Legal aspects of lending against shares

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As the NBFC segment is booming once again, loan against shares is on an upswing. Most investors in the equity market find it economically viable to leverage their investment with borrowings, to attain higher rates of returns. Loan/lending against shares (LAS) is basically getting instant liquidity from one's investment without selling them, and, at the same time, leveraging the investment. All corporate rights and benefits attached to and accrued on the shares remain with the borrower and still he can avail loan against them. Usually, the loans are granted with a significant margin, and are rolled on a regular basis. The loans are normally secured by pledge of the shares funded. The shares may be either in physical or demat format though demat format is getting more common of late. Besides the pledge, the client usually gives a power of attorney to the lender permitting it to sell the shares to realize the lent amount.

This article discusses the basic legal setup for LAS business.

Who can grant?

The entities which are engaged in LAS activities are generally NBFC-ND, non-banking non-financial companies, LLPs, and unincorporated lenders.

➢ ***NBFCs:***

The lending NBFCs whose principal business is acquiring shares, stocks or securities will fall under this category. The LAS can be granted by NBFC-ND-SI and NBFC-ND. However, they cannot lend against their own shares.

- ***Limitation Applicable To NBFCs For Extending LAS***

  Based on section 295 of the Companies Act, 1956 and RBI's circular no. **DNBS.PD/CC 94/03.10.042/2006-07 dated May, 8, 2007**an NBFC cannot grant this facility to:

- Directors/their relatives
- Firms in which directors are partners/employees/manager or guarantor
- An individual in respect of which director is a guarantor
- Companies/firms in which directors hold substantial interest
    - Substantial interest for companies means the holding of a beneficial interest by an individual or his spouse or minor child, whether singly or taken together, in the shares thereof, the amount paid-up on which exceeds Rs. 5 lacs or 10% of the paid-up capital of the company, whichever is less
    - Substantial interest for firms means the beneficial interest held therein by an individual or his spouse or minor child, whether singly or taken together, which represents more than ten per cent of the total capital subscribed by all the partners of the said firm
- Any company in India/outside where the flagship name reflects association with the NBFC.

However, the above limitations are applicable to NBFC-ND-SI only and will not be applicable if the lending company is a private company

- ***Non-Banking Non-Financial Companies:***

The companies incorporated under Companies Act, 1956 which are not engaged primarily in financial business as mentioned in section 45IC of RBI Act, 1934 may start lending business without falling within the purview of NBFC. However, if the financial assets of a company are more than 50 per cent of its total assets (netted off by intangible assets) and income from financial assets is more than 50 per cent of the gross income, then the company will be a NBFC and all the lending provisions applicable to NBFC will apply to such companies. The criteria of income/assets are cumulative, that is, both the tests are required to be satisfied simultaneously as the determinant factor for principal business of a company.

Though, there is no ambiguity in the fact that it is the primary activity carried on by the company which gives it a character and although the figures reported in the balance sheet reflects the business activity of the company, but the same cannot be the sole criteria to determine the character of a company.

- ***Unincorporated Lenders:***

There is no bar on unincorporated lenders engaging in financial business, including loans against shares. However, one may note sec 45S of the RBI Act. According to this provision, an unincorporated entity cannot accept deposits if it is engaged in financial business. Hence, as long

as unincorporated entity is not accepting deposits, there is no bar against carrying business of loans against shares.

Also, it is worthwhile noting the provisions of State Money-lending laws. There are money lending laws in different states – for example, Karnataka Money Lender Act, 1961, The Punjab Registration of Money-Lender's Act, 1938, The Bombay Money Lenders Act, 1946, The Assam Money Lenders Act, 1934, The Bengal Money Lenders Act, 1940 and many more. These laws may require a moneylender to have a license before one may carry money lending business. Banks have been kept out of the purview of these Acts as the same are governed by RBI Directions in this regard.

- ***LLPs:***

Since LLPs are a new form of entity, there are very scanty regulations currently applicable to LLPs. LLPs are not companies, and hence, they are not regulated by NBFC regulations. Sec 45S of the RBI Act or sec 58A of the Companies Act are also not applicable to LLPs. Hence, there is virtually no restriction on LLPs engaging in LAS business.

Applicable Rules and Directions to NBFCs

If the lender is an NBFC, RBI Regulations applicable to NBFCs apply to the lender. Below, we discuss significant provisions.

- ***RBI's Fair Practice Code***

The company must frame and approve lending practices that comply with RBI fair lending practices code (DNBS (PD) CC No. 80 / 03.10.042 / 2005-06 dated September 28, 2006). The fair lending codes must be published on the website of the company and must cover the following:

- Transparent terms/clauses of loan agreement- The terms and conditions of the loan must be clear and it should not have any hidden meaning to misguide the borrower
- Disclosure of true rate of interest in the loan document- The loan agreement must be specific about the interest rates to be charged by the lender.
- Simple method showing interest calculation for the understanding of the client
- A policy regarding non-discrimination on grounds of race, sex, religion etc so as to be fair and reasonable to all customers must be framed by the lender

- ***KYC Norms***

The lender must evaluate the KYC norms before granting any loan. The general norms will include following:

- The lenders must develop a clear Customer Acceptance Policy laying down explicit criteria for acceptance of customers. The CAP must be in place to ensure that
    - No account is opened in benami or fictitious name
    - Necessary checks have been made to ensure that the identity of the customer does not match with any person with known criminal background or with banned entities such as individual terrorists or terrorist organizations etc.
- Documents for customer identity are in order or not: If an existing customer, then KYC required for customers
    - ID and address proof, in case of individuals
    - Certificate of Incorporation, MOA/AOA, Board resolution, PAN etc in case of corporate
    - For partnership firms, check registration certificate, if registered, address proof, name of all partners and their address proof, power of attorney on the name of the partner for signing on behalf of the firm
    - For trusts and foundations, check registration certificate, if registered, Power of Attorney granted to transact business on its behalf, Any officially valid document to identify the trustees, settlers, beneficiaries and those holding Power of Attorney, founders/managers/ directors and their addresses etc.
- Transactions must be reviewed and monitored periodically
- Risk Management- normal and reasonable activity of the customer is recorded so that the company has the means of identifying transactions that fall outside the regular pattern of activity.

➢ ***Corporate Governance Guidelines***

As per the requirement of corporate governance guidelines, the NBFCs whose asset size is 50 crores or more are required to have an audit committee. This committee will ensure the proper compliance of the RBI norms. In addition, the companies are also required to have Nomination Committees and Asset Liability Management Committees for ensuring appointment of directors and for understanding asset liability mismatch risk etc.

➢ ***Compliance with Prevention of Money Laundering Act and Rules***

In terms of PMLA Rules, the lender must ensure that the borrower is not in the list of individuals and entities, approved by Security Council Committee established pursuant to various United Nations' Security Council Resolutions (UNSCRs). The company is required to maintain and preserve the records if the transaction value exceeds Rs. 10 lacs and is of suspicious nature and must report to FIU-IND in this respect.

How LAS Can Be Granted?

Generally, the loans are granted by creating a pledge on the shares funded. In addition to the pledging of shares, the borrower normally gives a power of attorney in favour of the lender so that the lender can sell and realize the money lent. However, in case the lender is a broker, such power of attorney should not be accepted as the same will be in violation of circular no. ***NSE/INSP/2005/42 dated 9th December, 2005***.

The shares available for pledge may be in physical or demat form. Though after introduction of Depositories Act, 1996 demat form of shares available for pledge is most common. The shares held in physical form are accepted by the lenders with higher margin as physical shares involves more risk and can only be pledged in market lots. RBI vide its various circulars has also put a threshold limit on the loan amount to be provided against physical shares by banks. Moreover, the interest rates charged on the pledge of physical shares are also higher than one charged on the pledged demat shares.

The laws have many provisions for making easier the pledge of shares. Section 108(1C) and 108(B) of the Companies Act, 1956 provides for exemption from the requirement of pre-stamping of a transfer deed in case of pledge of shares to banks, financial institutions etc.

Further, Regulation 58 of SEBI (Depositories & Participants) Regulation, 1996 lays down the manner of creating pledge over the shares. The general practice is:

- If a beneficial owner intends to create a pledge on a security he shall make an application to the depository through his participant.
- The participant shall make a note in its records of the notice of pledge and forward the application to the depository
- The depository, after confirmation from the pledge, shall within fifteen days of the receipt of the application create and record the pledge and send an intimation of the same to both the participants.
- On receipt of the intimation, both the participants shall inform the pledger and the pledgee respectively of the entry of creation of the pledge.
- If the depository does not create the pledge, it shall send along with the reasons an intimation to the participants.
- The entry of pledge may be cancelled by the depository if pledger or the pledgee makes an application to the depository through its participant.
- Any entry in the records of a depository should be evidence of a pledge or hypothecation.