

LOYALTY AND REWARD PROGRAMS IN INDIA: THE APPLICABLE REGULATORY FRAMEWORK

1. INTRODUCTION

In the current landscape of a highly competitive market, being customer centric, gaining brand loyalty, increasing the footfall on the platform and customer retention are the key drivers for any e-commerce player. To achieve this, marketplaces adopt various forms of incentivisation for their customers for the purchase of products and services. Offering loyalty rewards, referral programs and cash-backs are common mechanisms to achieve this.

We analyse below loyalty and reward programs offered by marketplaces through their online platforms to customers in light of the existing regulatory framework in India.

2. PRE-PAID INSTRUMENTS

The law governing ‘*payment systems*’ issuing pre-paid instruments (“**PPIs**”) to individuals or organisations in India (including conditions for their issuance) is the Master Directions on Issuance and Operation of Prepaid Payment Instruments, 2017 effective from October 11, 2017 (the “**PPI Guidelines**”) issued by the Reserve Bank of India (the “**RBI**”) under the Payment and Settlements Systems Act, 2007 (the “**PSS Act**”). The PPI Guidelines expressly state that all entities proposing to operate ‘*payment system*’ involving the issuance of PPIs are required to obtain authorisation from the RBI.

Under the PSS Act, a ‘*payment system*’ is defined as a system enabling payment to be affected between a payer and a beneficiary, involving a clearing, payment or settlement service, or all of them. Therefore, it implies the involvement of at least three parties: a *payer*; a *beneficiary*; and a *system provider*.

Notably, payment systems issuing PPIs (*which require authorisation from the RBI*), also deal with three parties: an *issuer*; a *holder*; and a *merchant* accepting PPIs as a payment method. Further, PPIs are payment instruments which facilitate the purchase of goods and services against the ‘*value*’ stored on them.

PPIs have been classified into *three* categories under the PPI Guidelines: *closed system*; *semi-closed system*; and *open system*. What is striking about *open system* PPIs as opposed to the other forms is that it can be issued only by banks and cash withdrawals are permitted. However, *semi-closed system* PPIs can be used for the purchase of goods and services at clearly identified merchant locations, which have a contract with the issuer to accept PPIs. *Semi-closed system* PPIs are regulated by the PPI Guidelines and any entity issuing *semi-closed system* PPIs requires a license from the RBI.

On the contrary, *closed system* PPIs fall outside the ambit of being classified as a ‘*payment system*’ and hence do not need authorisation from the RBI. The rationale for this is that they only *facilitate* the purchase of goods and services from the entity issuing them and they cannot be used for payments or settlement to third parties.

3. REWARD OR LOYALTY POINTS: SEMI-CLOSED SYSTEM PPIs OR CLOSED SYSTEM PPIs?

Now, let's take a scenario of loyalty or reward points being issued to customers in their account by an online marketplace (an *information technology platform acting as a facilitator between a buyer and a seller*) for use on their platform. The point to be considered here is whether these loyalty points, that are redeemed against the purchase of products sold by third party sellers on the platform, constitute *semi-closed* system PPIs, requiring authorisation from the RBI?

Firstly, although loyalty points are being provided to the customer for the purchase of products and services offered by third parties, the customer has the option to redeem loyalty points only on the platform of the marketplace and not anywhere else.

Secondly, there is no thread of money flow from the customer to the issuer (which is the marketplace in this case) for the credit or issuance of loyalty points. Put otherwise, no value is being loaded by a customer in its account for these points.

Further, note that the definition of '*holder*' and '*PPIs*' under the PPI Guidelines are also relevant in this regard. A *holder* is an organisation or individual who needs to '*obtain or purchase*' PPIs from the issuer. These PPIs can be loaded or reloaded using cash, debit card and credit cards. Notably, in the old PPI Guidelines, there was a specific mention in the definition of PPIs, that the value stored in the instrument represents the value paid for by holders through cash, by debit to a bank account, or by a credit card.

Therefore, on a joint reading of these definitions, it appears that '*value*' needs to be stored in PPIs, which is loaded by the customer. Given that, in the case of loyalty or reward points, it should be noted that the value is not loaded in the instrument by the customer and the loyalty or reward points can only be redeemed by the customer on the marketplace. Therefore, it may be construed as a *closed system* PPI.

Lastly and most importantly, the marketplace would have a contract with the participating merchant or third party only for redemption of loyalty points provided by the marketplace. The contract may, however, not be specifically for the acceptance by the merchant of these loyalty points as a mode of payment by the customer. Having said that, it may be fair to assume that loyalty points are not PPIs within the meaning of the PPI Guidelines. However, if they are viewed as PPIs, they should be considered as a *closed system* PPI rather than a *semi-closed* system PPI. Therefore, marketplaces issuing loyalty or reward points to their customers in their accounts will not require an authorisation from the RBI.

4. OPERATION OF LOYALTY POINTS

In order to ensure that these loyalty or reward programs are not construed as *semi-closed* system PPIs, online marketplaces need to adopt certain safeguards, while providing them to their customers. One of the key considerations is that the customer should not, in any manner, pay money for or in relation to the loyalty points being credited or issued to them. Also, loyalty points must not be issued to the customer against any payment due, for instance, in cases where the issuance of loyalty points is in place of a refund due, as this may be construed as loading of the instrument by the customer.

Also, marketplaces should clearly identify the objective of their loyalty or reward programs, defining clear parameters for the issuance and redemption of these loyalty points or schemes to its customers. The award of loyalty points or their redemption by the customer should not be linked to any money paid for the purchase of goods on the platform, or discounts offered on purchases made on the platform.

For instance, in a scenario wherein a customer purchases a membership offered by the marketplace by virtue of which the customer was entitled to loyalty rewards in the form of additional discounts at identified locations, marketplace must ensure that the entitlement of additional discounts by the customer is not linked to the price of the membership. To summarise, the access to loyalty points by the customer should be independent of the purchase price paid for products or for any other benefits.

To re-affirm the nature of promotional benefits being offered, marketplaces should clearly communicate to their customers that loyalty points are being given to them at the *discretion* of that marketplace. Also, the platform must ensure that no cash withdrawals are permitted and that clear guidelines for the redemption of loyalty points are defined including their validity. Further, upon termination of the arrangement, the customer should not have the option of redeeming loyalty points for cash or cash equivalent, since the customer has not loaded money into the account to be credited with those loyalty points.

Further, marketplaces should be abundantly cautious while issuing '*cash-backs*' to their customers which is another popular mode of attracting customers. Since, '*cash-backs*' are credited to the customer's account after a purchase is made by the customer on the platform, this may be viewed as a reward program that involves the return of money paid by the customer.

Thereby, the chances of any marketplace offering '*cash-backs*' structured in a manner which is construed as operating a *semi-closed* system PPI from a regulatory standpoint, increase. Also, a marketplace may be construed as undertaking an '*unfair trade practice*' if the marketplace offers '*cash-backs*' for promoting the sale of products on its platform, with the intention of creating an impression that it is being given or offered free of charge. For instance, where the marketplace adopts cash-back schemes that are tied to the purchase price of a specific product, but are positioned as reward programs being offered free of charge.

5. REWARD OR LOYALTY POINTS: NECESSARY TO OPEN NODAL ACCOUNT?

It should be further noted that '*online marketplaces*' in India, by virtue of being an '*intermediary*' under the Directions For Opening And Operation Of Accounts And Settlement Of Payments For Electronic Payment Transactions Involving Intermediaries dated November 24, 2009 (the "**Intermediaries Directions**") issued by the RBI are obligated to open and maintain nodal accounts with banks.

'*Intermediaries*' are defined to mean entities which collect monies from customers for payment to merchants using electronic or online payment mode for goods and services availed by them and subsequently facilitate the transfer of these monies to merchants in final settlement.

However, in the present scenario of loyalty or reward programs, there is no money being collected from the customer in respect of those loyalty points issued to them, which in turn creates a payment obligation on the marketplace for transfer to the merchant. Therefore, it appears that in the case of loyalty or reward programs, marketplaces may not be construed as '*intermediaries*' and the obligation to open and operate nodal accounts may not be applicable. Accordingly, also, the permissible credits and debits and the timelines for settlement of transactions provided under the Intermediaries Directions will not apply to the transactions undertaken by marketplaces involving the redemption of loyalty points.

6. CONCLUSION

On a parting note, it is evident that loyalty and reward programs are fast gaining popularity in India given the flexibility they offer to customers, customer retention strategies and the unregulated environment. However, there is a fine line of differentiation in the way *semi-closed* system PPIs and loyalty or reward

programs offered by a marketplace are perceived from a regulatory standpoint and marketplaces need to tread this line with caution. Any attempt to club loyalty points with refunds against product returns or other amounts paid by or due to the customer, may require the entity issuing loyalty points to procure a license from the RBI to operate a *semi-closed* system PPI.

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Date: December 24, 2018

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