

# CHAPTER 5

## LEGAL FRAMEWORK<sup>15</sup>

The exigencies of the market and the flexibility of the regulators are maintained through the exercise of delegated legislation to the regulators. Under this the regulators issue notifications, circulars and guidelines which are to be complied by the market participants.

Various activities in the securities market in India are regulated in a coordinated manner by four regulators namely Department of Economic Affairs (DEA) of the Ministry of Finance, Ministry of Company Affairs, Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI).

The regulatory and the supervisory framework of the securities market in India has been progressively strengthened through various legislative and administrative measures and is consistent with the best international benchmarks, such as, standards prescribed by the International Organisation of Securities Commissions (IOSCO).

### Rules and Regulations

The Government has framed rules under the Securities Contract (Regulation) Act SC(R)A, SEBI Act and the Depositories Act. SEBI has framed regulations under the SEBI Act and the Depositories Act for registration and regulation of all market intermediaries, for prevention of unfair trade practices, insider trading, etc. Under these Acts, Government and SEBI issue notifications, guidelines, and circulars, which need to be complied by the market participants.

The self-regulatory organizations (SROs) like stock exchanges have also laid down their rules and regulations for market participants.

### Regulators

The regulators ensure that the market participants behave in a desired manner so that the securities market continues to be a major source of finance for corporates and government and the interest of investors are protected. As noted earlier, the responsibility for regulating the securities market is shared by DEA, Ministry of Corporate Affairs, SEBI and RBI.

#### 5.1 SEBI (Intermediaries) Regulations, 2008

One of the main functions of SEBI is to register and regulate the functioning of various types of intermediaries and persons associated with securities market in a manner as to ensure smooth functioning of the markets and protection of interests of the investors. These

<sup>15</sup> This chapter only touches upon the broad regulatory framework for the Indian securities markets, giving the main clauses of various acts, rules and regulations that have a bearing on the functioning of the markets. For greater details, it is recommended that original acts, rules and regulations may be referred to.

intermediaries, as detailed in the SEBI Act are: stock-brokers, sub- broker, share transfer agents, bankers to an issue, trustees of trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers, depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies, asset management companies, clearing members of a clearing corporation, trading member of a derivative segment of a stock exchange, collective investment schemes, venture capital funds, mutual funds, and any other intermediary associated with the securities market.

SEBI had issued regulations governing the registration and regulatory framework for each of these intermediaries. However, given the fact that many requirements and obligations of most intermediaries are common, SEBI has recently consolidated these requirements and issued the SEBI (Intermediaries) Regulations, 2008. These regulations were notified on May 26, 2009.

These regulations apply to all the intermediaries mentioned above, except foreign institutional investors, foreign venture capital investors, mutual funds, collective investment schemes and venture capital funds.

The **salient features** of the Regulations are as under:

- a) The SEBI Regulations put in place a comprehensive regulation which is applicable to all intermediaries. The common requirements such as grant of registration, general obligations, common code of conduct, common procedure for action in case of default and miscellaneous provisions are applicable for all intermediaries.
- b) The registration process has been simplified. An applicant can file application in the prescribed format along with additional information as required under the relevant regulations along with the requisite fees. The existing intermediaries may, within the prescribed time, file the disclosure in the specified form. The disclosures are required to be made public by uploading the information on the website specified by SEBI. The information of commercial confidence and private information furnished to SEBI shall be treated confidential. In the event intermediary wishes to operate in a capacity as an intermediary in a new category, such person may only file the additional shortened forms disclosing the specific requirements of the new category as per the relevant regulations.
- c) The Fit and Proper criteria have been modified to make it principle based. The common code of conduct has been specified at one place.
- d) The registration granted to intermediaries has been made permanent unless surrendered by the intermediary or suspended or cancelled in accordance with these regulations.
- e) Procedure for action in case of default and manner of suspension or cancellation of certificate has been simplified to shorten the time usually faced by the parties without compromising with the right of reasonable opportunity to be heard. Surrender of certificate has been enabled without going through lengthy procedures



- f) While common requirements will be governed by the new regulations, the intermediaries specific requirements will continue to be as per the relevant regulations applicable to individual intermediaries. The relevant regulations will be amended to provide for the specific requirements.

## 5.2 SEBI (Prohibition of Insider Trading) Regulations, 1992

The malpractice of 'insider trading' affects the innocent investors. In simple terms 'insider trading' means selling or buying in securities on the basis of price sensitive unpublished information of a listed corporate which if published could lead to a fall or rise in the prices of shares of the corporate.

To tackle the problem of insider trading, SEBI issued the SEBI (Insider Trading) Regulations 1992. These regulations were further made stringent through amendments in February 2002 and they were notified as the SEBI (Insider Trading) (Amendment) Regulations 2002.

The important definitions used in the regulations are:

- (i) Dealing in securities** means an act of subscribing, buying, selling or agreeing to subscribe, buy, sell or deal in any securities by any person either as principal or agent.
- (ii) Insider** means any person who, is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access to unpublished price sensitive information in respect of securities of a company, or who has received or has had access to such unpublished price sensitive information.
- (iii) A connected person** means any person who:
  - a) Is a director, as defined in clause (13) of section 2 of the Companies Act, 1956 of a company, or is deemed to be a director of that company by virtue of sub-clause (10) of section 307 of that Act, or
  - b) Occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company whether temporary or permanent and who may reasonably be expected to have an access to unpublished price sensitive information in relation to that company.
- (iv) A person is deemed to be a connected person** if such person:
  - a) Is a company under the same management or group or any subsidiary company thereof within the meaning of section (1B) of section 370, or sub-section (11) of section 372, of the Companies Act, 1956 or sub-clause (g) of section 2 of the Monopolies and Restrictive Trade Practices Act, 1969 as the case may be; or
  - b) Is an intermediary as specified in section 12 of SEBI Act, 1992, Investment company, Trustee Company, Asset Management Company or an employee or

director thereof or an official of a stock exchange or of clearing house or corporation;

- c) Is a merchant banker, share transfer agent, registrar to an issue, debenture trustee, broker, portfolio manager, investment advisor, sub-broker, investment company or an employee thereof, or, is a member of the board of trustees of a mutual fund or a member of the board of directors of the asset management company of a mutual fund or is an employee thereof who have a fiduciary relationship with the company;
- d) Is a member of the board of directors, or an employee, of a public financial institution as defined in Section 4A of the Companies Act, 1956;
- e) Is an official or an employee of a self regulatory organisation recognised or authorised by the Board of a regulatory body;
- f) Is a relative of any of the aforementioned persons;
- g) Is a banker of the company;
- h) Relative of the connected person.

(v) **Price sensitive information** means any information which is related directly or indirectly to a company and which if published is likely to materially affect the price of securities of a company. It includes only such information which if published is likely to materially affect the price of securities of a company. The following is deemed to be price sensitive information:

- a) Periodical financial results of the company;
- b) Intended declaration of dividends (both interim and final);
- c) Issue of securities or buy-back of securities;
- d) Any major expansion plans or execution of new projects;
- e) Amalgamation, mergers or takeovers;
- f) Disposal of the whole or substantial part of the undertaking;
- g) Significant changes in policies, plans or operations of the company.

(vi) **Unpublished information** means information which is not published by the company or its agents and is not specific in nature. However, speculative reports in print or electronic media are not considered as published information.

### 5.2.1 Prohibition on Dealing, Communicating or Counseling (Chapter II)

Under this regulation, no insider should:

- a) Either on his own behalf or on behalf of any other person, deal in securities of a



company listed on any stock exchange when in possession of any unpublished price sensitive information;

- b) Communicate, counsel or procure, directly or indirectly, any unpublished price sensitive information to any person who while in possession of such unpublished price sensitive information should not deal in securities. This is however, not applicable to any communication required in the ordinary course of business or profession or employment or under any law.

The regulations require that no company should deal in the securities of another company or associate of that other company while in possession of any unpublished price sensitive information.

### **5.2.2 Investigation (Chapter III)**

If SEBI suspects any person of having violated the provisions of insider regulation, it may make inquiries with such person or with the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organisation in the securities market to form a *prima facie* opinion as to whether there is any violation of insider regulations.

Where SEBI forms a *prima facie* opinion that it is necessary to investigate and inspect the books of accounts, either documents and records of an insider or the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organisation in the securities market, it may appoint an investigating authority for the purpose.

The investigating authority has to submit its report to SEBI, after completion of investigations in accordance with the provisions of the regulations.

After considering the report, SEBI is required to communicate its findings to the suspected person and seek a reply from such person. Such suspected person is required to reply to the findings within 21 days to SEBI. After receipt of the reply, SEBI may take such measures to safeguard and protect the interest of investors, securities market and for due compliance with the insider trading regulations.

SEBI also has powers to appoint an auditor to investigate into the books of accounts or the affairs of the insider or the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organisation in the securities market.

### **5.2.3 Disclosures and Internal Procedure for Prevention of Insider Trading (Chapter IV)**

All listed companies and organisations associated with securities markets such as intermediaries, asset management company, trustees of mutual funds, self regulatory organisations recognised by SEBI, recognised stock exchanges, clearing house or corporations, public financial institutions and professional firms such as auditors,

accountancy firms, law firms, analysts, consultants, etc., assisting or advising listed companies, are required to frame a code of internal procedures and conduct as per the prescribed format provided in SEBI (Prohibition of Insider Trading) Regulations without diluting it any manner and ensure compliance of the same.

The regulations require certain disclosures to be made by directors, officers and substantial shareholders in listed companies. These are:

**(i) Initial Disclosure:**

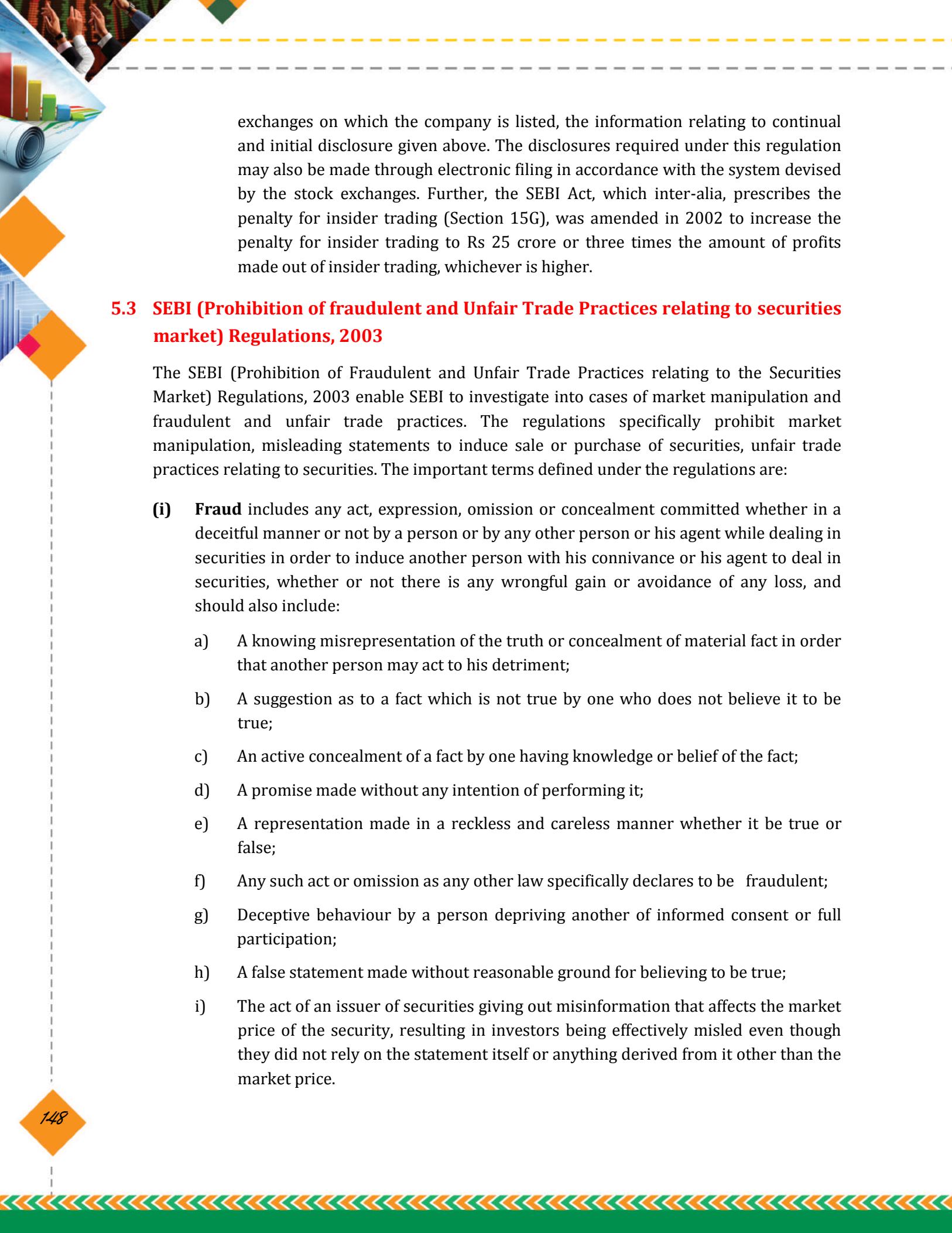
- a) Any person who holds more than 5% shares or voting rights in any listed company should disclose to the company in prescribed form, the number of shares or voting rights held by such person, on becoming such holder, within **2 working days** of:
  - (i) The receipt of intimation of allotment of shares; or
  - (ii) The acquisition of shares or voting rights, as the case may be.
- b) Any person who is a director or officer of a listed company should disclose to the company in prescribed form, the number of shares or voting rights held by such person, within **2 working days** of becoming a director or officer of the company.

**(ii) Continual Disclosure**

- a) Any person who holds more than 5% shares or voting rights in any listed company should disclose to the company in prescribed form the number of shares or voting rights held and change in shareholding or voting rights, even if such change results in shareholding falling below 5%, if there has been change in such holdings from the last disclosure and such change exceeds 2% of total shareholding or voting rights in the company.
- b) Any person who is a director or officer of a listed company, should disclose to the company in prescribed form, the total number of shares or voting rights held and change in shareholding or voting rights, if there has been a change in such holdings from the last disclosure made and the change exceeds ₹ 5 lakh in value or 25,000 shares or 1% of total shareholding or voting rights, whichever is lower. The disclosure mentioned above should be made within 2 working days of:
  - (i) The receipt of intimation of allotment of shares, or
  - (ii) The acquisition or sale of shares or voting rights, as the case may be.

**(iii) Disclosure by Company to Stock Exchanges**

Every listed company, within two days of receipt, should disclose to all stock



exchanges on which the company is listed, the information relating to continual and initial disclosure given above. The disclosures required under this regulation may also be made through electronic filing in accordance with the system devised by the stock exchanges. Further, the SEBI Act, which inter-alia, prescribes the penalty for insider trading (Section 15G), was amended in 2002 to increase the penalty for insider trading to Rs 25 crore or three times the amount of profits made out of insider trading, whichever is higher.

### 5.3 SEBI (Prohibition of fraudulent and Unfair Trade Practices relating to securities market) Regulations, 2003

The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 2003 enable SEBI to investigate into cases of market manipulation and fraudulent and unfair trade practices. The regulations specifically prohibit market manipulation, misleading statements to induce sale or purchase of securities, unfair trade practices relating to securities. The important terms defined under the regulations are:

**(i) Fraud** includes any act, expression, omission or concealment committed whether in a deceitful manner or not by a person or by any other person or his agent while dealing in securities in order to induce another person with his connivance or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and should also include:

- a) A knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment;
- b) A suggestion as to a fact which is not true by one who does not believe it to be true;
- c) An active concealment of a fact by one having knowledge or belief of the fact;
- d) A promise made without any intention of performing it;
- e) A representation made in a reckless and careless manner whether it be true or false;
- f) Any such act or omission as any other law specifically declares to be fraudulent;
- g) Deceptive behaviour by a person depriving another of informed consent or full participation;
- h) A false statement made without reasonable ground for believing to be true;
- i) The act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled even though they did not rely on the statement itself or anything derived from it other than the market price.

The term "fraudulent" should be construed accordingly. Nothing contained in this clause is applicable to any general comments made in good faith in regard to the economic policy of the Government; the economic situation of the country; trends in the securities market; any other matter of a like nature.

- (ii) **Dealing in Securities** is defined to include an act of buying, selling or subscribing pursuant to any issue of any securities or agreeing to buy, sell or subscribe to any issue of any securities or otherwise transacting in any way in any security by any person as principal, agent or intermediary as defined under the SEBI Act.

### 5.3.1 Prohibition of Certain Dealings in Securities

The regulation provides that no person should directly or indirectly:

- a) Buy, sell or otherwise deal in securities in a fraudulent manner;
- b) Use or employ, in connection with issue, purchase or sale of any security listed or proposed to be listed in a recognised stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the Act or the rules or the regulations made there under;
- c) Employ any device, scheme or artifice to defraud in connection with dealing in or issue of securities which are listed or proposed to be listed on a recognised stock exchange;
- d) Engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person in connection with any dealing in or issue of securities which are listed or proposed to be listed on a recognised stock exchange in contravention of the act, rules and regulations.

### 5.3.2 Prohibition of Manipulative, Fraudulent and Unfair Trade Practices

The Regulation provides that no person should indulge in a fraudulent or an unfair trade practice in securities. Any dealing in securities is deemed to be fraudulent or an unfair trade practice if it involves fraud and may include all or any of the following:

- a) Indulging in an act which creates false or misleading appearance of trading in the securities market;
- b) Dealing in a security not intended to effect transfer of beneficial ownership but intended to operate only as a device to inflate, depress or cause fluctuations in the price of such security for wrongful gain or avoidance of loss;
- c) Advancing or agreeing to advance any money to any person thereby inducing any other person to offer to buy any security in any issue only with the intention of securing the minimum subscription to such issue;

- d) Paying, offering or agreeing to pay or offer, directly or indirectly, to any person any money or money's worth for inducing such person for dealing in any security with the object of inflating, depressing, maintaining or causing fluctuation in the price of such security;
- e) Any act or omission amounting to manipulation of the price of a security;
- f) Publishing or causing to publish or reporting or causing to report by a person dealing in securities any information which is not true or which he does not believe to be true prior to or in the course of dealing in securities.
- g) Entering into a transaction in securities without intention of performing it or without intention of change in ownership of such security.
- h) Selling, dealing or pledging of stolen or counterfeit security whether in physical or dematerialized form.
- i) An intermediary promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in the price of such security and retaining the difference in prices as profit for himself.
- j) An intermediary providing his clients with such information relating to a security as cannot be verified by the clients before their dealing in such security.
- k) An advertisement that is misleading or that contains information in a distorted manner and which may influence the decision of the investors.
- l) An intermediary reporting trading transactions to his clients entered into on their behalf in an inflated manner in order to increase his commission and brokerage.
- m) An intermediary not disclosing to his client transactions entered into on his behalf including taking an option position.
- n) Circular transactions in respect of a security entered into between intermediaries in order to increase commission to provide a false appearance of trading in such security or to inflate, depress or cause fluctuations in the price of such security.
- o) Encouraging the clients by an intermediary to deal in securities solely with the object of enhancing his brokerage or commission.
- p) An intermediary predating or otherwise falsifying records such as contract notes.
- q) An intermediary buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract.
- r) Planting false or misleading news which may induce sale or purchase of securities.

#### 5.4 The Depositories Act, 1996

The paper based ownership and transfer of securities was a major drawback of the Indian securities markets since it often resulted in delay in settlement and transfer of securities,

leading to 'bad delivery', theft, forgery etc. The rapid growth in number and volume of transactions in the securities markets further highlighted the limitations of handling securities in the physical/paper mode. As a result, in line with the developments in the securities industry worldwide the paper based settlement and clearing system was replaced with depository system or a scrip less trading system. This transition was facilitated by the Depositories Act, 1996.

This Act provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by:

- a) Making securities of public limited companies freely transferable subject to certain exceptions;
- b) Dematerialising the securities in the depository mode; and
- c) Providing for maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages transfer of ownership of securities electronically by book entry without making the securities move from person to person.

The Act has made the securities of all public limited companies freely transferable, restricting the company's right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with.

The terms used in the Act are defined as under:

- a) **Beneficial owner** means a person whose name is recorded as such with a depository.
- b) **Depository** means a company, formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (1A) of section 12 of the SEBI Act, 1992.
- c) **Issuer** means any person making an issue of securities.
- d) **Participant** means a person registered as such under sub-section (1A) of section 12 of the SEBI Act, 1992.
- e) **Registered owner** means a depository whose name is entered as such in the register of the issuer.

No depository can act as a depository unless it obtains a certificate of commencement of business from the SEBI Board.

The Depositories Act, defines **the rights and obligations of depositories, participants, issuers and beneficial owners** which are mentioned below (Chapter III):

- (i) **Agreement between Depository and Participant:** A depository is required to enter into an agreement in the specified format with one or more participants as its agent.
- (ii) **Services of Depository:** Any person, through a participant, may enter into an agreement, in such form as may be specified by the bye-laws, with any depository for availing its services.

(iii) **Surrender of Certificate of Security:** Any person who has entered into an agreement with a depository should surrender the certificate of security, for which he seeks to avail the services of a depository, to the issuer in such manner as may be specified by the regulations. The issuer, on receipt of certificate of security, should cancel the certificate of security and substitute in its records the name of the depository as a registered owner in respect of that security and inform the depository accordingly. A depository should, on receipt of information enter the name of the person in its records, as the beneficial owner in respect of that security and inform the depository accordingly.

(iv) **Registration of Transfer of Securities with Depository:** On receipt of intimation from a participant, the depository is required to register the transfer of security in the name of the transferee. If a beneficial owner or a transferee of any security seeks to have custody of such security, the depository should inform the issuer accordingly.

(v) **Options to Receive Security Certificate or Hold Securities with Depository:** Every person subscribing to securities offered by an issuer should have the option either to receive the security certificates or hold securities with a depository. Where a person opts to hold a security with a depository, the issuer should intimate such depository the details of allotment of the security, and on receipt of such information the depository should enter in its records the name of the allottee as the beneficial owner of that security.

(vi) **Securities in Depositories to be in Fungible Form:** All securities held by a depository should be in dematerialised and be in fungible form.

(vii) **Rights of Depositories and Beneficial Owner:** A depository is deemed to be the registered owner for the purpose of effecting transfer of ownership of security on behalf of a beneficial owner. The depository as a registered owner does not have any voting rights or any other rights in respect of securities held by it. The beneficial owner is entitled to all the rights and benefits and is subjected to all the liabilities in respect of his securities held by a depository.

(viii) **Pledge or Hypothecation of Securities held in a Depository:** A beneficial owner may with the previous approval of the depository create a pledge or hypothecation in respect of a security owned by him through a depository. Every beneficial owner is required to give intimation of such pledge or hypothecation to the depository and accordingly the depository makes entries in its records. Any entry in the records of a depository would act as an evidence of a pledge or hypothecation.

(ix) **Furnishing of Information and Records by Depository and Issuer:** Every depository should furnish to the issuer information about the transfer of securities in the name of beneficial owners at such intervals and in such manner as may be specified by the bye-laws. Every issuer should make available to the depository copies of the relevant records in respect of securities held by such depository.

- (x) **Option to Opt out in Respect of any Security:** If a beneficial owner seeks to opt out of a depository in respect of any security, he should inform the depository accordingly. After receiving the information, the depository is required to make appropriate entries in its records and inform the issuer. Within thirty days of the receipt of intimation from the depository and on fulfillment of such conditions and payment of such fees as may be specified by the regulations, the issuer is required to issue the certificate of securities to the beneficial owner or the transferee, as the case may be.
- (xi) **Depository to Indemnify Loss in certain cases:** In case of any loss caused to the beneficial owner due to the negligence of the depository or the participant, the depository has to indemnify beneficial owner. Where the loss due to the negligence of the participant is indemnified by the depository, the depository has the right to recover the same from such participant.

## 5.5 Indian Contract Act, 1872

In the securities markets, the SCRA governs the contracts for or relating to the purchase or sale of securities. However, the provisions of the Indian Contract Act, 1872 also have a bearing on these securities' contracts as this is a general Act which governs the rights of parties in a contract and the effects thereof.

Following are some important terms/definitions used in the Indian Contract Act:

- (i) **Contract:** According to section 2(h) of the Indian Contract Act, 1872, a contract is an agreement enforceable by law. Therefore, there has to be an agreement to create a contract and secondly, it has to satisfy certain requirements mentioned in section 10 of the Act, i.e., the agreement has to be between parties competent to contract, with their free consent, for a lawful object and with lawful consideration, and it should not have been expressly declared as void agreement.
- (ii) **Standard Form Contracts:** With an enormous increase in commercial transactions, the concept of Standard Form Contracts has come into existence. Various business organisations like insurance companies, airways, securities market regulator, other businessman etc. generally get the terms of the contract printed on a standard form and the other side is simply required to agree to the same, or sometimes to sign in token of his having agreed to the terms of the contract so drafted. A standard form contract is a pre-established record of legal terms regularly used by a business entity or firm in transactions with customers. The record specifies the legal terms governing the relationship between the firm and another party. The firm requires the other party to accept the record without amendment and without expecting the other party to know or understand its terms. A Standard Form Contract is effective upon acceptance.
- (iii) **Agency Contract:** An agent is a person employed to do any act for another or to represent another in dealings with third persons, as per section 182 of the Indian Contract Act, 1872. The person for whom such act is done, or who is so represented, is



called the Principal. Principal is bound by the acts done by an agent or the contracts entered into by him on behalf of the principal in the same manner, as if the acts had been done or the contracts had been entered into by the principal himself, in person.

An agent has a dual capacity: one, he serves as a connecting link between his principal and the third person, and second, he can have a contractual relationship with his principal.

An agent, having an authority to do an act, has authority to do every lawful thing which is necessary in order to do such act. An agent having authority to carry on a business, has authority to do every lawful thing necessary for the purpose, or usually done in the course, of conducting such business.

**(iv) Sub-agent:** A sub-agent is a person employed by, and acting under the control of, the original agent in the business of the agency. Though the general rule is against delegation of authority by an agent or the appointment of a sub-agent, there could be such an appointment in exceptional situations recognised by law. Thus, when any act does not need personal performance by the agent himself, or the principal agrees to the appointment of a sub-agent, or the ordinary custom of trade permits the same, or the nature of the business of agency so warrants, nature of the agency so warrants, a sub-agent may be validly appointed by an agent.

When a sub-agent has been properly appointed the position of various parties is as under:

- The principal is, so far as regards third persons, represented by the sub-agent, and is bound by and responsible for his acts, as if he were an agent originally appointed by the principal.
- The agent is responsible to the principal for the acts of the sub-agent.
- The sub-agent is responsible for his acts to the agent, but not to the principal except in case of fraud or willful wrong.

## 5.6 Income Tax Act, 1961

Some of the important definitions related to Income Tax Act are as follows:

- Domestic Company** means an Indian company, or any other company which, in respect of its income liable to tax under this act, has made the prescribed arrangements for the declaration and payment, within India, of the dividends (including dividends on preference shares) payable out of such income, as per Section 2 (22A).
- Dividend**, according to Section 2(22) includes:
  - Any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or

any part of the assets of the company;

- b) Any distribution to its shareholders by a company of debentures, debenture-stock, or deposit certificates in any form, whether with or without interest, and any distribution to its preference shareholders of shares by way of bonus, to the extent to which the company possesses accumulated profits, whether capitalised or not;
- c) Any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not;
- d) Any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not;
- e) Any payment by a company, not being a company in which the public are substantially interested, of any sum (whether as representing a part of the assets of the company or otherwise) made after the 31st May, 1987, by way of advance or loan to a shareholder, being a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) holding not less than ten per cent of the voting power, or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest (hereafter in this clause referred to as the said concern) or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company in either case possesses accumulated profits.

but 'dividend' does not include:

- a) A distribution made in accordance with sub-clause (c) or sub-clause (d) in respect of any share issued for full cash consideration, where the holder of the shares is not entitled in the event of liquidation to participate in the surplus assets;
- b) A distribution made in accordance with sub-clause (c) or sub-clause (d) in so far as such distribution is attributable to the capitalised profits of the company representing bonus shares allotted to its equity shareholders after the 31st day of March, 1964 (and before the 1st day of April, 1965);
- c) Any advance or loan made to a shareholder (or the said concern) by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company;
- d) Any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend

within the meaning of sub-clause (e), to the extent to which it is so set off;

- e) Any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of section 77A of the Companies Act, 1956;
- f) Any distribution of shares pursuant to a demerger by the resulting company to the shareholders of the demerged company (whether or not there is a reduction of capital in the demerged company).

**(iii) Dividend Income** (Section 8): For the purposes of inclusion in the total income of an assessee:

- (i) Any dividend declared by a company or distributed or paid by it within the meaning of sub-clause (a) or sub-clause (b) or sub-clause (c) or sub-clause (d) or sub-clause (e) of clause (22) of Section 2, should be deemed to be the income of the previous year in which it is so declared, distributed or paid, as the case may be;
- (ii) Any interim dividend should be deemed to be the income of the previous year, in which the amount of such dividend is unconditionally made available by the company to the member who is entitled to it.

**(iv) Interest on Securities** (Clause 28B of Section 2) means:

- (i) Interest on any security of the Central Government or a State Government,
- (ii) Interest on debentures or other securities for money issued by or on behalf of a local authority or a company or a corporation established by a Central, State or provincial Act.

**(v) Capital Asset**

- (i) Long term capital asset means a capital asset which is not a short term capital asset, as per Clause 29A of Section 2.
- (ii) Short term capital asset means a capital asset held by an assessee for not more than thirty-six months\* immediately preceding the date of its transfer, (Clause 42A of Section 2)\* twelve months in the case of a share held in a company or any other security listed in a recognised stock exchange in India or a unit of the Unit Trust of India established under the Unit Trust of India Act, 1963 or a unit of a Mutual Fund specified under clause (23D) of section 10 or a zero coupon bond.

**(vi) Capital Gains** (Section 45)

Any profits or gains arising from the transfer of a capital asset effected in the previous year should, save as otherwise provided in sections (54, 54B, 54D, 54E, 54EA, 54EB, 54F, 54G and 54H), be chargeable to income-tax under the head 'Capital gains', and

should be deemed to be the income of the previous year in which the transfer took place.

Where any person has had at any time during previous year any beneficial interest in any securities, then any profits or gains arising from transfer made by the depository or participant of such beneficial interest in respect of securities should be chargeable to income-tax as the income of the beneficial owner of the previous year in which such transfer took place and should not be regarded as income of the depository who is deemed to be registered owner of securities by virtue of sub-section (1) of section 10 of the Depositories Act, 1996, and for the purposes of section 48 and provision to clause (42A) of section 2, the cost of acquisition and the period of holding of any securities should be determined on the basis of the first-in-first-out method.

### Types of Capital Gains

1. **Long term Capital Gain** means capital gain arising from the transfer of a long term capital asset.
2. **Short term Capital Gain** means capital gain arising from the transfer of a short term capital asset.

### PAN compulsory for Securities transaction

The Income-tax (Eighth Amendment) Rules, 2002 made it mandatory for a person to quote permanent account numbers (PAN), issued by the income tax department, for securities transactions of over ₹ 1 lakh.

### Tax on long-term capital gains (Section 112)

Where the total income of an assessee includes any income, arising from the transfer of a long-term capital asset, which is chargeable under the head 'Capital gains', the tax payable by the assessee on the total income should be the aggregate of:

- (i) **in the case of an individual or a Hindu Undivided Family, being a resident:**
  - a) The amount of income-tax payable on the total income as reduced by the amount of such long-term capital gains, had the total income as so reduced been his total income; and
  - b) The amount of income-tax calculated on such long-term capital gains at the rate of twenty per cent:
- (ii) **in the case of a domestic company:**
  - a) The amount of income-tax payable on the total income as reduced by the amount of such long-term capital gains, had the total income as so reduced been its total income; and

- b) The amount of income-tax calculated on such long-term capital gains at the rate of twenty per cent

**(iii) in the case of a non-resident (not being a company) or a foreign company:**

- a) The amount of income-tax payable on the total income as reduced by the amount of such long-term capital gains , had the total income as so reduced been its total income; and
- b) The amount of income-tax calculated on such long-term capital gains at the rate of twenty percent

**(iv) in any other case of a resident:**

- a) The amount of income-tax payable on the total income as reduced by the amount of long-term capital gains, had the total income as so reduced been its total income; and
- b) The amount of income-tax calculated on such long-term capital gains at the rate of twenty per cent

Where the gross total income of an assessee includes any income arising from the transfer of a long term capital asset, the gross total income should be reduced by the amount of such income and the deduction should be allowed as if the gross total income as so reduced were the gross total income of the assessee. Where the total income of an assessee includes any income arising from the transfer of a long-term capital asset, the total income should be reduced by the amount of such income and the rebate under section 88 should be allowed from the income-Tax on the total income as so reduced.