

September 2023

## **NCLAT: Stock broking companies are 'financial service providers' under IBC, proceedings for initiation of CIRP not maintainable against them**

In a recent decision in the case of *Nitin Pannalal Shah Vs. Vipul H Raja & Ors.*<sup>1</sup> and *National Stock Exchange of India Limited Vs. Mr. Hemant Kumar Gupta*<sup>2</sup>, the principal bench of the NCLAT has held that a stock broking company is a 'financial service provider' under Section 3(16) of the Insolvency and Bankruptcy Code, 2016 ("IBC"), and thus, outside the purview of the IBC. Therefore, an application for corporate insolvency resolution process ("CIRP") against a stockbroker (being a financial service provider) is not maintainable.

### **Financial service providers under IBC**

1. Under the IBC, CIRP can be initiated against a 'corporate debtor'. A corporate debtor is a 'corporate person' who owes a debt to any person.
2. A 'corporate person' means a company defined under Section 2(20) of the Companies Act, 2013, a limited liability partnership under Section 2(1)(n) of the Limited Liability Partnership Act, 2008, or any other person incorporated with limited liability under any law for the time being in force "but shall not include any financial service provider" (Section 3 (7) of the IBC).
3. Under Section 227 of the IBC, the central government has the power to notify 'financial service providers' against whom CIRP can be conducted under the IBC.
4. A 'financial service provider' means a person engaged in the business of providing financial services in terms of authorisation issued or registration granted by a financial sector regulator (Section 3(17) of the IBC).
5. The list of 'financial services' is listed in Section 3(16) of the IBC and a 'financial sector regulator' means an authority or body constituted under any law for the time being in force to regulate services or transactions of financial sector and includes the Reserve Bank of India, the Securities and Exchange Board of India ("SEBI"), the Insurance Regulatory and Development Authority of India, the Pension Fund Regulatory Authority and such other regulatory authorities as may be notified by the central government (Section 3(18) of the IBC).

### **Brief Facts**

This decision arises out of 2 (two) appeals decided together by the NCLAT on a common issue:

<sup>1</sup> (Company Appeal (AT) (Insolvency) No. 379 of 2021.

<sup>2</sup> Company Appeal (AT) (Insolvency) No. 749 of 2022.

1. The first appeal arises out of an erstwhile director's challenge to NCLT, Ahmedabad's order admitting Simandhar Broking Ltd. into CIRP<sup>3</sup>; and
2. The second appeal arises out of the National Stock Exchange's ("NSE") challenge to NCLT, Delhi's order admitting Astitva Capital Market Pvt. Ltd into CIRP<sup>4</sup>.

#### **Appeal regarding Simandhar Broking Ltd.:**

1. Simandhar Broking Ltd. was a registered stockbroker with SEBI and a trading member of the NSE. A client of Simandhar Broking Ltd. filed an application under Section 7 of the IBC seeking initiation of CIRP against the stockbroker.
2. In a nutshell, NCLT, Ahmedabad held that if companies engaged in the stock broking business, or in derivative transactions, were considered as a 'financial service provider' and were excluded from the purview of the IBC, then Section 5(8)(g) of the IBC<sup>5</sup> would have not been in existence. Hence, NCLT, Ahmedabad concluded that Simandhar Broking Ltd. was not a financial service provider, and upon proof of debt and default, there was no bar in admitting this company into CIRP.
3. In the appeal by the erstwhile director of Simandhar Broking Ltd., NSE intervened to clarify the position on NSE trading members and SEBI-registered stockbrokers being a financial service provider.

#### **Appeal regarding Astitva Capital Market Pvt. Ltd.:**

1. Astitva Capital Market Pvt. Ltd was also stockbroker registered with SEBI and a trading member of the NSE.
2. The erstwhile director of Astitva Capital Market Pvt. filed an application under Section 7 of the IBC seeking initiation of CIRP against the stockbroker.
3. NCLT, Delhi admitted the petition and NSE (a non-party to the Section 7 IBC proceedings) filed an appeal against the admission order, being an 'person aggrieved' under Section 61(1) of the IBC.

### **Issue**

Whether a stockbroker registered with SEBI is a 'financial service provider' under Section 3(16) of the IBC and should, therefore, be kept outside purview of the IBC.

### **Findings and Rationale**

The NCLAT allowed both the appeals and set aside the orders of the respective NCLTs, answering the issue in the affirmative to hold that stockbrokers registered with SEBI and being trading members of NSE are financial service providers under IBC. The NCLAT held that:

1. Section 3(16) of the IBC is an inclusive definition. Hence, in view of Section 3(16)(e)<sup>6</sup>, the stockbrokers that are registered with SEBI and are NSE trading members are providing 'financial services', these stockbrokers are "financial service providers".

<sup>3</sup> Order dated April 6, 2021, CP (IB) No.510/7/NCLT/ AHM/2019, NCLT, Ahmedabad.

<sup>4</sup> Order dated November 25, 2021, CP(IB) No.397 of 2021, NCLT, Delhi.

<sup>5</sup> (8) "financial debt" means a debt alongwith interest, if any, which is disbursed against the consideration for the time value of money and includes- (g) any derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price and for calculating the value of any derivative transaction, only the market value of such transaction shall be taken into account;

<sup>6</sup> 3(16) "financial service" includes any of the following services, namely: - (e) rendering or agreeing, for consideration, to render advice on or soliciting for the purposes of--

(i) buying, selling, or subscribing to, a financial product;

(ii) availing a financial service; or

(iii) exercising any right associated with financial product or financial service.

2. The definition of 'corporate debtor' under Section 3(17) expressly excludes any 'financial service provider'. Therefore, in view of Sections 3(7), Section 3(8) and Section 227 of the IBC, the IBC applications filed against the stockbrokers are not maintainable.
3. The NCLAT relied upon the Report of Sub-Committee of the Insolvency Law Committee (constituted for insolvency of financial service providers)<sup>7</sup> which recognised that SEBI-Registered Stockbrokers are financial service providers.
4. On a consideration of – (a) the nature of activities contained in the memorandum of association of both the stockbrokers, (b) the registration of these stockbrokers with SEBI, and that (c) these stockbrokers are regulated by SEBI (Stockbrokers and Sub-Brokers) Regulations, 1992, and (d) these stockbrokers were subject to various obligation and duties towards Investors, the NCLAT concluded that these stockbrokers fall within the definition of 'financial service provider' under the IBC.
5. In the case of *Simandhar Broking Ltd.*, the NCLAT held that the NCLT's application and interpretation of Section 5(8)(g) of the IBC is also incorrect. Section 5(8)(g) has to be read harmoniously with Section 7, Section 5(7) and Section 5(8) of the IBC. The derivative transactions contemplated under Section 5(8)(g) cannot be read to include the services of financial service providers, thus, these services cannot constitute 'financial debt' under IBC.
6. In the case of *Astitva Capital Market Pvt. Ltd.*, the NCLAT held that the NCLT failed to consider that the erstwhile director of the stockbroker had maliciously initiated CIRP proceedings against itself to take shelter under the moratorium to stall the proceedings initiated by the NSE against this stockbroker.

## Conclusion

In a big relief to stockbrokers, the NCLAT brings quietus to the conflicting views of the NCLTs and NCLAT to finally decide that stockbrokers do not fall under the purview of IBC.

1. The NCLAT has applied a literal interpretation of the IBC provisions to determine the status of stockbrokers as a 'financial service provider' under the IBC. The NCLAT's reliance on the NSE's submissions and the Sub-Committee Report will go a long way in this decision attaining finality.
2. This judgement throws light on the Sub-Committee's rationale behind the exclusion of financial service providers from the purview of the IBC. The Sub-Committee takes a view that financial firms are different from other firms. The Sub-Committee takes a view that while other firms mostly rely on equity and debt, many financial service providers handle large amounts of consumers' money. Thus, some of these financial service providers are systemically important as their failure has the effect of disrupting the financial system and having an adverse effect on the country's economy.

The NSE's proactivity in these proceedings is laudable and noteworthy. It is unusual and noteworthy for the NSE to proactively file an appeal and an intervention (in cases where it was not a party) to safeguard its trading members from the purview of the IBC. Typically, regulators only plead their position on sectoral matters when they are called upon by courts and do not usually interfere unless the regulator is directly affected.

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<sup>7</sup>Sub-Committee constituted under Section 227 of the IBC by the MCA's order dated August 16, 2019.

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