# Analytical Speaking

# RBI spreads its net to unregulated Private Placement of debentures by NBFCs: Guidelines issued

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# *Article*

Non Banking Financial Companies (NBFCs) raise money through issuance of capital/debt securities (including debentures) by way of public issue or private placement. Lately, a substantial increase in borrowings of NBFCs has been witnessed by way of issue of debentures major being on private placement basis. As per RBI's report on 'Trend and Progress of Banking in India', 2011-12, NBFCs-D has borrowed Rupees 238 billion by issue of debentures during the year 2011-12 and Rupees 2950 billion has been raised by NBFC-ND-SI during the same period. Such debentures consisted of both-secured and unsecured issues.

The reason for huge borrowing by way of issue of debentures may be that the extant guidelines may not be strict enough. The public issues of debentures by public NBFCs are governed by SEBI (Issue and Listing of Debt Securities) Regulations, 2008 however, there were as such no guidelines for issue of debentures on private placements by public or private NBFCs. Moreover, the limit of 49 subscribers for a private offer as envisaged by section 67 of the Companies Act, 1956 was not applicable to the NBFCs.

However, with the intent to regulate the privately placed issues of debentures by NBFCs and to ensure minimum compliances, RBI vide Notification No. RBI/2012-13/560 DNBD (PD) CC No. 330/03.10.001/2012-13[1] dated 27th June, 2013 (**the Notification**) has inter-alia issued Guidelines on Private Placement of securities by NBFCs (**the Guidelines**). The Guidelines shall come into existence with immediate effect from the date of the Notification. Further, RBI vide Notification No. RBI/2013-14/115 DNBS(PD) CC No.349/03.10.001/2013-14[2] dated 2nd July, 2013 (**the Clarification)** has issued Clarifications subsequent to receipt of number of queries from the industry in this matter.

In this Article, we have discussed the issue of debentures on private placement basis only.

## *Background:*

The Guidelines seem to have been issued against the backdrop of recent ruling of the Supreme Court in Sahara Real Estate Corporation (Sahara case) pertaining to raising of money by issue of OCDs which were issued on "private placement basis", wherein nearly

[1] http://rbidocs.rbi.org.in/rdocs/Notification/PDFs/CC330270613F.pdf
[2] http://rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=8206

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Rs 20000 crores of money had been raised, from 22.1 million investors, using services of nearly a million agents, at 2900 branches. And all this were regarded to be a private placement. In view of such adverse features brought to the notice of RBI, wherein NBFCs have been raising resources from the retail public on a large scale, through private placement, especially by issue of debentures, RBI has issued the guidelines overriding other instructions in this regard, wherever contradictory.

The purpose behind issuing the Guidelines was due to the practice followed by NBFCs to raise funds through issue of NCDs without any restriction. This reflected their inadequate resource planning and resulted in higher transaction cost. Taking away the current facility of issuing NCDs and implementing the minimum time gap requirements between two issues will surely lead to Asset Liability Mismatch (ALM) In view of the same, as per the Clarifications, RBI has directed NBFCs to formulate a Board approved policy for resource planning, covering the planning perspective and periodicity of private placement, before close of business on September 30, 2013.

## *Highlights of the Guidelines*

Number of subscribers for issue of securities on private placement basis has been restricted to 49 overriding section 67 (3) of the Companies Act.

Names of the subscribers to be identified upfront in case of private placements

NBFCs to issue secured debentures only. If the security cover is not sufficient at the time of making issue, sufficient security to be created within 1 month and till then issue proceeds are to be kept in escrow account

Minimum time gap of 6 months between two private placements

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## Provisions of Law Applicable to Private Placement of Debentures by NBFCs Prior to and Post Issue of the Guidelines:

### *Companies Act, 1956 ("Companies Act") and Rules framed thereunder*

**Section 67: Provision relating to 'deemed public offer'**

Section 67(3) of the Act providing for 'deemed public offer' if the issue of securities is to 49 people or more was not applicable to NBFCs

*However, the Guidelines have restricted the private placements to a maximum of 49 people and all such subscribers are to be identified upfront in case of private placement. Therefore, even if the Companies Act exempts NBFCs from the provision of 'deemed public offer', RBI has put a cap of 49 subscribers for issue by private placement.*

It is pertinent to note that the Guidelines covers the issue of shares also and therefore even the issue of shares to more than 49 people will be a public offer as per the Guidelines.

**Section 117C of the Companies Act requiring DRR**

This Section requires every company issuing debentures to create a debenture redemption reserve ("DRR") for the redemption of such debentures and transfer an '*adequate*' amount from its profits every year to such DRR until the issued debentures are redeemed. However, as per Ministry of Corporate Affairs clarification circular on February 11, 2013[3], no DRR is required to be maintained in case of privately placed debentures by NBFCs.

**Section 125 of the Companies Act requiring registration of charges**

The Guidelines makes this very clear that the non convertible debentures including short term, to be issued by an NBFC should be fully secured at the time of issue and such security is to be maintained during the whole tenure of the issued debentures. In terms of NBFCs (Acceptance of Public Deposit) Directions, 1998, debentures should be secured

[3] http://www.mca.gov.in/Ministry/pdf/General_Circular_04_2013.pdf

by mortgage of immovable property or any other asset of the issuer company. Security created by way of mortgage of immovable property would require registration under this section.

**Unlisted Public Companies (Preferential Allotment) Rules, 2003 as amended from time to time:**

These rules apply to all unlisted public companies in respect of preferential issue of shares or any other instrument convertible into shares including hybrid instruments convertible into shares on preferential basis.

Thus, NBFCs, which are unlisted public companies, raising money through preferential allotment of convertible debentures are required to comply with these rules. The issue of unsecured privately placed debentures or issue of convertible debentures by private companies shall be governed by the Guidelines.

## *SEBI Regulations*

**SEBI (Issue and Listing of Debt Securities) Regulations, 2008**

These regulations are applicable to-
(a) public issue of debt securities; and
(b) listing of debt securities issued through public issue or on private placement basis on a recognized stock exchange.

Therefore, these regulations shall not be applicable to privately placed debentures unless the issuer is to get the listing of such debentures.

**SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009**

These regulations will regulate the issue of convertible debentures on preferential basis by listed NBFCs.

## *RBI Directions*

**The present Guidelines**

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From June 27, 2013 onwards, any issue of debentures- whether convertible or non convertible, by NBFCs – whether public or private, listed or unlisted, on preferential basis or on privately placed basis, shall be governed by the Guidelines and provisions of the Guidelines shall have an overriding effect on provisions of other laws, if found contradictory with each other.

**Issuance of Non-Convertible Debentures (Reserve Bank) Directions, 2010**

These Directions will be applicable to Non-Convertible Debenture (NCD) issued by a corporate (including NBFCs) with original or initial maturity up to one year and issued by way of private placement.

## *Compliance needed under the Guidelines:*

1) **Offer Document:**
   a. Should be issued within maximum period of 6 months from the date of the Board Resolution authorizing the issue.
   b. Should include the names and designations of the authorized officials and must contain information on purpose for which resources are being raised.
   c. "For Private Circulation Only" should be printed or typed on the same.
   d. General information with respect to the issue should be clearly mentioned.

2) Debentures shall be issued by NBFCs only for deployment of funds on its own balance sheet and not to facilitate resource requests of group entities/ parent company / associates.

3) Private placement shall be done only to 49 investors identified upfront by NBFCs.

4) Minimum subscription amount for a single investor shall be Rs. 25 lakh and in multiples of Rs.10 lakh thereafter.

5) Minimum time gap of at least six months between two private placements was envisaged by the Guidelines. However, the Clarification has made this clear that this condition is to be complied with as and when so notified by the RBI.

6) **Issue of Secured Debentures:** NBFCs to issue only fully secured debentures. If, at the stage of issue, in case of insufficient security cover, the same needs to be created

within one month from the date of issue and till then the issue proceeds shall be placed under escrow.

## *Clarification issued by RBI to curb the damaging effect of the Guidelines:*

The Guidelines seems to have startled the NBFCs. This is evident from the quantum of queries and clarifications raised by the industry resulting in issue of the Clarifications by RBI within 5 days of issue of Guidelines.

| Position subsequent to issue of Guidelines | Position subsequent to issue of Clarifications |
|---|---|
| **Definition of "Preferential Allotment or Private Placement"** | |
| Guidelines encompassed an issue of capital by an NBFC pursuant to Section 81 (1A) of the Companies Act, 1956 | The Clarification suitably restricted the meaning of private placement to non-public offering of NCDs by NBFCs made to such number of select subscribers and such subscription amounts as may be specified by the RBI from time to time. |
| **Minimum time gap between two successive issuances:** | |
| Atleast 6 months between two private placements. | The instruction need not be operationalized immediately. RBI would decide upon the minimum time gap in due course. |
| **Applicability of the Guidelines** | |
| All NBFCs (including Primary Dealers) | All NBFCs (excluding Primary Dealers) |
| **Permissible Purpose of Issue of Debentures by NBFCs** | |
| For deployment of funds on its own balance sheet and not to facilitate resource requests of group entities/ parent company / associates. | The restriction is not applicable to Core Investment Companies. (CICs) |
| **Applicability of Security Cover requirement** | |
| To all debentures issued, including Short | The condition shall not apply to |

| | |
|---|---|
| Term NCDs | subordinated debt, as pursuant to definition[4] subordinated debt is an unsecured instrument. |

### *Amendment to the NBFC Public Deposit Directions:*

Prior to the amendment, in terms of Para 2(xii)(f) of the Directions, any amount raised by the issue of bonds or debentures secured by the mortgage of any immovable property of the company; or by any other asset or with an option to convert them into shares in the company were excluded from the definition of public deposits provided that the amount of such bonds or debentures did not exceed the market value of security. Further, para 2(xii)(i) of the Directions excludes any amount received as hybrid debt or subordinated debt with minimum maturity period of sixty months.

RBI by this Notification has suitably amended the Directions thereby clarifying that only *compulsorily convertible into equity* or fully secured would be exempted from the definition of public deposits. Further, it has been clarified that hybrid debt or subordinated debt would be excluded if such instruments have been issued with no recall option within the tenure of the instrument.

For ease of reference, below we reproduce the changes notified by the RBI in the definition of 'Public Deposit':

| **Position prior to amendment** | **Post Amendment** |
|---|---|
| Exemption was to debentures issued with *an option to convert them into shares* of the company. | *Debentures compulsorily convertible into equity* are excluded |
| Exemption was to hybrid debt or subordinated debt with minimum maturity period of sixty months. | Hybrid debt or subordinated debt with minimum maturity period of sixty months will be excluded *provided no recall option to issuer has been given.* |

[4] Provided in paragraph 2(1)(xvii) of the Non-Banking Financial (Non-Deposit Accepting or Holding Companies Prudential Norms (Reserve Bank) Directions, 2007

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## *Effect on existing issues of debentures of NBFCs:*

The Guidelines were applicable to Private Placement by NBFCs by any issue of shares and/or debentures, as the Guidelines defined the term 'private placement' as *issue of capital under section 81(1)(A) of the Companies Act*, having an overriding effect on provisions of other laws, if found contradictory with each other . However, pursuant to the Clarification, the Guidelines will apply only to *non-public offering of Non Convertible Debentures (NCDs) by NBFCs (excluding Primary Dealers)*. Further, there being no clarity on applicability of Guidelines on the existing issues of debentures, the author's view is that all NCDs issued after the date of notification will necessarily have to comply with the Guidelines. Therefore, there is no need to create security over existing unsecured debentures in terms of the Guidelines issued by the NBFCs so far. The Guidelines have come into effect with effect from the notification date i.e. from June 27, 2013.

## *Applicability of Guidelines to NBFC-CIC:*

Core Investment Companies (CICs) are the class of NBFCs which does not require registration with RBI if they fulfill the prescribed conditions. Such companies are NBFCs but not registered. Applicability of the Guidelines to such Companies is not clear in the notification issued by RBI. However, the Guidelines have defined 'NBFC' as an NBFC defined in the RBI Act. It is pertinent to note that the Guidelines do not use the phrases 'registered as NBFC with the RBI'. Therefore, in author's view, debentures issued by CICs shall also be governed by the Guidelines. However, in view of the Clarification, the restriction pertaining to issue of debentures for deployment of funds on its own balance sheet shall not apply to CICs.

## *Status of Housing Finance Companies ("HFCs"):*

The Guidelines are applicable to NBFCs as defined in Section 45 I (f) read with Section 45 I (c) of the RBI Act, 1934. Therefore, the Guidelines will not be applicable to the HFCs which are registered with NHB.

## *Conclusion*

The Guidelines has been issued by RBI with an intent to curb the practice of NBFCs of raising resources from the retail public on a large scale, through private placement, especially by issue of debentures and to ensure proper resource planning to be undertaken by NBFCs. Despite being excluded from the limit of 49 investors under the Companies Act, NBFCs will not be able to privately place their debentures with more than 49 investors as per the Guidelines. The stringent condition requiring sufficient security cover even for privately placed debentures, including NCDs, will surely affect the NBFCs who primarily raise money by issue of debentures. However, RBI seems determined to correct the faulty resource planning of NBFCs and may come up with a circular specifying the minimum time gap between two private placements too in near future.

**Also see our other related write-ups:**

- **See our primer on debentures at https://india-financing.com/Primer_on_debentures.pdf**
- **Article on 'MCA Circular widens scope for secured corporate debentures, grants exemption from Public Deposit norms' at http://india-financing.com/MCA_Circular_widens_scope_for_secured_corporate_debentures_grants_exemption_from_Public_Deposit_norms.pdf**
- **Article on 'Corporate Bond Market-Removing the Bottlenecks' at http://india-financing.com/Corporate_Bond_Market-Removing_the_Bottlenecks.pdf**
- **Article on 'New DRR provisions- will they promote or demote the Bond Market' at http://india-financing.com/New_Debenture_Redemption_Reserve_Provisions-%20Will_they_promote_or_demote_the_Bond_Market.pdf**
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