

# De Jure

August 06, 2016

## CIS – TRANSITIONAL TRAUMA



## COLLECTIVE INVESTMENT SCHEMES – TRANSITIONAL TRAUMA

Collective Investment Scheme or CIS is an arrangement where investors pool in their funds to derive some return on investment. The pool of funds is, in turn, used for purposes of the scheme or arrangement.

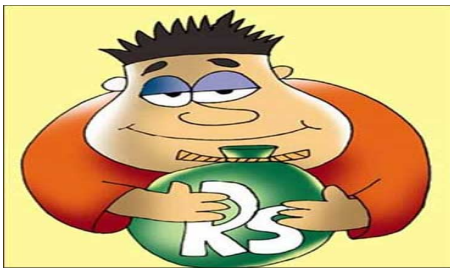
CIS is governed by the Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 ("CIS Regulations") and Securities and Exchange Board of India Act, 1992 ("SEBI Act").

Section 12 of the SEBI Act deals with registration of stock-brokers, sub-brokers, share transfer agents, etc.

Section 12(1B) of the SEBI Act, which was inserted on January 25, 1995 ("Amendment Date"), states that no person shall engage in or carry on CIS activities, unless he obtains a certificate of registration from SEBI. The proviso grants an exemption to CIS in transition, inasmuch as, it states that if a person was operating a CIS immediately before the Amendment Date (for which no certificate of registration was required prior to the Amendment Date), such person may continue to operate the CIS till such time the regulations were notified. The CIS Regulations were notified on October 15, 1999 ("Notification Date").

It is thus clear that Section 12(1B) of the SEBI Act prohibits CIS from sponsoring any new scheme till the regulations are notified, which would imply that entities wanting to undertake CIS activity after the Amendment Date were prohibited from doing so or from raising any funds. In short, new CIS activity was to be suspended up to the Notification Date.

On the other hand, a person operating a CIS prior to the Amendment Date was permitted to continue to operate up to the Notification Date. On the Notification Date, such person must obtain a certificate of registration to continue CIS activities.



Recently, an interesting question of law came up before the Supreme Court of India in an appeal filed by SEBI (SEBI V/s. Gaurav Varshney & Anr, Criminal Appeal Nos. 827-830 of 2012) with respect to the applicability of the total prohibition imposed by Section 12(1B) to CIS commenced after the Amendment Date. Gaurav Varshney and Vinod Kumar Varshney (collectively, "Varshneys") incorporated Gaurav Agrigenetics Limited on July 3, 1995 (after the Amendment Date) and commenced CIS activities.

---

SEBI initiated criminal proceedings ("Criminal Complaint") against the Varshneys alleging that Varshneys had breached the bar created by Section 12(1B), which had forbidden carrying on of CIS activity, without obtaining a certificate of registration. Varshneys then filed a Criminal Miscellaneous Case in the Delhi High Court to quash the Criminal Complaint. The Delhi High Court quashed the Criminal Complaint. Dissatisfied with the determination of the Delhi High Court, SEBI appealed to the Supreme Court to raise a challenge to the order passed by the Delhi High Court

The legal question before the Supreme Court was whether by carrying out CIS activity during the period when section 12(1B) (that imposes a bar on such activity without registration) was in force but not the CIS Regulations (that prescribe the mode of obtaining SEBI approval), the Varshneys were in breach of the legal regime, so as to be subject to criminal action and whether the bar against commencement of CIS activity after the Amendment Date would operate from that date or from the Notification Date.

The Supreme Court analysed Section 12(1B) and the proviso thereto and noted that the first part relates to persons who had not commenced CIS activity prior to the Amendment Date, when Section 12(1B) was inserted in the SEBI Act. The second part, signified by the proviso, relates to those who were carrying on CIS activity even prior to the Amendment Date.



Upon hearing SEBI and the Varshneys, the Supreme Court concluded that the Varshneys case will fall after the Amendment Date and classify as a new CIS activity. The question before the Supreme Court then was whether the restriction against commencement of CIS activity after the Amendment Date would operate from the Amendment Date or from the Notification Date.

The Court in clear terms ruled that the restriction against commencing CIS activity without registration would operate from the Amendment Date and not from the Notification Date. The Supreme Court also stated that absence of rules does not render an act inoperative or that non-framing of rules does not curtail the power of an authority.

When deciding on this appeal, the Supreme Court observed that carrying on CIS activity, for the first time, on or after the Amendment Date was a complete bar in the absence of a certificate of registration from SEBI, and a breach of this provision would tantamount to breaching the express mandate contained in Section 12(1B) of the SEBI Act.

---

---

The Supreme Court stated that there can be no doubt that the Amendment Date has no relevance insofar as the breach of Section 12(1B) of the SEBI Act, with reference to such new entrepreneurs is concerned. The bar to carry on any CIS activity by a new entrepreneur after the Amendment Date was not dependent on framing of the regulations. The above bar was absolute and unconditional, till the new entrepreneur obtained a certificate of registration, in accordance with the regulations. The said bar would, therefore, undoubtedly extend till the framing of the regulations.

The Supreme Court's decision has implications on restrictions of commercial activity imposed by legislation, especially when such activity is subject to registration requirements. Since such restrictions are subject to detailed regulations to be announced by the regulatory authorities, the decision has implications as to how a person may engage in such activities during the transition period, i.e. the time that the legislation has imposed a restriction and before the regulatory authorities frame the regulations.

The Supreme Court's resonant answer is that the activity cannot be carried out in the interim, which operates as a total prohibition. The prohibition is lifted only when the regulations are subsequently announced. The issue becomes even more acute when there is a considerable delay between the imposition of the legislative restriction and the subsequent announcement of the regulations, as was the case with section 12(1B) and the CIS Regulations, which faced a delay of over three years. This puts affected parties at a disadvantage, as no CIS activity could have been carried on in the interim period.



It is time the regulatory authorities wake up to this fact and initiate mechanisms for registration as soon as restrictions are imposed by legislation, without any inordinate delay.

As for the Varshneys, the Supreme Court dismissed the appeal against the Varshneys, since SEBI failed to establish violation of Section 12(1B) by the Varshneys on certain technical grounds.

***Contributed by:***

**Sangeeta Lakhi:** [sangeeta@rajaniassociates.net](mailto:sangeeta@rajaniassociates.net)

**Amit Iyer:** [aiyer@rajaniassociates.net](mailto:aiyer@rajaniassociates.net)

---

---

## AREAS OF PRACTICE

| Capital Markets | Private Equity | Mergers and Acquisitions | Corporate Litigation & Arbitration | Projects & Project Finance |  
| Real Estate & Trust | Corporate & Commercial | Banking & Finance | Structuring | TMT | IPR | Employment

---

## DISCLAIMER

This update only contains a summary/ limited description of the topic dealt with hereinabove for general information purposes and should not be construed as a legal opinion or be relied upon in absence of specific legal advice. For further information or legal advice please feel free to contact us.

---

## CONTACT US



# Rajani Associates

simple solutions

**Address:** Krishna Chambers  
59 New Marine Lines  
Churchgate  
Mumbai 400020  
Maharashtra, India  
**Telephone:** (+91-22) 40961000  
**Facsimile:** (+91-22) 40961010  
**Email:** [dejure@rajaniassociates.net](mailto:dejure@rajaniassociates.net)  
**Website:** [www.rajaniassociates.net](http://www.rajaniassociates.net)

---