Corpsec Hotline

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SEBI INTRODUCES RECORDING ON NON-DISPOSAL UNDERTAKING

- SEBI issues circular for recording of non-disposal undertakings in depository system
- Non-disposal undertakings to now be recorded in separate modules maintained by depositories

In a bid to ensure further transparency and adequate disclosures by promoters, the Securities and Exchange Board of India ("**SEBI**") has issued a circular requiring non-disposal undertakings to be recorded in the depository system.

BACKGROUND

The Depositories Act, 1996 introduced the concept of dematerialized securities in India. In addition to the other advantages of dematerialization of securities, a notable feature of this legislation was the mechanism that was put in place for the creation of a pledge of shares. Traditionally, a pledge of shares involves passing of the 'constructive possession' of the pledged shares in favour of the pledgee upon execution of the deed of pledge. Upon the creation of a pledge of dematerialised shares, the same is notified to the depository participant, and the pledged shares are frozen by the depository participant. The freezing of pledged shares by the depository restricts the beneficial owner (i.e. the shareholder in the records of the depository) from transferring or otherwise dealing with the shares for as long as the shares are pledged. However, no such mechanism existed for non-disposal undertakings ("**NDU**"). NDUs are undertakings given by a shareholder to another person (generally a lender) undertaking not to transfer or otherwise alienate the securities held by such shareholder in a company. Considering that dematerialized shares are fungible, tracking NDUs were practically impossible.

As per the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (**"Takeover Code"**) promoters are required to disclose details of 'encumbered' shares. Under the Takeover Regulations[1] 'encumbrance' includes any "*pledge, lien, or any such transaction, by whatever name called.*" Thus, the term 'encumbrance' does not merely mean a *simpliciter* pledge or lien, but also includes, any other transaction, which may entail a risk of the shares held by promoters being appropriated by a third party and thus covers within its definition a 'NDU'. However, due to lack of mechanism to monitor creation of NDU on dematerialized shares, a depository would be unable to track shares which are subject of an NDU, and NDUs would go undisclosed in a depository's system. It is in this light that SEBI has, on June 14, 2017 issued a circular to the depositories (i.e. NSDL and CDSL) ("**Circular**") directing the depositories to implement the contents of the Circular within 4 months from the date of the issuance of the Circular.

PROVISION AND ANALYSIS

(i) Provision: To record the NDU, both the beneficial owner ("**BO**") and the person in favour of whom the NDU is being created ("**Beneficiary**") are required have a demat account with the same depository. Once the NDU is created, the BO and the Beneficiary are required to make an application to the depository through the depository participant ("**DP**") to record the NDU.

Analysis

- The rationale for the requirement for both the BO and the Beneficiary to have a demat account with the same depository is unclear. The requirement seems to be rational in case of pledge, where the pledgee has the right to invoke the pledge, and take over the securities or transfer the shares. However, in case of an NDU, the only right that the Beneficiary has it to approve any transfer or disposal. The consent of the Beneficiary can be in the form of instruction slip/ approval/ consent letter, and the requirement for the Beneficiary to have a demat account with the same depository could be an unnecessary procedural requirement.
- The framework contemplates the execution of an NDU. Accordingly, it is expected that the mechanism for the creation of the NDU would be similar to that for a pledge, where the pledgor and the pledgee execute a pledge agreement, and the relevant filings with the depositories are made subsequently.

(ii) Provision: Once the NDU is recorded (which implies that the shares are frozen in the system), the depository shall not facilitate or effect any transfer, pledge, hypothecation, lending, rematerialisation or alienation in any manner or otherwise dealing in such shares, till receipt of instruction from both parties for the cancellation of the NDU. In case the entry of the NDU is required to be cancelled, the parties to the NDU are required to make a joint application requesting cancellation of NDU and unfreezing of shares.

Analysis

- The Circular requires that any dealing with securities against which an NDU has been recorded earlier can be dealt with only with the prior consent of the BO and the Beneficiary. This seems to be a logical extension of the

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concept of NDUs, as currently understood. Unlike a pledge, a Beneficiary cannot dispose or alienate shares unilaterally, at its discretion. It is only the BO which has a right to transfer/ alienate the shares, although the consent of the Beneficiary may be required as per the contractual terms agreed (in the NDU).

- While the Circular specifically lists any transfer, pledge, hypothecation, alienation as actions requiring the consent of both the BO and the Beneficiary, it is unclear whether a second NDU would fall under the ambit of the restriction, especially the residuary clause being 'otherwise dealing in such shares'. It would appear that the restriction should apply and the BO should not be permitted to offer a second NDU in favour of a third party, if one NDU is already recorded, without a joint application by the BO and the Beneficiary.
- However, it would be interesting to note how the interest of various Beneficiaries are dealt. If a first Beneficiary agrees for a second NDU to be created, it appears that any transfer / alienation/ disposal of the subjected shares would require the consent of both Beneficiaries. This assumes more importance in terms of a pledge being created subsequent to an NDU being in place, in which case, consent will have to be obtained by the NDU holder before a pledge is created. In such case, it is to be seen whether the Beneficiary's consent be required for transferring the pledged shares, or would the pledgee's rights supersede that of the Beneficiary. It appears that considering the subservient nature of an NDU to a pledge as security in concept, the requirement of the joint application by a BO and a Beneficiary would be overridden by the pledgee's right to transfer the subject shares. Another aspect unclear is whether the Beneficiary's NDU would be carried forward with respect to shares (now held by the new beneficial owner), or would the NDU fall off.

CONCLUSION

Although the Circular has put in place a mechanism for recording NDU in depository system, the Circular does not completely preclude creation of NDUs outside the depository system. However, the Circular is only one step towards furthering the recording of NDUs.

Having said the above, it is likely that banks[2] and other persons in favour of whom such NDUs are created would require all NDUs to be recorded, since recording of such NDUs offer better protection to the lenders as security. Further, while the intent was to further recording of shares of listed companies, it is likely that unlisted companies (including private companies) having their shares held in the dematerialized form would also benefit from the Circular.

– Swati Sharma, Abhinav Harlalka & Simone Reis
You can direct your queries or comments to the authors

[1] Regulation 28(3)

[2] Banks are the most common beneficiaries of NDUs since they are not permitted to take a pledge over 100% of the shares of any borrower under the extant banking laws. Accordingly, a 30:70 split, being pledge of 30% of the shares of the company and NDUs over 70% shares are quite common.

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