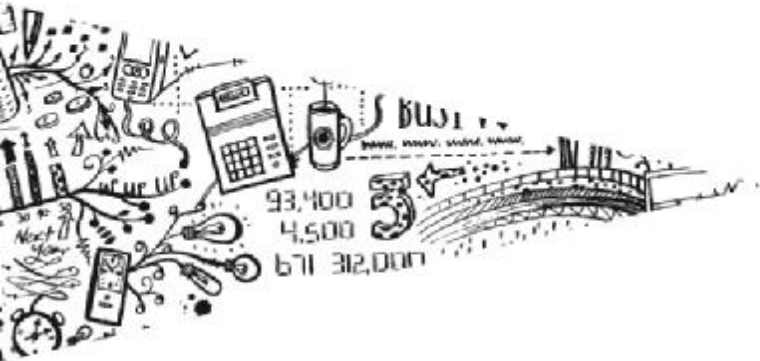


18 May 2011

EY Regulatory Alert

Pledge of shares by non-resident shareholders



Background

Until 2 May 2011, pledge of shares in respect of all FDI transactions (except certain pledges in connection with External Commercial Borrowings) required prior permission of the Reserve Bank of India (RBI) other.

The Reserve Bank of India (RB), in order to enhance the credit facilities for an Indian company as well as the non-resident shareholders, has issued A.P. (DIR Series) Circular No. 57 dated 2 May 2011 (Circular) liberalising the provisions relating to pledge of shares in respect of FDI dispensing the need of RBI approval in specified cases.

As per the Circular, the Authorised Dealers Category I (ADs) are empowered to allow non-residents to pledge of shares of an Indian company in favour of Indian and overseas banks, subject to certain conditions listed below:

Key conditions

1. Pledge in favour of Indian bank:

Shares of an Indian company held by the non-resident investor can be pledged in favour of an Indian bank in India to secure the credit facilities being extended to the resident investee company for bonafide business purposes subject to the following conditions:

- a. in case of invocation of pledge, transfer of shares should be in accordance with the FDI policy in vogue at the time of creation of pledge;
 - b. submission of a declaration / annual certificate from the statutory auditor of the investee company that the loan proceeds will be / have been utilized for the declared purpose;
 - c. the Indian company has to follow the relevant SEBI disclosure norms; and
 - d. pledge of shares in favour of the Indian bank should be subject to compliance with the Section 19 of the Banking Regulation Act, 1949¹ (Banking Act);
- c. overseas investment should not result in any capital inflow into India;
 - d. in case of invocation of pledge, transfer should be in accordance with the FDI policy in vogue at the time of creation of pledge; and
 - e. submission of a declaration/ annual certificate from a Chartered Accountant/ Certified Public Accountant of the non-resident borrower that the loan proceeds will be / have been utilized for the declared purpose.

2. Pledge in favour of an Overseas bank:

Shares of the Indian company held by the non-resident investor can be pledged in favour of an overseas bank to secure the credit facilities being extended to the non-resident investor/ non-resident promoter of the Indian company or its overseas group company, subject to the following conditions:

- a. loan is availed of only from an overseas bank;
- b. loan is utilized for genuine business purposes overseas and not for any investments either directly or indirectly in India;

¹ As per Section 19 of the Banking Act, no banking corporation can hold shares in any company by way of pledge, mortgage or absolute owner of shares constituting 30 per cent of the paid-up share capital of the company or 30 per cent of its on share capital whichever is less.

EY Comments

- The Circular indicates that the transfer of shares upon the invocation of pledge should be in accordance with the FDI policy in vogue at the time of creation of pledge. In case the invocation of pledge results in transfer of shares to a resident shareholder, it appears that price cannot exceed the price determined in accordance with the relevant pricing guidelines **at the time of creation of pledge (as against invocation)**. Where there is a substantial appreciation since the time of creation of pledge, this could result a loss to the non-resident holders.
- The Circular provides relaxation from RBI approval for pledge of shares only to Indian bank /overseas banks. Thus, for pledge of shares for obtaining credit facilities from financial institutions (which are not banks/ banking companies), prior approval of RBI will continue be required.

Conclusion

This welcome move by the RBI will simplify and significantly ease the process of raising monies in India and overseas. However, the smooth implementation and attractiveness of the above relaxation would be enhanced if the RBI could clear certain issues identified above.

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