NEWSLETTER

Legal, Compliance and ESG

5 September 2019

Dear Readers,

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A) LEGAL AND REGULATORY UPDATES:

I. Clarification on 'Appointed Date' under Section 232(6) Of the Companies Act, 2013[1]

The Ministry of Corporate Affairs (MCA) has provided below clarification with respect to interpretation of section 232(6) of Companies Act, 2013 which that states "*the scheme shall clearly indicate an appointed date from which it shall be effective and the scheme shall be deemed to be effective from such date and not a date subsequent to appointed date*".

a) Appointed date may be a specific calendar date or may be tied to the occurrence of an event such as grant of license by a competent authority or fulfilment of any preconditions agreed upon by the parties, which are relevant to the scheme.

b) Appointed Date identified under scheme shall also be deemed to be the 'acquisition date' and date of

[1] For more details please refer the below link: http://www.mca.gov.in/Ministry/pdf/GeneralCircular_21082019.pdf

transfer of control for the purpose of conforming to accounting standards (including Ind-AS 103 Business Combinations).

c) Where 'appointed date' is significantly ante-dated beyond a year from the date of filing, the justification for the same would have to be specifically brought out in the scheme and it should not be against public interest.

d) In case of event-based date being a date subsequent to the date of filing the order with Registrar under section 232(5), the company shall file an intimation of same with Registrar within 30 days of such scheme into effect.

II. Reserve Bank of India ("RBI") circular on Priority Sector Lending – Lending by banks to NBFCs for On-Lending[2]

As per the circular, in order to boost credit to the needy segment of borrowers, it has been decided that bank credit to registered NBFCs (other than MFIs) for on-lending will be eligible for classification as priority sector under respective categories subject to the following conditions:

a) Agriculture: On-lending by NBFCs for 'Term lending' component under Agriculture will be allowed up to Rs. 10 lakh per borrower.

b) Micro & Small enterprises: On-lending by NBFC will be allowed up to Rs. 20 lakh per borrower.

c) Housing: Enhancement of the existing limits for on-lending by HFCs vide para 10.5 of our Master Direction on Priority Sector lending, from Rs. 10 lakh per borrower to Rs. 20 lakh per borrower.

Under the above on-lending model, banks can classify only the fresh loans sanctioned by NBFCs out of bank borrowings, on or after the date of issue of this circular. However, loans given by HFCs under the existing on-lending guidelines will continue to be classified under priority sector by banks.

Bank credit to NBFCs for On-Lending will be allowed upto a limit of five percent of individual bank's total priority sector lending on an ongoing basis. The above instructions will be valid for the current financial year upto March 31, 2020 and will be reviewed thereafter. Loans disbursed under the on-lending model will continue to be classified under Priority Sector till the date of repayment/maturity.

III. RBI's press release dated August 13, 2019: Review of the extant guidelines pertaining to Housing Finance Companies (HFCs)[3]

The Reserve Bank of India ("RBI"), in a press release dated August 13, 2019 ("Press Release"), has stated that it will carry out a review of the extant guidelines pertaining to Housing Finance Companies ("HFCs"). The Press Release follows the notification of Part VII of Chapter VI of the Finance Act (No. 2) of 2019 which confers certain powers for regulation of HFCs with the RBI.

According to the Press Release, the HFCs will henceforth be treated as one of the categories of Non-Banking Financial Companies ("NBFCs") for

[2] For more details please refer the below link https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NT393B81B166B6EA476BB2D1BF9AF0946AC0.PDF

[3] For more details please refer the below link https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR4198DC0F884BC40420B97CFC04971BA9E3E.PDF

regulatory purposes. The RBI will carry out a review of the extant regulatory framework applicable to the HFCs and will come out with revised regulations in due course. In the meantime, HFCs will continue to comply with the directions and instructions issued by the National Housing Bank ("NHB") till the RBI issues a revised framework.

The Press Release also provides that an HFC desirous of making an application for registration under sub-section 2 of section 29A of the NHB Act, 1987 (as amended) may now approach the RBI's Department of Non-Banking Regulation.

IV. SEBI Circular: Disclosure of Reasons for Encumbrance by Promoters of Listed Companies (Notification Dated: 07.08.2019)[4]

The promoter of every listed company shall disclose detailed reason for encumbrance in Format specified in Annexure II of this circular in addition to existing disclosure under Regulation 31(1) and 31(2) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 within 2 Working Days to Stock Exchange and Company if encumbrance by promoter with PACs equals to or exceeds:

• 50% of existing shareholding in Company.

• 20% of total share capital of Company.

If the existing combined encumbrance by the promoter along with PACs with him is either 50% or more of their shareholding in the company or 20% or more of the total share capital of the company as on September 30, 2019, he shall specifically make first disclosure on detailed reasons for encumbrance in the format provided at Annexure - II, by October 04, 2019.

Disclosure in Annexure II shall be uploaded on Company website within 2 Working Days of receipt of disclosure.

V. Companies (Share Capital and Debentures) Amendment Rules, 2019 (Notification Dated: 16.08.2019)[5]

MCA vide notification dated August 16, 2019 amended Companies (Share Capital and Debentures) Rules 2014 by notifying the Companies (Share Capital and Debentures) Amendment Rules,2019 below a gist of the said Rules:

• Rule 4 (1) (c): Voting power in respect of shares with differential rights of the company shall not exceed 74% of total voting power. (earlier: shall not exceed 26% of post issue paid up equity share capital)

• Rule 4 (1) (d) has been omitted. (earlier: Company must have consistent track record of distributable profit for last 3 years)

• Rule 12 (1): In case of startup company, employee belonging to promoter group or director (holding more than 10% of equity shares himself and through its relatives) shall eligible to Employee stock option upto 10 years of incorporation (earlier: Employee belonging to promoter group or director (holding more than 10% of equity shares himself and through its relatives) shall eligible to Employee stock option upto 5 years of incorporation)

[4] For more details please refer the link: https://www.sebi.gov.in/legal/circulars/aug-2019/disclosure-of-reasons-for-encumbrance-by-promoter-of-listed-companies_43837.html

[5] For more details please refer the link: http://www.mca.gov.in/Ministry/pdf/ShareCapitalRules_16082019.pdf

• Rule 18 (7): Change in criteria for creation of Debenture Redemption Reserve for the purpose of redemption of debentures.

B) CONCEPT NOTE ON WILFUL DEFAULTER

Who is Wilful Defaulter?

The general meaning of the word 'default' is failure to repay loans availed by a borrower from a bank and/or financial institution(s). A wilful defaulter is an entity (legal/natural) who has not repaid the loan amount despite its financial ability to repay it.

The Reserve Bank of India ("RBI") has defined the 'wilful default' as a 'unit' (individual/company) which has defaulted in meeting its payment obligations or not utilized the finance from the lender for the specific purposes for which finance was availed or has siphoned off the funds.

Scenarios to Identify Wilful Defaulters

The RBI identified the following scenarios on occurrence of which a unit shall be identified as a 'wilful defaulter' under its Master circular dated Reserve Bank of India - Master Circulars July 01, 2015

When the unit has defaulted in meeting payment / repayment obligations to the lender:

a. even after having the financial capacity to honour the said obligations;
b. and has not utilised the credit facilities received from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes;
c. as it has siphoned off the funds and the funds are untraceable in the unit;
d. and it has also disposed off or removed the movable fixed assets or immovable property given for the purpose of securing the loan without the knowledge of the lender.

The RBI has further specified that the identification of the wilful defaulter should be made keeping in view the track record of the borrower and should not be decided on the basis of isolated transactions / incidents. The default shall be categorised as wilful default only when its 'intentional', 'deliberate' and 'calculated'.

What is Siphoning/Diversion of Funds?

Siphoning/diversion of funds means utilisation of funds by the borrower in deviation of sanction terms of the lender.
Apex court has constructed in the case of Bikram Chatterji v. Union of India.

a. utilisation of short-term working capital funds for long-term purposes, which is not in conformity with the terms of sanction of the loan availed;
b. deploying borrowed funds for purposes / activities or creation of assets other than those for which the loan was sanctioned;
c. transferring borrowed funds to the subsidiaries / group companies or other corporates by whatever modalities;
d. routing of funds through any bank/financial institution, other than the lender or members of consortium without prior permission of the lender;
e. investment in other companies by way of acquiring equities / debt instruments without prior approval of the lender(s);

f. shortfall in deployment of funds vis-à-vis the amounts disbursed / drawn and the difference not being accounted for.

Steps to be taken while dealing with a wilful default

The RBI has listed the following steps to be taken while dealing with a 'wilful default':

a. In the event an evidence arises of a wilful default on the part of the borrower (in case of a company) and its promoter / whole-time director at the relevant time should be examined by a Committee ("Identification Committee") headed by an Executive Director or equivalent and consisting of two other senior officers of the rank of General Manager/Deputy General Manager.
b. If the Identification Committee concludes that an event of wilful default has occurred, it shall issue a Show Cause Notice to the concerned borrower and the promoter / whole-time director and call for their submissions and after considering their submissions issue an order recording the fact of wilful default and the reasons for the same. An opportunity should be given to the borrower and the promoter / whole-time director for a personal hearing if the Identification Committee feels such an opportunity is necessary.
c. The Order of the Committee shall be thereafter reviewed by another Committee ("Review Committee") headed by the Chairman / Managing Director/ Chief Executive Officer and shall consist of two independent directors / non-executive directors of the bank. The Order of the first Committee shall become final only after it is confirmed by the said Review Committee. However, if the Identification Committee does not pass an Order declaring the borrower as a wilful defaulter, then the Review Committee need not be set up to review such decisions.

Further, except in very rare cases, a non-whole-time director should not be considered as a wilful defaulter unless it is conclusively established that:

a. he was aware of the fact of wilful default by the borrower by virtue of any proceedings recorded in the minutes of meeting of the Board or a Committee of the Board and has not recorded his objection to the same in the Minutes; or
b. the wilful default had taken place with his consent or connivance.

The above exception will however not apply to a promoter director even if he is not a whole-time director.

Guarantors not being directors

In connection with the guarantors, it was advised by the RBI that in terms of Section 128 of the Indian Contract Act, 1872, the liability of the surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract. Therefore, when a default is made in making repayment by the principal debtor, the banker will be able to proceed against the guarantor/surety even without exhausting the remedies against the principal debtor. As such, where a banker has made a claim on the guarantor on account of the default made by the principal debtor, the liability of the guarantor is immediate. In case the said guarantor refuses to comply with the demand made by the creditor/banker, despite having sufficient means to make payment of the dues, such guarantor would also be treated as a wilful defaulter.

Conclusion

On analysis of the above, we are in the opinion that this process of differentiating a simple defaulter from a wilful defaulter by RBI is progressive in nature. Unlike earlier, all defaulters

won't be treated harshly by the various financial institutions just on the first instance of defaulting. This also assures the entrepreneurs that if they follow the law of the land, the law shall not treat them severely for situation beyond the control of any entity. The concept of 'wilful default' clearly distinguish between a 'defaulter' and a 'wilful defaulter'.

C) ESG: Mutual fund houses are coming up with 'ESG' schemes

The environment, social and governance (ESG) theme is catching on among mutual funds amid a spate of corporate governance issues coming to the fore and the growing focus on climate change and sustainability.

After ESG schemes from Quantum Mutual Fund and SBI Mutual Fund, it is the turn of Kotak Mutual Fund and ICICI Prudential Mutual Fund. Both the fund houses have filed documents with SEBI for their ESG products.

ESG investing includes building a portfolio of companies that meet high environmental, social and governance standards. Ideally, this is what fund managers in all markets look for- companies that have high standards. Many market participants say that ESG as a concept is not tested in India yet.

Globally, ESG has been a success story, but mutual fund advisors say that maybe it is too early for the Indian market to follow the developed markets. The other school of thought has a different opinion. “Many that shrug ESG as a new concept, just fail to understand that ESG investing is a nothing more than a measure of sustainability and our question to them is -since when did investing in sustainable good companies become a new thing,” asks Chirag Mehta, Fund Manager, Quantum Mutual Fund.

According to Quantum Mutual Fund managers, ESG is a structured and better way of measuring the sustainability of companies by identifying risks hidden beneath a company’s business activities. However, it eliminates many big companies which indulge in production of tobacco, liquor, gambling etc. The process thus eliminates names like ITC from the stock selection.

“It is definitely a good thing, but in terms of returns from investment, we are not sure yet. Will it match the diversified equity products that we already have? That’s what we have to think about from the point of view of advisors and investors,” says Vishal Dhawan, Founder, Plan Ahead Wealth Advisors.

SBI Mutual Fund renamed SBI Magnum Equity Fund to SBI Magnum Equity ESG Fund which became India’s first ESG mutual fund. Hence, the performance record of the scheme cannot be used to judge how ESG schemes fare in the Indian market. “Just like index funds, Indian market will take time to check the viability and worth of ESG schemes. For retail investors, thematic schemes are not advised. Especially, when there is no past record about how these schemes will do in the market,” says Puneet Oberoi, Founder, Excellent Investment Advisors.

There is strong research evidence of ESG investing delivering better returns since companies with strong sustainability scores demonstrate better operational performance and are less risky. Such companies are typically less exposed to tail risks such as environmental accidents or punishment from regulators. However, mutual fund advisors say that it is too early to judge these schemes based on their performance in foreign markets.