Corpsec Hotline

July 29, 2013

ALL DEBENTURES TO BE ISSUED BY NBFCS, WHETHER PRIVATE OR PUBLIC, HAVE TO NOW BE FULLY SECURED!

The Reserve Bank of India ("**RBI**"), by its recently issued circular dated June 27, 2013[1] and a clarification thereon ("**Clarification**"), dated July 2, 2013[2] (together, the "**Circular**") imposed certain restrictions on the issue of debt securities by non-banking financial companies ("**NBFCs**"). The restrictions primarily include capping the number of investors to 49 in case of private placement, imposing minimum subscription amount of INR 25 lakhs for a single investor in case of private placement, mandating the debentures issued whether by way of private placement or public issue to be fully secured, etc.

BACKGROUND

The Circular has been introduced to address certain adverse features which have come to the notice of the RBI in private placements by certain NBFCs. Earlier too, in the Financial Stability Report December 2010 issued by the RBI ("**Report**")[3], it was noted that *'NBFCs are exempt from the provisions of Section 67 of the Companies Act, 1956, in terms of which issuance of shares / debentures to more than 49 investors needs to be through public issuance. This means that NBFCs, particularly those not regulated by the RBI, could issue debt or quasi-debt instruments to a large number of retail/institutional investors on a private placement basis. This would be tantamount to raising public deposits outside the extant regulatory framework.'*

The RBI in its Report acknowledged that specific concerns in this regard have arisen in the past in the context of private placement of convertible preference shares by few NBFCs, and stated it was in the process of formulating guidelines in conjunction with the Ministry of Corporate Affairs to plug this regulatory gap.

CHANGES INTRODUCED BY THE CIRCULAR

Recently, similar issue of private placement as against public issue was decided by the Supreme Court in the case of *Sahara India Real Estate Corporation Limited & Ors. versus Securities and Exchange Board of India & Anr.*, dated August 31, 2012 ("**Sahara Case**").[4] Please refer to our hotline on the subject by clicking → here.

1. **The Circular has introduced the following changes with respect to 'private placement' by NBFCs:**
    1. Definition of 'private placement' - The term 'private placement' has been defined to mean non-public offering of non-convertible debentures by NBFCs to such number of select subscribers and such subscription amounts, as may be specified by the RBI from time to time. Private placement has been restricted to not more than 49 investors, which are to be identified upfront by the NBFC.

       Analysis - Section 67 of the Companies Act, 1956 ("**Act**") deals with the classification of an offer as private placement or public issue. As held in the Sahara Case, an offer made to more than 49 persons would be treated as a public offer, per Section 67 of the Act. However, by virtue of Section 67 (3) of the Act, NBFCs were exempted from the applicability of this '49' persons rule. Section 67 (3A) mentions that Securities Exchange Board of India ("**SEBI**") shall in consultation with RBI, specify guidelines in respect of an offer made to the public by a NBFC.

       But now, the Circular makes NBFCs also subject to this '49' persons rule. To that extent, NBFCs may not be able to avail of the exception under the Act. This is a positive move, and clubbed with the other changes proposed under the Circular should help in curbing the practice of NBFCs raising funds from a large number of investors under the private placement route by availing of the exception to section 67(3) of the Act.

    2. Timeline for issue of offer document - The offer document for private placement has to be issued within 6 months from the date of the board resolution authorizing the issue. The offer document has to identify the names of the officials who are authorized to issue the offer document, as well as the purpose for which resources are being raised.

       Analysis - The rationale for identifying the names of the officials who are authorized to issue the offer document is to probably track the number of offer documents issued, and in case of excess issuances beyond 49, locate the liability.

    3. Usage of funds - NBFCs can issue debentures only for deployment of the funds on its own balance sheet and not to facilitate requests of group entities/ parent company/ associates. Core Investment Companies have been carved out from the applicability of this restriction.

       Analysis - The intent behind this change seems to prevent unscrupulous transactions between group entities and to prevent movement of cash out of the NBFC to its group entities. However, in such process genuine

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transactions based on arms' length transaction may also be restricted. For instance, an NBFC which finds a decent lending opportunity in another group entity with attractive returns may now not be able to tap it by virtue of this change.

Further, currently from the language of the Circular, it is not very clear as to whether 'resource requests' would also include equity investments in group entities or not. Clarity on this point and a carve-out for arms' length transaction would be welcome.

4. Minimum investment amount - The minimum subscription amount for a single investor has to be INR 25 lakhs and in multiples of INR 10 lakhs thereafter.

   Analysis - The rationale behind this change is to ensure that only sophisticated investors invest in an NBFC, and small time investors at large are not taken for a ride. This change seems to be line with the minimum investment of INR 25 lakh in the recently issued SEBI guidelines on angel funds.

5. Loan against debentures - NBFCs have been restricted from extending loans against the security of its own debentures, whether issued by way of private placement or public issue.

2. **Security cover for debentures (whether private placement or public issue)**

   In addition to the above, NBFCs now have to ensure that at all times the debentures issued (whether by way of private placement of public issue) are fully secured. If the security cover is inadequate, the proceeds have to be placed in an escrow account. The security has to be created within a month from the date of issuance. This restriction shall not apply to subordinated debt, as defined under paragraph 2(1) (xvii) of the Non-Banking Financial (Non-Deposit Accepting or Holding Companies Prudential Norms (Reserve Bank) Directions, 2007.

   Analysis - This is a big dampener for NBFCs as it takes away their flexibility to raise funds through unsecured debentures, which they could do earlier. Even NBFCs which issue debentures to its group entities, which are not subordinate, have to now create security, it seems. Also, since the security has to be created within one month of issuance and the monies cannot be used until then, the NBFCs cannot provide the loan or investment proposed to be made from the proceeds of debentures as a security. In effect, the security has to be from the past assets of the NBFC, which may be a big challenge for many NBFCs.

   Also, the requirement of creating security has been imposed on every issuance of debentures, whether by way of private placement or public issue. For public issue, the rationale behind creation of security seems to secure the public investors at large. However, for private placements, since additional safeguards have already been imposed by way of limiting the number to 49 and imposing minimum investment criteria, the rationale for creation of security seems unclear.

3. **Amendment to Directors pertaining to Deposit Accepting NBFCs**

   The Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 has been amended to clarify that only those debentures that are either compulsorily convertible into equity or fully secured would be exempt from the definition of 'public deposits'. Hybrid / subordinated debt with a maturity of not less than sixty months would continue to be exempt from the definition of public deposits provided there is no option for recall by the issuer within the period.

   Analysis - Since, as per the Circular, all debentures have to be mandatorily fully secured irrespective of whether issued by way of private placement or public issue, an NBFC intending to claim exemption from the definition of 'public deposits' could claim it by virtue of the debenture being fully secured, and may not even be required to resort to the exemption on account of convertibility into equity. Therefore, if claiming exemption from the definition of 'public deposit' is the purpose, this change may not have any impact on the nature of debentures to be issued, whether optionally convertible or mandatorily.

   This leaves us with bonds. Since, the Circular does not mandate creation of security in case of bonds, it appears that optionally convertible bonds now fall within the purview of 'public deposit' and only debentures mandatorily convertible into equity are exempt from the definition of 'public deposit'. Since, earlier, it was not prescribed as to whom the option should vest with, whether the NBFC or the bondholders, NBFCs could retain the option of conversion with themselves, leaving the bondholders high and dry, without any security or the right to convert into equity. This change seems to be aimed at addressing this issue and protecting the interest of unsophisticated public investors.

4. **Exclusion**

   None of the above restrictions are applicable to Primary Dealers, keeping in view the Primary Dealers' obligations with regard to G-Sec market.

CONCLUSION

Some of the changes introduced by the Circular for instance limiting the number of investors in case of private placement to 49 and imposing minimum investment criteria of INR 25 lakhs, are positive, and should address the issue of surrogate raising of deposits and protect the unwary public investors at large. However, imposing a requirement of creating security on even private placement of debentures, and a blanket restriction on usage of monies from private placed debentures for group entities, seem quite drastic and burdensome.

Many NBFCs raised a concern that withdrawal of the current facility of issuing NCDs without any restrictions would result in adversely impacting their Asset Liability Management ("**ALM**"). RBI in its Clarification noted that such freedom currently available to NBFCs has resulted in inadequate resource planning and higher transaction cost, and one of the main objectives of the said Circular is to promote discipline in resource planning and raising.

To tone down its earlier circular, and in order to facilitate the process of moving into a more robust ALM in a non-disruptive manner, RBI decided to remove the requirement of minimum six months gap between two successive private placement of NCDs, and noted that a decision on the appropriate minimum time gap would be taken in due course. However, having relaxed the above condition, they have advised NBFCs, in the meantime, to put in place before the close of business on September 30, 2013, a board approved policy for resource planning which, among

September 26, 2024

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September 22, 2024

other things should cover the planning horizon and the periodicity of private placement.

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You can direct your queries or comments to the authors

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[1] RBI/2012-13/560 DNBD(PD) CC No. 330/03.10.001/2012-13

[2] RBI/2013-14/115 DNBS(PD) CC No.349/03.10.001/2013-14

[3] Available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/FSR301210F.pdf; paragraph 5.6.2 onwards.

[4] Civil Appeal No. 9813 and 9833 of 2011
