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APRIL 20, 2020

RBI Directions to NBFCs: Change of Shareholding Rule

Non-banking financial companies (NBFCs), as the name suggests, are companies that aren't licensed to offer the full range of banking services. Instead, they provide a smaller bundle of financial services targeted towards particular groups. In order to provide credit to such groups, NBFCs need to raise capital at frequent intervals. Hence, raising capital is fundamental to the sector's growth.

The Reserve Bank of India (RBI), India's central bank, regulates NBFCs. The RBI was established following the enactment of the Reserve Bank of India Act, 1934 (RBI Act). That statute assigns the RBI the power to regulate, among others, banks and NBFCs. The RBI Act grants rulemaking powers to the RBI. It is in the exercise of these powers that the RBI issues directions from time to time governing the conduct of NBFCs.

One of the RBI's most noteworthy rules pertains to the change of management and control of an NBFC. Given how this rule affects NBFCs' capital-raising initiatives, they've had to keep a close watch over its development. Back when the directive was first introduced[1], its original intent was three-fold: (a) to protect the "*soundness of the financial system*"; (b) any new management taking over the reins of the NBFC "*subserves*" the same objective; and (c) the public is informed of any such management change. Over the years, the text and scope of this rule have undergone several amendments[2], but its basic characteristic — to regulate the change of management and control of NBFCs — has remained the same.

[1] DNBS. (PD).CC.No.11 /02.01/99-2000 dated November 15, 1999 (introduced the requirement of prior public notice for any change of management and control of NBFCs).

[2] DNBS.(PD).CC.No.12 /02.01/99-2000 dated January 13, 2000 (imposed the public notice requirement on a merger between an NBFC and any other company); DNBS (PD) C.C. No. 63 / 02.02 / 2005-06 dated January 24, 2006 (relaxed the requirement of public notice for a court approved merger and reduced the public notice period); DNBS (PD) CC No. 82 / 03.02.02 / 2006-07 dated October 27, 2006 (clarified the

The RBI currently administers this rule through the Non-Banking Financial Companies (Approval of Acquisition or Transfer of Control) Directions, 2015 (NBFC Directions).[3] The operative part of the NBFC Directions requires the prior approval of the RBI in following three cases:

a) *any takeover or acquisition of control of an NBFC, which may or may not result in change of management;*

b) *any change in the shareholding of an NBFC, including progressive increases over time, which would result in acquisition/ transfer of shareholding of 26 per cent or more of the paid up equity capital of the NBFC. Provided that, prior approval would not be required in case of any shareholding going beyond 26% due to buyback of shares/reduction in capital where it has approval of a competent Court. The same is to be reported to the Bank not later than one month from its occurrence;*

c) *any change in the management of the NBFC which would result in change in more than 30 per cent of the directors, excluding independent directors. Provided that, prior approval would not be required in case of directors who get re-elected on retirement by rotation.*

The first rule — the *Change of Control Rule* — is clearly deducible from prior enactments. The second rule — the *Change of Shareholding Rule* (*COSR*) — is a comparatively new rule, introduced in 2015. The third rule — the *Change of Management Rule* — is a mixed bag: Its objectives date back to 1999 but it has only recently been applied as a separate rule.

It has been more than four years since the NBFC Directions came into effect. During this time, NBFCs have faced difficulties, particularly with the *COSR*. This article discusses its shortcomings and proffers a new rule to take its place.

CHANGE OF SHAREHOLDING RULE

The NBFC Directions were made pursuant to the notice-and-comment rulemaking power of the RBI. Prior to their promulgation, the RBI issued draft directions[4] inviting

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parties who are required to issue the public notice); DNBS (PD) CC.No. 160 /03.10.001/2009-10 and DNBS.(PD) 208/ CGM(ANR)-2009 both dated September 17, 2009 (introduced the requirement for deposit taking NBFCs to obtain prior RBI approval); DNBS (PD) CC.No.376/03.10.001/2013-14 and DNBS.(PD) 275/ GM(AM)-2014 both dated May 26, 2014 (made the RBI approval requirement applicable to all NBFCs).

[3] DNBR.(PD) 029/CGM(CDS)-2015 dated July 9, 2015. The NBFC Directions are incorporated into the master directions applicable to NBFCs. Systemically important and non-systemically important NBFCs have their own master directions.

[4] Press Release: 2014-2015/2056 dated March 30, 2015.

public comments. These broke new ground by proposing a change of shareholding rule with a numerical threshold of 26 percent.[5] In the final rule that was adopted, the RBI kept the threshold intact but made two important changes — adding the words "*including progressive increases over time*" and carving out an exception for changes in shareholding due to a buyback or a court-approved reduction in the capital of the NBFC.

The *COSR* in its plain terms applies to any change of 26 percent or more in the shareholding of an NBFC. After parsing the text, it is evident that the *COSR* is a company-focused rule. It is not limited to ownership changes caused by a sole acquirer. It includes a stand-alone transaction of 26 percent or more undertaken by two or more persons who may have nothing in common with each other. It even encompasses a share transaction of less than 26 percent if such transaction, after adding past acquisitions, crosses the threshold. Its regulatory overreach has given rise to some unintended consequences and could be recrafted for the following four reasons:

First, the application of the *COSR* does not appear to take into account the size of a transaction or the absence of any connection between the parties to a transaction. Take an example of an NBFC that wants to raise capital equivalent to a 28 percent shareholding from four investors, by granting each of them a seven percent stake. Considering the size of the stake being acquired by each investor, it wouldn't be worth applying the *COSR* to them. But, just because they are all investing at the same time, their transaction triggers the rule. Consequently, the NBFC will need to get each of the investors approved by the RBI. Yet, if just one investor backs out; the acquisition by the other three (21 percent) all of a sudden falls outside the ambit of the rule and no longer requires RBI approval.

Consider a somewhat different situation where an investor has acquired a 25 percent stake in an NBFC. Since the shareholding change is less than 26 percent, the *COSR* does not apply. However, if, at a later date, another person (unrelated to the investor) wants to acquire a mere one percent stake, that person will trigger the *COSR*. Even though the RBI did not scrutinize the bonafides of the investor with the much bigger stake, it must approve the person proposing to purchase just one percent of the NBFC. Hence, neither the size of the transaction, nor the absence of any connection between

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[5] Supra note 4, rule 2(i)(b) of the draft directions: *"any change in the shareholding of an NBFC which would result in acquisition/transfer of shareholding of 26 per cent or more of the paid up equity capital of the NBFC."*

the parties seems to hold any real relevance for its application.

Second, the *COSR* includes within its scope *"progressive increases"* in the shareholding of an NBFC that have taken place in the past — increases not just in the shareholding of an acquirer but of the company in general. The concept of "*progressive increases*" is based on the aggregation doctrine. It targets small acquisitions which, if viewed in isolation, are not significant enough but when viewed collectively warrant regulatory oversight. It is logical to apply this doctrine to an acquirer-centric provision.

But it does not make much sense to impose it on a company-focused rule such as the *COSR.* The result is that past shareholding changes which may have happened long ago and have no correlation with a new transaction get unintentionally tagged to the new transaction. Thus, the RBI ends up regulating the wheat and at times the chaff, too.

Third, the *COSR* requires an NBFC to keep a track of all past shareholding changes, whether primary transactions or secondary ones from the date the NBFC Directions came into effect.[6] The NBFC also needs to know beforehand any proposed changes to its shareholding to ascertain if, after taking into account past changes, the proposed shareholding change will reach the *COSR* threshold. If it does and the NBFC obtains RBI approval for such proposed change, it then has to press the reset button and conduct the analysis afresh each time it receives an approval under this rule.

It is possible to keep track of all share-based transactions in closely-held companies. However, publicly listed companies are a totally different matter. They have dispersed owners who are allowed to trade freely on an exchange. It is nearly impossible to control this constituency. If their on-market transactions are taken into account, the NBFC will come to know of a shareholding change only after it has occurred. It is, therefore, pointless to apply the *COSR* to such transactions.

Fourth, the RBI has overlooked comparable laws and regulations while formulating the *COSR*. The RBI has sought to regulate change of control at NBFCs, in one form or the other, since its inception. For the RBI, the term "*control*" has always meant what the Indian takeover regulations say it means. The same regulations could instruct the *COSR* too. The takeover regulations are acquirer-centric and require an acquirer to

[6] The master directions repealed DNBR (PD) CC. No. 065/03.10.001/2015-16 dated July 9, 2015 which was issued along with the NBFC Directions. However, clause 5 of the circular reads as follows: "*The directions contained above are applicable with immediate effect, i.e., the same will apply on any takeover or acquisition of control, any change in the shareholding or any change in the management occurring after the date of this circular*."

make a public tender offer not only when it triggers a change of control, but also in cases where its shareholding exceeds a specified threshold.[7] Although the RBI has borrowed the concept of "*control*" from these regulations, it has overlooked them in the change of shareholding context. Another such example (where the RBI itself is the regulator) is the Banking Regulation Act, 1949 that governs banking companies. Even this statute has a similar acquirer-centric provision which requires prior RBI approval if any person acquires five percent or more of the shares of a banking company.[8]

The RBI could obviate the over-policing problem of the *COSR* by applying the same standard as it does to banking companies under the Banking Regulation Act, 1949. The RBI could limit the *COSR* to when: (a) shares of an NBFC are acquired by a person, whether individually or acting in concert with other persons; (b) the proposed acquisition increases their existing holding, if any; and (c) all of it taken together increases their aggregate shareholding to 26 percent or more of the paid-up share capital of the NBFC. Only if all the three factors are met should the rule apply. The RBI can also consider incorporating a reporting requirement for future acquisitions made by an acquirer who has obtained RBI approval under the *COSR* so that a second approval is not required if such acquirer proposes to purchase additional shares in the same NBFC.

PUBLIC NOTICE

In addition to obtaining the RBI's prior permission, the NBFC Directions require a public notice to be given in the newspapers.[9] This requirement puts two onerous conditions on the parties: *First*, it proscribes the publication of the notice prior to the receipt of RBI approval, which could take months. As a suggestion, the RBI should permit the notice to be made earlier with a caveat that it is subject to the receipt of RBI approval. In fact, allowing the public notice to be issued at the time of filing the RBI application would give the RBI a chance to consider any public objections before deciding whether or not to approve the case.

Second, the parties have to observe a standstill period of 30 days after the notice is published. The parties, therefore, cannot close their transaction even after obtaining RBI approval and publishing the notice in the newspapers. The statutory standstill period hampers the capital-raising efforts of an NBFC, especially when it needs to

[7] Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, *see* regulation 3 (Substantial acquisition of shares or voting rights).

[8] Banking Regulation Act, 1949, *see* section 12B (Regulation of acquisition of shares or voting rights).

[9] Supra note 3, *see* clause 5 of the NBFC Directions.

raise capital to meet its capital-adequacy requirements stipulated by the RBI.

Considering that a capital-raise transaction for an NBFC is, in most cases, time-sensitive, the publication of the notice should be allowed at the time of making the application to the RBI. In this way, the 30-day standstill period can run in parallel and assuming that the RBI will at least take a month to grant its approval, such a tweak to the notice requirement will ensure that the standstill period has passed by the time the RBI makes its decision.

CONCLUSION

The RBI could amend the *COSR* and make it an acquirer-focused rule. A clear, bright-line rule that retains the 26 percent threshold but targets the acquirer rather than the company will remove the unintended consequences that have crept into the *COSR*. Also, for the reasons discussed above, the RBI could consider permitting the public notice to be issued at the time an NBFC submits its application seeking prior approval of the RBI.

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