS* ACCESS TO MNPI/UPSI IN INSIDER TRADING CASES

The primary concept put forth by the author regarding the reasonable connection requirement is to ensure that a rational market participant can deduce a logical inference that the defendant or accused had access to or possession of MNPI at the time of trading. According to the SEBI Prohibition of Insider Trading ("**PIT**") Regulations, 2015, SEBI is tasked with establishing that an individual had access to UPSI at the time of trading. SEBI typically relies on direct evidence, and in the absence of such evidence, resorts to circumstantial evidence to demonstrate that the individual had access to UPSI at the time of trading.

Furthermore, under the current legal framework, SEBI is required to prove insider trading with a higher degree of probability. SEBI can achieve this by considering the totality of all the relevant facts and circumstances. However, in the proposed Regulations, SEBI presumes that the individual had access to MNPI at the time of trading based solely on two events - the trading pattern and the timing of the trade. In essence, SEBI relies on just two pieces of circumstantial evidence to invoke a presumption of guilt. Given the gravity of insider trading as a serious offence and the fact that it entails a reversal of the burden of proof, SEBI should be held to a high standard of proving foundational facts with a strong degree of probability.

Hence, it is suggested that, in order to establish that the accused reasonably had access to MNPI at the time of trading, SEBI should consider a cumulative analysis of all relevant facts and circumstances. By requiring SEBI to take into account the totality of the facts and circumstances surrounding the event, a high degree of probability can be assured. This concept of a high degree of probability is a precedent established by the Indian and U.S. judiciary when dealing with charges related to serious offences in the securities market, and it should not be disregarded. The proposed Regulations appeared to deviate from this established norm, and it is imperative to rectify this deviation. The correct course of action would be to mandate SEBI to once again adhere to the traditional yet effective approach of requiring a "higher degree of probabilities" through a cumulative analysis of all the facts and circumstances pertaining to insider trading cases in order to demonstrate that the individual is likely to have had access to material non-public information.

IX. RELEVANCY OF CIRCUMSTANTIAL EVIDENCES IN INSIDER TRADING CASE IN U.S. AND CANADA

By introducing the notion of 'reasonable connection', the author seeks to emphasis on non-exhaustive circumstantial evidences to prove access to MNPI/UPSI which is a foundational fact in insider trading cases. In this background, this section will examine the validity of circumstantial evidences in establishing insider trading cases. In U.S., the Hon'ble District Court

Southern District of New York in the matter of *United States of America v. Raj Rajaratnam*, has held that insider trading convictions can be sustained based on circumstantial evidences in considering such factors as *"(1) access to information; (2) relationship between the tipper and the tippee; (3) timing of contact between the tipper and the tippee; (4) timing of the trades; (5) pattern of the trades; and (6) attempts to conceal either the trades or the relationship between the tipper and the tippee."*[57]

Cases of establishing insider dealing based on circumstantial evidence can be found in Canada as well. In the case of *Walton v. Alberta*, the Alberta Court of Appeal has held that insider trading cases can be proved by using circumstantial evidences.[58] The Court also clarified that logical inferences cannot be drawn from mere speculations. Similarly, in the case of *Finkelstein v. Ontario Securities Commission*, the Ontario Court of Appeal held that since there is generally a lack of direct evidence in establishing insider trading, hence it is reasonable to find insider trading based on circumstantial evidence.[59]

X. JUDICIAL PRECEDENT OVER RELEVANCY OF CIRCUMSTANTIAL EVIDENCES IN INSIDER TRADING CASES

- **Supreme Court cases –**
  - In the case of *SEBI v. Kishore Ajmera,* the Supreme Court held that in the absence of direct evidence, the Court can take note of the immediate and proximate facts and other circumstances

[57] *United States of America v. Raj Rajaratnam 09 Cr. 1184 (RJH); see also United States v. Larrabee,* 240 F.3d 18, 21-22 (1st Cir. 2001).
[58] *Walton v. Alberta (Securities Commission),* (2014) ABCA 273.
[59] *Finkelstein v. Ontario Securities Commission*, (2018) ONCA 61.

surrounding the event to arrive at a reasonable conclusion.[60] In other words, *"totality of the attending facts and circumstances surrounding the allegations"* is what matters. In this case, the Court contemplated a non-exhaustive list of circumstantial factors to arrive at a reasonable conclusion, including but not limited to the volume of the trade affected, the duration of persistence in trading in the particular stock, and the proximity of time between two relevant factors, etc. The Court also cautioned that circumstantial evidence will be sufficient only when it leads to an "irresistible conclusion" that the accused had access to unpublished price-sensitive information.

- Similarly, in the case of *SEBI v. Rakhi Trading Private Limited,* the Supreme Court has reiterated its decision in *Kishore Ajmera case*.[61] In this case also, the Apex Court has cumulatively analysed several circumstantial factors to derive a reasonable inference.
- The Apex Court in the *SEBI v. Kanaiya Lal Baldevbhai Patel* has held that *"an inferential conclusion from proved and admitted facts would be permissible and legally justified so long as the same is reasonable."*[62] Hence, it can be inferred from the said judgment that a conclusion drawn on the basis of circumstantial evidence is legally valid as long as it is reasonable.

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[60] *SEBI v. Kishore Ajmera, (*2016) (6) SCC 368.
[61] *SEBI v. Rakhi Trading, (*2018) 13 SCC 753.
[62] *SEBI v. Kanaiya Lal Baldevbhai Patel,* (2017) 15 SCC 753.

- **Orders of Securities Appellate Tribunals -**

  - In the case of *Ketan Parekh v. SEBI*, the SAT held that list of circumstantial factors cannot be exhaustive. It went of observing that *"any one factor may or may not be decisive and it is from the cumulative effect of attending circumstantial factors that an inference will have to be drawn."* Also, it can be inferred from SAT's reasoning that the difficulty in proving facts, which are especially within the knowledge of the parties concerned, is a valid ground for using circumstantial evidence to establish violations in the securities market.[63]
  - Going further, in the case of *V.K. Kaul v. SEBI,* in the absence of sufficient direct evidence, the SAT based its decision on circumstantial evidence, including telephonic records, the timing of the trades, bank transactions, and Mr. Kaul's attempt to conceal his telephonic conversation. It held that Mr. Kaul had engaged in insider trading.[64]

- **Committee Report –**

The N.K. Sodhi Committee has also reported that obtaining direct evidence in all insider trading cases is very challenging. Accordingly, the facts and circumstances of the case need to be assessed to draw a reasonable

[63] *Ketan Parekh v. SEBI,* (2006) SCC OnLine SAT 221.
[64] *V. K. Kaul v. SEBI,* (2012) SCC OnLine SAT 203.

conclusion that a person has access to Unpublished Price-Sensitive Information (UPSI).[65]

Based on above decisions and report of the N.K. Sodhi Committee, it can be said that in the absence of direct evidence, circumstantial evidences can be taken by SEBI to arrive at a reasonable conclusion. However, in Balram Garg case, the Supreme Court gave a contradictory judgement. In this case, the Court asked SEBI to produce e-mails, letters, witnesses, or any other cogent evidences to prove communication of UPSI. Simply, the Court has applied the standard of proof of proving the case beyond reasonable doubt. Hence, the judgment has been heavily criticised for not treating direct and circumstantial evidences at same pedestal and mandating the SEBI to produce direct evidences to establish communication without paying heed to the fact that it is very difficult to adduce direct evidences in insider trading cases.[66]

Taking into account international practices, Indian judiciary's decisions validating the use of circumstantial evidence, the challenge of producing direct evidence, and the imperative to enhance the success rate in insider trading cases, SEBI took a deliberate step to codify circumstantial evidence as valid grounds for demonstrating that an individual had access to MNPI or UPSI. Nevertheless, the proposed Prohibition of Insider Trading and Unfair Trade Practices Regulations ("**PSUTA Regulations**") only mentions

[65] N. K. Sodhi, 'Report of the High-Level Committee to Review the Sebi (Prohibition of Insider Trading) Regulations, 1992' (7 December 2013), <https://www.SEBI.gov.in/SEBI_data/attachdocs/1386758945803.pdf> accessed 05 September 2023.

[66] Harsh N. Dudhe and Pranay Bhardwaj, 'Evaluating the Standard of Evidence Used in Insider Trading Cases' (*SCConline*, 3 January 2023) <https://www.scconline.com/blog/post/2023/01/03/evaluating-the-standard-of-evidence-used-in-insider-trading-cases/> accessed 06 September 2023.

SEBI should consider bolstering its workforce by hiring additional employees.

In addition to enhancing SEBI's surveillance capabilities through the authorization to intercept telecommunications and electronic communications, as well as augmenting its workforce, the Author proposes that the regulatory body should establish Memoranda of Understanding ("**MoUs**") with other investigative agencies, such as the CBI and the ED. These MoUs would facilitate the routine and automated exchange of information and data. Furthermore, beyond regular data sharing, SEBI and other relevant agencies should commit to sharing information from their respective databases upon request or proactively for the purposes of conducting examinations, inspections, investigations, and prosecutions. To oversee and improve the effectiveness of this data-sharing mechanism, a dedicated unit or group should be constituted. It is noteworthy that there are no legal impediments to the formation of such MoUs, as SEBI has already executed a MoU with the Central Board of Direct Taxes ("**CBDT**") for data exchange.[76] The establishment of such MoUs would promote enhanced cooperation and synergy between SEBI and various government agencies, thereby facilitating their collaborative efforts in conducting investigations, scrutiny, and prosecutions.

XII. CONCLUSION

The Author's conclusion applauds the SEBI for its progressive measure of reversing the burden of proof in cases of insider trading. This

[76] SEBI, 'SEBI signs MoU with CBDT' (*SEBI*, 08 July 2020) <https://www.SEBI.gov.in/media/press-releases/jul-2020/SEBI-signs-mou-with-cbdt_47030.html> accessed 17 September 2023.

commendation is rooted in the recognition of the inherent complexities associated with proving insider trading, which, in turn, places the onus on SEBI to ensure judicial efficiency and acknowledges the unique knowledge possessed by the defendant.

Throughout this paper, the author introduces the notion that, by introducing an additional requirement of establishing a reasonable connection, SEBI can systematically evaluate all relevant facts and circumstances. This, in turn, enables SEBI to fulfil its burden of proof by establishing that the insider likely had access to MNPI or UPSI. It is emphasised that neither the 'beyond reasonable doubt' standard nor a 'lower degree of preponderance of probabilities' is the optimal approach to combat insider trading. Instead, the author advocates for a more balanced strategy.

By incorporating a 'reasonable connection' requirement alongside factors such as unusual trading patterns and MNPI, a higher degree of preponderance of liabilities can be attained. Consequently, this approach strikes a middle ground that ensures that both wrongdoers do not escape SEBI's scrutiny and that innocent individuals are not wrongly targeted.

Additionally, the current legal landscape reveals conflicting judicial decisions on the admissibility of circumstantial evidence to prove that an individual was in possession of UPSI/MNPI during a trading episode. Therefore, there is an urgent need for the judiciary to adopt a consistent and uniform approach. This is imperative to safeguard the interests of investors and maintain the integrity of the market.

The author further posits that, in addition to adopting a balanced approach under the Prohibition of Insider Trading Regulations, it is paramount to modernise SEBI's investigative techniques. The amalgamation of all these elements forms a comprehensive strategy that would empower SEBI to fulfil its core mandate of eradicating unfair practices in the securities market. This approach serves the dual purpose of safeguarding investors' interests, instilling confidence in the securities market, and preserving its overall integrity.

III. EMPLOYER AS DATA FIDUCIARY: A NEGLECTED PROTECTION OR AN EXAMPLE OF POWER IMBALANCE?

- Intisar Aslam and Garima Kiran*

ABSTRACT

The laws of labor have always gained traction- the credit goes to the debates on the long working hours and no work-life balance. This takes the clock backwards to 1817 when Robert Owen formalized the goal of the Eight-Hour Work Day. While this social movement was focused on the rights of workers, the line of variance for employees has been blurred with time. Employment contracts, an 'act of submission' as termed by Kahn-Freund, found their roots in the old master-servant relationship. With the prime object of labor law being to be a countervailing force to the inherent inequality of bargaining power, little did employees know that the perforation of technology in the ever-evolving industrial world would entail the protection of their data collected by these industrial establishments. Though the Indian legislative picture has been painted with the enactment of the Digital Personal Data Protection Act, 2023, the Labour Codes remain unenforced in the territory of India. Notably, the Labour Codes are rather indifferent to the protection of data of any kind. Broadly, this paper has three aims. First, the authors underscore the need for the protection of employee data and the subsequent inadequacy of the present framework to address the same. Second, we explore the employer as a significant data fiduciary while highlighting the challenges of secondment. Next, we argue that employee consent may not be free. Lastly, the authors assess the stance of India in the cross-border transfer of employee data and conclude with a beneficent rule of construction.

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I. INTRODUCTION

India has witnessed several data breaches of employees like the HR portal of myrocket.co, Okta, etc.[1] In July 2023, a massive breach of employee data of the largest public sector bank in India, the State Bank of India ("**SBI**"), took place, where the data of more than 12,000 SBI employees was leaked on Telegram.[2] The leaked data of the SBI employees included personal information like names, addresses, contact numbers, PAN details, etc. Such leakages form the *foremost* reason not only for the protection of employee data but also emphasize the positioning of the organization as an accountable and ethical entity in the commercialized world. It is worth mentioning that SBI is an instrumentality of the State.[3] The Digital Personal Data Protection Act, 2023 ("**DPDP Act**") makes a provision for the exemption of the state and/or its instrumentalities from the provisions of the statute on the grounds of sovereignty and integrity of the country, public order, etc. Essentially, the central government can, at any time, free SBI from the clutches of this statute,

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[1] The Hindu Bureau, 'HR Portal myrocket.co data breach exposes information of Indian employees: Report' (*The Hindu* 18 January 2023) <https://www.thehindu.com/sci-tech/technology/hr-portal-myrocketco-data-breach-exposes-information-of-indian-employees-report/article66396467.ece> accessed on 10 November 2023; Bill Toulas, 'Okta hit by third-party breach exposing employee information' (*Bleeping Computer* 2 November 2023) <https://www.bleepingcomputer.com/news/security/okta-hit-by-third-party-data-breach-exposing-employee-information/#google_vignette> accessed on 10 November 2023.
[2] Bidisha Saha, '12,000 SBI employees' sensitive date leaked on Telegram channels' (*Business Today* 11 July 2023) <https://www.businesstoday.in/technology/news/story/12000-sbi-employees-sensitive-data-leaked-on-telegram-channels-389239-2023-07-11> accessed on 10 November 2023.
[3] M/s Legal Property & ANR and Chief Manager, State Bank of India & ANR [2023] LiveLaw (Kar) 298.

including the mandatory provision for the protection of data being stored or processed by it.[4] Such exemptions go against the interest of the employees with neither any measure to safeguard such data nor any remedy to pursue in breach of the same.

Secondly, the collection of a voluminous amount of employee data necessitates the need for effective management and protection of data. With a larger volume of data comes greater risk and therefore, regulation and monitoring are essential to minimize the risks of breaches. On these lines, the earlier draft of the Personal Data Protection Bill of 2018 through Clause 16 provided employment as a basis for processing only non-sensitive personal data.[5] Information such as sexual orientation, transgender status, caste, religion, etc. was covered under sensitive personal data. However, in the latest framework, employers have been given a free hand to elicit broad-based consent to process such sensitive information. Thus, there is also a high possibility of rampant discrimination based on caste, gender, and religion in workplaces.

Thirdly, the protection of employee data is crucial in the administration of benefits such as the Employees' Provident Fund ("**EPF**"). There is no use in providing benefits to an employee when, on the other hand, their personal data is being compromised. Eventually, it is a no-win, no-loss situation. Safeguarding employee data would help ensure the accuracy of records and the receiving of benefits to which they are entitled without any error or discrepancy. Furthermore, the benefits of insurance often require the details

[4] Digital Personal Data Protection Act 2023, s 8(5).
[5] Personal Data Protection Bill, 2018, cl 16.

of family members, thereby, further fortifying the need for protection of data by the employer.

Additionally, there are various other employment benefit programmes such as retirement plans that involve financial transactions. Besides the aforementioned, the health information of the employees also needs to be protected to build and preserve trust that their medical records are handled in a responsible manner by the employers. The same is practiced in the United States where the Health Insurance Portability and Accountability Act of 1996 ("**HIPPA**") requires the creation of national standards to protect sensitive personal information from being disclosed without the patient's consent.[6]

Section 42(1) of the Occupational Safety, Health, and Working Conditions Code, 2020 ("**OSHW Code**") read with Sections 70(3), 82(c), 85(a) and (c), 93(5) require medical assessment if the workers to ensure their fitness to perform diverse activities.[7] As per Section 85(1) of the OSHW Code, the occupier of a factory is required to maintain accurate health and medical records.[8] Such provisions including providing an assessment by a registered medical practitioner may give rise to data protection implications for the workers. Thus, employers must determine the legal basis before processing such data to ensure the lawfulness of the same.

In sum, the protection of employee data is integral for maintaining trust, ensuring fair treatment, and upholding ethical practices within

[6] Heath Insurance Portability and Accountability Act 1996.
[7] Occupational Safety, Health, and Working Conditions Code 2020.
[8] Occupational Safety, Health, and Working Conditions Code 2020, s 85(1).

organizations. Neglecting data protection not only jeopardizes individuals' privacy but also undermines the integrity of employee benefits programs.

II. CURRENT LEGAL FRAMEWORK OF INDIA

The earliest legislation on data protection in India has been the Information Technology Act of 2000 ("**IT Act**").[9] The existing literature has relied upon the same to make room for the protection of employee data through the applicability of provisions like Sections 43A, 72, and 72A.[10] However, while making room for its applicability, voids effecting inapplicability have been a go-by.

A. The IT Act Lens: Straightjacket Provisions of Negligent Disclosure

Section 43A imposes liability on body corporates that are negligent in dealing with 'sensitive' personal data.[11] The incorporation of '*negligence*' i.e., failure to exercise a duty of care in terms of tort law, imposes a civil liability on the body corporates. Essentially, the underlying meaning of such a provision revolves around the act and omission of body corporates. If there is a breach of the personal data of an individual, and the body corporates have maintained reasonable security practices and procedures, they shall not have any liability eventually, leaving the individual with no remedy. Section 72 is a saving provision that provides for a penalty for breach of confidentiality and privacy through the disclosure of any information about an individual to a third

[9] Information Technology Act 2000.
[10] Rakhi Jindal, Gowree Gokhale, Vikram Shroff, 'The Indian legal position on employee data protection and employee privacy' (*Nishith Desai Associates*, March 2012) <The_Indian_legal_position_on_employee_data_protection_and_employee_privacy.pdf (nishithdesai.com)> accessed 10 November 2023.
[11] Information Technology Act, 2000, s 43(A).

party without his consent.[12] While this provision gives importance to the consent of the data principal while sharing its data with a third party, it is yet again a provision that makes space for the body corporate or the 'original' data fiduciary to escape liability if it processes the data for its own purpose. Another saving provision, Section 72A, is a slightly different provision where disclosure is in breach of a lawful contract.[13] This provision, therefore, might reflect some resemblance with the employment contracts. At the same time, a scrutiny of the provision reveals that the obligations imposed therein are confined to persons '*providing*' services under the lawful contract. The distinction herein lies between '*providing*' and '*availing*'. Instead of imposing obligations of disclosure on body corporates or intermediaries '*availing*' services from individuals, the provision turns the situation topsy turvy. In sum and substance, the aforementioned provisions of the IT Act fail to bring employee data within its ambit to any extent whatsoever.

B. Data Processing and Third Parties: Liability or No Liability?

In 2011, in the exercise of the powers conferred by Section 43A read with Section 87(2)(ob), the Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules ("**SPDI Rules**") was brought in by the government.[14] It is pertinent to note here that the SPDI rules provide for sensitive personal data- a categorization that finds no place in the recent data protection framework of India. While it is anticipated that the IT Act shall be replaced by the Digital India Act, it is important to assess its overriding effect on the DPDP Act for the time being it

[12] Information Technology Act, 2000, s 72.
[13] Information Technology Act, 2000, s 72(A).
[14] Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, GSR 313(E).

is in force in light of the categorization of data.[15] Section 81 of the IT Act gives the statute an overriding effect over any law inconsistent with its provisions for the time being in force.[16] The primary contour of the applicability of this provision is the inconsistency between two similarly placed legislations.[17] In the DPDP Act, while there is no provision for the categorization of personal data, there is nothing to indicate that the legislative intent was to proscribe such categorization thereby, giving rise to any inconsistency. In the absence of otherwise, the IT Act could be read harmoniously with the provisions of the DPDP Act to establish a robust framework for India. However, the SPDI rules only address a smaller circle of issues and focus heavily on three aspects*: (i)* Disclosure of data and not processing; *(ii)* Liability for disclosure by body corporates and not third parties; and *(iii)* employee consent and lawful contracts. It is noteworthy that a 'lawful' contract is an exception to waive the obligation of obtaining consent to disclose such personal data. As a conclusion, the IT Act as a whole cannot delve into the purpose of holding data, the manner in which it was obtained, the duration of retention, security and encryption, and grounds for third-party sharing.[18]

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[15] Anika Chatterjee, 'India to introduce new Digital India Act to regulate Big Tech' *The Hindu Business Line* (01 May 2023) <https://www.thehindubusinessline.com/info-tech/india-to-introduce-new-digital-india-act-to-regulate-big-tech/article66799883.ece> accessed 10 November 2023.

[16] Information Technology Act 2000, s 81.

[17] *Sharda Devi v. State of Bihar* [2002] 3 SCC 705.

[18] Editor, 'Data Protection in the Workplace' (*Citizens Information Centre*, 03 June 2022) <https://www.citizensinformation.ie/en/employment/employment-rights-and-conditions/data-protection-at-work/data-protection-in-the-workplace/> accessed 10 November 2023.

III. THE DATA PROTECTION FRAMEWORK AND ITS INACCESSIBLE REMEDY TO EMPLOYEES

The question that arises now is whether the new data protection framework brings employee data within its ambit. Before delving into this question, an interesting case of First Choice Selection Services Limited ("**FCSSL**") must be discussed.[19] It is often witnessed that aggrieved employees file cases against their employer but lack information, which is indispensable for their claims to be successful. Consequently, even prior to commencing legal proceedings in the court of law, it is commonplace for employees in foreign jurisdictions to submit a Data Subject Access Request ("**DSAR**") to their employer. This request seeks copies of personal data that employees believe their employer holds. Obtaining such data can notably bolster cases that initially appeared weak.

In the FCSSL case,[20] the employer had wilfully refused to release the information to the employee to pursue its claim against the employer. The Office of the Information Commissioner held that the employer had breached its data protection obligations to the employee. The Indian data protection framework gives the right to the employer to process personal data as a '*legitimate use*' to safeguard itself from loss or liability under Section 7(i) of the DPDP Act.[21] Further, it specifically empowers the employer to process the data of its employee for "*provision of any service or benefit sought by a Data*

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[19] Information Commissioner, 'Enforcement Notice' (*Information Commissioner Office* 02 March 2021) <https://ico.org.uk/media/action-weve-taken/enforcement-notices/4017978/first-choice-selection-services-limited-en.pdf> accessed 10 November 2023.
[20] ibid.
[21] Digital Personal Data Protection Act 2023, s 7(i).

Principal who is an employee."[22] Apart from this employer-centric provision, no provision in the DPDP explicitly provides for the right to data protection of employees in the same manner as the employer has for processing. While social welfare legislations are being implemented, the inherent imbalance of power manifests itself in other forms and characters. Moreover, this gap in power is widened by the absence of a provision for Data Subject Access Request which would facilitate the pursuit of remedies by the employee for potential data breaches by the employer. Though Section 11 of the DPDP Act provides for access to personal data, this provision can be relaxed for the State and its instrumentalities under the exemptions provision.[23] It is unclear, therefore, if an employee would be able to seek a remedy against a state or its instrumentality in case of any grievance. The situation is akin to a locked door without a key: the remedy lies beyond but remains inaccessible. Though the legislation has been armed with the phrase 'data protection', in the labour jurisprudence, the provisions contained therein outcry an employer-centric processing framework.

IV. EMPLOYEE FAVORITISM: PROTECTION OF EMPLOYEE DATA OR DIGITAL EMPLOYEE DATA?

The Digital Personal Data Protection Act, 2023 gives a broad definition of a Data Principal to include any individual to whom the personal data relates.[24] Along similar lines, a data fiduciary includes any person who determines the purpose and means of processing personal data while a data

[22] ibid.
[23] Digital Personal Data Protection Act 2023, s 11.
[24] Digital Personal Data Protection Act 2023, s 2(j).

processor processes such data.[25] Section 2(s) gives clarity to these provisions, which define a person not only as an individual but also as a firm, company, or association of individuals, etc.[26] Clearly, an employer and an employee can fall under the respective ambits of data fiduciary and data principal but only in respect of digital data and not offline data. Thus, any employee data collected through offline means or data pertaining to labourers would fall outside the ambit of the DPDP Act. Furthermore, two questions that arise are: *(i)* Given that the employers collect voluminous, sensitive data about the employees, whether they all be notified as significant data fiduciaries? and *(ii)* In cases of secondment of employees, who shall be the data fiduciary and/or data processor?

A. Employers as Significant Data Fiduciaries

Section 10 of the DPDP Act determines a few factors to assess any data fiduciary as significant data fiduciary.[27] These include the volume and sensitivity of personal data processed, the risk to the rights of Data Principals and electoral democracy, and the potential impact on the sovereignty, integrity, security of India, and public order. With regards to the sensitivity of personal data, it is evident that employers not only collect data related to sexual orientation, physical and physiological conditions but also biometric and financial information of the employee.[28] In a recent case, the Dutch Data Protection Authority observed that the processing of biometric data was not

[25] Digital Personal Data Protection Act 2023, s 2(i); Digital Personal Data Protection Act 2023, s 2(k).
[26] Digital Personal Data Protection Act 2023, s 2(s).
[27] Digital Personal Data Protection Act 2023, s 10.
[28] Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, rule 3.

necessary for authentication or security purposes under the General Data Protection Regulation ("**GDPR**").[29] When it comes to the volume of data collected, employers also collect salary data, surveillance through security cameras, business trips, personal messages on company phones, and location data of the company car for private trips.[30] The list is not exhaustive and makes it evident that an employer can *prima facie* fall within the bracket of significant data fiduciaries. However, the usage of the term '*may*' gives discretion to the central government to impose any additional obligations on the employer. In *arguendo*, Section 17(3) gives the central government to exempt any government or private entity from these additional obligations, including obligations to protect personal data, serve notice to data principals, erasure of data post fulfilment of purpose, and provide access to information about personal data.[31] This brings India back to square one- the imbalance of power between an employer and employee- shifting the balance again in favour of the employer.

B. Secondment of Employees: Who is the Data Fiduciary and who is the Data Processor?

Article 4(16) of the GDPR defines the main establishment of a data fiduciary and data processor respectively in situations where there is more than one establishment.[32] For these purposes, the main establishment is where the

[29] Debbie Heywood, 'Processing Employee Fingerprint Data' (*Taylor Wessing*, 10 July 2020) <https://www.taylorwessing.com/en/global-data-hub/2020/july---hr-data/processing-employee-fingerprint-data> accessed 10 November 2023.
[30] Barnea Jaffa Lande & Co, 'Collecting Employee Information? It's Time to Wake Up' (*JD Supra*, 12 January 2021) <https://www.jdsupra.com/legalnews/collecting-employee-information-it-s-6974458/> accessed 10 November 2023.
[31] Digital Personal Data Protection Act 2023, s 17(3).
[32] General Data Protection Regulation (EU) 2016/679.

central administration takes place, unless some other establishment has the power to make decisions related to the purposes and means of processing personal data. Furthermore, in the recent case of *Yung Wai Tak Abraham William* v. *Natural Dairy (NZ) Holdings Ltd.*, the Court of First Instance held that a company could be the employer of the seconded employee even though there is no written employment contract between them.[33] In this case, the employee had no knowledge of his secondment, and no agreement was entered into to effect secondment. Moreover, since employees mainly had to deal with the work of the parent company, it constituted a separate employer-employee relationship despite the existence of an employment contract with the subsidiary company. This judgment is on similar lines with the Indian rulings laying importance on the language of the secondment agreement and, in its absence, the company having a greater degree of control, supervision, responsibility, termination, remuneration, etc.[34]

The DPDP Act, on the other hand, does not give any such reference to the place of establishment of a data fiduciary or processor and therefore, poses challenges in processing personal data in situations like secondment. It is the temporary transfer of an employee, whether domestic or international, for a short period within a company in the same organization or between different entities.[35] While secondments typically happen through agreements, in a

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[33] [2020] HKCFI 2067.

[34] *Centrica India Offshore Pvtl Ltd v. Income Tax-Ia* [2014] SCC OnLine Del 2739; *DIT (International Taxation) v Abbey Business Services India (P) Ltd* [2020] 122 taxmann.com 174 (Kar).

[35] Editor, 'Glossary: Secondment' (*Practical Law*) <https://uk.practicallaw.thomsonreuters.com/1-521-1558?transitionType=Default&contextData=(sc.Default)&firstPage=true#:~:text=The%20temporary%20assignment%20of%20an,between%20two%20unrelated%20business%20entities> accessed 10 November 2023.

situation otherwise, the lines between the data fiduciary and the data processor would be blurred. Even if the same are clearly identifiable, the likelihood that the consent of the employee would be '*presumed*' to have been given in respect of another entity is unsettling.

C. Cross-border Employee Data Transfer: Where does India stand?

Due to globalization, companies strive to have a global presence and to spread their operation in different jurisdictions, transfer of employee data beyond the national borders is necessary. In the European Union, GDPR allows for the transfer of data to a foreign jurisdiction or third party while ensuring the adequate and equivalent level of protection and safeguards as provided in the jurisdictions where the data is being transferred.[36] Furthermore, cross-border data transfer requires that the standard of protection offered by the data controllers and processors transmitting such data must be "*essentially equivalent*" to that offered by the General Data Protection Regulation.[37]

Similarly, in jurisdictions like Brazil and Singapore, the laws require that the jurisdiction to which the data is transferred must provide an adequate level of protection and employ necessary safeguards to protect the transferred data.[38] Along the same lines, the New Zealand Privacy Act 2020 also requires due diligence to be exercised over the third party to whom the data is being

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[36] Editor, 'HR Data Security: HR's Role in Employee Privacy & Data Protection' (*KBI*, 5 January 2023) <HR Data Security and Employee Privacy | KBI Benefits> accessed 10 November 2023.
[37] *Data Protection Commissioner v Facebook Ireland* [2020] C-311/18.
[38] Securiti Research Team, 'The HR Guide to Employee Data Protection' (*Securiti*, 11 August 2023) <The HR Guide to Employee Data Protection - Securiti> accessed 10 November 2023.

transferred to ensure compliance with the Act.[39] Thus, in essence, the stand of most jurisdictions is similar allowing transfer on grounds of the essentially equivalent principle.

On the other hand, the DPDP Act has undergone a series of transformations over time. The earlier drafts had come up with a local storage obligation for sensitive personal data and a hard localization obligation for an undefined category of critical personal data.[40] Next, the Digital Personal Data Protection Bill, 2021 envisioned whitelisted countries where cross-border transfer was permitted.[41] This provision is similar to the laws of foreign jurisdictions. However, in the latest 2023 framework, through Section 16, the legislature has taken a negative approach conferring the power on the Central government to notify certain blacklisted countries where the data transfer shall not be allowed.[42] At the same time, sub-section 2 also provides that the Act would not render any other existing law ineffective that imposes a higher degree of protection or restrictions on personal data transfers but it remains silent on the standard of protection that should be provided when the data is transferred overseas.[43] Further, the silence of the Act extends to the duty that the employers have during the transfer of cross-border employee data.

A 2019 report emphasized that realizing India as a $1 trillion digital economy hinges on establishing a conducive environment where capital, innovation, data, and design capabilities can seamlessly move to nations that

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[39] Dr Sam De Silva & Elizabeth Vincent, 'New Zealand- Data Protection Review' (*One Trust Data Guidance* October 2022) <https://www.dataguidance.com/notes/new-zealand-data-protection-overview> accessed 10 November, 2022.
[40] Personal Data Protection Bill 2018, s 40.
[41] Digital Personal Data Protection Bill 2022, s 17.
[42] Digital Personal Data Protection Act 2023, s 16(1).
[43] Digital Personal Data Protection Act 2023, s 16(2).

present fewer obstacles.[44] However, while making India '*digital*', any digital trade-off or, to put it differently, putting the employee data at stake would defeat the purpose of the vision *per se*. It is therefore important to strike a balance between flourishing global markets through seamless transfer and the basic rights and interests of the employees.

V. *BRAHMASTRA* OF THE EMPLOYER: IS THE EMPLOYEE CONSENT RELIABLE?

In an employer-employee relationship, the power imbalance between the two is a very common feature. The imbalance between the two is the outcome of several factors like access to financial resources, decision-making authority, and employment contracts whose terms and conditions are often determined by the employers. All these factors contribute to creating an imbalance of power between the two where the employer is at a higher pedestal than employees. Sir Otto Kahn-Freund, one of the greatest jurists of the twentieth century and scholar of labor law, viewed the relationship between the employer and an employee as a relationship between the bearer of power and one who is not a bearer of power.[45] It means an act of subordination where the employee submits to the employer. He believed such subordination to be inherent in any employment relationship and it could not be replaced by coordination between the two.

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[44] Ministry of Electronics and Information Technology, 'India's Trillion-Dollar Digital Opportunity' (2019) <https://web.archive.org/web/20220604181319/https://www.meity.gov.in/writereaddata/files/india_trillion-dollar_digital_opportunity.pdf> accessed 10 November 2023.

[45] Paul Davies and Mark Freedland, *Kahn-Freund's Labour and the Law* (3rd edn Stevens 1983) 18.

Even at present, there persists a fundamental imbalance in the bargaining power of employers and employees. As long as the employers have the authority to hire and fire making the employees vulnerable to sudden terminations, they set the terms and conditions of employment providing the employees with limited negotiation power. There are serious repercussions that prevail due to inequality in power like the lack of freedom for employees in the workplace, a threat to employee rights and protection, income inequality, and systemic race and gender discrimination.[46]

While such an imbalance persists, the consent given by the employees for processing their personal information by the employers cannot be regarded as free. The significant imbalance of power could lead an employee to act under a mental compulsion to comply with the employer's requests for consent. It is beyond doubt that the fear of getting fired from the post and/or other adverse consequences has the potential to undermine the voluntariness of the consent.

This imbalance can very much be demonstrated by two contemporary instances: *First*, the data privacy notice of Microsoft which disbelieves in obtaining the consent of its employees for processing most of their data unless it is legally required.

The privacy policy of Microsoft lays down,

"*The unique nature of the employment relationship means that choice may be more limited or not available for certain kinds of data processing (payroll processing for example). Similarly, where Microsoft*

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[46] Worker Stories, 'Unequal Power' (*Economic Policy Institute*) <https://www.epi.org/unequalpower/home/> accessed 10 November 2023.

has legal or contractual rights or obligations to process or disclose data, we cannot allow for choice in how that data is used."[47]

Furthermore, Microsoft claims to offer its employees the choice as to how the data may be processed but only when '*it'* believes it appropriate. Additionally, owing to the nature of the relationship and the subsequent subordination, the choices given to the employees are very limited and are not available for all kinds of data processing.

Second, in a case decided by the Dutch Data Protection Authority, the decision was delivered in favor of the employee which was based upon an observation that in instances where an employee had initially refused consent, the employee had ended up agreeing to provide their fingerprints after the interview with the director.[48]

While the DPDP Act requires that the consent given by the Data Principals should be free for processing personal data[49], labour laws would play a major role in diminishing the imbalance of power between employers and employees by establishing a framework that ensures fairness and a balanced employment relationship. The Industrial Relations Code, 2020 ("**IR Code**") for instance, provides for penalties to be imposed on employers, workers, and trade unions for committing any unfair labour practices under Section 84.[50] The second schedule of the IR Code provides for all such acts

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[47] Microsoft, 'Microsoft Global Data Privacy Notice for Employees, External Staff, Candidates and Guests' (October 2023) <https://privacy.microsoft.com/en-us/data-privacy-notice> accessed 10 November 2023.
[48] Debbie Heywood, 'Processing Employee Fingerprint Data' (*Taylor Wessing*, 10 July 2020) <https://www.taylorwessing.com/en/global-data-hub/2020/july---hr-data/processing-employee-fingerprint-data> accessed 10 November 2023.
[49] Digital Personal Data Protection Act 2023, s 6.
[50] The Industrial Relations Code 2020, s 84.

that constitute unfair labour practices which include interference with the rights of the workers to engage in collective bargaining by threatening workers with their dismissal or discharge.[51] Therefore, in the absence of any specific provision both in the DPDP Act and the Labour Codes, a harmonious application of both laws shall go a long way in ensuring the protection of employee data until interpretative rules are framed in this regard.

VI. CONCLUSION

Article 88(1) of the GDPR makes specific provisions for the protection of employee data by law and by collective agreements. It provides,

> *"Member States may, by law or by collective agreements, provide for more specific rules to ensure the protection of the rights and freedoms in respect of the processing of employees' personal data in the employment context, in particular for the purposes of the recruitment, the performance of the contract of employment, including discharge of obligations laid down by law or by collective agreements, management, planning and organisation of work, equality and diversity in the workplace, health and safety at work, protection of employer's or customer's property and for the purposes of the exercise and enjoyment, on an individual or collective basis, of rights and benefits related to employment, and for the purpose of the termination of the employment relationship."*[52]

On the contrary, the Labour Codes or the DPDP Act do not provide for any explicit provision in the interest of the employee. Therefore, at *first*, for the purposes of labour jurisprudence, the DPDP Act must be construed as

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[51] The Industrial Relations Code 2020, Second Schedule.
[52] General Data Protection Regulation (EU) 2016/679.

social welfare legislation. According to the rules of interpretation, the beneficent rule of construction of the provisions must be carried out to include employees, wherever possible.[53] At present, the only ray of hope provided by the lawmakers is the framing of broadly worded provisions of the legislation.

Secondly, pursuant to Section 40(1),[54] it is necessary for the Central government to frame rules under this Act to facilitate its proper implementation and provide further clarity on the provisions. Since secondment may also involve the assignment of employees to foreign entities, the rules may include provisions outlining factors based on which a distinction could be made between a data fiduciary and a data processor not only in cases of secondment but also for the cross-border sharing of data.

Thirdly, offline data collected by employers must be brought into the ambit of the statute. The DPDP Act leaves a large chunk of the working population in the lurch for the protection of their personal data. The labour force participation rate in India increased to 42.4% in Dec 2023, compared with 41.3% in the previous year.[55] In the 2011 Census[56], it was revealed that 21.9 million marginal workers consisted of individuals lacking literacy. This

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[53] *Workmen v. Firestone Tyre & Rubber Co of India (P) Ltd* [1973] 1 SCC 813.

[54] Digital Personal Data Protection Act 2023, s 40(1).

[55] CEIC, 'India Labour Force Participation Rate' <https://www.ceicdata.com/en/indicator/india/labour-force-participationrate#:~:text=India%20Labour%20Force%20Participation%20Rate%20increased%20to%2042.4%20%25%20in%20Dec,an%20average%20rate%20of%2054.2%20%25%20> accessed 10 November 2023.

[56] Prashant K. Nanda, 'Most Indian Workers are either illiterate or poorly educated, says Census Data' *Mint* (06 November 2015) <https://www.livemint.com/Politics/NlwY9eAAfRqkKE2vR2AeAP/Most-Indian-workers-are-either-illiterates-or-poorly-educate.html#:~:text=%E2%80%9CCensus%202011%20has%20shown%20that,Census%20Commissioner%20of%20India%20underlined> accessed 10 November 2023.

was trailed closely by 20.9 million individuals accounting for 37.6% who had received education below the secondary level.

Conclusively, the paper outlines several instances where the amount of control the employers exercise over the employees' data is unrestricted and unbridled. However, such regulation cannot be unreasonably intrusive. In a country like India, where employment generation is a serious concern, data protection of employees holds immense significance for buttressing the broader economic landscape. The trust built in employees about the protection of their personal data would eventually encourage their active participation in the Indian economy.

IV. DISSECTING SEBI'S PRIORITY DISTRIBUTION MODEL: UNPACKING THE CONSULTATION PAPER AND IMPLICATIONS OF THE BAN

- Anamika Goel & Hashvi*

ABSTRACT

Alternative Investment Funds (AIFs) are increasingly used investment instruments all over the world. It allows the investors to invest in the assets which they cannot individually invest in. There are various models for distribution of profits and losses in such funds and one such model is the Priority Distribution (PD) Model which has been followed all over the globe. It allows the investors to flexibly invest and accordingly the profits and losses are distributed giving priority to some investors in comparison to others.Securities and Exchange Board of India (SEBI) was apprehensive of this arbitrary distribution of profits among the investors. Therefore, it banned any future investment in Alternative Investment Funds which follow the Priority Distribution Model. Recently, SEBI came up with a consultation paper proposing revisions to the regulatory framework concerning the Priority Distribution Model within the Alternative Investment Funds. The focus lies on ensuring equitable rights for all investors. The present paper seeks to analyse the above-mentioned consultation paper of SEBI and its action of banning the Priority Distribution Model.

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I. ALTERNATIVE INVESTMENT FUNDS: A BUDDING OPTION FOR INVESTORS

Alternative Investment Funds **("AIFs")** are investment instruments wherein multiple investors pool their funds together to invest in a wide range of assets different from traditional assets such as stocks, bonds or cash. It provides an opportunity to invest across assets such as private equity, hedge funds, real estate or infrastructure, etc. in which an individual investor cannot invest alone. These funds are private and offer potentially higher returns and diversification benefits.[1]

AIFs play a crucial role in fostering economic growth. These funds help in pooling the investments for the non-traditional sectors such as Start-ups, Micro, Small, and Medium enterprises as well as other infrastructure projects which in turn boost the industrial growth of the country. Such investments also lead to an increase in job opportunities due to the development of new projects. The creation of such job opportunities leads to better living standards. Such funds also promote investments in research and development.

AIFs also boost market liquidity as the investments are diverted to markets where there is a money crunch. Investments in such sectors also attract other participants increasing the trade activities and reducing price volatility. Moreover, AIFs aim at long-term investments which bring stability in the market. Also, AIFs aim at the growth of disadvantaged sectors by pooling a

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[1] Flnoux, 'What is Alternative Investment Fund', (2023), ICICI Direct <https://www.icicidirect.com/research/equity/finace/what-is-alternative-investment-fund> accessed 25 February 2024.

large amount of funds into the same. Thus, AIFs act as boosters to the overall growth of the economy.

AIFs are controlled by the fund managers or investment firms who decide on behalf of funds. These funds can be open-ended or close-ended with varying conditions for liquidity and investments.

In India,[2] the Securities and Exchange Board of India **("SEBI")** regulates the working of AIFs. The minimum threshold for investing in such AIFs is 1 crore. Therefore, the investors need to carefully assess risks, investment strategies, fees, and other regulatory frameworks before making such investments.

II. INVESTMENTS IN AIFS: UNDERSTANDING PRO-RATA AND PARI-PASSU RIGHTS

Pro-rata indicates that the profit, losses, and expenses incurred by the investor will be proportional to his capital contribution. For example, if you own 5% of a company and it pays $100,000 as a dividend, you would receive $5,000 as profit. It signifies that investors attain an impartial share of returns and have to pay a fair portion of the expenses based on their contributed investments. The phrase "Pari-passu"[3] signifies the principle of equitable asset and obligation management, paired with the absence of preferential treatment. Pari-passu distribution is only possible when there is pro-rata allocation of

[2] 'Alternative Investment Funds', BSE, <https://www.bseindia.com/Static/about/alternative_investment_funds.aspx> accessed 20 February 2024.

[3] Robert A. Cohen, 'Sometimes a Cigar is Just a Cigar: The Simple Story of Pari Passu' (2011) 40 (1) HLR <https://scholarlycommons.law.hofstra.edu/hlr/vol40/iss1/3/> accessed 19 February 2024.

benefits because in such distribution each party receives its proportional contribution of investment.

Priority distribution may encompass the capacity to attract additional investors with an expanded asset and investment base. The below two figures signify that despite this fact the inequitable allocation can harm the investors. The benefits of disproportionate division are difficult to sustain for longer.

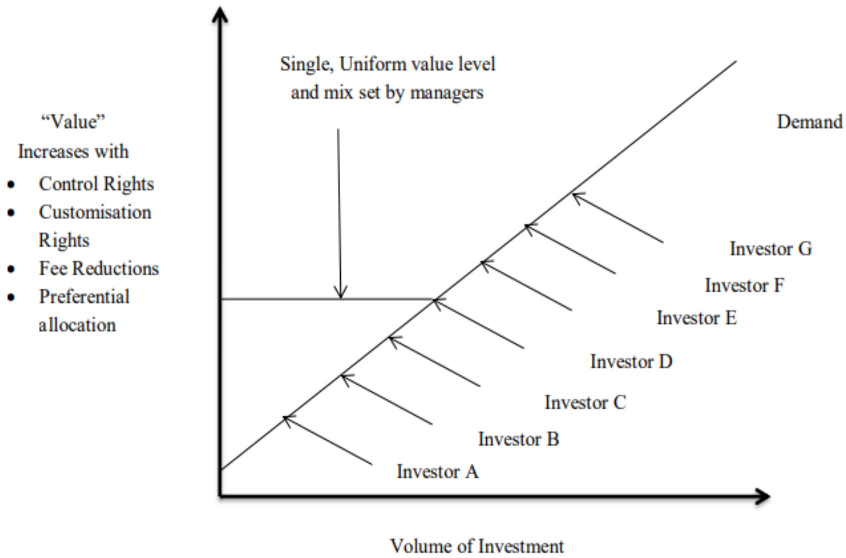

FIGURE 1[4]

In Figure 1, the y-axis demonstrates the "value" of the AIFs with a manager and the x-axis represents the "total investment". In the below divisions, the demand for investment increases with the increase in the "value" of the investment. Investors who are interested to invest at low "value" will

[4] William Clayton, 'Preferential Treatment and the Rise of Individualized Investing in Private Equity', (2017), SSRN <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2746725> accessed 19 February 2024.

get lower customisation rights, control rights and fund allocation and vice versa. In this approach, the preferential treatment of investors is not plausible.

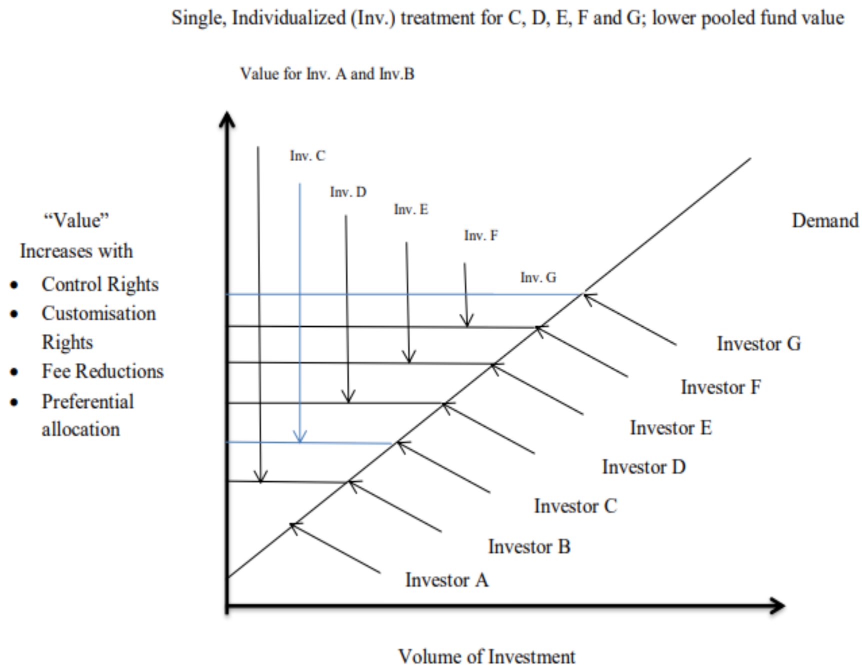

FIGURE 2[5]

Figure 2, represents the situation when there is differential treatment of investors. Rather than keeping all the investors in a "pooled fund" with Investors A and B, Investors C and D are offered dissimilar terms. When the manager makes such arrangements, Investors A and B no longer receive equal terms like Investor D. The value provided to the smaller "pooled fund" with Investors A and B is brought down to the minimum needed for attracting Investor B. Investor C also receives terms of lower value compared to the

[5] ibid.

original pooled fund. Only Investor D retains the same terms as in the original pooled funds.

There has been a continuous conflict between investors due to the preferential treatment of some investors over others. The utilization of the Priority Distribution **("PD")** Model is one such arrangement that follows differential treatment of investors making it a major cause of concern until recent times.

III. THE IMPERATIVE OF PRIORITY DISTRIBUTION MODEL IN AIFS

A. Operational Mechanism of PD Model

In the context of AIFs, the PD Model refers to the structure in which the funds, profits and gains are distributed among its shareholders and investors. AIFs usually have various classes of investors who have varied priorities when it comes to the returns on their investments. The PD Model helps in assuring the fair distribution of profits.

The Priority Distribution generally follows the below-mentioned sequence which may change according to the conditions agreed by the investors while investing in the fund or according to the prospectus of the fund:[6]

1. Before the distribution of any profits to the investors, the expenses incurred in the operation and management of the funds are deducted.

[6] 'Alternative Investment Funds in India', (2021), AmLegals, <https://amlegals.com/wp-content/uploads/2021/04/Alternative-Investment-Funds.pdf> accessed 18 February 2024.

Such expenses include operating expenses, management fees, administrative costs, and other expenses which have been incurred by the fund.

2. After the deduction of the operational expenses, the most favorable returns are given to the preferred investors. These favored percentages of returns are the minimum returns on the investment to be given to the preferred investors before the distribution of any profits among the other investors.

3. After the allocation of the preferred return after deducting the operational expenses, the capital allocations are done to the investors on a pro-rata basis depending upon the share of investments in the funds.

4. After all the above allocations are made; the remaining profits or gains are distributed among the investors depending upon the particular arrangements agreed by the investors of the funds.

The Fund Manager or the General Manager of the fund has the responsibility to assure the allocation of funds according to the governing documents of the fund. In the PD Model of AIFs, the senior class/tranche is given priority in comparison to the junior class/tranche.[7]

The profits and losses of the funds are shared according to the above preferential model. The shares of losses and profits are proportional to their investments. Junior-class investors will get less profit and will be provided

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[7] Clayton (n 4) 249.

with less security. On the other hand, the senior class investors will have more share in investors and more security for their funds. Thus in case of losses, the senior class investors will have to contribute less as the losses will be firstly covered using the funds of junior class investors.[8]

B. Positive Aspects

The PD Model is preferential but it serves several purposes and is beneficial in different ways. The model aims at synchronizing and aligning the interests of different investors and ensuring the interest of funds. For example, the fund manager is given interest after the fund's profitable performance to ensure proper management of the trust. The fund manager is rewarded depending on his skills, performance, capacity to overcome hurdles and various other benchmarks. Each trust varies according to the investors' needs and risk-taking capacity.[9]

The PD Model of AIFs leads to long-term investments as the returns and losses are based upon long intervals of time period. The conditions of AIFs are customized according to the particular investors and their preferences. The model helps the preferred investors preserve their capital by giving them a priority. Risk is shared among the various stakeholders depending upon their class and shares. Moreover, the investors who are not preferred, that is the junior class investors/tranche are already made aware about the risks.

[8] Donald R. Chambers, Keith Black, CFA and Nelson J. Lacey, 'Alternative Investments: A Primer for Investment Professionals', (2018), CFA Institute Research Foundation < https://www.cfapubs.org/doi/pdf/10.2469/ccb.v2014.n1.1.> accessed 17 February 2024.
[9]'Three Pillars of our approach to collective investment trusts', T. Rowe Price,<https://www.troweprice.com/content/dam/iinvestor/planning-and research/Insights/white-papers/benefits- alternative-investments.pdf> accessed 17 February 2024.

C. Areas For Improvement

SEBI recently was of the view that certain classes of investors have to suffer more losses as compared to another set of investors as some investors are allowed to exit from funds before others.[10] This sharing of losses is not according to the share of funds of the investors. According to SEBI, such distribution is unfair to some investors. The other concerns disclosed by SEBI include the abuse of such funds by Non-Banking Financial Companies **("NBFCs")** to restructure their stressed assets. If the stressed assets are not paid attention, they turn into Non-Performing Assets **("NPAs")**. NBFCs would definitely not want these stressed assets to be reflected in their balance sheets due to which they might invest such assets in AIFs. If SEBI bans the waterfall mechanism (order for distribution of profits according to sequential layers of investors) with priority distribution, then it would make it difficult for investors to find investments for these stressed assets with little or no credit enhancement through subordination.[11]

Another issue concerning the PD Model of AIF is its complexity. Investors who do not have a strong finance background have difficulty understanding such models despite the disclosures made by AIFs in their prospectus. The unequal distribution of profits also leads to conflicts among the shareholders. Such models also lack transparency in their functioning. The PD Model prioritizes the return of capital before profit distribution and generation of income. Due to the same, there are longer lock-up periods and a

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[10] Payaswini Upadhyay, 'Priority Distribution By AIFs: What's SEBI's Problem?', (2022), NDTV Profit, <https://www.bqprime.com/law-and-policy/priority-distribution-by-aifs-whats-sebis-problem> accessed 17 February 2024.
[11] ibid.

lack of liquidity for investors in such funds. Moreover, in such models, the returns are based entirely upon the performance of funds, so the risks involved are very high.

IV. SEBI'S REGULATORY PROPOSAL AND ITS COMPREHENSIVE EVALUATION

SEBI, vide its notification[12] has imposed a temporary ban on the inflow of any new funds in AIFs which follow the PD Model in the distribution of profits and losses among its investors. Following the above notification, SEBI in May 2023[13] has come up with a consultation paper suggesting the changes and regulations around the working of AIFs and its PD Model. Some of the suggestions include the equal distribution of profits among the investors, strict disclosure requirements, etc. Even if the use of such a model is necessary, the higher and the minimum threshold values for sharing of profits and losses should be set in advance and the same should be disclosed to the investors before investing. The creation of separate funds for separate class of investors is also proposed.

SEBI in his recent paper completely banned the future of Alternative Investment funds which are based upon proportional rights to the investors based on junior class and senior class divisions. It advocated equal rights to all

[12] 'Circular: Schemes of AIFs which have adopted priority in distribution among investors' (2022), SEBI, <https://www.sebi.gov.in/legal/circulars/nov-2022/circular-schemes-of-aifs-which-have-adopted-priority-in-distribution-among-investors_65393.html> accessed 16 February 2024.

[13] 'Consultation Paper on Proposal with Respect to Pro-Rata and Pari-Passu Rights of Investors of Alternative Investment Funds (AIFs)' (2023), SEBI, <https://www.sebi.gov.in/reports-and-statistics/reports/may-2023/consultation-paper-on-proposal-with-respect-to-pro-rata-and-pari-passu-rights-of-investors-of-alternative-investment-funds-aifs-71540.html> accessed 16 February 2024.

the investors. SEBI is correct in its approach when it comes to regulating the Priority Distribution of AIFs as it was disadvantageous to the junior class investors and was disproportional and had functionality issues. But completely banning the future investments in such AIFs would not be a feasible step as it would lead to lower investments in infrastructure and larger social projects in the near future. Also, giving equal rights to all kinds of investors will discourage the larger investors to invest more due to lack of profit incentives.

First of all, AIFs are different from Mutual Funds considering the investor classes and the private nature of the AIFs.[14] AIFs often cater to a different investor class compared to Mutual Funds. They target high-net-worth individuals, institutional investors, or qualified investors. Additionally, AIFs are typically structured as private funds, offering a more exclusive investment opportunity compared to Mutual Funds, which are open to retail investors. So, regulating them in such a manner that AIF distribution mechanisms are similar to Mutual Funds is arbitrary. The maintenance of strict equality among the different classes of investors is neither always fair nor desirable in the present situation. Unequal treatment should be allowed when it leads to growth along with the satisfaction of the individual interests of shareholders.

Moreover, AIFs are an instrument of investment for more sophisticated and high-end investors. With a minimum limit of 1 crore of Investment, it can be assumed that investors will be aware of the risks before making the investments. Taking away the flexibility in the functioning of such funds in order to reduce the risks involved might lead to a lack of interest in such

[14] 'Differential Economic Rights of AIF LPS under Threat', (2023), Nishith Desai and Associates, <https://www.nishithdesai.com/SectionCategory/33/Research-andArticles/12/29/NDA Hotline/10616/1.html> accessed 12 February 2024.

investments among the investors. Separate investment funds may also lead to a lack of investments in each fund since junior-class investors who want to invest alongside senior class investors in big funds may be unable to do so.

To deal with the concerns regarding the abuse of regulatory framework by NBFCs, SEBI may prescribe mandatory disclosure of the end-usage of the fund's commitments in its placement memorandum. It should also promote transparency in the functioning of AIFs and facilitate innovation which will benefit all classes of shareholders. Such reforms will be progressive rather than completely banning the investments in AIFs.

V. SUGGESTIVE LEGAL FRAMEWORK

A. Proposal For an Alternative Model

The Priority Distribution Model or any other alternative mechanism of distribution such as Pro-rata Rights and Pari-passu Rights have their advantages and disadvantages associated with them. Going with any one of them will have its problems as have been described above. In case, the PD Model is followed, SEBI’s concern about the arbitrary distribution of profits is a valid one. The issue of abuse by NBFCs is also to be considered. But completely banning the model is not a solution. Going for equal rights for all the investors without considering the other factors is also not a healthy alternative as it will demotivate some investors who want to take more risks and invest in such AIFs.

Instead, we can go for an Alternative Model of Investment based upon individual choice and share of investments. For example, an investor's choice of contribution in losses will determine his share in profits in proportionality to his investment amount. In such a model, the percentage of profits and losses shared by an individual will be decided considering the three factors that are his contribution to the fund, the minimum length of investment, and the maximum amount of contribution in losses. Here, the investors will be given priority based on the share of investments, the length of their investments and the risks they are ready to take.

The investors who are ready to take more risks and contribute more at the time of losses will be given more profits and prioritised at the time of distribution of profits. In this model, the share of profits and losses will be equal, unlike the PD Model where the investors who are given priority at the time of profit distribution are the last ones to contribute to the losses. This will help in solving the SEBI's concern of arbitrary distribution. Also, the investors will have flexibility when it comes to their investments. This mechanism will ensure the fair disposal of profits and losses of AIFs and prevent any arbitrariness in disposal mechanisms.

B. Mandatory Disclosures in AIFs

SEBI has, vide its Circular[15] dated 5th February 2020, introduced a standard Private Placement Memorandum **("PPM")** in which disclosure of certain minimum level of information has been specified. The scope of information to be provided in the PPM investment charter (a document that provides information about the services offered to investors, grievance procedures, duties of investors etc.) should be broadened. Even the minute

[15] 'Disclosure Standards for Alternative Investment Funds (AIFs)', (2020), SEBI, <https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-45919.html> accessed 13 February 2024.

information regarding the terms and conditions of preferential treatment should be specified to the investors.

Disclosures regarding customised benefits and profit sharing of the investments should be explicitly mentioned in the contractual terms. This provides the investors with the opportunity to negotiate for any conflict of interest[16]. If investors are not satisfied with the conditions of the agreement, they can refuse to continue with their investment.[17] In this situation, rather than switching investors, the managers should look at the points where conflict arises. After this, they should try to modify the contract to grant desirable protection to non-preferred investors.[18]

If the requirement of complete disclosure is voluntary, spill-over impacts arise due to the interrelated nature of the fund market.[19] This is because the voluntary disclosure model can provide a competitive disadvantage to the firm that voluntarily chooses to disclose the information. Since all other firms in the market have the option not to pay for the cost of the disclosure, firms that provide investors with accurate declarations are in a weaker position.[20] Thus, mandatory disclosure by the firms is imperative.

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[16] Andrew Ceresney, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (2016) <https://www.sec.gov/news/speech/private-equity-enforcement.html> accessed 13 February 2024.
[17] *H.T. Hackney Co. v. Robert E. Lee Hotel*, 300 S.W. 1, 3 (Tenn. 1927).
[18] *Scott v. Davis*, [2000] 204 C.L.R. 333, 367 (Austi.) (citing *Int'l Harvester Co. of Australia Pty Ltd. v Carrigan's Hazeldene Pastoral Co.* [1958] 100 C.L.R. 644,652).
[19] 'Preqin, Key Due Diligence Considerations For Private Equity Investors', (2014), <https://www.preqin.com/docs/reports/Preqin-Special-Report-Due-Diligence-Private-Equity-Investors> accessed 13 February 2024.
[20] *Von Colson and Kamann v. Land Nordrhein-Westfalen,* Case 14/83, 1984 E.C.R. 1891.

C. Mitigating Regulatory Misuse: Enhancing Transparency and Investor Protection

Now, the problem that arises with the disclosures is that 'pooled fund' investors find it difficult to determine whether the manager is fully revealing all pertinent data regarding the interests of all the investors. Even after contractual negotiations, the stakeholders do not find themselves in a strong position to confirm the manager's compliance with contractual obligations.

For example, various AIFs offers "excuse rights" to certain investors granting them the right to abstain from participating in specific investments of pooled funds. There is a lack of transparency restricting the non-preferred investor's ability to understand the utility of their investments.

The Mandatory Disclosure Model prohibits unaccountable terms unless written notice regarding the information is provided[21]. The manager has the option to fulfill the suggested disclosure obligations by sharing side letters (with sensitive details about other investors removed) exit.[22] The specific sequence of the time when the specified conditions for the delivery of the proposed rule will apply varies, based on whether the recipient is a potential or current investor in the AIFs. Regarding potential investors, the AIFs managers must supply a written notice before the investor makes any investment. As for current investors, if any differential treatment has been extended to any investor, the manager should be obligated to notify the same.

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[21] Michael J. Fishman & Kathleen M. Hagerty, 'Mandatory Versus Voluntary Disclosure in Markets with Informed and Uninformed Customers', (2003) 19 J.L. ECON. & ORG. 45.

[22] Hossein Nabilou, 'A Tale of Regulatory Divergence: Contrasting Transatlantic Policy Responses to the Alleged Role of Alternative Investment Funds in Financial Instability', (2017) 12 CAP. MKT. L. J. 94.

To fulfill the distribution requirement for existing investors, the AIFs must send a scripted notice to every investor. In case where an investor is in a 'pooled vehicle' of investment which is under the control of the manager, the manager must examine the contents of that pool to ensure that the notice reaches the investors within those pools. We think that this particular element of the disclosure rule would necessitate managers to regularly review and re-evaluate the selective terms offered to investors within the similar fund. As a result, investors would derive advantages by getting regular updates regarding the discriminatory terms extended to different investors within the similar fund.

Notices would equip the investors with the knowledge related to the status of similarly situated investors. Investors become aware of the better deals that other investors are procuring.[23] For example, the investor will receive the information when a manager provides a fee discount to a large, early-stage investor. After receiving this input the investor can also demand further information on additional privileges that large investors receive. The mechanism of enhanced transparency would provide investors with greater insights concerning the extent of exclusive treatment, the potential impact of such terms on the investment, and the probable expenses, consisting of compliance costs linked to these discriminatory terms.[24]

Another problem that will result in regulatory misuse is that compliance with the disclosure principles requires additional expenses for the

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[23] George A. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism', (1970) 84 Q.J. ECON. 488.

[24] Lodewijk Van Setten & Danny Busch, 'Alternative Investment Funds in Europe: Law and Practice', (2014) 154.

lawyers, accountants and compliance consultants.[25] There is a high possibility that the managers directly or indirectly pass on the expenses to their investors. The non-preferred investors will likely be more prone to the increased cost. This is because the preferred investors have greater leverage to negotiate for reduced fees and expenses.[26] To address regulatory arbitrage, incentives related to regulations should be carefully considered[27]. If a regulation imposes costs on an industry, it should provide corresponding benefits to offset those costs.[28]

One recent illustration of such compensatory advantages is the European Union's Alternative Investment Fund Managers Directive **("AIFMD").**[29] The directive announces a passport mechanism for hedge funds, granting the investors the ability to market their products throughout the EU, once they are registered with an EU Member State. However, it is imperative to consider that these benefits need to be weighed against the regulatory expenses imposed on AIFs due to stringent regulations. It appears

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[25] Alexander K, Eatwell J and Dhumale R, 'The International Regulation of Systemic Risk', Review of Global Governance of Financial Systems (*Cooper RN* 2016) <https://doi.org/10.2307/20031858> accessed on 10 February, 2024.

[26] Douglas W. Arner and Michael W. Taylor, 'The Financial Stability Board and the Future of International Financial Regulation' (Cambridge University Press, 5 February 2016) <https://www.cambridge.org/core/books/abs/reconceptualising-global-finance-and-its-regulation/financial-stability-board-and-the-future-of-international-financial-regulation/C28EB52D54F47E0AE2A95149F9A25FB8> accessed 10 February 2023.

[27] Joel F. Houston, 'Chen Lin & Yue Ma, Regulatory Arbitrage and International Bank Flows', (2012), 67 J. FIN. 1845, 1846.

[28] George Loewenstein & Richard H. Thaler, 'Anomalies: Intertemporal Choice', (1989), 3 J. ECON. PERSP. 181, 181.

[29] Hossein Nabilou, 'Regulatory Arbitrage and Hedge Fund Regulation: The Need for a Transnational Response', (2017) 22 (4) FORDHAM J. CORP. & FIN. L. https://ir.lawnet.fordham.edu/jcfl/vol22/iss4/2/ accessed 17 February 2024.

that discouraging regulatory arbitrage can only be achieved by offering competitive advantages to firms following the robust pre-disclosure model.[30]

To abridge, in order to mitigate the losses caused by preferential treatment, AIFs should encourage the disclosure of conflicts of interests[31]. The managers should consistently adhere to their contractual obligations, and provide transparent disclosure of performance, fees, and expenses. It is crucial to thoroughly examine and assess the actual worth of the regulator's contribution, taking into account the expenses associated with any initiative, and also considering the existence of alternative investment fund options. Policymakers must aim to enhance the disclosure requirement at a minimal cost, because the burden of costs associated with policies aimed at assisting non-preferred investors largely falls on them, and the excessive expenses can potentially create a negative impact on competition.

VI. CONCLUSION

AIFs boost the overall development of the economy as well as the private growth of the investing individuals. The country needs such funds for the expansion of its investment markets and a single individual cannot pool in such a huge investment. The distribution of profits and losses among the investors of AIFs has always been an area of conflict. Usually, the PD Model is followed which provides preferential treatment. SEBI considering such

[30] Mariia Domina Repiquet, 'Regulatory Competition in European Partnership Law: A Case of Alternative Investment Funds', (2018) 10 (1) Amsterdam L.F <https://amsterdamlawforum.org/articles/10.37974/ALF.313> accessed 15 February 2024.

[31] J. S. Aikman, 'When Prime Brokers Fail: The Unheeded Risk To Hedge Funds, Banks, And The Financial Industry', (2010).

treatment to be unfair to some investors has completely banned any future investment in AIFs through such model.

The model of priority distribution is inherently not a bad element. It has the potential to offer a wide range of benefits to investors, managers and AIFs as a whole. The contemporary need of the AIFs market is not to restrict the PD Model but to limit the harms caused by its misuse. Analyzing all the distribution mechanisms the authors believe that there is no need to explicitly ban the model of preferential treatment. Thus, they proposed an Alternative Model based upon mandatory disclosure requirements as well as proportional distribution of profits and losses taking into consideration the contribution to the fund, the minimum length of investment, and the maximum amount of contribution in losses.

Imposing an absolute ban on the investments in AIFs based on PD Model would exert a dampening effect on the overall investments while reducing the growth of the economy. Instead, going with the proposed model as an alternative to the existing framework would lead to the fair distribution of profits and losses along with the individual satisfaction of the investors. This would mark the beginning of a new era for future investments in AIFs, bringing about positive changes in the investment landscape.

V. KILLER ACQUISITIONS: MYTH OR REALITY? COMPARATIVELY ANALYZING THE UNCERTAINTIES OF COMPETITION IN THE DIGITAL AGE

- Praneel Panchagavi & Avani Hegde*

ABSTRACT

This paper delves into the intricate world of acquisitions involving nascent or potential competitors, highlighting the challenges faced by policymakers, regulators, and legal professionals in navigating this evolving landscape. While acknowledging concerns about dominant technology companies stifling competition through such acquisitions, the paper emphasizes the limited empirical evidence supporting the widespread occurrence of "killer acquisitions." Key considerations explored include the inherent difficulty of predicting future market trajectories, the potential for mergers to yield both pro-competitive and anti-competitive effects, and the crucial need for a balanced approach that fosters competition while nurturing innovation. The paper critiques proposals advocating for an absolute presumption of illegality for acquisitions by dominant platforms due to insufficient evidence justifying such a drastic policy shift. Ultimately, the paper emphasizes the importance of a case-by-case approach that takes into account the specific circumstances of each acquisition, while advocating for further research and dialogue to develop a more comprehensive understanding of these complex issues.

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I. INTRODUCTION

The assessment of competitive ramifications arising from acquisitions stands as a pivotal facet of antitrust enforcement, distinguished by a level of progression and formalization seldom paralleled in other antitrust endeavours.[1] Nonetheless, recent times have borne witness to a marked surge in focus directed toward a specific category of acquisitions—namely, the procurement of potential challengers and emerging competitive intrusions.[2] Within this closely interwoven context, apprehensions have emerged concerning the possibility that the acquiring entity, subsequent to the acquisition, could terminate the competitive or potentially competitive entity, a phenomenon colloquially termed as "killer acquisition." It's worth noting that the term "killer acquisition" also pertains to the broader concept of stifling potential competition, irrespective of whether the assimilated entity is discontinued.[3]

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[1] 'Horizontal Merger Guidelines' (*U.S. Department of Justice*, 19 August 2010), <https://www.justice.gov/atr/horizontal-merger-guidelines-08192010> accessed 1 August 2023.
[2] Stephen Smith & Matthew Hunt, 'Killer Acquisitions and PayPal/iZettle' (2019) 18 (4)Elgar online < https://www.elgaronline.com/view/journals/clj/18-4/clj.2019.04.04.xml> accessed 1 August 2023.
[3] Claire Turgot, 'Killer Acquisitions in Digital Markets: Evaluating the Effectiveness of the EU Merger Control Regime' (2021) 5 (2) Eur Competition & Reg L Rev <https://core.lexxion.eu/article/CORE/2021/2/6> accessed 2 August 2023.

These concerns have spurred inquiries into the prospect of anticompetitive acquisitions transpiring beyond the ambit of conventional merger analyses—specifically, within realms where an emerging entity has conceived or is on the cusp of conceiving an innovative and competitive product, poised to challenge the dominance of established entities. However, inherent uncertainty accompanying this theory of harm must also be acknowledged, potentially leading to elevated overall error costs. Notably, an array of policy recommendations has recently emerged, aimed at addressing the notion that dominant industry players are engaging in acquisitions of emerging and potential rivals. These recommendations span from formulating new evidentiary standards under Section 7[4] of the Clayton Act to pre-emptive regulatory restrictions against designated acquisition categories.[5]

In this discourse, we embark on an exploration of several critical queries. Does the acquisition conduct of significant technology giants or platforms in relation to emerging contenders warrant scrutiny, focusing on the stifling of competition before these budding challengers attain robust maturity? Furthermore, if such a predicament indeed exists, do prevailing antitrust statutes, coupled with their enforcement mechanisms, provide a comprehensive toolkit to effectively counter this issue? Should that not be the case, could a legislative remedy be sought?

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[4] Clayton Act 1914, s 7.

[5] Vaclav Smejkal, 'Concentrations in Digital Sector - A New EU Antitrust Standard for "Killer Acquisitions" Needed?' (*Semantic Scholar*, 2020) <https://www.semanticscholar.org/paper/CONCENTRATIONS-IN-DIGITAL-SECTOR-A-NEW-EU-ANTITRUST-%C5%A0mejkal/78abebb5ac5c9167d6888065473a44e7152b3d52> accessed 2 August 2023.

Within the context of India's legal terrain, similar concerns have garnered attention, particularly considering the burgeoning technology sector and its intersection with competition law. The Competition Act of 2002 serves as India's principal legislation addressing antitrust concerns. Sections 5[6] and 6[7] of the Act pertain to combinations (acquisitions and mergers), with the Competition Commission of India (CCI) vested with the authority to scrutinize these transactions for potential anticompetitive consequences.

CCI has dealt with instances where concerns about potential competition and stifling of rivals have been addressed. For instance, the Walmart-Flipkart deal[8] underwent CCI scrutiny due to fears of adverse effects on competition in the online retail sphere. The CCI assessed factors such as market dominance, potential competition, and impact on consumers before granting approval. Similarly, Facebook's acquisition of WhatsApp raised issues regarding data sharing and its implications for the instant messaging app market.[9] The CCI evaluated the potential for Facebook to leverage its social media dominance for unfair competitive advantage in the messaging sector.[10]

As the legal landscape evolves, vigilance and adaptability on the part of regulators, policymakers, and legal practitioners remain paramount to

[6] Competition Act, 2002 s 5.
[7] Competition Act, 2002 s 6.
[8] Richard Whish, 'Killer Acquisitions and Competition Law: Is There a Gap and How Should It Be Filled?' (2022) 34 (1). NLSIR < https://repository.nls.ac.in/nlsir/vol34/iss1/1/> accessed 2 September 2023.
[9] Bjorn Lundqvist, 'Killer Acquisitions and Other Forms of Anticompetitive Collaborations (Part I): A Case Study on the Pharmaceutical Industry' (2021) 5 (3) Eur Competition & Reg L Rev < https://core.lexxion.eu/article/CORE/2021/3/4> accessed 2 September 2023.
[10] ibid.

navigating the evolving dynamics at the confluence of competition and technology.

II. CLASSIFICATION AND CORRELATION WITH INDIA IN ANTITRUST JURISPRUDENCE

In the domain of antitrust jurisprudence, the distinction between "nascent" and "potential competitors" holds primacy. The term "potential competitor," gained prominence in the mid-20th century as scholars and policymakers sought to understand how market structures and dynamics impact competition and consumer welfare.[11] The term "potential competitor," steeped in historical context, delineates an entity promising to compete in the future or possessing the capacity to enter should prevailing market conditions transform, such as a price surge independent of cost considerations.

This concept branches into several allied yet subtly differing scenarios. Firstly, the acquiring entity might be an existing market player while the acquired one bears the potential of becoming a future market contender. Alternatively, the acquiring party could be an emerging market contender while the acquired company holds the standing of an established market participant. It's crucial to differentiate between "perceived potential competition," where acquiring a non-producing rival reduces ongoing competition but potential entry influences market dynamics, and "actual

[11] Rydell, J., and J. R. Speakman. "Evolution Of Nocturnality In Bats: Potential Competitors And Predators During Their Early History." (1995) 54 (2) Biol.J. Linn. Soc. <https://academic.oup.com/biolinnean/issue/54/2> accessed 4 September 2023.

potential competition," which pertains to an entity poised to influence competition from future entrants.[12]

Conversely, the term "nascent competitor," a relatively newer addition to antitrust discourse, emerged mainly in the late 1990s, notably during the Department of Justice's landmark Microsoft case.[13] This label applies to a supplier with an active product or technology, intrinsic or extrinsic to a relevant product market, which could potentially become a strong competitor over time.

From a broader perspective, the concept of potential competition signifies a product yet to establish itself in a specific market but expected to do so imminently. On the other hand, nascent competition centres on the realm of latent rivalry catalysed by an innovative product or technology that exists but hasn't matured as a significant contender, regardless of its presence within or outside the pertinent market. It forecasts future differentiation and the developmental path of a product or technology, alongside its potential market success.

A related concept worth noting is the "killer acquisition," where a company acquires another to suppress promising imminent competition, often

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[12] Amy C. Madl, 'Killing Innovation?: Antitrust Implications of Killer Acquisitions' (*Yale Law School Journals,* 2020) < https://openyls.law.yale.edu/handle/20.500.13051/5442> accessed 17 September 2023.

[13] Peter Alexiadis & Zuzanna Bobowiec, 'EU Merger Review of "Killer Acquisitions" in Digital Markets - Threshold Issues Governing Jurisdictional and Substantive Standards of Review' (2020) 16 (2) NLSIR L< https://repository.nls.ac.in/cgi/viewcontent.cgi?article=1030&context=ijlt> accessed 17 September 2023.

without an efficiency rationale. In India, these classifications significantly correlate with antitrust principles.[14]

In India's diverse and growing market landscape, the interplay between nascent and potential competitors gains prominence. The Supreme Court's stance in *Excel Crop Care Ltd. v. Competition Commission of India*[15] highlights preventing anticompetitive practices that hinder nascent or potential competitors from entering the market.[16] Reducing the competition doctrine involves relaxing the strict scrutiny applied to mergers, which is currently mandated by the substantial lessening of competition doctrine. This would mean easing the scrutiny of mergers and acquisitions, potentially allowing more consolidation within industries. However, such a move would likely conflict with the goals outlined in the Competition Act, which aims to safeguard consumers and ensure fair competition. By relaxing the competition doctrine, there's a risk of diminishing consumer welfare and market competitiveness, as it could lead to increased market concentration and reduced choices for consumers.

III. DOES A SYSTEMIC ISSUE EXIST REGARDING MAJOR TECHNOLOGY COMPANIES ACQUIRING POTENTIAL AND EMERGING COMPETITORS, THEREBY STIFLING

[14] Kelly Fayne & Kate Foreman, 'To Catch a Killer: Could Enhanced Premerger Screening for Killer Acquisitions Hurt Competition' (2020) 34 (2) Antitrust <https://www.lw.com/admin/upload/SiteAttachments/Sprng20-Fayne%c3%82.pdf> accessed 18 September 2023.

[15] *Excel Crop Care Ltd. v. Competition Commission of India*, 8 SCC 47 (2017).

[16] D. Daniel Sokol, 'Merger Law for Biotech and Killer Acquisitions' (SSRN, 31 August, 2020)<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3658337> accessed 18 September 2023.

COMPETITION BEFORE THEY HAVE THE CHANCE TO BECOME FORMIDABLE RIVALS?

To elucidate this quandary, it is imperative to delve into the realm of conjecture. What if colossal technology conglomerates refrained from assimilating diminutive enterprises like YouTube or Instagram? How might the landscapes of the respective markets have unfolded? Furthermore, would consumers have been bestowed with enhanced prospects? Google acquired YouTube in 2006 for $1.65 billion, solidifying its position as a dominant player in online video sharing.17 YouTube's user-generated content platform has since become a cornerstone of internet culture, with billions of users worldwide. In 2012, Facebook acquired Instagram for approximately $1 billion, strategically expanding its social media empire and tapping into the growing popularity of photo-sharing apps. Instagram's user-friendly interface and emphasis on visual content quickly propelled it to become one of the most influential social media platforms globally.[18]

An inherent measure of ambiguity will invariably persist, given that the hypothetical scenario—the permitting or thwarting of a merger—can never be tangibly observed. This reality engenders an arduous path for predictive assessments, and, to a certain extent, it might provide leeway for unsubstantiated assertions that deviate from the contours of plausible outcomes.[19] However, of paramount significance is not the appraisal of whether the antitrust agencies accurately adjudicated specific mergers, but

[17] Luo, Jiewen "Analysis of the Benefits and Risks of M&A--Taking Google's Acquisition of YouTube as an Example."(Darcy and Roy Press, 2024) <https://drpress.org/ojs/index.php/HBEM/article/view/16625> accessed 18 September 2023.
[18] ibid.
[19] *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 575 (1967).

rather the inquiry into whether these agencies are systematically predisposed to green-lighting anticompetitive mergers (entailing a Type II error or a false negative) or obstructing procompetitive mergers (entailing a Type I error or a false positive).[20]

The recognition that antitrust enforcement engenders error costs is, in essence, an acknowledgment of the limitations concomitant with an agency and court's capability to evaluate and balance certain market practices. Even for meticulously scrutinized commercial stratagems, such as resale price maintenance (RPM) and exclusivity, disputes persist amongst practitioners and economists regarding their comparative merits.[21] The legality of these practices hinges ultimately upon the specifics of individual cases, as both are subjected to scrutiny under a rule of reason analysis—a process necessitating the juxtaposition of evidence pertaining to anti-competitive detriment with evidence substantiating procompetitive advantages.[22]

Although the task of identifying and establishing causation may entail a certain degree of finesse, the solution lies within reach. However, this does not hold true for the realm of emerging and potential competition. The very crux of the harm theory revolving around the loss of an emerging or potential competitor rests upon the premise that conventional metrics of competition remain inchoate and fail to predict the level of competition which will be manifested in the future.

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[20]Madl. (n 12).
[21]Fayne and Foreman (n 14).
[22] Mikah Roberts, 'Killer Acquisitions and the Death of Competition in the Digital Economy' (2022) 24 (1) Transactions: Tenn J Bus L. < https://ir.law.utk.edu/transactions/vol24/iss1/3/> accessed 25 September 2023.

This demarcation is also what sets the harm theory apart from "standard" horizontal mergers that involve extant rivals; if the merger is intrinsically anticompetitive, evidence of the harvest yielded from their erstwhile rivalry should be discernible, now squandered by the anticipated assimilation. Herein, however, lies the absence of such evidence in markets featuring emerging and potential competitors—where the harm constitutes an intangible, presumed forfeiture of future competition. What are the means available to agencies and courts to evaluate this harm theory? Is there a beacon of guidance that can be extended or, perhaps, a paradigm shift in policy that is imperative? In the context of these ponderings, a slew of propositions has recently surfaced to grapple with this inherent ambiguity.

Furthermore, it is important to draw parallels with the Indian legal landscape when contemplating these propositions. Notable legislations such as the Competition Act, 2002, and prominent case laws such as the Tata Motors case[23] might offer intriguing perspectives.[24] In the aforementioned case, several factors can be gleaned to assess the acquisition of potential or nascent competitors. Firstly, the court's examination of market dominance and competitive behaviour provides insights into how an acquisition might impact market competition. Secondly, considerations of consumer welfare and market competitiveness, as emphasized in the court's rulings, offer guidance on evaluating the effects of an acquisition on consumer choice and market dynamics. Additionally, the court's scrutiny of anti-competitive practices and the need to uphold fair competition underscores the importance of assessing whether an acquisition could stifle innovation or hinder new market entrants.

[23] *Neha Gupta v. Tata Motors Ltd. And Others,* Case No. 21of 2019.
[24] Lawrence B. Landman, 'Competition to Innovate and Future Potential Competition' (2023) 103 J Pat & Trademark Off Soc'y 177.

The principles of market dominance and abuse of dominance, as enshrined within the Indian legal framework, could be juxtaposed with the problems of technology giants and their potential exploitation of nascent competitors.

To illustrate the intricacies of forecasting market trajectories for potential competitive scenarios, a notable historical instance which dates back to 1967 can be referred to, when the Federal Trade Commission (FTC) championed the divestment of the Clorox Company by Procter & Gamble (P&G). This manoeuvre followed P&G's acquisition of Clorox in 1957,[25] which was ostensibly predicated, in part, on the supposition that the amalgamation would considerably stifle nascent competition by virtue of Procter & Gamble's prospective ingress into the sector. Reflective of regulatory prudence, this matter underscores the preservation of potential competition in the American landscape. In an overarching exploration of the Indian antitrust ethos, it serves as a reminder to safeguard market dynamics through regulatory intervention.

IV. REVISITING COMPETITION PARADIGMS: THE CASE OF FACEBOOK'S ACQUISITION OF INSTAGRAM AND ITS IMPLICATIONS FOR ANTITRUST IN THE DIGITAL ECONOMY

With reference to digital economy, the acquisition of Instagram by Facebook in 2012 emerges as an exemplar that is frequently debated upon while discussing the incursion of strategic acquisitions leading to entrenched

[25] Bjorn Lundqvist, 'Killer Acquisitions and Other Forms of Anticompetitive Collaborations (Part II): A Proposal for a New Notification System' (2021) 5 (4) Eur Competition & Reg L Rev< https://core.lexxion.eu/article/CORE/2021/4/4> accessed 26 September 2023.

market dominance.[26] It spurs the discourse on competition authorities inadvertently overlooking transactions bearing anticompetitive imprints. Prior to its acquisition by Facebook, Instagram sported a revenue register with null figures and a skeletal workforce. However, since said acquisition, Instagram's user base has catapulted from a modest 30 million to an astronomical billion-plus.

Concurrently, Facebook's user base also increased from 900 million to over two billion.[27] This expansionary chronicle, at odds with the traditional script of anticompetitive stratagems, compels us to revisit and re-evaluate competition paradigms. It might be thought that if Instagram hadn't been bought, it could have still done really well, maybe even better than it's doing now. While this idea makes sense, just thinking about it alone isn't enough to say that buying Instagram was a bad idea in hindsight.

In recent times, a maelstrom of disclosures unfurled, offering a glimpse into Facebook's inner sanctum. The pertinent confidential documents unveil the perception of Instagram as a formidable competitive adversary. While these archives certainly merit gravity in any investigation, it's imperative to note that regulatory agencies take a wide variety of evidence into consideration during the investigation. The unveiling of such documents, in itself, does not

[26]Fayne and Foreman (n 14).
[27] Kevin A. Bryan & Erik Hovenkamp, 'Startup Acquisitions, Error Costs, and Antitrust Policy' (2020) 87 U Chi LRev <https://lawreview.uchicago.edu/sites/default/files/BryanHovenkamp_StartupAcquisitions_87UCLR331.pdf> accessed 28 September 2023.

inherently imply a dereliction on the FTC's part in pursuing a legal course of action.[28]

Immersed in this deliberation is the pivotal inquiry: if one were to assert that the post-merger trajectory of Facebook and Instagram encapsulates an instance of anticompetitive ramifications, what would then be deemed procompetitive? Imagine, for a moment, the scenario where Facebook decided to cease Instagram's operations within a year of acquisition. Would such a turn of events necessitate the inference that Instagram was a lacklustre offering, thus rendering the acquisition innocuous? Alternatively, could one posit that Facebook's acquisition transpired with a motive to stifle a burgeoning rival, a phenomenon colloquially christened as a "killer acquisition"?

V. CONTEMPLATING INSTAGRAM'S TRAJECTORY: EVALUATING THE IMPLICATIONS OF ACQUISITION ON COMPETITIVE DYNAMICS

In a similar vein, imagine an alternative situation where Instagram's trajectory persists but falls short of earlier growth projections. Would such a circumstance lead one to the inference that Instagram's calibre merely hovered around mediocrity, thereby casting the acquisition in a harmless light? On the other hand, could one contend that Facebook's investment fell short of the requisite quantum, hampering Instagram's potential? Essentially, the bedrock on which our determination rests pertains to the prognostication of what

[28] Mark Glick, Catherine Ruetschlin & Darren Bush, 'Big Tech's Buying Spree and the Failed Ideology of Competition Law' (2021) 72 (2) Hastings LJ <https://repository.uclawsf.edu/hastings_law_journal/vol72/iss2/1/> accessed 28 September 2023.

outcomes we anticipate as signals of either anticompetitive or procompetitive manifestations.

However, the challenge lies in understanding each situation in its own context and carefully considering many different possibilities. For instance, an acquisition culminating in the discontinuation of a product does not inherently bespeak either harm or benefit to consumers. The crux of the matter lies in contrasting the world absent the acquisition with the world influenced by its occurrence.[29] This comparative analysis embraces potential efficiencies reaped from the acquisition, ranging from synergies of intellectual property to abating transactional costs, exploiting economies of scope, and optimizing the allocation of skilled labour.

Nonetheless, an acquisition fanning the flames of prodigious expansion for both the acquiring and acquired entities inherently suggests a trajectory aligned with procompetitive undercurrents. This realization ushers us into a realm where the verdict remains contingent on the circumstantial particularities and a juxtaposition of varied counterfactuals.[30] As we traverse this complex terrain, one needs to scrutinize assumptions, fathom the consequences of market dynamics, and navigate with prudence the delicate balance between fostering competition and nurturing industrial growth.

VI. THE RISE AND FALL OF GOOGLE+: LESSONS IN MARKET DYNAMICS AND ANTITRUST CONSIDERATIONS

[29] Luo, Jiewen (n 17).
[30] Mark J. Roe, 'Corporate Purpose and Corporate Competition' (SSRN, 2021) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3817788> accessed 29 September 2023.

The triumph of prominent technology platforms in diverse markets is far from guaranteed. A noteworthy exemplar in this context is Google+, which made its debut on the 28th of June, 2011.[31] At that juncture, Google+ pronounced its ambitious intent: "We are transmuting Google + itself into a social haven at a calibre and extent heretofore not attempted—a quantum leap in terms of human resources, dwarfing any prior undertaking."[32] As espoused by Professor Catherine Tucker, an economist from the Massachusetts Institute of Technology, the potential for triumph seemed to be at Google's doorstep.[33] However, the curtain fell on Google + as a consumer-oriented entity on the 2nd of April, 2019. Google conceded to the astounding debacle that befell Google +.[34] Notwithstanding the allure of its online search emporium, consumers exercised their choice through alternative offerings. This Google + saga conveys the intricacies of prognosticating market ascendancy and predicting future competitive ramifications.

Evidently, the acquisition of a budding competitor can engender results that are detrimental to both consumers and innovation; conversely, it can also yield outcomes that unleash considerable consumer value. Over and above the customary efficiencies, an acquisition consummated in the early stages of a product's existence could substantially heighten the probability of the product's or technology's maturation and/or expedite its market introduction. Pre-emptively asserting that all or a majority of acquisitions orchestrated by

[31] Alexiadis & Bobowiec (n 13).
[32] Paul B. Stephan, 'Regulatory Competition and Anticorruption Law' (2012) 53 Va. J. Int'l L. < https://www.law.virginia.edu/scholarship/publication/paul-b-stephan/653676> accessed 25 August 2023.
[33] Neil Hodge, 'Competition Law: Avoiding Bad Behaviour' (2017) 2017 In-House Persp [13].
[34] Sharon Yadin, 'Shaming Big Pharma' (2018-2019) 36 JREG Bulletin <https://www.yalejreg.com/bulletin/shaming-big-pharma/> accessed 25 August 2023.

mammoth technological enterprises are injurious to consumers, sans substantial substantiation, risks dampening the reservoirs of innovation and consumer well-being.[35] This is not to insinuate that all research findings discount the issue of potential competition loss.

Amidst these uncertainties and the prerequisite to forge prognostications relating to market entry, product differentiation, and efficiencies that transcend the standard ambit of merger scrutiny, we are confronted with inquiries concerning the competency of agencies and tribunals to evaluate acquisitions encompassing nascent or potential competitors. Crucially, does this distinct paradigm warrant a novel evaluative approach? This is the inquiry that we now turn our focus to.

VII. RECENT PROPOSALS TO ADDRESS THE ALLEGED PROBLEMS OF NASCENT, POTENTIAL, AND KILLER ACQUISITIONS

In light of the amplified obscurity and intricacies entailed in scrutinizing acquisitions of budding and potential contenders, a plethora of novel propositions has recently been unveiled. In the ensuing discourse, we shall elaborate upon three such propositions and interject our commentary therein, specifically within the context of India.

A. Furman Report's Paradigm of "Equilibrium of Detriments"

[35] Sakshi Gupta, 'Sun Pharma - Ranbaxy: Combination Case Study' (2021) 3 (3)IJLLR <https://www.ijllr.com/post/sun-pharma-ranbaxy-combination-case-study> accessed 30 August 2023.

The Furman Report from the United Kingdom, propounds an innovative paradigm characterized by the “equilibrium of detriments” in grappling with mergers that enmesh budding competitors.[36] The crux of this conceptual framework lies in a careful computation of the anticipated value intrinsic to a merger's repercussions. This calculus mandates the assignment of probabilities to various states of the world, concomitant with the welfare accruals or depletions arising therefrom.

By way of illustration, imagine a scenario wherein a merger harbours a 20 percent likelihood of begetting $250 million in anticompetitive detriment, counterpoised by an 80 percent probability of eliciting net efficiencies amounting to $50 million.[37] Ergo, if the acquisition were to ensue, the transaction warrants impediment, as the calculus of anticipated value yields a deficit of substantial magnitude, manifesting as -$10 million.

The proposition at hand underscores a judicious and meditative endeavour to orchestrate economic scrutiny and welfare approximations as the linchpin of merger evaluations. The rationale of calculating the anticipated value is indeed compelling, as it assimilates the inherent unpredictability embedded in prognosticating the repercussions of a merger. If tenable, this calculus might be woven into a broader gamut of merger assessments, wherein various strands of evidence are imbued with commensurate gravitas.

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[36] D. M. Davis, 'Competition Law for the Digital Economy' (2020) 137 S African LJ <https://heinonline.org/HOL/Page?public=true&handle=hein.journals/soaf137&div=37&start_page=576&collection=journals&set_as_cursor=30&men_tab=srchresults> accessed 20 August 2023.

[37] Benjamin Little & Jeffrey Shafer, 'Canadian Competition Law and Internet Pharmacies' (2005) 2005 FDLI Update 46.

Notwithstanding, the pivot towards recalibrating merger policy to be centred on the outcomes of low probability underscored by pronounced detriments and advantages is not without reservations. For instance, imagine a scenario wherein a merger is fraught with a mere 5 percent probability of ushering in net efficiencies tantamount to $300 million per annum, as against a 35 percent probability of yielding net efficiencies approximating $45 million annually.[38] To compound matters, if the residual 60 percent of eventualities culminate in a net detriment of $50 million per annum, the merger would ostensibly be characterized as pro-competitive, courtesy of an anticipated value amounting to $0.75 million.[39]

While according primacy to an objective bedrock for engendering merger determinations has its merits, it presupposes that regulatory agencies possess lucid estimates of the assorted probabilities and welfare ramifications. Alas, this conjecture is liable to find a chasm of dissonance with most inquiries, rendering evaluations profoundly susceptible to infinitesimal fluctuations in probability assessments.[40]

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[38] Priyal Chandrakar, 'Competition Law and the Pharmaceutical Industry' (2021) 3 IJLLR <https://www.ijllr.com/post/competition-law-and-the-pharmaceutical-industry> accessed 20 August 2023.

[39] Steven C. Sunshine & Julia K. York, 'DOJ's Failure to Prove Its "Killer Acquisition" Claim in Sabre/Farelogix and Parallels to Other Recent Government Merger Litigation Losses' (2020-2023) 72 Fla. L. Rev. Forum <https://heinonline.org/HOL/Page?public=true&handle=hein.journals/flrf72&div=4&start_page=22&collection=journals&set_as_cursor=5&men_tab=srchresults> accessed 20 August 2023.

[40] Robert E. Green, 'The Court's New Giant Killer--The Tendency to Monopoly Clause' (1957) 9 Hastings LJ <https://repository.uclawsf.edu/cgi/viewcontent.cgi?article=1537&context=hastings_law_journal> accessed 15 August 2023.

Conclusively, the interface of the Furman Report's "equilibrium of detriments" model with the Indian legal and regulatory matrix beckons profound contemplation.[41] While the complexities and uncertainties intrinsic to merger evaluations remain universal, their manifestation and resolution within the Indian context coalesce as a nuanced narrative of legal evolution and pragmatic interpretation.

B. Crémer Report's "Significant Impact on Effective Competition (SIEC)" Test

The Crémer Report introduces a cogent and perspicacious framework known as the "Significant Impact on Effective Competition (SIEC)" test, which commends regulators to exercise a heightened vigilance when scrutinizing acquisitions in the realm of dominant platforms characterized by robust affirmative network effects.[42] This mandate is especially pertinent when the acquired entity exhibits a burgeoning user base replete with "high future market potential." The nomenclature attributed to this doctrine serves to delineate its focus and import.

This SIEC test is predicated on the discernment of acquisitions wherein the primary impetus is safeguarding the bedrock offering or ecosystem of the ascendant platform.[43] Consequently, regulatory bodies are enjoined to divert their attention from the strictures of product market overlaps and instead direct their scrutiny toward the cohabitation of the two enterprises in either the

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[41] Fayne & Foreman (n 14).
[42] Gupta (n 35).
[43] Alexandr Svetlicinii, 'Off-Label Use of Medicines under Scrutiny: Between Competition Law and Pharma Regulations' (2019) 38 SSRN <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3414068> accessed 20 September 2023.

"technological" or "user" sphere. This prescriptive divergence from conventional wisdom finds resonance in the nascent competition theory of harm exemplified by Microsoft.

In Microsoft, for instance, the focus was not solely on traditional product market overlaps but also on the potential for the merged entity to leverage its dominance in one market to stifle competition in adjacent or nascent markets.[44] Similarly, by considering whether the motivation behind an acquisition is to protect the dominant platform's core product or ecosystem, regulators can better assess the potential anti-competitive effects on nascent competitors and innovation.

In essence, the SIEC test coalesces harmoniously with the prevailing U.S. merger review modus operandi, eschewing a presumption of impropriety and prudently entertaining potential efficiencies that accrue from such unions.[45] The tenet of examining beyond the precincts of core product market overlap finds a concordant with the precedent set forth in the realm of nascent competition. An underpinning proviso, however, necessitates the regulatory authority's initial and unwavering determination of the network effects' nature—one that constricts market entry and confers formidable barriers thereto. Evidently, these effects are not homogenous but exhibit a heterogeneous array of attributes and strengths contingent upon the specific market dynamics.

[44] Devlin, Alan J. "Killing Nascent Innovation as Abuse of Dominance and Monopolization" Research Handbook on Abuse of Dominance and Monopolization. (*Edward Elgar Publishing*, 21 April 2023) <https://www.elgaronline.com/edcollchap/book/9781839108723/book-part-9781839108723-30.xml> accessed 20 September 2023.
[45] Hodge (n 33).

Applying this framework to the Indian landscape, one could extrapolate instances wherein the SIEC test's criteria could have pertinently applied. Consider, for instance, the acquisition of Instagram by Facebook. While Facebook's standing as a monopolistic entity is a subject of debate, the pertinent question revolves around the precise purview of its monopolistic dominion. Categorizing it as a “social media” monolith usher in a plethora of contenders such as YouTube, Twitter, Pinterest, Reddit, LinkedIn, and the more recent entrants—Snapchat and TikTok. The pivotal query that arises is whether Instagram, at its embryonic stage, could have been posited as a distinctive nascent contender with the potential to dislodge Facebook's monopolistic foothold.

The answer, while not unequivocal, begets a thorough investigation—one that should not disregard Instagram's growth as a photo-sharing platform. The act of procuring a swiftly burgeoning enterprise within a peripherally related or remotely situated market introduces the prospect of assimilating a premium-grade product accompanied by an assemblage of valuable assets. This, in turn, accentuates the potential for deriving substantial efficiencies, particularly in scenarios where the acquired offering starkly diverges from the acquirer's existing portfolio. However, the intricate conundrum persists: navigating the intricate labyrinth of pre-emptive assessments concerning the association of burgeoning products and emergent technologies with a discerning eye on their future trajectory and differentiation.

VIII. PRESUMPTION OF ILLEGALITY FOR ACQUISITIONS BY DOMINANT PLATFORMS

Several lawmakers in various jurisdictions such as the US have put forth a legislative remedy in response to the perceived problem arising from prominent digital platforms acquiring budding competitors. Their proposal entails an absolute proscription on takeovers meeting specific criteria.[46] A less stringent variant of this proposition leans toward a robust presumption of impropriety that can be challenged only within a restricted range of defences. While diverse formulations of this burden-shifting suggestion exist, its crux lies in obstructing acquisitions by technological conglomerates unless they can substantiate profound operational efficiencies.[47]

However, for a presumption of anti-competitive detriment to arise from substantial digital platforms procuring enterprises, substantial substantiation is imperative to confirm that these procurements genuinely culminate in anti-competitive practices and that they systematically evade rigorous enforcement under the existing legal framework.[48] As yet, no comprehensive study validating this assertion has come to our attention. Nonetheless, three recent studies have undertaken a scrutiny of antecedent platform acquisitions, delineated below. Collectively, these inquiries do not reveal pervasive evidence corroborating the notion of substantial technology acquisitions conforming to the "killer acquisition" narrative.[49] However, they

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[46] Mikah Roberts, 'Killer Acquisitions and the Death of Competition in the Digital Economy' (2022) 24 (1) Transactions: Tenn J Bus L < https://ir.law.utk.edu/transactions/vol24/iss1/3/> accessed 14 September 2023.
[47] Yadin (n 34).
[48] Stephan (n 32).
[49] 'Competition Law' (2013) 12 Intell Prop L & Pol'y 605.

do concede that whether some of these procurements can be construed as anti-competitive remains an unresolved query. At most, the evidentiary landscape presents a blend of indications.[50] Even reports that harbor reservations about the prevailing extent of antitrust enforcement are hesitant to advocate such a sweeping policy shift.

In the inaugural study, Latham et al. meticulously scrutinized acquisitions executed by the quartet of Google, Amazon, Facebook, and Apple (collectively referred to as GAFA) spanning the temporal arc from 2009 to 2020.[51] Their findings indicate that "only a minor fraction of transactions could potentially conform to the 'killer' narrative." Instead, "the predominant majority pertained to GAFA's acquisition of novel competencies and strategic positioning to penetrate fresh markets." In dissecting the repository of 409 acquisitions in their dataset, only 33 of these, constituting a mere 8 percent, adhered to what they termed a "core business" filter.[52] This filter operates on the basis of either a direct horizontal intersection or a scenario wherein the acquisition involves an entity "vertically connected to that core business and possesses credible potential to evolve into a competitive menace." Crucially, the authors underscore that among these 33 acquisitions, they "do not assert that transactions surviving these filters qualified as killer acquisitions."[53]

However, the study does raise a concern about "reverse killer acquisitions," wherein the incumbent entity discontinues its in-house product

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[50] Svetlicinii (n 43).
[51] Bryan & Hovenkamp (n 27).
[52] Lawrence B. Landman, 'Competition to Innovate and Future Potential Competition' (2023) 103 J. Pat. & Trademark Off. Soc'y <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4284370> accessed 14 September 2023.
[53] Little & Shafer (n 37).

development in favour of integrating the procured product. While this apprehension is legitimate, it does not axiomatically follow that a reverse killer acquisition is inevitable, and even if it materializes, its impact on innovation's trajectory remains uncertain. For instance, amalgamating the strengths of two distinct developmental processes to expedite the market debut of a more innovative product might entail the cessation of one of the pre-merger products.[54] Similarly, doubts persist whether, even in the absence of merger, internal development would have continued unabated or achieved the same echelon of efficiency.[55]

Gautier & Lamesch delve into the realm of acquisitions originating from major tech platforms, expounding their findings on the correlation between these acquisitions and the acquisition targets' valuable research and development inputs. Their investigation, spanning from 2015 to 2017 and involving a meticulous scrutiny of 175 deals, evinces a scarcity of compelling evidence in support of the proliferation of so-called "killer mergers."[56] Instead, their inquiry singles out a solitary prospective instance that might have merited more rigorous inspection from competition regulatory bodies. Notably, this instance pertains to the 2016 acquisition by Facebook of the photo filter application Masquerade.

Concurrently, Gautier & Lamesch illuminate an intriguing facet reminiscent of the findings by Latham et al., proposing the notion of reverse

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[54] Davis (n 36).
[55]. Roe (n 30).
[56] Mariya Papazova, 'Competition Protection Commission on the National Regulation of the Pharma Sector' (2020) 4 Eur. Competition & Reg. L. Rev. <https://pesquisa.bvsalud.org/global-literature-on-novel-coronavirus-2019-ncov/resource/pt/covidwho-926160> accessed 12 August 2023.

killer acquisitions. This conceptualization alludes to instances where the underlying motive behind an acquisition is not the attainment of synergistic benefits but rather the fortification of market dominance through the procurement of valuable market assets, thereby pre-empting their independent evolution and subsequent products.

Conclusively, the duo underscores that the resolution to this intricate puzzle is far from self-evident, necessitating a thoroughgoing, case-specific analysis to dispel ambiguity. Moving forward, Argentesi et al. extend their gaze towards mergers involving the tech titans Google, Facebook, and Amazon over the span of a decade, from 2008 to 2018.[57] In this pursuit, they encounter formidable challenges in gauging the competitive implications accompanying the absorption of nascent firms, whose trajectories remain enigmatic due to their relatively nascent life cycles. This uncertainty renders it arduous to prognosticate whether these targeted entities will eventually burgeon into substantial competitive forces.

Within this context, Argentesi et al. astutely encapsulate the intricate conundrums that beset competition authorities and agencies. The authors undertake a meticulous evaluation of the determinations rendered by the United Kingdom's Competition and Markets Authority (CMA) vis-à-vis the Facebook-Instagram and Google-Waze acquisitions.[58] Although they craft compelling arguments on both sides of the discourse, they refrain from delivering a resolute verdict.

[57] Alexiadis & Bobowiec (n 13).
[58] Roberts (n 46).

Evidently, the recent inquiries into the realm of substantial tech acquisitions do not culminate in categorical pronouncements. It is unequivocal that prognosticating the trajectory of products and technological advancements within the dynamic and highly innovative domains of the market is a daunting endeavour.[59] One salient insight gleaned from this analytical sojourn, pertinent to our ongoing policy discourse, is that the evidentiary basis does not substantiate the notion that regulatory agencies are systematically overlooking latent anticompetitive prospects within early-stage acquisitions. Consequently, there exists no imperious mandate to reconfigure the prevailing presumptions.

IX. DO THE PRESENT ANTITRUST STATUTES AND THEIR IMPLEMENTATION SUFFICE TO CONFRONT THE ISSUE AT HAND?

The assessment of prevailing antitrust legislation and its vigilant application in thwarting anticompetitive consolidations of burgeoning rivals invites a profound examination. Drawing from an array of evidentiary and scholarly discourse, it is posited that the current framework of U.S. federal antitrust laws, along with their invoked measures, demonstrates a sense of adequacy. This framework appears primed to effectively preclude injurious strides toward anti-competitive dominance.

Central to this discussion is the doctrine of potential competition, a venerable tenet within antitrust jurisprudence, spanning epochs of evolution.

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[59] Affeldt, Pauline, and Reinhold Kesler. "Big Tech Acquisitions—Towards Empirical Evidence." (2021) 12 (6) Jl. of Eu. Comp. Law & Practice. <https://academic.oup.com/jeclap/article-abstract/12/6/471/6232342> accessed 12 August 2023.

This doctrine, embedded in the initial pronouncement of the Horizontal Merger Guidelines jointly administered by the U.S. Department of Justice (DOJ) and the Federal Trade Commission (FTC), reflects a discerning recognition of the vitality of future rivalry.[60] This doctrine's historical lineage traces to its crystallization within the U.S. antitrust agencies, interweaving the notable doctrines of potential competition as seen in landmark cases such as El Paso Natural Gas and the nascent competition doctrine as exemplified in the Microsoft case.

However, transcending doctrinal intricacies, the vigilance of antitrust agencies in scrutinizing and, where warranted, enforcing actions comes into focus. This proactive stance is substantiated by active engagement, as evident in instances such as the FTC's scrutiny of the proposed acquisition of Arbitron by Nielsen in 2013.[61] Here, a novel strand of harm emerged, based on the concept of "potential-potential competition," creating a theoretical construct beyond conventional paradigms. This pioneering approach illuminates the FTC's disposition on the peripheries of the potential competition doctrine.

The year 2013 saw a crescendo of potential competition cases, exemplified by instances like Actavis-Warner Chilcott, Mylan-Agila, and Polypore-Microporous.[62] These underscored guardianship over nascent competition in the domain of forthcoming generic drug markets and demonstrated the FTC's stewardship in safeguarding prospective competition. The FTC's contestation of the Synergy Health acquisition by Steris Corporation in 2015 showcases its mettle in safeguarding potential

[60] Lundqvist (n 24).
[61] Smejkal (n 5).
[62] Whish (n 8).

competition.[63] Yet, judicial divergence was witnessed in instances like the Ohio district court's verdict in the Steris case, highlighting the complexities of applying nascent competition principles.

In the Indian context, there are significant parallels with antitrust efforts seen in other jurisdictions. Central to this is the Competition Act of 2002, which establishes the framework for antitrust regulation in India. The Competition Commission of India (CCI) plays a crucial role akin to the U.S. Federal Trade Commission (FTC), overseeing, adjudicating, and intervening in cases where competition is threatened.

A prominent example showcasing India's dedication to curbing the abuse of dominance and anticompetitive practices is the landmark case of CCI v. Google. In this case, the CCI investigated allegations against Google for abusing its dominant position in the market. Specifically, Google was accused of engaging in practices that favoured its own services over competitors' in search results, potentially stifling competition. This case exemplifies India's commitment to enforcing competition laws and ensuring a level playing field for all market participants.

Another significant case highlighting the Indian regulator's vigilance in safeguarding competition is the case of Uber India Systems v. CCI.[64] Here, the CCI intervened to protect nascent competition by scrutinizing agreements that restricted drivers from participating in rival platforms. Uber, a dominant player in the ride-hailing market, was under investigation for allegedly entering into agreements that hindered drivers' ability to work for competing

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[63] Smith & Hunt (n 2).
[64] *Uber India Systems Pvt. Ltd. v. Competition Commission of India*, (2019) (8) SCC 697.

platforms. The CCI's intervention in this case underscores its role in promoting competition and preventing anticompetitive behaviour, even in emerging markets.

In the intricate terrain of antitrust, the Indian legislative framework and jurisprudential narratives contribute to the discourse. The CCI's assertive role in protecting competition resonates with the U.S. approach. This global correlation is seen in the FTC's inquiry into Roche's acquisition of Spark Therapeutics in 2019, mirroring India's Bayer-Monsanto case.[65]

These examinations reiterate regulatory agencies' proactive stance, transcending borders. The complexities are undeniable, and active enforcement underscores the principle that inquiries rest on a meticulous evaluation of market entry probabilities. Such inquiries parallel India's evolving competition jurisprudence, exemplified by cases such as Flipkart-Walmart. The notion of occasional fallibility isn't exceptional. While scrutiny should persist, it mustn't overshadow the agencies' robust decisions. Vigilance, open dialogue, and continuous enhancement form the essence. This resonates with India's regulatory landscape, urging the CCI to uphold competition and welfare while fostering continual refinement.

X. CONCLUSION

While concerns exist regarding dominant technology companies acquiring potential rivals and stifling competition, the research in this paper suggests these "killer acquisitions" might not be as prevalent as initially thought. Predicting future market trajectories and discerning the true intent

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[65] Madl (n 20).

behind acquisitions pose significant challenges. Acquisitions can be both pro-competitive and anti-competitive, highlighting the need for a nuanced approach. Absolute bans on acquisitions by dominant platforms lack sufficient evidence to be justified. Instead, careful case-by-case analysis and further research are crucial to navigate the complexities of this evolving landscape and ensure a balance between fostering competition and encouraging innovation.

VI. TIME TO RETHINK SEBI'S DISGORGEMENT: AN EMPIRICAL ANALYSIS OF ITS EFFECTIVENESS

- Harshit Singh and Jay Shah*

ABSTRACT

Disgorgement is often described as an equitable remedy that is aimed at deterring wrongdoers from unjust enrichment through their illegal conduct. SEBI, since 2003 has widely used its power to issue disgorgement orders to claw back any ill-gotten gains resulting from the violation of securities laws. This Article expounds on whether disgorgement is an 'effective, equitable remedy' or is just a mere façade of equity.

In order to gauge its effectiveness, the Article seeks to answer two pertinent questions through empirical data- (a) Whether the disgorged amounts credited to the SEBI Investor Protection and Education Fund are being utilised for compensating the harmed investors through restitution, and (b) Whether through disgorgement, SEBI actually reverts the wrongdoer to the status quo and not a worse off position. For the first question, the authors argue that by retaining the disgorged amounts and not compensating the harmed investors, SEBI violates the fundamental principles of unjust enrichment as given under the Indian Contracts Act, of 1872. Further, the Securities Appellate Tribunal has also held that "disgorgement without restitution does not serve any purpose". For the second question, the authors argue that the primary justification behind disgorgement is to revert the wrongdoer to the status quo and no worse, or else it shall take the colour of a penalty. However, by analysing several SEBI orders on disgorgement, the authors have found that there were no orders that gave out the fact that the wrongdoer has actually been reverted to the status quo. Moreover, in certain cases, disgorgement orders have put the wrongdoer in a worse-off position than they were before committing the act.

Thus, this Article has analysed the effectiveness of disgorgement as an 'equitable' remedy by attempting to answer the above questions and has further suggested policy recommendations for the manner of utilisation of disgorged amounts to compensate the harmed investors.

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I. INTRODUCTION

Disgorgement, refers to the idea of forfeiting income or assets that were obtained illegally. It is a regulatory power widely exercised by securities market regulators across various jurisdictions to square off any unjust enrichment in the capital market.[1] The underlying idea behind this is that no one should make gains from their own wrongdoings by putting others in a worse position. In general parlance, disgorgement means forcibly giving up any illegal gains or profits.[2] Black's Law Dictionary has defined disgorgement as *"the act of giving up something (such as profits illegally obtained) on demand or by legal compulsion."*[3] The primary objective is to strip the wrongdoer of any profits illegally obtained from violating the law. A landmark

[1] Vidhi Shah, 'Determining Disgorgement in Securities Law', (2019) 10 THE LAW REVIEW GLC 138-139.
[2] Sumit Agrawal & Robin Joseph Baby, *Agarwal and Baby on SEBI Act 207* (Taxmann 2011).
[3] Henry Campbell Black, Black's Law Dictionary 554 (8th ed.)

judgement delivered by the Supreme Court of the United States of America ("**USA**") in the case of Huntington v. Attrill[4] stated that *"disgorgement is a pecuniary penalty imposed and enforced by the State, for a crime or offences against the laws".* By disgorging illicit profits, the securities regulators maintain a deterrent effect of their enforcement actions against other such violators.[5] It also enables the regulators to restore the *status quo ante*.[6]

In India, the Securities & Exchange Board of India ("**SEBI**") acts as a primary regulator for capital markets and exercises all three powers; administrative, legislative (through delegated legislation), and quasi-judicial. The preamble of the SEBI Act, 1992[7] envisages two-fold objectives for establishing SEBI- (a) protection of investors; and (b) development & regulation of the securities market. This obliges SEBI to maintain investor confidence and establish a level playing field for retail and institutional investors. In order to effectively regulate the securities market, provisions under the SEBI Act have provided various enforcement powers such as-

- Issuing directions and levying penalties (including the power to order for disgorgement);[8]
- Adjudicatory powers;[9]
- Enquiry proceedings;[10]
- Criminal proceedings.[11]

[4] *Huntington v. Attrill*, [1892] U.S. 146 (U.S.) 657, 667.
[5] *Kokesh v. SEC* [2017] US 581 U 3.
[6] Shruti Rajan & Jitesh Maheshwari, The Science and Art of Disgorgement under Securities Law, (*Bar and Bench,* Aug. 15 2023) <https://www.barandbench.com.> accessed 25 February 2024.
[7] The Securities and Exchange Board of India Act 1992 (SEBI 1992).
[8] SEBI 1992, s. 11(4) and s. 11B.
[9] SEBI 1992, s. 15.
[10] SEBI 1992, s. 12(3).
[11] SEBI 1992, s. 24.

Disgorgement is a widely used remedy by various regulators in India and can be found in the Companies Act[12] as well as in the Competition Act.[13] With respect to the securities market, explanation to Section 11B[14] of the SEBI Act is the key provision that grants SEBI the power to order for disgorgement of ill-gotten gains.

The primary objectives of disgorgement can be widely categorized into:

- ***Prevention & Deterrence***

The purpose of disgorgement is to prevent potential wrongdoers from engaging in dishonest or fraudulent conduct. Market participants are deterred from engaging in behaviour that could result in monetary gains through illegal means by the possibility of the regulator forfeiting such profits.

- ***Maintaining Market Integrity***

Maintaining market integrity is crucial for bolstering investor confidence and drawing money to the securities market. Disgorgement acts as a safeguard against manipulative practices, fraudulent schemes, and insider trading, all of which have the potential to undermine market confidence and create an uneven playing field.

- ***Corrective Justice***

Disgorgement is based on the doctrine of *Ex injuria jus non oritur*, which means that a person cannot take benefit of his own wrong. By

[12] The Companies Act 2013.
[13] The Competition Act 2002.
[14] SEBI (n 7).

disgorging ill-gotten gains, the regulator ensures that persons who have profited from his misconduct are not allowed to retain those benefits.

The principle of disgorgement has been well-recognised by securities market regulators globally, including the Securities Exchange Commission ("**SEC**") in the USA and SEBI in India. This Article seeks to determine the efficacy of such disgorgement orders passed by SEBI and whether the regulator is fulfilling its legislative mandate of protecting investors' interests. The authors argue that reconsideration is required for the justification given by SEBI while exercising its power of disgorgement. To analyse the effectiveness of disgorgement as a remedial action, the authors have relied on SEBI orders from 2018 to 2022, along with other empirical data available on the utilisation of SEBI Investor Protection and Education Fund. Part II attempts to lay down the distinction between disgorgement and other remedial actions like penalty, restitution, and forfeiture. Part III of the Article deals with the evolution and development of the principle of disgorgement in the USA and India. Analysis of the effectiveness of disgorgement as a remedy has been dealt with in two parts (Part IV & Part V).

Part IV of the Article deals with the effective utilisation of the disgorged money, and whether the same is actually used to compensate the harmed investors upon their identification. This is of utmost importance since a large amount of money has been collected by the SEBI through disgorgement in the recent past. As per Regulation 4(1)(h) of the SEBI (Investor Protection and Education Fund) Regulations, 2009 ("**SEBI IPEF Regulations**"), all amounts disgorged under Section 11B of the SEBI Act, 1992[15] should be

[15] ibid.

credited to the SEBI Investor Protection and Education Fund ("**IPEF Fund**"). The authors have analysed the inflows and outflows of the IPEF Fund from 2019 to 2023 from SEBI Annual Reports and have found that the Fund has never been utilised for compensating the harmed investors. The Article also argues that the collection and retention of the disgorged monies amount to 'unjust enrichment' on the part of the SEBI, which is violative of the fundamental principles enshrined under the Indian Contract Act, of 1872.[16]

Part V of the Article studies the justification given by SEBI for disgorgement and whether its usage by the regulator is fundamentally different from its theoretical understanding. Initially, the disgorgement power of SEBI was not explicitly recognised by the legislature. With time, the SEBI Act, 1992 was amended, and it was given statutory recognition. The justification given by SEBI for disgorgement was that it is an equitable remedy aimed at returning the wrongdoer to the *status quo* and, therefore, distinct from a penalty.[17] Through disgorgement, SEBI aims to return the wrongdoer to the *status quo* and no worse so as to ensure that it doesn't take the colour of a penalty. In this context, the authors have analysed the disgorgement orders of SEBI from 2018 to 2022 to determine whether such orders only take away the ill-gotten gains of the wrongdoer with an aim to return them to the *status quo*. We have found that in none of the orders during the given period, has there been an instance where the wrongdoer was brought back to the *status quo* and did not leave them worse off.

II. DISGORGEMENT *vis-à-vis* OTHER FORM OF REMEDIES

[16] Indian Contract Act 1872.
[17] Renuka Sane & S. Vivek, 'Reconsidering SEBI Disgorgement', (SSRN, 31 May 2022) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4124724> accessed 17 October 2023.

Disgorgement in its juridical evolution has been sobriquet under penalty, forfeiture and restitution. The application of securities regulatory bodies has time and again exercised disgorgement in a fashion similar to any punitive measure or civil remedy, specifically, penalty or forfeiture.

We saw this conundrum even in Kokesh v. SEC[18], "*JUSTICE ALITO: This case presents a unique challenge as we must determine whether the concept of "disgorgement" should be classified as a penalty or a forfeiture. To make this determination, it is crucial to comprehend the nature of disgorgement, which requires an understanding of its origin and the authority supporting it. The dilemma arises from the need to categorize it without a clear understanding of its form, origin, and exact characteristics.*"

This requires to understand the nature of such remedies systematically. Disgorgement asserts the confiscation of ill-gotten gains or gains arising out of an activity that is in contravention of the law. This is based on the principle that profit should arise from ethical and legal practice, and any taint of illegality shall be corrected. The current understanding of disgorgement deals with payment of profits earned illegally to the person from whom they are earned, or those who suffered a notional injury. This understanding of disgorgement goes against the theoretical purpose of disgorgement. To understand the distinguished nature of disgorgement, the authors shall aim to differentiate it from penalty, restitution, and impounding.

A. Disgorgement vis-à-vis penalty

[18] *Kokesh v. SEC (*n 5).

Penalty, as we understand, is imposed by the state for any act in contravention of the law. The reason disgorgement is often categorised as a penalty is because of the twin test it satisfies. Firstly, it is a wrong against the public due to the largely unidentifiable nature of victims, and secondly, for the role it plays in creating deterrence.[19] Disgorgement is often levied for violation of public laws and, moreover, has an inherent punitive measure.[20] In the absence of a legislative mandate to distribute the amount recovered in the form of compensation to 'identified' victims, it presents itself in the form of a penalty.[21] The nature of a penalty is punitive and retributive, while that of disgorgement is to limit unjust enrichment; this leads to the distinction between the both.

The difference arises from the understanding that disgorgement, at least in theory, should not exceed the amount of profit. Courts have gone to a certain length and calculate net profit after removing transaction costs as well. Disgorgement is meant to return the wrongdoer to the *status quo*. The penalty is generally prescribed in the statute, and the adjudicatory authority has the discretion to levy any penalty between the prescribed limits. However, disgorgement operates differently and does not provide a similar discretion to adjudicatory authority in the presence of a systematically developed binding methodology for calculating the disgorgement amount. Moreover, disgorgement cannot be exercised if no profit or loss aversion materialises, while a penalty can be imposed on mere contravention of the law. The penalty would thus be over and above the disgorgement imposed by SEBI and form a

[19] *Huntington v. Attrill*, (n 4).
[20] *Bell v Wolfish* [1979] USSC 441 U.S. 520-539.
[21] *Porter v. Warner Holding Co.*, 328 U. S. 395- 402.

stricter deterrence than the one created by disgorgement alone in an ideal theoretical application.[22]

B. Disgorgement vis-à-vis restitution

The traditional outlook of disgorgement shares a remedial nature with restitution. Restitution refers restoration of wealth to the sufferer on account of the defendant's wrongdoing. Restitution's objective is to prevent unjust enrichment at the expense of the claimant.[23] The premise of restitution rests on the theoretical underpinning that the gain of one party is equivalent to the loss of another party. It can be noted *"that disgorgement without restitution does not serve any purpose"*, but there are still thin-line differences between disgorgement and restitution.[24]

Restitution and disgorgement both have an underlying aim which is compensation. Restitution in the form of compensation generally arises in the form of contractual remedy wherein the amount awarded to the plaintiff would provide him *status quo* or the position has he not entered the contract. Disgorgement gains its distinction based on this inherent nature. Firstly, disgorgement can also be imposed if losses are averted. Thus, while restitution would prevent unjust enrichment, disgorgement may operate to put a person worse off and suffer losses. Secondly, the jurisprudence until now inclines

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[22] Buckberg, E. and Dunbar, F.C., Disgorgement: Punitive demands and remedial offers, (2008) 63 (2) Bus. Law. Rev. < https://www.jstor.org/stable/40688470> accessed 17 October 2023.

[23] Grantham, R.B. and Rickett, C.E., Disgorgement for unjust enrichment?, (2003) 62 (1) CLJ < https://www.cambridge.org/core/journals/cambridge-law-journal/article/abs/disgorgement-for-unjust-enrichment/BBFCFD53599524DFE39BA20573430C02> accessed 18 October 2023.

[24] Arnold S. Jacobs, Disgorgement, in 5E Disclosure and Remedies under the Securities Laws § 20.

towards the vanishing difference between restitution and disgorgement but fails to factor in how the anonymity of a capital market distinguishes it from a contract.[25] Let us assume, in a scenario an insider having a piece of positive material information, enters the secondary market for the acquisition of shares. Here the seller, who is a retail investor, is going to sell the shares immaterial of who is going to acquire them. The knowledge of an insider plays a role in his decision-making and not that of the seller, who is not concerned with the sale of shares to either an insider or any other ordinary retail investor. SEBI has provided a framework for assessing the loss suffered, but the same was in the case of an IPO[26] and not a secondary market. SEBI operates on an approximation basis. If the principle of restitution is applied to disgorgement, which is the loss of one party, then in several cases disgorgement would not be applicable. This is the reason that disgorgement functions on the discretionary level for the fact-finding of actual loss or harm which is otherwise indispensable in restitution. In a secondary market setup, a shareholder can sell shares to an insider and still make a profit or sell share to other ordinary retail investors and suffer losses. Thus, in such cases, by any stretch of judicial interpretation, the loss can only be notional, which cannot form the basis of restitution. This understanding is more apt for insider trading.[27]

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[25] P. Loughlan, No Right to the Remedy? An Analysis of Judicial Discretion in the Imposition of Equitable Remedies, (1989) 17 M.U.L.R. 1.

[26] In the matter of investigations into initial public offerings, (*SEBI*, 21 November 2006) <https://www.sebi.gov.in/enforcement/orders/nov-2006/in-the-matter-of-investigation-into-initial-public-offerings_15056.html> accessed 15 September 2023.

[27] Thomas C. Mira, The Measure of Disgorgement in SEC Enforcement Actions against Inside Traders Under Rule 10b-5, (1985) 34 (2) Cath. U. L. Rev. <https://scholarship.law.edu/lawreview/vol34/iss2/8> accessed 15 September 2023.

Disgorgement is different from restitution on the major standpoint that restitution returns the plaintiff to the *status quo* while disgorgement returns the defendant to the *status quo*.[28] This is the reason that restitution can extract monetary amounts greater than the exclusive loss envisaged in the contract and extract losses caused, in subsequent non-exclusive business transactions, due to the ill-doing of the defendant. While in disgorgement the amount which is forfeited cannot exceed the net gains. Therefore, a wider scope enjoyed by SEBI in disgorgement amount because it is based on ill-gotten profits and not injury suffered by investors. This empowers SEBI to order disgorgement even in cases where the injured party are unidentifiable.[29] Hence, it can be understood that disgorgement and restitution are different remedies and have different cause and operation.[30]

C. Disgorgement vis-a-vis impounding and forfeiture

SEBI has the power to impound assets which means that until the fixation and confirmation of the charge, SEBI can retain assets to prevent unjust enrichment. Impounding is more of a preventive and interim remedy while disgorgement has finality and is remedial as well as deterrent in nature. Impounding aims at preserving the value of an asset while disgorgement is meant for stripping an offender of ill-gotten gains.[31] Similarly, forfeiture can be distinguished from disgorgement as disgorgement prescribes the

[28] M. Mclnnes, Disgorgement for Wrongs: An Experiment in Alignment, (2000)8 R.L.R. <https://heinonline.org/HOL/Page?collection=journals&handle=hein.journals/restilwr8&id=581&men_tab=srchresults> accessed 16 September 2023.
[29] P. Birks, Unjust Enrichment and Wrongful Enrichment, (2001) 79 Texas. L.R.
[30] Alan R. Bromberg & Lewis D. Lowenfels, *Bromberg & Lowenfels on Securities Fraud Commodities Fraud* (2nd Ed., West Group 2007).
[31] S. Smith, Justifying the Law of Unjust Enrichment, (2001) 79 Texas L.R.

distribution of profits in case the parties that suffered loss can be identified, while forfeiture is loss of property for breach of contractual obligation.

III. EVOLUTION OF DISGORGEMENT IN THE USA AND INDIA

A. Evolution of Disgorgement in the USA

The paramount statute pertaining to securities law in the USA, which is the Securities Exchange Act, 1934, did not consist of any separate statutory provision for disgorgement initially. The purpose and scope of disgorgement have evolved through various case laws. It is pertinent to understand the development of jurisprudence concerning disgorgement in the USA in order to understand the underlying concept of its equitable nature and assess the manifestation of the same spirit in the application of the law.[32] Disgorgement was first exercised in 1968 in the *SEC v. Texas Gulf*.[33] In this case, disgorgement was exercised as *"restitution of ill-gotten gains."* The court ordered restitution of profits reaped by insiders to prevent unjust enrichment. Hence, the institution of disgorgement took birth in the form of a punitive measure, i.e., a penalty, on the grounds that insiders retaining profit would be in violation of the law even though it was envisaged to form an equitable remedy.

In *SEC v. Drexel Burnham Lambert Inc. (1989),*[34] defendants were ordered to disgorge remuneration earned as company directors through share parking, violating a standstill agreement. The court aimed to deter misconduct

[32] Ellsworth, J.D., Disgorgement in Securities Fraud Actions Brought by the SEC*,* (1977) Duke LJ 641.
[33] *SEC v. Texas Gulf*, 401 F.2d 833 (2d Cir. 1968).
[34] *SEC v. Drexel Burnham Lambert Inc*., 837 F. Supp. 587 (S.D.N.Y. 1993).

rather than provide an equitable remedy. Although acknowledging the need to return illicit profits, the court lacked a precise calculation method, approximating based on reason.[35] Pleas to return profits to the company were rejected due to ownership changes, benefiting the new holding company. The court suggested compensating minority shareholders but didn't implement it, prioritizing compensation for investors with actual losses.

In *SEC v. Manor Nursing Centers, Inc.,*[36] the court did not grant an extension of the disgorgement order over the income that was subsequently earned on the initial ill-gotten gains. It was established that there has to be a clear proximate nexus and cause-and-effect relationship between the illegality and the ultimate profits.

In *SEC v. First City Financial Corp.*,[37] the SEC created a distinction and pertinence to identify gains as lawful and unlawful. While observing that disgorgement is not meant to compensate investors, the nature of disgorgement was still essentially identified within the vague domain of penalty and restitution. In this case, the rise of scrip prices could be attributed to three different factors other than the disclosure of material information over which the insiders had acted, all of which provided different estimates of profits made by insiders ranging from zero dollars to eight hundred thousand dollars, disgorgement was ordered on the basis of violation of the law. Analysts even claimed that the insider was not liable to disgorgement. Thus, disgorgement was ordered as *"the line between restitution and penalty is unfortunately blurred."*

[35] *Elkind v. Liggett & Myers, Inc.,* 635 F.2d 156, 171 (2d Cir.1980).
[36] *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972).
[37] *SEC v. First City Financial Corporation*, 890 F.2d 1215 (D.C. Cir. 1989).

In *SEC v. Worldcom*,[38] the SEC provided a distribution plan of the amount disgorgement on account of financial fraud committed by the company. In *Liu v. SEC,*[39] the court identified that disgorgement is of remedial nature irrespective of the real victims of the offence and can be compensated due to the intricacies of tracing the actual victims and loss. Thus, the court has ruled that disgorgement should be limited to net profit or the ill-gotten gains of the accused.

B. Evolution of Disgorgement in India

The earliest attempts by SEBI for disgorgement appeared in 1998 in the case of *Hindustan Lever Limited v. SEBI,*[40] which was unsuccessful and was rejected by the appellate authority on the ground that there is no specific statutory provision in the parent legislation that provides for imposing such pecuniary burden. Another attempt was made in the case of *Rakesh Agarwal v. SEBI,*[41] where SEBI held that *"the power of direct disgorgement of alleged profits, to aggrieved investors is an equitable power which vests in SEBI, and that such a direction of disgorgement is compensatory in nature"*. However, this contention was rejected by the Securities Appellate Tribunal ("**SAT**"), which stated that equitable powers of this nature cannot be exercised by quasi-judicial authorities like SEBI, and can only be exercised by the courts. It was also held that disgorgement of alleged profits is a deterrent measure and not compensatory and therefore is penal in nature, which cannot be undertaken without an express statutory provision for the same.

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[38] *SEC v. WorldCom, Inc*., 273 F. Supp. 2d 431 (S.D.N.Y. 2003).
[39] *Liu v. SEC*, 140 S. Ct. 1936.
[40] *Hindustan Lever Limited v. SEBI*, (1998) 18 SCVL 311 (AA).
[41] *Rakesh Agarwal v. SEBI*, (2004) 29 SCL 351 (SAT).

The first successful attempt came in the IPO scam case of 2006[42] (also referred to as *Roopalben Panchal Scam*). SAT recognised and upheld the power of SEBI to issue disgorgement orders. SEBI noted that:

> *"It is well established that the power of disgorgement is an equitable remedy and is not a penal or even a quasi-penal action. Unlike damages, it is a method of forcing a defendant to give up the amount by which he or she was unjustly enriched. Disgorgement is intended not to impose on defendants any demand not already imposed by law, but only to deprive them of the fruit of their illegal behaviour. It is designed to undo what could have been prevented had the defendants not outdistanced the investors in their unlawful project.*
>
> *Disgorgement merely discontinues an illegal arrangement and restores the <u>status quo ante</u>. It is a useful equitable remedy because it strips the perpetrator of the fruits of his unlawful activity and <u>returns him to the position he was in before he broke the law</u>."*

The above approach of SEBI is a significant departure from previous instances wherein the disgorgement order was classified as compensatory.

The jurisprudence on disgorgement was further strengthened in *Karvy Stock Broking Ltd. v. SEBI,*[43] where the SAT observed that:

> *"Disgorgement is a monetary equitable remedy that is designed to prevent a wrongdoer from unjustly enriching himself as a result of his illegal conduct. It is not a punishment, nor is it concerned with the damages sustained by the victims of unlawful conduct. Disgorgement*

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[42] SEBI (n 26).
[43] *Karvy Stock Broking Ltd. v. SEBI*, (2008) 84 SCL 208 (SAT).

of ill-gotten gains may be ordered against one who has violated the securities laws/regulations, but it is not every violator who could be asked to disgorge. Only such wrongdoers who have made gains as a result of their illegal act(s) could be asked to do so. Since the chief purpose of ordering disgorgement is to make sure that the wrongdoers do not profit from their wrongdoing, <u>it would follow that the disgorgement amount should not exceed the total profits realized as the result of the unlawful activity</u>."

In the case of *Dushyant N. Dalal and Anr. v. SEBI,*[44] disgorgement powers of the SEBI were challenged on the grounds that there does not exist any specific provision in the parent legislation providing for the same, and hence such orders cannot be issued. SAT observed that:

"Since disgorgement is not a punishment but only a monetary equitable remedy meant to prevent a wrongdoer from unjustly enriching himself as a result of his illegal conduct, we are of the view that there need be no specific provision in the Act in this regard and this power to order disgorgement inheres in the SEBI."

It can be inferred from the above case laws that disgorgement has evolved from a compensatory nature in the *Hindustan Lever case*[45], then to equitable relief in the *Rakesh Agarwal case*[46] to the inherent power of SEBI in *Dushyant Dalal.*[47] The difficulty with respect to the characterisation of disgorgement as compensatory in nature is that

[44] *Dushyant N. Dalal and Anr. v. SEBI*, Appeal No. 182/2009, SAT Order dated 12.11.2010.
[45] *Hindustan Lever*, *(*n 40).
[46] *Rakesh Aggarwal*, (n 41).
[47] *Dushyant Dalal*, (n 44).

victim cannot always be clearly ascertainable and identifiable, due to the complexity of the securities market.[48]

All ambiguity with respect to the SEBI's power to pass an order for disgorgement has now been settled as the legislature in 2014 added a specific provision expressly recognising the power through the Securities Laws (Amendment) Act, 2014.[49] It expressly conferred SEBI with the power to issue a disgorgement order by inserting an explanation to Section 11B(1)[50] of the SEBI Act, which states that:

> *"For the removal of doubts, it is hereby declared that the power to issue directions under this section shall include and always be deemed to have been included the power to direct any person, who made profit or averted loss by indulging in any transaction or activity in contravention of the provisions of this Act or regulations made thereunder, to disgorge an amount equivalent to the wrongful gain made or loss averted by such contravention."*

Along with the SEBI Act, Section 21A of the Securities Contract (Regulation) Act, 1956 ("**SCRA**")[51] and Section 19 of the Depositories Act, 1996[52] was amended to expressly recognise the power of SEBI to issue an order for disgorgement. Therefore, in the Indian securities laws, disgorgement orders could be issued by the regulator, and the legislature expressly recognises such power in the SEBI Act, the SCRA, and the Depositories Act. The disgorged money is deposited in the IPEF Fund as per the SEBI IPEF

[48] *Agarwal and Baby* (n 2) at 211-212.
[49] The Securities and Exchange Board of India (Amendment) Act 2014.
[50] SEBI ACT (n 7) at s 11B (1).
[51] Securities Contracts (Regulation) Act 1956, s21A.
[52] The Depositories Act, 1996 s 19.

Regulations, unlike penalties which are deposited in the Consolidated Fund of India (in accordance with the SEBI Act, 1992).[53] The disgorged money that is deposited in the IPEF Fund is utilised as per the Regulations, and it also provides compensation to the victims where they are identifiable.[54] Currently, SEBI uses its power of disgorgement extensively in cases of violations of securities laws.

IV. DOES DISGORGEMENT PROTECTS INVESTOR?

The preamble of the SEBI Act, 1992 entrusts SEBI with the primary responsibility of protecting the interests of the investors. Perpetrators in the securities market, through their conduct, acquire ill-gotten gains, which harms the investors' interests. SEBI aims to promote healthy and orderly development of the securities market through its regulations and enhance investors' confidence.[55] An effective enforcement mechanism which creates deterrence in the securities market is essential so that it "*holds individuals and entities accountable and deters misconduct, promotes public confidence in financial services, creates an environment in which fair and efficient markets can thrive.*"[56]

Section 15JA of the SEBI Act[57] provides that sums realised by way of penalties must be credited to the consolidated fund of India, which can be utilised in the manner prescribed by the government. However, as per the SEBI IPEF Regulations, disgorged money should be credited to the SEBI IPEF

[53] SEBI ACT (n 7) at s 15JA.
[54] SEBI (Investor Protection and Education Fund) Regulations 2009, Regulation 5(3).
[55] *N. Narayanan v. Adjudicating Officer, SEBI*, (2013) 12 SCC 152.
[56] International Organization of Securities Commissions, Objective and Principles of Securities Regulation (2003).
[57] SEBI ACT (n 7) at s 15JA.

Fund. This shows the legislative intent that the Fund should provide for investor protection as well as investor education. The Article aims at highlighting a regulatory gap in the current functioning of the IPEF Fund, as the same is used for investor education but not for investor protection. In *Ram Kishori Gupta v. SEBI*[58], the SAT has aptly held that *"the basic idea behind disgorgement is restitution. As an investor protection measure, the appellants need to be compensated. Since disgorgement without restitution does not serve any purpose."*

A. Scope of Distribution of Disgorged Money and the Investor Protection Regime of India

Due to the ambiguity created by the SEBI Act and the statutes, legal aids of interpretation will have to be brought into use to resolve the same. The Supreme Court of India has held that *"the Court has to ascertain the object which the provision of law in question is to sub-serve and its design and the context in which it is enacted. If the object of the law will be defeated by non-compliance with it, it has to be regarded as mandatory."*[59] Regulation 5(3)[60] of the SEBI IPEF Regulations does provide for restitution of the disgorged money to compensate the identifiable victims, where the *'SEBI deems fit'*. This provides for broad discretionary power to SEBI in deciding whether the disgorged money should be restituted or not and thus leaves a wide room for ambiguity. This is in stark contrast to the provision under the Companies Act, 2013,[61] wherein the court is specifically authorised to distribute disgorged money out of the Investor Education and Protection Fund ("**IEPF**"), in cases

[58] *Ram Kishori Gupta v. SEBI*, 2019 SCC OnLine SAT 149.
[59] *Sharif-ud-Din v. Abdul Gani Lone*, (1980) 1 SCC 403.
[60] SEBI (Investor Protection and Education Fund) Regulations 2009, Regulation 5(3).
[61] Companies Act (n 14) at s 125(3)(c).

where the applicants who have suffered losses due to wrong actions by any person are identifiable. It is also pertinent to note that in the SEBI IPEF Regulations, the distribution of disgorged money is an administrative action giving the regulator a wider discretionary power, whereas, under the Companies Act,[62] the power is vested upon the court and is thus a judicial action.

Whilst there is no explanation provided for the creation of the IPEF Fund by SEBI, underlying intent could be imported from Section 308(a) of the Sarbanes-Oxley Act, 2022[63] ("**SOX Act**"), which provides for the creation of a Fair Fund and authorises the *"SEC to inter alia, utilise the disgorgement funds for the benefit of victims of securities law violation".* Further, SAT has held in the case of *Ram Kishori Gupta v. SEBI*[64] that the *"basic idea behind disgorgement is restitution*".

An analysis of various disgorgement orders and their recent rise shows that SEBI is increasingly resorting to disgorgement of 'ill-gotten gains' where the same could be quantified. In the recent past, the amount collected through disgorgement has exponentially increased.[65] Further, the Supreme Court in the case of *Sahara Real Estate Corp. Ltd. and Anr. v. SEBI*[66] held that the legislative mandate for the protection of investors' interests is best served when SEBI compensates the harmed investors.

[62] ibid.
[63] Sarbanes-Oxley Act of 2022s 308, Pub. L. No. 107-204 (2002).
[64] *Ram Kishori Gupta (*n 58).
[65] Dr. S.N Ghosh, 'Protection of Harmed Investors: The Missing Link in the Disgorgement Orders of the SEBI', (2020) 14 NSLR < https://nslr.in/wp-content/uploads/2020/07/NSLR-Volume-XIV.pdf> accessed 10 September 2023.
[66] *Sahara Real Estate Corp. Ltd. and Anr. v. SEBI*, (2012) 172 Comp Cas 154 (SC).

B. Investor Protection & SEBI's Utilisation of the IPEF Fund

Regulation 5 of the SEBI IPEF Regulations deals with the utilisation of the IPEF Fund by SEBI. It could be used for purposes like:

- Educational activities, research, training and seminars[67];
- Investor awareness programmes[68];
- Aiding investors' associations to undertake legal proceedings[69];
- Expenses and travel for the members of the Committee[70];
- Restitution of amounts disgorged for compensating eligible and identifiable investors who have suffered from losses[71], among others.

The authors have analysed SEBI Annual Reports for the past four financial years (2019-20, 2020-21, 2021-22, 2022-23) to ascertain whether SEBI actually utilises the disgorged money credited to the IPEF Fund for protecting investors' interests and compensating the victims. The findings are consolidated in the below-mentioned tables:

IPEF Expenses	Amount (in Rs. crore)
Financial Literacy	38.62
Seminar / Workshops by SMARTs	3.16
Seminars / Workshops by Investor Associations	1.72
Investor Education	15.08
Seminars / Workshop by CoTs	0.35
Capital Grants	0.06
Committee meetings	0.029
Others	0.412

67 SEBI (Investor Protection and Education Fund) Regulations 2009, Regulation 5(2)(a).
68 ibid at Regulation 5(2)(b).
69 ibid at Regulation 5(2)(d).
70 ibid at Regulation 5(2)(f).
71 ibid at Regulation 5(3).

Table 1: Expense-wise Utilisation of IPEF Fund by SEBI from 2019-20 to 2022-23.[72]

Year	IPEF Inflow (in Rs. crores)	IPEF Outflow (in Rs. crores)	Utilisation of IPEF in %
2021-22	1,720.1	6.81	0.39%
2020-21	1,203.1	28.84	2.3%
2019-20	883.44	11.84	1.3%

Table 2: Year-wise utilisation of IPEF Fund by SEBI.[73]

From the above tables, it can be inferred that during the above period of study, SEBI never utilised the disgorged money credited to the IPEF Fund to compensate the harmed investors through restitution. It also shows that the majority of the expenditure incurred in the IPEF Fund is only with respect to 'investor education' and not 'investor protection'. Further, the overall utilisation rate of the IPEF Fund from 2019 to 2022 has remained abysmally low, averaging at 1.33%. This defeats the intent behind disgorgement, which aims to be an equitable remedy and to compensate the identifiable victims. In the authors' opinion, this is due to the fact that Regulation 5(3) of the SEBI IPEF Regulations does not prescribe any procedure to be followed by the regulator while utilising the disgorged amounts for restitution, and hence, leaves an expansive room for administrative discretion.

On the contrary, in the USA, the SEC has issued an elaborate "Rules of Practice and Rules on Fair Fund and Disgorgement Plans."[74] It mandates the creation of a fund for the disgorged amounts, which shall be used for the

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[72] Securities & Exchange Board of India, Reports & Statistics- Annual Report 2022-23, Annual Report 2021-22, Annual Report 2020-21, Annual Report 2019-20, (*SEBI*, August 7, 2023) <https://www.sebi.gov.in> accessed 15 August 2023.
[73] ibid.
[74] U.S. Securities and Exchange Commission, Rules of Practice (*SEC*, 2018) <https://www.sec.gov/about/rules-of-practice-2018.pdf> accessed 15 August 2023.

benefit of the harmed investors. It also requires the regulator to have a plan for the distribution of funds in a disgorgement fund. The Rules further state that:

> *"Submit a plan for the administration and distribution of funds in a Fair Fund or disgorgement fund within 60 days. It will also contain a detailed plan for administration and distribution of funds to the harmed investors. The plan will include 'categories of persons potentially eligible to receive proceeds; procedures for providing notice to such persons of the existence of the fund and their potential eligibility to receive proceeds of the fund; procedures for making and approving claims, procedures for handling disputed claims, and a cut-off date for the making of claim; procedures for the administration of the fund, including selection, compensation; proposed date for the termination of the fund, including provision for the disposition of any funds not otherwise distributed and such other provisions as the Commission or the hearing officer may require."*

The authors suggest that a similar provision on the lines of the SEC's "Rules of Practice and Rules on Fair Fund and Disgorgement Plans" be enacted in India. It would streamline the process of distribution of disgorged amounts. Further, having a disgorgement plan in place will help in reducing administrative discretion that is involved in the process of determining harmed investors and the procedure for restitution of the disgorged amount. SEBI can also draw inspiration from the SEC and can have a dedicated 'Information for Harmed Investors' portal,[75] where harmed investors can fill out an 'Investor

[75] U.S. Securities and Exchange Commission, Information for Harmed Investors (SEC, 7 August 2021) <https://www.sec.gov/enforce/information-for-harmed-investors> accessed 15 August 2023.

Claim Form'. With advancements in surveillance mechanisms of the SEBI, tracing and identifying harmed investors is not as challenging as it used to be a decade ago.[76] All transactions in the capital markets are now routed digitally and leave a footprint and an audit trail. Therefore, validating claims of harmed investors will not be a herculean task for SEBI, and the same can be undertaken with the necessary systems in place.

V. DOES DISGORGEMENT ACTUALLY REVERTS THE WRONGDOER TO THE STATUS QUO?

The theoretical framework of disgorgement showcases the remedial nature of disgorgement and the intent of SEBI to create a market that protects the interest and confidence of investors. The primary intent of disgorgement is to return the wrongdoer to the *status quo*, by stripping the defendant off their ill-gotten gains. SEBI, has time and again, characterized disgorgement as a remedial action only aimed at returning the wrongdoer to the *status quo* and no worse, or else it would take the colour of a penalty.[77] Lest in practice, disgorgement does not provide the most equitable outcome. To assess the practicality of disgorgement, the authors have analysed SEBI orders from January 1, 2018, to July 15, 2022.

This consists of 551 orders against 46 companies and 60 noticees. Out of 551 orders, cases under SEBI (Prohibition of Fraudulent & Unfair Trade Practices) Regulations, 2003 ("**PFUTP**") constituted 80% of cases, SEBI (Prohibition of Insider Trading) Regulations, 2015 ("**PIT**") constituted 16% of cases, 3% cases included both PFUTP and PIT regulations and the

[76] *S.N. Ghosh (*n 65).
[77] *S. Vivek* (n 17).

remaining 1% were neither PFUTP nor PIT but other regulations like the SEBI (Substantial Acquisition of Shares & Takeover Regulations), 2011 ("**SAST**") etc. 226 cases (41%) had no direction of disgorgement and the remaining 325 cases (59%) had a direction for disgorgement. Out of the 325 cases, 194 cases (60%) had joint or several liability while 131 cases (40%) did not have joint or several liability.

Before delving into further analysis, we need to understand the applicability of disgorgement holistically. The Karvy case[78] provides a four-fold test for the same.

- ***Contravention of SEBI Act or regulations***

The first precondition is clearly laid down by the statute that there must be a contravention of any regulation. This implies that SEBI first must prove infringement like any private remedy. SEBI has taken a liberal approach in the interpretation and included SEBI circulars within the same ambit. In the period of the current study, a very small portion of orders were issued on the basis of circulars.

- ***Profit or loss averted by Noticee***

The statute expressly indicates the applicability of disgorgement when either profit was made, or loss was averted. Thus, there is an emphasis on gain, making it a defendant-oriented remedy.

- ***Such profit or loss to be in contravention of law***

[78] *Karvy Stock Broking Limited* (n 43).

` The statute further restricts the scope to acquiring the gain through any act which infringes the law. There is an express requirement for a reasonable nexus between contravention of law and wrongful gains made by the noticee.

- ***Return to the status quo***

As deciphered that disgorgement implies the status quo of the defendant, meaning, to put the defendant in a position before he acquired the wrongful gains or avoided losses. This indicates the non-penal nature of disgorgement.

A. Statistical Analysis of SEBI Disgorgement Order from 2018

When the orders of SEBI are analysed on these tests, it is found that in 9% of cases wherein disgorgement was ordered, the defendants made no profits or had averted no losses, which makes the application of disgorgement not only inequitable but also penal in nature by erasing the distinction between disgorgement and penalty. This would transform disgorgement virtually into a penalty. In the 295 cases where disgorgement was ordered on the basis of gains made in contravention of law, out of which in 180 cases, the order identified such gains as 'notional', while in 23 cases (8%), it was not clear. This indicates that SEBI imposed disgorgement on certain assumptions as in the majority of cases, the noticee did not generate any illegal gain. The complication with notional gains is that the calculations are based on assumptions, and the status quo cannot be assessed with precision. It is evident from the data that when notional profits/loss cannot be ascertained the disgorgement amounts are drastically higher. Further, through their analysis, the authors have also found that during the period of study, none of the cases have a finding that the direction of disgorgement only returns the wrongdoer back to the *status quo* and not worse. An analysis of disgorgement orders from 2018 to 2021 is mentioned in the below table:

Regulation	**Number of orders**	**Disgorgement Amount (Rs. Million)**
Others	3	3604.75
PFUTP	221	10.94
PIT	72	127.96
SEBI Orders	23	5.90

Table 3: Analysis of SEBI Disgorgement orders with respect to various regulations

VI. CONCLUSION

The Article begins with understanding disgorgement as a remedial measure and traces its jurisprudential evolution through various case laws in the USA and India. It also lays down a distinction between disgorgement and other remedial actions like penalty, restitution and forfeiture. In the later part of the Article, the authors have attempted to study the effectiveness of disgorgement carried out by SEBI from two perspectives- firstly, whether the disgorged amounts credited to the SEBI IPEF Fund are being effectively utilised for restituting the harmed investors through compensation; and secondly, whether the disgorgement orders of SEBI actually revert the wrongdoer to the *status quo* and not a worse off position, which would paint it as a penalty.

In the first part, the authors have analysed the inflows and outflows to the IPEF Fund as provided in the SEBI Annual Reports from 2019 to 2023. It can be concluded that in the period of study, the regulator has never utilised the disgorged amount credited to the Fund for restituting the harmed investors. While on the other hand, it has collected more than Rs. 3,748 million through the disgorgement of ill-gotten gains. Unutilised money collected through disgorgement amounts to unjust enrichment by the SEBI. The cardinal principle governing the law of restitution is that *"a person who has obtained a benefit at the expense of another should be liable to restitute the other from whom he has gained."*[79] It has also been held by SAT that *"disgorgement without restitution serves no purpose."*[80] In conclusion, specific guidelines should be provided in the SEBI IPEF Regulation wherein the disgorged amounts should be used for compensation of the harmed investors upon identification. The regulator can draw inspiration from the SEC's "Rules of Practice and Rules on Fair Fund and Disgorgement Plans".

In the second part, the authors have statistically analysed all SEBI orders for disgorgement from 2018 to 2022. The justification given by SEBI for categorising disgorgement as an 'equitable and remedial' power is that it only aims to return the wrongdoer back to the *status quo* and not worse. If the latter is the case, then it would become a penalising action. We have found that in none of the cases is there a direction that the wrongdoer has reverted to the *status quo* and is not worse off. Therefore, the critical element that qualified disgorgement as an equitable remedy is missing.

SEBI's power of disgorgement has failed on both the grounds mentioned above, and therefore the premise that disgorgement is always an equitable remedy is incorrect. The authors conclude by stating that disgorgement requires reconsideration from the legislature. Specific

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[79] *Renusagar Power Co. Ltd. v. General Electric Co.*, 1994 Supp (1) SCC 644.

[80] *Ram Kishori Gupta* (n 64).

guidelines must be prescribed for the utilisation of the disgorged amounts and curbing of the administrative discretion of SEBI in the same.

ARTICLES