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## SOVEREIGN GOLD BONDS AND THE MISCLASSIFICATION ISSUE IN NPS REGULATION

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### ABSTRACT

The PFRDA (NPS) Regulations 2015 include Sovereign Gold Bonds (SGBs) under Regulation 9 as an alternate investment, placing them in the same asset class as leveraged Alternative Investment Funds and subjecting them to a five percent allocation limit. SGBs are, however, government securities under the Government Securities Act 2006. Held up by one government promise, Class G tools face no upper limit on how much can go in. What follows makes a case against today's way of classifying Sovereign Gold Bonds - it doesn't match what the law says or fits within the rules set by PFRDA. Focus stays tight here: only this mismatch gets attention, nothing wider about how NPS picks investments ever comes into play. One issue stands out: does labeling SGBs as Class A fit within the rules laid down by the Government Securities Act of 2006? This ties into another point - how these bonds measure up against standards set in Section 23 of the PFRDA Act, passed in 2013. Instead of broad claims, focus falls on alignment with specific conditions meant to guide investments. Not assumptions, but actual wording matters here. The core lies in matching classification practices with legislative language. This paper argues it is not. PFRDA has the authority under Section 52 to correct this without Parliamentary amendment.

**Keywords:** National Pension System, PFRDA, Sovereign Gold Bonds, Government Securities Act, Asset Class A, Regulation 9, pension regulation, Article 14.

## **I. INTRODUCTION**

While the PFRDA investment regulations were being reviewed, the classification error in the National Pension System became apparent. SGBs which are issued by the Reserve Bank of India under the Government Securities Act 2006 and classified as government securities are classified among Alternate Investment Funds in Asset Class A. Whereas ordinary government securities are placed in Class G without any allocation ceiling at all. It can go up to hundred percent of the portfolio. PFRDA has not given any explanation as to why an instrument which is legally classified as government securities is grouped with leveraged private funds.

The five percent cap on Asset Class A is not a small issue to be overlooked, it restricts how much investment of a subscriber should go into SGBs without considering the subscriber's preference or the legal character of the instrument. The subscribers that invest in the National Pension System includes government employees, teachers, central and state service workers enrolled in it as it was required by the system. The system also has a number of subscribers from the private sector due to the tax benefits. The difference between a capped and uncapped allocation is the difference between a retirement that goes parallel with the inflation and one that doesn't.

Under Section 2(e) of the Government Securities Act 2006, an SGB is a government security (Government Securities Act 2006, s 2(e)). It carries a sovereign guarantee from the Government of India, pays a fixed coupon of 2.5 percent per annum, and capital gains on redemption are exempt from income tax under Section 47(viic) of the Income Tax Act 1961 (Income Tax Act 1961, s 47(viic)).

The paper looks at the contradiction between how Sovereign Gold Bonds are treated under rules and their official legal status. The paper is not saying that the National Pension System is broken, or that the 5% limit on AIF exposure makes no sense, or that India should copy overseas pension systems. The point here is, placing one financial tool under an unfit rule level happened by mistake and the law as it sits today holds the way forward to fixing it, without any need of new laws.

## **II. THE REGULATORY FRAMEWORK OF SGBs IN ASSET CLASS A**

### ***A. How Asset Class A Was Created***

The PFRDA makes rules and regulations regarding the pension funds under Section 23 of the

2013 law (Pension Fund Regulatory and Development Authority Act 2013, s 23). These rules determine the assets that are permitted and the allotment of cap to the instrument. Each decision made is shaped by the customer needs and guidelines reflect what protects the savings first.

Four asset categories each with set investment caps were outlined under Regulation 9 of the PFRDA (National Pension System) regulations, 2015 (Pension Fund Regulatory and Development Authority (National Pension System) Regulations 2015, reg 9). By December 2018, Asset Class A came into being. PFRDA's own review mentioned how foreign pension funds lean more heavily towards non traditional holdings and still, only five percent went allotted toward such investments.

The explanation given regarding this at that point of time was that the instruments and the market is at a nascent stage but that qualification has not been addressed. The nascent stage argument has a time limit. The regulators are supposed to change and make new rules as the markets develop and instruments mature. They are supposed to track the development and not halt it at the point of introduction. In India, over the past few years Sovereign Gold Bonds have emerged as a popular retail investment instrument. The reason given no longer supports the classification and yet no changes have been made. The issuances have surpassed ₹64,000 crore since 2015. Listed REITs and InvITs achieved a combined market capitalization exceeding ₹1 lakh crore by 2024. No later PFRDA circular or amendment has revised the ceiling.

### ***B. The Legal Character of SGBs***

SGBs are issued by the Reserve Bank of India on the behalf of the Central Government. A security issued by the Central Government when borrowing money is a government security under Section 2(e) of the Government Securities Act 2006 (Government Securities Act 2006, s 2(e)). Only those instruments that are issued directly qualify under this. Each issue notice refers to these as Government of India Stock. Redemption is what separates an SGB from a standard government bond. Instead of getting a fixed amount, the subscriber gets paid based on gold's rate at the time of maturity. The bonds represent a liability of the Government of India as indicated by the RBI Sovereign Gold Bonds Scheme 2016 (Reserve Bank of India Sovereign Gold Bonds Scheme 2016). The subscriber earns 2.5 percent each year on an SGB, but long dated government debt now pays nearly three times that, almost between 7 and 7.5 percent. Higher incomes such as this can make up uncertainty in gold markets.

It is really important to notice the difference between what an SGB is against what the rest of Class A contains. A category II AIF is an instrument where the investor's money is managed by an allotted fund manager, gets locked in for seven years and in which the result completely depends on private credit decisions, market timing and fund governance. An SGB legally contains sovereign guarantee from the government of India, where details regarding them such as the principal, the coupon and redemption, all of it is recorded on the government balance sheet. The RBI issues them and the documentation says that the bonds represent a liability of the Government of India (Reserve Bank of India Sovereign Gold Bonds Scheme 2016).

### ***C. Why the Grouping Makes No Sense***

The PFRDA (National Pension System) Regulations, 2015 rules shows that Class G covers government bonds without any applied caps whereas Class A holds alternate assets capped at five percent (Pension Fund Regulatory and Development Authority (National Pension System) Regulations 2015, reg 9). And the question comes whether putting SGBs under Class A rather than Class G work within the system's own reasoning.

The mismatch is clearly recognizable when the class A instruments are compared. SGBs don't face credit risk, are listed on NSE and BSE and are also freely accessible at all times. On the other hand, Category II AIF pools private money, locks it in for at least seven years all the while carrying concerns regarding illiquidity and default (Securities and Exchange Board of India (Alternative Investment Funds) Regulations 2012, reg 17). One cap has been applied to all these different forms and the reason for it hasn't been made public.

The grouping of SGBs with REITs, InvITs and AIFs was published in direction from December 2018 but the differences among them weren't explained. The logic behind such a decision haven't yet surfaced in official discussions or supporting documents. During the research, no drafts, expert inputs or policy review was found explaining this classification.

Any investment rules must weigh safety of principal along with subscriber concerns according to Section 23(2) of the PFRDA Act (Pension Fund Regulatory and Development Authority Act 2013, s 23(2)). The classification of SGBs along with leveraged private funds, without any justification of how it fits the criteria of Section 23(2), is hard to align with the statutory requirements.

### III. CONSTITUTIONAL AND ADMINISTRATIVE LAW GROUNDS

#### A. Article 14

The base of questioning SGB categories under Article 14 comes from the ruling in *EP Royappa v State of Tamil Nadu* (1974) 4 SCC 3. It said that equal right protection breaks when there is unequal treatment without clear reasoning. When classifications lack meaningful reasons to what lawmakers intended, they risk being taken down. The court viewed random sorting as incompatible with guarantees of fairness. Therefore classifications mustn't just exist they should also serve justice.

Article 14 says that if two things are being treated differently then there should be a reason. And if two things are being treated similarly there should be a reason for that as well. Here in this case two instruments with different legal characteristics, risk profiles and regulatory origins are being put under the same cap, without any reasoning for it. The ruling in *EP Royappa* applies here, that arbitrary action violates equality. And it's not because the five percent cap itself is unreasonable but because classifying SGBs along with leveraged private funds without any reasoning connecting both, is the definition of arbitrariness described by the court. The PFRDA does not get to classify by instinct and expect the classification to hold, reasons are required and it hasn't been provided.

Putting a public debt instrument together with high risk private investments under one cap is wrong when the main aim is subscriber safety. The aim shows up in the PFRDA Act through rules meant to supervise pension and support the growth of the investor. Investor trust breaks down when no reason explains how mixing both helps people. And when such situation rises doubt creeps in regarding whether the system lines up with what the law says.

In *RK Garg v Union of India* (1981) 4 SCC 675, the Supreme Court ruled that courts are not empowered to invalidate economic legislation merely because it could have been worded differently. The case *BALCO Employees' Union v Union of India* (2002) 2 SCC 333 expanded this principle, stating that the executive should be given significant discretion in economic issues. In *Swiss Ribbons Pvt Ltd v Union of India* (2019) 4 SCC 17 the court set a high bar for invalidating financial regulation on grounds of irrationality. These precedents do limit the Article 14 argument. However this case is distinguishable — Section 2(e) of the Government Securities Act 2006 already classifies SGBs as government securities. PFRDA's classification

contradicts a definition that exists in statute and no reasoning connecting this to the Section 23(2) criteria has been published.

### ***B. Ultra Vires***

It's easier to grasp the idea behind ultra vires. Power given through delegation has limits spelled out in the main law. Was PFRDA acting inside its role under Section 23 when it labeled SGBs as Class A (Pension Fund Regulatory and Development Authority Act 2013, s 23)? That section requires attention to safety, how easily assets can be turned into cash, and what benefits those who signed up actually get. Failure to prove the label matches such needs opens the door to legal pushback - a challenge based on going beyond authority, quite apart from claims about unfairness. One reason stands on its own when it comes to proof needed, another brings a different kind of fix - mixing them up muddies the water. Still, each path leads right to the same outcome: the label doesn't match what the law says.

The December 2018 PFRDA circular confirmed which instruments were permitted in Asset Class A without providing any reasoning for the classification choices made. On safety of principal — SGBs carry a sovereign guarantee and cannot default, while Category II AIFs carry fund-level default risk (Securities and Exchange Board of India (Alternative Investment Funds) Regulations 2012, reg 17). On liquidity — SGBs are exchange-listed and tradeable during market hours while AIFs lock money in for at least seven years. On subscriber interest — SGBs provide a fixed coupon and sovereign backing while AIFs offer no fixed return and no liquidity for the life of the fund. None of these distinctions were addressed in the circular.

Legal authority to challenge the Article 14 ground is different from legal authority used to determine ultra vires. The ultra vires question is whether PFRDA had the appropriate authority to mandate this classification under Section 23, given that the Section 23(2) conditions do not appear to have been satisfied. Where a statutory authority acts without satisfying the conditions attached to its power, that action goes beyond the authority granted and is liable to be set aside (*Cellular Operators Association of India v Telecom Regulatory Authority of India* (2016) 7 SCC 703).

## **IV. REQUIRED REFORM**

Starting off, the PFRDA Act 2013 lays out a defined path for updating rules. Instead of vague

powers, Section 52 empowers PFRDA to form regulations fitting within the law's framework (Pension Fund Regulatory and Development Authority Act 2013, s 52). When it comes to investments, Section 23 steps in - giving PFRDA power to decide on types of assets and how much can go where. Once those rules are made using Section 52, they land before both houses of Parliament. For at least thirty days, lawmakers hold the ability to change or cancel them. That stretch of time is non-negotiable.

Reclassifying SGBs necessitates a decision by the board and the Section 52(3) laying process (Pension Fund Regulatory and Development Authority Act 2013, s 52(3)). Does not need parliamentary legislation. A procedural pathway is available and falls within PFRDA's existing authority.

When it comes to court procedures, litigation before a constitutional court is slow, expensive and uncertain. Even courts that hear challenges to economic regulation are reluctant to pass judgement against a specialist regulator. The argument here is not that the classification must be struck down, its that PFRDA should fix it on its own with the authority it already has. Section 52 exists specifically so that PFRDA can update the rules and regulations according to the circumstances. Here reclassification, in terms of procedures is direct. It just needs a board decision, a notification, and the thirty day sitting period before the Parliament.

On standing: An NPS subscriber whose investment returns are directly affected by the allocation restriction could challenge the regulation through a writ of mandamus under Article 32 or Article 226 of the Constitution of India 1950. The scope of the Securities Appellate Tribunal's authority under Section 39 of the PFRDA Act regarding general investment guidelines, as opposed to specific orders, is not explicitly defined in the statute and would need individual examination. The point is not that legal action is the favored approach - a regulatory change would be simpler and more straightforward - but that the existence of a challenge option shows this is a legal issue, not just a policy matter.

## **V. CONCLUSION**

One main point raised against the paper touches on how commodities are treated. Unlike regular bonds, gold-backed payouts work differently, yet regulators did not treat them as such. Had they looked closely at portfolio risks, placing these assets in their own group could have made sense. But PFRDA didn't take that step. In December 2018, a directive named certain

tools for Class A, dropping them into place without explanation. No logic was shared. Not once was there mention of the conflict created by labeling sovereign gold bonds as government-issued debt. A regulator who had truly looked into the matter would have stated that. The lack of published justification makes the classification hard to justify.

The legal argument is simple and clear. SGBs fall under the Government Securities Act 2006 as government securities (Government Securities Act 2006, s 2(e)). Positioning them in Asset Class A with leveraged AIFs goes against that classification and is not in line with the Section 23(2) criteria that PFRDA must apply (Pension Fund Regulatory and Development Authority Act 2013, s 23(2)). Fixing this does not need action from Parliament. It necessitates a decision by the PFRDA board and the laying process as outlined in Section 52(3) (Pension Fund Regulatory and Development Authority Act 2013, s 52(3)).

Reclassification wouldn't precisely involve categorizing SGBs into Class G without any limit. Truth is, prices swing hard, so setting up a new category with tighter but still elevated limits makes more sense than what we have now - figuring out the right number though? That takes deeper study than this work can offer. Section III brings up points about constitutionality and authority overreach; they help the argument stand, even if real courtrooms often hesitate to question financial rulemakers' choices on investments. What works better here isn't debate - it's regulation, quieter, clearer, with a stronger chance of actually moving things forward.

This paper did not look into whether the same approach works for REITs and InvITs in Class A. Still unanswered. It would involve applying the same legal framework to various instruments, and that is a separate task. The SGB argument is not contingent on answering that question. The misclassification depends on statutory text that is not in dispute.

## REFERENCES

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