

Regulatory Hotline

June 27, 2014

NON-RESIDENTS CAN PLEDGE THE SHARES OF AN INDIAN LISTED COMPANY TO AN NBFC

- No RBI approval required by a non-resident shareholder of an Indian listed company to pledge its shares in favor of an NBFC to avail loans for the said Indian listed company.
- Enforcement of pledge of shares is subject to the credit concentration norms applicable to the NBFC.
- Disclosure requirements under the Takeover Code have to be fulfilled at the time of creation and invocation of pledge.
- Requirement for an open offer under the Takeover Code may also trigger on invocation of pledge.

INTRODUCTION

As a welcome change, the Reserve Bank of India ("RBI") vide circular dated June 6, 2014 ("**Circular 141**")¹ has relaxed the provisions relating to pledge of shares held by non-resident shareholders in Indian listed companies in favor of non-banking financial companies ("NBFCs"), to enable the Indian companies to leverage themselves for *bona fide* business purposes.

The RBI in its constant endeavor towards making Authorised Dealers Category – 1 ("**AD**") more accountable / accessible, has delegated to the ADs, the power to allow the pledge of such shares in favor of NBFCs subject to certain conditions as discussed herein below.

Earlier, RBI vide Circular No. 57 dated May 2011 ("**Circular 57**"), delegated the power to the ADs to allow the pledge of shares of an Indian company (listed and unlisted both) by non-residents in favor of Indian and overseas banks, subject to certain conditions. A detailed analysis on Circular 57 is provided in our previous hotline [here](#).

Circular 57 liberalized the pledging of shares by a non-resident in favor of an Indian bank, however pledge to an NBFC was still restricted under the TISPRO Regulations. Hence, if an Indian company with a foreign promoter / shareholder wanted to avail finance from an NBFC, providing collateral to the NBFC by way of pledge of shares was a challenge. Pledge being a relatively liquid form of security, is preferred by the lenders in India. However, under the extant exchange control laws, no person resident outside India is permitted to transfer any shares² except by way of a gift³ or sale.⁴ Since, the term 'transfer' is defined to include sale, purchase, exchange, mortgage, pledge, gift, loan,⁵ and exception was provided only for 'gift' or 'sale', other forms of transfer such as pledge were deemed as not being permitted without prior RBI approval.⁶ Circular 141 is aimed to reduce the delay and difficulty caused with the requirement of obtaining RBI approval for pledging non-residents shares to an NBFC.

CHANGES INTRODUCED BY CIRCULAR 141

Equity shares of an Indian company (listed on a recognized stock exchange(s) in India) held by the non-resident investor can now be pledged in favour of an NBFC in India to secure the credit facilities being extended to the resident investee company for bona fide business purposes subject to the following conditions:

- prior to sanction of loan, the investee company submits a board resolution stating that the loan proceeds will be utilized for the declared purpose;
- after the sanction of loan and the use of loan amount, the statutory auditor of the investee company, submits a certificate stating that the loan proceeds have been utilized for the declared purpose;
- the Indian company follows the relevant SEBI disclosure norms; and
- the pledge of shares in favour of the NBFC would be subject to the credit concentration norms. If there is a breach of credit concentration norms on the invocation of pledge, the shares should be sold and the breach shall be rectified within a period of 30 days from the date of invocation of pledge.

ANALYSIS AND IMPLICATIONS

Availability of further financing avenues:

Circular 141 will allow foreign shareholders to leverage their shareholding in an Indian listed company, and secure finance for the Indian company from a much wider segment of NBFCs. NBFCs, unlike banks are not subjected to the stringent regulations and to that extent Circular 141 may allow access to a much larger pool of capital for more liberal end uses. Considering the need for funds on a constant basis, Circular 141 not only allows easy finance to Indian companies but also provides a larger market to the NBFCs as well. Though the cost of borrowing capital from NBFCs may be higher than the bank, however in a situation where bank funding is not available, cost of borrowing from the

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NBFC may be substantially lower given that now the pledge of listed shares (being a listed security) is offered as collateral.

Unlisted companies not included:

Circular 141 will not benefit the foreign promoters of an unlisted Indian company. Considering, several Indian companies have foreign promoters and shareholders, pragmatic approach demands that these shareholders should have been allowed to pledge their shares and avail funding from NBFCs without the RBI approval.

Takeover Code implications:

SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("**Takeover Code**") provides that shares taken by way of encumbrance shall be treated as an acquisition, shares given upon release of encumbrance shall be treated as a disposal.⁷ As per the Takeover Code, an acquirer (NBFC in this case) which has rights entitling him to five percent or more of the shares or voting rights in the company, is obligated to disclose acquisition or disposal of shares or voting rights that are more than or equal to two percent.⁸ Although, scheduled commercial bank and public financial institutions are exempt from making any disclosures on the creation or release of encumbrance⁹, NBFCs do not enjoy this privilege. Also, the promoter of a listed company who pledges his shares, is obligated to disclose details of creation or invocation or release of encumbrance within seven working days to every stock exchange where the shares of the company are listed; and to the company at its registered office, which obligation will be applicable to foreign promoters of the Indian companies as well.

Unlike scheduled commercial banks and public financial institutions, acquisition of shares by an NBFC upon invocation of pledge is not exempt from the obligation to make an open offer under the provisions of Regulation 10(1)(b)(viii) of the Takeover Code.

Credit Concentration norms:

As per Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 a systemically important NBFC¹⁰ is not permitted to lend or invest in any single company exceeding 15% of its owned fund¹¹, or single group¹² of companies exceeding 25% of its owned fund. If however the systemically important NBFC is investing and lending, then these thresholds stand revised to 25% and 40% respectively ("**Credit Concentration Norms**").

In case of shares that are in dematerialized form, the treatment upon invocation of pledge is different as compared to the shares in physical form as the pledged shares are lien marked in favor of the pledgee and the depository directly transfers the shares to the demat account of the pledgee. Hence, upon default by the borrower, the NBFC may instruct the depository to (i) transfer such number of shares to its account that are equal to the outstanding amount of loan and interest in monetary terms, and (ii) release the remaining pledged shares back to the account of the foreign shareholder. However, while doing the above, an NBFC may breach the Credit Concentration Norms, and in such an event, the NBFC shall be obligated to sell the excess shares and rectify the breach within a period of 30 days from the date of invocation of pledge.

Ceiling price:

The extant foreign direct investment (FDI) policy provides a maximum price beyond which a non-resident cannot sell shares of an Indian company to an Indian resident ("**Ceiling Price**"). In case of listed shares, it is the price at which a preferential allotment of shares can be made under the Securities and Exchange Board of India ("**SEBI**") guidelines (together, the "**Pricing Norms**")¹³. Accordingly, any remittance from the NBFC to the pledgee will be subject to the Ceiling Price.

CONCLUSION

While the unlisted companies are still to get some respite, the move shall definitely benefit the foreign promoters / shareholders of Indian listed companies in arranging growth capital for the Indian company. However, unless the SEBI provides NBFCs the necessary exemptions under the Takeover Code, it will be difficult for the NBFCs to gather the momentum for providing loan against pledge of shares of listed Indian companies.

– Mukul Aggarwal, Sahil Shah & Ruchir Sinha

You can direct your queries or comments to the authors

¹ A.P. (DIR Series) Circular No. 141

² Regulation 3 of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("**TISPRO Regulations**")

³ Regulation 9(2)(i) of the TISPRO Regulations and Regulation 9(2)(iii)(a) of the TISPRO Regulations

⁴ Regulation 9(2)(i) of the TISPRO Regulations and Regulation 10B(2) of the TISPRO Regulations

⁵ Section 2(ze) of the Foreign Exchange Management Act, 1999

⁶ Foreign Exchange Management Act, 1999

⁷ Regulation 29(4) of the Takeover Code

⁸ Regulation 29(3) of the Takeover Code

⁹ Proviso to Regulation 29(4) of the Takeover Code

¹⁰ 'Systemically important non-deposit taking non-banking financial company', means a non-banking financial company not accepting / holding public deposits and having total assets of Rs 100 crore and above as shown in the last audited balance sheet.

¹¹ "Owned Fund" means *Equity Capital + CCPS + Free Reserves + Share Premium + Capital Reserves – (Accumulated losses + Book Value of intangible assets + Deferred Revenue Expenditure)*

¹² The term 'group' has not been defined in the Prudential Norms

¹³ Pricing of equity shares in case of preferential allotment by listed company has to be in accordance with regulation 76 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR Regulations**") under Chapter VII. Clause (1) Regulation 76 is reproduced below:

"76. (1) If the equity shares of the issuer have been listed on a recognised stock exchange for a period of six months or more as on the relevant date, the equity shares shall be allotted at a price not less than higher of the following:

(a) The average of the weekly high and low of the closing prices of the related equity shares quoted on the recognised stock exchange during the six months preceding the relevant date; or

(b) The average of the weekly high and low of the closing prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date.

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Also, the term 'relevant date' for the purpose of Chapter VII of the ICDR Regulation is provided under Regulation 71 as follows:
*"71. For the purpose of this Chapter, "relevant date" means:
(a) in case of preferential issue of equity shares, the date thirty days prior to the date on which the meeting of shareholders is held to consider the proposed preferential issue:"*

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