

## Discussion Paper on Proposed Amendments to Regulations framed under SEBI Act, 1992 for Imposing Restrictions on Wilful Defaulters

### I. OBJECTIVE

1. To review the Regulations framed under SEBI Act, 1992 with a view to impose restrictions on wilful defaulters from accessing the capital market.

### II. BACKGROUND

2. The term 'wilful default' is defined in the Master Circular (henceforth referred to as "Master Circular") issued by the Reserve Bank of India (henceforth referred to as "RBI") dated July 12, 2012.
3. The term 'wilful default' broadly covers the following:
  - a) Deliberate non-payment of the dues despite adequate cash flow and good net worth;
  - b) Siphoning off of funds to the detriment of the defaulting unit;
  - c) Assets financed either not been purchased or been sold and proceeds have been misutilized;
  - d) Misrepresentation / falsification of records;
  - e) Disposal / removal of securities without bank's knowledge;
  - f) Fraudulent transactions by the borrower.
4. The Master Circular contains instructions on identification and other matters relating to wilful defaulters.

5. In order to prevent the access to the capital markets by the wilful defaulters, a copy of the list of wilful defaulters (non-suit filed accounts and suit filed accounts) are forwarded to SEBI by RBI and Credit Information Bureau (India) Ltd. (CIBIL) respectively in terms of para 2.5 of the Master Circular.

### **III.NEED FOR REVIEW**

6. Regulation 4(2) of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (henceforth referred to as "SEBI (ICDR) Regulations, 2009") lays down conditions which debar an issuer company from making a public issue or rights issue.
7. Relevant extract of Regulation 4(2) of SEBI (ICDR) Regulations, 2009 reads as follows:
  - 4 (2) No issuer shall make a public issue or rights issue of specified securities:
    - (a) ...
    - (b) ...
    - (c) if the issuer of convertible debt instruments is in the list of wilful defaulters published by the Reserve Bank of India or it is in default of payment of interest or repayment of principal amount in respect of debt instruments issued by it to the public, if any, for a period of more than six months;
    - (d) ...
    - (e) ...
    - (f) ...
    - (g) ...
8. Even though regulation 4(2)(c) of SEBI (ICDR) Regulations, 2009, debar wilful defaulter from accessing capital market by way of public issue or rights issue, the same is currently limited to the issuer of convertible debt instruments.

9. There is no such similar provision in SEBI (Issue and Listing of Debt Securities) Regulations, 2008 (henceforth referred to as "SEBI (ILDS) Regulations, 2008") and in SEBI (Issue and Listing of Non-Convertible Redeemable Preference Shares) Regulations, 2013 (henceforth referred to as "SEBI (NCRPS) Regulations, 2013").
  
10. This is to imply that under the current regulatory framework if the issuer company is intending to issue equity shares / debt security / non-convertible redeemable preference shares (i.e., any instrument except convertible debt instrument), and is included in the list of wilful defaulters published by the RBI, such issuer company shall be able to access the capital market by way of public issue or rights issue.
  
11. As per para 2.5 of the Master Circular, following penal measures, inter-alia, can be initiated by a bank against the wilful defaulter:
  - 11.1. No additional facilities should be granted by any bank / FI to the listed wilful defaulters. In addition, the entrepreneurs / promoters of companies where banks / FIs have identified siphoning / diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions should be debarred from institutional finance from the scheduled commercial banks, Development Financial Institutions, Government owned NBFCs, investment institutions etc. for floating new ventures for a period of 5 years from the date the name of the wilful defaulter is published in the list of wilful defaulters by the RBI.
  
  - 11.2. The legal process, wherever warranted, against the borrowers / guarantors and foreclosure of recovery of dues should be initiated expeditiously. The lenders may initiate criminal proceedings against wilful defaulters, wherever necessary.

- 11.3. Wherever possible, the banks and FIs should adopt a proactive approach for a change of management of the wilfully defaulting borrower unit.
- 11.4. A covenant in the loan agreements, with the companies in which the banks / notified FIs have significant stake, should be incorporated by the banks / FIs to the effect that the borrowing company should not induct a person who is a promoter or director on the Board of a company which has been identified as a wilful defaulter as per the definition and that in case, such a person is found to be on the Board of the borrower company, it would take expeditious and effective steps for removal of the person from its Board.
12. Further, as per para 2.6 of the Master Circular, in cases where a letter of comfort and / or the guarantees furnished by the group companies on behalf of the wilfully defaulting units are not honored when invoked by the banks / FIs, such group companies should also be reckoned as wilful defaulters.
13. As per para 5.2 of the Master Circular, no material fact should be suppressed while disclosing the names of a company that is a defaulter and the names of all directors should be published. The said provision also requires that a suitable distinguishing remark should be made clarifying that the concerned person was an independent director / nominee director.
14. Therefore, it appears from Para 11 and 12 above that RBI has laid down sufficient safeguards to contain the financial activities of wilful defaulter, by restricting access to further bank finance to such entities; by providing for proactive approach by banks / financial institutions for change in management of the wilfully defaulting borrower unit; by requiring banks / financial institutions to take expeditious and effective steps for

removal of person, from the Board of a borrower company, who is a promoter or director on the Board of a company which has been identified as a wilful defaulter.

15. It also appears from para 13 above that even though independent directors / nominee directors are distinguished from other promoter directors of the wilful defaulter, such directors are brought within the purview of the Master Circular for the purpose of declaring them as wilful defaulters.
16. Under the existing regulatory framework prescribed by SEBI, a unit / promoter / director identified as wilful defaulter may raise money from capital markets by way of public issue or rights issue (except by way of issuance of convertible debt instrument) and effectively bypass the restriction of access to bank finance as envisaged in the Master Circular.
17. Further, a unit / promoter / director identified as wilful defaulter may attempt to take control of another listed company thereby potentially exposing more listed companies to the promoter / management of the wilful defaulter.

#### **IV.PROS AND CONS OF IMPOSING RESTRICTIONS BY SEBI**

**18. Pros:** Some of the perceived benefits are discussed below:

- 18.1. The wilful defaulters do not have access to bank finance which means that the exposure of banks to such wilful defaulters is restricted. Along the same lines, exposure in the capital markets to such wilful defaulters may also be restricted.

18.2. The wilful defaulters may be restricted from taking control in another listed companies thereby protecting more listed companies from the promoter/s / management of the wilful defaulter.

18.3. Such measures are expected to further enhance the protection of investors in the securities market.

**19. Cons:** Some of the perceived challenges are discussed below:

19.1. As per the Master Circular, the banks and notified All India Financial Institutions are required to submit to RBI the details of the wilful defaulters. In order to prevent the access to the capital markets by the wilful defaulters, a copy of the list of wilful defaulters (non-suit filed accounts) and list of wilful defaulters (suit filed accounts) are forwarded to SEBI by RBI and Credit Information Bureau (India) Ltd. (CIBIL) respectively.

19.2. Thus, while RBI does not declare any borrowing unit as wilful defaulter, the same is done by its intermediary as per the guidelines issued by the RBI. In view of the above, it needs to be considered if it would be appropriate for SEBI to take cognizance of such action initiated by an intermediary of RBI and then act upon it by restricting access to capital market by way of public issue or rights issue.

19.3. It may be considered that once a listed company is categorized as wilful defaulter, it cannot access bank finance as per the Master Circular. In that case, such listed company may resort to raising fresh funds from its existing shareholders by way of rights issue. Restriction of access to capital market by way of rights issue may negatively impact the operations of the listed company thereby negatively impacting its share price. Such a measure may not be in the

interest of the shareholders of the listed company. Theoretically, the shareholders should infuse funds if the company is in trouble. Shutting down finance even from own shareholders appears to be unreasonable.

19.4. If a hostile bid is made on a listed company which is controlled by a person categorized as wilful defaulter, restricting such wilful defaulter from making a counter offer may not be legally tenable.

19.5. With regard to extending the proposed restriction to an issuer company in case it has a director who is also on the board of wilfully defaulting unit, the recent Order of the Hon'ble High Court of Gujarat in the matter of Ionic Metalliks Limited relating to the Master Circular may need to be considered. As per the said Order, the Master Circular, so far as it is sought to be made applicable to all the directors of the company, is arbitrary and unreasonable. To this limited extent, that part of the Master Circular has been declared as ultra vires the powers of RBI and has been declared to be violative of Article 19(1)(g) of the Constitution of India. However, it has been stated that these observations will not apply to the promoters/ entrepreneurs.

## V. PROPOSAL

20. In line with the above, following recommendations are made to impose restrictions on wilful defaulters from accessing the capital market:

### **Recommendation 1**

- No issuer shall make a public issue of equity securities, if the issuer, its promoter, group company or director of the Issuer of such securities, is in the list of the Wilful defaulters, published by the Reserve Bank of India

### **Recommendation 2**

- No issuer shall make a public issue of the debt securities, if the issuer, its promoter, group company or director of the Issuer of such securities, is in the list of the Wilful defaulters, published by the Reserve Bank of India or it is in default of payment of interest or repayment of principal amount in respect of debt instruments issued by it to the public, if any .

### **Recommendation 3**

- No issuer shall make a public issue of non-convertible redeemable preference shares , if the issuer, its promoter, group company or director of the Issuer of such securities, is in the list of the Wilful defaulters, published by the Reserve Bank of India or it is in default of payment of interest or repayment of principal amount in respect of debt instruments issued by it to the public, if any.

### **Recommendation 4**

- Existing listed companies / its promoter / group company / director of the Issuer categorized as 'wilful defaulter' may make a rights issue / private placement to qualified institutional buyers, with full disclosures in the offer document.

### **Recommendation 5**

- Existing listed companies / its promoter / group company / director of the Issuer categorized as 'wilful defaulter' should not be allowed to take control over other listed entity in accordance with SEBI (SAST) Regulations, 2011.

### **Recommendation 6**

- Existing listed companies / its promoter / group company / director of the Issuer categorized as 'wilful defaulter' should be allowed to make counter offer in case of a hostile bid.



## VI. PUBLIC COMMENTS

21. In line with the recommendations of the Financial Sector Legislative Reforms Commission ("FSLRC") pertaining to framing of regulations, public comments are solicited on recommendations stated at Para 20 of the discussion paper. Specific comments/ suggestions in the format below would be highly appreciated:-

Name of entity / person / intermediary:			
Name of the Organization (if applicable) / Investor:			
Sr. No.	Pertains to Recommendation number	Proposed / suggested changes	Rationale

22. Such comments may please be emailed on or before January 23, 2015, to [wilfuldefaulters@sebi.gov.in](mailto:wilfuldefaulters@sebi.gov.in) or sent, by post, to:-

**Mr. Anindya Kumar Das**

Deputy General Manager

Corporation Finance Department

Securities and Exchange Board of India

SEBI Bhavan, Plot No. C4-A, "G" Block ,

Bandra Kurla Complex, Bandra (East),

Mumbai - 400 051

Ph: +912226449616/ +912226449301