M&A Thought Leadership:

Spotlight on Some Current Issues

cyril amarchand mangaldas
advocates & solicitors

character • competence • commitment

Contents*

M&A Thought Leadership : Spotlight on Some Current Issues

*Disclaimer:

This publication is not intended to serve as legal advice. The position of law expressed in the article is only valid as on 30th May 2019.

SBO Rules for trust structures

Over the past decade, there has been a renaissance of trusts as holding entities for private family wealth in India, particularly equity holdings in companies. Trusts have, however, typically been viewed as opaque entities and limited information was available till now on the controlling elements of trusts that are shareholders of companies. The recently introduced significant beneficial ownership regime seeks to change this by enhancing disclosures, but the rules will need further evolution to effectively peel through all the layers.

Following the FATF recommendation in 2017, detailed provisions on identification and disclosure of significant beneficial owners (**SBO**) of Indian companies was introduced in the Companies Act, 2013 (**2013 Act**). To further detail the SBO regime, the Companies (Significant Beneficial Owner) Rules, 2018 (**SBO Rules**) were notified in June 2018 (and later amended in February, 2019).

As per these provisions, every SBO is required to file declarations of his/her SBO status and change thereof with the company of which he/she is an SBO (**Reporting Company**), within a specific period of time. The Reporting Company in turn is required to file a return in respect of each such declaration with the Registrar of Companies and also to maintain a register of SBOs for inspection by its members.

Additionally, pursuant to a circular of the Securities and Exchange Board of India dated December 7, 2018 (modified on March 12, 2019), listed companies are required to disclose their SBOs, as part of the quarterly filing of their shareholding pattern with the stock exchanges, effective from June 30, 2019.

Identification of SBOs

An SBO of a Reporting Company is an individual who, acting alone or together with one or more persons or trusts, (i) holds (indirectly, or together with direct holdings) not less than 10% shares/ voting rights/right to receive dividend (**Interests**); or (ii) has the right to exercise, or actually exercises, significant influence or control over the Reporting Company.

If a trust (onshore or offshore) is a member of the Reporting Company (**Member**), the SBO Rules provide the manner of determination of the individuals who hold Interests for identification of the SBO. If the Interests exceed 10%, such individuals would qualify as SBOs.

- ### *Discretionary trusts*

Where the Member is a discretionary trust, every trustee who is an individual is to be regarded as holding Interests in the Reporting Company.

Trustees are legal owners of trust assets and are disclosed as members of the companies whose shares they hold. Therefore, the SBO declaration is, in its present form, unlikely to meaningfully supplement the information already available in the records of the company or depositories.

Further, the SBO provisions are silent on the manner of determination of the SBO if the trustee of the discretionary trust is not an individual. As a result, a vacuum exists in respect of those discretionary trusts whose sole trustee is a private trustee company or professional trustee, which are now quite commonplace.

Notably, beneficiaries of the trust are not regarded as having Interests in the discretionary trust, for the purpose of determination of SBO status. This is logical as, in a discretionary trust, beneficiaries do not have a fixed or vested share or interest in the underlying trust assets; their entitlement is entirely dependent on the trustees exercising their discretion to distribute the trust fund to them.

- ### *Specific / determinate trusts*

Where the Member is a specific/determinate trust, every individual beneficiary is to be regarded as holding Interests in the Reporting Company.

Unlike discretionary trusts, the share/interest of beneficiaries of determinate trusts is fixed by the trust instrument. Therefore, each beneficiary is assured of receiving the determined benefit from the trust. Interestingly, the SBO Rules do not lay down a numerical threshold for determining beneficiaries who hold Interests - therefore, even beneficiaries having miniscule shares will be regarded as holding Interests in the Reporting Company. Further, there is no distinction between income-only beneficiaries and capital beneficiaries.

- ***Revocable trusts***

A revocable trust is one which the settlor can revoke and then reclaim trust assets. In keeping with the ability of the settlor to control the trust assets, if the Member is a revocable trust, the settlor is to be regarded as holding Interests in the Reporting Company.

- ***Charitable trusts***

If the Member is a charitable trust, then as with discretionary trusts, the individual trustee is to be regarded as holding Interests in the Reporting Company. Few charitable trusts in India hold equity shares on account of restrictive income tax provisions - therefore, this provision would be relevant for only those charitable trusts whose shareholding was grandfathered from the income tax provisions or who do not claim income tax exemptions.

Laudable but lacking

In recent times, Indian promoters have been embracing hybrid and sophisticated holding structures, in keeping with global best practices. At the same time, while regulators have been trying to replicate international standards on increased disclosure of such structures, they have not necessarily managed to keep pace with the growing innovation on trust structures. For example, the SBO Rules do not contemplate a multi-layered hybrid structure with a company as the direct member and a trust as the ultimate holding entity, which is now a fairly ubiquitous structure. Further, they do not envisage office holders such as protectors, who often pull the strings in modern trust structures.

Therefore, although SBO declarations should now form a key diligence item for M&A transactions (particularly in respect of promoter holdings), owing to gaps in the SBO Rules in relation to trusts, the disclosures may not provide the full and correct picture on holdings through trust structures, particularly those which are not plain vanilla.

Valuation under the Companies Act for corporate transactions

Valuation remains the single most important factor and forms the basis for any corporate transaction. Prior to the introduction of the Companies Act, 2013 (**Companies Act**), valuation of securities, assets, net worth etc. in relation to corporate transactions was traditionally undertaken by chartered accountants or persons prescribed by the relevant applicable law, depending upon the nature and the purpose of the valuation. Company law itself did not prescribe the nature or qualification of the valuer. Further, no specific standards or guidelines were prescribed in relation to valuation.

The Companies Act, for the first time, introduced the concept of a registered valuer, stipulating that if any valuation is required to be made in respect of any property, stocks, shares, debentures, securities, goodwill or other assets or net worth or liabilities of a company, such valuation has to be undertaken by a registered valuer, to be appointed by the audit committee or the board of directors (in the absence of an audit committee). The Companies (Registered Valuers and Valuation) Rules, 2017 (**Valuation Rules**) sets out the requirements on the eligibility, qualifications and experience of a registered valuer; the Insolvency and Bankruptcy Board of India (**IBBI**) has been designated as the registering authority with respect to registration of valuers.

Requirement for Valuation

Key instances that require valuation to be undertaken by a registered valuer under the Companies Act read with the rules framed thereunder include: (a) further issue of securities by way of preferential allotment or sweat equity shares, (b) non-cash transactions with directors, (c) schemes for amalgamations, compromises or arrangements with creditors or members, (d) arriving at the reserve price for the sale of any industrial undertaking of a company or for fixing of lease rent or share exchange ratio, (e) submission of company liquidator's report to the tribunal for the purposes of winding up a company and (f) declaration of solvency in case of a proposal to voluntarily wind up a company.

In order to bring in more transparency and governance, the Companies Act read with the Valuation Rules require the registered valuer to clearly spell out, in the valuation report, the background information of the asset being valued, purpose of valuation and appointing authority, identity of the valuer and any other experts involved in the valuation, disclosure of valuer interest/conflict, if any, date of appointment, valuation date and date of the report, sources of information, procedures adopted in carrying out the valuation, valuation methodology, major factors that influenced the valuation, conclusion, caveats, limitations and disclaimers. Further, the registered valuer is required to back the valuation with proper due diligence.

Standard of Valuation

The Valuation Rules require the valuation to be undertaken in accordance with the valuation standards notified by the Central Government from time to time. Until such time as the valuation standards are notified, the registered valuers shall undertake valuation through: (a) an internationally accepted valuation methodology, (b) valuation standards adopted by any valuation professional organisation or (c) valuation standards specified by the Reserve Bank of India, Securities and Exchange Board of India or any other statutory regulatory body. The Institute of Chartered Accountants of India (**ICAI**) has issued the 'ICAI Valuation Standards, 2018' (**ICAI Valuation Standards**) to set up concepts, principles and procedures which are generally accepted internationally having regard to the legal framework and practices prevalent in India. The ICAI Valuation Standards were made applicable for all valuation engagements under the Companies Act and were effective for valuation reports issued on or after July 1, 2018.

Liability of the Valuer

Further, to ensure that the highest standards are followed, the Valuation Rules restrict the registered valuer from disclaiming liability for his/its expertise or deny his/its duty of care (except to the extent that the assumptions are statements of fact provided by the company and not generated by the valuer). Further, the registered valuer is required to back the valuation with proper due diligence. Proceedings can be initiated against registered valuers in instances of contravention of the applicable provisions of the Companies Act and the Valuation Rules by the registered valuer. Contravention may also result in imprisonment if it is determined that contravention was with an intention to defraud the company or its members as well as de-registration.

Teething troubles and Practical Experiences

Though it took a while for the Government to get the framework for valuation and the registered valuer in place, the move has seen a positive response. Having said that, certain issues persist. A big concern is the shortage of registered valuers. As of May, 2019 there are only over 1600 valuers who have registered themselves with the IBBI, which is insufficient to cater to the high levels of transactional activity in corporate India. There is an urgent need to increase this number significantly.

Valuation itself continues to be a highly fact-specific activity. This has been acknowledged by the Indian courts which have ruled that valuation is not an exact science. While the courts have been reluctant to impugn or interfere with the valuations by experts in the absence of any fraud or illegality, challenges to valuation can frequently delay transactions. Subject to the evolving jurisprudence on the matter, the law in its current form should ensure that the quality of valuers, and resultantly the valuation, is not compromised, resulting in better valuation reports, which would be beneficial to all the stakeholders. With express personal liability for registered valuers, it is expected that they will perform their duties diligently and 'opinion-shopping' will reduce.

Schemes of arrangement in liquidation - a second chance for bidders?

The landmark Insolvency and Bankruptcy Code, 2016 (**IBC**) enacted to address the burgeoning non-performing loan problem in the Indian banking system presents an attractive opportunity for acquisition of stressed, but otherwise sound, assets. An interested bidder, meeting pre-qualification criteria that creditors may impose, has the opportunity to present a resolution plan for resolving the debt, and acquiring control, of the insolvent company. Since persons in control of defaulting companies are usually disqualified from proposing resolution plans, third party buyers can bid to acquire such companies at competitive valuations. However, where no resolution plan is received, or plans received are rejected by either the creditors' committee or the adjudicating authority, the IBC provides for mandatory liquidation of such insolvent company.

Bidders may however have a second opportunity to acquire such companies given the recent spate of judgements by the National Company Law Appellate Tribunal (**NCLAT**), directing/encouraging the liquidator to explore revival through a scheme of arrangement, prior to undertaking a sale under liquidation.

Schemes of Arrangement and Liquidation

Company law in India allows companies, their members, creditors, and for a company being wound up, the liquidator, to propose a "scheme of compromise or arrangement" between a company and its creditors or members or any class of each. The ambit of what is possible under a scheme of arrangement is wide, and includes debt restructuring, corporate and capital restructuring. Although originally introduced to bail out companies facing liquidation, in recent times, such schemes have been used more for mergers and other forms of corporate restructuring, including a recent trend towards acquisition transactions being undertaken through a scheme (which offers the advantage of an all-stock transaction). While the Companies Act, 2013 (**Companies Act**) has always allowed a liquidator to prefer a scheme of compromise or restructuring, in view of the current liquidation regime (now under the IBC and not the Companies Act), this route poses interesting challenges.

Ambiguities under the IBC

The direction of judicial thinking seems to be in line with the policy intent of facilitating resolution in the interests of all stakeholders, with liquidation being initiated as a last resort. This has been reiterated by the judiciary in several cases, including in the landmark judgement of the Supreme Court upholding the constitutional validity of the IBC, *Swiss Ribbons Pvt. Ltd & Anr* v. *Union of India and Ors while drawing reference to the long title of the IBC.*

Interestingly, this is not borne out by the express scheme of the IBC, which provides clear steps for time bound insolvency resolution, failing which, an insolvent company is mandatorily required to be liquidated. There are, however, hints of a potential resolution in liquidation in Regulation 32 of the IBBI (Liquidation Process) Regulations, 2016 (**Liquidation Regulations**), which allows a liquidator to sell "the corporate debtor as a going concern". While it is debatable whether this includes a scheme of arrangement under which the corporate debtor survives, the Insolvency and Bankruptcy Board of India (**IBBI**) is attempting to provide a clearer framework - it's discussion paper of April 27, 2019 proposes inclusion of a new regulation in the Liquidation Regulations, which will allow the liquidator, a creditor (or class of creditors), or a member (or class of members) to propose a compromise/arrangement under Section 230 of the Companies Act. Under the proposed amendments, the liquidation process is suspended if a scheme for compromise or arrangement is receivedwithin 10 days, and reinitiated if the application to initiate the scheme process, or the scheme itself, is

not approved within the prescribed time period.

While this will certainly provide an enabling framework, various other questions remain unanswered.

Interaction of Two Parallel regimes

At present, the IBC and Liquidation Regulations provide a time bound process for liquidation. While the proposed amendments allow suspension of the liquidation process for an (extendable) period of 3 months if a scheme of arrangement is proposed, pending such amendment, will the two processes run parallel? For instance, the liquidator is ordinarily required to sell assets through a public auction in a time bound manner. How will this tie in with a sale as a going concern to a potential acquirer under a scheme of arrangement? Further, schemes of arrangement typically take not less than 6-9 months to be completed -s even if the Liquidation Regulations are amended, the timeline of 3 months provided is woefully inadequate and extensions will become the rule rather than the exception.

Schemes of arrangement in liquidation - a second chance for bidders? (contd.)

Process Uncertainties

Presentation and implementation of a scheme of arrangement continues to be governed by the Companies Act. The requirements prescribed thereunder could complicate the process in a liquidation scenario, reintroducing approval requirements which are exempted during the preceding insolvency resolution process.

Illustratively, the Companies Act requires: (i) pre-approval of 75% of secured creditors to a scheme of arrangement; and (ii) approval of a majority of persons representing ¾ in value of each class of shareholders and creditors (in separate class meetings, with very limited exemptions) of companies which are parties to the scheme.

- This is contrary to the liquidation process under which no such approvals are required. Even applying the IBC requirements for insolvency resolution, only 66% (in value) of the creditors committee must approve a resolution plan, and exemptions have been granted from shareholders approval requirements. Since these exemptions are specifically for actions taken pursuant to a resolution plan, they would not extend to a scheme of arrangement in liquidation. While approvals required will be a fact specific determination (for instance, if the scheme is only for debt resolution with the creditors where members rights are not impacted, no shareholders resolution may be required, unlike a scheme which contemplates acquisition of control or a write down of existing capital), this increases compliance requirements.

- How will "class" be construed in this context? Company law jurisprudence has established that persons who have commonality of interests are considered a class for approval of a scheme of arrangement. Different classes with different interests must each approve a scheme with the required majority –secured and unsecured creditors are traditionally considered separate classes, holders of debentures may be considered a distinct class as well. The IBC categorises creditors into 'financial creditors' and 'operational creditors'. If the traditional classification of secured and unsecured creditors is applied, operational creditors (including government and statutory creditors) will be included in the unsecured creditor class and accordingly, there could be enhanced approval requirements with equal weightage to smaller but distinct classes of shareholders and creditors, adding to the uncertainty.

Regulatory Approvals

Various regulators have provided exemptions from compliance with procedural formalities / conditions under a resolution plan to enable swift resolution. In particular, a scheme of arrangement involving a listed company requires pre clearance from SEBI/the stock exchanges, and has various conditions and procedural compliances which do not apply to a resolution plan, but will apply to a scheme in liquidation. This will further complicate and extend the timeline.

A second chance for promoters

Section 29A of the IBC disqualifies promoters of defaulting companies from proposing a resolution plan, and the IBC prohibits the liquidator from selling assets to such persons. It is unclear whether this embargo will extend to schemes of arrangement proposed by promoters – the proposed amendments to the Liquidation Rules allow any member to propose a scheme, and the Discussion Paper specifically notes wthat the application of 29A was considered and rejected. While it is a settled position that no person has an inherent right to have their resolution plan considered, a member of the company (including a promoter) may assert that such a right exists under Section 230 of the Companies Act.

Looking Ahead

While the intent behind introducing the option of restructuring through a scheme of arrangement as an intermediate step before liquidation is laudable, there are practical and regulatory challenges to successful implementation given the current legal framework. The success of this form of resolution may depend to a large extent on whether the Government and other regulators amend laws, and tribunals progressively create jurisprudence to facilitate the same. It may better serve stakeholders to explore a scheme of arrangement to rehabilitate an insolvent company prior to initiation of insolvency proceedings.

Due Diligence and the insider trading rules

Acquisition of / investment in a company (**Target**) is usually preceded by a due diligence exercise by a proposed investor. The objectives of due diligence include ascertaining the Target's valuation, reviewing compliance with applicable laws, flagging business and transaction risks and identifying requirements for consents / approvals. If the Target is listed, material information pertaining to it is usually available in the public domain under robust Indian securities law disclosure requirements. Investors may nonetheless seek additional information before a material investment in a listed Target, which may include unpublished price sensitive information (**UPSI**), to facilitate an in-depth analysis of the Target's business. This could pose issues, since the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (**PIT Regulations**) prohibit both communication and procurement of UPSI, subject to certain limited exceptions.

What is UPSI?

The PIT Regulations define 'UPSI' as any information relating to a company or its securities, directly or indirectly, that is not generally available and which upon becoming generally available, is likely to materially affect the price of the securities. Categories of information that are prescribed as ordinarily constituting UPSI, include information relating to: (i) financial results; (ii) dividends; (iii) change in capital structure; (iv) mergers, de-mergers, acquisitions, delisting, disposals and expansion of business and similar transactions; and (v) changes in key managerial personnel.

The Diligence Exception

One exception to the prohibition on sharing of UPSI is where information is proposed to be shared in connection with a transaction, if the board of directors of the Target (**Board**) is of the informed opinion that sharing such information is in the best interests of the Target. Therefore, before a Target shares UPSI with a potential investor and conversely, before an investor accesses UPSI, parties should ensure that the Board has passed appropriate resolutions to this effect. The Board must also ensure that a structured digital database is maintained containing names of persons or entities with whom UPSI is shared, along with corresponding identifiers authorized by law. It is interesting to note that in March 31, 2019, the Board's obligation to determine the desirability of sharing of information replaced its obligation to determine whether the 'proposed transaction' is in the best interests of the Target, thereby reflecting the regulatory acknowledgement that a Board may not be in a position to determine the viability of a proposed transaction at the diligence stage.

While this regulatory change is welcome, certain other challenges remain. A Board's determination of whether to share UPSI is comparatively easier in a primary issuance of securities (factors could include a strategic investor adding value to the business, or a financial investor providing funds without day-to-day interference in management). However, for secondary transactions between shareholders, the Board may not even be aware of the identity of the investors. In such instances, it is debatable whether the Board is equipped to ascertain whether sharing of information would be in the best interests of the Target. Prior to approving the disclosure of UPSI in these cases, the Board should preferably undertake an enquiry on the potential investor and the proposed transaction, to be able to arrive at an informed decision of benefits and drawbacks of sharing UPSI. However, such an enquiry may not be feasible if the parties to the transaction intend to maintain confidentiality.

Other Conditions

Before sharing UPSI under the above exemption, the Target is obligated to execute confidentiality and non-disclosure agreements with parties, and the recipient of UPSI is required to keep the UPSI so received confidential (except for the purposes of the proposed transaction). The recipients are also prohibited from trading in the Target's securities when in possession of UPSI. Again, in the case of a secondary sale, the Target may not be in direct dialogue with the buyer, and it is typically the selling shareholder (in India, often a promoter) who requests such information for sharing. In such a case, care must be taken to ensure that the obligations under the PIT Regulations are equally adhered to for all persons with whom UPSI is being shared, directly and indirectly.

Information Symmetry

The PIT Regulations impose a number of checks and balances to ensure information symmetry in the market between the stage of due diligence and consummation of a transaction. If a transaction involves an open offer, the offer documents must disclose all information required to enable shareholders to make an informed decision on the offer and cannot omit any relevant information. If UPSI has been shared in connection with a transaction that does not involve an open offer, the UPSI must be disseminated and made generally available at least 2 trading days prior to the proposed transaction being effected, in such form as the Board may determine to be adequate and fair to cover all relevant and material facts.

What if the Deal Fails?

The PIT Regulations do not prescribe any mechanism to disseminate UPSI or "cleanse" a potential investor of its knowledge of UPSI where due diligence is undertaken but the transaction fails for any reason. In such cases, the potential investor in possession of UPSI is prohibited from trading in the Target's securities so long as the information it possesses continues to be unpublished and price sensitive. An added complication is the absence of bright line tests to determine when information ceases to be price sensitive. Pending further clarity on such cleansing mechanisms, investors conducting due diligence on (or otherwise accessing UPSI of) a listed Target, could seek to protect themselves contractually including by requiring UPSI to be explicitly marked and prescribing timelines after which such information will be mandatorily disclosed or otherwise cease to constitute UPSI. Of course, the practicality of these measures depends on the nature and extent of UPSI being shared.

M&A Governance : Five takeaways for directors of Indian companies

India is seeing greater regulatory and investor scrutiny of the role of the Board in M&A transactions. Once protected under the shield of the business judgement rule, the issues underlying Board responsibility in M&A transactions are no longer just on fair valuation or strategic fit. Red flags are raised on more nuanced positions of stakeholder governance, internal controls to prevent personal 'kickbacks', higher standards of conflict of interest, litigation/ bankruptcy risk arising from fraud/ misrepresentations, and lapses in process (whether inadvertent or otherwise). Drawing from lessons that can be learnt from recent cases, we summarise below five takeaways for persons sitting on the Boards of Indian companies while evaluating transactions:

01 Identify and Balance trade-offs between Stakeholders

02 Closely consider potential conflict of interest and exercise independent judgement

03 Don't be late to the Related Party

04 Ensure adequate and fair disclosure to the buyer and the shareholders

05 Be Militant about Process

Identify and Balance trade-offs between Stakeholders

The Companies Act, 2013 has codified the stakeholder governance model. It mandates that directors must act in the best interests of the company, its shareholders, its employees, the community and for the protection of the environment (Sec. 166). As a first step, this would involve identification of the respective interests of each stakeholder in the relevant M&A transaction, discerning the trade-offs to be made amongst the interests so identified, and thereafter, making a decision that prima facie demonstrates the balanced interest of all stakeholders. Boards can no longer review M&A transactions solely from the perspective of the interests of the company as a whole. In a recent case, an influential minority shareholder of a company in the hotel industry questioned the decision of the board as 'mismanagement and oppression' for having sold material assets to a foreign buyer, where the bulk of the proceeds were proposed to be used to repay a lender who was also a significant shareholder of the company, arguably to the detriment of all other shareholders of the company (demonstrating disproportionate consideration of one shareholder's interests).

Closely consider potential conflict of interest and exercise independent judgement

To ensure that personal interest does not take precedence over collective interest of all stakeholders, the Board is tasked with the duty of being a gatekeeper to M&A. In addition to the duty of the Board to review a potential M&A transaction from a strategic and financial perspective, the law also mandates the Board to assist executive management by challenging the assumptions underlying the acquisition and make a critical risk assessment. In a recent instance, the role of the Board and the process followed was closely reviewed in multiple investigations following an anonymous whistle-blower complaint that the executive management had received 'personal kickbacks' in two overseas acquisitions undertaken by a listed Indian multinational. The said acquisitions went up for sale in less than two years of the acquisition, at a valuation of less than 50% of the acquisition price, which factor added further concern to the issues raised in the whistleblower complaint.

Don't be late to the Related Party

The law mandates several checks and balances for related party transactions, which include disclosure and recusal of interested directors, prior approval of audit committee and shareholders. The role of the Board in approving related party transactions has often come under fire due to fraudulent transactions that may not surface during routine process checks. While the learnings from the Satyam case are still being internalized by corporate India, in another recent case, a merger between a parent and subsidiary of a multi-national corporation was severely criticized by the analysts and minority shareholders as the deal was alleged to be the parent company's attempt to socialize its debts across the minority shareholders of both the companies (to the benefit of the promoter) as the scheme contemplated that the existing loan from the merging entity to surviving parent be written off.

Ensure adequate and fair disclosure to the buyer and the shareholders

Adequate and fair disclosure has increasingly become a sticky area of board responsibility in M&A transactions. This responsibility applies as much towards shareholders, as it does towards counterparty buyers in M&A transactions. In a recent cautionary tale related to the acquisition of a pharmaceutical company, the consequences of suppression/ misrepresentation was brought to the fore where, after completion of the acquisition, it was found that adequate disclosures had not been made in respect of pending regulatory action of the United States Food and Drug Administration. This ultimately resulted in the award of significant damages against the seller pursuant to arbitration proceedings instituted in the matter. Similarly, the standard of disclosure to shareholders was also keenly considered in another matter where two business groups in India announced a merger of their financial services business. In this case, the proxy advisory firms recommended against the proposal on the grounds that the rationale behind the payment of a heavy non-compete fee to the promoters of the merging entity was unclear.

Be Militant about Process

Irrespective of whether the M&A is a negotiated acquisition, scheme of arrangement, or a strategic defence against a hostile takeover, the Board is obligated to ensure that it's decision-making is not only fair, but is also seen to be fair. It has been found time and again that, due and diligent process becomes the bedrock of a defence against director liability for an M&A gone wrong. For instance, any chance of building a case around the Corwin doctrine (which laid down that a transaction will be protected under the business judgment rule if it has been approved by a majority of fully informed and un-coerced stockholders) is heavily dependent on the process adopted and followed by the Board in approving a transaction. It is also more likely that the regulatory consequences on failure of process, such as not seeking prior approval of the audit committee, not only attracts a definitive penalty for regulatory breach but also drives other negative inferences on the discharge of the board of its fiduciary responsibilities to shareholders.

Strategic M&A and dealing with clean teams

Information sharing in an M&A transaction, from inception to closing (and in some cases, many months after closing) is critical from multiple perspectives - information forms the basis of the decision to execute binding agreements, the manner of implementation of the transaction and then, integration planning - the tricky exercise of aligning the interests, processes and people of the entities. There are, however, challenges to unhindered access to commercially sensitive information about a counterparty's business, particularly when competitors are involved.

Given the fine line between legitimate information exchange and anti-competitive collusion, transacting parties must tread with caution while assessing risks from an antitrust perspective. The real challenge lies in ensuring that any information exchanged between transacting parties is within the contours of what is permissible under the Competition Act, 2002 (**Act**). Under the Act, the implications of exchange of commercially sensitive information are two-fold: (i) "gun jumping"- in violation of the suspensory merger control provisions; and (ii) anti-competitive agreements - in violation of Section 3(3) of the Act. Both violations can result in severe consequences for parties, including imposition of monetary penalties.

Potential risks from an antitrust perspective

Given that the Act prescribes a mandatory and suspensory merger control regime, if a transaction is notifiable to the Competition Commission of India (**CCI**) for approval, the thumb rule is that parties must act in the "ordinary course of business" and continue to compete until the transaction is closed. Failure to do so may result in "gun jumping". The risk is further aggravated in strategic transactions involving competitors since under Section 3(3) of the Act, competitors are prohibited from entering into anti-competitive agreements to determine prices, limit or control production, share markets, rig bids, etc. The exchange of commercially sensitive information (such as current and future prices, customer/supplier lists and strategic business plans) during M&A transactions could be viewed as reducing uncertainty of the parties' commercial behavior (and in turn competition), or enabling concerted action by competitors (especially if the proposed transaction stretches over a few months) in the making. In case a transaction is abandoned (for reasons not limited to the CCI's non-approval), competitors would be in a position to use such commercially sensitive information to reduce competitiveness in the market. In a recent case arising from a leniency application,

parties explained that commercially sensitive information was exchanged and present on their respective systems because they were proposing an acquisition that eventually failed. However, the CCI remained unimpressed and observed that this was a contravention of the law. Interestingly, this risk is not limited to transactions between competitors, and may also exist in private equity/financial investment transactions, if the private equity fund/financial investor has existing overlapping interests in competing firms, resulting in common ownership. While globally, the European Commission has conducted "dawn raids" at offices of parties to a transaction to investigate whether they had been exchanging commercially sensitive information, there is no known precedent of the CCI starting an investigation into information exchange in an M&A transaction – however, CCI has, in precedents, articulated the principle of gun-jumping in this context.

Mitigating the Risk: Clean Teams

To balance the regulatory risk with the need to facilitate information exchange, it has become increasingly common for transacting parties to adopt a "clean teams" approach to monitor the flow of sensitive information, until closing. "Clean teams" comprise a limited set of individuals from both parties (typically, former employees, third party consultants, in-house and external legal teams) who are entrusted with the task of evaluating and integrating the businesses and through whom exchange of commercially sensitive information can occur. It is usually recommended that a separate data room be established for exchange of commercially sensitive information. It is important, however, that such exchange be solely limited to due diligence and planning for post-closing integration. Members of the clean team should not (directly or indirectly) be responsible for day-to-day business operations of the parties, including pricing, marketing, sales, business strategy. This is to enable a defence, particularly if a transaction is abandoned, that the clean team members who received commercially sensitive information, do not have the ability to influence commercial decisions of their respective companies. To further strengthen this rationale, clean team members are ideally subject to a "cooling off" period of at least 1 year prior to resuming any operational/management role.

However, given the commercial difficulties of having non-operational people evaluate a transaction, parties often seek to implement structures which allow review by people with operational roles, but include safeguards to avoid regulatory breach. For instance, clean team members often prepare reports that aggregate or summarize the information in a format that redacts the sensitive details to facilitate review by the parties' boards or management in a compliant manner.

Clean team members may also visit each other's offices to discuss information received. In such cases, it is preferable for parties to circulate a pre-determined agenda and individually record minutes of such meetings to evidence the benign nature of any activity undertaken. Each member of the clean team should also abide by strict confidentiality obligations by executing individual non-disclosure agreements and undertaking not to divulge or discuss any information with non-clean team members.

Takeaways

Since competition laws continue to apply in full force during all phases of a transaction, i.e., right from consideration of a transaction to closing, transacting parties can mitigate potential risks by restricting exchange of information to a "clean team" (established through a well-documented clean team arrangement). It is also recommended that parties rely on antitrust counsel to establish strict procedures for information flow and to ensure that established protocols are adhered.

Shares with differential voting rights - SEBI's sequel trumps the original

The Securities Exchange Board of India (**SEBI**) has recently circulated a consultation paper on Differential Voting Rights (**DVRs**). Issuance of shares with differential voting or dividend rights is not a novel concept for India. It has been around since 2000 and a few listed companies, like Tata Motors and Pantaloons, have issued shares with differential voting / dividend rights.

However, ever since SEBI amended the Listing Regulations in 2009 to state that listed companies are not permitted to issue shares with 'superior rights', there have hardly been any takers for this instrument. SEBI's current proposal appears to be an attempt to breathe some life into such instruments by providing more flexibility in structuring the terms of such issuances, albeit with some checks and balances.

The Companies Act, 2013 (**Companies Act**) permits all companies to issue equity shares with differential rights as to dividend, voting or otherwise – provided they comply with the conditions prescribed by Rule 4 of the SEBI (Share Capital and Debentures) Rules, 2014. Key conditions for such issuance include the company having a consistent track record of distributable profits for the past three years and the shares with differential rights not exceeding 26% of the total post-issue paid-up equity share capital. Moreover, a company is not permitted to convert its existing equity share capital into share capital with differential voting rights and *vice versa*. Given the existing framework, SEBI's consultation paper proposes a new regime governing issuance of shares with differential voting rights. The paper deals with two kinds of shares:

1. **SR Shares** – shares with superior voting rights as compared to ordinary equity shares.

2. **FR Shares** – shares with fractional voting rights as compared to ordinary equity shares.

SR Shares

The key conditions relating to the issuance of SR shares are as follows:

- SR Shares can be issued only by companies whose equity shares are proposed to be listed. It is therefore not possible to issue further SR Shares once the ordinary shares of the company are listed. There exists some ambiguity as to whether it is possible to only list the ordinary shares (and retain the SR Shares in unlisted form). The SEBI proposal also states that, once listed, any subsequent rights or bonus issue, will not be by way of SR shares. It could therefore only be by way of ordinary shares or FR Shares.

- Only promoters of the company are entitled to subscribe to SR Shares. The term used is 'promoter' i.e. any person who has control over the company, as opposed to a founder of the company (which normally refers to entrepreneurial individuals who may have founded the company).

- The Companies Act cap will apply, meaning that, differential shares cannot exceed 26% of the total paid-up equity share capital. Additionally, the promoter voting rights (an aggregate of ordinary, FR and SR Shares) cannot exceed 75% of the total voting rights.

- The SR Shares will be illiquid shares and cannot be traded, even if they are listed. They are under perpetual lock-in after the IPO and the promoters are not permitted to encumber them in any manner whatsoever, including by way of a pledge or a non-disposal undertaking. Transfer of SR Shares *inter-se* promoters is also not permitted.

- SR shareholders are entitled to the same dividend rights as ordinary shareholders. The differential voting rights of SR shares shall be a maximum of 10:1 *vis-à-vis* ordinary shares.

- There are certain coat-tail provisions – wherein, for certain resolutions such as amendment to charter documents, change in control etc., all shareholders including SR shareholders will have only one vote per share. This is prescribed by SEBI and not for the promoters to offer at the time of listing.

- The SR Shares will automatically get converted into ordinary shares at the end of five years (which is extendable for another five-year period with shareholder consent) or on the occurrence of certain events such as a merger or acquisition, demise of promoter, etc. This may require amendment to the Rules, which currently do not permit conversion of differential shares into ordinary shares.

FR Shares

Key conditions relating to the issuance of FR shares are as follows:

- FR Shares can be issued by a company whose equity shares are already listed and traded on a recognised stock exchange for at least one year. They could be by way of a fresh issue, bonus issue or rights issue.
- A preferential issue, a qualified institutional placement or issuance of depository receipts is also possible after one year of the initial FR Share issuance.
- The voting rights on FR Shares shall not exceed a ratio of 1:10 *vis-à-vis* ordinary shares.
- The company may at its discretion pay additional dividends to FR Shareholders.
- The FR Shares can be converted into ordinary shares only through a scheme of arrangement.

A Tool for Start Ups

Shares with DVRs or dual classes of shares, have been historically used by founders / promoters to retain control of the company whilst raising funds for the business's growth. It has been particularly popular with new-age technology companies such as Google, Facebook and Alibaba.

In the past decade, India has witnessed a tremendous surge in entrepreneurial efforts, especially in the technology space; and one of the key issues faced by founders is to raise funds for growth without diluting control. SEBI's attempt to address this concern, by improving access to the Indian capital markets through a regulated DVR regime, is timely. However, it will be successful, only if the Companies Act requirement of a three-year track record of distributable profits is relaxed for technology / start-up companies.

Will there be Takers?

SEBI's attempt to balance the concerns of the promoter with that of prudent corporate governance measures, by making the SR Shares non-transferable, providing for coat-tail provisions, sunset period etc., are appreciated, and highly necessary in the Indian scenario where adherence to corporate governance norms is generally lax. Having said that, SEBI could consider providing further flexibility in terms of monetising the SR Shares, permitting transfer of SR Shares *inter-se* promoters, permitting the shareholders to determine the sunset period etc. Such steps would make this instrument an attractive / viable option for founders. The FR Shares, on the other hand, may not find very many takers, as they are not fundamentally different from the existing regime relating to issuance of shares with inferior differential rights.

Key trends in private equity control transactions

PE investors in India have shown an increased appetite for control transactions in the recent past. This may be attributed to a maturing awareness among PE investors of the value of a controlling stake in determining the timing/mechanics of their exit, as well as the potential such stakes offer for consolidation/integration of the portfolio companies of such investors. Some of the key deal trends in such control transactions are as follows.

Concurrent Restructuring

In share-based control transactions, in addition to acquisition agreements, parties often execute agreements to give effect to restructuring actions (such as business transfers, refinancing of seller loans, group company hive-offs and amendments to related party/seller group contracts as required by buyer). Parties also execute agreements governing their relationship post-completion (such as shareholders agreement, transition services agreement and joint action plans).

Risk Allocation

Risks that can be quantified by the buyer upfront are allocated to the seller through purchase price adjustments, earn-outs and by obtaining specific indemnities. However, many businesses in India contain inherent risks that are either uncertain or unquantifiable. Such risks are addressed by obtaining extensive representations and warranties from the company/ seller. The loss occasioned to the buyer from warranty breaches is usually compensated by an indemnity from the seller or a financially sound group/holding entity (guarantor entity). Key focus areas include related party liabilities, validity of key contracts and affirmative statements on the operational capacity and quality of business-critical assets.

Specific warranties have been introduced on account of recent changes in Indian law. Chief among these are warranties on holding period / cost of acquisition of sale shares (to enable the buyer to claim appropriate tax deduction), insolvency risks in group companies and adoption of the new accounting standards.

Sellers are also more open to providing warranties on compliance with sectoral regulations (albeit over a defined prior period). Experienced PE buyers have demonstrated a greater appetite for accepting business related warranties qualified by the knowledge of the seller. In some cases, publicly available information was pragmatically accepted as qualifying business warranties to make bids more attractive to sellers.

Indemnity Trends

As a further line of defence, sellers stipulate monetary and temporal limits on indemnity claims from the buyer. While this principle has found acceptance with buyers, fraud and willful misconduct are customary exceptions. While some buyers continue to insist that indemnities for certain fundamental warranties such as those on title to sale shares, capital structure of the target and ownership of key assets should remain uncapped, many have accepted limits on these as well.

Sellers insist on monetary indemnity limits such as:

a. a 'de minimis' threshold (this is usually a defined amount or, occasionally, a miniscule fraction of the acquisition price, such as 0.5%) along with a 'basket threshold' (usually, an amount being a multiple of the 'de minimis' threshold). This ensures that the seller has the operational flexibility to entertain buyer claims only after they meet a specified monetary threshold.

b. a maximum liability cap (this is at the very least, equal to the acquisition price). However, the practice is to provide different monetary caps for distinct sets of warranties.

It is now common to see parties negotiate separate monetary caps, each being a certain percentage of the acquisition price - for tax warranties (30-35% or a defined amount), general warranties (25-35%) and for deal-specific critical warranties (such as materiality of litigation).

Buyers are seen to accept sunset periods/temporal limits on their ability to claim indemnities for breaches of tax warranties (7 to 8 years), general warranties (18 months to 3 years) and specific matters being indemnified depending on the facts of the case.

Third Party Claims

A key consideration in control transactions is the right of the seller to defend third party claims against the target, that may arise after the transaction is complete. This right has gained acceptance and typically a seller is given the ability to manage and defend the third party claim, provided the buyer retains the ultimate say in settlement of the claim. Depending on the litigation appetite of the buyer, mechanisms to revoke such seller authorization are put in place, to enable the buyer to step in and protect the interests of the target.

R&W Insurance

Use of representation and warranty insurance is finding some acceptance in the Indian deal space especially when the deal is between parties that are familiar with use of such products in other jurisdictions. However, domestic demand for such products is still low, on account of the considerable sunk costs in premium payments and high retention amounts. There is also the time factor (4-6 weeks) in negotiating and obtaining a feasible insurance policy, in line with the acquisition agreements and commercial objectives of the parties.

On-market closing of negotiated share sales

Tax considerations frequently drive the manner and timing of transfers of shares of Indian companies. Transfer of shares of a listed Indian company on the floor of the stock exchange could offer significant tax benefits to sellers, who frequently seek "on-exchange closings". Further, since provisions which could potentially result in taxation on notional gains of the buyer are not applicable if the share purchase transaction is undertaken on the floor of the stock exchange, buyers are sometimes equally incentivized to seek on-exchange closings. However, there are various complexities under Indian law which could result in a closing of a negotiated transaction on the floor of the stock exchange becoming a challenge. We have presented a summary of some of these below.

Manner of on-exchange closing

Closing a share purchase agreement on Indian stock exchanges can take two forms:

1. "block trades", being trades which can be undertaken during separate deal windows available for a period of 15 minutes twice a day (once in the morning and then in the afternoon). A block trade can be conducted within the price band of $\pm$ 1% of the applicable reference price (i.e. the closing price of previous day or the volume weighted average market price for trades executed during a specified time period in the morning, as applicable);

2. "bulk trades", being trades conducted in the normal trading window and exceeding 0.5% of the total number of listed shares of the company. There are no specific price restrictions applicable to bulk trades, however, general circuit filter restrictions apply.

Block trades are preferred since they offer certainty of a transaction between the buyer and seller (the separate deal window ensures no risk of leakage to other buyers/sellers in the market). The evident challenge is often the pricing restriction, since the negotiated price may be outside the narrow range prescribed. Bulk trades have the advantage of not having any specific pricing restrictions. However, the risk of leakage of shares to third parties who may have placed bids at the same time and price is a critical commercial risk. Further, the possibility of regulatory scrutiny (from the perspective of market manipulation or unfair trade practices) by the Securities and Exchange Board of India in a bulk trade, particularly where there is a significant divergence between the prevailing market price and the price at which the trade is undertaken, cannot be ruled out.

Restrictions on Foreign Acquirers

Non-residents, other than registered foreign portfolio investors and controlling shareholders, are prohibited from acquiring shares on the exchange under Indian exchange control laws. Accordingly, a non-resident non-FPI acquirer (who is not in control of the target company prior to the closing of the share purchase agreement), can only undertake an off-market closing.

Concerns under Takeover Regulations

In transactions that trigger a tender offer under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (**Takeover Regulations**), certain other concerns arise.

The Takeover Regulations permit the underlying share purchase to be completed before the tender offer is completed, subject to expiry of approximately 25 working days from the deal signing and the deposit of 100% of the offer consideration in a cash escrow account. This option is often exercised by acquirers to avoid uncertainties in the process.

However, the Takeover Regulations allow an acquirer to acquire shares of the Indian target during the offer period only "through the stock exchange settlement process, other than through bulk deals or block deals". While this restriction may be

interpreted as applying only to market purchases by the acquirer (and not to the underlying trade itself), SEBI has, in certain instances cited this provision while objecting to such on-exchange closings.

While clarity from the regulator on the issues mentioned above would certainly go a long way in structuring transactions in a tax efficient manner, in the interim, if the sellers and buyers are aligned in favour of on-exchange closings, we do expect more underlying transactions closing on the exchanges after undertaking nuanced and considered risk assessments from regulatory and commercial perspectives. For instance, the much in news recent L&T acquisition of shares of Mindtree from certain sellers appears to have been undertaken through a combination of block trades and bulk trades on the floor of the exchange, prior to completion of the tender offer, and its success could help in clearing some of the regulatory ambiguities.

Recent developments in the financial services sector - the KYC Aadhaar conundrum

Over the recent years, the financial services sector in India has evolved significantly, in terms of sophistication of market players as well as diversity in client and product profiles. With the advent of mobile technology and growing focus on financial inclusion, market players have taken significant steps towards improving last mile connectivity for delivery of financial products such as, insurance, broking, credit, payment solutions, and the like.

Irrespective of their regulatory parentage, one common thread that runs across all financial services is the requirement for institutions to complete Know Your Customer (**KYC**) processes prior to on – boarding clients. Compliance with KYC requirements is a critical aspect of any financial services business and has long been a subject matter of lengthy, prescriptive regulations by sector regulators as well. KYC documents typically include proof of identity/address, such as passport, driving license, etc. When Aadhaar was rolled out as a unique 12 digit identifier that could be obtained by Indian residents, it was quickly co-opted as a convenient mode to undertake KYC on customers.

However, in the past year or so, the regulatory ambiguity regarding the usage of Aadhaar for the KYC process undertaken by financial intermediaries (such as banks, non – banking financial companies, securities market intermediaries, payment solution providers, etc.) has caused a fair amount of disruption in the financial services space, which has consequent implications for M&A and fund raising exercises by players in this market. The Supreme Court's ruling on the constitutional validity of the Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016 (**Aadhaar Act**) has resulted in far reaching legal changes and practical challenges faced by financial market players.

Aadhaar: The Changing Legal Landscape

The use and validity of the Aadhaar number has been wrought with controversy from its very inception, with concerns around its infringement on the right to privacy. However, the Aadhaar framework was swiftly adopted by financial intermediaries, specifically fintech entities, as it enabled on – boarding of clients in an efficient and seamless manner by reducing friction of multiple touchpoints. While the use of Aadhaar became increasingly prevalent in the market, the constitutional validity of the Aadhaar Act itself was challenged before the Supreme Court in the matter of *Justice K.S. Puttaswamy (Retd.)* v *Union of India* and the judgment was pronounced in September, 2018.

Critically for the financial services industry, the Supreme Court, among other observations and findings, ruled that private entities could not avail Aadhaar authentication on the basis of a contractual arrangement alone, and accordingly certain portions of the Aadhaar Act were held to be unconstitutional. This had serious repercussions for market players as they were required to reconsider the legality of using Aadhaar as a channel for on – boarding of clients and KYC compliance. The onus, therefore, shifted to the regulators and government authorities to issue clear guidelines around the usage of Aadhaar.

In this background, there have been two significant legislative changes that bear discussion. In October, 2018, the rules framed under the Prevention of Money Laundering Act, 2002, which prescribe the nature of documents, viz., officially valid documents, proof of identify, address, etc., that intermediaries are required to collect from clients, were amended to *inter alia* state that individuals would be required to submit Aadhaar number in

[1] Writ Petition (Civil) No. 494 of 2012. Reported as (2019) 1 SCC 1

order to avail any benefit or subsidy under any scheme notified under the Aadhaar Act.

Thereafter, the Aadhaar and Other Laws (Amendment) Ordinance, 2019 (**Aadhaar Ordinance**) was promulgated earlier this year and further muddied waters by stipulating that Aadhaar number holders could voluntarily use their Aadhaar number to establish their identity, while at the same time restricting the manner in which Aadhaar authentication could actually be carried out by bank and non-bank financial entities. It is interesting to note that amidst these various legislative upheavals, the KYC guidelines issued by the Reserve Bank of India were finally amended on May 29, 2019, and largely re-state the provisions of the Aadhaar Ordinance. Therefore, the key question of whether financial sector entities can utilise the Aadhaar framework to complete client KYC has remained a vexing issue for a while and it remains to be seen if the updated RBI guidlines on KYC resolves this completely.

Market Reality: Risk to businesses

There are numerous financial services entities that have developed business models and protocols around the Aadhaar framework, but now face uncertainty regarding the legal validity of their operations. This uncertainty is a deterrent to deal-making as participants are unsure on whether an Aadhaar – reliant business model would need to be completely re-engineered. Also, while the existing ambiguity has led to certain market players continuing to rely on the Aadhaar framework, continuing apathy on this count could ultimately result in severe disruption for market players and consumers alike.

Further, the uncertainty surrounding Aadhaar is also an impediment to innovation and financial inclusion, both being matters that are universally considered to be critical for development of the financial services sector. While regulators seem to be keen to understand the interplay of their sectoral businesses with technology (be it the fintech sandbox mooted by the RBI or SEBI's interest in strengthening cyber resilience frameworks for intermediaries), such a subsisting impasse in the KYC process and delay in issuing clarificatory regulations threatens to not only unravel and discourage innovation but also stymie funding and transactions in the market. Instances of this nature require decisive direction from regulators to give comfort to the market, provide certainty of business and bring overall stability to the financial services sector at large.

FDI in e-commerce - a level playing field?

The e-commerce market in India is one of the fastest growing in the world, riding on the back of increasing internet penetration in the country and a favourable demographic profile. The sector has witnessed significant deal activity, with private equity and venture capital investments in e-commerce and consumer internet companies exceeding USD 7 billion in 2018, and Walmart's acquisition of Flipkart being reported as the largest acquisition of an e-commerce company in the world.

The Indian government has historically applied a protectionist approach towards domestic retail traders, and this approach was reflected in the regulations applicable for foreign direct investment (**FDI**) in the sector, which were introduced in 2016. Even while the FDI policy permitted foreign investment in the marketplace model of e-commerce under the automatic route (that is, without prior governmental approval), such investments were subject to compliance with certain conditions, which sought to ensure the objective of providing a 'level playing field' to all participants.

The introduction of these conditions in 2016 compelled companies desirous of receiving FDI to make certain changes to their business models. Three years hence, the government announced further changes to the conditions for FDI in the sector by issuing a press note in the last week of 2018 (PN 2). These changes, which were to come into effect in just over a month of being announced, caused an initial stir in the sector. The amendments, though labelled as clarifications by the ministry, were perceived to be modifications to the then existing regulatory framework, designed to restrict business models that the government believed were effectively carrying out the inventory based model of e-commerce, in which FDI is prohibited.

Deemed Control, Equity Participation and the Inventory Model

One of the key changes introduced by PN 2 is the condition that if more than 25% of purchases of a vendor on an e-commerce marketplace are from the marketplace entity or its group companies, then the marketplace entity would be deemed to have control over the inventory, and render the business into an inventory model. What is queer about this condition is that this places a marketplace e-commerce entity at risk of non-compliance with conditions relating to sourcing by vendors over which it has no control, including having no say or visibility on the ability of vendors on its platform to find third party suppliers such that the 25% limit is not breached.

Another condition introduced by PN2 is to disallow vendors from selling products on a marketplace if such vendor has any equity participation by that e-commerce marketplace entity or its group companies, or if that e-commerce marketplace or its group companies exercise control over the inventory of such vendor. While this is aimed at ensuring that the marketplace is only a technology platform to facilitate transactions between buyers and sellers, the confusing wording of the regulations created some ambiguity besides resulting in unintended consequences. There is lack of clarity as to whether companies with common ownership would constitute group companies, and whether indirect equity participation (through a minority shareholding in an intermediate company) would also disqualify a vendor from selling on a particular marketplace. While the general FDI regime under the regulatory framework for downstream foreign investment is based on a majority or controlling equity ownership in an Indian company, this "no equity participation" condition deviates from the general rule by linking deemed control to any (even an insignificant) equity participation.

Impact and Looking Forward

The changes were reported to have in the immediate term, affected some of the largest e-commerce entities operating in India, with sales having dropped by over 25%, and the number of sellers

on these platforms having fallen by 30%. This was perhaps during the period of uncertainty and subsequent migration immediately after the new regulations came into effect. The e-commerce entities have had to undertake changes to their supply chains and systems to remain in compliance with the new norms. Initial reactions to the changed regulations also suggested that the new regulations could impact the ability of e-commerce market places to pass on consumer friendly offers and discounts.

While the objective of the amended policy was to prevent "distortionary effects, either through means of price control, inventory or vendor control" and discourage capital dumping, it did create additional hurdles for Indian e-commerce companies to receive FDI, urging them to function within the newly prescribed parameters and conditions. Questions were asked whether this places them at a disadvantage compared to other Indian e-commerce companies that have not received FDI. Indian businesses that seek foreign capital will need to factor in this added cost of compliance towards creation of the business model as now required by the market place rules. The regulations also view all kinds of foreign investment with the same lens, and treat Indian subsidiaries of global e-commerce entities in the same way as an Indian e-commerce start-up that has raised minority venture capital funding from foreign investors.

There is an initial fear of causing some distortionary effects on competition, since global e-commerce players may be able to use their deep pockets to their advantage in absorbing losses and having a wider range of restructuring options available. The changes, therefore, are likely to have a greater impact on Indian e-commerce start-ups who are reliant on venture capital funding under the FDI route, as also Indian traders who had established favourable commercial terms as well as a reliable source of supply for the goods that they sold on the e-commerce marketplace. What it may boost, on the other hand, are more players (big and small) who would have opportunities to be part of the supply chain system in the Indian market.

The government's attempt to create what it believes to be a level playing field has come with some unintended consequences and at the expense of other conditions necessary to retain the attractiveness of the sector as an investment opportunity, such as a stable and predictable regulatory environment and following a consultative process of rule-making to take into account concerns of stakeholders. A level playing field would be effective if it operates without artificial bias, and with greater certainty and consistency in the rules of the game. The interpretation and implementation of the new regulations will develop over time, and new and complex structures are expected to evolve for the e-commerce companies to continue to make the most of the growth story while staying within the boundaries of the regulations.

Contributors

Editors:

- Akila Agrawal
- Nivedita Rao

Contributors:

- Akila Agrawal
- Akshay Bhat
- Amita Katragadda
- Anchal Dhir
- Anshuman Sakle
- Avaantika Kakkar
- Gaurav Gupte
- Manan Mehta
- Nivedita Rao
- Radhika Gaggar
- Rohil Vashist
- Shruti Rajan
- Sourav Biswas
- Adishree Mishra
- Aishwarya Gopalakrishnan
- Anshu Choudhary
- Shaishavi Kadakia
- Rohan Banerjee
- Umang Pathak

cyril amarchand mangaldas
advocates & solicitors

www.cyrilshroff.com

mumbai
peninsula chambers,
peninsula corporate park,
gk marg, lower parel,
mumbai – 400 013.
t: +91 22 2496 4455
email: cam.mumbai@cyrilshroff.com

new delhi
4th floor, prius platinum,
d-3, district centre,
saket,
new delhi – 110 017.
t: +91 11 6622 9000
email: cam.delhi@cyrilshroff.com

bengaluru
201,
midford house,
off. m. g. road,
bengaluru – 560 001.
t: +91 80 2558 4870
email: cam.bengaluru@cyrilshroff.com

ahmedabad
shapath -v, 1304/1305,
opp. karnavati club
s.g. road,
ahmedabad – 380 051.
t: +91 79 49039900
email: cam.ahmedabad@cyrilshroff.com

hyderabad
8-2-622/5/a, 3rd floor, indira chambers,
road no. 10, banjara hills,
hyderabad – 500 034,
telangana.
t: +91 40 6730 6000
email: cam.hyderabad@cyrilshroff.com

chennai
2nd floor, asv chamiers square,
87/48, chamiers road,
r. a. puram,
chennai – 600 028.
t: +91 44 6668 4455
email: cam.chennai@cyrilshroff.com