Liabilities of parties; Dishonour of cheque.

UTTRAKHAND OPEN UNIVERSITY ***LL.M.-105***

SCHOOL OF SOCIAL SCIENCE **बैंकिंग विधि**

(BANKING LAW)

Expert Committee

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Rtd. Vice Chancellor
Kumaoun University, Nainital
Uttarakhand

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Mr. Narendra Kumar Jaguri
Law Departmet
Uttrakhand Open University Haldwani,
Uttarakhand

Mrs. Sapna Agarwal
Academic Consultant Law
Uttrakhand Open University Haldwani,
Uttarakhand

Course Coordination & Editing

Mr. Narendra Kumar Jaguri
Law Departmet
Uttrakhand Open University Haldwani, Uttarakhand

Unit Writers

No. Of Unit

Dr. Amit Ludhari 1,2,3,4,5,6,7, & 11,12,13,14
Assistant Professor
Law Department
Kurukchetra University
Kurukchetra

Dr.Arshad Hussain, 8,9,10
Assistant Professor
S.S.J. Campus AlmoraKumaun University
Nainital, Uttarakhand

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UTTRAKHAND OPEN UNIVERSITY HALDWANI

BANKING LAW

LL.M.-105

बैंकिंग विधि

LL.M. Part-1

PAPER- BANKING LAW

Block 1 - INTRODUCTION AND SOCIAL CONTROL OVER BANKING

Unit I – NATURE AND DEVELOPMENT OF BANKING LAW

STRUCTURE

1.1 INTRODUCTION

In the today's commercial world, without banking business one cannot survive. Money is the driving force behind all enterprises; it is the fountain-head of trade and commerce. When you don't-have an immediate use for your money but you don't, want to lose it ether, you have got to save it. Banks not only deal in money but they also create money. Credit money, popularly referred to as cheques, rule the money market today.
Today, Indian banking has come long way from the English Agency Houses at Calcutta and Mumbai. To quote O.W. Holmes, 'Put not your trust in money but put your money in trust". For the Indian populace, Holmes' statement simply means you can bank on Indian bank"
Banking in India is not new; it has long history of around 200 years for its existence as well as developments. During this period Banking as in functions, administrations, and regulations has changed a lot. The overall development of mankind in the century and very fast technology development in past 30-35 years has caused this. Besides to that the overall pace of the commercialization added with technological facilities has increased the customer needs and expectations in Banking Industry.
Any such, changes in retrospect give much interesting things to notice as well as improve the future. With this vision, if we look back the history of banking in India it has much interesting events. This banking, as and when needed different regulations, gives still more interesting events how variety of regulations went on emerging and how ultimately the present "Banking Regulation Act, l949 came into existence. The regulation catered the more- than one and half decade need of regulation on Banking.

1.2. OBJECTIVES

The objective of this unit is to study the overall development of banking in India. An imperative is also made to' study the general features of banking. The concepts of nationalization of banking, relation between banker and customer, banking business, banker's lien, types of accounts and special types of

accounts are being discussed in detail. By going through this unit, student will find, whole concept about banks and banking business. After nationalism of banks whole scenario of banking business has been changed.

1.3.1 NATURE AND DEVELOPMENT OF BANKING

The three Presidency Towns viz. Calcutta Bombay and Madras were having Presidency Banks respectively w.e.f 1809 - Bank of Bengal, 1840-Bank of Bombay, 1849 - Bank of Madras, in – 1867. The Bank of Bengal approached the Government with a proposal for amalgamation of these three banks. For two reasons the Government did not approve the idea. Firstly, it held that the single institution so formed would be too powerful. Secondly, it thought that for managing such a big institution countrywide there may not be available the required persons. But in 1899, the Government itself proposed the amalgamation. This time the Chambers of Commerce and the entire three presidency Banks opposed it. It is in the year 1919 that all agreed for amalgamation and it saw the year 1921 to amalgamate the presidency Banks. The new institution came to be known as Imperial Bank of India i.e. the present State Bank of India.

The idea to have a separate central bank, for regulatory function including issuance of currency notes, called as Reserve Bank of India came in 1926 in the recommendations of the Hilton Young Commission established in August, 1925 to examine and report on' Indian exchange and currency system. The idea was to take central Bank function from Imperial Bank and keep commercial banking function with imperial Bank. RBI, however, came into existence in 1935.

The first attempt on banking in India was the passing of the Indian Companies (Amendment) Act 1936, on January 15, 1937 incorporating a separate chapter on provisions relating to banking companies. Prior to its enactment, banks were governed for all important matters by the Indian Companies Act 1913. It applied commonly to banking as well as non-banking companies. There were only certain provisions in the Companies Act, which made a distinction between banks and other companies. These were Sec. 4 prohibiting a partnership

exceeding ten partners from carrying on the business of banking unless it was registered as a Company, Sec. 136. Company doing banking business to display six statement showing assets and liabilities, Sec. 138 empowering Government to appoint inspectors to investigate the affairs of a. banking company on the application of members holding not less than 1/5 of the shares as against 1/10 of the shares in case of other companies, Sec, 145 regarding some provisions relating to audit of Banking Company who has branches outside India.

The Banking Companies Act came into force on 16 March 1949. The name of the Banking Companies Act, 1949 stood changed to The Banking Regulation Act, 1949 by the amendment Act 23 of 1956 w.e.f. March 1966.

Initially the Act was not applicable to Co-Operative Banks but in 1965 it was made applicable to them also. In fact when the Act was aimed to regulate the Banking in India why the Co-Operative sector was left out, can not be understood. By the time Act came into existence, the Co-Operative Banking was much established in India.

Till date there are several amendments in the Banking Regulation Act, 1949, which were required to be made as per the changing needs of time and changing Banking practices, but by and Large the Act has proved to be of great help both to the Reserve Bank of India as well as Banks mainly it has been an administrative law in the ‘hands of the RBI. If test of any law is considered from the challenges, it receives in Courts of Law and the interpretations the judiciary has to add and contribute for the particular enactment, it can be said that the Banking Regulation Act, 1949 has stood the Exception to this is however about addition of Sec. 21-A w.e.f. 15th February 1984 by the Amendment Act 1984.

The Reserve Bank of India was nationalized in 1948 and this was followed by ‘the Banking Regulation Act of 1949. Subsequently, 14 major commercial banks were nationalized in 1969 and 1980 respectively. In 1993, the ‘New Bank of India, a nationalized bank was merged with the Punjab National Bank. Thus, the present tally of nationalized commercial banks amounts to 19 approximately.

Today, the preponderant bank 'in' the' Indian banking hierarchy is the Reserve Bank of India. The Indian Banking industry could be broadly classified into commercial banks and co-operative banks. The banks listed in the Second Schedule of the Reserve Bank of India Act, 1934 comprise the scheduled commercial banks while the others are non-scheduled commercial banks.

The State Bank of India was constituted on 1st July, 1955 under the State Bank of India Act to make over from the Imperial Bank of India. 60% of the share capital of S.B.I. is held by R.B.I. S.B.I commends a fifth of the Indian banking business and was the first bank of Indian origin to float a highly successful Global Depository Receipt in October, 1996.

The stage is all set for an autonomous banking environment wholly driven by market forces. The line that divided the Banks and Financial Institutions is getting thinner day by day. The norms have been eased for capital project funding by banks while Financial Institutions are venturing into short term working capital advances. The day is not very far when the convergence of the two sectors would usher 'universal' banking into India.

The Indian economy is poised to become the fourth largest economy in the world and Indian banks are already spreading their wings to conquer the huge global market.

1.3.2 NATIONALIZATION OF BANKS

The debate on the question of nationalization of commercial banks started after the imperial Bank of India was nationalized in 1955. Fourteen large Banks, which owned 84 per cent of the total deposits of all scheduled banks, were nationalized on July 19, 1969. In addition to this, 6 more banks, with deposits of Rs. 200 crores and above, were nationalized on April 15, 1980. With the increase in the number of public sector banks, the, debate on the issue on nationalization of banks assumed added significance. Private sector banks with a small aggregate paid-up capital are at present controlling a huge amount of public deposits and are thus encouraging Concentration of power and wealth as well as growth of monopolies. The Mahalanobis Committee in its report

submitted in February 1964 observed that 1 per cent of the country's households own over 75 per cent of the privately hold stocks and even within this small minority there was high degree of concentration. The Monopolies Enquiry Commission in its report submitted in December, 1965, observed that management control was more concentrated than ownership control and liberal loans by bank and other financial intermediaries strengthened this trend towards concentration. Nationalization of banks, it is argued, will help to remedy this social evil to some extent.

The commercial banks operating in the private sector are dominated by industrialists who use the entire volume of public deposits for, their own purpose. General share capital represented about 2 per cent of the available funds in their hands. Usually the big business houses do not put a limit to their financial and speculative operations because they have a small fraction of share capital in their hands. Instead, they get extra credit facilities from banks. In fact, vast resources of the commercial banks are utilized by businessmen even for pure speculation and also for hoarding of essential commodities since the directors of many banks are their personal friends. The findings of the Vivian Bose commission revealed the antisocial and anti-national activities of banks in regard to Mundra deals, violation of the exchange control regulations and many other fraudulent activities. Nationalization is expected to stop these malpractices.

Nationalization of commercial banks will enable our banking system to open new branches in the rural and semi-urban areas and help to accelerate the rate of mobilization of savings from these areas.

Nationalization of Banks will provide 100 percent safety to the depositors and thus it will not be necessary to incur any expenditure on account of the Deposit insurance corporation.

Nationalization will partially remedy the evil of unaccounted money ancl'concea1ed income and wealth. It will also bring in more revenues and resources for meeting our defense needs and development requirements.

Lastly, if we consider the role of exchange banks, the plea for nationalization becomes stronger. Foreign exchange banks at present have deposits of over Rs.30 Crores without investing

their own capital in India. These banks offer strong competition to the Indian Joint-stock banks. Moreover, profits earned by them are remitted abroad and this has its obvious repercussion on our balance of payments position. Nationalization will surely help us to get rid of the foreign exchange banks.

1.3.3VIEWS AGAINST NATIONALIZATION

Nationalization will bring to an end the efficient personalized service which we now get from the private sector banks, particularly the foreign exchange banks. Red-tapism, inordinate delay, lack of initiative and quick decision on the part of management will impair the smooth functioning of the banking system after nationalization.

The pleas for nationalization of all commercial banks do not follow from the efficient working of the State Bank of India for more than a decade. It appears that the State Bank of India has been functioning effectively because it has to face stiff competition from the well- organized and well-managed private sector banks. With all banks nationalized, the depositors will have no choice to shift to other banks if their requirements are not met. Naturally, in such circumstances banking facilities arid services will deteriorate.

The argument relating to the neglect of agriculture and small industries, located in the rural and semi-urban areas, by the private sector banks cannot tell water since commercial banks have to follow certain canons regarding the liquidity of their business. In fact, commercial banks cannot be expected to lock their funds for a long time in un remunerative and perilous. Ventures. It is well that the financing of these activities really belong to the Government which, in our case, should operate through the Reserved Bank of India the State Bank of India and the Co-Operative network.

The question of 100 per cent security to the depositors through nationalization should not arise in our case since the Indian Deposit Insurance Corporation is working quite efficiently and has succeeded in providing good deal of psychological relief to the Indian depositors.

As regards the charges of malpractices against the banks in the private sector, it may be observed that the package deal

approach, in which monetary measures are integrated with the fiscal gadgets and physical controls, can do a lot in this direction if it is effectively implemented. Moreover, a thorough remodeling of the inspecting staff of the Reserve Bank of India will also help in removing some of these irregularities.

Nationalization cannot bring a huge amount of revenue to the public exchequer because it Involves payment of compensation to the shareholders. Moreover, even after nationalization, sufficient margin of profits should be kept aside for strengthening the reserve fund.

In our case, it will be wrong to view the nationalization of commercial banks in isolation. It should constitute an important element of a comprehensive programme for socialization for which some amount of ground preparation is necessary. The Government, instead of adopting proper measures for effective ground preparation work, decided to experiment with the scheme for a social control of commercial banks as a stopgap measure before the nationalization of the bigger commercial banks was undertaken.

1.3.4 BANKING FUNCTIONS

Banking

In addition to this primary functions, a banker renders a number of services to his customer. The relationship between them primarily is that of a creditor and a debtor. A banker also acts as an agent or trustee of his customer if the latter entrusts the former with agency or trust work. In such cases, the banker acts as a debtor, an agent and a trustee simultaneously but in relation to the specified business.

On the opening of an account the banker assumes the position of a debtor. He is not a depository or trustee of the customer's money because the money handed over to the banker becomes a debt due from him to the customer. A depository accepts something for safe custody on the condition that it will not be opened or replaced by similar commodity. A banker does not accept -the depositors' money on such condition. The money deposited by the customer with the banker is, in legal terms, lent by the customer to the banker, who makes use of the same according to his discretion. The creditor has the right

to demand back his money from the banker and the banker is under an obligation to repay the debt as and when he is required to do so. But it is not necessary that the repayment is made in terms of the same currency notes and coins. The payment, of course, must be made in terms of legal tender currency of the country.

A depositor remains a creditor of his banker so long as his account carries a credit balance. But he does not get any charge over the assets of his: debtor/banker and remains an unsecured creditor of the banker. Since the introduction of deposit insurance in India in 1962 the element of risk to the depositor is minimized as the Deposit Insurance and Credit Guarantee Corporation undertakes to insure the deposits up to a specified amount.

Banker's relationship with the customer is reversed as soon as the customer's account is redrawn. Banker becomes creditor of the customer who has taken a loan from the banker and Continues in that capacity tin the loan is re-paid. As the loans and advances granted by a banker are usually secured by the tangible assets of the borrower, the banker becomes a secured creditor of his customer.

Though the relationship between a banker and his customer is mainly that of a debtor and creditor, this relationship differs from similar relationship, arising out of ordinary commercial debts

The creditor must demand payment in case of ordinary commercial debt, the debtor pays the amount on the specified date or earlier or whenever demanded by the creditor as per the term of the contract. But in case of a deposit in the bank, the debtor-banker is not required to repay the amount on his own accord. It is essential that the depositor (creditor) must make a demand for the payment of the deposit in the proper manner. This difference is due to the fact that a banker is not an ordinary debtor; he accepts the deposits with an additional obligation to honor his customer's cheques. If he returns the deposited amount on his own accord by closing that account, some of the cheques issued by the depositor might be dishonored 'and his reputation might be adversely affected. Moreover, according to the statutory definition of banking, the 'deposits are repayable on demand or otherwise. The depositor

makes the deposit for his convenience, apart from 'his motive to cant an income (except current account). Demand by the creditor is therefore essential for the refund of the deposited money. Thus the deposit made by a customer with his banker differs substantially from an ordinary debt.

The demand by the creditor must be made at the proper place and in proper time. A commercial bank, having a number of branches, is considered to be one entity, but the depositor enters into relationship with only that branch where an Account is opened in his name. His demand for the repayment of the deposit must be made at the same branch of the bank concerned otherwise the banker is not bound to honour his commitment. However, the customer may make special arrangement with the banker for the repayment of the deposited money, at some other branch. For example in case of bank drafts, traveler's cheques, etc., the branch receiving the money undertakes, to re-pay it at a specified branch or at any branch of the bank.

Demand must be made in proper manner According to the statutory definition of, banking, deposits are withdraw able by cheques drafts, order or otherwise. It means that the demand for the refund of money deposited must be made through a cheque or an order as per the common usage amongst the banker. In other words, the demand should not be made verbally or through a telephonic message or in any, such manner.

Ordinarily, a banker is a debtor of his customer in respect of the deposits made by the latter, but in certain circumstances he acts as a trustee also. A trustee holds money or assets and performs certain functions for the benefit of some other person called the beneficiary. For example, if the customer deposits securities or other valuables with the banker for sale custody, the latter acts as a trustee of his customer. The customer continues to be the owner oft, the valuables deposited with the banker. The legal position of the banker as a trustee therefore, differs from that of a debtor of his customer. In the former case the money or documents held by him are not treated as his own and are not available for distribution amongst his general creditors in case of liquidation.

The position of a banker as a trustee or as a debtor is determined according to the circumstances of each case. If he does something in the ordinary course of his business, without any specific direction from the customer, he acts as a debtor (or creditor). In case of money or bills etc., deposited with the bank for specific purpose, the bankers position will be determined by ascertaining whether the amount was actually debited or credited to the customer's account or not. For example, in case of cheques sent for collection from another banker, the banker acts as trustee till the cheque is realized and credited to his customer" account and thereafter he will be the debtor for the same amount. If the collecting bank fails before the payment of the cheque is actually received by it from the paying bank, the money so realized after the failure of the bank will belong to the customer and will not be available for distribution amongst the general creditors of the bank.

On the other hand, if a customer instructs his bank to purchase certain securities out of his deposit with the latter, but the bank fails before making such purchase, the bank will continue to be a debtor of his customer (and not a trustee) in respect of the amount which was not withdrawn from or debited to his account to carry out his specific instruction

A banker acts as an agent of his customer and performs a number of agency functions for the convenience of his customers. For example, lie buys or sells securities on behalf of his customer, collect cheques on his behalf and makes payment of various dues of his Customers, e.g. insurance premium, etc. The range of such agency functions has become much wider and the banks are now rendering a large number of agency services of diverse nature. For example, some banks have established Tax Service to take up the tax problems of their customers.

1.3.5 BANKING BUSINESS

A Sank is usually thought of as a reliable agency with which money is deposited. The idea is wanting in precision. Banks do receive valuables for safe custody and undertake to return them, but that is only a subsidiary function. Usually it is jewelry, deeds, securities and similar articles, which are given

to the Bank as safe custody deposits. But the services rendered by a bank either as depository or as trustee are only few of the many services, some of them of a more important nature, a modern commercial bank renders. In very general terms, the functions of a commercial bank can be classified under the following main heads:

This is, perhaps, the most important function of almost au modern banks, as it is largely by means of deposits that a bank prepares the basis for several other activities. The money power of a bank, by which it helps largely the business community, depends considerably upon the amounts t can borrow by way of deposits, which may be in the form of fixed, savings or current deposits. All these go towards augmenting its resources. The money received on fixed deposits can be used without any risk of withdrawal before the due date, and, in the case of savings deposits, a bank can use a very large part of them, as generally the demands of customers having such deposits are comparatively small, on account of restrictions placed as to the amount to be Withdrawn and the number of withdrawals to be made within a week: By the opening of current accounts, a bank not only funds, but also provides its clients with deposit currency which is both more convenient and more economical than other forms of currency. By taking money on deposit, a bank provides safe keeping for people's money. But the money is not set apart in a strong room. It is replaced by a debt due from a banker, who ordinarily pays interest so long as the money is retained by him as a deposit. The principle together with interest is returned on its being claimed in accordance with the terms of the contract.

This function, which was once, considered to be the most paying part of a banker's business, is in modern times performed generally by central banking institutions, in most of the leading countries of the world. Its importance to banks in general has dwindled in some of the important countries, in which the cheque currency has replaced bank-notes to a large extent. For instance, in England and in the United States of America, the part which is played by bank-note is becoming more and more insignificant, although they are stilt very popular in certain European countries such as France and

Germany, where serious efforts are being made to popularize the use of cheques a means of payment.

This function is not only very important, but is also the main source of profit to most of the banks. When a bank agrees to discount a bill, or gives funds in exchange for a promissory note, the transaction is known either as a discount or a loan. In either case, the bank agrees to place funds at the disposal of the borrower1 in exchange for a promise of payment at a future date. This enables those persons and corporations, who find their own capital insufficient for carrying on business on a large scale, to do so with the help of the funds borrowed from a bank, and thus use their capital more profitably than they could otherwise do bank therefore, is able to help not only merchants but also others who, in turn, may use funds not only to their advantage, but also to the advantage of the community.

Modern Banks are, generally, in a position to remit money, from one place or country to another, by means of drafts drawn upon their branches or agents. They can, also, by purchasing bills of exchange, enable merchants and other to; receive money from their debtor, in other cities or countries. These facilities have helped not only the internal trade of different countries, but also the international commerce. It will be evident that the great strides which have been made by trade and commerce, which, in turn, have been to a large extent responsible for the industrial development of different parts of the world, would have been an impossibility but for the facilities of exchange provided by banks.

1.3.6 MISCELLANEOUS FUNCTIONS

In addition to the main function given, above, modern banks perform miscellaneous services, such as

1) The issue of various forms of credits, e.g. letters of credit, travelers' cheques, credit cards and circular notes;
2) under-writing of capital issues;
3) the acceptance of bills of exchange, whereby the banker lends his name to his customers in return for a commission;

4) the safe custody of valuables;
5) acting as executors and trustees for customers;
6) preparing income-tax returns for their customers; and
7) Furnishing guarantees on behalf of customers, etc.

1.3.7 TYPES OF ACCOUNT

In case of current account, or what are also called demand deposits, the banker incurs the obligation of paying all cheques drawn against him so long as there is enough money to the credit of his customer. The customer on the other hand pays money in form of cash, cheques, drafts, postal- orders, money orders, etc., into the current- account. This be does by filling up paying in slips which are supplied either loose or in book form by the banker. These paying-in-slips have to be signed by the customer or his agent who pays the same in. When the slips are in book, form, there are counterfoils which the cashier of the bank rubber-stamps, or initials, after receiving cash. The legal effect of this stamping is a mere acknowledgement to the effect that the slip was in order and that the effects when cleared would be credited td the customer. It is not a receipt that would require revenue stamp if the amount happens to be over the limit fixed by the Stamp Act.

While Current Accounts are mainly meant for the business class, savings bank accounts are meant for the people to save and build up balances in accounts. While no interest is allowed on the current accounts, interest is allowed on the S.B. Accounts and it is governed by the .RBI directive. For the first time, the RBI made a distinction between savings accounts with and without cheque facilities. Savings deposit accounts without cheque facilities could be paid 5 per cent interest whereas those with cheque facilities could be paid only 3 per cent interest. These new rates came into force with effect from June 1, 1977. But again with effect from March 1, 1978, RBI abolished the distinction between the above two types of Savings Accounts and now interest shall be paid on deposits in S.B. Accounts at 4½ per cent p.a. irrespective of whether the cheque facility is extended or not, Interest shall be calculated on the minimum balance at the credit of the accounts during the period from 10th to the last day of each calendar month. No

interest shall be paid if the deposits Under the S.B. Accounts fail to earn a minimum of 50 paisa per half year. Interest payment shall be only at half yearly rests i.e., usually in May and November of each calendar year.

There are certain types of accounts which are different from individual or proprietary accounts requiring some care and attention not only while opening such accounts, but even thereafter. There are well–known Precautions to be taken for special types of accounts. Such a special account may be a deposit account, or a borrowing account, but in any case certain principles governing special types of accounts must be known to a banker. The following accounts may be considered as special types of accounts:

i) Minor's Account
ii) Lunatics
iii) Intoxicated Persons
iv) Insolvents
v) Joint Account
vi) Joint Account' between Husband & Wife
vii) Married Woman
viii) Joint Hindu Family Firm

1.4 SUMMARY

Today, Indian banking has come long way from the English Agency Houses at Calcutta and Mumbai. To quote O.W. Holmes, 'Put not your trust in money but put your money in trust". For the Indian populace, Holmes' statement simply means you can bank on Indian bank"

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In case of current account, or what are also called demand deposits, the banker incurs the obligation of paying all cheques drawn against him so long as there is enough money to the credit of his customer. The customer on the other hand pays money in form of cash, cheques, drafts, postal- orders, money orders, etc., into the current- account. This be does by filling up paying in slips which are supplied either loose or in book form by the banker. These paying-in-slips have to be signed by

the customer or his agent who pays the same in. When the slips are in book, form, there are counterfoils which the cashier of the bank rubber-stamps, or initials, after receiving cash. The legal effect of this stamping is a mere acknowledgement to the effect that the slip was in order and that the effects when cleared would be credited td the customer. It is not a receipt that would require revenue stamp if the amount happens to be over the limit fixed by the Stamp Act.

While Current Accounts are mainly meant for the business class, savings bank accounts are meant for the people to save and build up balances in accounts. While no interest is allowed on the current accounts, interest is allowed on the S.B. Accounts and it is governed by the .RBI directive. For the first time, the RBI made a distinction between savings accounts with and without cheque facilities. Savings deposit accounts without cheque facilities could be paid 5 per cent interest whereas those with cheque facilities could be paid only 3 per cent interest. These new rates came into force with effect from June 1, 1977. But again with effect from March 1, 1978, RBI abolished the distinction between the above two types of Savings Accounts and now interest shall be paid on deposits in S.B. Accounts at 4½ per cent p.a. irrespective of whether the cheque facility is extended or not, Interest shall be calculated on the minimum balance at the credit of the accounts during the period from 10th to the last day of each calendar month. No interest shall be paid if the deposits Under the S.B. Accounts fail to earn a minimum of 50 paise per half year. Interest payment shall be only at half yearly rests i.e., usually in May and November of each calendar year.

There are certain types of accounts which are different from individual or proprietary accounts requiring some care and attention not only while opening such accounts, but even thereafter. There are well–known Precautions to be taken for special types of accounts. Such a special account may be a deposit account, or a borrowing account, but in any case certain principles governing special types of accounts must be known to a banker. The following accounts may be considered as special types of accounts:

i) Minor's Account
ii) Lunatics

iii) Intoxicated Persons
iv) Insolvents
v) Joint Account
vi) Joint Account' between Husband & Wife
vii) Married Woman
viii) Joint Hindu Family Fir

1.5 SUGGESTED READINGS

P.N. Varshney, Banking Law and Practice.
Tannan's, Banking law and practice in India.
Singhvi,L.M., Bank Naqtionalisation and the Supreme Cour Judgment,1971

1.6 TERMINAL QUESTIONS

1. Write a essay on development of banking in India.
2. Discuss the relationship of banker with customer.
3. How many types of account in banks?
4. Write a essay on banking business in India.

LL.M. PART – I
PAPER- BANKING LAW

Block I - INTRODUCTION AND SOCIAL CONTROL OVER BANKING

Unit 2– NATIONALIZATION; EVALUATION: PRIVATE OWNERSHIP, NATIONALIZATION AND DISINVESTMENT

STRUCTURE

2.1 INTRODUCTION

After independence, India adopted a socialist pattern of society as its goal. This means, in. non-technical language, a society with wealth distributed as equitably as possible without making the country a totalitarian State. The goal is purported to be achieved through democratic processes. With this aim in view, a mixed pattern of planning is evolved. The two sectors,- private and public, are allowed in function independently of each other. The public sector is wholly owned and controlled by the Government. The private sector is regulated through a system of regulations, licences, controls and legislative acts, the latest of which is the Monopolies and Restrictive Trade Practices Act, 1969. The public sector is made to grow by nationalization of industries and institutions.

The banking institutions are the custodians of private savings and a powerful instrument to provide credit. They mobilise the resources of the country by accepting deposits and channellise them for industrial and national development by granting advances. In 1955 the Imperial Bank of India was nationalized and its undertaking was taken over by the State Bank of India. As regards the scheduled banks, there were complaints that Indian commercial banks were directing their advances to the large and medium scale industries and big business houses and that the sectors demanding priority such agriculture, small-scale industries and exports were not receiving their, due share.

Although steps had been taken in January, 1969, by amending the Banking Regulation Act, for the purposes of imposing “social control” with a view to remedy the basic weak nesses of the Indian banking system and to ensure that banks would cater to the ‘needs of the hitherto neglected and weaker sections of the community instead of big businesses and those connected with them, it was felt that the imposition of “social control” had not changed the position very much and there were complaints that the Indian commercial banks continued to direct their advances to large and medium scale industries and that sectors demanding priority such as agriculture, small-scale industries and imports were not receiving the attention due to them of the banks.

On 19th July, 1969 fourteen major banks viz., The Central Bank of India Ltd., The Bank of India Ltd. The Punjab National Bank Ltd., The Bank of Baroda Ltd., The United Commercial Bank Ltd., The Canara Bank, Ltd., The United Bank of India Ltd., The Dena Bank Ltd The Syndicate Bank, Ltd The Union Bank of India Ltd, The Allahabad Bank Ltd., The Indian Bank Ltd.., The Bank of Maharashtra Ltd. and The Indian Overseas Bank Ltd., each having deposits of more than Rs. 50 crores and having between themselves aggregate deposits of Rs. 2,632 crores with 4,130 branches were nationalized and taken over The nationalization of the commercial banks was a revolution in the Indian banking system. This "revolution' did not merely signify a change of the ownership of these banks but it was the beginning of a coordinated endeavour to use an important part of the financial mechanism for the country's economic development.

It was stated that, in nationalizing the banks, Government was only putting into effect its programme for achieving socialistic pattern of society and it was hoped that nationalization would effectively decentralize credits with the result that the priority sectors such as agriculture, small-scale industries, exports, self-employed etc., would be provided with liberal banking facilities and that banking units would be extended to rural areas. The critics of nationalization argued that the "social control" on banks should have been given a fair chance and trial for its success and tried for a longer period. It was also argued that in line with the performance of other public sector undertaking inefficiency and nepotism would creep in the banking system specially in an industry like banking which is more personalized than other industries.

Nationalized banks are expected to give priority to the schemes of the neglected sectors and exports, to meet some of the demands of the public sector undertaking and to use the balance of the available sources for organized industries on the basis that new enterprises and those in backward areas will be preferred to the big business houses. To achieve those objects, sectors constituting weak and backward areas and the exporting sector may be charged lower rate of interest than that charged to established businesses thereby subsidizing these sectors. A further step in the form of credit guarantee

insurance payable by the stronger parts of the community to insure the risk involved in the lending to the weaker sector is also envisaged.On 15th April, 1980, six more banks were nationalized.

2.2 OBJECTIVES

In this unit nationalization of banks is discussed in detail by citing arguments for nationalization and against the nationalization. Further, an attempt is made to discuss the legal mode for nationalization of banks, public issues and regulations for Nationalized Banks.

2.3.1 ARGUMENTS FOR NATIONALIZATION OF 14 BANKS

The reason for the sudden step was stated officially to be that 'public ownership of the major banks will help most effectively the mobilization and development of national resources and its utilization for productive purposes in accordance with the Plans and priorities." The long title of the Ordinance promulgated on 19-7-1969 explained that the fourteen banks were taken over by the Government "in order to serve better the needs of development of the economy in conformity with the national policy and objectives."
The object of the social control was also the same, but the Government thought that it was not 'successful During the debate on the Bill on 29-7-1970 for nationalization, of 14 bank the Prime Minister gave the Government's reply in the following words to - the question, "Why the, social control could not have been tried for a longer period" :-

The weakness of social control was that in many banks people who had been controlling their policies in the past continued to exercise their influence over them in one way or another, sometimes by the continued presence of the old Chairman or Vice-Chairman of the Boards. The banks might as some did, obey the instructions and directions given to them. But there is all the difference in the world between people who carry out a policy wholeheartedly and with enthusiasm and those who do only because of certain instructions."

It was also argued that the restrictions imposed by social control measures were capable of being flouted in spirit although observed in form. For instance, the restraints on advances to directors and their interested concerns could be mutually adjusted amongst bankers in such a way as to defeat the very purpose of such restraints. It was stated that it would' have taken a 'long' time for the banks to throwaway their traditional outlook; indirect influence, howsoever stringent the' laws may be, could not achieve the purpose; direct control would be more effective; the needs of the time were pressing; the country could not afford the trial and error method and "an element of dynamism and new vigour into-the process of our development" was necessary.

One further argument was that the-major banks were operating mostly with other people's money. The financial stake of the shareholders was almost negligible. "Against a total deposit of Rs. 2,750 crores at the end of December, 1968, the paid-up capital was only Rs. 28.5 crores or just a little over one per cent". This aspect of banking has led even predominantly capitalist countries to nationalize their banks or keep an eagle eye on them. France has nationalized four of its six large banks and Italy, four out of its five.It was stated that in nationalizing the 14 banks the Government was merely putting into effect its own long decided programme or achieving the socialist pattern of society.

Hope and enthusiasm were liberally expressed that the nationalization 'Will effectively channellise the credits to priority fields of agriculture small-scale and exports; that banking units now would expand in rural areas and the public confidence will be greatly enhanced. The employees' welcome to the step indicated that the efficiency and service will no suffer.

2.3.2 ARGUMENTS AGAINST NATIONALIZATION

Several eminent persons opposed the measure. They argued that 168 days from 1-2-1969, the day of imposition of "social control" to 19.7.1969 the day of nationalization was too short a period to judge the results of "social control" and there was no reason to conclude that it bad failed. There were on the contrary ample indications that the banks had welcomed the

spirit of “social control”. They showed that they were acting not under - compulsion but in a spirit of cooperation and willingness. For instance, from June 1968 to March 1969 credit given by 20 major banks to agriculture increased from Rs. 30 crores to Rs. 97 crores and to small-scale industries from Rs. 167 crores to Rs. 222 crores. The floating of the Agricultural Finance Corporation by the scheduled banks was very significant.

The opponents also argued that there was no such pressing need as made out by Government. The timing of the step was determined by political tussles and it was the result of inter-party struggle for power. They argued that a switch over to the public sector is not the only remedy for the evils, revealed in the private sector; the process merely results in substitution of one group of evils for the other The internal control of the Government is accompanied by equal or perhaps more harmful evils; public sector institutions are known for their lack of dynamism.

As to the reference to foreign countries, the opponents argued that banking industry is not nationalized in all- socialist countries. Commercial banks in Norway, Sweden, Finland and Denmark are in private hands and “every Russian bankers talk like bankers”!

The opponents also argued that the experience of public sector undertakings has not been happy. Public control leaves the door open for corruption and favoritism. Their performances are not always commendable. Their losses are heavy. The common man has a justifiable belief that public sector undertakings do not respect an individual and delays and lethargy in work and service are a bane of such undertaking. Particularly in a personalized service like banking these evils are likely to be more rampant.

As against the achievements made since nationalization it is being suggested that, because of lack of competition between the banks and the fact that employees have become public sector minded, quality of services rendered by, them has dropped on the one band whilst on the other charges made by nationalized banks have increased progressively. It is also being argued that by virtue of the control which is being exercised since nationalization by Reserve Bank and

Government authorities, the executives and other officials of the banks are afraid to take decisions which has naturally affected adversely and slowed down the services to the nationalized banks customers.

2.3.3 LEGAL MODE ADOPTED FOR NATIONALISATION OF 14 BANKS

Late in the afternoon of Saturday the 19th of July, 1969 the Vice–President of India (acting as an Ordinance No. 8 of 1969 in exercise of his power under Article 123 (1) of the Constitution. It was called The Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969. The undertakings of the 14 banking companies each with a deposit of Rs. 50 crores or more were purported to be transferred to 14 new body corporates called "corresponding new banks". The ordinance provided for the machinery of management of the 14 new banks and payment of compensations to the shareholders of the Corresponding banking companies, which were taken over.

Petitions challenging the competence of the Ordinance were filed in the Supreme Court of India on 21st July, 1969. But before they were heard, the Parliament passed and enacted on 9th August, 1969 the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969 (Act 22 of 1969). The Ordinance 8 of 1969 was repealed by the Act. The Act was also challenged in the Supreme Court. An ad interim injunction was granted by the Supreme Court against the operation of the Act.

The Supreme Court Bench of 11 judges, decided the petitions on 10th February, 1970 holding by a majority of 10 to 1 that although the Act 22 of 1969 was within the legislative competence of Parliament, it was void in its entirely for the following main reasons:

2. The Act prohibited the 14 banking companies from carrying on banking business, whereas other banks, Indian and permitted to carry on banking business; this was hostile discrimination
2. Although the 14 banking companies would carry on any other business, since they were stopped of their assets,

staff, premises and even names, it was impossible for them to carry on any other business; this was an unreasonable restriction.

3. The principles adopted for determining the compensation to the 14 banking companies were illusory and irrelevant [*Rustom Cowasji Cooper* v. *Union of India*. AIR 1970 SC 564}

The President promulgated another Ordinance (No.3 of 1970) on 14.2.1970 which was followed by another Act.

The Act received the President's assent on 31st March, 1970. Under its Section 1 (2) most of its provisions are deemed to have come into force on 19th July, 1969, the day on which the Ordinance No. 8 of 1969 was promulgated. The new Act attempted to plug the constitutional loopholes pointed out by the Supreme Court. The Act has come to stay.

2.3.4 MAIN PROVISIONS OF THE NATIONALIZING ACT

The long title of the Act reads:

> "An Act to provide for the Acquisition and Transfer to the undertakings of certain banking companies, having regard to their Size, resources, coverage and organization, in order to control the heights of the economy and to meet progressively and serve better, the needs of development of the economy in conformity with national policy and objectives and for matters connected therewith or incidental thereto."

The long title appears to provide dome of the reasons and arguments justifying the nationalization of the bank. From a strictly legal point of view, the title is a mere decoration and is hardly likely to be useful in the interpretation of the Act. The Supreme Court has observed in the judgment in the bank nationalization case, 'whether the policy followed by the Government in office or the police propounded by the opponents may reasonably attain the natural objectives are matters which have little relevance in determining the legality of a measure". The Act deals mainly with three topics:

2. The mode and mechanics of transfer of the undertakings of the 14 existing banking companies;

2. Payment of compensation to the 14 banking companies, undertakings of which are taken over;
3. Management of the 14 new banks nationalized.

2.3.5 PUBLIC ISSUE OF NATIONALISED BANKS

The Narasimham Committee on the Financial System had suggested that State Bank of India and public sector banks should be allowed to increase capital through public issue the Committee recommended that in respect of banks whose operations have been profitable and when enjoy a good reputation in the markets. They could straightaway approach the capital market for enhancement of their capital. In respect of such banks, issue of fish capital to the public through the capital market should be permitted. Subscribers to such issues could include mutual funds, profitable public sector undertakings and employees of the institutions besides the general public. Therefore, the Banking Companies (Acquisition and Transfer of Undertakings) Amendment Act, 1994 has been passed to amend Banking Companies (Acquisition and Transfer of Undertakings Act, 1970 and. 1980 to provide for public issue of the nationalized banks and to provide that the entire paid-up capital of banks, except the paid-up capital raised by public issue shall stand vested in the Central, Government. However, the Central Government shall hold not less than 51 % of share capital of each Bank.

In accordance with the suggestions made by the Narasimham Committee, some of the public sector banks are also tapping the capital market directly to mobilise equity funds from the public. For this purpose, the scope of State Bank of India provision for partial private shareholding in its statute was enhanced by issuing an ordinance in October, 1993 for amending the State Bank of India Act, 1955. The SBI was the first public sector bank to access the capital market and it raised Rs. 2,210 crores in the form of equity and Rs. 1,000 crores through bonds.

The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980 have also been amended to enable the public to subscribe to the capital of the nationalized banks upto 49 % of their total capital. Government will however

continue to hold at least 51 % of the equity of each of the nationalized banks. The nationalized banks have not raised capital from the market, but some banks intend to raise capital equity directly from the capital market shortly.
The Acts, as duly amended provide for many provisions about the nationalized banks provide as under:

Paid-up capital of banks.—

The paid-up capital of each new bank was equal to the paid-up capital of the corresponding banking company. After amendment, the authorised capital of every bank shall be one thousand five hundred crores of rupees divided into one hundred fifty crores fully paid-up shares of ten rupees each. The Central Government may, after consultation with the Reserve Bank and by notification in the official Gazette, increase or reduce the authorised capital as it thinks fit, so however, that after such in crease or reduction, the authorised capital shall not exceed three thousand crores, or be less than one thousand five hundred crores of rupees.
The paid-up capital of every new bank may from time to time be increased by—

(a) such amounts as the Board of Directors of the corresponding new bank may after consultation with the Reserve Bank and with the previous sanction of the Central Government transfer from the reserve fund established by such bank to such paid-up capital;
(b) Such amounts as the Central Government, may after consultation with the Reserve Bank contribute to such paid-up capital;
(c) such amounts as the Board of Directors of the corresponding new bank may, after consultation with the Reserve Bank and with the previous sanction of the Central Government, raise by public issue of share in such manner as may be prescribed, so however, that the Central Government shall at all times, hold not less than fifty one per cent of the paid-up capital of each new bank. The entire paid-up capital up of a new bank, except the paid-up capital raised by public issue shall stand vested in and allotted to the Central Government.

The shares of every corresponding new bank not held by the Central Government shall be freely transferable, provided that no individual or company resident outside India or any company incorporated under any law not in force in India or any branch of such company, whether resident outside India or not, shall at any time hold or acquire by transfer or otherwise shares of the new bank, so that such investment in aggregate exceed the percentage, not being more than twenty per cent of the paid-up capital, as may be specified by the Central Government by notification in the official a Gazette. For the purpose of this provision, the clause "company" means any body corporate and includes a firm or other association of individuals.

Voting rights of shareholder of new bank—

No shareholder of the corresponding new bank, other than the Central Government shall be entitled to exercise voting rights in respect of any shares held by him in excess of one per cent of the total voting rights of all the shareholders of the corresponding new bank.

Book of shareholders to be kept at head office of corresponding new bank. —

Every corresponding new bank shall keep at its head office a register, in one or more books, of the shareholders and shall enter therein the following particulars:

(i) the names, addresses and occupations, if any of the shareholders and a statement of shares held by each shareholder, distinguishing each share by its denoting number;

(ii) the date on which each person is so entered as a shareholder;

(iii) the date on which any person ceases to be a shareholder and;

(iv) Such other particulars as may be prescribed.

The corresponding new banks can keep the register in computer floppies or diskettes subject to such safeguards as may be prescribed.

The Act provides that notwithstanding anything contained in the Indian Evidence Act, 1872 (1 of 1872) a copy of, or extract from the register, certified to be a true copy under the hand of an officer of the corresponding new bank authorized in this behalf by it, shall in all legal proceedings, be admissible in evidence.

Trust not to be entered on register.—

No notice of any trust, express or implied, or constructive, shall be entered on the register, or be receivable by the corresponding new bank.

Management of nationalized banks.—

The Scheme regarding the management of the nationalized bank is required to provide that the Board shall include representatives of the employees and of depositors of the bank and such other persons as may represent farmers, workers and artisans. These representatives are to be elected or nominated in such manner as may be specified in the Scheme (Section 9). The Scheme is required to be placed before both the Houses of Parliament as soon as it is made. Every Board of Directors of a corresponding new bank shall include:

(a) Not more than two whole time directors to be appointed by the Central Government after consultation with the Reserve Bank;

(b) one director who is an official of the Central Government to be nominated by the Central Government;
Provided that no such director shall be a director any other corresponding new bank.

(c) One director who is an officer of the Reserve Bank to be nominated by the Central Government on the recommendation of the Reserve Bank.

(d) not more than two directors to be nominated by the Central Government from amongst the Securities and Exchange Board of India established under Section 3 of the Securities and Exchange Board of India Act, 1992, the National Bank for Agriculture and Rural Development established under Section 3 of the National Bank for Agriculture and Rural Development Act, 1981 (61 of 1981) public financial institutions as specified in sub-section (1) or notified from time to time under sub-section (2) of Section 4-A of the Companies Act, 1956 (1 of

1956) and other institutions established or constituted by or under any Central Act or incorporated under the Companies Act, 1956 (1 of 1956) and having not less than fifty one per cent of the paid-up share capital held or controlled by the Central Government;

(e) one director from among such of the employees of the corresponding new bank who are workman under clause (g) of Section 2 of the Industrial Disputes Act, 1947 (14 of 1947) to be nominated by the Central Government in such manner as may be specified in a scheme made under this section;

(f) one director from among the employees of the corresponding new bank who are not workman under clause (g) of Section 2 of the Industrial Disputes Act, 1947 (14 of 1947) to be nominated by the Central Government after consultation with the Reserve Bank;

(g) one director who has been a Chartered Accountant for not less than 15 years to be nominated by the Central Government after consultation with the Reserve Bank;

(h) subject to the provisions of clause (i) not more than six directors to be nominated by the Central Government;

(i) Where the capital issued under clause (c) of sub section (2-B) of Section 3 is;

(ii) not more than twenty per cent of the total paid-up capital not more than two directors;

(iii) more than twenty per cent, but more than forty per cent of the total paid-up capital, not more than four directors;

(iv) more than forty per cent, of the total paid-up capital, not more than six directors.

To be selected by the shareholders other than the Central Government from amongst themselves

Provided that on the assumption of charge after election of any such directors under this clause, equal number of directors nominated under clause (h) shall retire in such manner as may be specified in the scheme.

The directors to be nominated under clause (h) or to be elected under clause (i) of subsection (3) shall—

(A) Have special knowledge of practical experience in respect of one or more of the following matters namely

(i) Agricultural and rural economy,
(ii) Banking,
(iii) Cooperation,
(iv) Economics,
(v) Finance,
(vi) Law,
(vii) Small-scale industry,
(viii) Any other matter the special knowledge of, and practical experience in, which would, in the Opinion of the Reserve Bank, be useful to the corresponding new bank.

(B) Represent the interest of depositors; or
(C) Represent the interest of farmers, workers andartisans.

Where the Reserve Bank, is of the Opinion that any director of a bank elected under clause (i) of sub-section (3) does not fulfill the requirements of sub-section (3-A), it may, after giving to such director and the Bank a reasonable opportunity of being heard, by an orders, remove such director, and on such removal, the Board of Directors shall co-opt any other person fulfilling the requirements of sub-section (3-A) as a director in place of the person, a, removed till a director is duly elected by the shareholders of the con-responding new bank, in the next annual general meeting and the person so co-opted shall be deemed to have been duly elected by the shareholders of the corresponding new bank as a director.

2.3.6 SCHEME BY CENTRAL GOVERNMENT TO CONSTITUTE OF BOARD OF DIRECTORS OF NATIONALIZED BANKS

In *All India Bank Officer confederation and others* v. *Union of India and others*,(AIR 198 SC 2045) it was held that the object on Section 9 of the Banking Companies (Acquisition & Transfer of Undertakings) Act, 1970, which is regarding Central Government's power to make a scheme for constitution of Board of Directors, is to give the Boards truly representative character, so as to reflect the genuine interests of the Various persons manning or dealing with the bank as an industry and a Commercial enterprise. The legislature has left it to the Central Government to make the scheme providing for appointment to the Board from amongst the specified categories either by

election or by nomination. The discretion of the Central Government is, however, not as unrestrained discretion, but, a discretion which must be reasonably exercised so as to give effect to the true intent of the legislature as to the composition of the Boyd of Directors What is postulated in such election or nomination as would tend to the Board of Directors; its truly representative character in Consonance and harmony with the expending dedicate, vital and significant role a the banking industry in the context of the National policy and objectives and economic development. The mode of election or nomination, must, therefore, be such as would be ideally suitable and appropriate to the banking industry. The Central Government must in this regard act in consultation with the Reserve Bank of India.

In exercise of its discretion, the Central Government cannot avoid election even where election is appropriate and feasible in respect of a particular category of persons. For the appointment of representative of depositions, farmers, workers, other than employees and artisans the discretion is entirely that of Central Government to choose the mode of representatives. In the case of employees, election is the most logical, the most appropriate, the most democratic and certainly the most advantageous forms of representation. They are well identified, well organized, well motivated and interested associates, and participants in the banking Industry. They are as such a part of the bank as the management is.

The nationalization Act does not contemplate a management unmindful of the true and legitimate interests of the employees, in a nationalization bank, everyone is one as much as employee, as he Is an employer. There is no antithesis between the management and employees. The traditionally existed of management culture prior to nationalization is no longer applicable and the true management culture is that culture that represents various interests of all persons specified under Section 9 as well as the larger and wider interests of national economy as postulated in the preamble to the Act.

Accounts and Audit.—

The books of the new banks are to be closed and balanced on 31st December each year or such other date in each year as

the Central Government may, by notification in the Official Gazette, specify. The auditors' report and certificates are required to be on the same lines as in case of banking companies. The copies of the audited report are to be sent to the Reserve Bank and Central Government (Section 10, sub-sections 3, 4, 5, 6). The bank shall furnish to the Central Government and to the Reserve Bank the annual balance-sheet, the profit and loss account, and the auditors' report and a report by its Board of Directors on the working and activities of bank. [Section 10(7-A)]. The reports are to be placed before the Houses of Parliament after receipt thereof by the Government. [Section 10(8)]. The Central Government is empowered to appoint, at any time, such number of auditors as it thinks fit to examine and report on the accounts of a nationalized bank.

Profits to Government.—Section 10(7) reads:

After making provision for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds and all other matters for which provision is necessary under any law, or which are usually provided for by banking companies, a new bank shall may Out of its net profits, declare a dividend and retain the surplus, if any.

Transfer of Services of employees of old banks.—.

Under Section 12(2) of the Act, every officer or other employee of an existing bank shall become on 19.7.1969 an officer or other employee of the corresponding new bank and "shall hold his office or service in that bank on the same terms and conditions and with the same rights to pension, gratuity and other matters as would have been admissible to him if the undertaking of the existing bank had not been transferred to and vested in the corresponding new bank and continue to do so unless and until his employment in corresponding new bank is terminated or until his remuneration, terms or conditions are duly altered by the corresponding the new bank."

Bonus.—

Section 12-A has been inserted by the Banking Laws (Amendment) Act, 1984 (Act 64 of 1984) according to which all public, sector banks including the State Bank of India come under the purview of the Payment of Bonus Act, 1965 and no bonus other than what is required to be paid under the

Payment of Bonus Act, 1965, shall be paid. Section 43-A has been inserted in the State Bank of India Act, 1955 to this effect. The express provision has been made in view of an award of the Central Government Administrative Tribunal, Madras, notified on January 14, 1984, in which it was held that the employees of the State Bank of India covered by the award should be paid bonus at the rate of one month's substantive pay every half year on the ground that this has all along been the custom and practice. A writ petition has, been filed against this award in the Madras High Court. Sub-section (3) of the inserted section provides that 'The provisions of this section shall have effect notwithstanding any judgment, decree or order of any court, tribunal or other authority and notwithstanding anything contained in any other provision of this Act or in the Industrial Disputes Act, 1947, or any other law for the time being in force or any practice, usage or custom or any contract, agreement, settlement, award or other instrument."

2.3.7 LIMITED APPLICATION OF BANKING REGULATION ACT, 1949 TO NEW BANKS

The Banking Regulation Act as such does not apply to the nationalized banks. Only certain pro visions of that Act are made applicable to the new banks especially by virtue of certain sections of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980.

In the Banking Regulation Act, a banking company is defined as any company which transacts the business of banking in India [Section 5(c)]. Company is defined as any company as defined in Section 3 of the Companies Act, 1956, which means a company registered under the Companies Act. The 14 new banks acquire their corporate characters not from any registration under the Companies Act; they are established under the nationalizing Act. They are therefore not companies in the sense of the Banking Regulation Act or the Companies Act and no provisions of those Acts as such can apply to them. The nationalizing Act, however, refers to certain sections of the Banking Regulation Act and makes them applicable to the 14 new banks.

Section 3(5) of the nationalization Act provides that every new bank shall carry on and transact the business of banking as defined in Section 5(b) of the Banking Regulation Act and may engage in one or more of the other forms of business specified in Section 6(1) of that Act.

Section 20 of the nationalizing Act makes Sections 34-A, 36-AD and 51 of the Banking Regulation Act applicable to the 14 new banks.

Under Section 34-A, a banking company, the Industrial Development Bank of India, the Reserve Bank. the State Bank of India and any of the nationalized banks, the Exim Bank, Reconstruction Bank the National Housing Bank, National Bank Small Industries Bank a regional rural bank and a subsidiary bank cannot be compelled to produce or give inspection of books of accounts or other documents when they are claimed to be of a confidential nature.

Section 36-AD of Banking Regulation Act is discussed in Chapter 3,

Section 51 of the Banking Regulation Act (As amended by Act 66 of 1988, w.e.f. 30.12.1988) makes the following sections of Banking Regulation Act applicable to the nationalized banks:

Sections 10, 13 to 15, 17, 19 to 21-A, 23 to 28, 29 [excluding sub-section (3)], subsections (1-B), (1-C) and (2) of Sections 30, 31, 34, 35, 35-A, 36 [excluding clause (d) of sub-sections (1)), 45-Y to 45-ZF, 46 to 48, 50, 52 and 53.

2.3.8 REGULATIONS FOR NATIONALIZED BANKS

Section 19 of the nationalizing Act empowers the Board of Directors of the corresponding new bank to make Regulations after consultation with the Reserve Bank and with the previous sanction of the Central Government by notification in the official Gazette not inconsistent with provisions of this Act or any Scheme that may be found there under. The regulations may provide for :–

(1) powers, functions and duties of local banks and local Committees and the procedure of the conduct of business;

(2) delegation of power and function of the Board to Directors executives, officers and employees;

(3) conditions of appointment of advisors, officers or other employees or the corresponding new bank and their duties and conduct;
(4) provident fund and other benefits to the staff and authorities to administer the same;
(5) the conduct and defence of legal proceedings by or against the corresponding new bank and the manner of signing pleadings;
(6) the provision of a Seal for the corresponding bank and the manner and effect of its use;
(7) the form and manner if which contracts binding on the new corresponding banks may be executed;
(8) conditions of loans and advances, and discounting and purchasing of bills;
(9) submission of statements of programmes of activities and finances;
(10) the nature of shares, the manner in which and the conditions subject to which shares may be held and transferred and generally all matters relating to the rights and duties of shareholders;
(11) maintenance of register and the particulars to be entered in the register the safeguards to be observed in the maintenance of register and computer floppies or diskettes, inspection and closure of the register and all other matters connected therewith;
(12) the manner in which general meetings shall be convened, the procedure to be followed thereat and the manner in which voting rights may be exercised;
(13) the holding of meetings of shareholders and the business to be transacted thereat;
(14) the manner in which notices may be served on behalf of the new corresponding bank upon shareholders or other persons;
(15) the manner in which the directors nominated under clause (h) of sub-section (3) of Section 9 shall retire.

Until regulations are made, the Articles of Association of the corresponding existing bank and all its regulations, rules, bye-laws and orders shall be deemed to be the regulations of the new bank. The regulation shall be forwarded to the Central

Government and that Government shall lay a copy of the same before each House of Parliament (Section 19).

Annual General Meeting.—

A general meeting of every corresponding new bank which has issued capital shall be held at the place of the head office of the Bank in each year at such time as shall from time to time be specified by the Board of Directors. The annual general meeting shall be held before the expiry of six weeks from the date on which the balance-Sheet together with the profit and loss account and auditors reports forwarded to the Central Government or to the Reserve Bank which ever date is easier.

The shareholders present at an annual general meeting shall be entitled to discuss the balance sheet and the profit and loss account of the corresponding new bank made up to the previous 31st day of March, the report of the Board of Directors on the working and activities of the corresponding new bank for the period covered by the accounts and the auditor's report on the balance-sheet and accounts.

Meetings of Board of Directors of Nationalized Bank.—

The meetings of the Board of the Directors of the nationalized bank shall ordinarily be held at least six times in a year and at least once in each quarter. They shall be held at the head Office of the nationalized Bank or such other place as the Board may decide. No business other than that for which the meetings have been convened is to be transacted except with the consent of the Chairman of the meeting and a majority of the directors present unless one week's notice for such business has been given in writing to the Chairman. The quorum for a meeting shall be one-third of the number of directors holding office as such directors of the Board on the day of meeting, subject to a minimum of 3 directors. In the absence of the Chairman of the Board of the meeting, the Managing Director is to preside over the meeting and in the absence of both the Chairman and the Managing Director any other director present may be elected by the directors present to preside over the meeting. All questions are to be decided by majority of votes of the, directors present and in case of a poll, the Chairman of the meeting has a casting vote. A director who is directly

or indirectly concerned or interested in any contract, loan, arrangement or proposal entered into or proposed to be entered into, shall not be present at the meeting of the Board when the subject is discussed unless his presence is required by the other directors for the purposes of elucidating information. In any case, such a director is not entitled to vote on any such subject.No meeting of the Board may be called ordinarily at less than 15 days' notice.

Appointment of Committees of Board.—

The Nationalized Banks (Management and Miscellaneous Provisions) Scheme, 1970 and 1980 has been amended in 1986. Clause 13 has been inserted to constitute a Management Committee of the Board.

The Board may Constitute Management Committee Advisory Committees and Regional Consultative Committee consisting of directors or other persons, or partly directors and partly other persons to render advice to the Board on the matters referred to them.

Regional Consultative Committees –

In order to provide for advice on and conduct of regional matters the Scheme provides for the appointment of Regional Consultative Committees. There shall be a Regional Consultative Committee for each of the six regions specified by the Government. The Committee shall consist of not more than three persons nominated by the Central Government and two representatives from each of the States and one from each of the Union Territories included in the respective regions nominated by the Government of the State or Union Territory, as the case may be, and one representative to be nominated by such of the nationalized banks having offices in the region designated by the Reserve Bank. The meetings of these Committees shall be presided over by the Ministry of Finance or by such Minister or Deputy Minister of Finance is the Union Ministry of Finance as may be nominated by the Minister of Finance. The functions of these Committees shall be to review banking developments within the region and recommend such steps as they may deem appropriate in that direction for the consideration of the Central Government and the Reserve Bank.

The Scheme includes similar provisions as applying to the directors for the appointment and disqualifications for membership of the Committees.

Nationalities of 6 More Banks

On 15th April, 1980, six more private sector banks having demand and time liabilities of not less than Rs. 200 crores each were nationalized; extending further the area of pub-lie control, over the country's banking system. The undertaking of these banks was transferred to six corresponding new banks under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (Act 40 of 1980).

The Banks are: The Andhra Bank Ltd., Corporation Bank Ltd., The New Bank India Ltd., The Oriental Bank of Commerce Ltd., The Punjab and Sind Bank Ltd. and Vijaya Bank Ltd. Each of the corresponding new bank bears the same name as the Corresponding old bank except that the words 'The" and "Limited" stand omitted.

The preamble to the Act reads as under:

> *"An Act to provide for the acquisition and transfer of the undertakings of certain banking companies, having regard to their size, resources, coverage and organization, in order further to control the heights of the economy, to meet progressively, and serve better, the needs of the development of the economy and to promote the welfare of the people, in conformity with the policy of the State towards securing the principles laid down in clauses (b) and (c) of Article 39 of the Constitution and for matters connected therewith or incidental thereto."*

The relevant clauses of Article 39 of the Constitution of India provide that the State shall, in particular, direct its policy towards securing—

"(b) That the ownership and control of the material resources of the community are so distributed as best to sub-serve the common good;

(c) That the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment."

2.4 SUMMARY

After independence, India adopted a socialist pattern of society as its goal. This means, in. non-technical language, a society with wealth distributed as equitably as possible without making the country a totalitarian State. The goal is purported to be achieved through democratic processes. With this aim in view, a mixed pattern of planning is evolved. The two sectors,- private and public, are allowed in function independently of each other. The public sector is wholly owned and controlled by the Government. The private sector is regulated through a system of regulations, licences, controls and legislative acts, the latest of which is the Monopolies and Restrictive Trade Practices Act, 1969. The public sector is made to grow by nationalization of industries and institutions.

The banking institutions are the custodians of private savings and a powerful instrument to provide credit. They mobilise the resources of the country by accepting deposits and channellise them for industrial and national development by granting advances. In 1955 the Imperial Bank of India was nationalized and its undertaking was taken over by the State Bank of India. As regards the scheduled banks, there were complaints that Indian commercial banks were directing their advances to the large and medium scale industries and big business houses and that the sectors demanding priority such agriculture, small-scale industries and exports were not receiving their, due share.

Although steps had been taken in January, 1969, by amending the Banking Regulation Act, for the purposes of imposing “social control” with a view to remedy the basic weak nesses of the Indian banking system and to ensure that banks would cater to the ‘needs of the hitherto neglected and weaker sections of the community instead of big businesses and those connected with them, it was felt that the imposition of “social control” had not changed the position very much and there were complaints that the Indian commercial banks continued to direct their advances to large and medium scale industries and that sectors demanding priority such as agriculture, small-scale industries and imports were not receiving the attention due to them of the banks.

It was stated that, in nationalizing the banks, Government was only putting into effect its programme for achieving socialistic

pattern of society and it was hoped that nationalization would effectively decentralize credits with the result that the priority sectors such as agriculture, small-scale industries, exports, self-employed etc., would be provided with liberal banking facilities and that banking units would be extended to rural areas. The critics of nationalization argued that the "social control" on banks should have been given a fair chance and trial for its success and tried for a longer period. It was also argued that in line with the performance of other public sector undertaking inefficiency and nepotism would creep in the banking system specially in an industry like banking which is more personalized than other industries.Nationalized banks are expected to give priority to the schemes of the neglected sectors and exports, to meet some of the demands of the public sector undertaking and to use the balance of the available sources for organized industries on the basis that new enterprises and those in backward areas will be preferred to the big business houses. To achieve those objects, sectors constituting weak and backward areas and the exporting sector may be charged lower rate of interest than that charged to established businesses thereby subsidizing these sectors. A further step in the form of credit guarantee insurance payable by the stronger parts of the community to insure the risk involved in the lending to the weaker sector is also envisaged.

On 15th April, 1980, six more banks were nationalized. For detailed discussion see post.

The reason for the sudden step was stated officially to be that 'public ownership of the major banks will help most effectively the mobilization and development of national resources and its utilization for productive purposes in accordance with the Plans and priorities." The long title of the Ordinance promulgated on 19-7-1969 explained that the fourteen banks were taken over by the Government "in order to serve better the needs of development of the economy in conformity with the national policy and objectives."

The object of the social control was also the same, but the Government thought that it was not 'successful During the debate on the Bill on 29-7-1970 for nationalization, of 14 bank the Prime Minister gave the Government's reply in the following

words to - the question, “Why the, social control could not have been tried for a longer period” :-

"The weakness of social control was that in many banks people who had been controlling their policies in the past continued to exercise their influence over them in one way or another, sometimes by the continued presence of the old Chairman or Vice-Chairman of the Boards. The banks might as some did, obey the instructions and directions given to them. But there is all the difference in the world between people who carry out a policy wholeheartedly and with enthusiasm and those who do only because of certain instructions.”

It was also argued that the restrictions imposed by social control measures were capable of being flouted in spirit although observed in form. For instance, the restraints on advances to directors and their interested concerns could be mutually adjusted amongst bankers in such a way as to defeat the very purpose of such restraints. It was stated that it would’ have taken a ‘long’ time for the banks to throwaway their traditional outlook; indirect influence, howsoever stringent the’ laws may be, could not achieve the purpose; direct control would be more effective; the needs of the time were pressing; the country could not afford the trial and error method and “an element of dynamism and new vigour into-the process of our development” was necessary.

One further argument was that the-major banks were operating mostly with other people’s money. The financial stake of the shareholders was almost negligible. “Against a total deposit of Rs. 2,750 crores at the end of December, 1968, the paid-up capital was only Rs. 28.5 crores or just a little over one per cent”. This aspect of banking has led even predominantly capitalist countries to nationalize their banks or keep an eagle eye on them. France has nationalized four of its six large banks and Italy, four out of its five.

It was stated that in nationalizing the 14 banks the Government was merely putting into effect its own long decided programme or achieving the socialist pattern of society.

Hope and enthusiasm were liberally expressed that the nationalization ‘Will effectively channellise the credits to priority fields of agriculture small-scale and exports; that banking units now would expand in rural areas and the public confidence will

be greatly enhanced. The employees' welcome to the step indicated that the efficiency and service will no suffer.

The Narasimham Committee on the Financial System had suggested that State Bank of India and public sector banks should be allowed to increase capital through public issue the Committee recommended that in respect of banks whose operations have been profitable and when enjoy a good reputation in the markets. They could straightaway approach the capital market for enhancement of their capital. In respect of such banks, issue of fish capital to the public through the capital market should be permitted. Subscribers to such issues could include mutual funds, profitable public sector undertakings and employees of the institutions besides the general public. Therefore, the Banking Companies (Acquisition and Transfer of Undertakings) Amendment Act, 1994 has been passed to amend Banking Companies (Acquisition and Transfer of Undertakings Act, 1970 and. 1980 to provide for public issue of the nationalized banks and to provide that the entire paid-up capital of banks, except the paid-up capital raised by public issue shall stand vested in the Central, Government. However, the Central Government shall hold not less than 51 % of share capital of each Bank.

In accordance with the suggestions made by the Narasimham Committee, some of the public sector banks are also tapping the capital market directly to mobilise equity funds from the public. For this purpose, the scope of State Bank of India provision for partial private shareholding in its statute was enhanced by issuing an ordinance in October, 1993 for amending the State Bank of India Act, 1955. The SBI was the first public sector bank to access the capital market and it raised Rs. 2,210 crores in the form of equity and Rs. 1,000 crores through bonds.

The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980 have also been amended to enable the public to subscribe to the capital of the nationalized banks upto 49 % of their total capital. Government will however continue to hold at least 51 % of the equity of each of the nationalized banks. The nationalized banks have not raised capital from the market, but some banks intend to raise capital equity directly from the capital market shortly.

The Acts, as duly amended provide for many provisions about the nationalized banks provide as under:

Paid-up capital of banks.—

The paid-up capital of each new bank was equal to the paid-up capital of the corresponding banking company. After amendment, the authorised capital of every bank shall be one thousand five hundred crores of rupees divided into one hundred fifty crores fully paid-up shares of ten rupees each. The Central Government may, after consultation with the Reserve Bank and by notification in the official Gazette, increase or reduce the authorised capital as it thinks fit, so however, that after such in crease or reduction, the authorised capital shall not exceed three thousand crores, or be less than one thousand five hundred crores of rupees.

The paid-up capital of every new bank may from time to time be increased by—

(a) such amounts as the Board of Directors of the corresponding new bank may after consultation with the Reserve Bank and with the previous sanction of the Central Government transfer from the reserve fund established by such bank to such paid-up capital;

(b) Such amounts as the Central Government, may after consultation with the Reserve Bank contribute to such paid-up capital;

(c) such amounts as the Board of Directors of the corresponding new bank may, after consultation with the Reserve Bank and with the previous sanction of the Central Government, raise by public issue of share in such manner as may be prescribed, so however, that the Central Government shall at all times, hold not less than fifty one per cent of the paid-up capital of each new bank. The entire paid-up capital up of a new bank, except the paid-up capital raised by public issue shall stand vested in and allotted to the Central Government.

The shares of every corresponding new bank not held by the Central Government shall be freely transferable, provided that no individual or company resident outside India or any company incorporated under any law not in force in India or any branch of such company, whether resident outside India or not, shall at any time hold or acquire by transfer or otherwise

shares of the new bank, so that such investment in aggregate exceed the percentage, not being more than twenty per cent of the paid-up capital, as may be specified by the Central Government by notification in the official a Gazette. For the purpose of this provision, the clause "company" means any body corporate and includes a firm or other association of individuals.

Voting rights of shareholder of new bank—

No shareholder of the corresponding new bank, other than the Central Government shall be entitled to exercise voting rights in respect of any shares held by him in excess of one per cent of the total voting rights of all the shareholders of the corresponding new bank.

Book of shareholders to be kept at head office of corresponding new bank. —

Every corresponding new bank shall keep at its head office a register, in one or more books, of the shareholders and shall enter therein the following particulars:

(i) the names, addresses and occupations, if any of the shareholders and a statement of shares held by each shareholder, distinguishing each share by its denoting number;

(ii) the date on which each person is so entered as a shareholder;

(iii) the date on which any person ceases to be a shareholder and;

(iv) Such other particulars as may be prescribed.

The corresponding new banks can keep the register in computer floppies or diskettes subject to such safeguards as may be prescribed.

The Act provides that notwithstanding anything contained in the Indian Evidence Act, 1872 (1 of 1872) a copy of, or extract from the register, certified to be a true copy under the hand of an officer of the corresponding new bank authorized in this behalf by it, shall in all legal proceedings, be admissible in evidence.

Trust not to be entered on register.—

No notice of any trust, express or implied, or constructive, shall be entered on the register, or be receivable by the corresponding new bank.

Management of nationalized banks.—

The Scheme regarding the management of the nationalized bank is required to provide that the Board shall include representatives of the employees and of depositors of the bank and such other persons as may represent farmers, workers and artisans. These representatives are to be elected or nominated in such manner as may be specified in the Scheme (Section 9).

2.5 SUGGESTED READINGS

1 Singh, Avtar, Principles of Mercantile Law, 6th ed. 1996.
2 P.N. Varshney, Banking Law and Practice
3 Tannan's, Banking law and practice in India
4 Indian Economy: Dr. Rudra Dutt

2.6 TERMINAL QUESTIONS

1.Write a essay on nationalization of banks.
2. Write down the arguments in favour of nationalization of banks.
3. Discuss the main provisions for the nationalization Act.

L.L.M. PART – I
PAPER- BANKING LAW

Block-I-INTRODUCTION AND SOCIAL CONTROL OVER BANKING
Unit 3- PROTECTION OF DEPOSITORS

STRUCTURE

3.1 INTRODUCTION

The two exclusive legislations that governed the securities market till early 1992 were the Capital Issues (Control) Act, 1947 (CICA) and the Securities Contracts (Regulation) Act, 1956 (SCRA).[1] The CICA had its origin during the war in 1943 when the objective was to channel resources to support the war effort. Control of capital issues was introduced through the Defence of India Rules in May 1943 under the Defence of India Act, 1939. The control was retained after the war with some modifications as means of controlling the raising of capital by companies and to ensure that national resources were channeled into proper lines, i.e., for desirable purposes to serve goals and priorities of the government, and to protect the interests of investors. The relevant provisions in the Defence of India Rules were replaced by the Capital Issues (Continuance of Control) Act in April 1947. This Act was made permanent in 1956 and enacted as the Capital Issues (Control) Act, 1947. Under the Act, the Controller of Capital Issues was set up which granted approval for issue of securities and also determined the amount, type and price of the issue. This Act was, however, repealed in 1992 as a part of liberalization process to allow the companies to approach the market directly provided they issue securities in compliance with prescribed guidelines relating to disclosure and investor protection.

The authorities have been quite sensitive to requirements of the development of securities market, so much so that the last decade (1992-2003) witnessed nine special legislative interventions, including two new enactments, namely the Securities and Exchange Board of India (SEBI) Act, 1992 and the Depositories Act, 1996. The SCRA, the SEBI Act and the Depositories Act were amended six, five and three times respectively during the same period. The developmental need was so urgent at times, that the last decade witnessed five ordinances relating to securities laws. Besides, a number of other legislations (the Income Tax Act, the Companies Act, the Indian Stamps Act, the Bankers' Book Evidence Act, the Benami Transactions (Prohibition) Act etc.) having bearing on securities markets have been amended in the recent past to complement amendments in securities laws.

[1] Writer acknowledges **M S SAHOO,** FCS, Chief General Manager, SEBI, for taking excerpts in writing of this unit from his paper Historical Perspective of Securities laws

The legal reforms began with the enactment of the SEBI Act, 1992, which established SEBI with statutory responsibilities to (i) protect the interest of investors in securities, (ii) promote the development of the securities market, and (iii) regulate the securities market. This was followed by repeal of the Capital Issues (Control) Act, 1947 in 1992 which paved way for market determined allocation of resources. Then followed the Securities Laws (Amendment) Act in 1995, which extended SEBI's jurisdiction over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It empowered SEBI to appoint adjudicating officers to adjudicate wide range of violations and impose monetary penalties and provided for establishment of Securities Appellate Tribunals (SATs) to hear appeals against the orders of the adjudicating officers. Then followed the Depositories Act in 1996 to provide for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security. It made securities of public limited companies freely transferable subject to certain exceptions; dematerialized the securities in the depository mode; and provided for maintenance of ownership records in a book entry form. The Depositories Related Laws (Amendment) Act, 1997 amended various legislations to facilitate dematerialization of securities. The Securities Laws (Amendment) Act, 1999 was enacted to provide a legal framework for trading of derivatives of securities and units of CIS. The Securities Laws (Second Amendment) Act, 1999 was enacted to empower SAT to deal with appeals against orders of SEBI under the Depositories Act and the SEBI Act, and against refusal of stock exchanges to list securities under the SCRA. The next intervention is the SEBI (Amendment) Act, 2002 which enhanced powers of SEBI substantially in respect of inspection, investigation and enforcement. The latest and the ninth legislative intervention namely the Securities Laws (Amendment) Bill, 2003 introduced in the monsoon session of the Parliament to amend the SCRA to provide for demutualisation of stock exchanges is awaiting approval. The approval to this bill is a matter of time as it is a money bill. This paper explains the provisions in these nine legislative interventions in a historical perspective.

3.2 OBJECTIVES

The two exclusive legislations that governed the securities market till early 1992 were the Capital Issues (Control) Act, 1947 (CICA) and the Securities Contracts (Regulation) Act, 1956 (SCRA). The object of this unit is to analyze the law relating to public depositories and further the purpose is to acquaint the students with the latest amendments in this regard.

3.3.1 THE DEPOSITORIES ACT, 1996

The system of transfer of ownership of securities prevailing till mid 1990s was gossly inefficient as every transfer was required to be accomplished by the physical movement of paper securities to the issuer for registration and the ownership was evidenced by the endorsement on the security certificate. The process of transfer in many cases took much longer time than two months stipulated in the Companies Act, 1956 or the SCRA. A significant proportion of transactions ended up as ' bad delivery' due to faulty compliance of paper work, mismatch of signatures on transfer deeds with the specimen records of the issuer or for other procedural reasons. Theft, forgery, mutilation of certificates and other irregularities were rampant.[2] The inherent right of the issuer to refuse the transfer of a security added to the misery of the investors. The cumbersome paraphernelia associated with the transfer of securities under section 108 of the Companies Act, 1956, along with huge paper work, printing of stationary, safe custody of securities, transportation and dispatch added to the cost of servicing paper securities, delay in settlement and restricted liquidity in securities and made investor grievance redressal time consuming and at times intractable. All these problems had not surfaced overnight but these were compounded by burgeoning trade volumes in secondary market and increasing dependence on securities market for financing trade and industry. This underscored the need for streamlining the

[2] Writer acknowledges **M S SAHOO,** FCS, Chief General Manager, SEBI, for taking excerpts in writing of this unit from his paper Historical Perspective of Securities laws

transfer of ownership of securities which was sought to be accomplished by the Depositories Act, 1996. The Act provides a legal basis for establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making the securities of public limited companies freely transferable; (b) dematerializing the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form.

Legal Basis : The Depositories Act, 1996, read with section 12 of the SEBI Act, 1992, provides a legal basis for establishment of multiple depositories and entrusts them with responsibility of maintaining ownership records of securities and effecting transfer of securities through book entry only. The depositories render, through participants, any service connected with recording of:

(a) allotment of securities; and

(b) transfer of ownership of securities.

By fiction of law under section 10 of the Depositories Act, the depository is deemed to be registered owner of securities with the limited purpose of effecting transfer of ownership of security. In respect of securities held in a depository, the name of the depository appears in the records of the issuer as registered owner of securities. The depository has right to effect the transfer of securities and shall not have any other right associated with them. The owners of the securities become beneficial owners on the records of the depository in respect of the securities held in a depository. The beneficial owner has all the rights and liabilities associated with the securities. The depositories holding the securities maintain ownership records in the name of the each participant. Each such participant, as an agent of the depository, in turn, maintains ownership records of every beneficial owner in book entry form. The depository and participants have a principal and agent relationship and their relations are governed by the bye-laws of the depository and the agreement between them.

Both the depository and participant need to be registered with SEBI under section 12 of the SEBI Act, 1992, and are regulated by SEBI. Only a company formed and registered

under the Companies Act, 1956 can be registered as a depository. However, before commencing business, the depository registered with SEBI has to obtain a certificate of commencement of business from SEBI. Such certificate is issued by SEBI on being fully satisfied that the depository has adequate systems and safeguards to ensure against manipulation of records and transactions. SEBI is empowered to suspend or cancel the certificate of registration of a depository as well as of the participants after giving a reasonable opportunity of hearing.

The ownership records of securities maintained by depositories/participants, whether maintained in the form of books or machine readable form, shall be accepted as prima facie evidence in legal proceedings. The depository is treated as if it were a bank under the Bankers' Books of Evidence Act, 1891.

The depository services shall be available in respect of the securities as may be specified by SEBI. The type of securities and the eligibility criteria for admission to the depository mode shall be determined by SEBI regulations. This provides the flexibility to SEBI, for example, to admit certain instruments like units of mutual funds and prohibit admission of certain securities like shares of private limited companies from depository mode.

Free Transferability of Securities: The securities of all public companies have been made freely transferable. The Act took away the companies' right to use discretion in effecting transfer of securities by deleting section 22A from the SCRA and by inserting section 111A in the Companies Act, 1956. These provisions, read with section 7 of the Depositories Act make the transfer of securities in any company, whether listed or not, other than a private company and a deemed public company, free and automatic. That is, once the agreed consideration is paid and the purchase transaction is settled, the buyer is automatically entitled to all the rights associated with the security. As soon as the intimation regarding delivery of security against the payment of cash (delivery v. payment) is received, the transfer will be effected by the depository or company and the transferee will enjoy all the rights and

obligations associated with the security immediately. If the securities are in the depository mode, depository would effect the transfer on the basis of intimation (contract notes or some other suitable evidence) from the participants. If the securities are outside the depository mode, the company would effect the transfer on receipt of the transfer deed. For the securities in the depository mode, no transfer deed is required and other procedural requirements under section 108 of the Companies Act were dispensed with. The transferee in both the modes would be entitled to all the rights including voting rights and obligations associated with security.

However, if it is felt that the transfer of a security is in contravention of any of the provisions of the SEBI Act, 1992 or Regulations made thereunder or Sick Industrial Companies (Special Provisions) Act (SICA), 1985, the company, depository, participant, investor or SEBI can make an application to the Company Law Board (CLB) to determine if the alleged contravention has taken place. After enquiry, if the CLB is satisfied of the contravention, it can direct the company/ depository to make rectification in ownership records. In other words, transfer has to be effected immediately even if the transfer is contravention of SEBI Act, 1992 or SICA, 1985, subject to subsequent rectification by the direction of CLB. Pending the completion of enquiry, CLB can suspend voting rights in respect of securities so transferred. The transferee will continue to enjoy economic rights (bonus, dividend, rights etc) which cannot be suspended under any circumstances. During the pendency of the application with CLB, the transferee can transfer the securities and such further transfer will entitle the transferee to the voting rights also unless the voting rights in respect of transferee has also been suspended.

Partial Dematerialisation of Securities: Section 9 of the Depositories Act provides that the securities held by a depository shall be dematerialized and be fungible. The Act envisages dematerialization of securities in the depository mode as against immobilization of securities. The later refers to a situation when the depositories hold securities in physical form side by side with ownership records. In such a case physical movement of securities does not accompany the

transfers but securities are in existence in the custody of the depository. What the Act envisages is that ownership of securities shall be reflected through book entry system and this will not require existence of securities certificates. However, the securities outside the depository would be represented by physical security certificate. Hence, the depository mode envisaged is one of the partial dematerialization, that is, a portion of securities is dematerialized and the other portion remains in physical form.

Supremacy of Investor : The investor has been given the option between holding physical securities as at present or opting for a depository based ownership records. At the time of fresh issue, the issuer is under obligation to give the option to the investors either to seek physical securities under the existing paper based system (non-depository mode) or opt for book entry system of recording ownership (depository mode). The decision on whether or not to hold securities within the depository mode, if in depository mode, which depository or participant, would be entirely with the investor. Such freedom can be exercised either at the time of the initial offer of the security by indicating his choice in the application form or at any subsequent time. He will also have the freedom to switch from depository mode to non-depository mode and vice versa.

At the time of initial offer, if the investor opts to hold a security in the depository mode, the issuer shall be intimate concerned depository the details of allotment of securities and record the depository as registered owner of the securities. On receipt of such information, the depository shall enter in its records the names of allottees as the beneficial owners.

An investor who holds physical securities and seeks to avail the services of a depository will surrender the certificates to the issuer. The issuer on receipt of certificates shall cancel them and substitute in its records the name of the depository as a registered owner in respect of that security and inform the depository accordingly. The depository shall thereafter enter the name of the investor in its records as beneficial owner.

If a beneficial owner or a transferee of securities seeks to opt out of a depository in respect of any security, he shall inform the depository of his intention. The depository in turn shall

make appropriate entries in its records and shall inform the issuer. The issuer shall make arrangements for the issue of certificate of securities to the investor.

The depository shall record all transfers made within the depository mode on receipt of intimation from a participant. The type of intimation would be specified by SEBI regulations.

An investor, before availing the services of a depository, shall enter into an agreement with a depository through a participant. The participant is also required to enter into an agreement with the depository to act as the latter's agent. There will also be an agreement between the depository and the issuer of securities. The rights and obligations of depositories, participants, issuers and investors would be governed by the agreement among them, the bye-laws of the depository and the regulations of SEBI.

The Depositories Act, 1996 has laid down the legislative framework for facilitating the dematerialisation and book entry transfer of securities in a depository. The Act, inter alia, provides for the following:

1. registration with SEBI of a depository, which is required to be a company under the Companies Act, 1956, and of depository participants, who are agents of the depository

2. the dematerialization of securities in a depository with the records of beneficial ownership being recorded by the depository, and the transfer of beneficial ownership which takes place through electronic book entry by the depository

3. indemnification, in the first instance by the depository, of beneficial owners for the negligence of the participant

4. interfaces between the depository, participants, issuers and beneficial owners, several of which are required to be in the bye-laws which a depository has to make with the approval of SEBI

5. option to investors to hold securities in physical or dematerialised form, or to rematerialise securities previously held in dematerialised form

6. enquiries, inspection and penalties in case of default

7. the Act also amends other statutes to facilitate the setting up and functioning of depositories and introduces the free transferability of securities.

3.3.2 THE DEPOSITORY RELATED LAWS (AMENDMENT) ACT, 1997

While amending the Depositories Act, 1996, this amendment Act amended the Companies Act, 1956, the Indian Stamp Act, 1899, the State Bank of India Act, 1955, the State Bank of India (Subsidiary Banks) Act, 1959, the Industrial Development Bank of India Act, 1964, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 to facilitate dematerialization of securities. The Act amended the Depositories Act to provide that the provision of the Companies Act relating to securities held in trust shall not apply to a depository in respect of such securities, even though the depository is the registered owner of the securities. It restored section 83 in the Companies Act relating to distinct numbers for securities. However, the securities held in a depository may not have distinct numbers. It amended section 111A to restrict free transferability of securities provided originally in the Depositories Act, 1996. It provided that if a company refuses to register securities within 2 months, the transferee can appeal before the CLB for registration of securities in his favour. It also provided that if the transfer is in violation of any law for the time being in force, the depository, depository participant, company, SEBI or investor may apply to CLB within 2 months for rectification of register or records. It amended the Indian Stamp Act to exempt stamp duty on transfer of beneficial ownership of units of mutual funds dealt with by a depository. (Subsequently the stamp duty was

exempted on transfer of beneficial ownership of debt securities.)

3.3.3 SECURITIES LAWS (AMENDMENT) ACT, 1999

This Act has inserted provisions relating to derivatives, units of CIS and delegation of powers under the SCRA to RBI.

Derivatives : Despite withdrawal of prohibitions on derivatives by the Securities Laws (Amendment) Act, 1995, the market for derivatives, however, did not take off, as there was no regulatory framework to govern trading of derivatives. SEBI set up a 24 member Committee under the Chairmanship of Dr. L. C. Gupta on 18th November 1996 to develop appropriate regulatory framework for derivatives trading in India. The Committee submitted its report on March 17, 1998 recommending among others, that the derivatives may be declared as securities under section 2(h) (ii)(a) of the SCRA, so that the regulatory framework applicable to trading of securities could govern trading of derivatives also. Section 2 (h) of the SCRA, which provides an inclusive definition of 'securities', empowers Central Government to declare "such other" instruments as "securities". Government, however, did not declare derivatives to be securities, rather amended the SCRA, to explicitly define securities to include derivatives, probably because it's power to declare any instruments as "securities" was limited by the words "such other".

The Securities Contracts (Regulation) Amendment Bill, 1998 was introduced in the Lok Sabha on 4th July 1998 proposing to expand the definition of "securities" to include derivatives within its ambit so that trading in derivatives could be introduced and regulated under the SCRA. The Bill was referred to the Standing Committee on Finance (SCF) on 10th July 1998 for examination and report thereon. The Committee submitted its report on 17th March 1999. The committee was of the opinion that the introduction of derivatives, if implemented with proper safeguards and risk containment measures, will certainly give a fillip to the sagging market, result in enhanced investment activity and instill greater confidence among the investors/participants. The Committee after having examined the Bill and being convinced of the needs and objectives of the Bill approved the same for enactment by Parliament with certain modifications. The Bill, however, lapsed following the dissolution of

12th Lok Sabha. A fresh bill, the Securities Laws (Amendment) Bill 1999 was introduced in the Lok Sabha on 28th October 1999 incorporating the amendments proposed in the Securities Contracts Regulation (Amendment) Bill, 1998 as well as the modifications suggested by the SCF. This Bill was converted into an Act on 16th December 1999.

The Act inserted clause (aa) in section 2 to define derivatives to include: (a) a security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security, and (b) a contract which derives its value from the prices, or index of prices, of underlying securities. It also inserted sub-clause (ia) in section 2 (h) to include derivatives within the ambit of securities. Since derivative contracts are generally cash settled, these may be classified as wagers. The trading in wagers being null and void under section 30 of the Indian Contracts Act 1872, it may be difficult to enforce derivatives contracts. In order to avoid such legal uncertainties, a new section 18A was inserted to provide that notwithstanding anything contained in any other law for the time being in force, contracts in derivatives shall be legal and valid if such contracts are traded on a recognised stock exchange and settled on its clearing house in accordance with rules and bye-laws of such stock exchange. Section 23 was amended to provide that any body who enters into contract in contravention of section 18A shall be punishable.

By a notification issued on 1st March 2000, Government lifted the three-decade-old prohibition on forward trading in securities by rescinding 1969 notification. This prohibition was imposed by government in exercise of its powers under section 16 of the SCRA by a notification issued on 27th June 1969 in order to curb certain unhealthy trends that had developed in the securities market at that time and to prevent undesirable speculation. In the changed financial environment, the relevance of this prohibition had vastly reduced. Through appropriate amendments in the byelaws of the stock exchanges, carry forward transactions in securities were permitted. Similarly, periodic amendments to the aforesaid notification were made to permit repo transactions in government securities by authorised intermediaries. Even though the notification of 1969 was in force, exceptions had been carved out in course of

time as market needs changed and some form of forward trading (carry forward/ready forward) was prevalent.

The provisions in the SCRA and the regulatory framework developed thereunder govern the trading in securities. The amendments of the SCRA to include derivatives within the ambit of "securities" in the SCRA made trading in derivatives possible within the framework of that Act.

Collective Investment Scheme : During mid 1990s, many companies especially plantation companies had been raising capital from investors through schemes, which were in the form of CIS. Though SEBI is authorised under the SEBI Act, 1992 to register and regulate CIS, there was no suitable regulatory framework to allow an orderly development of market for units/instruments by them. Since SEBI's jurisdiction is limited to protect the interests of investors in securities, it could not take steps to protect the interests of investors in CIS units which were not securities. In order to allow for this and to strengthen the hands of SEBI to protect interests of investors in plantation companies, the Act amended the definition of "securities" to include within its ambit the units or any other instruments issued by any CIS to the investors in such schemes. The Act empowered the Central Government to make rules to provide for the requirements, which shall be complied with by CIS for the purpose of getting their units listed on any stock exchange. Such rules have been incorporated in the Securities Contracts (Regulation) Rules. This is aimed at an orderly development of market for these units while protecting the interest of investors therein. The Act also inserted a definition of the CIS in the SEBI Act, 1993. The CIS was defined to mean any scheme or arrangement made or offered by any company under which (a) the contributions, or payments made by the investors, by whatever name called, are pooled and utilised solely for the purposes of the scheme or arrangement; (b) the contributions or payments are made to such scheme or arrangement by the investors with a view to receive profits, income, produce or property whether movable or immovable from such scheme or arrangement; (c) the property, contribution or investment forming part of scheme or arrangement, whether identifiable or not, is managed on behalf of the investors; and (d) the investors do not have day to day control over the management and operation of the scheme or arrangement. The CIS, however, does not include any

scheme or arrangement (a) made or offered by a cooperative society, (b) under which deposits are accepted by non banking financial companies, (c) being a contract of insurance, (d) providing for any Scheme, Pension Scheme or the Insurance Scheme framed under the Employees Provident Fund and Miscellaneous Provision Act, 1952, (e) under which deposits are accepted under section 58A of the Companies Act, 1956, (f) under which deposits are accepted by a company declared as Nidhi or mutual benefit society under section 620A of the Companies Act, 1956, (g) falling within the meaning of Chit business as defined in clause (d) of section 2 of the Chit Fund Act, 1982 and (h) under which contributions made are in the nature of subscriptions to a mutual fund.

Delegation of Powers to RBI : The Government had power to delegate regulatory authority to SEBI. To provide additional flexibility, the Act amended section 29A of the SCRA so as to empower the Central Government to delegate powers to RBI also along with SEBI, to enable the former to regulate transactions under the SCRA as may be necessary. Now the Central Government, SEBI, and the RBI depending on their jurisdiction as may be mutually agreed upon can exercise the powers under the Act.

With the repeal of the 1969 notification in 2000, the then prevailing regulatory framework, which governed repo transactions, disappeared. It was, therefore, necessary to work out an arrangement whereby the regulators could regulate such transactions. In pursuance to this and in exercise of its newly acquired power, Central Government issued a notification on 2nd March 2000 delineating the areas of responsibility between RBI and SEBI. In terms of this notification, the powers exercisable by Central Government under section 16 of the SCRA in relation to the contracts in government securities, gold related securities, money market securities and in securities derived from these securities and in relation to ready forward contracts in bonds, debentures, debenture stock, securitised debt and other debt securities shall also be exercised by RBI. Such contracts, if executed on stock exchanges, shall, however, be regulated by (i) the rules and regulations or the byelaws made under the SCRA, or the SEBI Act or the directions issued by SEBI under these Acts, (ii) the provisions contained in the notifications issued by RBI under the SCRA, and (iii) the rules or regulations or directions issued by RBI under the RBI

Act, 1934, the Banking Regulations Act, 1949 or the Foreign Exchange Regulation Act, 1973.

RBI and SEBI have also issued consequential notifications on 2nd March 2000 specifying the regulatory framework in their respective areas. In terms of RBI notification, no person can enter into any (a) contract for the sale or purchase of government securities, gold related securities and money market securities other than spot delivery contract or such other contracts traded on a recognised stock exchange as is permissible under the SCRA, rules and byelaws of such stock exchange, and (b) ready forward contracts in bonds, debentures, debentures stock, securities debt, and other debt securities. Ready forward contracts may, however, be entered into by permitted persons in all government securities put through the Subsidiary General Ledger Account held with RBI in accordance with terms and conditions as may be specified by RBI. SEBI by its notification has prohibited all contracts in securities other than such spot delivery contract or contract for cash or hand delivery or special delivery or contract in derivatives as is permissible under the SCRA or the SEBI Act and rules and regulations made thereunder and rules, regulations and byelaws of a recognised stock exchange.

3.3.4 THE SECURITIES LAWS (SECOND AMENDMENT) ACT, 1999

The SCRA provided the right of appeal before the Central Government against refusal, omission or failure by a stock exchange to list the securities of any public company. The SEBI Act, 1992 provided for two kinds of appeals. Under section 20 of the Act, any person aggrieved by any order of the SEBI under the Act or rules or regulations made thereunder, may prefer an appeal to the Central Government. Accordingly, the Central Government had notified the SEBI (Appeal to the Central Government) Rules, 1993 and constituted an Appellate Authority for disposal of appeals. Section 15K of the Act provided for establishment of one or more SATs to hear appeals from orders of adjudicating officer of SEBI imposing monetary penalty as per Rules framed by the Central Government. Government has accordingly established a SAT at Mumbai to hear appeals from the orders of adjudicating officers. Under section 23 of the Depositories Act, 1996, any person aggrieved by an order of SEBI under the Depositories Act 1996 or Rules and Regulations

made thereunder may prefer an appeal to the Central Government. Accordingly, the Central Government had notified the Depositories (Appeal to the Central Government) Rules, 1998 and constituted an Appellate Authority for disposal of appeals. Thus the Central Government was conferred with powers to dispose of appeals in respect of all matters (except disposal of appeals against the orders of adjudicating officer under the SEBI Act, 1992) under all the three Acts.

In addition, the Central Government was empowered to issue directions to SEBI and make rules under these Acts. It was empowered to approve / amend / make rules / byelaws / regulations of the stock exchanges. Further, Central Government was represented on the management of SEBI as well as of the stock exchanges. The powers of the Central Government to issue directions and to make rules and appoint members of the SEBI as well as all governing bodies of the stock exchanges were perceived as compromising on its appellate powers. The Appellate Authorities appointed by the government under the SEBI Act and the Depositories Act had been receiving and disposing of appeals in accordance with the Rules. However, since government constituted these, their orders were perceived at times as orders of the government. When an order of SEBI was struck down, even on merits, there was a feeling that SEBI's autonomy as the regulator has been compromised. In order to remove such misgivings and impart transparency and impartiality to the process of disposal of appeals and to make the administration of penal provisions in the securities laws by the regulators more accountable and impartial, the Securities Laws (Second Amendment) Act 1999 amended all the three Acts to transfer appellate functions from the Central Government to an independent body, SAT.

The Amendment Act freezed section 22 of the SCRA and inserted a new section 22A to provide for right of appeal before SAT against refusal, omission or failure by a stock exchange to list the securities of any public company within 15 days of such refusal, omission or failure. An obligation was cast on SAT to dispose off appeals as expeditiously as possible, and to endeavour to dispose of finally within six months. Section 23 was amended to provide penalty for failure to comply with orders of SAT. Similar amendments were effected in the SEBI Act, 1992 and the Depositories Act 1996. Section 15K of the SEBI Act was amended to expand jurisdiction of

SAT to deal with appeals also under any other law. Section 15T was amended to empower SAT to deal with appeals from any person aggrieved by an order of SEBI as well as of an adjudicating officer under the SEBI Act. Section 20 of the SEBI Act, which provided for appeals to Central Government, was freezed. Section 23 of the Depositories Act, 1996, which provided for appeals to the Central Government, was also freezed. A new section 23A was inserted to provide for appeals to SAT under the Act. Hence, all appeals, namely the appeals against the orders of SEBI under the SEBI Act and the Depositories Act, appeals against the orders of the adjudicating officers under the SEBI Act, and appeals against refusal of stock exchanges to list securities were allowed to be preferred to SAT. It was further provided that any person aggrieved by the order of SAT may prefer appeal to High Court within 60 days.

Provisions were made in all three Acts to provide for appearance of the appellant in person or through one or more chartered accountants or company secretaries or cost accountants or legal practitioners or any of its officers before a SAT.

Central government was empowered to make rules to provide for the form in which an appeal may be filed before the SAT and the fees payable in respect of such appeals. Consequently, the SEBI (Appeal to the Central Government) Rules, 1993 and the Depositories (Appeal to the Central Government) Rules, 1998 were repealed. Government notified on 18th February 2000 three Appeal Rules, Viz. (a) Securities Appellate Tribunal (Procedure) Rules, 2000 under the SEBI Act, 1992, (b) The Depositories (Appeal to Securities Appellate Tribunal) Rules, 2000 under the Depositories Act, 1996, and (c) The Securities Contracts (Regulation) (Appeal to Securities Appellate Tribunal) Rules, 2000 under the SCRA. These rules provide for fees, form and procedure for filing appeal and the process of their disposal by the SAT. The appeals (except appeals against adjudication orders under the SEBI Act) under all three Acts need to be accompanied by a fee of Rs. 5,000/- only. The appeals against the adjudication orders need to be accompanied by a fee of Rs. 500/- if the penalty imposed is less than Rs.10,000/-, Rs.1,200/- if the penalty imposed is more than Rs. 10,000/- but less than Rs. 1,00,000/- and an additional Rs. 1,000/- for every additional one lakh of penalty or fraction thereof.

3.3.5 INVESTOR PROTECTION

Investors are the backbone of the securities market. Protection of their interest is essential for sustenance of their interest in securities and hence development of market.

The consumer fora provide an expeditious remedy to a consumer who has suffered loss on account of deficiency in goods/services purchased by him. A system ombudsman is working well in the banking and insurance sector. A similar arrangement is called for redressal of investor grievances.

The investor forum as well as other authorities should have power to dispose off the cases summarily and to award compensation to the investor. It is not enough if the culprit is punished. The culprit needs to be punished in an exemplary manner, while investor should have means to recover his loss caused by the culprit. The law should empower the authorities not only to levy penalties, but also award compensation to investor.

The depositors are protected up to Rs. 1 lakh in the event of liquidation/bankruptcy of a bank. This protects innocent depositors and thereby contributes to the stability of the financial system. A similar mechanism may be insituted to compensate an investor up to Rs. 5 lakh if he suffers a loss on account of the failure of the system or mischief by any market participant. An organization called Securities Investor Protection Corporation operates in the USA to provide similar protection to investors.

A large number of shares in the hands of a large number of shareholders is essential for sustenance of a continuous market for listed securities to provide liquidity to investors and to discover fair prices. To ensure this, a public company seeking listing of its securities on a stock exchange is required to offer at least 10% of securities to public. This framework suffers from following limitations: (i) 10% offer to public is too low to prevent price manipulation. (ii) The public offer is of no consequence unless the public are actually allotted shares. Even allotment has no meaning, unless sizeable number of shares remains in the hands of public to provide a continuous market. The law should speak in terms of allotment to public and public holding. (iii) The units of CIS are securities. But there is a different standard for listing of units of CIS. The same requirement (10% + 20 lakh + Rs. 100 crore or 25%, as the case may be) as applicable to listing of securities, should also apply to

listing of units of CIS. The units of MFs are being considered as securities and are being traded like securities on exchanges. The requirement of public holding may apply to units of MFs as well. The investors in securities – shares, units of CIS or units of MFs – have need for same level of protection and hence the conditions of listing for all kinds of securities should be uniform. (iv) There should not be any discrimination between a government company and a non-government company. The powers of the stock exchange to relax this requirement in respect of a government company needs to be withdrawn. The powers of SEBI to relax or waive strict enforcement of listing requirement may also be withdrawn. (v) The words 'public' or 'offer to public' have not been defined. The Rules permit 10% public offer subject to the condition that 60% of the issue is allocated to QIBs. Since QIBs are part of public, allocating 60% to QIBs would automatically constitute 60% public offer and the retail public would not get any share. Or, if 60% of public offer of 10% is allocated to QIBs, the retail public would be left with just 4%. It is, therefore, necessary to define 'public' and other terms and explicitly exclude allocation to QIBs from the public offer.

To ensure availability of reasonable floating stock on continuous basis, the listing agreement requires a company to maintain the minimum level of non-promoter holding at the level of public shareholding as required at the time of listing. If, however, the non-promoter holding of an listed company as on April 1, 2001 was less than that is required at the time of initial listing, the company was required raise the level of non-public holding to at least 10% within one year. This arrangement prescribes different standards for continued listing for companies listed before April 2001 and for companies listed thereafter. A company listed before April 2001 can have non-promoter holding of at least 10%, if as on April 1, 2001 it had non-promoter holding less than that is required at the time of initial listing. Otherwise it will have non-promoter holding as required at the time of initial listing, which may be 60% if it was listed before 1993. A company listed after April 2001 would maintain a minimum level of non-promoter holding at the level of public holding as required at the time of listing, that is, at 10% plus 20 lakh securities plus Rs. 100 crore or 25%, as the case may be. Thus existing listed and would be listed companies and consequently investors in these companies are treated differently.

Non-promoter holding required at the time of listing is quite vague as it has changed over time. If we follow the listing agreement, the companies listed before 1993 would maintain non-promoter holding at 60%, the companies listed between 1993 and 2001 would maintain at 25% and the companies listed after 2001 would maintain at 10% + 20 lakh + Rs. 100 crore or 25%, as the case may be. If minimum non-promoter holding is prescribed in the interest of investors and investors in all companies are to be treated uniformly, regulation has to be uniform and all companies should be required to maintain non-promoter holding of 10% + 20 lakh + Rs. 100 crore or 25%, as the case may be.

The confidence of the investors can be maintained and enhanced by making provision for professional intermediation services. Industry/SROs/Regulators have made a modest beginning, but not adequate given the dimensions of the market. There must be a formal and adequate arrangement to equip the personnel working with the intermediaries with the skills required to operate in the securities market. Probably an institute like ICSI or ICAI is necessary for securities market.

An investor normally deals in securities through an intermediary, whose acts of omission and commission can cause loss to him. In order for the investor to choose the right intermediary through whom he may transact business, it may be useful to help him in taking informed decision by making details of intermediaries available to him. Even, the intermediaries may be rated and their ratings are disseminated.

The sustenance of investors' interest and confidence in the securities market depends crucially on corporate governance. An investor, however, is generally not equipped to form an idea about the level of corporate governance in a company. As he is helped by credit rating in respect of his investments in debt instruments, he needs to be helped by a summary figure such as corporate governance index in respect of his investments in the concerned company.

3.3.6 AMENDMENTS IN OTHER ACTS:

To provide for the smooth operation of the depositories, the Depositories Act amended a few other Acts such as the Indian

Stamps Act, 1989, the Companies Act, 1956, the Securities Contracts (Regulation) Act, 1956, the Income-tax Act, 1961, the Benami Transactions (Prohibition) Act, 1988 and the Securities and Exchange Board of India Act, 1993. The major amendments in these Acts are discussed below:

Amendment to the Indian Stamps Act : Section 8A was inserted in the Indian Stamps Act to provide for the following:

(i) At the time of issue of securities, shares or otherwise, the issuer shall pay the Stamp duty on the total amount of the security issued by it, whether through a depository or direct to investors, even though there will be no physical securities (instrument) which can be stamped (executed).

(ii) Entry into depository involves change of registered ownership as the investor becomes the beneficial owner and the depository becomes the registered owner in respect of the security. As it involves change in registered ownership, it attracts stamp duty under the existing provisions. The new section 8A, however, exempted such change of registered ownership of shares from an investor to a depository from the stamp duty.

(iii) All transactions of securities involving change in registered ownership and/or beneficial ownership of shares within the depository mode shall not attract any stamp duty.

(iv) If an investor opts to exit from the depository and seeks the issue of physical certificate of securities from the issuer, the issue of such certificates shall attract stamp duty as is payable on the issue of duplicate certificates.

(v) All transactions outside the depository mode shall attract stamp duty as at present.

Amendments to the Income Tax Act : Sub-section 2A was inserted in section 45 to provide that the depositories as well as the participants would not be liable to pay any capital gains tax in respect of profits or gains arising from transfer securities held in depositories and transacted from time to time since these securities are held on behalf of the beneficial owners. In other words, inter-se transfer of securities between the

participants in the books of a depository as well as between the depositories in the records of an issuer shall not be treated as transfer unless it involves change in beneficial ownership. If it involves any change in the beneficial ownership, only the beneficial owner shall be chargeable to capital gains tax, not the registered owner.

Due to fungible characteristic of the securities, while calculating capital gains tax, the cost of acquisition of securities shall not be determined with reference to cost of acquisition of specific identifiable securities, but be ascertained on the principle of first in first out. That is, the securities acquired first by the beneficial owner would be deemed to have been transferred first irrespective of the intention of the investor. This principle would be applicable only in respect of securities held in a depository.

Amendment to the Companies Act : Section 83 of the Companies Act was deleted. This did away with the mandatory requirement of each company limited by shares to distinguish the shares by distinguishing numbers, in order to introduce the concept of fungibility. The abolition of section 83, however, did not prohibit a company from having distinct numbers, although there was no mandatory requirement to that effect.

Section 108 was amended to provide that the provisions of section 108 shall apply to transfer of securities effected outside the depository mode. The provisions of section 108 shall not apply to transfers of securities affected within the depository mode.

Section 111 was amended to provide that the provisions of section 111 shall apply to a private company and a deemed public company. The new section 111A was inserted to govern the transfer of securities of a public limited company. The shares or debentures and any interest therein of a company were made freely transferable and all the rights and obligations associated with them immediately accrue to the transferee. However, if the transfer violates any of the provisions of the SEBI Act, 1992 or SICA, 1985, the depository, company, participant, investor or SEBI can make an application to the CLB. The CLB, pending completion of enquiry may make an interim order to suspend the voting rights in respect of those

securities, and on completion of the enquiry, may direct the company or depository to rectify the register or records if transfer is in violation of the aforesaid provisions. During the pendency of the application with CLB, the economic rights accrue to the transferee and the transferee has a right to transfer the securities further and such further transferee shall be entitled to voting rights also.

3.4 SUMMARY

The two exclusive legislations that governed the securities market till early 1992 were the Capital Issues (Control) Act, 1947 (CICA) and the Securities Contracts (Regulation) Act, 1956 (SCRA). The CICA had its origin during the war in 1943 when the objective was to channel resources to support the war effort. Control of capital issues was introduced through the Defence of India Rules in May 1943 under the Defence of India Act, 1939. The control was retained after the war with some modifications as means of controlling the raising of capital by companies and to ensure that national resources were channeled into proper lines, i.e., for desirable purposes to serve goals and priorities of the government, and to protect the interests of investors. The relevant provisions in the Defence of India Rules were replaced by the Capital Issues (Continuance of Control) Act in April 1947. This Act was made permanent in 1956 and enacted as the Capital Issues (Control) Act, 1947. Under the Act, the Controller of Capital Issues was set up which granted approval for issue of securities and also determined the amount, type and price of the issue. This Act was, however, repealed in 1992 as a part of liberalization process to allow the companies to approach the market directly provided they issue securities in compliance with prescribed guidelines relating to disclosure and investor protection.

The authorities have been quite sensitive to requirements of the development of securities market, so much so that the last decade (1992-2003) witnessed nine special legislative interventions, including two new enactments, namely the Securities and Exchange Board of India (SEBI) Act, 1992 and the Depositories Act, 1996. The SCRA, the SEBI Act and the Depositories Act were amended six, five and three times respectively during the same period. The developmental need was so urgent at times, that the last decade witnessed five ordinances relating to securities laws. Besides, a

number of other legislations (the Income Tax Act, the Companies Act, the Indian Stamps Act, the Bankers' Book Evidence Act, the Benami Transactions (Prohibition) Act etc.) having bearing on securities markets have been amended in the recent past to complement amendments in securities laws.

The legal reforms began with the enactment of the SEBI Act, 1992, which established SEBI with statutory responsibilities to (i) protect the interest of investors in securities, (ii) promote the development of the securities market, and (iii) regulate the securities market. This was followed by repeal of the Capital Issues (Control) Act, 1947 in 1992 which paved way for market determined allocation of resources. Then followed the Securities Laws (Amendment) Act in 1995, which extended SEBI's jurisdiction over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It empowered SEBI to appoint adjudicating officers to adjudicate wide range of violations and impose monetary penalties and provided for establishment of Securities Appellate Tribunals (SATs) to hear appeals against the orders of the adjudicating officers. Then followed the Depositories Act in 1996 to provide for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security. It made securities of public limited companies freely transferable subject to certain exceptions; dematerialized the securities in the depository mode; and provided for maintenance of ownership records in a book entry form. The Depositories Related Laws (Amendment) Act, 1997 amended various legislations to facilitate dematerialization of securities. The Securities Laws (Amendment) Act, 1999 was enacted to provide a legal framework for trading of derivatives of securities and units of CIS. The Securities Laws (Second Amendment) Act, 1999 was enacted to empower SAT to deal with appeals against orders of SEBI under the Depositories Act and the SEBI Act, and against refusal of stock exchanges to list securities under the SCRA. The next intervention is the SEBI (Amendment) Act, 2002 which enhanced powers of SEBI substantially in respect of inspection, investigation and enforcement. The latest and the ninth legislative intervention namely the Securities Laws (Amendment) Bill, 2003 introduced in the monsoon session of the Parliament to amend the SCRA to provide for demutualisation of stock exchanges is awaiting approval. The approval to this bill is a

matter of time as it is a money bill. This paper explains the provisions in these nine legislative interventions in a historical perspective.

The system of transfer of ownership of securities prevailing till mid 1990s was grossly inefficient as every transfer was required to be accomplished by the physical movement of paper securities to the issuer for registration and the ownership was evidenced by the endorsement on the security certificate. The process of transfer in many cases took much longer time than two months stipulated in the Companies Act, 1956 or the SCRA. A significant proportion of transactions ended up as ' bad delivery' due to faulty compliance of paper work, mismatch of signatures on transfer deeds with the specimen records of the issuer or for other procedural reasons. Theft, forgery, mutilation of certificates and other irregularities were rampant. The inherent right of the issuer to refuse the transfer of a security added to the misery of the investors. The cumbersome paraphernalia associated with the transfer of securities under section 108 of the Companies Act, 1956, along with huge paper work, printing of stationary, safe custody of securities, transportation and dispatch added to the cost of servicing paper securities, delay in settlement and restricted liquidity in securities and made investor grievance redressal time consuming and at times intractable. All these problems had not surfaced overnight but these were compounded by burgeoning trade volumes in secondary market and increasing dependence on securities market for financing trade and industry. This underscored the need for streamlining the transfer of ownership of securities which was sought to be accomplished by the Depositories Act, 1996. The Act provides a legal basis for establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making the securities of public limited companies freely transferable; (b) dematerializing the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form.

The Government had power to delegate regulatory authority to SEBI. To provide additional flexibility, the Act amended section 29A of the SCRA so as to empower the Central Government to delegate

powers to RBI also along with SEBI, to enable the former to regulate transactions under the SCRA as may be necessary. Now the Central Government, SEBI, and the RBI depending on their jurisdiction as may be mutually agreed upon can exercise the powers under the Act.

With the repeal of the 1969 notification in 2000, the then prevailing regulatory framework, which governed repo transactions, disappeared. It was, therefore, necessary to work out an arrangement whereby the regulators could regulate such transactions. In pursuance to this and in exercise of its newly acquired power, Central Government issued a notification on 2nd March 2000 delineating the areas of responsibility between RBI and SEBI. In terms of this notification, the powers exercisable by Central Government under section 16 of the SCRA in relation to the contracts in government securities, gold related securities, money market securities and in securities derived from these securities and in relation to ready forward contracts in bonds, debentures, debenture stock, securitized debt and other debt securities shall also be exercised by RBI. Such contracts, if executed on stock exchanges, shall, however, be regulated by (i) the rules and regulations or the byelaws made under the SCRA, or the SEBI Act or the directions issued by SEBI under these Acts, (ii) the provisions contained in the notifications issued by RBI under the SCRA, and (iii) the rules or regulations or directions issued by RBI under the RBI Act, 1934, the Banking Regulations Act, 1949 or the Foreign Exchange Regulation Act, 1973.

RBI and SEBI have also issued consequential notifications on 2nd March 2000 specifying the regulatory framework in their respective areas. In terms of RBI notification, no person can enter into any (a) contract for the sale or purchase of government securities, gold related securities and money market securities other than spot delivery contract or such other contracts traded on a recognised stock exchange as is permissible under the SCRA, rules and byelaws of such stock exchange, and (b) ready forward contracts in bonds, debentures, debentures stock, securities debt, and other debt securities. Ready forward contracts may, however, be entered into by permitted persons in all government securities put through the Subsidiary General Ledger Account held with RBI in accordance with terms and conditions as may be specified by RBI. SEBI by its notification has prohibited all contracts in securities other than such

spot delivery contract or contract for cash or hand delivery or special delivery or contract in derivatives as is permissible under the SCRA or the SEBI Act and rules and regulations made there under and rules, regulations and byelaws of a recognized stock exchange.

The SCRA provided the right of appeal before the Central Government against refusal, omission or failure by a stock exchange to list the securities of any public company. The SEBI Act, 1992 provided for two kinds of appeals. Under section 20 of the Act, any person aggrieved by any order of the SEBI under the Act or rules or regulations made there under, may prefer an appeal to the Central Government. Accordingly, the Central Government had notified the SEBI (Appeal to the Central Government) Rules, 1993 and constituted an Appellate Authority for disposal of appeals. Section 15K of the Act provided for establishment of one or more SATs to hear appeals from orders of adjudicating officer of SEBI imposing monetary penalty as per Rules framed by the Central Government. Government has accordingly established a SAT at Mumbai to hear appeals from the orders of adjudicating officers. Under section 23 of the Depositories Act, 1996, any person aggrieved by an order of SEBI under the Depositories Act 1996 or Rules and Regulations made thereunder may prefer an appeal to the Central Government. Accordingly, the Central Government had notified the Depositories (Appeal to the Central Government) Rules, 1998 and constituted an Appellate Authority for disposal of appeals. Thus the Central Government was conferred with powers to dispose of appeals in respect of all matters (except disposal of appeals against the orders of adjudicating officer under the SEBI Act, 1992) under all the three Acts.

In addition, the Central Government was empowered to issue directions to SEBI and make rules under these Acts. It was empowered to approve / amend / make rules / byelaws / regulations of the stock exchanges. Further, Central Government was represented on the management of SEBI as well as of the stock exchanges. The powers of the Central Government to issue directions and to make rules and appoint members of the SEBI as well as all governing bodies of the stock exchanges were perceived as compromising on its appellate powers. The Appellate Authorities appointed by the government under the SEBI Act and the Depositories Act had been receiving and disposing of appeals in accordance with the Rules. However, since government constituted

these, their orders were perceived at times as orders of the government. When an order of SEBI was struck down, even on merits, there was a feeling that SEBI's autonomy as the regulator has been compromised. In order to remove such misgivings and impart transparency and impartiality to the process of disposal of appeals and to make the administration of penal provisions in the securities laws by the regulators more accountable and impartial, the Securities Laws (Second Amendment) Act 1999 amended all the three Acts to transfer appellate functions from the Central Government to an independent body, SAT.

Investors are the backbone of the securities market. Protection of their interest is essential for sustenance of their interest in securities and hence development of market.

The consumer for a provide an expeditious remedy to a consumer who has suffered loss on account of deficiency in goods/services purchased by him. A system ombudsman is working well in the banking and insurance sector. A similar arrangement is called for redressal of investor grievances.

The investor forum as well as other authorities should have power to dispose off the cases summarily and to award compensation to the investor. It is not enough if the culprit is punished. The culprit needs to be punished in an exemplary manner, while investor should have means to recover his loss caused by the culprit. The law should empower the authorities not only to levy penalties, but also award compensation to investor.

The depositors are protected up to Rs. 1 lakh in the event of liquidation/bankruptcy of a bank. This protects innocent depositors and thereby contributes to the stability of the financial system. A similar mechanism may be instituted to compensate an investor up to Rs. 5 lakh if he suffers a loss on account of the failure of the system or mischief by any market participant. An organization called Securities Investor Protection Corporation operates in the USA to provide similar protection to investors.

A large number of shares in the hands of a large number of shareholders is essential for sustenance of a continuous market for listed securities to provide liquidity to investors and to discover fair prices. To ensure this, a public company seeking listing of its securities on a stock exchange is required to offer at least 10% of

securities to public. This framework suffers from following limitations: (i) 10% offer to public is too low to prevent price manipulation. (ii) The public offer is of no consequence unless the public are actually allotted shares. Even allotment has no meaning, unless sizeable number of shares remains in the hands of public to provide a continuous market. The law should speak in terms of allotment to public and public holding. (iii) The units of CIS are securities. But there is a different standard for listing of units of CIS. The same requirement (10% + 20 lakh + Rs. 100 crore or 25%, as the case may be) as applicable to listing of securities, should also apply to listing of units of CIS. The units of MFs are being considered as securities and are being traded like securities on exchanges. The requirement of public holding may apply to units of MFs as well. The investors in securities – shares, units of CIS or units of MFs – have need for same level of protection and hence the conditions of listing for all kinds of securities should be uniform. (iv) There should not be any discrimination between a government company and a non-government company. The powers of the stock exchange to relax this requirement in respect of a government company needs to be withdrawn. The powers of SEBI to relax or waive strict enforcement of listing requirement may also be withdrawn. (v) The words 'public' or 'offer to public' have not been defined. The Rules permit 10% public offer subject to the condition that 60% of the issue is allocated to QIBs. Since QIBs are part of public, allocating 60% to QIBs would automatically constitute 60% public offer and the retail public would not get any share. Or, if 60% of public offer of 10% is allocated to QIBs, the retail public would be left with just 4%. It is, therefore, necessary to define 'public' and other terms and explicitly exclude allocation to QIBs from the public offer.

To provide for the smooth operation of the depositories, the Depositories Act amended a few other Acts such as the Indian Stamps Act, 1989, the Companies Act, 1956, the Securities Contracts (Regulation) Act, 1956, the Income-tax Act, 1961, the Benami Transactions (Prohibition) Act, 1988 and the Securities and Exchange Board of India Act, 1993. The major amendments in these Acts are Amendment to the Indian Stamps Act, Amendments to the Income Tax Act and Amendment to the Companies Act

3.5 SUGGESTED READINGS

M S SAHOO, Historical perspective of Securities laws
The Depositories Act, 1996

The Depository Related Laws (amendment) Act, 1997

Securities Laws (amendment) Act, 1999

The Securities Laws (second amendment) Act, 1999

3.6 TERMINAL QUESTIONS

1. Write a short Essay on Public Depositories
3. Discuss the relevant Provisions of Public Depositories Act, 1996 for the protection of public depositories.
3.How the interest of Investor is Protected?

LL.M. PART – I
PAPER- BANKING LAW

Block II -THE CENTRAL BANK
Unit-4-EVOLUTION OF CENTRAL BANK; CHARACTERISTICS ECONOMIC AND SOCIAL

STRUCTURE

2.1 INTRODUCTION

After independence, India adopted a socialist pattern of society as its goal. This means, in. non-technical language, a society with wealth distributed as equitably as possible without making the country a totalitarian State. The goal is purported to be achieved through democratic processes. With this aim in view, a mixed pattern of planning is evolved. The two sectors,- private and public, are allowed in function independently of each other. The public sector is wholly owned and controlled by the Government. The private sector is regulated through a system of regulations, licenses, controls and legislative acts, the latest of which is the Monopolies and Restrictive Trade Practices Act, 1969. The public sector is made to grow by nationalization of industries and institutions.

The banking institutions are the custodians of private savings and a powerful instrument to provide credit. They mobilise the resources of the country by accepting deposits and channellise them for industrial and national development by granting advances. In 1955 the Imperial Bank of India was nationalized and its undertaking was taken over by the State Bank of India. As regards the scheduled banks, there were complaints that Indian commercial banks were directing their advances to the large and medium scale industries and big business houses and that the sectors demanding priority such agriculture, small-scale industries and exports were not receiving their, due share.

Although steps had been taken in January, 1969, by amending the Banking Regulation Act, for the purposes of imposing “social control” with a view to remedy the basic weak nesses of the Indian banking system and to ensure that banks would cater to the ‘needs of the hitherto neglected and weaker sections of the community instead of big businesses and those connected with them, it was felt that the imposition of “social control” had not changed the position very much and there were complaints that the Indian commercial banks continued to direct their advances to large and medium scale industries and that sectors demanding priority such as agriculture, small-scale industries and imports were not receiving the attention due to them of the banks.

Necessity of regulatory framework for the financial system has been universally felt, primarily to safeguard the interests of a large number of savers/depositors and also to ensure proper and efficient functioning of the institutions that are part and parcel of the financial system. We have, in India,two principal regulatory authorities, namely, the ReserveBank of India (RBI) and the Securities and Exchange Boardof India (SEBI). They are entrusted with the responsibilities of development and regulation of the money market and capital market respectively. These regulators derive their powen from various legislative enactments and exercise their discretion as well. The financial system thus functions wlthin the regulatory framework. The objective of this and the next Units are to give you a broad account of such Lng System and *y* Market regulatory framework. In this Unit,. we shall deal with the regulatory environment for the money market and the participants therein, i.e. the Commercial Banks, the Cooperative Banks, financial institutions and the non-banking finance companies.

4.2 OBJECTIVES

In this unit an attempt is made to discuss the evolution of central bank, regulations over commercial banks and working of regulations over cooperative banks. Further, in the light of above, an attempt is also made to analyze all relevant aspects

4.3.1 RESERVE BANK OF INDIA: ITS FUNCTIONS AS A CENTRAL BANK

Reserve Bank of India, besides being the Central Bank of the country, is the principal regulatory authority in the Indian money market. It derives its powers from two principal enactments, namely the Reserve Bank of India Act, 1934 and the Banking Regulations act, 1949. The Reserve Bank of India Act, 1934, apart from providing for the Constitution management and functions of the RBI, also empowers it to exercise control and regulations, over the Commercial Banks,the non-banking finance companies and the financial

institutions. The Banking Regulation Act 1949 contains various provisions ‘governing the Commercial Banks in India! Many of these provisions are also applicable to the Co- operative Banks. The State Bank of India, its subsidiary banks and the nationalized banks, are also governed by the status under which they have been incorporated. In the subsequent sections of this Unit, we shall deal with the I regulatory framework. First, we shall discuss the main functions performed by the Reserve Bank of India. The Reserve Bank of India was established on April 1, 1935, under the Reserve Bank of India Act, 1934. As the country's Central Bank, the Reserve Bank of India performs the following function:

a) Issuer of Currency Notes: Reserve Bank of India is the sole authority to issue currency notes, except one-rupee note and coins of smaller he nominations. Within the RBI, all functions relating to the issuance of notes are undertaken by the 'Issue Department', which is responsible for issue of notes and t'he maintenance of eligible assets of equivalent value to back the notes issued.

b) Banker to the Government: RBI acts as banker to the Central Government under the Reserve Bank of India Act, and to the State Governments, under agreements with them. As the banker to the Government, RBI provides services, such as acceptance of deposits, withdrawal of funds, receipts - and payments on behalf of the Government, transfer of funds and the management of public debt.

c) Banker's Bank: The Reserve Bank of India controls the volume of resources at the disposal of the Commercial Banks through the various measures of credit control. This checks the ability of banks to create/squeeze credit to the industry,
Trade and commerce.

d) Supervisory Authority: RBI has the powers to supervise and control Commercial Banks. It issues licenses for starting new banks and for opening new branches. It has the power to vary the reserve ratios, to inspect the working -
of banks, and to approve the appointment of Chairman and Chief Executive Officers of the banks.

e) Exchange Control Authority: The Reserve Bank of India regulates the demands for foreign exchange in terms of the

Foreign Exchange Management Act, besides maintaining the external value of Indian rupee.

***f)* Regulation of Credit**: One of the most important functions of the Reserve Bank of India is to regulate the flow of credit to industry. This is achieved by measures such as the Bank rate, Reserve Requirements, Open Market Operations, selective credit controls and moral suasion.

4.3.2 R-EGULATIONS OVER COMMERCIAL BANKS

Main provisions of the Banking Regulation Act, 1949, which govern the Commercial Banks, are as follows:

1) Establishment

It is essential for every banking company-Indian or foreign, to acquire a licence from the Reserve Bank of India, before it commences its business in India. Reserve Bank of India issues a licence, if it is satisfied that the company fulfils the Following conditions:

i) the company is/or will be in a position to pay its present or future depositors in full as their claims accrue,

ii) the affairs of the company are not being, or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors,

iii) the general character of the proposed management of the company will not be prejudicial to the public interest, or the interests, of its depositors,

iv) the company has adequate capital structure and earning prospects,

v) public interest will be served by the grant of a licence to the company to carry on banking business in India,

vi) the grant of licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth, and

vii) any other condition to ensure that the carrying on of the banking business in India by the company will not be prejudicial to the public interest or the interests of the depositors. A foreign bank must, in addition, satisfy the following conditions:

i) the carrying on of banking business by such company in India will be in the public interest,

ii) the Government or the law of the country in which it is incorporated does not discriminate in any way against banking companies in India, and
iii) the company complies with all the provisions cf the Act applicable to such companies.

2) Opening of Branches

Every banking company (Indian as well as foreign) is required to take Reserve Bank's prior permission for opening a new place of business in India or outside India, or to change the location of an existing place of business in India or outside. Reserve Bank, before granting its permission, takes into account -
i) the financial condition and history of the company,
ii) the general character of its management,
iii) the adequacy of its capital structure and earning prospects, and
iv)whether public interest will be served by the opening/change of location of the place of business.

3) Business Permitted and Prohibited

Section 6 contains a list of businesses which may be undertaken by a banking company. Under Clause 'O', any other business may also be specified by the Central Government as the lawful business of a banking company. But, a banking company is prohibited from undertaking, directly or indirectly, trading activities and trading risks (except for the realization of the amount lent or in connection
With the realization of bills for collection/ negotiations).

4) Subsidiary Company

A subsidiary company for undertaking any business permitted under Section 6, or for carrying on the business of banking exclusively outside India, or for undertaking any other business, which in the opinion of Reserve Bank, would be conducive to the spread of banking in India or to be useful in public interest.

5) Paid-up Capital

The Act stipulates the minimum aggregate value of its paid-up capital and reserves for banks established before 1964. Minimum amount of capital was raised to Rs. 5 Lakhs for banks set up after 1964. The revised guidelines issued by Reserve Bank for establishing new private sector banks prescribed

minimum paid-up capital for such bank: at Rs. 200 crore, which shall be increased to Rs. 300 crore in the next three years, out of which promoter's contribution will be 25% (or 20% in case paid-up capidal exceeds Rs. 100 crore). Non-Resident .Indians may participate in the equity of a new bank to the extent of 40%.The authorized capital of a nationalized bank is Rs. 1580 crore, which may be raised to Rs. 3000 crores. These banks are allowed to reduce the capital also but nor below Rs.1500 crore. These banks are permitted to issue shares ta the public also, but the share of the Central Government is not allowed to be less than 51% of the paid-up capital. The paid-up capital may be reduced at any time so as to render it below 25% of the paid-up capital as on 1995.

6) Maintenance of Liquid Assets

Section 24 required every banking company to maintain in India in cash, gold or unencumbered approved securities an amount which shall not, at the close of business on any day, be less than 25% of the total of its net demand and time liabilities in India. Reserve Bank of India is empowered to step up this ratio, called Statutory Liquid Ratio (SLR), up to 40% of the net demand and time liabilities. When this ratio is raised, banks are compelled to keep larger proportion of their deposits in these specified liquid assets. SLR is to be maintained on a daily basis. The amount of SLR is calculated on the basis of net demand and time liabilities as on the last Friday of the second preceding fortnight. Reserve Bank also possesses the power to decide the mode of valuation of the securities held by banks, i.e. valuation may be with reference to cost price, and book value or face value as may be decided by Reserve Bank of India from time to time. Approved securities mean the securities in which the trustees may invest trust funds under Section 20 of the Indian Trusts Act 1884. 'The securities should be unencumbered i.e. free of charge in favour of any creditor. The Act also provides for penalties for default in maintaining the liquid assets under Section 24. At present SLR is to be maintained @ 25% of net demand and time liabilities (which excludes net inter bank liabilities).

7) Maintenance of Assets in India

'Section 25 requires that the assets of every banking company in India at the close of business on the last Friday of every

quarter shall not be less than 75% of its demand and time liabilities.

8) Inspection by Reserve Bank

Under Section 35, the Reserve Bank may, either at its own initiative or at the instance of the Central Government, cause an inspection to be made by one or more of the officers, of any banking company and its books and accounts. If, on the basis of the inspection report submitted by the Reserve Bank, the Central Government is of the opinion that the affairs of the banking company are conducted to detriment the interests of its depositors, it may prohibit the banking company from receiving fresh deposits or direct the Reserve Bank to apply for the winding up of banking company.

***9)* Reserve Bank's Power to Issue Directions**

Reserve Bank of India is vested with wide powers under Section 35 A to issue direction to banking companies generally, or to any banking company, in particular:

i) in the public interest or in the interest or banking policy,
0r

ii) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company, or

iii) to secure proper management of ally banking company generally.

The banking company shall be bound to comply with such direction. The Reserve bank to caution or prohibit banking companies against entering into any particular transaction or class of transactions, literally give advice to the banking company. Reserve Bank also possesses the powers to ask the banking company to call a meeting of Board of Directors, to depute its officers, to watch the proceedings-of the meetings of the Board, to appoint its officers.

10) Management of Banks

The constitution of the Board of Directors of the private sector commercial banks must be in accordance with the provisions of the Banking Regulation Act, 1949. Section 10 lays down the Board of Directors be constituted in such a way that not less than 51% of the total number of members shall consist of persons who satisfy the following two conditions: i) they have

special knowledge or practical experience in respect of accountancy, agriculture, rural economy, banking, co-operation, economics, finance, law, small scale industry, or any other related matter.

ii) they do not have substantial interest in, or be connected with any company or firm which carries on any trading, commercial or industrial concern (this excludes those connected with small-scale industries or companies registered under Section 25 of the Companies Act). Reserve Bank of India has conferred the power to direct a banking company to reconstitute the Board, if it is not constituted as above. It may remove a Director and appoint a suitable director also. A person cannot be a Director of two banking companies or a Director of a banking company, if he is ;.A Director of companies which are entitled to exercises voting rights in excess of 25% of the total voting rights of all shareholders of the banking company. The Act also requires that the Chairman of a banking company shall be a person who has special knowledge and practical experience of the working of a bank or financial ~institution, or that of financial, economic or business administration. But he shall not be a Director of a company, partner in a firm or have substantial interest in any company . / firm If, the Reserve Bank of India is of the opinion that person appointed as Chairman is not a fit/proper person C hold such office; it may request the bank to elect another person. If it fails to do so, the Reserve Bank of India is authorized to remove the said person and to appoint a suitable person in his place. Reserve Bank's approval is also required to appoint, re-appoint, or terminate the appointment of a Chairman, Director, or Chief Executive Officer. Reserve Bank has the power to remove top managerial personnel of the banking companies, if the Bank feels it necessary in the public interest, or for preventing the affairs of a banking company being conducted in a manner detrimental to the interests of the depositors. Reserve Bank may appoint a suitable person in place of the person so removed. Moreover, Reserve Bank is also empowered to appoint Additional Directors not exceeding five or one third of the maximum strength of the Board, whichever is less. The Board of Directors of the nationalized banks are to be constituted in accordance with the provisions of Section 9 of the Banking

Companies (Acquisition and Transfer of Undertakings) Act, 1970 or 1980. It provides for appointment as Directors or officials of RBI, Central Government, other financial institutions and from amongst the officers and workmen of the bank concerned. Moreover, six Directors are to be nominated by the Central Government, and two to six directors are to be elected by shareholders other than Central Government. These Directors are required to be experts in, or have practical experience in the subjects enumerated above in case of private banks' Directors. If the Reserve Bank is of the opinion that any Director elected by the shareholders (other than Government) does not fulfill the aforesaid requirement, it can remove such Director, and the Board of Directors shall co-opt another person in his place. The nationalized banks are under an obligation to comply with the guidance given by the Central Government. According to Section 8 of the (Nationalization) Act, "every nationalized bank shall, in the discharge of its functions, be guided by such directions in regard to matters of policy, involving public interest as the Central Government may, after consultation with the Governor of the Reserve Bank, give".

11) Control over Advances

Section 21 confers wide powers on the Reserve Bank of India to issue directive to the banking companies with regard to the advances to be granted by the banking companies either generally or by any of them in particular. These directions may relate to any or all of the following: a) the purposes for which advances may, or may not be,granted,b) the margins to be maintained in respect of secured advances,c) the maximum amount of advance to any one company, firm, individual or association of persons) the maximum amount upto which guarantees may be given by the banking company on behalf of any company or firm, and e) the rate of interest and other terms and conditions, on which advances may be made or guarantees may be given. The directive issued under this Section is called Selective Credit Control Directives, if they relate to advances on the security of selected commodities. Banks are bound to comply with these directives.

12) Restrictions on Loans and Advances: A banking company is prohibited from anctioning loans and advances on

the security of its own shares. Restrictions are also imposed under Section 20 on the loans granted by banks to the persons interested in the management of banks.

13) Maintenance of Cash Reserve with Reserve Bank:

Section 42 of the Reserve Bank Act, 1934 requires every scheduled bank to maintain with the Reserve Bank of India an average daily balance, the amount of which shall not be less than 3% of the net demand and time liabilities of the bank in India. Reserve Bank of India is empowered to increase this rate up to 20% of the net demand and time liabilities. If a bank fails to maintain the cash balance as required by the Reserve Bank, penalty may be imposed as prescribed in the Act. This provision applies to all scheduled banks, commercial banks, state co-operative banks, and Regional Rural Banks. With effect from December 29, 2001, commercial banks are required to maintain Cash Reserve Ratio @ 5.5% of their net demand and time liabilities of the second preceding fortnight. It was reduced by 2 percentage points from 7.5% to 5.5% with effect from that date and further to 5% w.e.f. June 1, 2004. Reserve Bank of India pays interest on eligible cash reserves as per the Bank Rate (6.5%).

4.3.3 REGULATIONS OVER COOPERATIVE BANKS

The c3tegory of co-operative banks comprises of the central and state co-operative banks and urban co-operative banks. They are organized co-operative societies, which are registered and governed by State Governments under the respective Cooperative societies Act. Thus, matters relating to registration, administration, recruitments, liquidation and amalgamation are controlled by State Governments. As they perform the functions of a bank, certain provisions of the Banking Regulation Act, 1949 also apply to them. Thus, they are regulated by Reserve Bank of India so far as matters relating to banking are concerned. Reserve Bank's supervision and control over urban cooperative banks is far weaker. They are subject to dual control, which remains a problem. Reserve Bank has, however, prescribed prudential norms relating to income recognition, asset classification and provisioning. Exposure

4.4 SUMMARY

Necessity of regulatory framework for the financial system has been universally felt, primarily to safeguard the interests of a large number of savers/depositors and also to ensure proper and efficient functioning of the institutions that are part and parcel of the financial system. We have, in India, two principal regulatory authorities, namely, the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI). They are entrusted with the responsibilities of development and regulation of the money market and capital market respectively. These regulators derive their power from various legislative enactments and exercise their discretion as well. The financial system thus functions within the regulatory framework. The objective of this and the next Units are to give you a broad account of such Long System and *y* Market regulatory framework. In this Unit,. we shall deal with the regulatory environment for the money market and the participants therein, i.e. the Commercial Banks, the Cooperative Banks, financial institutions and the non-banking finance companies.

Reserve Bank of India, besides being the Central Bank of the country, is the principal regulatory authority in the Indian money market. It derives its powers from two principal enactments, namely the Reserve Bank of India Act, 1934 and the Banking Regulations act, 1949. The Reserve Bank of India Act, 1934, apart from providing for the Constitution management and functions of the RBI, also empowers it to exercise control and regulations, over the Commercial Banks, the non-banking finance companies and the financial institutions. The Banking Regulation Act 1949 contains various provisions' governing the Commercial Banks in India! Many of these provisions are also applicable to the Co- operative Banks. The State Bank of India, its subsidiary banks and the nationalized banks, are also governed by the status under which they have been incorporated. In the subsequent sections of this Unit, we shall deal with the I regulatory framework. First, we shall discuss the main functions performed by the Reserve Bank of India. The Reserve Bank of India was established on

April 1, 1935, under the Reserve Bank of India Act, 1934. As the country's Central Bank, the Reserve
Bank of India performs the following functions:

a) Issuer of Currency Notes: Reserve Bank of India is the sole authority to issue currency notes, except one-rupee note and coins of smaller he nominations. Within the RBI, all functions relating to the issuance of notes are undertaken by the 'Issue Department', which is responsible for issue of notes and the maintenance of eligible assets of equivalent value to back the notes issued.

b) Banker to the Government: RBI acts as banker to the Central Government under the Reserve Bank of India Act, and to the State Governments, under agreements with them. As the banker to the Government, RBI provides services, such as acceptance of deposits, withdrawal of funds, receipts - and payments on behalf of the Government, transfer of funds and the management of public debt.

c) Banker's Bank: The Reserve Bank of India controls the volume of resources at the disposal of the Commercial Banks through the various measures of credit control. This checks the ability of banks to create/squeeze credit to the industry,Trade and commerce.

d) Supervisory Authority: RBI has the powers to supervise and control Commercial Banks. It issues licenses for starting new banks and for opening new branches. It has the power to vary the reserve ratios, to inspect the working of banks, and to approve the appointment of Chairman and Chief Executive Officers of the banks.

e) Exchange Control Authority: The Reserve Bank of India regulates the demands for foreign exchange in terms of the Foreign Exchange Management Act, besides maintaining the external value of Indian rupee.

***f)*Regulation of Credit**: One of the most important functions of the Reserve Bank of India is to regulate the flow of credit to industry. This is achieved by measures such as the Bank rate, Reserve Requirements, Open Market Operations, selective credit controls and moral suasion.

Main provisions of the Banking Regulation Act, 1949, which govern the Commercial Banks, are as follows:

1) Establishment

It is essential for every banking company-Indian or foreign,to acquire a licence from the Reserve Bank of India, before it commences its business in India. Reserve Bank of India issues a licence, if it is satisfied that the company fulfils the
Following conditions:
i) the company is/or will be in a position to pay its present or future depositors in full as their claims accrue,
ii) the affairs of the company are not being, or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors,
iii) the general character of the proposed management of the company will not be prejudicial to the public interest, or the interests, of its depositors,
iv) the company has adequate capital structure and earning prospects,
v) public interest will be served by the grant of a licence to the company to carry on banking business in India,
vi) the grant of licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth, and
vii) any other condition to ensure that the carrying on of the banking business in India by the company will not be prejudicial to the public interest or the interests of the depositors. A foreign bank must, in addition, satisfy the following
conditions:
i) the carrying on of banking business by such company in India will be in the public interest,
ii) the Government or the law of the country in which it is incorporated does not discriminate in any way against banking companies in India, and
iii) the company complies with all the provisions cf the Act applicable to such companies.
2) opening of Branches
3) Business Permitted and Prohibited
4) Subsidiary Company
5) Paid-up Capital
6) Maintenance of Liquid Assets
7) Maintenance of Assets in India
8) Inspection by Reserve Bank

9) Reserve Bank's Power to Issue Directions
10) Management of Banks
11) Control over Advances

The category of co-operative banks comprises of the central and state co-operative banks and urban co-operative banks. They are organized co-operative societies, which are registered and governed by State Governments under the respective Cooperative ocieties Act. Thus, matters relating to registration, administration, recruitments, liquidation and amalgamation are controlled by State Governments. As they perform the functions of a bank, certain provisions of the Banking Regulation Act, 1949 also apply to them. Thus, they are regulated by Reserve Bank of India so far as matters relating to banking are concerned. Reserve Bank's supervision and control over urban cooperative banks is far weaker.

4.5 SUGGESTED READINGS

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2 P.N. Varshney, Banking Law and Practice.
3 Tannan's, Banking law and practice in India.
4 Indian Economy: Dr. Rudra Dutt.
5 Paget's Law of Banking, 8th edn.

4.6 TERMINAL QUESTIONS

1. Discuss the role of RBI in controlling the cooperative Banks.
2. Discuss the role of RBI in controlling commercial Banks.
3. Discuss the functions of RBI .

LL.M. PART – I
PAPER- BANKING LAW

Block 1I - THE CENTRAL BANK
Unit 5 – ORGANIZATIONAL STRUCTURE AND FUNCTIONS OF RBI

STRUCTURE

5.1 INTRODUCTION

The financial system of the any country consist of specialized and non-specialized financial institutions, of organized and unorganized financial markets, which facilitate transfer of funds. According to one classification financial institution are divided into the banking and non-banking one. The banking institutions participate in the economy's payment mechanism that is, they provide transaction services, their deposit, liabilities constitute a major part of the national money supply, and they can as a whole, create deposit or credit, which i.e. money. Banks subject to legal reserve requirements can advance credit by creating claims against themselves. So the banks are creators of credit.

5.2 OBJECTIVES

The study of financial institution in India appropriately begins with a brief discussion of the functions, role, working and policy of the Reserve Bank of India. The RBI as the Central bank of the country is the nerve centre of the Indian monetary system. The purpose of this chapter is to provide understanding about the working of Reserve Bank of India.

5.3.1. RESERVE BANK OF INDIA ACT, 1934

Central Bank occupies a significant status in the context of monetary and banking system of a country. Reserve Bank of India is country's Central Bank. Reserve Bank performs all the functions of central bank, viz. issue of notes, banker to the state, regulation of banking system in the country, exchange control, credit control, etc. It advises the Government on the formulation of monetary policy. It meets the financial needs of agriculture industry, trade, transport, small industry etc in the interest of the economic development of the country. It helps in alleviating poverty, removing regional inequalities and unemployment; in short, it performs both banking and developmental functions.

5.3.2 ORGANIZATION OF THE RESERVE BANK OF INDIA

The affairs of the Reserve Bank of India are managed by the Central Board of Directors. The Central Board of Directors consists of

1. Governor, not more than four Deputy Governors appointed by the Central Government under section 8(1) (a) of the Reserve Bank of India Act, 1934.
2. Four Directors nominated by the Central Government one from each of the four Local Boards in terms of Section 8 (1) (b).
3. Ten Directors nominated by the Central Government under Section 8(1) (c), and
4. One Government official nominated by the Central Government under section 8(1) (d).

The Reserve Bank of India has a Local Board with Headquarters at Bombay, Calcutta, Madras and New Delhi. Local Board consists of five members and these members are appointed by the Central Government to represent territorial and economic interest and the interest of co-operatives and indigenous banks.

The Chairman of the Central Board of Directors of the Reserve Bank is called the Chief Executive Authority of the Bank and he is known as the Governor. The Governor has the powers of general superintendence and all the powers which may be exercised by the bank. In the absence of the Governor, the Deputy Governor nominated by him exercises his powers.

Organizationally, the Reserve Bank Operates through various departments. They are:

1. **Issue Department:** Its main function is to issue and distribute paper currency.
2. **Banking Department**: This department deals with the government transactions, manages public debt and arranges for the transfer of government funds (b) maintains the cash reserves of the scheduled banks, provides accumulation to the banks and functions as a clearing house:

3. **Department of Banking Development**:It aims at expanding banking facilities in unbanked and rural areas.
4. **Department of Banking Operations**: Its function is to supervise, regulate and convert the working of banking institutions in the country. It grants license for opening new banks or the new branches of the existing banks.
5. **Agricultural Credit Department**: It deals with the problems of agricultural credit and provides facilities of rural credit to State Governments and state cooperatives.
6. **Industrial Finance Department**: Its main objective is to provide financial help to small and medium scale industries.
7. **Non Banking Companies Department:** It supervises the activities of nonbanking companies and financial institutions in the country.
8. **Exchange control department**: It conducts the business of sale and purchase of foreign change.
9. **Legal Department**: It provides advice to various departments on legal issues. It also gives legal advice on the implementation of banking laws in the country.
10. **Department of Research and Statistics:** The objective of this department is (a) to conduct research on problems relating to money, credit, finance, production etc (b) to collect important statistics relating to various aspects of the economy; and (c) publish these statistics.
11. **Department of Planning and Reorganisation**: It deals with the formulation of new plans or reorganization of existing policies fro making them effective.
15. **Economic Department:** It is concerned with framing proper banking policies for better implementation of economic policies of the government.
13. **Inspection Department**:. It undertakes the function of inspecting various offices of the commercial banks.

14. **Department of Accounts and Expenditure**:. It keeps proper records of all receipts and expenditures of the Reserve Bank.
15. **RBI Service Board**: It deals with the selection of new employees, for different posts in the Reserve Bank.
16. **Department of Supervision:** A new department i.e. Departments of supervision, was set up on December 23, 1993 for the supervision of commercial banks.

5.3.3 FUNCTIONS OF RESERVE BANK

The reserve bank of India performs various traditional central banking functions as well as undertakes different promotional and developmental measures to meet the dynamic requirements of the country. The broad objectives of Reserve Bank are: (a) regulating the issue of currency in India; (b) keeping the foreign exchange reserves of the country (c) establishing the monetary stability in the country; and (d) developing the financial structure of the country on sound. Main functions of the Reserve Bank are described below:

ISSUE OF PAPER CURRENCY

The Reserve Bank has the monopoly of note issue in the country. It has the sole right to issue currency notes of all denominations except one rupee notes. One rupee notes are issued by the Ministry of Finance of the Government of India. The reserve bank has a separate issue department which is entrusted with the job of issuing currency notes. The reserve bank has adopted minimum reserve system of note issue. Since 1957, it maintains gold and foreign exchange reserves of Rs. 200 crores, of which at least Rs 115 crores should be in gold.

Banker to Government

The reserve bank acts as the banker, agent and adviser to Government of India: (a) It maintains and operates Government deposits (b) It collects and makes payments on behalf of the government (c) It helps the Government to float new loan and manages the public debt. (d) It sells for

the Central Government treasury bills of 91 days duration (e) it makes 'Ways and Means advances to the central and state governments for periods not exceeding three months. (f) It provides development finance to the Government for carrying out five year plans (g) it undertakes foreign exchange transactions on behalf of the central government (h) It acts as the agent of the Government of India in the latter's dealings with the international monetary fund (IMF), the Word Bank and other international finance institutions (i) It advises the Government on all financial matters such as loan operations, investments, agricultural and industrial finance, planning, economic development etc.

Banker's Bank

The Reserve Bank acts as the banker's bank in the following respects: (a) every bank is under the statutory obligation to keep a certain minimum of cash reserves with the Reserve Bank. The purpose of the reserves is to enable the reserve bank to extend financial assistance to the scheduled banks in times of emergency and thus to act as the lender of the last resort. According to the Banker Regulation Act, 1949, all scheduled banks are required to maintain with the Reserve Bank minimum cash reserves of 5% of their demand liabilities and 2% of their time liabilities. The Reserve Bank (Amendment) Act, 1956 empowered the reserve bank to raise the cash reserve ratio to 20% in the case of demand deposits and to 8% in case of time deposits. Due to the difficulty of classifying deposits into demand and time categories, the amendment to banking. Regulation act in November 1972 changed the provision (b) the reserve bank provide financial assistance to the scheduled bank by discounting their eligible bills and through loans and advances against approved securities. (c) Under the Banking Regulation Act, 1949, and its various amendments, the Reserve Bank has been given extensive powers of supervision and control over the banking system. These regulatory powers relate to the licensing of banks and their branch expansion; liquidity of assets of the banks; management and methods of working

of the banks; amalgamation, reconstruction and liquidation of banks; inspection of banks etc.

Custodian of Exchange Reserves

The Reserve Bank is the custodian of India's foreign exchange reserves. It maintains and stabilities the external value of the rupee, administers exchange controls and other restrictions imposed by the government, and manages the foreign exchange reserves. Initially, the stability of exchange rate was maintained through selling and purchasing sterling at fixed rates. But after India became a member of international Monetary Fund (IMF) in 1947, the rupee was declined with sterling and became a multilaterally convertible currency. Therefore the Reserve Bank now sells and buys foreign currencies and not sterling in order to achieve the objective of change, stability. The Reserve Bank fixes the selling and buying rates of foreign currencies. All Indian remittances to India are made through reserve bank.

Controller of Credit

As the central bank of the country, the Reserve Bank undertakes the responsibility of controlling credit in order to ensure internal price stability and promote economic growth. Through the function, the Reserve Bank attempts to achieve price stability in the country. Price stability is essential for economic development. The Reserve Bank makes extensive use of various quantitative and qualitative techniques of effective control and regulates credit in the country.

Ordinary Banking Functions

The Reserve Bank also performs various ordinary banking functions: (a) It accepts deposits from the central government, state governments and even private individuals without interest. (b) It buys sells and rediscounts the bills of exchange and promissory notes of the scheduled banks without restrictions. (c) It grants loans and advances to the central government, state governments, local authorities, scheduled banks and state cooperative banks, repayable within 90 days. (d) It buys and sells securities of the Government of India and foreign securities. (e) It buys from and sells to the scheduled

banks foreign exchange for a minimum amount of Rs. 1 Lakh . (f) It can borrow from any scheduled bank in India or from any foreign bank. (g) It can open an account in the World Bank or in some foreign central bank. (h) It accepts valuables, securities etc for keeping them in safe custody. (i) It buys and sells gold and silver.

Miscellaneous Functions

In addition to the central banking and ordinary banking functions, the Reserve Bank performs the following miscellaneous functions: (a) Banker's Training College has been set up to extend training facilities. In supervisory staff of commercial banks. Arrangements have been made to impart training to the cooperative personnel.(b) The Reserve Bank collects and publishes statistical information relating to banking, finance, credit, currency, agricultural and industrial production etc. It also publishes the results of various studies and review of economic situation of the country in its monthly bulletins and periodicals.

5.3.4 PROMOTIONAL AND DEVELOPMENTAL FUNCTIONS

Besides the traditional central banking functions, the Reserve Bank also performs variety, a professional and developmental functions: (a) by encouraging the commercial banks to expand their branches in the semi-urban and rural areas on the, the Reserve Bank helps to reduce the dependence of the people in these areas on the defective organized sector of indigenous bankers and money lenders, and (b) by establishing the Deposit insurance Corporation, the Reserve Bank helps to develop the banking system of the country, instills confidence of the helps in developing the banking system in its country and terminates appropriate monetary policy to deal with economic situation in the country. The Reserve Bank also provides training facilities to the staff working in the banking and financial institutions. The reserve bank also issues new note in replacement of old and torn currency note which are not being accepted in the market.

Therefore the promotional and developments functions of Reserve Bank can be listed as under:
1. Promotion of Agriculture and Rural Credit.
5. Promotion of commercial banking.
3. Promotion of co-operative banking.
4. Promotion of Export Finance.
5. Promotion of Industrial Finance.
6. Providing Training Facilities to the Staff.
7. Formulation of suitable monetary policy.

5.3.5 PROHIBITORY FUNCTIONS OF RESERVE BANK OF INDIA

The Reserve Bank of India is prohibited by the RBI Act to perform the following functions:

i. Reserve Bank cannot participate in any industry, trade of Business.
ii. Reserve Bank cannot purchase its own shares.
iii. Reserved Bank cannot give loans on the security of shares and immovable property.
iv. Reserve Bank cannot purchase immovable property except for the establishment of its offices.
v. Reserve bank cannot give interest on deposits held by it.

5.3.6 CENTRAL BANKING FUNCTIONS

Reserve Bank is the Central Bank of India. Its Central Banking functions are as under:

1. Issue of Paper Currency
2. Regulation of Credit
3. Bank of banks
4. Banker of the Government
5. Regulation of foreign exchange
6. Other Functions: Beside the above stated specific functions, the Reserve Bank of India performs the following other functions:

i. **Export Assistance**: Reserve Bank gives loans to the Export industries. These loans are given directly as

well as indirectly by refinancing the loans given by other banks.

ii. **Clearing House Functions**: Being Central Bank of the country the Reserve Bank also functions as Clearing House. Inter-banking obligations are conveniently settled through this house.

iii. **Change of Currency**: The bank changes bit notes into small ones and small notes into coins.

iv. **Transfer of Currency**: The bank also facilitates the transfer of currency. It also issues demand hundies on its branches.

v. **Publication of Statistics and Other Information**: Reserve Bank publishes data on various parameters, such as money, credit, finance, agricultural and industries output. Reports on these data are also periodically published.

vi. **Training in Banking**: The Reserve Bank has opened various Training Centers to produce talented bankers: (i)Banking Training college (ii) College of Agricultural Banking Pune (iii) Reserve Bank Staff College, Madras (iv) National Institute of Bank Management (v) Zonal Training Centers.

5.3.7 GENERAL BANKING FUNCTIONS

Reserve Bank is not a commercial bank. Yet, being the Central Bank it performs certain general banking functions as well. These functions are as follows:

1. **To accept deposits**: The bank accepts deposits of the Central Government, State Governments, Port-Trust and private individuals. But no interest paid on these deposits.
2. **To Deal in Bills**: Reserve Bank buys, sells and rediscounts the Bills, Promissory Notes and Hun dies. However, these bills should not be of the

duration exceeding 90 days and should be payable within the country.

3. **Lending of Money**: As a central bank, the Reserve Bank of India gives loans to the Central and State Governments. These loans are of the duration of not more than 90 days. The loans are given against securities, credit notes of the banks and gold or silver.
4. **To deal in agricultural bills**: Reserve Bank also buys, sells and discounts agricultural bills. These bills should be payable in India and should not be of the duration exceeding 15 months.
5. **To deal in Foreign securities**: The bank deals in all such foreign securities which are encashable within 10 years from the date of purchase.
6. **To deal in Costly Metals:** Reserve Bank deals in the sale and purchase of gold, silver as well as the coins of these metals.
7. **To deal with the Banks of others countries**: Being a member of IMF, Reserve Bank establishes business relations with the banks of other member countries. It can open accounts with those banks act as their agent or handle I.M.F. cleanings.

5.3.8 PROHIBITION OF ACCEPTANCE OF DEPOSIT BY INCORPORATED BODIES

The Banking Regulation Act, 1949, the Reserve Bank of India is given a power to issue license to commercial banks to open branches. No commercial bank can commence the business of banking without obtaining license from the Reserve Bank of India. The Reserve Bank of India has been given a power to inspect the commercial banks under section 33 of the Banking Regulation Act. Under this power, the Reserve Bank can itself at any time cause an inspection to be carried out by one or more of its officers of any bank and its books and account and if there are defects, the banks concerned are required to rectify

them and the Reserve Bank of India has power to appoint Additional Directors on the Boards of Directors.

Under the Banking Regulation Act, the Reserve Bank of India has wide powers of overall control over the management of banks. Under this Act, Section 35(b), the approval of the Reserve Bank of India is necessary for the appointment or re-appointment or termination of an opportunity of a Chairman, Managing or Whole Time Director. The Reserve Bank of India has a power to prevent a commercial bank from undertaking certain types of transaction.

Under section 21, the Reserve Bank of India has been given a power to control advances granted by the commercial banks. This power is known as the power of Selective Credit Control. Under this Section, the Reserve Bank of India has been authorized to issue directions to banks as regards the purpose of the advances, the margins to be maintained in respect of the secured advances and it can also prescribe the rate of interest and other terms and conditions on which advances may be made.

Apart form the Selective Control of Credit exercised by the Reserve Bank of India; the Reserve Bank of India controls the volume of credit in a quantitative way so as to influence the total volume of bank credit. The Reserve Bank of India does this through the use of following instruments:

1. The Bank Rate
2. Open Market Operations.
3. Variable ash Reserve Requirements.

5.3.9THE RESERVE BANK OF INDIA AND ITS PROMOTIONALROLE

The Reserve Bank of India, as a central bank of our country, has to perform not merely the negative role of controlling credit and currency in the economy to maintain the internal and external value of the rupee to ensure price stability in the economy, but also to act as a promoter of financial institutions in the country so that its

policies could be effective in promoting economic growth as per the guidelines formulated by the Government. When the Reserve Bank of India was established in 1935, our country was a backward country which lacked a well-developed commercial banking system apart from the absence of a well-developed money market in the country. After 1949 the Reserve Bank of India became very active to take steps to promote and develop financial institutions so that the Reserve Bank of India can pursue appropriate credit and monetary policies for the economic growth and development in an era of planned economic development of the country.

With economic growth assuming new urgency since Independence, the range of the Reserve Bank's functions has steadily widened. The bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the industrial Reconstruction Corporation of India in 1975. These institutions were set up directly or indirectly by the Reserve Bank to promote saving habit and to mobilize savings, and to provide industrial finance a well as agricultural finance. As far back a 1935, the Reserve Bank of India set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. The Bank has developed the co-operative credit movement to encourage saving, to eliminate money-lenders from the villages and to route its short term credit to agriculture. The RBI has set up the Agricultural Refinance and Developmental Corporation to provide longer-term finance to farmers.

Apart from performing the functions already mentioned, the RBI has distinguished itself by rendering

"development" or "promotional" services which have strengthened the country's banking and financial structure. This has helped in the mobilization of savings and directing credit flows to desired channels, there by helping to achieve the objective of economic development with social justice. It has played a major role in deepening and widening the financial system. As a part of its promotional role, the Bank has been pre-empting credit for certain sectors at concessional rates.

In the money market, the RBI has continuously worked for the integration of its unorganized the organized sectors by trying to bring indigenous bankers into the mainstream of the banking by trying to bring indigenous bankers into the mainstream of the banking business. In order to improve the quality of finance provided by the money market, it introduced two Bill Market Schemes, one in 1952, and the other in 1970. With a view to increasing the strength and viability of the banking system, it carried out a programme of amalgamations and mergers of weak banks with the strong ones. When the social Control of banks was introduced in 1968, it was the responsibility of the RBI to administer the country for achieving the desired objectives. After the nationalization of banks, the RBI's responsibility to develop banking system on the desired lines has increased. It has been acting as a leader in sponsoring and implementing the Lead Bank scheme. With the help of a statutory provision for licensing the branch expansion of banks, the RBI has been trying to bring about an appropriate geographical distribution of bank branches. In order to ensure the security of deposits with banks, the RBI took the initiative in 1962 in creating the Deposits Insurance Corporation.

The RBI has rendered yeoman's service in directing an increased flow of credit to the agricultural sector. It has been entrusted with the task of providing agricultural credit in terms of the Reserve Bank of India Act, 1937. The importance with which the RBI takes this function is reflected in the fact that since 1955, it has appointed a separate Deputy Governor in charge of rural credit and has generated basic data and information in this area.

This was first done in 1954 by conducting an All-India Rural Credit Review Committee in 1968, the Committee to Review Arrangements for Institutional Credit for Agriculture and rural Development in 1978, and the Agricultural Credit Review Committee in 1986.

As a part of its efforts to increase the supply of agricultural credit, the Bank has been striving to strengthen the co-operative banking structure through provision of finance, supervision and inspection. It provides the co-operative banks (through the State Co-operative Banks) short term finance at a concessional rate for seasonal agricultural operations and marketing of crops. It subscribes to the debentures of Land Development Banks. It operates the National Agricultural Credit (Long-Term Operations) Fund, and the National Agricultural Credit (Stabilization) Fund, through which it provides long-term and medium term finance to cooperative institutions. It established the Agricultural Refinance Co-operation (now know as NABARD) in July 1963 for providing medium-term and long term finance for agriculture. It also helped in establishing and Agricultural Finance Corporation.

The role of the Bank in diversifying the institutional structure for providing industrial finance has been equally commendable. The UTI for example, was originally an associate institution of the RBI. A number of institutions providing financial and other services such as guarantees, technical consultancy, and so on have come into being on account of the efforts of the RBI.

Through these institutions, the RBI has been providing short-term and long-term funds to the agricultural and rural sectors, to small-scale industries, to medium and large industries, and to the export sector. It has helped to develop guarantee services in respect of loans to agriculture, small industry, exports and sick unites. It also co-ordinates the efforts of banks, financial institutions, and Government agencies to rehabilitate sick units.

The Bank has evolved and put through practice the consortium, co-operative, and participatory approach to lending among banks, and other financial institutions, and

among other financial institutions. By developing the culture of inter-institutional participation, of expertise pooling, and of geographical presence, it has helped to upgrade credit delivery and service capability of the financial system. By issuing appropriate guidelines in 1977 regarding the transfer of loan accounts by the borrowers, it has evolved mutually acceptable system of lending, so that the banking business should grow in a healthy manner and without cut-throat competition.

5.4. SUMMARY

The financial system of the any country consists of specialized and non-specialized financial institutions, of organized and unorganized financial markets, which facilitate transfer of funds. According to one classification financial institution are divided into the banking and non-banking one. The banking institutions participate in the economy's payment mechanism that is, they provide transaction services, their deposit, liabilities constitute a major part of the national money supply, and they can as a whole, create deposit or credit, which i.e. money. Banks subject to legal reserve requirements can advance credit by creating claims against themselves. So the banks are creators of credit.

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The RBI has rendered yeoman's service in directing an increased flow of credit to the agricultural sector. It has been entrusted with the task of providing agricultural credit in terms of the Reserve Bank of India Act, 1937. The importance with which the RBI takes this function is reflected in the fact that since 1955, it has appointed a separate Deputy Governor in charge of rural credit and

has generated basic data and information in this area. This was first done in 1954 by conducting an All-India Rural Credit Review Committee in 1968, the Committee to Review Arrangements for Institutional Credit for Agriculture and rural Development in 1978, and the Agricultural Credit Review Committee in 1986.

As a part of its efforts to increase the supply of agricultural credit, the Bank has been striving to strengthen the co-operative banking structure through

provision of finance, supervision and inspection. It provides the co-operative banks (through the State Co-operative Banks) short term finance at a concessional rate for seasonal agricultural operations and marketing of crops. It subscribes to the debentures of Land Development Banks. It operates the National Agricultural Credit (Long-Term Operations) Fund, and the National Agricultural Credit (Stabilization) Fund, through which it provides long-term and medium term finance to cooperative institutions. It established the Agricultural Refinance Co-operation (now know as NABARD) in July 1963 for providing medium-term and long term finance for agriculture. It also helped in establishing and Agricultural Finance Corporation.

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Through these institutions, the RBI has been providing short-term and long-term funds to the agricultural and rural sectors, to small-scale industries, to medium and large industries, and to the export sector. It has helped to develop guarantee services in respect of loans to agriculture, small industry, exports and sick unites. It also co-ordinates the efforts of banks, financial institutions, and Government agencies to rehabilitate sick units.

5.5. SUGGESTED READING

1.Indian Economy: Dr. Rudra Dutt
5.Tannan's Banking:M L Tannnan

5.6. SELF-ASSESSMENT QUESTIONS

1. Discuss the legal provisions regarding organizational structure of Reserve Bank of India Act, 1934
2. Discuss the functions of RBI Act,1934.
3. Discuss the organization and its working of Reserve Bank of India.
4. Give a detailed account of central banking and promotional functions stipulated under RBI Act, 1934.

L.L.M. PART – I
PAPER- BANKING LAW

Block 1I - THE CENTRAL BANK
Unit 6 – FUNCTIONS OF RBI

STRUCTURE

6.1 INTRODUCTION

As the central bank of the country, the Reserve Bank of India performs both the traditional functions of a central bank and a variety of development and promotional functions. The Reserve Bank of India Act, 1934, confers upon if the powers to act as note-issuing authority, banker's bank and banker to the Government. The currency of our country consists of one-rupee notes and coins (including subsidiary coins) issued by the Government of India and bank notes issued by the Reserve Bank. As required by Section 38 of the Reserve Bank of India Act, 1934, Government puts into circulation one-rupees coins and notes through Reserve Bank only. The Reserve Bank has the sole right to issue bank notes in India. The notes issued by the Reserve Bank and the one-rupee notes and coins issued by the Government are unlimited legal tender. Reserve Bank also bears the responsibility of exchanging notes and coins into those of other denominations as required by the public.

6.2 OBJECTIVES

The object of this unit is to analyses the functions of RBI comprehensively. Further, also to analyses the relationship between reserve bank and commercial banks

6.3.1 RESERVE BANK OF INDIA{ FUNCTIONS}

Reserve Bank as Note-issuing Authority

The currency of our country consists of one-rupee notes and coins (including subsidiary coins) issued by the Government of India and bank notes issued by the Reserve Bank. As required by Section 38 of the Reserve Bank of India Act,1934, Government puts into circulation one-rupees coins and notes through Reserve Bank only. The Reserve Bank has the sole right to issue bank notes in India. The notes issued by the Reserve Bank and the one-rupee notes and coins issued by the Government are unlimited legal tender. Reserve Bank also bears the responsibility of exchanging notes and coins into those of other denominations as required by the public.

As required by the Reserve Bank of India Act, the issue of notes and the general banking business of the Bank are undertaken by two separate departments of the Bank. The Issue Department is responsible for the issue of new notes. It keeps its assets, which forms the backing for the note issue, quite separate from the assets of the Banking Department.

The business of banking is undertaken by the Banking Department which holds stock of currency with itself. Whenever necessary, the Bank Department replenishes the stock of currency from the Issue Department against equivalent transfer of eligible assets. Similarly, if the stock of currency with the Banking Department becomes surplus to its normal requirement, the excess is returned to the issue Department in exchange of equivalent assets.

The assets of the Issue Department against which bank notes are issued consist of the following, namely :

(i) gold coins and bullion.
(ii) foreign securities.
(iii) Rupee coins.
(iv) Government of India rupee securities and
(v) the bills of exchange and promissory notes payable in India, which are eligible for purchase by the Bank.

The aggregate value of gold coins and billion shall not at any time be less than Rs. 115 crores and together with foreign securities (i.e., the total of (i) and (ii) above not less than Rs. 200 crores. The Reserve Bank is also empowered to reduce its holding of foreign securities in the issue Department to any lesser amount, with previous sanction of the Central Government.

Currency Chests

The Reserve Bank has made adequate administrative arrangements for undertaking the function of distribution of currency notes and coins. The Issue Department has opened its offices in 10 leading cites for this purpose. Moreover, currency chests have been maintained all over the country to facilitate the expansion and contraction of currency in the country. Currency chests are receptacles (i.e., boxes or containers) in which stocks of new or re issuable notes are stored along with rupee coins. The currency chests and repositories are run by the Reserve Bank. State Bank, and its

subsidiaries, public sector banks and Government Treasuries and sub-Treasuries. The stock of new notes is thus held in currency chests scattered over the entire country and maintained by the public sector banks in most of the cases. There are several advantages to the bank or the Treasury maintaining a currency chest :

(1) If its payments on a particular day exceed its own balance, it can immediately withdraw funds from the chest. Likewise, if the funds are in surplus it can deposit into it any such surplus funds. Thus the necessity for the physical transfer of cash at frequent intervals from one place to another is avoided. The Treasuries and bank branches work with relatively small balances.

(2) The currency chests facilitate the exchange of rupees coins for notes and supply of notes of lower denomination for those of higher denominations and *vice versa* and also the issue of new notes for old and soiled notes.

(3) The currency chests also serve as the basis for providing remittance facilities to banks and the public.

Reserve Bank as Banker to Government

Reserve Bank of India acts as banker to the Central and State Governments. According to Section 20, it is obligatory for the Bank to transact government business including the management of the public debt of the Union. Section 21 requires the Central Government to entrust the Bank all its money, remittance, exchange and banking transactions in India and in particular deposit free of interest all its cash balances with Bank. In terms of Section 21-A, the Reserve Bank performs similar functions on behalf of the State Governments. The Bank has entered into agreements with the Central and State Governments for carrying on these functions. For conducting ordinary banking business of the Central Government, the Bank is not entitled to any remuneration; it holds cash balances of the Government free of interest. For the management of the public debt, the Bank is entitled to charge a commission. The Bank is also required to maintain currency chests of its Issue Department at places prescribed by the Government and to maintain sufficient notes and coins therein.

According to Section 45, it is obligatory on the part of the Reserve Bank to appoint the State Bank of India as its sole agent at all places where the Bank has no branch or office of its Banking Department but where there is a branch of the State Bank or its subsidiary bank. The State Bank has entered into agency arrangements with all its subsidiary banks. The agency and sub-agency banks transact government's general banking business and receive commission for the same.

The Reserve Bank is also authorized to make to the Central and State Governments ways and means advances which are repayable within 3 months from the date of making the advance. The Bank also acts as adviser to the government on important economic and financial matters.

Reserve Bank as Bankers' Bank

Reserve Bank is the banker to the banks – commercial, co-operative and Regional Rural Banks. This relationship is established once the name of a bank is included in the Second Schedule to the Reserve Bank of India Act, 1934. Such banks, called the scheduled banks, are entitled to avail of the facilities of refinance from the Reserve Bank..

The classification of commercial banks into scheduled and non-scheduled was introduced at the time of inauguration of the Reserve Bank of India in 1935. The object was to establish contact between the Reserve Bank and the commercial banks with sound financial position. The Act, therefore, provided certain eligibility conditions for the inclusion of a bank in the list of scheduled banks. Since 1966 the State co-operative Banks have also been made eligible for inclusion in the Second Schedule to the Act. The Regional Rural Banks, established since 1975, also enjoy the status of schedule banks. The public sector banks (including the State Bank group) have been notified as scheduled banks by the Central Government. The category of scheduled banks thus includes (i), commercial banks— Indian and foreign, (ii) State Co-operative Banks and (iii) Regional Rural Banks.

A 'Scheduled Bank' means a bank included in the Second Schedule to the Reserve Bank of India Act, 1934. The Reserve Bank is empowered o include in the Second Schedule the name of a bank which carries on the business of banking in

India, and which satisfies the, following conditions laid down in Section 42 (6):

(i) It must have a paid-up 'capital and reserves of an aggregate value of not less than Rs.5 lakhs;

(ii) It must satisfy the Reserve Bank that its affairs are not being conducted in a manner detrimental to the interest of its depositors, and

(iii) It must be—

  (a) a State co-operative bank, or

  (b) a company as defined in the Companies Act, 1956, or

  (c) an institution notified by the Central Government in this behalf, or

  (d) a corporation or a company incorporated by or under any law in force in anyplace outside India.

Before including the name of a bank in the Second Schedule, the Reserve Bank must be satisfied as to both of the following conditions:

(i) Minimum Value of paid-up Capital and Reserves. The Act requires that the bank must have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakhs. For this purpose the expression 'value' means the real or exchangeable value and not the nominal value as shown in the books of the bank. The real value of paid-up capital and reserves is estimated by finding out the worth of the shareholders capital (including free reserves). This is done by estimating or assessing the realizable value of the assets of the bank and by deducting there from the amount of outside liabilities. Each asset is examined or scrutinized to find out its present realizable value. If the total realizable value of all the assets of a bank, minus its outside liabilities, is equal to or more than rupees five lakhs the bank satisfies this condition for inclusion in the Second Schedule. If any dispute arises in computing the aggregate value of the paid-up capital and reserves of a bank, the determination of the value by the Reserve Bank shall be final.

(ii) *Depositors Interests.* The Reserve Bank must also be satisfied that the affairs of the bank are not being conducted in a manner detrimental to the interests of depositors. This

necessitates a thorough and detailed examination of all aspects of a bank's working which affect its soundness and solvency and ultimately the interest of the depositors. The Reserve Bank forms its opinion in this regard, by considering various aspects of a bank's affairs, e.g., the quality of its management, the position of liquid resources in relation to demand liabilities, safety of investments and advances, financial soundness etc.

The Reserve Bank is also authorized to exclude the name of any bank from the Second Schedule1iri case of any of the above-mentioned conditions is not continued to be fulfilled or it goes into liquidation or otherwise ceases 1o carry on banking business. The Reserve Bank may, however, give an opportunity to such scheduled bank to increase the value of paid-up capital or to remove the defect in the conduct of its affairs.

The status of Scheduled Bank confers certain privileges upon the banks, e.g., they become eligible for availing of the facilities of accommodation from the Reserve Bank. A scheduled bank, on the other hand, has to fulfill the obligation to maintain statutory reserves with the Reserve Bank.

6.3.2 RELATIONSHIP BETWEEN RESERVE BANK AND COMMERCIAL BANKS

By virtue of the powers conferred upon it by the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949, the relationship between the Reserve Bank of India and the scheduled commercial banks is very close and of varied nature:

As Supervisory and Controlling Authority over Banks

The Banking Regulation Act, 1949, confers wide powers upon the Reserve Bank to supervise and control the affairs of banking companies as follows:

1. Licensing of Banking Companies. Section 22 requires every company to hold a license from the Reserve Bank to carry on the business of banking in India. The Reserve Bank is empowered to conduct an inspection of the books of the banking company for this purpose, and to issue a licence if it is satisfied, that the following conditions are fulfilled:

(i) the company is or will be in a position to pay its present or future depositors in full as their claims accrue;
(ii) That the affairs of the company are not being or are not likely to be conducted in a manner detrimental to the interests of its present or future depositors;
(iii) That the general character of the proposed management of the company will not be prejudicial to the public interest or the interests of its depositors;
(iv) That the company has adequate capital structure and earning prospects;
(v) That the public interest will be served by the grant of a licence to the company to carry on banking business in India;
(vi) That the grant of licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary tabç1tand economic growth.

Thus a licence can be ranted if the company has satisfactory financial position. In case of a foreign bank, the Reserve Bank must also be satisfied about the fact that (a) the carrying on of banking business by such bank in India ill be in the public interest, (1) that the Government or law of the country of its origin does not discriminate against banking companies registered in India, and (c) that 'the company complies with all the provisions of the Act applicable to such companies. The Reserve Bank is also empowered to cancel the license granted to a banking company.

Permission for Opening Branches. Section. 23 requires every banking company to take Reserve Bank's prior permission for opening a new place of business in India or to change the location of an existing place of business in India or outside. The Reserve Bank takes into account the financial position, the history, the general character of management and adequacy of its capital structure and earning prospects and the fact whether public interest will be served or not, before granting permission.

Power to Inspect Banking Companies. Under Section 35, the Reserve Bank may, either at its own initiative or at the instance of the Central Government, inspect any banking company and its books and accounts. If on the basis of the inspection report submitted by the Reserve Bank, the Central Government is of

the opinion that the affairs of the banking company are being conducted to the detriment of interests of its depositors, it may by order in writing prohibit the banking company from receiving fresh deposits or direct the Reserve Bank to apply for the winding up of the banking company.

Power to Issue Directions. Section 35-A confers powers on the Reserve Bank of issue directions to a banking company or companies in the public interest or in the interest of banking policy or to prevent the affairs of the banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial cal to the interest's of the banking company or to secure proper management of the banking company. Section 36 confers powers on the Reserve Bank to caution or prohibit banking companies against entering into any particular transaction and generally give advice to any banking company. It may pass orders, requiring the banks to carry out the specified instructions.

Control over Top Management. The Reserve Bank of India has wide powers of overall control over the top management of banks. Reserve Bank's prior approval is necessary for appointment or re-appointment or termination of appointment of a chairman, managing director, manager 'or, chief executive officer.

Section 36-AA empowers the bank to remove from office any chairman, director, chief executive officer or other officer or employee of a bank, if it considers it necessary or desirable. The Bank may appoint any other suitable person in place of the person removed by it. The Reserve Bank can appoint one or more additional directors on the Board of Directors of banks, if it considers it necessary in the interest of banking policy or in the public interest or in the interests of the bank or its depositors.

As Controller of Credit

Reserve Bank of India exercises control over the credit granted by the commercial banks in the following ways:

By changing the statutory requirement regarding maintenance of liquid assets. Section 24 of the Banking Regulation Act, 1949, requires every banking company to maintain in India in cash, gold or unencumbered approved securities an the close of business on any day, be less than 25 per cent of its net

demand and time liabilities in India. This is called the Statutory Liquidity Ratio (SLR). Reserve Bank is empowered to step up this ratio up to 40 per cent.

By raising the statutory liquidity ratio, the Reserve Bank compels the banks to keep a larger proportion of their deposit liabilities in liquid assets, particularly in government and other approved securities and thus the loan able resources of the banks are reduced correspondingly. At present, all scheduled commercial banks are required to maintain SLR © 31.8% on deposit liabilities outstanding as on September 30, 1994 and © 25% on incremental deposits after that date.

By issuing directives under Section 21 of the Banking Regulation Act, 949. The Reserve Bank is empowered to issue directives to the banking companies to determine the policy in relation to advances to be followed by them. These directives may relate to (1) the purpose for which advances may or may not be made, (2) the margins to be maintained in respect of secured advances, (3) the maximum amount of advance to any borrower (4) the maximum amount up to which guarantees may be given by the banking company on 'behalf of any firm, company, etc., and (5) the rate of Interest and other terms and conditions for granting advances.

The Reserve Bank has made fairly wide use of the powers vested in it. The directives issued are intended to check speculation and rising prices.

As Banker to the Banks

As banker to the banks, the Reserve Bank acts as the lender of last resort and grants accommodation to the scheduled banks in the following forms:

(i) Re-discounting or purchase of eligible bills, and
(ii) Loans and advances against certain securities.

Sections 17 (2) and 17 (3) authorize the Reserve Bank to grant accommodation by way of purchase or re-discount of the various kinds of bills specified therein. Section 17 (4) enables the Reserve Bank to grant loans and advances against the specified securities.

Re-discounting of bills. Section 17 (2) lays down 'that the following categories of bills are eligible for re-discounting with the Reserve bank:

(i) *Commercial Bill.* A commercial bill arises out of bonafide commercial or trade transaction. It should be drawn on and payable. In India and mature within 90 days from the date of purchase, or discount. The period of maturity may be 180 days if the bill arises out of transaction relating to export of goods from India. It is essential that the bill bears two or more good signatures one of which should be that of a scheduled bank or a State Co-operative Bank.

(ii) *Bill for Financing Agricultural Operations.* Such a bill should be drawn or issued for the purpose of financing seasonal agricultural 'operations or the marketing of crops and mature within 15 months from the date of purchase or re-discount. They should be drawn and payable in India and bear two or more good signatures including that of a scheduled bank or a State Co-operative Bank.

(iii) Bill for Financing Cottage and small – scale Industries. These bills are drawn or issued for the purpose of financing the production or marketing activities of cottage and small-scale industries approved by the Reserve Bank and mature within 12 months from the date of discount. They should be drawn and payable in India, bear two or more good signatures including that of a State Co-operative Bank or a State Financial Corporation and a guarantee from the State Government regarding the payment of the principal and interest on the bill.

(iv) Bill for Holding or Trading in Government Securities. Such a bill should bear the signature of a scheduled bank and mature within 90 days from the date of purchase or re-discount and be drawn and payable in India.

(v) A Foreign Bill. Such a bill must arise out of any bonafide transaction relating to the export of goods from India and mature within 180 days. It must be drawn in or on any country outside India which is a member of International Monetary Fund. The period of maturity will be 90 days if the bill is not related to export of goods from India.

It should be noted that the bills eligible for re-discounting must have a fixed maturity. The accommodation granted by the Reserve Bank had been in the form of loans and advances

against securities including the above-mentioned eligible bills. To encourage the practice of re-discounting of bills, the Reserve Bank introduced the Bills Re-discounting Scheme with effect from November 1, 1971.

After the enactment of Reserve Bank of India (Amendment) Act, 1974, the bills of exchange falling in categories (i), (ii) and (iii) above, and bearing the signature of any financial institution, which Is predominantly engaged in the acceptance of or discounting of bills of exchange and promissory notes and is approved by the Reserve Bank in this behalf are also eligible for the purpose of re-discounting.

(b) Loans and Advances. Section 17(4) enables the Reserve Bank to grant loans and advances to the scheduled banks, repay on demand or on the expiry of fixed periods not exceeding 90 days against the security of the following:

(i) Stocks, funds and securities (other than immovable property) in which a trustee is authorized to invest trust money.

(ii) Gold or silver or documents of title to the same.

(iii) Such bills of exchange and promissory notes as are eligible for purchase or re-discount by the Reserve Bank (stated above) or those guaranteed by the State Government as to the repayment of the principal and interest.

(iv) Promissory notes of any scheduled bank or State Co-operative Bank supported by documents of title to goods (such documents having been transferred, assigned or pledged to any other bank as security for a loan or advance made for bonafide commercial or trade transactions or for the purpose of financing agricultural operations or the marketing of crops).Section 17 (3-A) was Inserted in 1962 to enable the bank to secure accommodation from the Reserve Bank of India on easier terms in connection with export finance provided by them. The Reserve Bank may make loans and advances to any scheduled bank against the promissory note of the latter repayable on demand or on the expiry of a fixed period not exceeding 180 days, provided the borrowing bank furnishes a declaration in writing to the effect that—

(i) It holds bills of exchange arising out of any transaction relating to export of goods from India, which are drawn in India and on any place in a country outside India which is a member of the IMF or notified by the Reserve Bank and which mature within 180 days from the date of loan and advance. The borrowing bank shall hold the bills o a value equal to the amount of such loan from the Reserve Bank and shall continue to hold such bills, till the loan is repaid, up to the value of the amount of the outstanding loan; or

(ii) It has granted a pre-shipment loan or advance to an exporter or any other person in India to enable him to export goods from India. The amount of such loan should not be less than the amount borrowed by the bank from the Reserve Bank.

The Reserve Bank of India introduced 'Export Bills Credit Scheme' in March, 1963 to give effect to this provision The main difference between this scheme and the discounting of foreign bills is that in case of the former the banks are not required to lodge the foreign bills with the Reserve Bank (as is required under re-discounting). They have just to give a declaration to the effect that they hold such bills of the value equal to the amount of the loan.

A new sub-section 3-B was inserted by the Reserve Bank of India (Amendment) Act, 1974. Under this sub-section, the Reserve Bank of India may make to any scheduled bank or State Co-operative Bank, loan and advances repayable on demand or on the expiry of fixed periods not exceeding 180 days against the promissory notes of such bank. The borrowing bank is required to furnish a declaration in writing to the effect that it has made loans and advances for (i) bonafide commercial or trade transactions, or (ii) financing agricultural "operations or the marketing of crops or for other agricultural purposes as set out in the declaration. The declaration shall also Include any other particulars as required by the Reserve Bank.

Emergency Advances

The commercial banks and co-operative banks may be granted emergency advances by the Reserve Bank under Section 18 on such special occasions when the Reserve Bank is satisfied

that the grant of such loans is necessary for the purpose of regulating credit in the interests of Indian trade commerce, industry and agriculture. Such emergency advances may be given notwithstanding any limitation contained in Section 17.
Section, as amended in 1978, authorizes the Reserve Bank of India—

(1) to purchase, sell or discount any bill of exchange or promissory note, which may not be eligible for purchase or discount by the Reserve Bank of India under Section 17, or
(2) to make loans or advances to (a) a State Co-operative Bank or (b) on the recommendation of a State Co-operative Bank to a Co-operative Society registered within the area in which the State Co-operative Bank operates or (c) any other person, repayable on demand or on the expiry of fixed periods, not exceeding 90 days on such terms and conditions as the Bank may consider to be sufficient.

6.4 SUMMARY

As the central bank of the country, the Reserve Bank of India performs both the traditional functions of a central bank and a variety of development and promotional functions. The Reserve Bank of India Act, 1934, confers upon if the powers to act as note-issuing authority, banker's bank and banker to the Government. The currency of our country consists of one-rupee notes and coins (including subsidiary coins) issued by the Government of India and bank notes issued by the Reserve Bank. As required by Section 38 of the Reserve Bank of India Act, Government puts into circulation one-rupees coins and notes through Reserve Bank only. The Reserve Bank has the sole right to issue bank notes in India. The notes issued by the Reserve Bank and the one-rupee notes and coins issued by the Government are unlimited legal tender. Reserve Bank also bears the responsibility of exchanging notes and coins into those of other denominations as required by the public.
The currency of our country consists of one-rupee notes and coins (including subsidiary coins) issued by the Government of India and bank notes issued by the Reserve Bank. As required

by Section 38 of the Reserve Bank of India Act, Government puts into circulation one-rupee coins and notes through Reserve Bank only. The Reserve Bank has the sole right to issue bank notes in India. The notes issued by the Reserve Bank and the one-rupee notes and coins issued by the Government are unlimited legal tender. Reserve Bank also bears the responsibility of exchanging notes and coins into those of other denominations as required by the public.

As required by the Reserve Bank of India Act, the issue of notes and the general banking business of the Bank are undertaken by two separate departments of the Bank. The Issue Department is responsible for the issue of new notes. It keeps its assets, which forms the backing for the note issue, quite separate from the assets of the Banking Department.

The business of banking is undertaken by the Banking Department which holds stock of currency with itself. Whenever necessary, the Bank Department replenishes the stock of currency from the Issue Department against equivalent transfer of eligible assets. Similarly, if the stock of currency with the Banking Department becomes surplus to its normal requirement, the excess is returned to the issue Department in exchange of equivalent assets.

The assets of the issue Department against which bank notes are issued consist of the following, namely:

(vi) gold coins and bullion.
(vii) foreign securities.
(viii) rupee coins.
(ix) Government of India rupee securities and
(x) the bills of exchange and promissory notes payable in India, which are eligible for purchase by the Bank.

The aggregate value of gold coins and billion shall not at any time be less than Rs. 115 crores and together with foreign securities (i.e., the total of (i) and (ii) above not less than Rs. 200 crores. The Reserve Bank is also empowered to reduce its holding of foreign securities in the issue Department to any lesser amount, with previous sanction of the Central Government.

The Reserve Bank has made adequate administrative arrangements for undertaking the function of distribution of currency notes and coins. The Issue Department has opened

its offices in 10 leading cites for this purpose. Moreover, currency chests have been maintained all over the country to facilitate the expansion and contraction of currency in the country. Currency chests are receptacles (i.e., boxes or containers) in which stocks of new or re issuable notes are stored along with rupee coins. The currency chests and repositories are run by the Reserve Bank. State Bank, and its subsidiaries, public sector banks and Government Treasuries and sub-Treasuries. The stock of new notes is thus held in currency chests scattered over the entire country and maintained by the public sector banks in most of the cases. There are several advantages to the bank or the Treasury maintaining a currency chest

Reserve Bank of India acts as banker to the Central and State Governments According to Section 20, it is obligatory for the Bank to transact government business including the management of the public debt of the Union. Section 21 requires the Central Government to entrust the Bank all its money, remittance, exchange and banking transactions in India and in particular deposit free of interest all its cash balances with Bank. In terms of Section 21-A, the Reserve Bank performs similar functions on behalf of the State Governments. The Bank has entered into agreements with the Central and State Governments for carrying on these functions. For conducting ordinary banking business of the Central Government, the Bank is not entitled to any remuneration; it holds cash balances of the Government free of interest. For the management of the public debt, the Bank is entitled to charge a commission. The Bank is also required to maintain currency chests of its Issue Department at places prescribed by the Government and to maintain sufficient notes and coins therein.

According to Section 45, it is obligatory on the part of the Reserve Bank to appoint the State Bank of India as its sole agent at all places where the Bank has no branch or office of its Banking Department but where there is a branch of the State Bank or its subsidiary bank. The State Bank has entered into agency arrangements with all its subsidiary banks. The agency and sub-agency banks transact government's general banking business and receive commission for the same.

The Reserve Bank of India introduced 'Export Bills Credit Scheme' in March, 1963 to give effect to this provision The main difference between this scheme and the discounting of foreign bills is that in case of the former the banks are not required to lodge the foreign bills with the Reserve Bank (as is required under re-discounting). They have just to give a declaration to the effect that they hold such bills of the value equal to the amount of the loan.

A new sub-section 3-B was inserted by the Reserve Bank of India (Amendment) Act, 1974. Under this sub-section, the Reserve Bank of India may make to any scheduled bank or State Co-operative Bank, loan and advances repayable on demand or on the expiry of fixed periods not exceeding 180 days against the promissory notes of such bank. The borrowing bank is required to furnish a declaration in writing to the effect that it has made loans and advances for (i) bonafide commercial or trade transactions, or (ii) financing agricultural "operations or the marketing of crops or for other agricultural purposes as set out in the declaration. The declaration shall also include any other particulars as required by the Reserve Bank.

The commercial banks and co-operative banks may be granted emergency advances by the Reserve Bank under Section 18 on such special occasions when the Reserve Bank is satisfied that the grant of such loans is necessary for the purpose of regulating credit in the interests of Indian trade commerce, industry and agriculture. Such emergency advances may be given notwithstanding any limitation contained in Section 17.

6.5 SUGGESTED READINGS

P.N. Varshney, Banking Law and Practice
Tannan's, Banking law and practice in India

6.6. SELF-ASSESSMENT QUESTIONS

1. Discuss in detail the functions of Reserve Bank of India
6. Discuss the relationship between Reserve Bank and Commercial Banks

L.L.M. 05 PART – I
PAPER- BANKING LAW

Block II - THE CENTRAL BANK
Unit 7 – CONTROL OF RBI OVER NON-BANKING COMPANIES

STRUCTURE

7.1 INTRODUCTION

Necessity of regulatory framework for the financial system has been universally felt, primarily to safeguard the interests of a large number of savers/depositors and also to ensure proper and efficient functioning of the institutions that are part and parcel of the financial system. Reserve Bank of India, besides being the Central Bank of the country, is the principal regulatory authority in the Indian money market. It derives its powers from two principal enactments, namely the Reserve Bank of India Act, 1934 and the Banking Regulations act, 1949. The Reserve Bank of India Act, 1934, apart from providing for the Constitution management and functions of the RBI, also empowers it to exercise control and regulations, over the Commercial Banks, the non-banking finance companies and the financial institutions. The Banking Regulation Act 1949 contains various provisions' governing the Commercial Banks in India. Many of these provisions are also applicable to the Co- operative Banks. The State Bank of India, its subsidiary banks and the nationalized banks ,are also governed by the status under which they have been incorporated. In the subsequent sections of this Unit, we shall deal with the regulatory frame work. First, we shall discuss the main functions performed by the Reserve Bank of India. The Reserve Bank of India was established on April 1, 1935 ,under the Reserve Bank of India Act, 1934

We have, in India, two principal regulatory authorities, namely, the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI). They are entrusted with the responsibilities of development and regulation of the money market and capital market respectively. These regulators derive their power from various legislative enactments and exercise their discretion as well. The financial system thus functions within the regulatory framework. The objective of this and the next Units are to give a broad account of such Long System and Market regulatory framework. In this Unit, we shall deal with the regulatory environment for the money market and the participants therein, i.e. the Commercial Banks, the Cooperative Banks, financial institutions and the non-banking finance companies.

Reserve Bank of India, besides being the Central Bank of the country, is the principal regulatory authority in the Indian money market. It derives its powers from two principal enactments, namely the Reserve Bank of India Act, 1934 and the Banking Regulations act, 1949. The Reserve Bank of India Act, 1934, apart from providing for the Constitution management and functions of the RBI, also empowers it to exercise control and regulations, over the Commercial Banks, the non-banking finance companies and the financial institutions. The Banking Regulation Act 1949 contains various provisions' governing the Commercial Banks in India. Many of these provisions are also applicable to the Co- operative Banks. The State Bank of India, its subsidiary banks and the nationalised banks are also governed by the status under which they have been incorporated.

7.2 OBJECTIVES

In this unit an attempt is made to discuss the regulations of central bank, over NBFC companies and working of regulations. Further, in the light of above, an attempt is also made to analyze all relevant aspects of NBFCs Acceptance of Public Deposits (Reserve Bank) and Prudential Norms for NBFCs

7.3.1 REGULATIONS OVER NON-BANKING FINANCE COMPANIES

The Non-Banking Finance Companies perform very important financial intermediation function in India. They supplement the role of the banking institutions, as they cater to the needs of those borrowers who remain beyond the purview of the banking institutions and mobilize the savings from the depositors. Iiire purchase finance and leasing companies, loans and investment companies and housing finance companies are the important categories of such Non-Banking Finance Companies (NBFCs).In view of the significant role played by NRFCs, regulatory framework has been devised, particularly to safeguard the interests of the depositors. Chapter 111 B of the Reserve Bank of India Act, 1934 provides for such regulatory

framework over NBFCs. Significant amendments to this Chapter were made in January, 1997, vesting more powers in the Reserve Bank of India to regulate the activities of such companies. 1) Reserve Bank of India Act, 1834

The powers vested in the Reserve Bank of India Act under Chapter I11 B of Reserve Bank of India Act, 1934 are as follows:

i) To regulate or prohibit issue of prospectus

In the public interest, the Reserve Bank of India may regulate or prohibit the issue by any non-banking company of any prospectus or advertisement soliciting deposits of money from the public. The Bank may also give directions to these companies as to the particulars to be included in such advertisements.

ii) To collect information as to deposits and to give direction

The Reserve Bank of India is empowered to direct every non-banking institution to furnish to it information or particulars relating to the deposits received by it. The Bank may also issue directions in the public interest, to such institutions generally, or to any institution in particular, or group of such institutions in particular, on any of the matters connected with the receipt of deposits. If any such institution fails to comply with any direction, the Bank may prohibit the acceptance of deposits by such institutions.

iii) To conduct inspection

The Reserve Bank of India may, at any time, cause an inspection to be made of any non-banking institution to verify the correctness/completeness of the particulars furnished to the Bank or to obtain any such particulars, if not submitted. iv) The Reserve Bank of India (Amendment) Act, 1997, has conferred explicit powers on the Reserve Bank of India as follows:

(a) A new NBFC cannot operate unless it is registered with Reserve Bank of India and has minimum owned funds of Rs. 25 lakhs. Reserve Bank has been vested with the power of enhancing the minimum Net Owned Funds (NOF) of NBFCs to Rs. 2 crore in case of companies which are incorporated on or after April 20, 1999, and which seek registration with Reserve Bank of India. (b) Every NBFC is required to create a Reserve

Fund and transfer not less than 20% of its net profit each year to such fund before declaring any dividend. (*c)* Reserve Bank of India is given the power to prescribe the minimum level of liquid assets, as a percentage of the deposits, to be maintained in unencumbered approved securities (i.e. government securities/ guaranteed bonds).
Money Market (d) The Company Law Board has been empowered to direct NBFCs to repay deposits that have matured, if it finds that the company is unable or unwilling to repay the depositors. (e) Powers have been conferred upon the Reserve Bank of India to: give directions to the NBPCs regarding prudential norms, give directions to the NBFCs and their auditors on matters relating to balance sheets and cause special audit as well as to impose penalty on erring auditors, prohibit NBFCs from accepting deposits for violation of the provisions of the RBI Act and to direct NBFCs not to alienate their assets, file winding up petition against erring NBFCs, impose penalty directly on the erring NBFCs.

7.3.2NBFCs Acceptance of Public Deposits (Reserve Bank)

In exercise of the powers vested in it under Chapter 111 of the Reserve Bank of India, issued these directions to NBFCs regarding acceptance of deposits from the public. These directions were substantially revised in January, 1998, to include prudential norms to be followed by NBFCs. The salient features of RBI Directions, as further revised in December, 1998 are as follows:
i) For regulatory purposes, NBFCs have been classified into three categories:
a) those accepting public deposits,
b) those not accepting public deposits, but engaged in financial business ,
c) core investment companies, with 90% of their total assets in investments in the securities of their group/holding/ subsidiary companies. The thrust of RBI regulation is on companies accepting public deposits.
ii) Public deposits have been defined to include field/recurring deposits received from public, deposits received from relatives and friends, deposits from shareholders by a public limited

company and money raised by issue of unsecured debentures and bonds to shareholders and the public. Public Deposits exclude money raised by way of issue of secured debentures and bonds, borrowings from banks and financial institutions (including by way of unsecured debentures), deposits from directors, inter-corporate deposits, deposits from foreign citizens, deposits received by private limited companies from their shareholders, t security deposits from employees, advance receipt of lease and hire purchase installments.
iii) NBFCs with net owned funds (NOF) of less than Rs. 25 lakh (with or without credit rating) are not allowed to accept public deposits.
iv) Ceilings on public deposits for NBFCs, with NOF of Rs. 25 lakh and above, have been prescribed as follows. These ceiling limits were enforced in December, 1998. Prior to that, these limits were based on the credit rating (effective January, 1998).

7.3.3Equipment Leasing and Hire Purchase Finance Companies

a) For unrated and under-rated (i.e. rating below the minimum investment grade) NBFCs-1.5 times of their NOF or Rs. 10 crore, whichever is less (provided their CRAR is 15%, or above, as per their last audited balance sheet).
b) For NBFCs with minimum investment grade credit rating-4 times of their NOF (provided they have CRAR of not less than 10% as on 31.3.1998 and not less than 12% as on 3 1.3.1999). They are required to increase CRAR to 15% as early as possible.

7.3.4 B) Loan and Investment Companies

a) unrated and under-rated-not entitled to accept public deposits (irrespective of their NOF and CRAR).b) with minimum Investment Grade Credit Rating-1.5 times of NOF (provided they have CRAR of 15% or above). Further, it has been stipulated that loan and investment companies which do not have minimum CRAR of 15% as on date, but other-wise comply with all the prudential norms and a) have credit rating of AAA may accept or renew public deposits upto the level outstanding as on December 18, 1998 or 1.5 times of the NOF

whichever is more, subject to the condition that they should attain CRAR or 15% by 31"' March, 2000 and bring down the excess deposits, if any, by December 3 1, 2000, and b) have credit rating of AA/A may accept or renew public deposits as per the existing provisions of Directions (i.e. 0.5 or 1 time of their NOF), but they should attain the minimum CRAR of 15% on or before 3 EMt arch, 2000 as per their audited balance sheet, failing which they should regularize their position by repayment or otherwise by December 3 1, 200 1. And The above benefit will not be available to those companies whose CRAR is presently 15% and above but slips down below the minimum level of 15% subsequently. v) The maximum permissible interest rate on public deposits has been fixed at 16% per annum. NBFCs can pay uniform maximum brokerage of 2% on deposits for 1 year to 5 years. Brokers may also be reimbursed other expenses not! Exceeding 0.5% of the collected deposits. iIvi) Only those NBFCs, which are accepting public deposits, I are required to submit to Reserve Bank annual statutory returns and financial statements. Other NBFCs are exempted from this requirement.

7.3.5 Prudential Norms for NBFCs

Reserve Bank of India issued guidelines prescribing the prudential norms for NBFCs in June, 1994. Companies accepting public deposits have to comply with all the guidelines,? While leasing, hire purchase finance, loan and investment companies, not accepting public deposits, are required to comply with prudential norms other norms on capital adequacy and credit investment concentration. Similarly, investment companies holding not less than 90% of their assets being securities of their /holding/subsidiary companies and not accepting public deposits are exempted from prudential norms, These guidelines are as follows:

i) Income Recognition

NBFCs are required not to take into books income due but not received within a period of six months, till it is actually received.

ii) Classification of Assets

NBlFCs are required to classify their assets as non-performing assets if payment of principal/installment is due but not received within six months. For leasing, hire purchase finance companies such assets are to be treated as NPAs, if lease rentals and hire purchase installments remain past due for 12 months. Guidelines regarding classification of assets into 4 categories and provisioning issued to commercial banks, are applicable to NBFCs also.

iii) Capital Adequacy Norm

In January 1998, the capital adequacy requirement for NBFCs with net owned funds of Rs. 25 lakhs and above and having public deposits had been raised from *8%* to 10% (effective 3 1.3.1998), and further to 12% (effective 31.3.1999).The composition of capital and risk weights attached to assets and conversion of off Balance Sheet items are the as applicable to banks.

iv) Credit/ Investment Concentration Norms

Registered finance companies are required not to lend more than 15% of their net owned funds to a single borrower and not more than 25% of their owned fund; to a group of borrowers. These limits are also applicable to investment in a single company or a single group of companies. Composite limits of credit to and investment in a single company or a single group of companies have been prescribed at 25% and 40% respectively of its owned funds. NBFCs are not permitted to lend on the security of their own shares. The ceiling on investment in unquoted shares of companies other than their group/subsidiary companies has been fixed at 10% of their owned funds for equipment leasing and hire purchase finance companies and 20% of the owned funds for loan and investment companies. NBFCs are advised not to invest more than 10% of their owned funds in land and building except for their own use. NBFCs are required to dispose off excess of the assets over the indicated ceilings within three years.

v) Liquid Assets

NBFCs are required to maintain certain percentage of their deposits in liquid assets to ensure their liquidity and to safeguard the interests of the depositors. With effect from January 2, 1998, the ratio of liquid assets is uniform for all NBFCs accepting public deposits. It has been prescribed at

17.5% with effect from April 1, 1998 and at 15% with effect from April 1, 1999. The liquid assets are to be maintained with relation to public deposits only. NBFCs are required to keep Government securities and Government guaranteed bonds in the custody of a scheduled bank at the place of its head office. These securities are permitted to be withdrawn for repayment to depositors or for replacing them by other securities or in the case of reduction of deposits. The above account shows that the Resewe Bank of India has instituted a comprehensive regulatory framework for NBFCs. Out .of 8802 applications of NBFCs which were eligible for registration on the basis of Minimum Net Owned Funds of Rs. 25 lakh, registration has been granted to 7555 NBFCs. Out of them only 584 NBFCs have been permitted to accept public deposits. Applications of 1030 companies have been rejected. 28676 companies with NOF below Rs. 25 lakh have been given time upto January 8, 2000 to achieve the minimum NOF. Thus, an era of consolidating and strengthening the Non-Banking Financial Companies has commenced and better results may be expected in future.

7.4 SUMMARY

Necessity of regulatory framework for the financial system has been universally felt, primarily to safeguard the interests of a large number of savers/depositors and also to ensure proper and efficient functioning of the institutions that are part and parcel of the financial system. Reserve Bank of India, besides being the Central Bank of the country, is the principal regulatory authority in the Indian money market. It derives its powers from two principal enactments, namely the Reserve Bank of India Act, 1934 and the Banking Regulations act, 1949. The Reserve Bank of India Act, 1934, apart from providing for the Constitution management and functions of the RBI, also empowers it to exercise control and regulations, over the Commercial Banks, the non-banking finance companies and the financial institutions. The Banking Regulation Act 1949 contains various provisions' governing the Commercial Banks in India. Many of these provisions are also applicable to the Co- operative Banks. The State Bank of India, its subsidiary

banks and the nationalised banks ,are also governed by the status under which they have been incorporated. In the subsequent sections of this Unit, we shall deal with the regulatory frame work. First, we shall discuss the main functions performed by the Reserve Bank of India. The Reserve Bank of India was established on April 1, 1935 ,under the Reserve Bank of India Act, 1934

We have, in India, two principal regulatory authorities, namely, the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI). They are entrusted with the responsibilities of development and regulation of the money market and capital market respectively. These regulators derive their power from various legislative enactments and exercise their discretion as well. The financial system thus functions within the regulatory framework. The objective of this and the next Units are to give a broad account of such Long System and Market regulatory framework. In this Unit, we shall deal with the regulatory environment for the money market and the participants therein, i.e. the Commercial Banks, the Cooperative Banks, financial institutions and the non-banking finance companies.

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The Non-Banking Finance Companies perform very important financial intermediation function in India. They supplement the role of the banking institutions, as they cater to the needs of those borrowers who remain beyond the purview of the banking

institutions and mobilize the savings from the depositors. Iiire purchase finance and leasing companies, loans and investment companies and housing finance companies are the important categories of such Non-Banking Finance Companies (NBFCs).In view of the significant role played by NRFCs, regulatory framework has been devised, particularly to safeguard the interests of the depositors. Chapter 111 B of the Reserve Bank of India Act, 1934 provides for such regulatory framework over NBFCs. Significant amendments to this Chapter were made in January, 1997, vesting more powers in the Reserve Bank of India to regulate the activities of such companies.

1) Reserve Bank of India Act, 1834

The powers vested in the Reserve Bank of India Act under Chapter I11 B of Reserve Bank of India Act, 1934 are as follows:

i) To regulate or prohibit issue of prospectus

In the public interest, the Reserve Bank of India may regulate or prohibit the issue by any non-banking company of any prospectus or advertisement soliciting deposits of money from the public. The Bank may also give directions to these companies as to the particulars to be included in such advertisements.

ii) To collect information as to deposits and to give direction

The Reserve Bank of India is empowered to direct every non-banking institution to furnish to it information or particulars relating to the deposits received by it. The Bank may also issue directions in the public interest, to such institutions generally, or to any institution in particular, or group of such institutions in particular, on any of the matters connected with the receipt of deposits. If any such institution fails to comply with any direction, the Bank may prohibit the acceptance of deposits by such institutions.

iii) To conduct inspection

The Reserve Bank of India may, at any time, cause an inspection to be made of any non-banking institution to verify the correctness/completeness of the particulars furnished to the Bank or to obtain any such particulars, if not submitted. iv) The Reserve Bank of India (Amendment) Act, 1997, has

conferred explicit powers on the Reserve Bank of India as follows:

In exercise of the powers vested in it under Chapter 111 of the Reserve Bank of India, issued these directions to NBFCs regarding acceptance of deposits from the public. These directions were substantially revised in January, 1998, to include prudential norms to be followed by NBFCs. The salient features of RBI Directions, as further revised in December, 1998 are as follows:

i) For regulatory purposes, NBFCs have been classified into three categories:

a) those accepting public deposits,

b) those not accepting public deposits, but engaged in financial business ,

c) core investment companies, with 90% of their total assets in investments in the securities of their group/holding/ subsidiary companies. The thrust of RBI regulation is on companies accepting public deposits.

ii) Public deposits have been defined to include field/recurring deposits received from public, deposits received from relatives and friends, deposits from shareholders by a public limited company and money raised by issue of unsecured debentures and bonds to shareholders and the public. Public Deposits exclude money raised by way of issue of secured debentures and bonds, borrowings from banks and financial institutions (including by way of unsecured debentures), deposits from directors, inter-corporate deposits, deposits from foreign citizens, deposits received by private limited companies from their shareholders, t security deposits from employees, advance receipt of lease and hire purchase installments.

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iv) Ceilings on public deposits for NBFCs, with NOF of Rs. 25 lakh and above, have been prescribed as follows. These ceiling limits were enforced in December, 1998. Prior to that, these limits were based on the credit rating (effective January, 1998).

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group/subsidiary companies has been fixed at 10% of their owned funds for equipment leasing and hire purchase finan'ce companies and 20% of the owned funds for loan and investment companies. NBFCs are advised not to invest more than 10% of their owned funds in land and building except for their own use. NBFCs are required to dispose off excess of the assets over the indicated ceilings within three years.

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7.5 SUGGESTED READINGS

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7 Varshney, P.N. Edition (2002) – Indian Financial System, Sultan Chand & Sons, Delhi.

7.6 TERMINAL QUESTIONS

1. Discuss the provisions of RBI ACT to control and monitor non - banking company's.
7.Discuss the role of NBFCS Acceptance of Public Deposits (Reserve Bank).
3.Write a short note on Equipment Leasing and Hire Purchase Finance Companies.
4.How inspection is conducted of conduct NBFCS.

LL.M. – Ist Year
Paper: Banking Law

Block-III:Relationship of Banker and Customer and Recent Trends of Banking system in India
Unit-08: Various Kinds of relationship between banker and customer

STRUCTURE

8.1 Introduction

The term Customer has not been defined by any .act..The 'word 'customer' has been derived from the word 'custom', which means a 'habit or tendency' to-do certain things in a regular or a particular manner's .In terms of Sec, 131 of Negotiable Instrument Act, when a banker receives payment of a crossed cheque in good faith and without negligence for a customer. the bank does not incur any liability to the true owner of the cheque by reason only of having received such payment. It obviously means that to become a customer account relationship is must. Account relationship is a contractual relationship.

8.2 Objective

It is generally believed that any individual or an organization, which conducts banking transactions with a bank, is the customer of bank. However, there are many persons who do utilize services of banks, but do not maintain any account with the bank.

Thus bank customers can be ‘categorized in to four broad categories as under:

(a)Those who maintain account relationship with banks i.e. Existing customers. (b)Those who had account relationship with bank i.e. Former Customers

(c)Those who do not maintain any account relationship with the bank but frequently visit branch of a bank for availing banking facilities such as for purchasing a draft, encasing a cheque, etc. Technically they are noncustomers, as they do not maintain any account with the bank branch.

(d)prospective/ Potential customers: Those who intend to have account relationship with the bank.. A person will be deemed to be a 'customer' even if he had only handed over the account opening form duly filled in and signed by him to the bank and the bank has accepted the it for opening the account,

even though no account has actually been opened by the bank in its books or record.

The practice followed by banks in the past was therefore opening account there has to be an initial deposit in cash. However the condition of initial cash deposit for opening the account appears to have been dispensed with the opening of 'No FriW account by banks as per directives of Reserve Bank of (ndia. 'No Frill' accounts are opened with 'Nil' or with meager balance.

The term 'customer' is used only with respect to the branch, where the account is maintained. He cannot be treated as a 'customer' for other branches of the same bank. However with the implementation of 'Core Banking Solution' the customer is the customer of the bank and not of a particular branch as he can operate his account ii'om any branch of the bank and from anywhere. (n the event of arising any cause of action. the customer is required to approach the branch with w11ich it had opened account and not with any other branch.

The relationship between a banker and a customer depends on the activities: products or services provided by bank to its customers or availed by the customer. Thus the relationship between a banker and customer is the transactional relationship. Bank's business depends much on the strong bondage with the customer. "Trust" plays an important role in building healthy relationship between a banker and customer.

8.3.1 Definition of a 'BANKER'

The Banking Regulations Act (B R Act) 1949 does not define the term 'banker' but defines what banking is?

As per Sce.S (b) of the BRAct "Banking' means accepting, for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise and withdraw able by cheque, draft, order or otherwise. " As per See. 3 of the Indian Negotiable Instruments Act 1881, the word "banker includes any person acting as banker and any post office savings bank".

According to Sec. 2 of the Bill of Exchange Act, 1882, 'banker includes a body of persons, whether incorporated or not who carryon the business of banking. '

See.S(e) of BR Act defines "banking company" as a company that transacts the business of banking in India. Since a banker or a banking company undertakes banking related activities we can derive the meaning of banker or a banking company from Sec 5(b) as a body corporate that:

(a) Accepts deposits from public.

(b) Lends or

(c) Invests the money so collected by way of deposits.

(d) Allows withdrawals of deposits on demand or by any other means.

Accepting deposits from the 'public' means that a bank accepts deposits from anyone who offers money for the purpose. Unless a person has an account with the bank, it does not accept deposit. For depositing or bolt owing money there has to be an account relationship with the bank. A bank can refuse to open an account for undesirable persons. It is banks right to open an account. Reserve Bank of India has stipulated certain norms "Know Your Customer" (KYC) guidelines for opening account and banks have to strictly follow them.

In addition to the activities mentioned in Sec.5 (b) of B R Act, banks can also carry out activities mentioned in Sec. 6 of the Act.

8.3.2 'Know Your Customer' Guidelines and Customer:

As per 'Know Your Customer' guidelines issued by Reserve Bank of India, customer has been defined as:

(i)A person or entity that maintains an account and/or has a business relationship with the bank;

(ii)One on whose behalf the account is maintained (i.e. the beneficial owner); (iii)Beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and

(iv)Any person or entity connected with a financial transaction, which can pose significant reputational or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

8.3.3Banker-Customer Relationship:

Banking is a trust-based relationship. There are numerous kinds of relationship between the bank and the customer. The relationship between a banker and a customer depends on the type of transaction. Thus the relationship is based on contract, and on certain term and conditions.

These relationships confer certain rights and obligations both on the part of the banker and on the customer. However, the personal relationship between the bank and its customers is the long lasting relationship. Some banks even say that they have generation-to-generation banking relationship with their customers. The banker customer relationship is fiducially relationship. The terms and conditions governing the relationship is not be leaked by the banker to a third party.

8.3.4 Classification of Relationship:

The relationship between a bank and its customers can be broadly categorized in to General Relationship and Special Relationship.

If we look at Sec 5(b) of Banking Regulation Act, we would notice that bank's business hovers around accepting of deposits for the purposes of lending. Thus the relationship arising out of these two main activities are known as General Relationship. In addition to these two activities banks also undertake other activities mentioned in Sec.6 of Banking Regulation Act. Relationship arising out of the activities mentioned in Sec.6 of the act is termed as special relationship.

8.3.5 General Relationship:

Debtor-Creditor: When a 'customer' opens an account with a bank, he fills in and signs the account opening form. By signing

the form he enters into an agreement/contract with the bank. When customer deposits money in his account the bank becomes a debtor of the customer and customer a creditor. The money so deposited by customer becomes bank's property and bank has a right to use the money as it likes. The bank is not bound to inform the depositor the manner of utilization of funds deposited by him. Bank does not give any security to the depositor i.e. debtor. The bank has borrowed money and it is only when the depositor demands, banker pays. Bank's position is quite different li'om normal debtors.

Banker does not pay money on its own, as banker is not required to repay the debt voluntarily. The demand is to be made at the branch where the account exists and in a proper manner and during working days and working hours.

The debtor has to follow the terms and conditions of bank said to have been mentioned in the account opening form. Though the terms and conditions are not mentioned in the account opening form, but the account 'opening form contains a declaration that the terms and conditions have been read and understood or has been explained. In fact the terms and conditions are mentioned in the passbook, which is issued to the customer only after the account has been opened.

In the past while opening account some of the banks had the practice of giving a printed handbill containing the tern1S and conditions of account along with the account opening form. This practice has since been discontinued. For convenience and information of prospective customers a few banks have uploaded the account opening form, terms and conditions for opening account, rate charge in respect of various services provided by the bank etc., on their web site.

While issuing Demand Draft, Mail/Telegraphic Transfer, bank becomes a debtor as it owns money to the payee/ beneficiary.

8.3.6 Creditor-Debtor:

Lending money is the most important activities of a barllc The resources mobilized by banks are utilized for lending operations. Customer who borrows money from bank owns money to the bank. In the case of any loan/advances account,

the banker is the creditor and the customer is the debtor. The relationship in the first case when a person deposits money with the bank reverses when he borrows money from the bank. Borrower executes documents and offer security to the bank before utilizing the credit facility.

In addition to opening of a deposit/loan account banks provide variety of services, which makes the relationship more wide and complex. Depending upon the type of services rendered and the nature of transaction, the banker acts as a bailee, trustee, principal, agent, lessor, custodian etc.

Special Relationship:

8.3.7. Bank as a Trustee:

As per Sec. 3 of Indian Trust Act, 1882

A "trust" is an obligation annexed to the ownership of property, and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner.' Thus trustee is the holder of property on behalf of a beneficiary.

As per Sec. 15 of the 'Indian Trust Act, 1882 'A trustee is bound to deal with the trust-property as carefully as a man of ordinary prudence would deal with such property if it were his own; and, in the absence of a contract to the contrary, a trustee so dealing is not responsible for the loss, destruction or deterioration of the trust-property.' A trustee has the right to reimbursement of expenses (Sec.32 of Indian Trust Act.).

In case of trust banker customer relationship is a special contract. When a person entrusts valuable items with another person with an intention that such items would be returned on demand to the keeper the relationship becomes of a trustee and trustier. Customers keep certain valuables or securities with the bank for safekeeping or deposits certain money for a specific purpose (Escrow accounts) the banker in such cases acts as a trustee. Banks charge fee for safekeeping valuables

8.3.8 Bailee - Bailor:

Sec. 148 of Indian Contract Act, 1872, defines "Bailment" "bailor" and "bailee". A "bailment" is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them. The person delivering the goods is called the "bailor". The person to whom they are delivered is called, the "bailee".

Banks secure their advances by obtaining tangible securities. In some cases physical possession of securities goods (Pledge), valuables, bonds etc., are taken. While taking physical possession of securities the bank becomes bailee and the customer bailor. Banks also keeps articles, valuables, securities etc., of its customers in Safe Custody and acts as a Bailee. As a bailee the bank is required to take care of the goods bailed.

8.3.9.Lessor and Lessee:

Sec. 105 of 'Transfer of property Act 1882' defines lease, Lessor, lessee, premium and rent. As per the section "A lease of immovable property is a transfer of a right to enjoy such property, made for a certain time, express or implied, or in perpetuity, in consideration of a price paid or promised, or of money, a share of crops, service or any other thing of value, to be rendered periodically or on specified occasions to the transferor by the transferee, who accepts the transfer on such terms:'

8.3.10 Definition of Lessor, lessee, premium and rent:

(I)The transferor is called the lessor,

(2)The transferee is called the lessee,

(3)The price is called the premium, and

(4)The money, share, service or other thing to be so rendered is called the rent."

Providing safe deposit lockers is as an ancillary service provided by banks to customers. While providing Safe Deposit Vault locker facility to their customers bank enters into an agreement with the customer. The agreement is known as "Memorandum of letting" and attracts stamp duty.

The relationship between the bank and the customer is that of lessor and lessee. Banks lease (hire lockers to their customers) their immovable property to the customer and give them the right to enjoy such property during the specified period i.e. during the office/ banking hours and charge rentals. Bank has the right to break-open the locker in case the locker holder defaults in payment of rent. Banks do not assume any liability or responsibility in case of any damage to the contents kept in the locker. Banks do not insure the contents kept in the lockers by customers.

8.3.11 Agent and Principal:

Sec. 182 of 'The Indian Contract Act, 1872' defines "an agent" as a person employed to do any act for another or to represent another in dealings with third persons. The person for whom such act is done or who is so represented is called "the Principal".

Thus an agent is a person, who acts for and on behalf of the principal and under the latter's express or implied authority and the acts done within such authority are binding on his principal and, the principal is liable to the party for the acts of the agent.

Banks collect cheques, bills, and makes payment to various authorities viz., rent, telephone bills, insurance premium etc., on behalf of customers. . Banks also abides by the standing instructions given by its customers. In all such cases bank acts as an agent of its customer, and charges for theses services. As per Indian contract Act agent is entitled to charges. No charges are levied in collection of local cheques through clearing house. Charges are levied in only when the cheque is returned in the clearinghouse.

5. As a Custodian: A custodian is a person who acts as a caretaker of some thing. Banks take legal responsibility for a

customer's securities. While opening a dmat account bank becomes a custodian.

6. As a Guarantor: Banks give guarantee on behalf of their customers and enter in to their shoes. Guarantee is a contingent contract. As per sec 31 ,of Indian contract Act guarantee is a " contingent contract". Contingent contract is a contract to do or not to do something, if some event, collateral to such contract, does or does not happen.

It would thus be observed that banker customer relationship is transactional relationship.

Termination of relationship between a banker and a customer:

The relationship between a bank and a customer ceases on:

(a) The death, insolvency, lunacy of the customer.

(b) The customer closing the account i.e. Voluntary termination

(c) Liquidation of the company

(d) The closing of the account by the bank after giving due notice.

(e) The completion of the contract or the specific transaction.

The relationship developed between a banker and customer involves some duties on the part of both. .

8.3.12 Duties of a banker:

A 'Banker' has certain duties vis-a-vis his customer. These are:

(a)Outy to maintain secrecy/confidentiality of customers' accounts.

(b)Outy to honour cheques drawn by customers on their accounts and collect cheque, bills on his behalf.

(c)Duty to pay bills etc., as per standing instructions of the customer.

(d)Outy to provide proper services.

(e)Outy to act as per the directions given by the customer. If directions are not given the banker has to act according to how he is expected to act.

(t)Outy to submit periodical statements i.e. informing customers of the state of the account

(g)Articles/items kept should not be released to a third party without due authorization by the customer

8.3.13Duty to maintain secrecy:

Banker has a duty to maintain secrecy of customers' accounts. Maintaining secrecy is not only a moral duty but bank is legally bound to keep the affairs of the customer secret. The principle behind this duty is that disclosure about the dealings of the customer to any unauthorized person may harm the reputation of customer and the bank may be held liable. The duty of maintaining secrecy does not cease with the closing of account or on the death of the account holder.

As per Sec. 13 of "Banking Companies Acquisition and Transfer of Undertakings Act 1970"

"Every corresponding new bank shall observe, except as otherwise required by law, the practices and usages customary among bankers, and, in particular, it shall not divulge any information relating to or to the affairs of its constituents except in circumstances in which it is, in accordance with law or practices and usages customary among bankers, necessary or appropriate for the corresponding new bank to divulge such information."

Maintaining secrecy is implied terms of the contract with the customer which bank enters into with the customer at the time of opening an account.

Bank has not only to maintain secrecy of transactions, but secrecy is also to be maintained in respect of operations through A TM/ debit cards. Bank has also to maintain secrecy of user 10 pins with due care so that it does fall in wrong hands.

Failure to maintain secrecy:

Bank is liable to pay damages to the account holder for loss of money and reputation if it fails in its duty to maintain secrecy

and discloses information relating to a customer's account or conduct of the account to any unauthorized person.

Bank can also be liable to the third party if its wrongful disclosure harms the interest of the third party. If bank Knowingly furnishes wrong information There has been a misrepresentation

Over estimation of favourable opinion Circumstances under which banker can disclose information of customer's account:

A bank can disclose information regarding customer's account to a person(s) under the following circumstances.

(a) Under compulsion of law.

(b) Under banking practices.

(c)For protecting national interest.

(d)For protecting bank's own interest

(e) Under express or implied consent of the customer

Disclosure under compulsion of law:

Banks disclose information to various authorities who by virtue of powers vested in them under provisions of various acts require banks to furnish information about customer's account. The information is called under:

(i)Section 4 of Banker's Book Evidence Act, 1891

(ii)Section 94 (3) of Code of Civil Procedure Act, 1908

(iii)Section 45 (B) of Reserve Bank of India Act, 1934

(iv)Section 26 of Banking Regulation Act, 1949

(v)Section 36 of Gift Tax Act,] 958

(vi)Sections]31, 133 ofIncome Tax Act, 1961

(vii)Section 29 of Industrial Development Bank of India Act,] 964 (viii)Section 120f Foreign Exchange Management Act, (FEMA) 1999 (ix)Section 12 of the Prevention of Money Laundering Act, 2002

Banks are required to furnish only the called for information (no additional information is to be furnished) on receipt of written request of the person who is vested with the authority to call

for such information under the said acts. The customer is kept informed about the disclosure of the information.

8.3.14Disclosure under banking practices:

In order to ascertain financial position and credit worthiness of the person banks obtain information from other banks with which they are maintaining accounts. It is an established practice among bankers and implied consent of the customer is presumed to exist. The opinion is given in strictest confidence and without responsibility on the part of the bank furnishing such information. Credit information is furnished in coded terms to other banks on IBA format and without signatures.

Duty to provide proper accounts:

Banks are under duty bound to provide proper accounts to the customer of all the transactions done by him. Bank is required to submit a statement of accounts / passbook to the customer containing all the credits and debits in the account.

8.3.15Duty to honour cheques:

As 'banking' means accepting of deposits withdrawable by cheque, draft, order or otherwise, the banker is duty bound to honour cheques issued by the customers on their accounts.

Sec. 31 of Negotiable Instruments Act, 1881 specifies the liability of drawee of cheque. As per Sec. 31 "The drawee of a cheque having sufficient funds of the drawer in his hands properly applicable to the payment of such cheque must pay the cheque when duly required so to do, and, in. default of such payment, must compensate the drawer for any loss or damage caused by such default. "

Therefore it is the duty of a bank to honour the cheques issued by the account holder if:

The cheque has been properly drawn and is in order in all respects i.e. it is properly dated, amount in words and figures have been expressed properly, is neither stale nor post dated nor mutilated and the signature of accountholder tallies with the specimen recorded with the bank. The cheque should be

drawn on the branch where the account is maintained. (Due to implementation of technology and core banking solution a customer can present cheques on any branch of a bank. RBI has advised banks to issue multi city cheques to account holders.) (a)There is sufficient balance in the account and the balance is properly

applicable for payment of the cheque.

(b)The cheque is presented for payment on a working day and during the business

hours of the branch.

(c)Endorsements on the cheque are regular and proper.

(d)The payment of the cheque is not countermanded by the drawer

Duty to honour cheques ceases on receipt of:

(a)Stop payment instructions from the account holder.

(b)Notice about the death of the drawer.

(c)A garnishee order attaching the balance in the account or an income-tax

attachment order received by the banker.

(d) Drawer of the cheque becoming insolvent and/or a lunatic at the time of drawing

the cheque.

Bank can refuse to honour the cheques if: There

is in sufficient 1 balance in the account to make payment of the cheque.

Cheque issued does not pertain to the account on which it has been drawn.

l.If the cheque is not in order (post dated, stale, payment countermanded, amount in words and figure differs, etc.)

2.The balances held in account are earmarked for some specific purpose and the remaining balance is not sufficient to honour the cheque.

8.3.16Rights of a banker:

It is not that the bank has only duties to wards its customers, it too has certain rights vis-a-vis his customers. The rights can broadly be classified as:

Right of General Lien

a)Right of Set-On'

b)Right of Appropriation

c)Act as per the mandate of customer

d)Right to Charge Interest, Commission, Incidental Charges etc.

8.3.17Lien:

A lien is the right of a creditor in possession of goods, securities or any other assets belonging to the debtor to retain them until the debt is repaid, provided that there is no contract express or implied, to the contrary. It is a right to retain possession of specific goods or securities or other movables of which the ownership vests in some other person and the possession can be retained till the owner discharges the debt or obligation to the possessor. The creditor (bank) has the right to maintain the security of the debtor but not to sell it. There are two types of lien viz.

I. Particular Lien and 2.Right of General Lien

8.3.18 (a) Particular Lien:

A 'particular lien' gives the right to retain possession only of those goods in respect of which the dues have arisen. It is also termed as ordinm'y lien. If the bank has obtained a particular security for a particular debt, then the banker's right gets converted into a particular lien.

(b) Right of General Lien:

Banker has a right of general lien against his borrower. General lien confers banks right in

respect of all dues and not for a particular due. It is a statutory right of the bank and is available even in absence of an agreement but it does not confer the right to pledge. A 'general lien' gives the right to retain possession of any goods in the legal possession of the creditor until the whole of the debt due from the debtor is paid.

Section 171 of Indian Contract Act, 1872 confers the right of general lien to banks. As per the section" Bankers, factors, wharfingers, attorneys of a High Court and policy-brokers may, in the absence of a contract to the contrary, retain, as a security for a general balance of account any goods bailed to them; but no other persons have a right to retain, as a security for such balance, goods bailed to them, unless there is an express contract to the effect."

Bank has a right of lien only when goods. securities are received in the capacity as a creditor. While granting advances banks take documents. These documents confer right to convert general lien as an implied pledge. A banker's lien is more than a general lien, it is an implied pledge and he has the right to sell the goods in case of default Bank has a 'Right of Sale' of goods under lien. Banker's right of lien is not barred by the Law of Limitation.

Exercising Right of Lien:

Bank has the right of lien on goods and securities entrusted to him legally and standing in the name of the borrower.

Bank can exercise right of lien on the securities in its possession *for* the dues of the same borrower, even aller the loan taken against that particular security has been re-paid.

Right of lien can be exercised on bills, cheques, promissory notes, share certificates, bonds, debentures etc.

Where right of lien cannot be exercised:

Bank cannot exercise right of lien on goods received for safe custody, goods held in capacity as a trustee, or as an agent of the customer, SOY, or left in bank by mistake

8.3.19Right of set-off:

The banker has the right to set off the accounts of its customer. It is a statutory right available to a bank, to set off a debt owned to him by a creditor from the credit balances held in other accounts of the borrower. The right of set-off can be exercised only if there is no agreement express or implied to the contrary. This right is applicable in respect of dues that are due, are becoming due i.e. certain and not contingent. It is not applicable on future debts. It is applicable in respect of deposits that are due for payment.

The right of set off enables bank to combine all kinds of credit and debit balances of a customer for arriving at a net sum due.

The right is also available for deposits kept in other branches of the same bank. The right can be exercised after death, insolvency, and dissolution of a company, after receipt of a garnishee/ attachment order .The right is also available for time barred debts.

Deposits held in the name of a guarantor cannot be set off to the debit balance in borrowers account until a demand is made to the guarantor and his liability becomes certain. Banks cannot set off the credit balance of customer's personal account *for* a joint loan account of the customer with another person unless both the joint accountholders are jointly and severally liable. Banks exercise the Right of set off only after serving a notice on the customer informing him that the bank is going to exercise the right of set-off.

Automatic right of set of 1':

Depending on the situation, sometimes the set off takes place automatically without the permission from the customer. In the following events the set off happens automatically i.e. without the permission from the customer.

a)On the death of the customer,

b)On customer becoming insolvent.

c)On receipt of a Garnishee order on customer's account by court.

d)On receipt of a notice of assignment of credit balance by the customer to the banker.

e)On receipt of notice of second charge on the securities already charged to the bank.

Conditions while exercising right of Set - Off:

a)The account should be in the sale name of the customer.

b)The amount of debts must be certain and measurable.

c)There should not be any agreement to the contrary

d)Funds should not be held in trust accounts

e)The right cannot be exercised in respect of future or contingent debts.

f)The banker has the right to exercise this right before a garnishee order is received by it.

8.3.20Right of Appropriation:

It is the right of the customers to direct his banker against which debt (when more than one debt is outstanding) the payment made by him should be appropriated. In case no such direction is given, the bank can exercise its right of appropriation and apply it in payment of any debt. Section 59,60 and 61 of Indian Contract Act, 1872 lays down the rules of appropriation.

Sec.59.Application of payment where debt to be discharged is indicated: (i.e.- As per borrowers instructions)

Where a debtor, owing several distinct debts to one person, makes a payment to him, either with express intimation, or under circumstances implying that the payment is to be applied to the discharge of some particular debt, the payment, if accepted, must be applied accordingly.

Sec.60. Application of payment where debt to be discharged is not indicated: (i.e. in the absence of express or implied intention of debtor)

Sec.60 of the Indian Contract Act states that if the debtor does not intimate or there is no circumstance of indicating how the payment is to be used, the right of appropriation is vested in the creditor.

According to the Act, "Where the debtor has omitted to intimate and there are no other circumstances. indicating to which debt the payment is to be applied, the creditor may apply it at his discretion to any lawful debt actually due and payable to him from the debtor, whether its recovery is or is not barred by the law in force for the time being as to the limitation of suits."

Sec.61.Application of payment where neither party appropriates.

Where neither party makes any appropriation the payment shall be applied in discharge of the debts in order of time, whether they are or are not baited by the law in force for the time being as to the limitation of suits. If the debts are of equal standing, the payment shall be applied in discharge of each proportionally.

Unless there is an agreement to the contrary, any payment made by a debtor is applied first towards interest and thereafter towards principal. If a customer has only one account and he deposits and withdraws money from it regularly, the order in which the credit entry will set off the debit entry is in the chronological order, this is known as Clayton's rule.

Rule in Clayton's case:

The rule was laid down in famous Oevayanas Vs. Noble. The rule applies to running accounts like *CCI* 00 with debit balance. The rule states that each withdrawal in a debit account is considered as a new loan and each deposit as a repayment in that chronological order.

Banker's right to charge interest, commission, incidental charges etc. :

Banker has an implied right to charge for services rendered and sold to a customer. Bank charges interest on amount advanced, processing charges for the advance, charges for non-utilization of

credit facilities sanctioned, charges commission, exchange, incidental charges etc. depending on the terms and conditions of advance banks charge interest at monthly, quarterly or semiannually or annually. Banks charge customers if the

balance in deposit account falls below the prescribed amount. Usually the bank informs such charges to the customer by various means.

8.3.21Nomination Facility:

Nomination is expression of wish of a person about transfer of his assets after his death to a named person. Nomination is not a will but it serves the purpose of will. In terms of Sections 45ZA to 45 ZF of the Banking Regulation Act, 1949, Banking Companies (Nomination) Rules,

1985 have been framed. Nomination facility simplifies the procedure for settlement of claims of deceased depositors and locker holders. In an unfortunate event of the death of a depositor, nomination enables the bank to make payment to the nominee of a deceased depositor, of the amount standing to the credit of the depositor, return the articles left by a deceased person in the bank's safe custody to the nominee without asking for succession certificate or verifying claims of legal heirs.

Nomination does not take away the rights of legal heirs on the estate of the deceased. The nominee receives the money from the bank as a trustee of the legal heirs. In the case of a joint deposit account the nominee's right arises only after the death of all the depositors. Nomination facility is intended for individuals and sole proprietary concerns.

Where the nominee is a minor, the depositor making the nomination appoints any person to receive the amount of deposit in the event of his death during the minority of the nominee. A person legally empowered to operate a minor's account can file a nomination on behalf of the. mmor.

Nomination can be made in account opening form itself or on a separate form indicating the name and address of the nominee. The account holders can change the nomination any time. There can be only one Nominee for a deposit account whether held singly or jointly. There can be two nominees for a jointly held locker.

A vailability of the Nomination facility:

Nomination facility is available for all types of bank deposits, safe deposit lockers, and safe custody articles. This is also applicable to deposits having operating instructions "Either or Survivor". Nomination can be made in favour of one person only.

In case of a joint account, nomination is to be made by all depositors jointly.

Nomination cannot be made in accounts where deposits are held in a representative capacity e.g. trust accounts etc. and in accounts of partnership firms, H.U.F., companies, associations, clubs etc.

Nomination can be made in favour of a minor. However while making the nomination, the nominee has to appoint another person (not a minor), to receive the amount of the deposit on behalf of the nominee in the event of the death of the depose or during the minority of the nominee. Date of birth of minor be obtained and noted.

A nomination will continue to be in force even on renewal of term deposit, unless specifically cancelled or changed. Banks obtain separate nomination form for each term deposit receipt

A non-resident can be nominated as a nominee in a resident account

In case of non-resident nominees, the amount entitled to him from the account(s)/ deposits(s) of a deceased person, will be credited to his NRO account. The amount so credited cannot be remitted outside India.

8.3.22Insurance of Bank Deposits:

The Deposit Insurance and Credit Guarantee Corporation of India, a public limited company promoted by Reserve Bank of India, insure bank deposits. The authorized capital of the Corporation is Rs.50 crore, which is fully issued and subscribed by the Reserve Bank of India (RBI). The managemelll of the Corporation vests in a Board of Directors of which a Deputy Governor, Reserve bank of India, is the Chairman.

The Corporation protects the interest of depositors and infuses confidence by providing deposit insurance on account of failure of banks. All commercial banks including the branches of foreign banks functioning in India, local area banks, regional rural banks, all eligible co-operative banks are covered under the Deposit Insurance Scheme. The insurance covers the loss of all or part of their deposits in all branches of a bank to a maximum of Rs.l, 00,000. It insures all deposits such as savings, fixed, current, recurring, etc except the following types of deposits.

(i) Deposits of foreign Governments,

(ii) Deposits of Central/State Governments,

(iii) Inter-bank deposits,

(iv) Deposits of the State Land Development Banks with the State co-operative bank;

(v) any amount due on account of and deposit received outside India

(vi) any amount, which has been specifically exempted by the corporation with the previous approval of Reserve Bank of India.

The Corporation charges insurance premium from banks on deposits @ 10 paisa per Rs.l OOof assessable deposits per annum. The premium is charged twice a year on the assessable deposits as at 31 st March and 30th September. Though the premium is charged on the full amount of deposit kept by depositors in a bank is insured up to a maximum of Rs. I ,00,000 (Rupees One Lakh) only for both principal and interest amount.

The corporation pays to each depositor through the liquidator, the amount of his deposit up to Rupees one lakh within two months from the date of receipt of claim list fTOm the liquidator. If a bank is reconstmcted or amalgamated / merged with another bank, it pays the bank concerned, the difference between the full amount of deposit or the limit of insurance cover in force at the time, whichever is less and the amount received by him under the reconstmction / amalgamation

scheme within two months from the date of receipt of claim list from the transferee bank / Chief

Executive Officer of the insured bank/transferee bank as the case may be. .

In the second report of Narasimham Committee (April 1998) on "Banking Sector Reforms" recommendations have been made for reforming scheme of Deposit insurance. The committee has recommended that instead of "flat'" rate premium, it should be ' risk based' or 'variable rate' premium.

Know Your Customer Norms and Cash transactions:

The objective of KYC guidelines is to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering activities. KYC procedures enable banks to know/understand their customers and their financial dealings better, which in turn help them, manage their risks pmdently. Necessary checks before opening a new account ensures that the identity of the customer does not match with any person with known criminal background or with banned entities such as individual terrorists or terrorist organizations etc. and that no account is opened in anonymous or fictitious/ benami name(s).

Banks are supposed to adopt due diligence and appropriate KYC norms at the time of opening of accounts. The objectives of the KY C are to ensure appropriate customer identification and to monitor transactions of a suspicious nature. While opening an account a bank is supposed to obtain all information necessary for establishing the identity/legal existence of each new customer by taking and verifying the introductory reference from an existing account holder/a person known to the bank or on the basis of documents provided by the customer. The means of establishing identity can be passport, driving license etc. In respect of existing customers banks are required to complete customer identification at the earliest.

Ceiling and monitoring of cash transactions

As per RBI guidelines issued under Section 35 *(A)* of the Banking Regulation Act, 1949: (i)Banks are required to issue travelers cheques, demand drafts, mail transfers, and

telegraphic transfers for Rs.50, 000 and above only by debit to customers' accounts or against cheques and not against cash. While purchasing travellers cheques, demand drafts, mail transfers, and telegraphic transfers for Rs.50, 000 and above purchaser has to mention his Permanent Income Tax Account Number (PAN) on the application.

(ii) The banks are required to keep a close watch of cash withdrawals and deposits for Rs.l0 lakhs and above in deposit, cash credit or Overdraft accounts and keep record of details of these large cash transactions in a separate register. Branches of banks are required to report all cash deposits and withdrawals of Rs.l 0 lakhs and above as well as transactions of suspicious nature with full details in fortnightly statements to their controlling offices.

Bankers' Fair Practice Code:

Indian Banks' Association has prepared a code, which sets standards of fair banking practices. This document is a broad framework under which the rights of common depositors are recognized. It is a voluntary Code that promotes competition and encourages market forces to achieve higher operating standards for the benefit of customers. The Code applies to current, savings and all other deposit accounts, collection and remittance services offered by the banks, loans and overdrafts, foreign-exchange services, card products and third party products offered by banks. to the limitation of suits.

8.4 Question

1. What do you understand by the word ‘Customer”
2. Define banker?
3. Briefly explain duties of banker?
4. What do you mean by nomination faculty?

8.5 Suggested Readings

1. Indian Contract Act by Bangia
2. Indian Contract Act by Avtar Singh
3. Banking Regulation
4. Partnership Act

LL.M. – Ist Year
Paper: Banking Laws

Block-III: Relationship of Banker and Customer and Recent Trends of Banking system in India
Unit-09:NewTechnology-InformationTechnology, Automation and Legal Aspect of Automatic Machine

STRUCTURE

9.1 Introduction

Information technology in India

The Information technology industry in India has gained a brand identity as a knowledge economy due to its IT and ITES sector. The IT–ITES industry has two major components: IT Services and business process outsourcing (BPO). The growth in the service sector in India has been led by the IT–ITES sector, contributing substantially to increase in GDP, employment, and exports. The sector has increased its contribution to India's GDP from 1.2% in FY1998 to 7.1% in FY2011.[1] According to NASSCOM, the IT–BPO sector in India aggregated revenues of US$88.1 billion in FY2011, where export and domestic revenue stood at US$59 billion and US$29 billion respectively.[1] The top seven cities that account for about 90% of this sectors exports are Bangalore, Chennai, Hyderabad, Mumbai, Pune, Delhi, Kolkata, Coimbatore and Kochi.[2] Export dominate the IT–ITES industry, and constitute about 77% of the total industry revenue. Though the IT–ITES sector is export driven, the domestic market is also significant with a robust revenue growth.[1] The industry's share of total Indian exports (merchandise plus services) increased from less than 4% in FY1998 to about 25% in FY2012.

This sector has also led to employment generation. Direct employment in the IT services and BPO/ITES segment was 2.3 million in 2009-10 and is estimated to reach nearly 2.5 million by the end of financial year 2010-11. Indirect employment of over 8.3 million job opportunities is also expected to be generated due to the growth of this sector in 2010-11. Generally dominant player in the global outsourcing sector. However, the sector continues to face challenges of competitiveness in the globalized world, particularly from countries like China and Philippines.

India's growing stature in the Information Age enabled it to form close ties with both the United States of America and the European Union. However, the recent global financial crises has deeply impacted the Indian IT companies as well as global companies. As a result hiring has dropped sharply, and employees are looking at different sectors like the financial service, telecommunications, and manufacturing industries, which have been growing phenomenally over the last few years. India's IT Services industry was born in Mumbai in 1967 with the establishment of Tata Group in partnership

with Burroughs.[4] The first software export zone SEEPZ was set up here way back in 1973, the old avatar of the modern day IT park. More than 80 percent of the country's software exports happened out of SEEPZ, Mumbai in 80s.

9.2 Objective

The objective of this unit is to make the students aware of the new technology when is being used by almost every day into his/her day to day life. In today's world every today is dependent on these technology. They should know it history of Information technology.

9.3.1 History

The Indian Government acquired the EVS EM computers from the Soviet Union, which were used in large companies and research laboratories. In 1968 Tata Consultancy Services—established in SEEPZ, Mumbai[4] by the Tata Group—were the country's largest software producers during the 1960s. As an outcome of the various policies of Jawaharlal Nehru (office: 15 August 1947 – 27 May 1964) the economically beleaguered country was able to build a large scientific workforce, third in numbers only to that of the United States of America and the Soviet Union. On 18 August 1951 the minister of education Maulana Abul Kalam Azad, inaugurated the Indian Institute of Technology at Kharagpur in West Bengal. Possibly modeled after the Massachusetts Institute of Technology these institutions were conceived by a 22 member committee of scholars and entrepreneurs under the chairmanship of N. R. Sarkar.

Relaxed immigration laws in the United States of America (1965) attracted a number of skilled Indian professionals aiming for research. By 1960 as many as 10,000 Indians were estimated to have settled in the US. By the 1980s a number of engineers from India were seeking employment in other countries. In response, the Indian companies realigned wages to retain their experienced staff. In the *Encyclopedia of India*, Kamdar (2006) reports on the role of Indian immigrants (1980 - early 1990s) in promoting technology-driven growth:

The United States' technological lead was driven in no small part by the brain power of brilliant immigrants, many of whom

came from India. The inestimable contributions of thousands of highly trained Indian migrants in every area of American scientific and technological achievement culminated with the information technology revolution most associated with California's Silicon Valley in the 1980s and 1990s.

The National Informatics Centre was established in March 1975. The inception of The Computer Maintenance Company (CMC) followed in October 1976. During 1977-1980 the country's Information Technology companies Tata Infotech, Patni Computer Systems and Wipro had become visible. The 'microchip revolution' of the 1980s had convinced both Indira Gandhi and her successor Rajiv Gandhi that electronics and telecommunications were vital to India's growth and development. MTNL underwent technological improvements. During 1986-1987, the Indian government embarked upon the creation of three wide-area computer networking schemes: INDONET (intended to serve the IBM mainframes in India), NICNET (the network for India's National Informatics Centre), and the academic research oriented Education and Research Network (ERNET).

9.3.2 Post liberalization

In 1991 the Department of Electronics broke this impasse, creating a corporation called Software Technology Parks of India (STPI) that, being owned by the government, could provide VSAT communications without breaching its monopoly. STPI set up software technology parks in different cities, each of which provided satellite links to be used by firms; the local link was a wireless radio link. In 1993 the government began to allow individual companies their own dedicated links, which allowed work done in India to be transmitted abroad directly. Indian firms soon convinced their American customers that a satellite link was as reliable as a team of programmers working in the clients' office.

Videsh Sanchar Nigam Limited (VSNL) introduced Gateway Electronic Mail Service in 1991, the 64 kbit/s leased line service in 1992, and commercial Internet access on a visible scale in 1992. Election results were displayed via National Informatics Centre's NICNET.

The Indian economy underwent economic reforms in 1991, leading to a new era of globalization and international economic integration. Economic growth of over 6% annually was seen during 1993-2002. The economic reforms were driven in part by significant the internet usage in the country. The new administration under Atal Bihari Vajpayee—which placed the development of Information Technology among its top five priorities— formed the Indian National Task Force on Information Technology and Software Development.
Wolcott & Goodman (2003) report on the role of the Indian National Task Force on Information Technology and Software Development:

Within 90 days of its establishment, the Task Force produced an extensive background report on the state of technology in India and an IT Action Plan with 108 recommendations. The Task Force could act quickly because it built upon the experience and frustrations of state governments, central government agencies, universities, and the software industry. Much of what it proposed was also consistent with the thinking and recommendations of international bodies like the *World Trade Organization* (WTO), International Telecommunications Union (ITU), and World Bank. In addition, the Task Force incorporated the experiences of Singapore and other nations, which implemented similar programs. It was less a task of invention than of sparking action on a consensus that had already evolved within the networking community and government.

9.3.3 The New Telecommunications Policy, 1999

(NTP 1999) helped further liberalize India's telecommunications sector. The Information Technology Act 2000 created legal procedures for electronic transactions and e-commerce.
Throughout the 1990s, another wave of Indian professionals entered the United States. The number of Indian Americans reached 1.7 million by 2000. This immigration consisted largely of highly educated technologically proficient workers. Within the United States, Indians fared well in science, engineering, and management. Graduates from the Indian Institutes of Technology (IIT) became known for their technical skills. The success of Information Technology in India not only had economic repercussions but also had far-reaching political consequences. India's reputation both as a

source and a destination for skilled workforce helped it improve its relations with a number of world economies. The relationship between economy and technology—valued in the western world—facilitated the growth of an entrepreneurial class of immigrant Indians, which further helped aid in promoting technology-driven growth.

9.3.4 Recent development

The economic effect of the technologically inclined services sector in India—accounting for 40% of the country's GDP and 30% of export earnings as of 2006, while employing only 25% of its workforce—is summarized by Sharma (2006):

The share of IT (mainly software) in total exports increased from 1 percent in 1990 to 18 percent in 2001. IT-enabled services such as backoffice operations, remote maintenance, accounting, public call centers, medical transcription, insurance claims, and other bulk processing are rapidly expanding. Indian companies such as HCL, TCS, Wipro, and Infosys may yet become household names around the world.

Today, Bangalore is known as the Silicon Valley of India and contributes 33% of Indian IT Exports. India's second and third largest software companies are head-quartered in Bangalore, as are many of the global SEI-CMM Level 5 Companies.

Mumbai too has its share of IT companies that are India's first and largest, like TCS and well established like Reliance mPatni, LnT Infotech, i-Flex, WNS, Shine, Naukri, Jobspert etc. are head-quartered in Mumbai. And these IT and dot com companies are ruling the roost of Mumbai's relatively high octane industry of Information Technology.

Such is the growth in investment and outsourcing, it was revealed that Cap Gemini will soon have more staff in India than it does in its home market of France with 21,000 personnel+ in India.[7]

On 25 June 2002 India and the European Union agreed to bilateral cooperation in the field of science and technology. A joint EU-India group of scholars was formed on 23 November 2001 to further promote joint research and development. India holds observer status at CERN while a joint India-EU Software Education and Development Center is due at Bangalore.

9.3.5 Automation

For a hierarchical presentation of automation topics, see Outline of automation. For other uses, see Automation (disambiguation).

Automation is the use of control systems and information technologies to reduce the need for human work in the production of goods and services. In the scope of industrialization, automation is a step beyond mechanization. Whereas mechanization provides human operators with machinery to assist them with the muscular requirements of work, automation greatly decreases the need for human sensory and mental requirements as well. Automation plays an increasingly important role in the world economy and in daily experience.

Automation has had a notable impact in a wide range of industries beyond manufacturing (where it began). Once-ubiquitous telephone operators have been replaced largely by automated telephone switchboards and answering machines. Medical processes such as primary screening in electrocardiography or radiography and laboratory analysis of human genes, sera, cells, and tissues are carried out at much greater speed and accuracy by automated systems. Automated teller machines have reduced the need for bank visits to obtain cash and carry out transactions. In general, automation has been responsible for the shift in the world economy from industrial jobs to service jobs in the 20th and 21st centuries.

The term *automation*, inspired by the earlier word *automatic* (coming from *automaton*), was not widely used before 1947, when General Motors established the automation department. At that time automation technologies were electrical, mechanical, hydraulic and pneumatic. Between 1957 and 1964 factory output nearly doubled while the number of blue collar workers started to decline.

9.3.6 Advantages and disadvantages

The main advantages of automation are:

- Replacing human operators in tasks that involve hard physical or monotonous work.
- Replacing humans in tasks done in dangerous environments (i.e. fire, space, volcanoes, nuclear facilities, underwater, etc.)

- Performing tasks that are beyond human capabilities of size, weight, speed, endurance, etc.
- Economy improvement: Automation may improve in economy of enterprises, society or most of humanity. For example, when an enterprise invests in automation, technology recovers its investment; or when a state or country increases its income due to automation like Germany or Japan in the 20th Century.
- Reduces operation time and work handling time significantly.
- Frees up workers to take on other roles.
- Provides higher level jobs in the development, deployment, maintenance and running of the automated processes.

The main disadvantages of automation are:

- Security Threats/Vulnerability: An automated system may have a limited level of intelligence, and is therefore more susceptible to committing an error.
- Unpredictable development costs: The research and development cost of automating a process may exceed the cost saved by the automation itself.
- High initial cost: The automation of a new product or plant requires a huge initial investment in comparison with the unit cost of the product, although the cost of automation is spread among many products.

In manufacturing, the purpose of automation has shifted to issues broader than productivity, cost, and time.

9.3.7Reliability and precision

The old focus on using automation simply to increase productivity and reduce costs was seen to be short-sighted, because it is also necessary to provide a skilled workforce who can make repairs and manage the machinery. Moreover, the initial costs of automation were high and often could not be recovered by the time entirely new manufacturing processes replaced the old. (Japan's "robot junkyards" were once world famous in the manufacturing industry.)
Automation is now often applied primarily to increase quality in the manufacturing process, where automation can increase quality substantially. For example, internal combustion engine pistons used

to be installed manually. This is rapidly being transitioned to automated machine installation, because the error rate for manual installment was around 1-1.5%, but has been reduced to 0.00001% with automation

9.3.8Health and environment

The costs of automation to the environment are different depending on the technology, product or engine automated. There are automated engines that consume more energy resources from the Earth in comparison with previous engines and those that do the opposite too. Hazardous operations, such as oil refining, the manufacturing of industrial chemicals, and all forms of metal working, were always early contenders for automation.

9.3.9Convertibility and turnaround time

Another major shift in automation is the increased demand for flexibility and convertibility in manufacturing processes. Manufacturers are increasingly demanding the ability to easily switch from manufacturing Product A to manufacturing Product B without having to completely rebuild the production lines. Flexibility and distributed processes have led to the introduction of Automated Guided Vehicles with Natural Features Navigation.

Digital electronics helped too. Former analogue-based instrumentation was replaced by digital equivalents which can be more accurate and flexible, and offer greater scope for more sophisticated configuration, parametrization and operation. This was accompanied by the fieldbus revolution which provided a networked (i.e. a single cable) means of communicating between control systems and field level instrumentation, eliminating hard-wiring.

Discrete manufacturing plants adopted these technologies fast. The more conservative process industries with their longer plant life cycles have been slower to adopt and analogue-based measurement and control still dominates. The growing use of Industrial Ethernet on the factory floor is pushing these trends still further, enabling manufacturing plants to be integrated more tightly within the enterprise, via the internet if necessary. Global competition has also increased demand for **Reconfigurable Manufacturing Systems.**

9.3.0Automation tools

Engineers now can have numerical control over automated devices. The result has been a rapidly expanding range of applications and human activities. Computer-aided technologies (or CAx) now serve the basis for mathematical and organizational tools used to create complex systems. Notable examples of CAx include Computer-aided design (CAD software) and Computer-aided manufacturing (CAM software). The improved design, analysis, and manufacture of products enabled by CAx has been beneficial for industry.[4]
Information technology, together with industrial machinery and processes, can assist in the design, implementation, and monitoring of control systems. One example of an industrial control system is a programmable logic controller (PLC). PLCs are specialized hardened computers which are frequently used to synchronize the flow of inputs from (physical) sensors and events with the flow of outputs to actuators and events.[5]
An automated online assistant on a website, with an avatar for enhanced human–computer interaction.
Human-machine interfaces (HMI) or computer human interfaces (CHI), formerly known as *man-machine interfaces*, are usually employed to communicate with PLCs and other computers. Service personnel who monitor and control through HMIs can be called by different names. In industrial process and manufacturing environments, they are called operators or something similar. In boiler houses and central utilities departments they are called stationary engineers.[6]
Different types of automation tools exist:

- ANN - Artificial neural network
- DCS - Distributed Control System
- HMI - Human Machine Interface
- SCADA - Supervisory Control and Data Acquisition
- PLC - Programmable Logic Controller
- PAC - Programmable automation controller
- Instrumentation
- Motion control
- Robotics

9.3.11 Limitations to automation

- Current technology is unable to automate all the desired tasks.
- As a process becomes increasingly automated, there is less and less labor to be saved or quality improvement to be gained. This is an example of both diminishing returns and the logistic function.
- Similar to the above, as more and more processes become automated, there are fewer remaining non-automated processes. This is an example of exhaustion of opportunities.

The General Assembly of UNO resolved in December 1996 to create a United Nations Commission on International Trade Law (UNCITRAL) to promote progressive harmony and unification of the law of international trade. The objective was to remove unnecessary obstacles to international trade caused by inadequacies and divergence in legal enactments of the member countries.

In tune with such international developments, India has enacted the Information Technology Act, 2000 (IT Act) while giving due consideration to the Committee recommendations on Electronic Funds Transfer Scheme.

The Information Technology Act, 2000 has come into force w.e.f. 17.10.2000 and covers all states including Jammu and Kashmir. The IT Act is made applicable to cyber crimes committed in and outside India. The Act brings into its ambit recognition and authentication of electronic transactions, records and digital signatures. A legal framework for regulating the e-commerce transactions and imposition of punishments and penalties for violating the regulations is also put in place by the Act.

The Act also considers the local realities in India such as the lack pf infrastructure for new technology and functional alternatives in certain transactions by excluding certain instruments from the purview of the .Act.

9.3.12LEGAL-ERAMEWORK FOR IT RELATED TRANSACTIONS

The Information Technology Act, 2000

OBJECTS

To provide legal recognition to transactions carried out by means of electronic data interchange and other electronic communication commonly referred to as electronic commerce (e-commerce). E-commerce is regarded as an alternative to the paper based method of communication and storage of information.
To facilitate electronic filing of documents with government departments/ agencies.
To bring suitable amendments to the existing laws in pursuit of the objectives of the Act.
To give favorabic consideration to the model law recommended by UNCITRAL to maintain harmony with international laws.

9.3.13 EXCLUSION OF INSTRUMENTS/CONTRACT FROM THE PURVIEW OF ACT

Having regard to the existing stage of development in the Information Technology Area and computer literacy in our country, the Information Technology Act, 2000, Section I (4) provides that the Act shall not apply to:
a. A negotiable instrument as defined in Section 13 of the Negotiable Instruments Act, 1881 (excluding cheques as amended).
b. Power of attorney as defined in Section I A of the power of Attorney Act, 1882.
c. A trust as defined in Section 3 of the Indian Trusts Act, 1882 (2 of 1882).
d. A will as defined in Clause (h) of Section 2 of the Indian Succession Act, 1925 including any other testamentary instrument.
e. Any contract for sale or conveyance of immovable property or any interest in such property.
The law governing the business transactions ,3 the Indian Contract Act, 1872. Under the Indian Contract Act, 1872, the acceptance of a valid offer results in a valid contract. It is crucial to know when a contract is concluded online and whether any difference exists between contracts concluded by traditional modes. such as by post. Section 4 deals with the rule regarding completion of the communication of acceptance.

The communication of acceptance is complete as against the offeree, when it reaches the knowledge of offeror. But the Supreme Court has held that in the case of communication by oral means, by telex or by telephone an acceptance is communicated only when it is actually received by the offeror. The question that would arise is when has the acceptance been conveyed. i.e. (a) when the e-mail was sent; or (b) when it was received by the addressee; or (c) when it reaches the 'host computer', which provides the e-mail facility to the addressee.'

Determinants of the liability arising out of a contract are:

- Time and place of contract.
- Time and place of communication of acceptance by the offered.
- Time and place of communication of acceptance received by the offer or.

Section 4 of the Indian Contract Act, 1872 deals with the rule regarding completion of the communication of acceptance. As per this Section, the communication of acceptance is complete *as against the offered,* when it is put in a course of transmission to him so as to be out of the power of the acceptor. The Supreme Court in *Bhagwandas vs. GirdharilaP* has held that Section. 4 of the Contract Act is only applicable in cases of non-instantaneous forms of communication and would not apply when instantaneous forms of communication are used. The contract is complete only at the end of the off error when he received the acceptance to offer. The place of offer or where acceptance is received shall have the jurisdiction for enforcement.

In the case of e-commerce, acceptance is made via e-mail or by pressing the 'Accept' or 'Buy' icons. A contract through Internet is complete only when an acceptance is received at the end of the originator.

E-mail contracts may be categorized under the non-instantaneous forms of ;;communication. Though the sender receives an acknowledgement, it does not indicate whether the other party has the knowledge of the receipt. Thus the above rule enunciated in *Bhagwandas vs. Girdharilal,* would be applicable to e-mail contracts. In the case of web-click contracts, a contract is completed when the offeror receives

the acceptance. Further, communication of an offer or acceptance in the web-click mode is complete when the addressee receives the electronic record as defined in Section 13 (2) of the IT Act (Time and Place of Contract).3 Receipt occurs at thc time when the electronic :record enters the desiglla~td computer resource. Contract through Internet being instantaneous the contract is complete at the end of the offer or where acceptance is received.

9.3.14 VALIDITY OF ONLINE CONTRACTS

The validity and the formation of contracts forms the kernel of e-commerce law. The Indian Contract Act, 1872 gives a statutory effect to the basic common law contractual rule that a valid contract may be formed if it is made by free consent of the parties, competent to contract, for a lawful consideration and for a lawful object and which is not *void ab initio.* The Contract Act does not prescribe or favour any particular way of communicating the offer dnd its acceptance. It may be done by word of mouth, writing or even by conduct. Thus, there is no requisite of writing for the validity of contracts except for cases, which are specifically required by law to be in writing. It would appear that even in the absence of any specific legislation, validating online contracts cannot be challenged solely on such technical grounds. Therefore, the IT Act avoids incorporating any specific provision giving validity to online contracts.

9.3.15 TIME OF FORMATION OF CONTRACT

The importance of time of the formation of contract is well known viz., to decide priorities between competing claims, to determine the law applicable to the contract etc. The time aspect of the contract formation is also important in ascertaining the place aspect of the contract formation.

Coming back to the Indian Information Technology Act, 2000 section I3 provides the framework for understanding the principles of contract formation in the cases of electronic contracts. It lays down *inter alia,* that unless otherwise agreed:

The dispatch of an electronic record occurs when it enters a computer resource outside the control of the originator.
The time of receipt of an electronic record is the time when the record enters the designated computer resource (ifthe addressee has a designated computer resource).
If the electronic record is sent to a computer resource of the addressee that is not the designated computer resource, receipt occurs at the time when the electronic record is retrieved by the addressee.
If the addressee has not designated a computer resource along with specified timings, if any, receipt occurs when the electronic record enters the computer resource of the addressee.
However, the above rules do not tell us anything more than when the dispatch and receipt of electronic records takes place. Therefore, in order. to understand the rules relating to the electronic contract formation, the principles of the Indian Contract Act will have to be applied in this context. Section 4 of the Contract Act lays down the following rules regarding the communication of offers and acceptances:
The communication of a proposal is complete when it comes to the knowledge of a person to whom it is made.
The communication of an acceptance is complete - as against the proposer, when it is put in a course of transmission to him, so as to be out of the power of the acceptor; as against t'"Je acceptor, when it comes to the knowledge of the proposer.
The communication of a revocation is complete as against the person who makes it, when it is put into a course of transmission to the person to whom it is made, so as to be out of the power of the person who makes it; as against the person to whom it is made, when it comes to his knowledge.
A combined appiicat;ol1 of sectjan 4 of the Contr;1l,;t Act and section 13 of the IT Act would reveal the following law for contract formation in the case of electronic contracts in the event that nothing contrary has been agreed to between the parties in their contract:

a. The communication of an offer becomes complete at the time when the electronic offer enters any information system designated by the offered for the purpose, or, if no system is designated for the purpose, when the

electronic offer enters the information system of the offeree, or if any information system has been designated, but the electronic offer is sent to some other informal.ion system, when the offeree retrieves such electronic record.

b. The communication of an acceptance is complete - as against the offer or when the electronic acceptance is dispatched such that it enters a computer resource outside the control of the acceptor.

9.3.16 AUTHENTCA TION OF ELECTRONIC RECORDS

A record is the documentation of a transaction that happens as a result of someone taking a particular action at a particular time - so it is the *evidence,* the proof, of
what has happened, who was involved and when. There have been discussions during the past decade of what a record is in an electronic environment. Electronic records are extremely good at generating and storing data, but much less adequate at identifying when that data could be considered a record.
Purpose: *Records* are kept to provide evidence of business activity; *documents* may be kept for a wide range of purposes, including for use of the information they contain and for recycling into other documents.
Context: Records are created in the course of business and thereby document business transactions; documents mayor may not be created in the course of business and be connected with a business transaction.
On this basis, most records are also documents and some documents are also records. But a document only functions as a record if it was created or received in the course of business *and* has been kept as evidence of that business activity. In other words, a document becomes a record when it takes part in a business transaction and is kept to provide evidence. One creates a document when one composes an electronic mail message; it becomes a record when one sends it.

9.3.17 Meaning of Electronic Record

The meaning of electronic record has to be understood in the light of the context it is used. Electronic record as a mere document might not be much relevant or significant whereas electronic record as a document of evidence needs a judicious explanation and legal recognition. In general an "electronic record" is simply a record, which is... communicated and maintained by means of electronic equipment."

Electronic documents are recognized as equivalent to written documents. Digital signature is recognized as equivalent to written signature and the use of electronic documents and payments in Government transactions is enabled.

The importance of legal recognition of digital signatures in the facilitation of ecommerce needs little mention. The Act provides legal recognition to digital signatures and also envisages a scheme of digital signature certificates to be issued by the third parties. The Model Law offers a broad definition of digital signatures and is technologically neutral. However, the Information Technology Act in Section; while trying to define the digital signature seeks to circumscribe it within certain technological limits. It provides that authentication of an electronic record can only be affected by the asymmetric crypto system and hash function.

In the virtual world where raid change and progress is the norm, it is absurd to restrictively legalize the use of a particular technology in the form of asymmetric crypto system.

9.3.18 Authentication by - Digital Signatures

Section 3 of Chapter II of the Information Technology Act, 2000 deals with authentication of electronic records and transactions:

Subject to the provisions, any subscriber may authenticate an electronic record by affixing his digital signature.

The authentication shall b~ effected by the use of asymmetric crypto system and hash function that envelops and transforms the initial electronic record into another electronic record.

Digital signature is evolved under two steps. First, the electronic record is converted into a message digest by hash function. This ensures integrity of the content of communication.

Secondly, the identity of the person affixing the digital signature is authenticated through the use of a private key which attaches itself to the message digest and which can be verified by any person who has the public key corresponding to such private key. The private and public keys are unique to the subscriber and constitute a functional key pair. Any person can verify the electronic record by using the public key of the subscriber.

Section 4 of the Act confers recognition for electronic records rendered or made available/accessible so as to be usable for subsequent references. Section 5 recognizes the digital signature as equal to affixing signature.

Section 6 enables electronic governance by permitting the filing of any form, application or other documents, creation, retention or preservation of records, issue or grant of any license or permit or receipt or payment in government offices and its agencies through the means of electronic form.

Section 7 deals with retention of electronic records that represent accurately the information originally generated, sent or received.

9.3.19 LEGAL STATUS FOR ELECTRONIC RECORDS

Amendments to Negotiable Instruments Act

Some changes that have been brought into the Negotiable Instrument Act, 1881 by the Amendment Act, 2002 are given below:

The definition of Cheques in Section 6 of the Negotiable Instrument Act and Section 13 of the Information Technology Act is amended to include truncated and electronic clearance of cheques. As per Explanation I (a) to Section 6, 'a cheque in the electronic form' means a cheque which contains the exact mirror image of a paper cheque, and is generated, written and signed by a secure system ensuring the minimum safety standards with the use of digital signature (with or without biometrics signature) and asymmetric crypto system.

As per Explanation I (b) to Section 6, 'a truncated cheque' means a cheque which is truncated during the clearing cycle, either by the clearing house during the course of a clearing cycle, either by the clearing house or by the bank whether

paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.
According to Section 5, "A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument". Section (I)(4)(a) of the Information Technology Act provides that the Act will not apply to the Bill of Exchange. Thus, a bill of exchange cannot be made by electronic means.
With regard to the amendments that are made to NI Act, 1881, even in IT Act also certain amendments are being made. Section 81-A was added after Section 81. Section 81- A of the Act applies to electronic cheque and truncated cheque. According to Sec 81-A, the provisions of this Act, for the time being in force, shall apply to, or -in relation to, electronic cheques and the truncated cheques-subject to such modifications and amendments as may be necessary for carrying out the purposes 'of the Negotiable Instruments Act, 1881 (26 of]881) by the Central Government, in consultation with the Reserve Bank of India, by notification in the Official Gazette.

9.3.20 Amendment to RBI Act, 1934

Section 94 of the 4th Schedule of Information Technology Act, 2000 enables the following amendment vesting the statutory power with RBI to regulate Electronic Funds Transfer.
According to Section 58 of the RBI Act, 1934, Sub-section (2) after Clause (P) - (PP),
"The regulation of funds transfer through electronic means between banks or between banks and other financial institutions shall participate in such fund transfers, the manner of such fund transfers and rights and obligations of participants in such transfers."

9.3.21 Amendment to Banker's Books Evidence Act, 1891 -- Inclusion of

Electronic Data/Records as Evidence

Third Schedule (Section 93) of Information Technology Act, 2000 substitutes as follows:
Section (2) Clause (3) Bankers books include "ledgers and books, day books, cash books, account books, and all other books used in ordinary business of a bank whether kept in written form or as printouts of data stored in a floppy, disc, tape or any other form of electro-magnetic data storage device.
Section 2(8) refers to certified copies through mechanical or other processes which in itself assume the accuracy of a copy.
Section 2(8)(b) consists of printouts of data stored in a floppy, disc, tape or any other electro-magnetic data, storage device, a printout of such entry or a copy of such printout together with such certificate as per provisions of Section 2-A. Section 2-A stipulates the conditions in the certificate accompanying the printouts. . A certificate to the effect that it is a printout of such entry or copy of such printout by the principal accountant or a branch manager. A certificate by a person-in-charge of the computer system containing a brief description of the computer system and the particulars. of safeguards adopted by the system to ensure operation by the authorized persons; prevent and detect unauthorized change of data: retrieve data that is lost due to systemic failure or a; other reason; - prevent and detect any tampering with the system. Particulars of the manner in which data is transferred from the "system to removal media like floppies, discs, tapes or other electro-magnetic data storage devices; the mode of verification in order to ensure that data has been accurately transferred to such removable media; the mode of identification of such data storage devices; the arrangements for the storage and custody of such storage devices; any other factor which will vouch for the integrity and accuracy of the system.
A further certificate from the person-in-charge of the computer system to the effect that to the best of his knowledge and belief such computer system operated properly at the material time and he was provided with all the relevant data and the printout in question represents correctly or is appropriately derived from the data.

9.3.22 CYBER OFFENCES AND PENALTIES

The Act provides for stringent punishment for Cyber crimes like theft of data, hacking and tampering with the confidentiality of the data. The Act also creates a legal framework for electronic transactions and usage of the digital signatures.

The Information Technology Act, 2000 is a major enactment initiative to provide legal frameworks for security provisions of e-commerce in harmony with international cyber laws. Banker's vigilance has to cover new areas coming under e-commerce with the support of the Information Technology Act. In the context of low computer literacy level of customers, the present law could serve the purpose adequately. It is equally important to note that majority of the legal claims fall under the purview of existing Acts like Indian Contracts Act, Negotiable Instruments Act and Sale of Goods Act and there is no conflict between these laws and the Information Technology Act. The Information Technology Act has only enabled the insertion of suitable clauses to envelope the electronic forms of banking transactions, which arc otherwise already offered :n the existing laws. Probably, in the years to come when electronic banking takes full shape, codification of various provisions of different enactments under a comprehensive legislation may become necessary.

The following tables summarize the nature of various cyber crimes and penalties imposed under IT Act, 2000.

Figure: 1
Classification of Crimes

Against individuals	Against Individual Property	Against Organization	Against society at Large
Harassment via emails **Cyber stalking** **Sending of obscene material** **Defamation** **Unauthorized**	**Transmitting virus** **Net trespass** **Unauthorized control** **IP crimes** **Time-thefts**	**Unauthorized control** **Possession of unauthorized information** **Cyber terrorism** **Cyber**	**Pomography** **Trafficking** **Financial crimes** **Sale of illegal articles** **Online gambling**

control over computer Indecent exposure Email spooling Cheating and Fraud		**terrorism Distribution of pirated software**	**Forgery**

Offences and Penalties under I.T. Act, 2000

Table 2

Offence	Penalty	Section
Damaging Computer/System/Data/ Network Without the permission of the owner or person in charge of a computer system Securing access to the system. Downloading data or copying them Computer Contamination/Injecting virus. Denial of access to other authorized persons. Changing the series availed by the person to the account of another person by tempering or manipulating the computer system or network	**Compensation up to rupees one crore to the person affected.**	**43**
Non-compliance with Reporting System Failure to furnish any document/return or report to the controller of certifying authority. Failure to file any returns of	**Not exceeding Rs. 1.50 lakh for each failure** **Not, exceeding Rs. 5,000 per day during the**	**44 (a)** **44(b)**

furnish any information, books or other documents within the time stipulated. Failure to maintain books of account or record. Contravention of any rules or regulations for which no specific penalty is provided elsewhere in the Act.	period of non-compliance. Up to Rs. 10000 per day. Compensation up to rs. 25000 to the affected person or a penalty up to Rs. 250000	44© 45
Tampering Tempering with computer source document–concealing, destroying, altering	Imprisonment up to 3 years or fine upto Rs. 2 lakh or with both.	65
Hacking Hacking with computer system causing wrongful loss or damage to public or any person. Deleting, altering, destroying any information residing in the computer	Imprisonment up to 3 years or fine upto Rs. 2 lakh or both.	66 (2)
Transmission of Obscene Material Publishing or transmitting obscene material in electronic form.	Imprisonment upto 5 years and fine upto Rs. 1 lakh for first conviction. Imprisonment upto 10 years and fine upto Rs. 2 lakh for second and subsequent convicitions.	67

Offence	Penalty	Section
Misrepresentation to Controller of Certifying Authority Mis- representation nor sup oppression of material facts to the controller of certifying authority to obtain Digital Signature Certificate.	**Imprisonment upto 2 years of fine upto Rs. 1 lakh or both.**	**71**
False information in Digital Signature Certificate Publishing Digital Signature Certificate with false particulars	**Imprisonment upto 2 years of fine upto Rs. 1 lakh or both.**	**73**
Breach of Confidentiality Securing access to electronic record disclosing electronic record/information documents.	**Imprisonment upto 2 years or fine upto Rs. 1 lakh or both.**	**72**
Misuse of Digital Signature Certificate Creating, publishing or making available a Digital Signature Certificate for any fraudulent or unlawful purpose	**Imprisonment upto 2 years or fine upto Rs. 1 lakh or both.**	**74**

9.4 Question

1.Give in brief the History of Information Technology in India?
2. What are recent development in this area?
3. What do you mean by Automation?
4.Define Objective of Information Technology Act 2000?
5. What are electronic records?

9.5 Suggested Readings

1. Information Technology Act 2000
2. Reserve Bank of India Act 1934
3. The Indian Telegraph Act 1885
4. Cyber Law Intellectual Property and e-commerce security by Krishna Kumar.
5. The Indian Cyber Law by Suresh. T. Vishwawnathan.
6. Cyber Regulatory Appellate Tribunal Rules (2000)
7. National Information Technology Policy.

LL.M. 1st Year
Paper–Banking law

Block- III :Relationship of Banker and Customer and Recent Trends of Banking System in India

Unit-10: Use of Internet, Smart Card, Use of expert system, Credit Cards.

STRUCTURE

10.1 Introduction

The Internet was the result of some visionary thinking by people in the early *1960s* who saw great otential value in allowing computers to share information on research and development in scientific and military fields. J.C.R. Licklider of MIT, first proposed a global network of computers in 1962, and moved over to the Defense Advanced Research Projects Agency (DARPA) in late 1962 to head the work to develop it. Leonard Kleinrock of MIT and later UCLA developed the theory of packet switching, which was to form the basis of Internet connections. Lawrence Roberts of MIT connected a Massachusetts computer with a California computer in 1965 over dial-up telephone lines. It showed the feasibility of wide area networking, but also showed that the telephone line's circuit splotching was inadequate. Kleinrock's packet switching theory was confirmed. Roberts moved over to DARPA in 1966 and developed his plan for ARPANET. These visionaries and many more left unnamed here are the real founders of the Internet.

When the late Senator Ted Kennedy heard in 1968 that the pioneering Massachusetts company BBN had won the ARPA contract for an "interface message processor (IMP)," he sent a congratulatory telegram to BBN for their ecumenical spirit in winning the "interfaith message processor" contract.

The Internet, then known as ARPANET, was brought online in 1969 under a contract let by the renamed Advanced Research Projects Agency (ARPA) which initially connected four major computers at universities in the southwestern US (UCLA, Stanford Research Institute, UCSB, and the University of Utah). The contract was carried out by BBN of Cambridge, MA under Bob Kahn and went online in December 1969. By June 1970, MIT, Harvard, BBN, and Systems Development Corp (SDC) in Santa Monica, Cal. were added. By January 1971, Stanford, MIT's Lincoln Labs, Carnegie-Mellon, and Case-Western Reserve U were added. In months to come, NASA/Ames, Mitre, Burroughs, RAND, and the U of Illinois plugged in. After that, there were far too many to keep listing here.

Who was the first to use the Internet?

Charley Kline at UCLA sent the first packets on Arpanet as he tried to connect to Stanford Research Institute on Oct 29, 1969. The system crashed as he reached the G in LOGIN!

The Internet was designed to provide a communications network that would work even if some of the major sites were down. If the most direct route was not available, routers would direct traffic around the network via alternate routes.

The early Internet was used by computer experts, engineers, scientists, and librarians. There was nothing friendly about it. There were no home or office personal computers in those days, and anyone who used it, whether a computer professional or an engineer or scientist or librarian, had to learn to use a very complex system.

Did Al Goreinvent the Internet?

According to a CNN transcript of an interview with Wolf Blitzer, Al Gore said,"During my service in the United States Congress, I took the initiative in creating the Internet." Al Gore was not yet in Congress in 1969 when ARPANET started or in 1974 when the term Internet first came into use. Gore was elected to Congress in 1976. In fairness, Bob Kahn and Vint Cerf acknowledge in a paper titled Al Gore and the Internet that Gore has probably done more than any other elected official to support the growth and development of the Internet from the 1970's to the present.

E-mail was adapted for ARPANET by Ray Tomlinson of BBN in 1972. He picked the @ symbol from the available symbols on his teletype to link the username and address. The telnet protocol, enabling logging on to a remote computer, was published as a Request for Comments (RFC) in 1972. RFC's are a means of sharing developmental work throughout community. The ftp protocol, enabling file transfers between Inte~net sites, was published as an RFC in 1973, and from then on RFC's were available electronically to anyone who had use of the ftp protocol.

Libraries began automating and networking their catalogs in the late 1960s independent from ARPA. The visionary Frederick G. Kilgour of the Ohio College Library Center (now

OClC, Inc.) led networking of Ohio libraries during the '60s and '70s. In the mid 1970s more regional consortia from New England, the Southwest states, and the Middle Atlantic states, etc., joined with Ohio to form a national, later international, network. Automated catalogs, not very user-friendly at first, became available to the world, first through telnet or the awkward IBM variant TN3270 and only many years later, through the web. See The History of OClC

Ethernet, a protocol for many local networks, appeared in 1974, an outgrowth of Harvard student Bob Metcalfe's dissertation on "Packet Networks." The dissertation was initially rejected by the University for not being analytical enough. It later won acceptance when he added some more equations to it.

The Internet matured in the 70's as a result of the TCPjIP architecture first proposed by Bob Kahn at BBN and further developed by Kahn and Vint Cerf at Stanford and others throughout the 70's. It was adopted by the Defense Department in 1980 replacing the earlier Network Control Protocol (NCP) and universally adopted by 1983.

The Unix to Unix Copy Protocol (UUCP) was invented in 1978 at Bell labs. Usenet was started in 1979 based on UUCP. Newsgroups, which are discussion groups focusing on a topic, followed, providing a means of exchanging information throughout the world. While Usenet is not considered as part of the Internet, since it does not share the use of TCPjIP, it linked unix systems around the world, and many Internet sites took advantage of the availability of newsgroups. It was a significant part of the community building that took place on the networks.

10.2 Objective

Internet has been the most useful technology of the modern times which helps us not only in our daily lives, but also our personal and professional lives developments. The internet helps us achieve this in several different ways.

For the students and educational purposes the internet is widely used to gather information so as to do the research or add to the knowledge of any sort of subject they have. Even the business personals and the professions like doctors,

access the internet to filter the necessary information for their use. The internet is therefore the largest encyclopedia for everyone, in all age categories.

The internet has served to be more useful in maintaining contacts with friends and relatives who live abroad permanently. The easiest communication means like the internet chatting systems and the emails are the best and the most common for the maintaining contacts with the people around the world.

Not to forget internet is useful in providing with most of the fun these days. May it be all the games, and networking conferences or the online movies, songs, dramas and quizzes, internet has provided the users with a great opportunity to eradicate the boredom from their lives.

Internet is also used to upgrade the internet and use special software to work on the projects and documentation works as the internet enables the user to download a myriad of different software for a variety of different purposes, making it much easier than buying the costly software cds.

10.3.1 Use in Internet

The use of the Internet offers a variety of benefits to everyone who is willing to use it. The enormous amount of information available and the many uses one can have through the internet have made it the most valuable tool in various settings of a person's life. The Internet has an enormous amount of publications added on it every day and it's evolving as the most powerful source of information. Also, use of the Internet has made jobs easier and oversimplified tasks that would take an enormous amount of time before. Moreover, the Internet has become a great tool for avoiding the hassles of the bank, offering the chance to make the transactions quickly and safely. It also offers a powerful source for shopping and the easiness of having your products delivered straight to your house, should you decide you do not want to go out. Furthermore, the widespread use of the Internet has opened new areas of jobs in all countries and expanded the availabilities of working from home. Last, the Internet is one of the most valuable tools in educations since it provides an

enormous amount of information and is the greatest source of reference for educators and students. The electronic libraries are of utmost importance for University students looking for scientific information for their courses. Another major benefit of the internet is its ability to minimize distances and provide communication services efficiently and without any cost. In general, the Internet is a multi-tool with applications on every aspect of someone's life.

10.3.2 THE INTERNET (R) EVOLUTION

The available material, programs, websites and other services of the internet are multiplied every day, revolutionizing the technology being used. Its applications grow exponentially and it would be impossible to outline everything in this booklet. The most important aspect of the Internet evolution however, is that its exponential growth allows it to ease and transform people's life and increase their knowledge.

10.3.3 THE PRECIOUSNESS OF TIME

Some people say "time is money". Some others say that time is precious and should not be wasted. Whatever applies to you however, one thing is true: Today's needs and demands of society have taken over our time that feels it's not enough for doing everything we need to be doing every day. The appearance of the Internet saving matter came as a life saver for many tasks that would take days to complete before. The ability of the internet to store materials, its ability to calculate instantly almost anything, and its worldwide application databases had made tasks much easier and less time consuming in almost every industry on the planet.

10.3.4 THE INTERNET BANK

The advanced technologies of the internet managed to free people from the hassles of losing an enormous amount of time waiting in the line to be served at the bank branches. Internet banking is the easy way of dealing with bank transactions safely and quickly. Internet banking offers a wide lange of

transactions that can be done including bill payments and transfers. Internet banking is convenient also in that it is available twenty-four hours a day.

10.3.5 THE INTERNATIONAL MARKET

Did you ever find yourself in a position that urgently needed to go out and buy something but was not in the mood or did not have the time to go out and do it? If your answer is yes, then the internet can solve your problem. The Internet enables you to buy anything you need from the comfort of your own house. Many supermarkets take online orders and deliver the stock within the day at your doorstep. Many consumer stores offer online purchases about almost anything you can imagine (shoes, clothes, apparel, accessories). Online shopping can save you time and money since it offers a wide range of specials in much cheaper prices than what you will find in the actual stores.

10.3.6 THE UNEMPLOYMENT AGENT

Another benefit that the internet has brought into our lives is that ever since the internet has been introduced, new areas of jobs and careers have opened up to the public. Web designing, computer technician and programmer, are among the many that are found at their peak demand for employers. Almost every company nowadays, needs to have a website that promotes its products and patents that web designers are among the most highly requested professionals needed. Furthermore, consultants, sellers, dealers and all sorts of professionals are needed to promote and help people over the internet. The training needed is of high education and career opportunities through the web are exquisite. Housewives, mothers and disabled people, can now have a chance to work from their house and earn money that would otherwise be difficult to obtain.

THE TREASURE BANK

The biggest benefit of the internet can be found in the educational sector. Educators can obtain learning material

from it, prepare courses online and deliver audio/visual information to students.

For instructors it is a valuable source for referencing material and enhancing the knowledge of their students. The Internet provides a great place for conferencing and collaborating with students from all over the world. Students can search for information regarding their school courses via electronic libraries who offer a great variety of journals and scientific articles. The resources available over the net cover almost every aspect of the school curriculum and students have a valuable machine for enhancing their knowledge and expanding their assigned work.

SO CLOSE…YET SO FAR AWAY!

One of the most important benefits offered from the wide applications of the internet is communication. The internet managed to eliminate distances and provide people with a unique opportunity to talk, watch and have fun with their loved ones, friends or acquaintances. Chat rooms, messenger services, emails and conferencing programs are the most common uses for communicating over the internet. People can enjoy the benefits of the cheap communication and maintain close contact with loved ones from all over the world.

10.3.7 Smart Card

A smart card is a plastic card about the size of a credit card, with an embedded microchip that can be loaded with data, used for telephone calling, electronic cash payments, and other applications, and then periodically refreshed for additional use. Currently or soon, you may be able to use a smart card to:

Dial a connection on a mobile telephone and be charged on a per-call basis Establish your identity when logging on to an Internet access provider or to an online bank Pay for parking at parking meters or to get on subways, trains, or buses Give hospitals or doctors personal data without filling out a form

Make small purchases at electronic stores on the Web (a kind of cyber cash) Buy gasoline at a gasoline station.

Over a billion smart cards are already in use. Currently, Europe is the region where they are most used. Ovum, a research firm, predicts that 2.7 billion smart cards will be shipped annually by 2003. Another study forecasts a $26.5 billion market for recharging smart cards by 2005. Compaq and I Hewlett-Packard are reportedly working on keyboards that include smart card slots that can be read *lake* bank credit cards. The hardware for making the cards and the devices that can read them is currently made principally by Bull, Gemplus, and Schlumberger.

10.3.8 How Smart Cards Work

A smart card contains more information than a magnetic stripe card and it can be programmed for different applications. Some cards can contain programming and data to support multiple applications and some can be updated to add new applications after they are issued. Smart cards can be designed to be inserted into a slot and read by a special reader or to be read at a distance, such as at a toll booth. Cards can be isposable (as at a trade-show) or reloadable (for most applications).

An industry standard interface between programming and PC hardware in a smart card has been defined by the PC/SC Working Group, representing Microsoft, IBM, Bull, Schlumberger, and other interested companies. Another standard is called Open Card. There are two leading smart card operating systems: Java Card and MULTOS.

Related glossary terms: RSA algorithm (Rivets-Shamir-Adelman), data key, greynet (or graynet), spam cocktail (or anti-spam cocktail), finger scanning (fingerprint scanning), mugging, insider threat, authentication server, defense in depth, no repudiation

Smart cards currently exist for a vast array of applications. However, the expected growth in the industry will not be due merely to growth in these segments, but also to the addition of the Internet and electronic commerce with their myriad of uses.

10.3.9 Current Applications

As mart card, as mentioned above, is a portable computational device with data storage ability. As such, they can be a very reliable form of personal identification and a tamper-proof secure information repository. The main possible applications of smart cards are the following:

10.3.10 Payphones

Outside of the United States there is a widespread use of payphones equipped with card readers rather than -p; or in addition to -p; coin recognition and storage. The main advantages are that the phone company does not have to collect coins, and the users do not have to have coins or remember long access numbers and PIN codes. Smart cards have the further advantage over magnetic stripe cards of being reloadable, and allowing advanced features like phone banking, automatic memory dialing and on-line services.

10.3.11 Mobile Communications

Smart cards are used as identification device for GSM digital mobile phones. The card stores all the necessary information in order to properly identify and bill the user, so that any user can use any phone terminal.

10.3.12 Banking & Retail

Smart banking cards can be used as credit, direct debit or stored value cards, offering a counterfeit and tamper-proof device. The intelligent microchip on the card and the card readers use mutual authentication procedures that protect users, merchants and banks from fraudulent use. Other services enabled by smart cards are advanced loyalty programs and electronic coupons.

10.3.13 Electronic Purse

A smart card can be used to store a monetary value for small purchases. Card readers retrieve the amount currently stored, and subtract the amount for the goods or services being

purchased. Groceries, transportation tickets, parking, Laundromats, cafeterias, taxis and all types of vending machines are only some of the purchases that often do not reach amounts to justify the hassle of using a credit card (a cash card reader does not require a permanent phone connection with a host computer). Radio-read smart cards will allow the free flow of people through transportation systems, avoiding the need of ticketing machines or validation gates.

10.3.14 Health Care

Smart cards allow the information for a patient's history to be reliably and safely stored. Health care professionals can instantaneously access such information when needed, and update the content. Instant patient verification allows immediate insurance processing and refund. Doctors and nurses themselves can carry smart card-based IDs that allow secure, multi-level access to private information.

10.3.15 ID Verification and Access Control

The computational power of smart cards allows running mutual authentication and public-key encryption software in order to reliably identify the bearer of the card. For higher security needs, a smart card is a tamper-proof device to store such information as a user's picture or fingerprints. Smart cards can be used also for network access: in addition or in alternative to user IDs and passwords, a networked computer equipped with a smart card reader can reliably identify the user.

10.3.16 Expert System

In artificial intelligence, an expert system is a computer system that emulates the decision-making ability of a human expert. Expert systems are designed to solve complex problems by reasoning about knowledge, like an expert, and not by following the procedure of a developer as is the case in conventional programming.The first expert systems were created in the 1970s and then proliferated in the 1980s. Expert

systems were among the first truly successful forms of AI software.
An expert system has a unique structure, different from traditional programs. It is divided into two parts, one fixed, independent of the expert system: the inference engine, and one variable: the knowledge base. To run an expert system, the engine reasons about the knowledge base like a human.] In the 80s a third part appeared: a dialog interface to communicate with users. This ability to conduct a conversation with users was later called I conversational".

10.3.17 History

Expert systems were introduced by researchers in the Stanford Heuristic Programming Project, including the "father of expert systems" the great USTAD from BhopI(Nitin Jain), with the Dendral and Mycin systems. Principal contributors to the technology were Bruce Buchanan, Edward Shortliffe, Randall Davis, William van Melle, Carli Scott and others at Stanford. Expert systems were among the first truly successful forms of AI software.
Research is also very active in France, where researchers focus on the automation of reasoning and logic engines. The French Prolog computer language, designed in 1972, marks a real advance over expert systems like Dendral or Mycin: it is a shell. that is to say a software structure ready to receive any expert system and to run it. It integrates an engine using First-Order logic, with rules and facts. It's a tool for mass production of expert systems and was the first operational declarative language. later becoming the best selling AI language in the world. However Prolog is not particularly user friendly and is an order of logic away from human logic.
In the 1980s, expert systems proliferated as they were recognized as a practical tool for solving real old problems. Universities offered expert system courses and two thirds of the Fortune 1000
ompanies applied the technology in daily business activities. Interest was international with he Fifth Generation Computer Systems project in Japan and increased research funding in Europe. Growth in the field continued into the 1990s.

The development of expert systems was aided by the development of the symbolic processing languages Lisp and Prolog. To avoid re-inventing the wheel, expert system shells were created that had more specialized features for building large expert systems.

In 1981 the first IBM PC was introduced, with MS-DOS operating system. Its low price started to multiply users and opened a new market for computing and expert systems. In the 80's the image of AI was very good and people believed it would succeed within a short time. Many companies began to market expert systems shells from universities, renamed IIgenerators,r because they added to the shell a tool for writing rules in plain language and thus, theoretically, allowed to write expert systems without a programming language nor any other software. The best known: Guru (USA) inspired by Mycin, Personal Consultant Plus (USA), Inexpert Object (developed by Neuron Data, company founded in California by three French), Genesia (developed by French public company Electricity de France and marketed by Steria), VP Expert (USA). But eventually the tools were only used in research projects. They did not penetrate the business market, showing that AI technology was not mature.

10.3.18 Example and application

Expert systems are designed to facilitate tasks in the fields of accounting, medicine, process control, financial service, production, human resources, among others. Typically, the problem area is complex enough that a more simple traditional algorithm cannot provide a proper solution. The foundation of a successful expert system depends on a series of technical procedures and development that may be designed by technicians and related experts. As such, expert systems do not typically provide a definitive answer, but provide probabilistic recommendations.

An example of the 'application of expert systems in the financial field is expert systems for mortgages. Loan departments are interested in expert systems for mortgages because of the growing cost of labour, which makes the handling and acceptance of relatively small loans less

profitable. They also see a possibility for standardized, efficient handling of mortgage loan by applying expert systems, appreciating that for the acceptance of mortgages there are hard and fast rules which do not always exist with other types of loans. Another common application in the financial area for expert systems are in trading recommendations in various marketplaces. These markets involve numerous variables and human emotions which may be impossible to deterministically characterize, thus expert systems based on the rules of thumb from experts and simulation data are used. Expert system of this type can range from ones providing regional retail recommendations, like Wishabi, to ones used to assist monetary decisions by financial institutions and governments.

10.3.18 Credit Card

A credit card is a small plastic card issued to users as a system of payment. It allows its holder to buy goods and services based on the holder's promise to pay for these goods and services. The issuer of the card creates a revolving account and grants a line of credit to the consumer (or the user) from which the user can borrow money for payment to a merchant or as a cash advance to the user.
A credit card is different from a charge card: a charge card requires the balance to be paid in full each month. In contrast, credit cards allow the consumers a continuing balance of debt, subject to interest being charged. A credit card also differs from a cash card, which can be used like currency by the owner of the card. Most credit cards are issued by banks or credit uniorls,.and are the shape and size specified by the ISO/IEC 7810 standard as 10-1. This is defined as 85.60 x 53.98 mm (33/8 x 21/8 in) in size.

10.3.19 How credit cards work

Credit cards are issued by a credit card issuer, such as a bank or credit union, after an account has been approved by the credit provider, after which cardholders can use it to make purchases at merchants accepting that card. Merchants often advertise which cards they accept by displaying acceptance

marks - generally derived from logos - or may communicate this orally, as in "We take (brands X, Y, and Z)" or "We don't take credit cards".

When a purchase is made, the credit card user agrees to pay the card issuer. The cardholder indicates consent to pay by signing a receipt with a record of the card details and indicating the amount to be paid or by entering a personal identification number (PIN). Also, many merchants now accept verbal authorizations via telephone and electronic authorization using the Internet, known as a card not present transaction (CNP).

Electronic verification systems allow merchants to verify in a few seconds that the card is valid and the credit card customer has sufficient credit to cover the purchase, allowing the verification to happen at time of purchase. The verification is performed using a credit card payment terminal or point-of-sale (PaS) system with a communications link to the merchant's acquiring bank. Data from the card is obtained from a magnetic stripe or chip on the card; the latter system is called Chip and PIN in the United Kingdom and Ireland, and is implemented as an EMV card.

For card not present transactions where the card is not shown (e.g., e-commerce, mail order, and telephone sales merchants additionally verify that the customer is in physical possession of the card and is the authorized user by asking for additional information such as the security code printed on the back of the card, date of expiry, and billing address.

Each month, the credit card user is sent a statement indicating the purchases undertaken with the card, any outstanding fees, and the total amount owed. After receiving the statement, the cardholder may dispute any charges that he or she thinks are incorrect (see 15 U.s.e. § 1643, which limits cardholder liability for unauthorized use of a credit card to $50, and the Fair Credit Billing Act for details of the US regulations). Otherwise, the cardholder must pay a defined minimum proportion of the bill by a due date, or may choose to pay a higher amount up to the entire amount owed. The credit issuer charges interest on the amount owed if the balance is not paid in full (typically at a much higher rate than most other forms of debt). In addition, if the credit card user fails to make at least the minimum payment by the due date, the issuer may impose a "late fee"

and/or other penalties on the user. To help mitigate this, some financial institutions can arrange for automatic payments to be deducted from the user's bank accounts, thus avoiding such penalties altogether as long as the cardholder has sufficient funds.

10.3.20 History

The concept of using a card for purchases was described in 1887 by Edward Bellamy in his utopian novel Looking Backward. Bellamy used the term credit card eleven times in this novel.

The modern credit card was the successor of a variety of merchant credit schemes. It was first used in the 1920s, in the United States, specifically to sell fuel to a growing number of automobile owners. In 1938 several companies started to accept each other's cards. Western Union had begun issuing charge cards to its frequent customers in 1921. Some charge cards were printed on paper card stock, but were easily counterfeited.

The Charge-Plate, developed in 1928, was an early predecessor to the credit card and used in the U.S. from the 1930s to the late 1950s. It was a 2:2 in x 1 ¼ in rectangle of sheet metal related to Addressograph and military dog tag systems. It was embossed with the customer's name, city and state. It held a small paper card for a signature. In recording a purchase, the plate was laid into a recess in the imprinter, with a paper "charge slip" positioned on top of it. The record of the transaction included an impression of the embossed information, made by the imprinter pressing an inked ribbon against the charge slip.[5] Charga-Plate was a trademark of Farrington Manufacturing Co. Charga-Plates were issued by large-scale merchants to their regular customers, much like department store credit cards of today. In some cases, the plates were kept in the issuing store rather than held by customers. When an authorized user made a purchase, a clerk retrieved the plate from the store's files and then processed the purchase. Charga-Plates speeded back-office bookkeeping that was done manually in paper ledgers in each store, before computers.

In 1934, American Airlines and the Air Transport Association simplified the process even more with the advent of the Air Travel Card.[6] They created a numbering scheme that identified the Issuer of card as well as the Customer account. This is the reason the modern UATP cards still start with the number 1. With an Air Travel Card passengers could "buy now, and pay later" for a ticket against their credit and receive a fifteen percent discount at any of the accepting airlines. By the 1940s, all of the major domestic airlines offered Air Travel Cards that could be used on 17 different airlines. By 1941 about half of the Airlines Revenues came through the Air Travel Card agreement. The Airlines had also started offering installment plans to lure new travelers into the air. In October 1948 the Air Travel Card became the first inter-nationally valid Charge Card within all members of the International Air Transport Association.

10.3.12 How credit cards work

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10.4 Question for self assessment

1. What are the uses of internet in our day to day life?
2. What do you mean by smart card.
3. What it an expert system and how does it works?
4. What do you mean by credit card?

10.5 Suggested Readings

1. The Indian Cyber law by Suresh T.Vishwanathan
2. Cyber Law Intellectual Property and e-commerce security by Krishna Kumar
3. Wikipedia.

L.L.M. 05 PART – I
PAPER- BANKING LAW

Block IV - NEGOTIABLE INSTRUMENTS
Unit 11 – MEANING AND KINDS; TRANSFER AND NEGOTIATIONS

STRUCTURE

11.1 INTRODUCTION

Negotiable instruments have great significance in the modern business world. These instruments have gained prominence as the principle instruments for making payment and discharging business obligations. A negotiable instrument is a transferable document which satisfies certain conditions. These instruments pass freely from hand to hand and thus form an integral part of the modern business mechanism. The law relating to negotiable instruments in India is contained in the Negotiable Instruments Act, 1881. In this part of the book we shall deal with the law and practice relating to negotiable Instruments in India.

11.2 OBJECTIVES

In this unit, an imperative is made to discuss negotiations and transfer of negotiable instruments. There are different modes to transfer negotiable instruments, writer made an attempt to analyze the mode of transfers under negotiable instruments Act, which is useful to students.

11.3.1 DEFINITION OF NEGOTIABLE INSTRUMENT

The Negotiable Instruments Act does not define a negotiable Instrument and merely states that a negotiable instrument means a “promissory note, bill of exchange or cheque payable either to order or bearer” (Section 13) This does not Indicate the characteristics of a negotiable instrument but only states that three instrument—cheque bill of exchange and promissory note — are-negotiable ‘Instruments These three instruments are therefore negotiable instruments by statute Section 13 does not prohibit any other instrument which satisfies the essential features of negotiability, to be treated as negotiable instrument The essential feature of a negotiable instrument is its negotiability as discussed below.

Justice K.C. Willis defines a negotiable instrument as "one the property in which is acquired by any one who takes it *bona fide* and for value notwithstanding any defect of title in the person from whom he took it.”

Another useful definition is given by Thomas who states that an instrument is negotiable when it is by a legally recognized custom of trade or by law transferable by delivery or by endorsement and delivery, without notice to the party liable, in such a way that (a) the holder of it for the time being may sue upon it in his own name, and (b) the property in it passes to a bonafide transferee for value free from any defect In the title of the person from whom he obtained It.'

These definitions clearly reveal the true nature of a negotiable instrument. A negotiable instrument is a transferable document either by the application of the law or by the custom of the trade concerned. The special feature of such an instrument is the privilege it confers on the person who receives it *bona fide* and for value, to possess good title thereto, even if the transferor had no title or had defective title to the instrument.

11.3.2ESSENTIAL FEATURES OF NEGOTIABLE INSTRUMENTS

The following are the special features of the negotiable instruments:

(i) The negotiable Instruments are easily transferable from person to person and the ownership of the property in the instrument may be passed on by mere delivery, in case of a bearer Instrument, or by endorsement-and delivery In case of an order instrument Transferability is an essential feature of a negotiable instrument but all transferable instruments are not negotiable instruments. Herein lies the difference between transferability and negotiability which is explained below.

(ii) A negotiable Instrument confers absolute and good title on the transferee, who takes it in good faith, for value and without notice of the fact that the transferor had defective title thereto. This s the most important characteristic of a negotiable instrument. A person who takes a negotiable Instrument from another person who had stolen it from somebody also, will have absolute and undisputable title to the Instrument provided he receives the same for value (i.e. after paying its full value) and. in good faith without knowing that the transferor was not the true owner of the instrument. Such a person is called the

holder in due course and his interest in the instrument is well protected by the law.

Difference between transferability and negotiability:

In case of any goods or commodity, which is transferable from person to person the general rule of law is that the transferor cannot transfer title better than what he himself possesses. For example, X purchases an article or a commodity. say a book, from Y against payment of its full value. But Y had stolen the book from the house of Z if the thief i.e. Y is caught for this theft or if the stolen article is found in the possession of X the latter shall have to return the some of the true owner of the article because the title of X to the property is not deemed to be better than the title possessed by Y. In fact, Y had no title thereto and hence X will also stand on the same footing.

A negotiable instrument is an exception to this general rule of law. Suppose in the above Illustration X takes a cheque, he will have good title thereto and will not be responsible to the true owner Z. The latter will have a right against Y. the thief of the instrument. This privilege of the holder of a negotiable instrument in due course constitutes the main difference between a transferable instrument or article and a negotiable instrument.

(iii) Such holder of a negotiable instrument, who is legally called .the holder in due course, possesses the right to sue upon the instrument in his own name. Thus, he can recover the amount of the instrument from the party liable to pay thereon.

Where a debtor has drawn a negotiable instrument in favour of his creditor and has also executed a mortgage to provide, further security, the creditor has a right to sue on the basis of negotiable instrument even without exhausting security in the shape of mortgage, *Baijnath Agarwal* v. *Ram Kumar Agarwal*.

11.3.3 TYPES OF NEGOTIABLE INSTRUMENTS

Though the negotiable instruments possess the above-mentioned features, they fall under two categories as follows:

(i) *Negotiable instruments by statute.* As already stated the Negotiable Instruments Act states three Instruments—cheque, bill of exchange and promissory notes—as

negotiable instruments. They are, therefore, called negotiable instruments by statute.

(ii) Negotiable instruments by custom or usage. Some other instruments have, acquired the character of negotiability by custom usage of trade. Section 137 of the Transfer of Property Act, 1882 also recognized that an instrument may be negotiable by law or custom. Thus, in India, Government promissory notes, shah jog hundis, delivery orders and railway receipts have been held to be negotiable by usage or custom of the trade

Generally the negotiable instruments possess all the essential features discussed above. But sometimes the drawer or the holder may take away. The essential charlatanistic of negotiability and thus the instrument ceases to be a transferable or negotiable instrument. Examples: (i) if a cheque is payable to a specified person only and not to his order or the bearer, it cannot be transferred to any other person and hence it loses its negotiability, (ii) if a cheque is crossed 'Not Negotiable' it can tie transferred but without conferring on the transferee absolute and good title In all cases The transferee of such a cheque will stand at par with the transferee of any other commodity and shall not possess title better than that of his transferor.

11.3.4 HOLDER AND HOLDER IN DUE COURSE:

A negotiable Instrument is transferable from person to person. The Negotiable Instrument Act confers upon the person, who acquired it *bona fid* and for value, the right to possess good title to the instrument. Such person is called ‘holder in due course’. Each and every person in possession of a cheque or bill cannot be its holder. In due course and cannot claim the statutory protection granted under the Act. If an Instrument falls into wrong hands, the holder there to cannot enjoy the privileges of a holder in due course.

11.3.5 HOLDER

According to Section 8 the “holder of a promissory note, bill of exchange on cheque means any person entitled,in his own

name to the possession thereof and to receive or recover the amount due thereon from the parties thereto."

A person is called the holder of a negotiable instrument if the following conditions are satisfied:

(a) He must be entitled to the possession of the instrument in his own name and under a legal title Actual possession of the instrument is not essential; the holder must have the legal right to possess the Instrument in his own name. It means that the title to the Instrument is acquired lawfully and in a proper manner. For example, if a person acquires a cheque or bill by theft, fraud, or forged, endorsement or finds it lying somewhere, he does not acquire in his own name legal title thereto and hence he cannot be called its holder.

(b) He must be entitled to receive or recover the amount from the parties concerned in his own name. For this purpose it is essential that the name of the holder appears on the document as its payee or endorsee, if it is art order instrument, in case of a bearer instrument, the bearer may claim the money without having his name mentioned on the cheque. The holder is competent to receive payment or recover the amount by filing a suit in his own name against other parties, to negotiate the instrument and to give a valid discharge.

In case a bill, note or cheque is lost or destroyed, its holder is the person so entitled at the time of such loss or destruction (Section 8). In other words, the person who was entitled to receive payment at the time the instrument was lost, will continue to be regarded as its bolder, the finder does not become its holder.

11.3.6 HOLDER IN DUE COURSE

According to Section 9 “holder in due course means any person for consideration, became the possessor of a promissory note, bill of exchange or cheque, if payable to bearer, or the payee or endorsee thereof if payable to order, before the amount mentioned in it became payable, and without having sufficient cause of believe that defect existed in the title of the person from whom he derived his title."

A person becomes a holder in due course of a negotiable instrument if the following conditions are satisfied:

(i) The negotiable instrument must be in the possession of the holder in due course. In case of an order instrument, he must be its payee or endorsee, i.e. his name must appear on the instrument:

(ii) The negotiable instrument must be regular and complete in all respects. Alterations, if any, must be confirmed by the drawee through his signature. Holder of an incomplete document cannot be its holder in due course. The instrument must have been properly delivered to the holder in due course. The case of an order cheque endorsement in favour of the holder is essential. A postdated cheque is not deemed to be irregular.

(iii) The instrument must, have been obtained for valuable consideration, i.e. by paying its full value. A person who receives a cheque as a gift will not be called ite holder in due course for want of consideration. The consideration must be legal and adequate. For example, if a cheque is given in respect of a debt incurred in gambling, the consideration for the cheque is unlawful. If the value of the consideration falls short of the of the Instrument, the person will be deemed as holder in due course to the extent of the value of consideration.

(iv) The instrument must have been obtained before the amount mentioned therein becomes payable. This condition is applicable to document payable otheriwse than on demand and does not apply to cheque which is always payable on demand.

(v) The holder In due course must obtain the instrument without having sufficient cause to believe that any defect existed in the title of the transferor. This is the most important condition to be satisfied. The title of a person to the negotiable Instrument is deemed to be defective if he acquires it by unfair means, e.g., by fraud, coercion, undue influence or by any other illegal method or for an illegal consideration. If he does not possess any title thereto, his title is also deemed to be defective.

Section 9 lays heavy responsibility fifty on the person accepting negotiable instrument in this regard. He should not

only have no notice of any defect in the transferor's title thereto, but he should have no cause to believe that the title was defective. It means that the circumstances of the case should not give rise to any doubt or suspicion about the defective title of the transferor. The holder in due course should, therefore, exercise great care and take all necessary precautions in finding out if the transferor's title was defective. If he shows negligence or does not take due care in this regard, he shall not be called the holder in due course.

11.3.7DIFFERENCE BETWEEN HOLDER AND HOLDER IN DUE COURSE.

From the definitions of the terms 'holder' and 'holder in due course we may derive the following points of difference between them:

(1) Consideration. The existence of consideration is not essential In case of a holder, but a holder in due course obtains the instrument after paying its full value. For example if a cheque is issued to provide a gift or donation to a charitable trust, the trust does not become its holder in due course. On the other hand, tuition fee paid to a school or college is for a valuable consideration. Hence the school or the college acquires the status of holder In due course.

(2)Possession. The person entitled to be called holder in due course must become the possessor of the instrument before it became payable. For example, if a bill of exchange is payable on March 2O, 1997, a person who possesses it before this date is entitled to be its holder in due course. If it is obtained after this date, the possessor will not be called its holder in due course. In case of a holder neither actual possession nor any time limit within which it must be acquired is required.

(3) Defect in the transferor's title. The: most important point of difference is that a holder in due course acquires an instrument without having sufficient cause to believe that any defect existed in the title of the transferor. This condition is not essential in case of holder. This condition casts a heavy responsibility on a person who claims to be a holder in due course—he should not only not have knowledge of the defective title of the transferor but in the circumstances of each

case, there should be no cause to believe that any defect exists in the title of the transferor. It means that the holder in due course must obtain an instrument after taking all possible care about the transferor's good title.

Examples:

(1) A debt is due from a partner of a firm to X. The partner endorses in favour of X a cheque drawn in favour of the firm.

The circumstances of the case give rise to doubt about the title of the partner to the cheque drawn in. favour of the firm. If X satisfies himself about the partner's valid title to the cheque he becomes its holder in due course.

(2) A cheque for Rs. 10,000 is issued by U.S. Embassy in favour a furniture supplier in New Delhi. It bears an endorsement in favour of X, who is a Government servant. The latter endorses it to Y for valuable consideration. The circumstances of this case are sufficient to cause a doubt in the mind of Y as to how the cheque could have come into the hands of Government servant from a furniture suppliers. Y is entitled to become holder in due course only if he accept the cheque after of his transferor,

11.3.8 RIGHT OF A HOLDER

The holder of a negotiable Instrument enjoys the following rights:

(i) An endorsement in blank may be converted by film into an endorsement in full.

(ii) He is entitled to cross a cheque either generally or specially and also with the words "Not Negotiable".

(iii) He can negotiate a cheque to a third person, if such negotiation is not prohibited by the direction given in the cheque.

(iv) He can claim payment of the Instrument and can sue in his own name on the Instrument.

(v) A duplicate copy of a lost cheque may be obtained by a holder.

11.3.9 PRIVILEGES OF A HOLDER IN DUE COURSE

Besides the aforesaid light of a holder, a holder in due course enjoys the following privileges under various sections of the Negotiable instruments Act:
He possesses better title free from defects. This is the greatest privilege of a holder due course. He always possesses better title than that of his transferor or any of the previous parties and can give: the subsequent parties the good title that he possesses. Section 53 states that "a holder of a negotiable instrument who derives title from a holder in due course has the right thereon of that holder in due course. The holder In due course is entitled to recover amount of the instrument from any or all of the previous parties.

11.3.10 MEANING OF NEGOTIATION

The chief characteristic of a negotiable instrument is Its negotiability, i.e., It can be negotiated from one person to another. According to Section 14, "when a promissory note, bill of exchange or cheque is transferred to any person, so as to constitute that person the holder thereof, the instrument is said to be negotiated". The essence of negotiation thus lies not in mere transfer of the instrument from one person to another but also in the fact that the transferee of an instrument get the right as the holder of the instrument. If the transferee of an instrument cannot be called its holder, as define in Section 8, the instrument is not said to have been negotiated.
An instrument may be negotiated in any of the following two ways:
(1) By Delivery. "A promissory note, bill of exchange or cheque payable to bearer is negotiable by delivery thereof' (Section 47). Thus in case of a bearer instrument mere delivery thereof constitutes its negotiation. The delivery may be given either to the transferee himself or to his agent or banker acting for him.
Examples.
(a)A, the holder of a negotiable instrument payable to bearer, delivers it to B's agent to keep it for B. The instrument is thus negotiated.
(b) A is the holder of a negotiable instrument payable to bearer the instrument is in the hands of A's banker who is at the time

the banker of B also. A directs the banker to transfer the instrument to B's credit in the banker's account withB. The banker does so and accordingly now possesses the Instrument as B's agent. The instrument is thus negotiated and B becomes its holder.

(2) By Endorsement and Delivery. "A promissory note, bill of exchange or cheque payable to order is negotiable by the holder by endorsement and delivery thereof' (Section 48). Thus the negotiation of an order instrument requires first an endorsement thereon by its holder and thereafter its delivery to the transferee.

11.3.11 DEFINITION OF ENDORSEMENT

Section 15 defines endorsement as follows:

"When the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or art a slip of paper annexed thereto or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to have endorsed the same and is called endorser.

Thus, an endorsement consists of the signature of the maker (or drawer) of a negotiable instrument or any holder thereof but it is essential that the intention of signing the instrument must be negotiations otherwise it will not constitute an endorsement. The person who signs the instrument for the purpose of negotiation is called the 'endorser' and the person in whose favour instrument is transferred is called the endorsee'. The endorser may sign either on the face or on the back of the negotiable Instrument but according to the common usage. endorsements are usually made on the back of the instrument. If the space on the back is insufficient for this purpose a piece of paper, known as 'allonge' may be attached thereto for the purpose of recording the endorsements.

Legal Provisions regarding Endorsements

The following provisions are contained In the Act as regards Endorsements:

(1) Effect of Endorsement. The endorsement of a negotiable instrument followed by delivery transfers to the endorsee the property therein with the right of further negotiation (Section

50). Thus the endorsee acquires property or interest in the Instrument as its holder He can also negotiate It further. (His right can, of course, be restricted by the endorser in case of a restrictive endorsement.)

Section 50 also permits that an Instrument may also be endorsed so as to constitute the endorsee an agent of the endorser —

(1) to endorse the instrument further, or

(2) to receive its amount for the endorser or for some other specified person.

The examples of such endorsements are as follows;

(i) Pay C for my use.

(ii) Pay C or order for the account of B.

Where a negotiable instrument is endorsed for any of the above purposes the endorsee becomes its holder and property therein is passed on to the endorsee. In *Kunju Pillai and Other* v. *Periasami case*, the original payee, after endorsing the promote in favour of the endorsee for the purpose of collection, died. The endorsee filed a suit against the maker of the pronote for the recovery of the amount due. The trial Court held that the endorsement for collection created the relationship of principal and agent between the original payee and the endorsee and on the death of the payee, the agency came to an end in terms of Section 201 of the Indian Contract Act, 1872. On appeal, the High Court held that a holder of a negotiable instrument, who secures the same by endorsement, does not lose the right of his action by reason of the death of the original payee. In *Mothireddy* v. *Pothireddy case,* the Andhra Pradesh High Court also held that "the right based on the endorsement having been made for a specific purpose, namely, collection of the amount, will be valid till that purpose is served." The ordinary law regarding agency does not, therefore, apply in such cases.

(2) Endorser. "Every sole maker, drawer, payee or endorsee or all of several joint makers, drawers, payees or endorsees, of a negotiable instrument may endorse and negotiate the same." This is subject to the condition that the right to negotiate has not been restricted or excluded (Section 51). Thus in case the Instrument is held jointly by a number of persons, endorsement by all of them Is essential. One cannot represent the other.

The absence .of the words “or order” in the instrument or endorsement thereon does not restrict further negotiation. For example a bill is drawn payable to A or order. A endorses it to B but the endorsement does not contain the words “or order” or any equivalent words. B may further negotiate-the instrument.

It is, however, essential that the maker or drawer of an instrument must have lawful possession over it, i.e., he must be its holder In order to enable him to endorse or negotiate it. A payee or an endorsee of the instrument must be its holder for the same purpose.

(3) Time. A negotiable instrument may be negotiated until its payment has been made by the banker, drawee or acceptor at or after maturity but not thereafter (Section 60).

(4) Endorsement for a part of the amount. The instrument must be endorsed for its entire amount. Section 56 provides that “no writing on a negotiable instrument is valid for the purpose of negotiation if such writing purports to transfer only a part of the amount appearing to be due on the instrument.” Thus an endorsement for a part of the amount of the instrument is invalid.

But In case an instrument has been partly paid, it may be negotiated for the balance of the amount provided a note to that effect is given on the instrument (Section 56).

If the endorser intends to transfer the document to two or more endorsees separately, it will not constitute a valid endorsement.

(5) The legal representative of a deceased person cannot negotiate by delivery only, a promissory note, bill of exchange or cheque payable to order and endorsed by the deceased but not delivered (Section 57). If-the endorser dies after endorsing the instrument payable to order but without delivering the same to the endorsee, such endorsement shall not be valid and his legal representative cannot complete its negotiation by mere delivery thereof.

(6) Unless contrary is proved it is presumed under Section 118 that “the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.” It means that the endorsement which appears on an instrument first is presumed to have been made earlier to the second one.

11.3.12KINDS OF ENDORSEMENTS/TRANSFERS

According to the Negotiable Instruments Act Endorsements are of the following kinds:

1.Endorsement in Blank. If the endorser signs his name only, the endorsement is said to be "in blank' (Section 16). The endorser does not specify the name of endorsee with the effect that an instrument endorsed in blank becomes payable td the bearer (subject to the provisions as regards crossed cheques) even though originally payable to order (Section 54) and no further endorsement is required for its negotiation. For example, if a cheque is payable to 'X or order' and X merely signs on its back, such endorsement is called endorsement in blank. Such endorsement makes it a bearer cheque which may be further negotiated by mere delivery. But if such a cheque is a crossed one, its payment cannot be made at the counter of the bank, even if it is endorsed in blank. If the endorsement in blank is followed by endorsement in full (discussed below), It becomes payable to or to the order of the person mentioned in the last endorsement.

2. Endorsement in Full. If in addition to his signature, the endorser adds a direction to pay the amount mentioned in the instrument to, or to the order of, a specified person, the endorsement is said to be 'endorsement in full' (Section 16). If In the above illustration X adds the words "Pay to Y" or "Pay to Y or order", such endorsement is called endorsement in full. The instrument will then be payable to Y or his order and will necessitate endorsement by Y for its further negotiation.

An endorsement in blank may be converted into an endorsement in full. The holder of a negotiable instrument endorsed in blank may without signing his own name, by writing above the endorser's signature a direction to pay to any other person convert the endorsement in blank into an endorsement in full, and the holder does not thereby incur the responsibility of an endorser (Section 49). For example, a cheque is endorsed in blank by X by signing on its back. Y, its holder, may convert the endorsement In blank into an endorsement in full by writing above Xs signature "Pay to Z or order". Thus Z will become the endorsee, but Y will not be liable to him as the endorser because his name does not figure

in the endorsement in full. If the cheque is dishonoured, Z can make all other parties except Y liable on the cheque.

According to Section 55, "if a negotiable instrument after having been endorsed in blank, is endorsed in full, the amount of it cannot be claimed from the endorser In full, except by the person to whom it has been endorsed in full or by one who derives title through such person," For example a cheque Is endorsed in blank by X and transferred to Y who endorses it In favour of Z. The latter transfers it without any endorsement to 9. If the cheque is dishonoured, 9 cannot sue Y or Z. He can sue X only.

3. Conditional Endorsement. If the endorser of a negotiable Instrument, by express words in the endorsement, makes his liability or the right of the endorsee to receive the amount due thereon, dependent on the happening of a specified event, although such event may never happen, such endorsement Is called a conditional endorsement (Section 52). Such an endorser gets the following rights:

(a) He may make his liability on the instrument conditional on the happening of a particular event. He will not be liable to the subsequent holder if the specified event does not take place. The endorsee in such a case can sue other parties to the instrument even before the particular event takes place.

(b) He may make the right of the endorsee of the instrument conditional on the happening of a particular event. For example, "Pay C If he returns from Bombay". Thus C- gets the right to receive payment only on the happening of a particular event, i.e., if he returns from Bombay. If the event does not take place, the endorsee cannot sue any of the parties.

Conditional endorsements do not make the instruments nontransferable. However, such endorsements are generally not used.

4.Restrictive Endorsement. Generally, an endorsee of a negotiable Instrument is fully competent to negotiate it further but section 50 permits restrictive endorsements which take away the negotiability of such instruments. 'The endorsement may, by express words, restrict or exclude the right to negotiate or may merely constitute the endorsee an agent to

endorse the instrument or to receive its contents for the endorser or for some other specified person, "Such an endorsement prohibits further endorsement and is called 'Restrictive endorsement'. For example, if B endorses an instrument payable to hearer as follows, the right of C to further negotiate is excluded:

(a) Pay the contents to C only
(b) Pay C for my use
(c) Pay C or order for the account of B
(d) The within must be credited to C

But the following endorsements are not restrictive endorsements

(i) Pay C
(ii) Pay C value in account of X Bank

Because the endorser has not specifically restricted the negotiability not restricted by the omission of the word "Or order" (Section 52).

5. Endorsement 'Sans Recourse'. An endorser of a negotiable instrument may, by express words in the endorsernent, exclude his own liability thereon (Section 52). For example, if R endorses a cheque as follows :

(i) Pay to X or order at his own risk
(ii) Pay to C without recourse to me.

he (R) will not be liable to X or any of the subsequent endorsees if the bank dishonors the cheque subsequently. They may sue any party prior to such endorser. But if an endorser who so excludes his liability afterwards becomes the holder of the instrument, all intermediate endorsers are liable to him. For example, R has excluded his personal liability by endorsing the cheque "without recourse". He transfers it to B, B endorses to C, who endorses it back to R. Thus Rshall have the rights as endorsee against B and C, who endorsed the Instrument, before it came back to R.

6. Facultative Endorsement. The endorsee must give notice of dishonour of the Instrument to the endorser, but the latter may waive this duty of the endorsee by writing in the endorsement 'Notice of dishonor waived'. The endorser remains liable to the endorsee for the non-payment of the instrument.

11.4 SUMMARY

The Negotiable Instruments Act does not define a negotiable Instrument and merely states that a negotiable instrument means a “promissory note, bill of exchange or cheque payable either to order or bearer” (Section 13) This does not Indicate the characteristics of a negotiable instrument but only states that three instrument—cheque bill of exchange and promissory note — are-negotiable ‘Instruments These three instruments are therefore negotiable instruments by statute Section 13 does not prohibit any other instrument which satisfies the essential features of negotiability, to be treated as negotiable instrument The essential feature of a negotiable instrument is its negotiability as discussed below.

Justice K.C. Willis defines a negotiable instrument as "one the property in which is acquired by any one who takes it *bona fide* and for value notwithstanding any defect of title in the person from whom he took it.”

Another useful definition is given by Thomas who states that an instrument is negotiable when it is by a legally recognized custom of trade or by law transferable by delivery or by endorsement and delivery, without notice to the party liable, in such a way that (a) the holder of it for the time being may sue upon it in his own name, and (b) the property in it passes to a bonafide transferee for value free from any defect In the title of the person from whom he obtained It.’

These definitions clearly reveal the true nature of a negotiable instrument. A negotiable instrument is a transferable document either by the application of the law or by the custom of the trade concerned. The special feature of such an instrument is the privilege it confers on the person who receives it *bona fide* and for value, to possess good title thereto, even if the transferor had no title or had defective title to the instrument.

The following are the special features of the negotiable instruments:

The negotiable Instruments are easily transferable from person to person and the ownership of the property in the instrument may be passed on by mere delivery, in case of a bearer Instrument, or by endorsement-and delivery In case of an order instrument Transferability is an essential feature of a

negotiable instrument but all transferable instruments are not negotiable instruments. Herein lies the difference between transferability and negotiability which is explained below.

A negotiable Instrument confers absolute and good title on the transferee, who takes it in good faith, for value and without notice of the fact that the transferor had defective title thereto. This is the most important characteristic of a negotiable instrument. A person who takes a negotiable Instrument from another person who had stolen it from somebody also, will have absolute and undisputable title to the Instrument provided he receives the same for value (i.e. after paying its full value) and. in good faith without knowing that the transferor was not the true owner of the instrument. Such a person is called the holder in due course and his interest in the instrument is well protected by the law.

Difference between transferability and negotiability: In case of any goods or commodity, which is transferable from person to person the general rule of law is that the transferor cannot transfer title better than what he himself possesses. For example, X purchases an article or a commodity. say a book, from Y against payment of its full value. But Y had stolen the book from the house of Z if the thief i.e. Y is caught for this theft or if the stolen article is found in the possession of X the latter shall have to return the some of the true owner of the article because the title of X to the property is not deemed to be better than the title possessed by Y. In fact, Y had no title thereto and hence X will also stand on the same footing.

A negotiable instrument is an exception to this general rule of law. Suppose in the above Illustration X takes a cheque, he will have good title thereto and will not be responsible to the true owner Z. The latter will have a right against Y. the thief of the instrument. This privilege of the holder of a negotiable instrument in due course constitutes the main difference between a transferable instrument or article and a negotiable instrument.

(iii) Such holder of a negotiable instrument, who is legally called .the holder in due course, possesses the right to sue upon the instrument in his own name. Thus, he can recover the amount of the instrument from the party liable to pay thereon.

Where a debtor has drawn a negotiable instrument in favour of his creditor and has also executed a mortgage to provide, further security, the creditor has a right to sue on the basis of negotiable instrument even without exhausting security in the shape of mortgage, *Baijnath Agarwal* v. *Ram Kumar Agarwal*.

Though the negotiable instruments possess the above-mentioned features, they fall under two categories as follows:

(i) *Negotiable instruments by statute.* As already stated the Negotiable Instruments Act states three Instruments—cheque, bill of exchange and promissory notes—as negotiable instruments. They are, therefore, called negotiable instruments by statute.

(ii) Negotiable instruments by custom or usage. Some other instruments have, acquired the character of negotiability by custom usage of trade. Section 137 of the Transfer of Property Act, 1882 also recognised that an instrument may be negotiable by law or custom. Thus, in India, Government promissory notes, shah jog hundis, delivery orders and railway receipts have been held to be negotiable by usage or custom of the trade

Generally the negotiable instruments possess all the essential features discussed above. But sometimes the drawer or the holder may take away. The essential charlatanistic of negotiability and thus the instrument ceases to be a transferable or negotiable instrument. Examples: (i) if a cheque is payable to a specified person only and not to his order or the bearer, it cannot be transferred to any other person and hence it loses its negotiability, (ii) if a cheque is crossed 'Not Negotiable' it can tie transferred but without conferring on the transferee absolute and good title In all cases The transferee of such a cheque will stand at par with the transferee of any other commodity and shall not possess title better than that of his transferor.

An instrument may be negotiated in any of the following two ways:

(1) By Delivery. “A promissory note, bill of exchange or cheque payable to bearer is negotiable by delivery thereof’ (Section 47). Thus in case of a bearer instrument mere delivery thereof constitutes its negotiation. The delivery may be given

either to the transferee himself or to his agent or banker acting for him.

Examples. (a)A, the holder of a negotiable instrument payable to bearer, delivers it to B's agent to keep it for B. The instrument is thus negotiated.

(b) A is the holder of a negotiable instrument payable to bearer the instrument is in the hands of A's banker who is at the time the banker of B also. A directs the banker to transfer the instrument to B's credit in the banker's account with B. The banker does so and accordingly now possesses the Instrument as B's agent. The instrument is thus negotiated and B becomes its holder.

(2) By Endorsement and Delivery. "A promissory note, bill of exchange or cheque payable to order is negotiable by the holder by endorsement and delivery thereof' (Section 48). Thus the negotiation of an order instrument requires first an endorsement thereon by its holder and thereafter its delivery to the transferee.

Section 15 defines endorsement as follows:

"When the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or art a slip of paper annexed thereto or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to have endorsed the same and is called endorser.

Thus, an endorsement consists of the signature of the maker (or drawer) of a negotiable instrument or any holder thereof but it is essential that the intention of signing the instrument must be negotiations otherwise it will not constitute an endorsement. The person who signs the instrument for the purpose of negotiation is called the 'endorser' and the person in whose favour instrument is transferred is called the endorsee'. The endorser may sign either on the face or on the back of the negotiable Instrument but according to the common usage. Endorsements are usually made on the back of the instrument. If the space on the back is insufficient for this purpose a piece of paper, known as 'along' may be attached thereto for the purpose of recording the endorsements.

According to the Negotiable Instruments Act Endorsements are of the following kinds:

1. Endorsement in Blank.
2. Endorsement in Full.
3. Conditional Endorsement.
11. Restrictive Endorsement.

11.5 SUGGESTED READINGS

1 Bangia, R.K., The Negotiable Instrument Act, 6th ed. 1997.
2 Singh, Avtar, Principles of Mercantile Law, 6th ed. 1996.
3 Aggarwal, C.L.Law of Hundi And Negotiable

4 Tannan's, Banking law and practice in India
5 Wills, The Law of Negotiable Securities, 5 (4th ed.).
6 Bhashyam & Adiga's. The Negotiable Instrument Act, 16th edn. 1997

11.6 TERMINAL QUESTIONS

1. How negotiations are made of negotiable instruments?
2. Discuss the transfer mode of negotiable instruments in detail
3. Discuss the different kinds of transfer
4. What is the meaning of negotiations and transfer under the Act?

LL.M. 05 PART – I
PAPER- BANKING LAW

BLOCK 4 NEGOTIABLE INSTRUMENTS

UNIT I2 HOLDER AND HOLDER IN DUE COURSE

STRUCTURE

12.1. INTRODUCTION:

An instrument initially belongs to the payee and he is entitled to its possession. The payee can transfer it to any person in payment of his own debt. This transfer is known as negotiation and it takes place in two ways: A bearer instrument passes by simple delivery and the person to whom it is delivered becomes the holder. An order instrument on the other hand, can be negotiated only by endorsement and delivery and the endorsee becomes the holder. Hence, holder means either the bearer or endorsee of an instrument Section 2 of the English Bills of Exchange Act, 1882, provides that "holder means the payee or endorsee of a bill or note who is in possession of it or the bearer thereof "The definition contained in Section 8 of the Indian Act is to the same effect, although expressed in different words. It says that holder "means any person entitled in his own name to the possession of an instrument "and to receive and recover the amount," Hence, no one can be entitled to the possession of a bill or note unless he becomes either the bearer or endorsee there of.

The property in a negotiable instrument is acquired by anyone who takes it bonafide and for value, notwithstanding any defect of title in the person from whom he took it.[3] A person who takes an instrument "in good faith and for value becomes the true owner of the instrument and is known as a "holder in due course.'

12.2. OBJECTIVES

The main object of this lesson is to discuss who may be 'holder' and 'Holder in due Course' including essential conditions in detail with the help of statutory provisions as well as judicial approach. Further in this chapter efforts have been made to distinguish between Inland & Foreign Instruments and in n ambiguous and inchoate instrument with the help of examples and case law.

3. Wills, The Law of Negotiable Securities, 5 (4th ed.)

12.3.1 HOLDER

According to Section 8 'Holder' – The “holder” of a promissory note, bill of exchange or cheque means any person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the party’s thereto.

Thus If a person is entitled to the possession of a negotiable instrument in his own name he will be the holder. What is required is a right to possession. A person in possession of an instrument without having a right to possess the same cannot be called a holder. Thus a thief or a person taking a negotiable instrument, although may be having a de–facto possession but he cannot be called the holder because his possession is wrongful and he is not entitled to the possession of the negotiable instrument. Similarly, if I deliver a negotiable instrument to my servant for safe custody he does not become the holder because he is not entitled to the possession of his own name. Holder, therefore, means only a de jure holder” and not merely a “de facto holder.”

If the note or cheque is lost or destroyed, its holder is the person so entitled at their time of such loss or destruction. It means that even if a person loses a negotiable instrument, he still continues to be its holder, i.e. he remains entitled to its possession. Thus if some body finds a negotiable instrument, he does not thereby be come the holder. Similarly, if a negotiable instrument is destroyed, the person who is the holder thereof at the time of destruction, continues to remain the holder thereof, and continues to have the rights of a holder in t hat instrument.

Where a bill of exchange has been lost before it is overdue, the person who was the holder of it may apply to the drawer to give him another bill of the same tenor. In such a case the holder has to give security to the drawer, if required, to indemnify him against all people whatever in the case the bill alleged to have been lost shall be found again. If the drawer on request as aforesaid refuses to give a duplicate bill, he may be compelled to do so.[4] (Section 45-A)

4. Bangia, R.K., The Negotiable Instrument Act, 6th ed. 1997.

In every original negotiable instrument, the payee is the holder of the same. In case the payee transfers his rights to another person, then the transferee becomes the holder in place of the payee. In this case of a bearer instrument the transfer to whom the negotiable is delivered is known as the 'Bearer' of the instrument and such transferee (bearer) is the holder. In the case of an order instrument when it is transferred by an endorsement and delivery to the endorsee in such a case the 'endorsee' becomes the holder. Thus, the term holder would include the following:

a) The Payee.
b) The Bearer (i.e., The transferee of a bearer instrument) or
c) The endorsee (i.e. The transferee of an order instrument).

12.3.2 HOLDER IN DUE COURSE

Holder in due course (Section -9) — "Holder in due course" means any person who for consideration became the possessor of a promissory note, bill of exchange or cheque, if payable to bearer, or the payee or endorses thereof, if payable to order, before the amount mentioned in it became payable and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived the' title.

To be a holder in due course following conditions are necessary;

a) The holder must have taken the Instrument for value.
b) He must have obtained the instrument before its maturity.
c) The instrument route be completed and regular on its face.
d) He must have taken the instrument in good faith and without notice of any defect either in the instrument or in the title of the person negotiating it to him.

12.3.2.1 Consideration

A holder in due course must have obtained the instrument for consideration. Such consideration must be valuable consideration and not merely a good consideration. A person who takes a bill or note without consideration cannot enforce it. However, in order to secure free circulation of negotiable securities the doctrine of consideration has been relaxed in certain respects... Firstly, if a person warns to enforce on simple contract, he must prove that he has given consideration for it. But in the case of negotiable instruments consideration is always presumed to have been given. "The presumption in such a case is that the instrument was given for good consideration and if the defendant intends to set up the defence that value has not been given... the burden of proving that lies on him.[5] Every holder, therefore, is presumed to be a holder for value. Secondly, in a simple contract the only person who can sue upon it is the person from whom the consideration moves."[6] But in the case of negotiable instrument, if there be a consideration for it, it does not matter from whom it moves. Thirdly, a past consideration is sufficient to support a contract in a bill or note. A promissory note issued for the price of a buffalo sold sometimes before was held to be supported by valid consideration.[7] There is authority to the effect that the antecedent debt must be due between the parties. Where an instrument was issued for a consideration owned by a third person, the instrument could not be enforced.[8] Fourthly, if the holder has taken the instrument for consideration, the party liable will not be permitted to plead any defect or want of consideration at any earlier stage.

12.3.2.2 Before Maturity

Section 9 requires that to be a holder in due course, a person must take the negotiable instrument "before the amount due thereon became payable" For example, if the date of maturity

5. Singh, Avtar, Principles of Mercantile Law, 6th ed. 1996, p. 698
6. Wills, The Law of Negotiable Securities, 61 (4th ed.)
7. JMS Pinto v. AC Rodrigues, AIR 1976 Goa 8.
8. *Oliver v. Davis* (1949) 2 All ER 353.

of a negotiable instruments 1st March and a person takes the instrument on 1st March or' thereafter, he cannot be said to be a holder in due course as he did not receive the negotiable instrument before its maturity. But if a person takes such an instrument before IST March be has taken it before the amount due thereon has become payable and can be a holder in due course. It was laid down as early as 1825 in *Down* v *Hailing*[9], that "if a bill or note or cheque betaken after it is due", the person taking it takes at his peril. He "can have no better title to it than the party from whom he takes it, and therefore, cannot recover upon it if it turns out that it has been previously lost or stolen." This principle is stated in the first part of section 59 of the Act which provides that a person taking a negotiable instrument after its maturity has the rights thereon of a transferor. It means that a person taking art instrument after maturity wilt-not he a holder in due course and will not be capable of having a better title than that of the transferor.

The reason for the above stated provision is that, when the payment has become due and the person in possession has not taken the payment but tries to transfer the negotiable instrument after its maturity, a suspicion is raised that there might be something wrong with his title because of which he had not taken the payment of the instrument, himself.

12.3.2.3 Complete and Regular

Another requirement of the holder in due course is that the instrument should be complete and regular on the face of it. And "face" for this purpose includes back also. It is the duty of every person who takes a negotiable instrument to examine its form, for, if it contains any material defect, he will not become a holder in due course. An instrument may be defective in several ways. In *Hogarth* v. *Latham & Co case,*[10] the plaintiff took two bills of exchange without any drawer's name and completed them himself.

The court held that he could not recover upon the bills. "Anybody who takes such an instrument as this knowing that when it was accepted the bill had not the name of any drawer

9. (1825) KB 107 ER 1082.
10. (1878) 3 QBD 643.

upon it takes it at his peril.[11] An instrument may also be incomplete because it is nor properly dated or stamped. But bill of exchange does not need acceptance to make it complete and regular. Some unusual marks on the instrument may make it defective, such as the marks of dishonour, blanks, or restrictive or conditional endorsements. An improper endorsement renders the whole of the instrument irregular. This happened in the case of *Arab Bank Ltd.* v. *Ross*[12] In this case the plaintiff bank discounted for value two promissory notes given by the defendant. The notes had been made out in the name of "F and FN Co." as payee. One of the partners in fraud of the others indorsed them to the bank thus; "F and FN," the word." Company" being omitted. It was held "that the omission of the word 'Company' was sufficient to give rise to reasonable doubt whether the payee and the indorses were necessarily the same. Therefore, the note was not complete and regular on the face of them and the bank could not succeed as holders in due course." The plaintiffs were, however permitted to recover on the ground that the defendant had failed to show any defect in the title of any previous party. A mistake in spelling the name of the endorser does affect the endorser. For example, in *Leonard* v. *Wilson*,[13] a cheque payable to "Tarney and Fancy" was endorsed "Tourney and Farley," It was held that the endorsement, which though miss spelt was authorized, passed the property in the cheque. The Law on this point is best summed up on Chalmers Digest of Bills of Exchange;[14] "If the bill itself conveys a warning. Its holder, however honest, can acquire no better title than that of his transferor. The holder takes at his peril a blank acceptance, or a bill warning in any material particular so also a bill which has been torn and the pieces pasted together, at least if the tears appears to show an intention to cancel it. A post dated cheque is not irregular."

12.3.2.4 Good Faith

11. Ibid. Bramwell LJ at 645 (QBD)
12. (1925) 2 QB 216.
13. (1834) 39 RR 855.
14. 11th ed., p. 78

The Act does not use the term "Good Faith" but instead says that to be holder in due course, a person must take the negotiable instrument "without having sufficient cause to believe that any defect existed in the title of the person from whom he derives his title." The condition requires that he should act in good faith and with reasonable condition.[15] It means that holder should have received the instrument with an honest belief that the title of the transferor is a good one and, moreover, there should be nothing which could arouse a suspicion in his mind that the title of the transfer or is defective. If there is something to arouse a suspicion and he takes the negotiable instrument without making proper inquiries he cannot be said acting in good faith and thus cannot be called a holder in due course. For example when he takes a negotiable instrument which was torn into pieces and then the pieces have been pasted together or there is some over writing in the negotiable instrument and he takes it without satisfying himself that the transferor had good tide, he is not a holder in due course. Similarly, he has reason to believe that the title of the transferor could be defective, but negligently or otherwise omits to make inquiries lest the defect would come to his knowledge, he cannot be called a holder in due course.[16]

There are two methods of ascertaining a person's good faith, "subjective and" objective". In the subjective test the court has to see the holder's own mind and the only question is "did he take the instrument honestly"? In the objective test, on the other hand, the court has to go beyond the holder's mind and see whether he exercised as much care in taking the security as a reasonably careful person ought to have done. The subjective test requires "honesty", Objective "due cane and caution".

In its test whether there is a good faith or not, Indian law is stricter than English law on the subject. According to Section 90 (English) Bills of Exchange Act, "A thing is deemed to be done in Good faith, within the meaning of this Act, where it is infact done honestly, whether it is done negligently or not. "The test of presence of good faith under English law, therefore, is

15. *U. Ponnappa v. C.S. Bank*, AIR 1991 SC 441.

16. Bangia, R.K., Negotiable Instruments Act, Sixth ed.

to see whether the instrument was taken under the honest belief that the title of the transferor is a good one. If that honest belief is present, there is said to be a good faith even though the person taking the negotiable instrument is acting negligently.

The rule of 'honesty' was applied in *Raphael* v. *Bank of England'*[17] where some bank notes, issued by the Bank of England were stolen from B.S & Co. of Liverpool, on 13th Nov. 1852. Notice regarding the robbery of the notes was given to the Bank of England and then the same was circulated by hand bills to various banking institutions, in Liverpool, London's and Paris. Such a handbill was also received by St. Paul, a firm of moneychangers in Paris, in April 1853. One of the stolen bank notes for $ 500 was, presented to St. Poul on 25th June 1854 and after verifying that the holder had the passport, and obtaining his signatures, the payment of the same was made to the bolder in French money. At the time of payment St. Paul did not look at the file containing notice of robbery of the relevant bank note. Otherwise the payment would not have been made.

Raphel, who was St. Paul's correspondent in London, sought to recover the- amount of the bank notes from the Bank of England, The Bank of England contended that since St. Paul was negligent, in so far as he did not look at the file containing notice about the robbery of the bank notes, he was not a holder in due course, and therefore, he was not entitled to the payment of the stolen bank notes. But court held that a person is deemed to be acting in goad faith when be is acting bonafide, and has no notice at the time of taking the instrument there was any defect in the title of the transferor of it, even though that time he had the means of knowledge of that fact, of which means he neglected to avail himself. Forgetting or omitting to look at the notice was not considered as evidence of malafides. The plaintiff was, therefore, entitled to claim the money of the banknote in question from the Bank of England.

In this way, according to English law when a person is acting honestly, he acts in good faith even though he is negligent in taking an instrument. But in this regard Indian Law is stricter. If

17. (1855) 104 RR 638; 25 LJ CP 33.

a case similar to that of *Raphail* v. *Bank of England*[18] arises in India-the plaintiff (person taking the instrument) will no be deemed to be acting in good faith when he is negligent and does not avail himself of the means of knowledge of the fact of the defect in title of the transferor of the instrument, because according to section 9 of our Negotiable Instruments Act. If a person has "sufficient cause to believe" that the title of the transferor is defective he not acting in good faith.

12.3.2.5 Rights and Privileges of Holder in Due Course

A holder in due course enjoys following rights and privileges under the Negotiable Instruments Act,

12.3.2.6 Presumptions

According to section 118 of this Act, the first privilege is that "every holder is deemed prima facie to be a holder in due course." The burden of proving his title did not lie on him. Once it is shown that the history of the bill is tainted with fraud or illegality the burden is shifted to the holder to prove that he is a holder in due course.[19] When the burden of establishing his bonafides is thus cast upon the holder, has to show either that subsequently to the alleged fraud or illegality, value has in good faith been given for the instrument or that he is a bonafide holder for value.

12.3.2.7 Privilege against inchoate Stamped Instruments

Sometimes a person may sign and deliver to another person an inchoate or an incomplete stamped instrument that implies that the holder may fill in the amount for which authority has been given. When the holder exceeds the authority in filling the blanks and fills more amount than what was authorised he cannot enforce the instrument. If such an instrument is passed on to a holder in course then the holder in due course can claim in whole of the amount so entered in the instrument although the amount filled is in excess of authority provided

18. *Ibid.*
19. *Banku Bihari Sikdar v. Secretary of State for India*, (1908) 36 Cal. 239.

that the amount filled is covered by the stamp fixed thereon. Thus, the defense that the amount filled by the holder was in excess of the authority given cannot be taken against a holder in due course.[20]

Thus, we can say that Section 20 is applicable when the person to whom an inchoate instrument has been given passes of the same to a holder in due course, the holder in due course would be entitled to recover the amount. If the defendant signed a blank stamped paper arid not became a holder in due course by completing it and making himself the payee. The reason for this is, 'that the "payee who takes an incomplete instrument cannot be said o be a holder in due course because the transfer and negotiation in such a case, to the payee is not of negotiable instrument but only of an inchoate instrument, which is not a negotiable instrument.[21]

12.3.2.8 Fictitious drawer or payee

According to Section 42 "An acceptor of a bill of exchange drawn in a fictitious name and payable to the drawer's order is not by reason that such name is fictitious, relieved from liability to any holder in due course claiming under an endorsement by the same hand as the drawer's signature, and purporting to be made by the drawer." It means that when a bill of exchange is payable to the drawer's order and the drawer is a fictitious person (thereby meaning that the payee is also a fictitious person), the acceptor of such a bill of exchange will be liable to the holder in due course, if the latter can show that he got the bill under an endorsement by the same hand as the drawer's signatures, and purporting to be made by the drawer. Section 42 represents the rule of common law which is as follows, "Where a bill is drawn in the name of a fictitious person payable to the order of the drawer the acceptor is considered as undertaking to pay to the order of the person who signed the drawer and therefore an endorsee may bring evidence to show that the signature of the supposed drawer to the bill and to the first endorsement, are the in the same hand writing."[22]

20. Section 20
21. *Kadarkarai Reddiar v. Arumugam Nadar*, AIR 1992 Mad. 346 at 350.
22. Cooper v. Meyer, (1820) 10 B & C 468

The reason behind the rules is that there is, deemed to be an undertaking by the acceptor to pay to the order of the person who signed it as drawer, and therefore, the endorsee who is a holder in due course is entitled to recover the amount by showing that the signatures of the supposed drawer and the first endorsement on it are in the same handwriting.

12.3.2.9 Endorsee from a holder in due course

Section 53 provides that a holder who receives an instrument from a holder in due course gets the rights of the holder in due course, even if he had the knowledge of the prior defects, provided that he was not a party to them, This will apply to the case of a drawer also who has received back his bill from a holder in due course. A seller drew a bill upon his buyer for the price of two consignments of steel. The seller discounted the bill with a bank which transferred it to another bank. It was accepted by the buyer in due course, but he ultimately refused payment because of a dispute about the quality of steel. The bill came back to the seller by the process of negotiation back. The seller claimed payment of the bill from the buyer. It was held that although the seller was the drawer, he was also the holder in due course and his rights fell to be determined as such.[23]

12.3.2.10 Payment due Course

Payment in due course means payment in accordance with the apparent tenor of the instrument that is according to what appears on the face of the instrument to be the intention of the parties. A payment cannot be a payment in due course if it is made to a person not entitled to receive it. or if it is made before the due date or if it is made with a knowledge of the facts which justly impair or destroy the rights of the holder to receive the money, or under circumstances affording reasonable grounds for believing that the holder is not entitled to receive payment. Lastly, the payment must be to a person who has the right, authority and capacity to make it. Where a

23. *Jade International v .Robert Nicholas (Steels),* (1978) 3 WLR 350 CA:

bank makes payment in accordance with the apparent tenor of the instrument in good faith and without negligence under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment, payment is said to be done in due course.[24]

12.3.2.11 Payment in money only

Money means cash or anything recognized as legal tender, such as currency notes. An agent authorized to receive payment generally cannot take payment of goods[25] nor can he take a cheque in lieu of payment,[26] but if once a cheque is tendered and received and the creditor or his agent objects only to the amount, he cannot after wards object to the nature of the tender.[27]

12.3.2.12 Payment before maturity

A payment before maturity is not, payment according to the tenor of the instrument, and so, although the payment may discharge the immediate parties to the transaction, yet as to third person its effect is otherwise, for payment in due course means payment at maturity and not by anticipation. Thus, if after such premature payment the instrument is indorsed over, it is valid in the hands of a bonafide endorsee.[28] Even the maker of a note or the acceptor of a bill becoming the holder of the instrument by transfer may reissue the bill before maturity, so as to bind himself and other subsequent parties.[29]

12.3.2.13 Payment by whom

24. *Das (PM) v. Central Bank of India*, AIR 1978 Cal. 55.
25. *Howard* v. *Chapman* (1861) 4 C & P 508.
26. *Bank of Scotland* v. *Dominion Bank* (Toronoto) (1891) AC 592.
27. *Boyle Chand* v. *Moulard*, 4 Cal. 572; Steam Stoker Co., Re. (1875) LR 19 Eq 416.
28. See under Sections 60 and 90. See Bhashyam & Adiga's, The Negotiable Instruments Act, ed. 1997, p. 165.
29. *Morley* v. *Celverwell* (1840) 7 M & W 174 at 178; *Attenborough* v. *Mackenzie* (1856) 25 LJ Ex. 2412.

Any party to a bill may pay it, and such party acquires the right of the holder from whom he took the instrument against all parties prior to him, but no stranger has a right to pay the bill or note payable by another, so as acquire, the rights of a holder, except supra protest and for honour of some party to the bill or note. A payment by a stranger has been held to be a valid satisfaction of the bill if it be made on account of the acceptor, and the acceptor either presently agrees to it, or subsequently adopts it, but under the Indian law it will be a valid satisfaction even if the acceptor does not ratify.[30]

12.3.2.14 Payment to Whom

The person to whom payment is made should be in possession of the Instrument. A payment cannot be a payment in due course if it is made without requiring production of the Instrument, it is necessary that payment should be made to a person who is in a position to give a valid discharge. So, payment must be made to the "holder" or some person authorized to receive payment on his behalf. Where the instrument is payb1e to particular person or order and is not indorsed by hint, payment to any person in actual possession of such an instrument will not amount to a payment in due course. But if an instrument is payable to bearer or is indorsed in blank, payment to the person in possession of the instrument, in the, absence of suspicious circumstance, is payment in due course.

12.3.2.15 Payment in Good Faith

The payment should be made in good faith, without negligence and under circumstance which do not afford- a reasonable ground for believing that the person to whom it is made is not entitled to receive the amount. If there are suspicious circumstances, the person making the payment is at once put an inquiry, and if he pays and neglects to make inquires, such payment is not a payment in due course. Thus a bill payable to bearer is stolen, and the thief presents it to the acceptor at

30. *Belshaw* v. *Bush* (1851) 11 CB 191 191.

maturity, if the acceptor pays it to him in good faith and without having reason to believe that the Presenter is the thief it is payment in due course and acceptor is discharged. But payment of an instrument, in effect payable to bearer is not in due course, if the person paying knows or has reason to believe that instrument is a stolen one and the person demanding payment is not entitled to receive it. A payment by the acceptor of a bill, after receiving orders from the drawer to stop payment, is not payment in due course.[31] Further before making a payment on a negotiable instrument, the persons who make such payment should make sure that the person presenting it for payment is the person entitled to receive payment thereon. Thus, if the drawer of a hundi negligently makes payment to a wrong person, such payment is not a payment in due course, and the drawee will remain liable against the lawful owner of the full amount of the hundi.[32]

12.4 SUMMARY

An instrument initially belongs to the payee and he is entitled to its possession. The payee can transfer it to any person in payment of his own debt. This transfer is known as negotiation and it takes place in two ways: A bearer instrument passes by simple delivery and the person to whom it is delivered becomes the holder. An order instrument on the other hand, can be negotiated only by endorsement and delivery and the endorsee becomes the holder. Hence, holder means either the bearer or endorsee of an instrument Section 2 of the English Bills of Exchange Act, 1882, provides that “holder means the payee or endorsee of a bill or note who is in possession of it or the bearer thereof “The definition contained in Section 8 of the Indian Act is to the same effect, although expressed in different words. It says that holder “means any person entitled in his own name to the possession of an instrument “and to receive and recover the amount,” Hence, no one can be entitled to the possession of a bill or note unless he becomes either the bearer or endorsee there of.

31. *Lalla Mal* v. *Kashav Dass,* 26 All. 495.
32. *Rai Bahadur Sahu* v. *Charles,* (1901) 9 CWN 841; See M.S. Parthasarathy, 'The Negotiable Instruments Act, 17th ed., 1990 at p. 52

According to Section 8 'Holder' – The “holder” of a promissory note, bill of exchange or cheque means any person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the party’s thereto.

Thus If a person is entitled to the possession of a negotiable instrument in his own name he will be the holder. What is required is a right to possession. A person in possession of an instrument without having a right to possess the same cannot be called a holder. Thus a thief or a person taking a negotiable instrument, although may be having a de–facto possession but he cannot be called the holder because his possession is wrongful and he is not entitled to the possession of the negotiable instrument. Similarly, if I deliver a negotiable instrument to my servant for safe custody he does not become the holder because he is not entitled to the possession of his own name. Holder, therefore, means only a de jure holder” and not merely a “de facto holder.”

Holder in due course (Section -9)— “Holder in due course” means any person who for consideration became the possessor of a promissory note, bill of exchange or cheque, if payable to bearer, or the payee or endorses thereof, if payable to order, before the amount mentioned in it became payable and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived the’ title.

To be a holder in due course following conditions are necessary;

a) The holder must have taken the Instrument for value.
b) He must have obtained the instrument before its maturity.
c) The instrument route be complete and regular on its face.
d) He must have taken the instrument in good faith and without notice of any defect either in the instrument or in the title of the person negotiating it to him.

A holder in due course must have obtained the instrument for consideration. Such consideration must be valuable consideration and not merely a good consideration. A person

who takes a bill or note without consideration cannot enforce it. However, in order to secure free circulation of negotiable securities the doctrine of consideration has been relaxed in certain respects... Firstly, if a person warns to enforce on simple contract, he must prove that he has given consideration for it. But in the case of negotiable instruments consideration is always presumed to have been given. “The presumption in such a case is that the instrument was given for good consideration and if the defendant intends to set up the defence that value has not been given... the burden of proving that lies on him. Every holder, therefore, is presumed to be a holder for value. Secondly, in a simple contract the only person who can sue upon it is the person from whom the consideration moves.” But in the case of negotiable instrument, if there be a consideration for it, it does not matter from whom it moves. Thirdly, a past consideration is sufficient to support a contract in a bill or note. A promissory note issued for the price of a buffalo sold sometimes before was held to be supported by valid consideration. There is authority to the effect that the antecedent debt must be due between the parties. Where an instrument was issued for a consideration owned by a third person, the instrument could not be enforced. Fourthly, if the holder has taken the instrument for consideration, the party liable will not be permitted to plead any defect or want of consideration at any earlier stage.

A holder in due course enjoys following rights and privileges under the Negotiable Instruments Act,

According to section 118 of this Act, the first privilege is that “every holder is deemed prima facie to be a holder in due course.” The burden of proving his title did not lie on him. Once it is shown that the history of the bill is tainted with fraud or illegality the burden is shifted to the holder to prove that he is a holder in due course. When the burden of establishing his bonafides is thus cast upon the holder, has to show either that subsequently to the alleged fraud or illegality, value has in good faith been given for the instrument or that he is a bonafide holder for value.

Sometimes a person may sign and deliver to another person an inchoate or an incomplete stamped instrument that implies that the holder may fill in the amount for which authority has been

given. When the holder exceeds the authority in filling the blanks and fills more amount than what was authorised he cannot enforce the instrument. If such an instrument is passed on to a holder in course then the holder in due course can claim in whole of the amount so entered in the instrument although the amount filled is in excess of authority provided that the amount filled is covered by the stamp fixed thereon. Thus, the defense that the amount filled by the holder was in excess of the authority given cannot be taken against a holder in due course.

Thus, we can say that Section 20 is applicable when the person to whom an inchoate instrument has been given passes of the same to a holder in due course, the holder in due course would be entitled to recover the amount. If the defendant signed a blank stamped paper arid not became a holder in due course by completing it and making himself the payee. The reason for this is, 'that the "payee who takes an incomplete instrument cannot be said o be a holder in due course because the transfer and negotiation in such a case, to the payee is not of negotiable instrument but only of an inchoate instrument, which is not a negotiable instrument.

According to Section 42 "An acceptor of a bill of exchange drawn in a fictitious name and payable to the drawer's order is not by reason that such name is fictitious, relieved from liability to any holder in due course claiming under an endorsement by the same hand as the drawer's signature, and purporting to be made by the drawer." It means that when a bill of exchange is payable to the drawer's order and the drawer is a fictitious person (thereby meaning that the payee is also a fictitious person), the acceptor of such a bill of exchange will be liable to the holder in due course, if the latter can show that he got the bill under an endorsement by the same hand as the drawer's signatures, and purporting to be made by the drawer. Section 42 represents the rule of common law which is as follows, "Where a bill is drawn in the name of a fictitious person payable to the order of the drawer the acceptor is considered as undertaking to pay to the order of the person who signed the drawer and therefore an endorsee may bring evidence to show that the signature of the supposed drawer to the bill and to the first endorsement, are the in the same hand writing." The

reason behind the rules is that there is, deemed to be an undertaking by the acceptor to pay to the order of the person who signed it as drawer, and therefore, the endorsee who is a holder in due course is entitled to recover the amount by showing that the signatures of the supposed drawer and the first endorsement on it are in the same handwriting.

The payment should be made in good faith, without negligence and under circumstance which do not afford- a reasonable ground for believing that the person to whom it is made is not entitled to receive the amount. If there are suspicious circumstances, the person making the payment is at once put an inquiry, and if he pays and neglects to make inquires, such payment is not a payment in due course. Thus a bill payable to bearer is stolen, and the thief presents it to the acceptor at maturity, if the acceptor pays it to him in good faith and without having reason to believe that the Presenter is the thief it is payment in due course and acceptor is discharged. But payment of an instrument, in effect payable to bearer is not in due course, if the person paying knows or has reason to believe that instrument is a stolen one and the person demanding payment is not entitled to receive it. A payment by the acceptor of a bill, after receiving orders from the drawer to stop payment, is not payment in due course. Further before making a payment on a negotiable instrument, the persons who make such payment should make sure that the person presenting it for payment is the person entitled to receive payment thereon. Thus, if the drawer of a hundi negligently makes payment to a wrong person, such payment is not a payment in due course, and the drawee will remain liable against the lawful owner of the full amount of the hundi.

12.5 SUGGESTED READINGS

Wills, The Law of Negotiable Securities, 5 (4th ed.).
Bangia, R.K., The Negotiable Instrument Act, 6th ed. 1997.
Singh, Avtar, Principles of Mercantile Law, 6th ed. 1996.
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Aggarwal, C.L.Law of Hundi And Negotiable

12.6 TERMINAL QUESTIONS

1.Explain in detail about the holder and holder in due course

2.Write down the privileges granted to a holder in due course under N.I Act, 1881

3. How holder becomes holder in due course?

LL.M. 05 PART – I
PAPER- BANKING LAW

BLOCK 4 NEGOTIABLE INSTRUMENTS

UNIT I3 PRESENTMENT AND PAYMENT

STRUCTURE

13.1. INTRODUCTION :

A negotiable instrument may be dishonored by non-acceptance or non-payment, as presentment for acceptance is required only in case of bills of exchange. It is only the bills of exchange which may be dishonored by non-acceptance. Of course any type of negotiable instrument, like promissory note bill of exchange or cheque may be dishonored by non-payment.

The Negotiable Instrument Act provides the following three kinds of presentment:

1. Presentment of bill of exchange for acceptance.[33]
2. Presentment promissory note for sight.[34]
3. Presentment of a promissory note, bill of exchange or cheque for payment.[35]

Acceptance is required only in the case of bill of exchange and therefore it is only in the case of a bill of exchange that presentment for acceptance is there. Every negotiable instrument, promissory note, bill of exchange or cheque is ultimately meant for payment. To process the payment it has to be presented to the maker, drawee or acceptor, as the case may be. A bill of exchange may have to be presented twice, once for acceptance and again for payment. Promissory note and a cheque do not require acceptance and therefore; they have to be presented only for payment.

13.2. OBJECTIVES

The objective of this lesson is to discuss in detail the Presentment for acceptance and payment, presentment to agent etc., time and place of presentment. An attempt is made to discuss all the relevant provisions with case law.

13.3.1 PRESENTMENT FOR ACCEPTANCE

A bill of exchange may have to, be presented for acceptance before it is presented for payment. But every bill of exchange is

33. Section 61.
34. Section 62.
35. Section 613.

not required to be presented for acceptance. Presented for acceptance is necessary only where :

1. The bill is payable at a given time after acceptance or after sight. The expression "after sight" means that the bill is payable at a given time after it has been' sighted or presented to the drawee for his knowledge.
2. The bill expressly stipulates that it shall be presented for acceptance before it is presented for payment.
3. The bill is made payable at a place other than the place of residence or business of the drawee.

When a bill of exchange is expressed to be payable "after sight", it means that its payment is to be made only "after acceptance".[36] To fix the maturity of such a bill of exchange its acceptance which, includes its presentment for acceptance is which includes its presentment for acceptance, is absolutely necessary. Thus, if A draws a bill of exchange on 13 on 1st January, ordering him to pay "Two months after sight", its payment will become due only after the lapse of a period of two months from the date it is accepted by B. If B does not accept this bill, its payment will never become due. Therefore, a bill of exchange payable after sight must be presented to the drawee thereof for acceptance.[37]

Although the presentment for acceptance is compulsory only in bill of exchange as discussed above and not in other cases, there are certain advantages of presenting bills for acceptance even though the same is not compulsory. The, first advantage is that in case the drawee accepts the bill, there is an additional security of the acceptor's name to the bill. And secondly, if the drawee dishonors' the bill, the holder can immediately have his recourse against the drawer or the endorsers, if any. The drawer also, on receiving the notice of dishonor, can get his effects from the hands of the drawee.

13.3.1.1 Presentation to Whom:

36. See Section 21.
37. Section 61.

1. Generally it is the drawee to whom the presentment is to be made for acceptance.[38] Acceptance can also be made by a duly authorized agent on behalf of a drawee.[39]
2. Where there are several drawees, all of there are required to accept[40] and therefore presentment for acceptance is to be made to them all. But if some of the drawees have the authority from the others to accept, or where the drawees are partners in which case a partner has the power to accept on behalf of other partners, presentment, to a person having such an authority or to a partner is enough.[41]
3. If the drawee is dead, the presentment may be made to his legal representatives.[42] The legal representative, would be personally liable by such an acceptance unless be expressly limits his liability to the extent of the assets received by him as such.[43]
13. If the drawee becomes insolvent, the presentment may be made to his assignee.[44]

When a drawee in case of need has also been mentioned in a bill of exchange, on the disbonour of bill of exchange by the drawee the same has to be presented to the drawee in case of need. Where a drawee in case of need is named in a bill of exchange, or in any endorsement there on, the bill is not dishonoured until it has been dishonoured by such drawee.[45]

13.3.1.2 Presentment by Whom

The presentment is to be made by the holder of a bill of exchange. A bill of exchange may be negotiated even before the acceptance has been obtained. The holder who takes the, bill impliedly, undertakes to procure the acceptance there of by

38. Section 61
39. Section 27
40. Section 33 and 313.
41. Section 34
42. Section 75
43. Section 29
44. Section 75
45. Section 115

properly presenting the same as required by section 61. If the person presenting turns out to be not a rightful holder, the drawee's acceptance will ensure to the benefit of the person really entitled to the bill. By presenting the bill for acceptance, the holder does not guarantee that the bill or documents attached hereto are genuine.[46]

13.3.1.3 Time-Place of Presentment

When time or place for presentment is specified in a bill of exchange it must be presented for acceptance accordingly. When no time and place for presentment is mentioned in the ball at must be presented within a reasonable time after it has been drawn; and in business hours on a business day. The presentment may be made either at the place of business of the drawee or at his residence. If the drawee had no known place of business or fixed residence, and no place is specified in the instrument for acceptance such presentment may be made to him in person wherever he can be found. The presentment of course is to be made, if the drawee can, after reasonable search be found. If the drawee can not after reasonable search be found, the bill is dishonored.[47] Where the agreement or the usage of trade so allows, a presentment through the post office by means of a registered letter is sufficient.[48]

It has been, noted above that where no times for presentment "as been specified, a bill must be presented within a reasonable time after it has been drawn i.e., the presentment of the bill is to be made without reasonable delay. In determining what is reasonable time for presentment for acceptance regard shall be had to the nature of the instrument and the usual course of dealing with respect to similar instruments and in calculating such time public holidays shall be excluded.[49] Delay in presentment is excused if the delay is caused by circumstances beyond the control of the holder, and not imputable to his default misconduct or negligence. When

46. Bhashyam & Adhiga's The Negotiable Instruments Act, Sixteenth Ed., 1997 at p. 440.
47. Section 61 and 91.
48. Section 61.
49. Section 105.

the cause of delay ceases to operate, presentment must be made within a reasonable time.[50]

13.3.1.4 Holder's Duties and Presentment

The holder may allow the drawee 48 hours (exclusive of public holidays) to consider whether he will accept the bill or not.[51] It means that if the drawee wants time for deliberation, the holder is to allow him maximum of 48 hours.

On the expiry of the period of 48 hours the holder must demand back the bill whether accepted or not. If the drawee does not return the accepted bill within 48 hours the holder should deem the bill to have been dishonoured. It the holder of the bill allows the drawee more than 48 hours exclusive of public holidays to consider whether he will accept the same, all previous parties not consenting to such allowance are thereby discharged from liability to such holder.[52]

Another duty of the holder is to obtain only unqualified and unconditional acceptance of the bill of exchange. If the drawee makes a qualified acceptance, the holder should consider the bill which has been dishonoured. If the holder acquiesces in qualified acceptance, all previous parties whole consent is not obtained to such acceptance and discharged a against the holder.[53]

Following are the holder's duty on presentment;

1. To present the bill of exchange for acceptance within the time specified in the bill for that purpose, and if no time is specified, within a reasonable time after it has been drawn.[54]
2. To present the bill at the place, if any mentioned in the bill, and if no place in mentioned, at the usual place of business of the drawee or his residence.
3. To allow the drawee only 48 hours and not more, to consider whether he will accept the bill or not.[55]
4. To obtain an unqualified acceptance of the bill.[56]

50. Section 75-A. This section was inserted by a amendment in 1920.
51. Section 63.
52. Section 83
53. Section 86
54. Section 61 and 3.
55. Section 63

13.3.1.5 Effect of non-presentment

As above discussed it is the duty of holder to present the bill of exchange for acceptance within the time specified in the bill for that purpose, and if no time is specified within a reasonable time after it has been drawn. In default of such presentment no party thereto is liable thereon to the person making such default.[57] It means that not only the drawee cannot be made liable since he has made no acceptance, the other parties thereto, i.e, the drawer and the endorsers, if any also cease to be liable or in other words, are discharged from their liability to such a bolder who, having a duty to present makes default it the presentment of bill

13.3.1.6 When presentment excused

Section 91 provides that where presentment is excused the bill is deemed to be dishonoured for non-acceptance. Apart from two instances contained in paragraph 2 and 3 of this section where such constructive dishonour takes place there is no provision enumerating the cases where presentment is excused. Section 39(4) and 4(2) of the bill of Exchange Act enumerates the instances where the presentment is excused. Thus, presentment for acceptance is excused when the drawee is a fictitious person, or in capable of contracting or if he cannot after reasonable search be found. Again if presentment is made irregularly, such irregularity is excused when acceptance is refused on, some other ground. But the fact that the holder has reason to believe that the bill on presentment will be dishonoured does not excuse presentment.[58]

13.3.2PRESENTMENT OF PROMISSORY NOTE FOR SIGHT

When a bill or promissory note is payable after sight it must be presented by the holder for the drawee's or maker's acceptance within the specified time or if no time is specified within, a reasonable time of its issue. Reasonable time is a

56. Section 83 and 86.
57. Section 61
58. Section 41 (3) of (English) Bills of Exchange Act, 1882.

question of fact that depends upon- the means of communication available and the usages of a particular trade. Regard must also be had to the interests of the holder, drawer and endorsers. Also presentment must be made in the business hours on a business day. It is, however, advisable for the holder to get an acknowledgement of presentment by the maker writing "seen" on the instrument, initialing, and dating the promissory note.

If the holder fails in this duty, the drawer and all endorsers prior to him shall be discharged from their liability to him. Thus, in a case before Privy Council.[59]

A party in Calcutta drew bill on a party in Hong Kong, payable sixty days after sight. The holder retained it for five months and when he ultimately presented it for acceptance, the china bills had lost their value. This was held to be an unreasonable delay discharging the parties.

13.3.3 PRESENTMENT FOR PAYMENT

All promissory notes, bills of exchange and cheques are required to be presented for payment at maturity. The presumption generally is that the payment is to be made at the debtor's place. The maker of the promissory note, or the acceptor of a bill of exchange being principal debtor could be charged with liability even without presentment for payment. But even against the maker and the acceptor action would succeed with costs if the presentment was made and payment refused. To charge other parties to the instrument presentment for payment is necessary, except in the cases, mentioned in Section 76, when the presentment is excused. If there is a default in making such presentment the parties other than the maker acceptor or drawee are not liable thereon such holder.[60]

13.3.3.1 Presentment to whom

The presentment for payment of promissory notes, bills of exchange and cheques must be made to the maker, acceptor or drawee, thereof respectively, or the duly authorized agent of

59. Singh Avtar Principles of Mercantile Law Sixth ed., 1996, p. 727
60. Section 64

the drawee, maker or acceptor, as the case may be, or where the drawee maker or acceptor has died, to his legal representatives or where he has been declared insolvent to his assignee.[61]

13.3.3.2 Presentment by Whom

Th. presentment should be made by or on behalf of the holder of the promissory note, bill of exchange or cheque. He is bound to make presentment unless the case is covered by Section 76 where the instrument may be deemed to be dishonored even without presentment.

13.3.3.3 Time for Presentment

Where an instrument is payable after a fixed period of time it should be presented for payment on its maturity.[62] The maturity of a promissory note or bill of exchange in the date at which it falls due. Every promissory note or bill of exchange which is not expressed to be payable on demand, at sight or on presentment is at maturity on the third day after the day on which it is expressed to be payable.[63] It means that in respect of promissory notes or bills to exchange payable otherwise than on demand three days of grace are to be allowed. For examples, if a promissory note or a bill of exchange is expressed to be payable on 1st June, its date of maturity is 4th June.

A promissory note payable by installments must be presented for payment on the third day after the date fixed for payment of each installment and non-payable on such presentment has the same-effect as non-payment of a note on maturity.[64] Therefore, when the payment is to be made by installments three day of grace are allowed for each installment. Non-presentment in respect of a particular installment discharges the endorser from liability towards the holder making default, only as regards

61. Section 64, 27 and 75.
62. Section 66
63. Section 22.
64. Section 67

liability in respect of that particular installment; unless there is a contract to the contrary.

No question of maturity arises for a promissory note or bill of exchange payable at sight or on demand and also a cheque, which is always payb1e on demand because such Instrument becomes due for payment from the date of their issue. A negotiable instrument payable on demand must be presented for payment within a reasonable time after it is received by the holder.[65] In determining reasonable time regard shall he had to the nature of the instrument and the usual course of dealing with respect to similar instruments and in calculating such time, public holidays shall be excluded.[66]

13.3.3.4 Presentment of Cheque to Charge Drawer

Section 72 provides that in order to charge the drawer, a cheque must be presented at the bank upon which it is drawn before the relation between the drawer and his banker has been altered to the prejudice of the drawer. This provision is subject to Section 84, which says that if the holder makes a delay in the presentment of the cheque for payment arid during the delay there occurs a change in the relation between the banker and the drawer (for instance when the bank fails) resulting in some loss to the drawer, the drawer is discouraged to the extent such a loss. Thus, if there were sufficient funds to meet the cheque when the same ought to in have been presented, but subsequently, since the bank fails the holder cannot blame the drawer for the same and cannot sue the drawer. The holder himself ranks as a creditor to the drawee bank for such amount.[67]

13.3.3.5 Presentment of Cheque to Charge Endorsers

Section 73 provides that in order in charge any other person than the drawer, i.e to charge the endorser, a cheque must be presented within a reasonable time after delivery thereof by such person, other persons than the drawer are obviously

65. Section 74
66. Section 105
67. Bangia, R.K. the Negotiable instrument Act, Sixth ed., 1997, p. 83

endorser. To charge a particular endorser it is necessary that the cheque must be presented for payment within a reasonable time after the delivery by such endorser. Reasonable time is to be counted from the date of the delivery by a particular endorser and is form the date of receipt by the holder. There is the therefore, a possibility that he presentment may be within a reasonable time after the deliver by some endorsers and delayed as regards some after endorsers, because all the endorsers do not always deliver on the same date. For example, A who is the payer of a cheque endorses and delivers it to B.B. retains the cheque within him for unreasonably long time and then endorses and delivers to C.C. presents this cheque within a reasonable time of receiving it from B but its cheque is dishonourd. Since the presentment was made within a reasonable time after its delivery by B, C can enforce payment against B. But the presentment is not within a reasonable time after A had delivered the cheque, C cannot charge A: in order the presentment is a proper one, it must be made during the usual hours of business and if at a banker's within banking hours.[68] Delay in presentment is excused the same is caused by circumstance beyond the control of the holder and not imputable to his default. Misconduct or negligence, when the cause of delay, ceases to operate, presentment must be made within a reasonable time.[69]

13.3.3.6 Place for Presentment

Where a promissory note, bill or cheque is made drawn or accepted payable at a specified place and not elsewhere it must, be presented at that place, otherwise no party would be liable to the holder.[70] Similarly, a bill or note made payable at a specified place must be presented at that place, otherwise the drawer or maker will be discharged from liability to the holder.[71] The other parties will remain liable. The words “specified place” means a statement which gives the precise address of the place where the instrument is required to be presented. It

68. Section 65
69. Section 75–A
70. Section 63
71. Section 69

means, for example, in a case before the Madras High Court,[72] a promissory note was made payable at Madras", the court after a careful consideration of all the aspects of the question", came to the conclusion, "that the place of payment mentioned in the bill should be precise, certain and definite". The mere mention of the name of a big city "Madras" does not make the instrument payable at a specified place and therefore, no question of presentment at a specified place arises. This will be so even if the bolder happens to know the address of the maker, because "the subsequent holder or endorsee cannot be taxed with knowledge of the address of the maker at which presentment has to be made, and the obligation to present would, therefore, not exist.

When no place for presentment is specified in the promissory note or bill, presentment must be made at the place of business, if any, or at the usage residence of the maker, drawee or acceptor as the case may be.[73] If the maker, drawee or acceptor has no known place of business or fixed residence and the instrument does not also specify any place for presentment for acceptance or payment, then presentment may be made to him in person wherever he can be found.[74]

13.3.3.7 Effect of Non-presentment

As discussed above a negotiable instrument payable on demand must be presented for payment within a reasonable time after it is received by the holder and other instruments are to be presented within reasonable time of their maturity. The holder of a promissory notes bill of exchange or cheque must present for payment to the maker, acceptor or drawee thereof respectively at a proper place and at a proper time. In default of such presentment the other parties thereto are not liable there on to such holder.[75] Non – presentment for payment does not discharge the maker, or the drawer. It simply discharges other parties. i.e., the drawer and the endorsers. In the case of a bill of exchange or cheque the drawer and the endorsers, if

72. *Sivaram* v. *Jayaram,* AIR 1966 Mad. 297.
73. *Pihilpolt* v. *Bryani* (1827) 3 C & P 244; 172 ER 405.
74. Section 71.
75. Section 64

any, and in the case of promissory note, the endorsers, are the persons discharged. On non-presentment under section 61 and 62, no party to the negotiable instrument can be made liable thereon, whereas on non-presentment for payment under section 64, the maker, acceptor and the drawee can still be made liable and. the parities who arc discharged other than these. Thus, in *Canara Bank* v. *Sanjeev Enterprises case*,[76] it has been held thus if a hundi is not presented for payment its acceptor is not exempted from liability but that amount to the exemption of other parties to the Hundi from liability.

13.3.3.8 When Presentment Unnecessary

Section 76 provides the following 'circumstances when no presentment for payment is negotiable and the instrument is at the due date of presentment;

(1)If the. instrument drawee or acceptor intentionally prevents the presentment of the instrument.

(2)If the instrument is payable at his place of business he closes such place on a business day during the usual business hours.

(3)If the instrument is payable at some other specified place, neither be nor any person authorized to pay it attends at such place during the usual business boils. Thus where a instrument was payable at the "Alliance Bank of India", and on due date neither the acceptor nor any person on his, behalf appeared there, no further presentment was necessary to charge him.[77]

(4)If the instrument is not payable at any specified place, the party liable cannot after due search be found.

(5)If the party who is sought to be charged has engaged to pay not with standing non-presentment. This is known as the waiver of presentment. The holder of a note sent a registered notice claiming payment due on a promissory note. The dependant denied

76. AIR 1988 Delhi 372.
77. *Ram Singh* v. *Gulab Ram*, 1 LR, Law 262.

his liability. Presentment was need to have been waived by the denial.[78]

(6)The party sought o be made liable makes part payment without presentment on account of the amount due on the instrument.

(7)The party sought to be charged promises without presentment to pay the amount due in whole in part.

(8)The party liable otherwise waives his right to take advantage of any default in presentment for payment.

(9)As against the drawee, no presentment for payment is necessary if he could not suffer any damages for want of such presentment.

13.3.4 DISHONOUR BY NON-ACCEPTANCE

Acceptance is required only in the case of a bill of exchange and therefore, it is only, in the case of a bill of exchange that presentment for acceptance is there. Section 91 provides that the dishonor of a bill of exchange, by non–acceptance, may take place in any or the following ways :

(1)If the drawee does not accept the bill within 48 hours from the lime of presentment for acceptance, or refuses to accept, bill becomes dishonored at once. If there are two or more drawees who are not partners and if one of them refuses to accept, the bill becomes dishonored, unless these several drawees are partners.[79] Generally, when there are a number of drawees all of them must accept the same, but when the drawees are partners acceptance by one of them means acceptance by all.

(2)Where presentment for acceptance is excused and the bill is not accepted; it is said to be dishonored by non-acceptance. The circumstance under which a presentment for acceptance is excused are :

(a)Where the drawee after reasonable search cannot be found

(b)Where the drawee is in competent to contract.

78. *Maheshwar Dayal* v. *Amar Singh*, AIR 1983 P & H. 197

79. Section 33 and 313.

(c)Where the drawee is a fictitious person.

(d)Where the drawee becomes a bankrupt, or is dead, for under Section 75, presentment for acceptance to the receiver or the legal representative has been made optional, perhaps on the ground that presentment for acceptance must as for as possible be personal.

(e)Were although presentment for acceptance is irregular acceptance is refused on some other ground.

(3)When the drawee makes a qualified acceptance, the holder may treat the bill of exchange having been dishonored. It is expected that the drawee will make an unqualified acceptance. If the drawee makes a qualified acceptance and the holder agrees to that all these parties who do not consent to such an acceptance are discharged from their liability towards the holder.[80] It is, therefore, in the interest of the holder that when there is a qualified acceptance by the drawee he should consider the bill to be dishonored. Examples of qualified acceptance are accepting to pay a different sum or to pay subject to fulfillment of condition or to pay at a different place than stated by the drawer in the bill of exchange.

The provisions of this section are applicable to bills of exchange payable or sight or on demand.[81] In *Nanak Chand* v. *Lal Chand*,[82] the Panjab & Haryana High Court has held that a bill payable at sight or on demand is not required by law to be presented for acceptance only. This is not correct. As pointed out by the, Supreme Court in *Jagjivan* v. *Ranchhoddas*,[83] presentment for acceptance must always and in every case precede presentment for payment and in the case of bill payable at sight or on demand both stages synchronize and there is only one presentment which is, both for acceptance and for payment. If the bill is not paid, it is dishonoured by non-acceptance.

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80. Section 86.
81. *Veerappa Chetry* v. *Veeldanet Ambulam,* 101 W 39; 52 IC 370.
82. AIR 1958 Punj. 222; ILR (1958) Punj. 1178.
83. AIR 1954 SC 554; See Bhashyam & Adiga's the Negotiable Instrument Act, Sixteenth ed., 1997, p. 570.

13.4 SUMMARY

A negotiable instrument may be dishonoured by non-acceptance or non-payment, as presentment for acceptance is required only in case of bills of exchange. It is only the bills of exchange which may be dishonored by non-acceptance. Of course any type of negotiable instrument, like promissory note bill of exchange or cheque may be dishonoured by non-payment.

The Negotiable Instrument Act provides the following three kinds of presentment:

1. Presentment of bill of exchange for acceptance.
2. Presentment promissory note for sight.
3. Presentment of a promissory note, bill of exchange or cheque for payment.

A bill of exchange may have to, be presented for acceptance before it is presented for payment. But every bill of exchange is not required to be presented for acceptance. Presented for acceptance is necessary only where :

1. The bill is payable at a given time after acceptance or after sight. The expression "after sight" means that the bill is payable at a given time after it has been' sighted or presented to the drawee for his knowledge.
2. The bill expressly stipulates that it shall be presented for acceptance before it is presented for payment.
3. The bill is made payable at a place other than the place of residence or business of the drawee.

When a bill of exchange is expressed to be payable "after sight", it means that its payment is to be made only "after acceptance". To fix the maturity of such a bill of exchange its acceptance which, includes its presentment for acceptance is which includes its presentment for acceptance, is absolutely necessary. Thus, if A draws a bill of exchange on 13 on 1st January, ordering him to pay "Two months after sight", its payment will become due only after the lapse of a period of two months from the date it is accepted by B. If B does not accept this bill, its payment will never become due. Therefore, a bill of exchange payable after sight must be presented to the drawee thereof for acceptance.

When time or place for presentment is specified in a bill of exchange it must be presented for acceptance accordingly. When no time and place for presentment is mentioned in the ball at must be presented within a reasonable time after it has been drawn; and in business hours on a business day. The presentment may be made either at the place of business of the drawee or at his residence. If the drawee had no known place of business or fixed residence, and no place is specified in the instrument for acceptance such presentment may be made to him in person wherever he can be found. The presentment of course is to be made, if the drawee can, after reasonable search be found. If the drawee can not after reasonable search be found, the bill is dishonored. Where the agreement or the usage of trade so allows, a presentment through the post office by means of a registered letter is sufficient.

Acceptance is required only in the case of a bill of exchange and therefore, it is only, in the case of a bill of exchange that presentment for acceptance is there. Section 91 provides that the dishonor of a bill of exchange, by non–acceptance, may take place in three ways.

13.5 SUGGESTED READINGS

1 Bangia, R.K., The Negotiable Instrument Act, 6th ed. 1997.
2 Singh, Avtar, Principles of Mercantile Law, 6th ed. 1996.
3 Bangia, R.K., Negotiable Instruments Act, Sixth ed.
4 Aggarwal, C.L.Law of Hundi And Negotiable
5 P.N. Varshney, Banking Law and Practice
6 Tannan's, Banking law and practice in India

13.6 TERMINAL QUESTIONS

1. Discuss in detail the 'presentment for acceptance' of negotiable instrument.
2. When negotiable instruments are said to be dishonored?.
3. For what purpose instruments are presented for acceptance?.
4. Discuss acceptance for honour.

LL.M. 05 PART – I
PAPER- BANKING LAW

BLOCK 4- NEGOTIABLE INSTRUMENTS
UNIT 14 – LIABILITIES OF PARTIES AND DISHONOUR OF CHEQUE

STRUCTURE

14.1 INTRODUCTION:

The maker of a promissory note and the acceptor of a bill are bound to pay the amount of the instrument at maturity according to the apparent tenor of the promissory note or of the acceptance respectively in default, such person is bound to compensate any party to the instrument for the loss or damage caused to him by such default. The maker of a promissory note is stopped from denying the validity of the instrument as originally made, and cannot in a suit by a holder in due course plead the incapacity of the payee to endorse the instrument. The acceptor too cannot deny the payee's capacity, nor can be deny the authority of the drawer to draw or Indorse the bill, though he may plead that the bill was not really drawn by the person by whom it purports to have been drawn. It is also open to an acceptor to show that an endorsement is forged, but if the accepted the bill knowing or having reason to believe that the endorsement was forged, he cannot escape liability. As regards an endorser, his liability is much the same as that of the drawer of a bill of exchange. In fact he is said to be a new drawer and is bound to compensate every subsequent holder in case of dishonour by the drawee, maker or acceptor, for any loss or damage, caused to him provided he receives due notice of dishonour.

14.2 OBJECTIVES

The main object of this lesson is to discuss the liability of acceptor maker, drawer and drawee with the help of statutory provisions and relevant case law including the circumstances in which banker is bound or justified in dishonouring the custom's Cheques.

14.3.1 LIABILITY OF ACCEPTOR OR MAKER

According to Section 32 of the Negotiable Instruments Act, 1881, which provides about the liability of the maker of a note or the acceptor of a bill, is as follows:
In the absence of a contract of the contrary, the maker of a promissory note and the acceptor before maturity of a bill of

exchange are bound to pay the amount thereof at maturity according to the apparent tenor of the note acceptance respectively and the acceptor of a bill of exchange at after the maturity is bound to pay the amount thereof to the holder on demand.

In default of such payment' as aforesaid, such maker or acceptor is bound to compensate the party to the note or bill for any loss or damage sustained by him and caused by such default. .

14.3.1.1 Maker's Liability

When the maker of a promissory note signs the same there is an unconditional undertaking made by him to pay the amount of the note according to its tenor. He is not bound to pay the note before maturity, and even if he does so without having it surrendered up to him. He will be liable to any subsequent bonafide holder for value without notice before it becomes due.[84] The moment it is admitted that the maker of a note or acceptor of a bill, made or accepted it, the onus is upon him to get rid of his liability, unless the person suing on the bill or note, is charged with fraud or some *prima facie* case is made out against him, for the person who signs a bill is presumed to be liable for the whole amount appearing on the face of the document.[85] If one partner gave to his copartner a note which was in such a form at to bind not the firm but the partner who gave it, he might be sued upon by the copartner although the note in question had reference to some partnership transaction even without taking final accounts of the partnership.[86] In one important case[87], the maker of a pronote contended that he executed the document only as a guarantor to his brother-in-law's loan and also produced an agreement to that effect between his brother-in-law and himself. In this case, the Court held that the agreement would hive no effect on his obligation to pay the amount and even if he executed the pronote as

84. *Glass Code* v. *Bails* (1889) 24 QBD 13 (CA).
85. *Nair Ali* v. *Kherchand* 36 IC 996.
86. *Sarbulal* v. *Vishal Chand* (1960) MP 113.
87. *Jose Inaco Lourenco* v. *Xec Hamza* AIR 1975 Goa. 29.

guarantor or surety, it would amount to a proper consideration and would bind the defendant to honour the pronote.

14.3.1.2 Acceptor's Liability

The drawer of a bill of exchange becomes liable on the bill when he accepts the same. An acceptance by him means his undertaking to pay the amount according to the tenor of the bill.

The liability of the acceptor of a bill of exchange is similar to that of the maker of the promissory note. A bill of exchange contains an unconditional order and when the drawee accepts to pay the amount, there is obviously an unconditional undertaking by him to pay in accordance with the tenor of the bill. On acceptance, the acceptor becomes primarily liable to pay the amount of the bill on its maturity.

The acceptor of the bill of exchange is himself a 'principal debtor, he is the person primarily liable to pay the holder in due course. The maker or drawee of bill of exchange is at best relegated to the position of surety. As a principal debtor the liability of the acceptor is absolute. Thus, liability goes to the extent that the acceptor is not bound to pay before the maturity of hundi. However, if he does so, without having the same surrendered, he will be liable to pay any subsequent bonafide holder for value without having notice.[88] In a suit filed against acceptor of bill of exchange where the drawer is not made part to suit, the suit 'is maintainable as acceptor of bill of exchange is liable under the Act, as principal debtor.[89]

According to Section 42 of the Act, when a bill of exchange is payable to the drawer's order and the drawer is a fictitious person, the acceptor of the bill will still be liable to a holder in due course provided the later can show that he got the bill purporting to be indorsed by the drawer and the signatures of the first endorsement and of the drawer are in same handwriting.

Generally, a forged endorsement cannot convey a good title even to a holder in due course and therefore no person can be

88. *Bank of Maharashtra* v. *Swastik Sales Corpn.* 11 (1992) BC 590; (1992) (1) CCC 462.
89. Bhashyam & Adiga's. The Negotiable Instrument Act, 16th ed. 1997, p. 325

made liable on a negotiable instrument towards one who derives his title through a forged endorsement. To this general rule there is an exception if the forged endorsement is there before acceptance, negligently accepting such a bill will make the acceptor liable. An acceptor of a bill of exchange already endorsed is not relieved from liability by reason that such endorsement is forged, if he knew or had reason to believe the endorsement to be forged when he accepted the bill.[90] The reason for the acceptor's liability on the forged endorsement is that he accepted the bill either with the knowledge or having reason to believe that an endorsement on the bill which had been made prior to his acceptance was forged and such, an acceptor cannot take advantage of his own wrong. He ought not to have accepted such a bill but once he accepts he cannot be relieved from the liability on the plea that the endorsement was forged. Of course, an acceptor is not liable in respect of a forged endorsement made prior to the acceptance of which he neither knew nor as a reasonable man could have known. An acceptor is also not liable towards a holder deriving title out of a forged endorsement which was made after the bill has been accepted.[91]

14.3.1.3 Liability of Drawer of a Bill

The drawer of a bill of exchange or cheque is bound, in case of dishonour by the drawer or acceptor, thereof to compensate the holder, provided due notice of dishonour has been given to, or received by, the drawer[92] as herein after provided.

The drawer of a bill of exchange is primarily liable until the bill has been accepted by the drawer. But after acceptance the acceptor becomes primarily liable. The liability of the drawer then becomes secondary to that of the acceptor. Thus, the liability of the drawer of a bill can be put in terms of the following propositions;

1) By drawing and issuing the bill he engages that it shall be accepted and paid by the drawer according to its apparent tenor, and

90. Section 41
91. R.K. Bangia, Negotiable Instruments Act, 6th ed. 1997.
92 Section 30

2) That if it is dishonoured either by non-acceptance or by non-payment, he shall compensate the holder or every endorser who has been compelled to any for the loss suffered by him provided that a notice of dishonour has been given to or received by him.

The drawer of a cheque gives a guarantee to the holder that it shall be paid by the banker when it is duly presented for payment, if the cheque is dishonoured, the drawer is liable to compensate the holder provided that he has received notice of dishonour. There is however, this difference between the liability of the drawer of a bill and that of a cheque that the liability of the drawer of a cheque is primarily and not secondary. This is so because the holder of a bill can sue the acceptor, but the holder of a cheque has no remedy against the banker. His remedy is only against the drawer.[93]

14.3.1.4 Liability of Drawee

There' is no provision in the Negotiable Instruments Act that the drawee is as such liable on the instrument the only exception being under Section 31 (in the case of a drawee of a cheque having sufficient funds of the customer) in his hands 'and even then the liability s only towards the drawer and not to the payee.[94] The drawer of a cheque is always a banker. A person who keeps an account with a banker is called a "customer". The relationship between the banker and his customer is contractual. The banker's contractual duty to pay cheque is owed only to the customer and not to the payee or the holder of the cheque. Thus, if the banker refuses to pay the cheque the holder has no remedy against the banker and this will be so even if the cheque has been marked as good for payment by the drawee banker. This was laid down by the Privy Council in *Bank of Baroda* v. *Punjab National Bank*.case, [95] In this case, one G was indebted to one M.G. gave M a post-dated cheque on the Bank of Baroda for Rs. 2,75.000 in satisfaction of his debt. The cheque was marked by B Bank as

93. *Punjab National Bank* v. *Bank of Baroda,* (1994) 71 IA 124, AIR 1944 PC 58.
94. *Jagjivan Mavji* v. *Ranchhoddas* AIR 1954 SC 554 .
95. (1994) AC 176.

“good for payment on 20.6.39 M discounted this cheque with the Punjab National Bank and obtained Rs. 2,40,000 immediately. On 20.6.39 the Punjab Bank presented the cheque on the counter of the Baroda Bank. A clerk consulted G’s account and found therein a credit of annas 7 and pies three only. The payment was accordingly refused.

The Punjab Bank sued the Baroda Bank to secure the payment of the cheque. Their contention was that by marking the cheque as good for payment the Baroda Bank had accepted the cheque within the meaning of Section 7 of the Act and, therefore should be held liable as acceptor. Rejecting this contention, Lord Wright laid down as;

"There is no case in the banks on the acceptance of a cheque... Writers are of the opinion that marking or certification is neither in form nor in effect an acceptance. Their Lordships are of opinion that the certification relied on as constituting acceptance of the cheque is not an acceptance within the meaning of the English and Indian Acts. It is not necessary to hold that a cheque can never be accepted it is enough to say that it is done in very unusual and special circumstances. No case is reported in England or in India of a banker being held liable or even sued, as an acceptor of a cheque drawn upon him.

14.3.1.5 Where funds insufficient

Section 31 of the Negotiable Instruments Act, 1881 provided that it is the duty of banker to pay a customer’s cheque when he had “sufficient funds of the drawer in his hand.” Therefore, when either there are no funds to meet the cheque or the amount to the customer’s credit is insufficient to meet the whole amount of the cheque, the banker is justified in refusing the payment of that cheque. However, if there is a contract between the banker and the customer whereby the banker has already undertaken to meet the customer’s cheques even though there are no sufficient funds of the customer to meet the same, the banker is bound to honour the cheque, otherwise the banker would tender himself liable to the customer for the

breach of the contract.[96] The banker cannot make part payment where more than one cheques are presented at the same time and the balance is sufficient to meet some but riot all. According to a decision of a Canadian Court; the banker should refuse payment of all the cheques.[97] But in the United State the banker has to pay in whatever order he likes until the balance is no longer sufficient.[98]

14.3.1.6 When customer becomes insolvent

The banker's authority is also determined when he has received notice of the customer's insolvency or of presentation of an insolvency petition against him.[99] When a customer is adjudicated insolvent his assets vest in the official assignee, which only has a power to deal with them. In such a case the banker must refuse to pay the insolvent customer's cheques.[100]

14.3.1.7 Where customer has become a person of unsound mind

A person of unsound mind is not competent to contract. A cheque being a contract of payment is suspended during the period of the customer's insanity provided that the banker has notice of the fact.

14.3.2 LIABILITY OF THE ENDORSER

Section 35 of the Negotiable Instruments Act provides that every endorser impliedly undertakes to be liable to every subsequent holder of the maker, drawee or the acceptor dishonour the same. Thus, the endorser stands in the position of a surety to the prior parties. His liability arises only if there is a default by the party who is primarily liable to pay the instrument on its maturity. The endorser can exclude his

96. *Flemming* v. *Bank of New Zealand* (1990) A.C. 577: *Rayner & G.* v. *Hambros Banks,* (1942) 2 ALL ER 5914.
97. *Villiers* v. *Bank of Montreal,* (1993) OWN 649.
98. *Reinisch* v. *Consolidate National Bank.*
99. Re Dalton (1963) 1 Ch. 336; 2 ALL ER 497 (CA).
100. R.K. Bangia, Negotiable Instruments Act, Sixth ed., 1997.

liability by express words in the endorsement or can make it conditional. Section 62 of the Act permits an endorser to make the endorsement in such a way that he either excludes his own liability (by sans recourse endorsement), or, makes such liability or the right of the endorsee to receive the amount due thereon depend upon the happening of a specified event. For example, in an endorsement made by 'X' he writes 'pay to Y without recourse'. X does not incur any liability on this instrument, and. Y cannot bring an action against X, even though the. Instrument is dishonoured by those who were hound to pay the sane. Such an endorsement is known as *sans recourse* endorsement Similarly, X in his endorsement could write, "pay to Y, if a ship arrives". In such a case the right of the endorsee Y to receive the amount or the liability of X to pay the same cannot arise unless the ship arrives.

14.3.2.1 Nature of liability of the various parties similar to that under a contract of guarantee

It is clear from above discussion that making of a promissory note, acceptance of bill of exchange, drawing of a bill or a cheque, or the endorsement of a negotiable instrument implies some undertaking on the part of the person making, accepting, drawing or endorsing a negotiable instrument. Though various parties to a negotiable instrument could be liable thereon but the nature of the liability of each one of them is not similar. The liability of some of them is similar of that of a principal debtor whereas the liability of some others is similar to that of a surety. According to section 37 of the Negotiable Instruments Act.

> *The maker of a promissory note or cheque, the drawer of a bill of exchange until acceptance, and the acceptor are, in the absence of a contract to the contrary respectively, liable therein as principal debtors, and other parties there of are liable thereon as sureties for the maker, drawer or acceptor, as the case may be".*

In a contract of guarantee a person who undertakes to be primarily liable is the principal debtor and the person who

undertakes to be liable if the principal debtor does not perform his duty as a surety. Four persons i.e., the maker of a promissory note, the maker or drawer of a cheque, the drawer of a bill of exchange until acceptance and the acceptor of a bill of exchange occupy the position of a principal debtor. When a person makes a promissory note there is an unconditional promise from his side to pay, and, therefore his undertaking to pay is similar to that of principal debtor. Similarly, then a person drawn a cheque, he is the only person to whom the payee can look upon to enforce his right of getting the payment of the cheque and he is the principal debtor, because the payee or the holder do not have any privity of contract with the drawee bank and the drawee bank does not incur any responsibility towards the holder of the cheque. The position of the drawer of a bill of exchange before its acceptance is similar to that of the drawer of a cheque; i.e., he is the only person responsible and his liability is that of a principal debtor. After the acceptance of a bill of exchange; there is deemed to be an express promise by the acceptor of a bill of exchange to pay the amount, his liability is primary and unconditional i.e., that of a principal debtor.

The parties other than those stated above are liable as sureties for those who are liable as principal debtor. Thus, after a bill of exchange has been accepted the acceptor is the principal debtor and the drawee is a surety for the acceptor similarly, where the negotiable instrument is endorsed, the endorser is a surely for those who are already liable on the negotiable instrument. For example, draws a bill payable to his own order on B, who accepts. A afterwards indorses the bill to C, C to D, and D to E. In this case, B the acceptor of the bill is the principal debtor and all other parties, i.e., A, the drawer and indorse and C and D, who are endorsers thereon, are liable as sureties for the principal debtor, B. Of course, the liability of all of them is towards E, who is the holder of the bill of exchange.

Where there are two or more sureties, the position inter–se them s stated in section 8 of the Negotiable Instruments Act which is as follows; “As. between the parties so liable as sureties each prior party is, in the absence of a contract to’ the contrary, also liable thereon as a principal debtor in respect of each subsequent party.”

The above stated prevision implies that various persons liable on a negotiable instrument are not merely co-sureties, but as between themselves, each prior party is a principal debtor as related to each subsequent party, who is his surety. Thus, if A draws a bill payable to his own order on B, who accepts, A afterwards indorses the bill to C, C to D, and D to E. As between B and B, B is the Principal debtor and A, C and D are his sureties. As between B and C, C is the principal debtor and D his surety.[101]

14.3.3 DISHONOUR

Dishonour is of two kinds :

1) Dishonour of a bill of exchange by non-acceptance.
2) Dishonour of a promissory note, bill of exchange or cheque by non-payment.

14.3.3.1 Dishonour By Non-acceptance

Acceptance is required only in the case of a bill of exchange and therefore, it is only, in the case of a bill of exchange that presentment for acceptance is there. Section 91 provides that the disbonour of a bill of exchange, by non–acceptance, may cake place in any or the following ways :

(1) If the drawee does not accept the bill within 48 hours from the time of presentment for acceptance, or refuses to accept, bill becomes dishonoured at once. If there are two or more drawees who are not partners and if one of them refuses to accept, the bill becomes dishonoured, unless these several drawees are partners.[102] Generally, when there are a number of drawees all of them must accept the same, but when the drawees are partner's acceptance by one of them means acceptance by all.

(2)Where presentment for acceptance is excused and the bill is not accepted; it is said to be dishonoured by non-acceptance. The circumstance under which a presentment for acceptance is excused are as follows:

101. Illustration to Section 38.
102. Section 33 and 314.

(a) Where the drawee after reasonable search cannot be found
(b) Where the drawee is in competent to contract.
(c) Where the drawee is a fictitious person.
(d) Where the drawee becomes a bankrupt, or is dead, for under Section 75, presentment for acceptance to the receiver or the legal representative has been made optional, perhaps on the ground that presentment for acceptance must as for as possible be personal.
(e) Were although presentment for acceptance is irregular acceptance is refused on some other ground.

(3)When the drawee makes a qualified acceptance, the holder may treat the bill of exchange having been dishonoured. It is expected that the drawee will make an unqualified acceptance. If the drawee makes a qualified acceptance and the holder agrees to that all these parties who do not consent to such an acceptance are discharged from their liability towards the holder.[103] It is, therefore, in the interest of the holder that when there is a qualified acceptance by the drawee he should consider the bill to be dishonoured. Examples of qualified acceptance are accepting to pay a different sum or to pay subject to fulfillment of condition or to pay at a different place than stated by the drawer in the bill of exchange.

The provisions of this Section are applicable to bills of exchange payable or sight or on demand.[104] In *Nanak Chand* v. *Lal Chand*,[105] the Panjab & Haryana High Court has held that a bill payable at sight or on demand is not required by law to be presented for acceptance only. This is not correct, as pointed out by the, Supreme Court in *Jagjivan* v. *Ranchhoddas*,[106] presentment for acceptance must always and in every case precede presentment for payment and in the case of bill payable at sight or on demand both stages synchronise and there is only one presentment which is, both for acceptance

103. Section 86.
104. *Veerappa Chetry* v. *Veeldanet Ambulam,* 101 W 39; 52 IC 370.
105. AIR 1958 Punj. 222.
106. Bhashyam & Adiga's, The Negotiable Instrument Act, Sixteenth ed., 1997.

and for payment. If the bill is not paid, it is dishonoured by non-acceptance.

14.3.3.2 Dishonour by Non-payment

When promissory note, bill of exchange or cheque is duly presented for payment and payment is refused then such instrument is dishonoured by non-payment. When a bill had been accepted already, then the acceptor is bound to provide for its payment at the time and place it is due, and his failure to do so is dishonouring the bill he had undertake to pay. Since a cheque is not accepted by the drawee-banker, he is not found to honour the cheque unless he has contracted to do so with the drawer of the cheque. This does not, however, affect the question of the dishonour of the cheque for the drawer by his drawing declares to the payee that if he presents it to the banker oh whom it s drawn, he will honour it. If on such presentment, the banker does not pay, then dishonour takes place, and the holder acquires at once a right of recourse against the drawer and the other parties on the cheque in the case of promissory note, dishonour takes place as soon as the maker does not pay on the due date.

14.4 SUMMARY

The maker of a promissory note and the acceptor of a bill are bound to pay the amount of the instrument at maturity according to the apparent tenor of the promissory note or of the acceptance respectively in default, such person is bound to compensate any party to the instrument for the loss or damage caused to him by such default. The maker of a promissory note is estopped from denying the validity of the instrument as originally made, and cannot in a suit by a holder in due course plead the incapacity of the payee to endorse the instrument. The acceptor too cannot deny the payee's capacity, nor can be deny the authority of the drawer to draw or Indorse the bill, though he may plead that the bill was not really drawn by the person by whom it purports to have been drawn. It is also open to an acceptor to show that an endorsement is forged, but if the accepted the bill knowing or having reason to believe that

the endorsement was forged, he cannot escape liability. As regards an endorser, his liability is much the same as that of the drawer of a bill of exchange. In fact he is said to be a new drawer and is bound to compensate every subsequent holder in case of dishonour by the drawee, maker or acceptor, for any loss or damage, caused to him provided he receives due notice of dishonour.

When the maker of a promissory note signs the same there is an unconditional undertaking made by him to pay the amount of the note according to its tenor. He is not bound to pay the note before maturity, and even if he does so without having it surrendered up to him. He will be liable to any subsequent bonafide holder for value without notice before it becomes due. The moment it is admitted that the maker of a note or acceptor of a bill, made or accepted it, the onus is upon him to get rid of his liability, unless the person suing on the bill or note, is charged with fraud or some *prima facie* case is made out against him, for the person who signs a bill is presumed to be liable for the whole amount appearing on the face of the document. If one partner gave to his copartner a note which was in such a form at to bind not the firm but the partner who gave it, he might be sued upon by the copartner although the note in question had reference to some partnership transaction even without taking final accounts of the partnership. In one important case, the maker of a pronote contended that he executed the document only as a guarantor to his brother-in-law's loan and also produced an agreement to that effect between his brother-in-law and himself. In this case, the Court held that the agreement would hive no effect on his obligation to pay the amount and even if he executed the pronote as guarantor or surety, it would amount to a proper consideration and would bind the defendant to honour the pronote.

The drawer of a bill of exchange becomes liable on the bill when he accepts the same. An acceptance by him means his undertaking to pay the amount according to the tenor of the bill.

The liability of the acceptor of a bill of exchange is similar to that of the maker of the promissory note. A bill of exchange contains an unconditional order and when the drawee accepts to pay the amount, there is obviously an unconditional

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The acceptor of the bill of exchange is himself a 'principal debtor, he is the person primarily liable to pay the holder in due course. The maker or drawee of bill of exchange is at best relegated to the position of surety. As a principal debtor the liability of the acceptor is absolute. Thus, liability goes to the extent that the acceptor is not bound to pay before the maturity of *hundi*. However, if he does so, without having the same surrendered, he will be liable to pay any subsequent bonafide holder for value without having notice. In a suit filed against acceptor of bill of exchange where the drawer is not made part to suit, the suit 'is maintainable as acceptor of bill of exchange is liable under the Act, as principal debtor.

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Generally, a forged endorsement cannot convey a good title even to a holder in due course and therefore no person can be made liable on a negotiable instrument towards one who derives his title through a forged endorsement. To this general rule there is an exception if the forged endorsement is there before acceptance, negligently accepting such a bill will make the acceptor liable. An acceptor of a bill of exchange already endorsed is not relieved from liability by reason that such endorsement is forged, if he knew or had reason to believe the endorsement to be forged when he accepted the bill. The reason for the acceptor's liability on the forged endorsement is that he accepted the bill either with the knowledge or having reason to believe that an endorsement on the bill which had been made prior to his acceptance was forged and such, an acceptor cannot take advantage of his own wrong. He ought not to have accepted such a bill but once he accepts he cannot be relieved from the liability on the plea that the endorsement was forged. Of course, an acceptor is not liable in respect of a

forged endorsement made prior to the acceptance of which he neither knew nor as a reasonable man could have known. An acceptor is also not liable towards a holder deriving title out of a forged endorsement which was made after the bill has been accepted.

Section 35 of the Negotiable Instruments Act provides that every endorser impliedly undertakes to be liable to every subsequent holder of the maker, drawee or the acceptor dishonour the same. Thus, the endorser stands in the position of a surety to the prior parties. His liability arises only if there is a default by the party who is primarily liable to pay the instrument on its maturity. The endorser can exclude his liability by express words in the endorsement or can make it conditional. Section 62 of the Act permits an endorser to make the endorsement in such a way that he either excludes his own liability (by sans recourse endorsement), or, makes such liability or the right of the endorsee to receive the amount due thereon depend upon the happening of a specified event. For example, in an endorsement made by 'X' he writes 'pay to Y without recourse'. X does not incur any liability on this instrument, and. Y cannot bring an action against X, even though the. Instrument is dishonoured by those who were hound to pay the sane. Such an endorsement is known as *sans recourse* endorsement Similarly, X in his endorsement could write, "pay to Y, if a ship arrives". In such a case the right of the endorsee Y to receive the amount or the liability of X to pay the same cannot arise unless the ship arrives.

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(2)Where presentment for acceptance is excused and the bill is not accepted; it is said to be dishonoured by non-acceptance. The circumstance under which a presentment for acceptance is excused are as follows:

(a) Where the drawee after reasonable search cannot be found
(b) Where the drawee is in competent to contract.
(c) Where the drawee is a fictitious person.
(d) Where the drawee becomes a bankrupt, or is dead, for under Section 75, presentment for acceptance to the receiver or the legal representative has been made optional, perhaps on the ground that presentment for acceptance must as for as possible be personal.
(e) Were although presentment for acceptance is irregular acceptance is refused on some other ground.

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107. Section 33 and 314.
108. Section 86.

14.5 SUGGESTED READINGS

1 Bhashyam & Adiga's. The Negotiable Instrument Act, 16th edn. 1997
2 R.K. Bangia, Negotiable Instruments Act, 6th edn. 1997.
3 Avtar Singh, Principles of Mercantile Law, 6th edn., 1996.
4 Chalmers Bill of Exchange 31st edn.
5 Paget's Law of Banking, 8th edn.

14.6 TERMINAL QUESTIONS

1.Discuss the liabilities of maker and acceptor to negotiable instrument.
2. Discuss the liabilities of endorser.
3. Write a essay on dishonour of cheque.