CONSEQUENCES OF NBFC OWNERSHIP/MANAGEMENT CHANGES WITHOUT RBI APPROVAL (SBR FRAMEWORK)

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1. RBI Prior Approval Requirements under SBR Directions

Under the **Scale-Based Regulation (SBR) Directions** for NBFCs, prior written approval of the Reserve Bank of India (RBI) is mandatory before effecting certain significant changes in an NBFC's ownership or management. In particular, RBI approval is required for the following scenarios :

- **Major Shareholding Changes** – Any acquisition or transfer of **26% or more** of the NBFC's paid-up share capital (whether in a single transaction or through progressive increases over time) needs RBI's prior approval. (If shareholding crosses 26% due to a **buyback or capital reduction** approved by a court, prior approval is exempted, but RBI must be informed within one month.)

- **Change in Control/Takeover** – Any **takeover or acquisition of control** of the NBFC (even if it doesn't involve a management change) must be pre-approved by RBI. This covers direct or indirect changes in the controlling interest of the NBFC.

- **Significant Management Reshuffle** – Any change in the board's composition that results in **more than 30% of the directors** being changed (excluding independent directors) requires prior RBI approval. (Routine re-election of directors by rotation is not counted towards this 30% threshold .)

These requirements – often called the "Change in Shareholding Rule" and "Change in Management Rule" – aim to ensure that any new owners or managers of an NBFC meet RBI's fit-and-proper criteria and that the **soundness of the financial system** is maintained .

NBFCs must apply to RBI (via Pravah Portal) with all required information about the proposed new shareholders or directors (e.g. personal/business background, financial resources, declarations of no criminal or regulatory disqualifications, etc.) .

Additionally, once RBI grants approval, the NBFC and incoming parties must issue a public notice at least 30 days before consummating the change, disclosing the intent and details of the new ownership/management in newspapers.

In summary, NBFCs are obligated to seek RBI's prior written consent before implementing any ownership or management changes that hit the above – mentioned thresholds. The onus is on the NBFC to obtain this approval; proceeding without it is a contravention of the RBI's NBFC regulations.

2. Legal Consequences of Non-Compliance with Prior Approval Rules

Failing to obtain the RBI's prior approval for the specified changes is a regulatory violation that can lead to **serious consequences** under the RBI's NBFC regulations and the RBI Act, 1934. Key legal consequences include:

(a) Monetary Penalties:

The RBI can and does impose **financial penalties** on NBFCs that consummate a **26% + share transfer or >30% board change** without prior approval. In recent enforcement actions, RBI has levied fines on several institutions for such breaches – for example, RBI imposed a penalty of Rs. 1.55 lakhs on Nido Home Finance Ltd. and Rs. 1.70 Lakhs on West End Housing Finance Ltd. for failing to seek prior approval for a shareholding change. Likewise, a ₹5 lakh penalty was imposed on Bajaj Housing Finance Ltd. for inducting new directors beyond the 30% limit without the RBI's prior nod. These penalties are typically imposed under the RBI Act's provisions (Section 58B and 58G) empowering the RBI to punish non-compliance with its directions. They serve as both punishment and deterrence –

RBI's message is that NBFCs *cannot* bypass approval requirements and simply ask for forgiveness later.

(b) Regulatory Orders and License Action:

Besides monetary fines, the RBI has the authority to take **further regulatory action** for such violations. Notably, **cancellation of the NBFC's Certificate of Registration** is a possible extreme measure if the breach is egregious or if the entity is unable/unwilling to comply with RBI's directions.

In practice, the RBI would likely resort to license cancellation only if the violation isn't remedied (for instance, if an unapproved new owner refuses to divest or if the NBFC persistently defies regulatory instructions). Lesser enforcement actions can include regulatory directions to freeze further business, or replacing management under RBI's powers, until compliance is achieved.

(c) Voidance of Unapproved Changes:

If RBI **denies approval post-facto** (i.e. does not ratify the change after it has occurred), the implication is that the transaction or appointment **cannot be given effect**. The NBFC would be expected to **reverse or unwind** the change in ownership/control.

For example, if a share transfer to a new investor was completed without approval and the RBI subsequently rejects that investor as unfit, the NBFC would need to unwind the transaction (e.g., restoring the previous shareholding) to remain in regulatory compliance. While the SBR Directions do not spell out the mechanism of unwinding, in principle, a change "not approved" by the RBI *cannot be consummated* or sustained. Any corporate actions taken by unapproved directors or owners could be deemed invalid. Possibly, the acts of a director appointed without required approval are **not legally validated unless and until the RBI later confirms the appointment**.

(d) Show Cause and Reputational Impact:

Upon discovering a violation (either via the NBFC's intimation, regulatory inspection, or third-party reference), RBI typically issues a **Show Cause Notice (SCN)** to the NBFC, asking why penal action should not be taken. The NBFC gets an opportunity to explain its position in writing and through a personal hearing. If the explanation is unsatisfactory (as is likely in a clear rule breach), the RBI may proceed to impose a fine through a speaking order. Such enforcement orders are published as RBI press releases, which can tarnish the NBFC's reputation in the market. The public disclosure that an NBFC violated RBI's directives and was penalized can erode trust among investors and customers.

In summary, an NBFC that fails to obtain prior RBI approval for major ownership or management changes faces **regulatory sanctions**. At a minimum, the NBFC will incur monetary penalties for the compliance failure. In more severe cases – especially if RBI refuses to approve the change even after the fact – the NBFC may be forced to **reverse the transaction** and could even lose its NBFC license.

The **legal basis** for these actions lies in Chapter V of the RBI Act: violation of RBI's directions is an offence under Section 58B(5) (aa) punishable by fines, and Section 58G allows RBI to impose those fines directly (up to ₹10 lakh or more, depending on the contravention) . Notably, once RBI imposes a penalty for the contravention, that may **close the matter** (the RBI's action effectively *compounds* the offence).

3. <u>Precedents: Post-Facto Approval Outcomes and RBI Approach</u>

Regulatory practice to date shows that the RBI rarely "condones" a lapse without penalty. If an NBFC proceeds with a change in control or directors first and seeks RBI approval later (a post-facto approval), RBI's stance has been strict – the NBFC has still violated the law and will usually face a penalty even if the substantive change is eventually approved.

For instance, in the cases of Nido Home Finance and West End Housing Finance (both housing finance companies under RBI supervision), the transactions of significant share transfer were completed before approval; the RBI later granted or considered approval, but nonetheless
imposed monetary penalties on the entities for the contravention.

Similarly, Srestha Finvest Ltd. in Chennai appointed new directors (>30% change in board) without prior permission; when this came to light, the RBI fined the company ₹2 lakh for non-compliance, after giving it an opportunity to explain its position. These examples underscore that **post-facto regularization does not shield the NBFC from punitive action** – the RBI will levy fines for the period of non-compliance.
As for whether RBI ever *accepts* a post-facto request without consequences, **there is no public record of RBI outright waiving the violation**. At best, the RBI may still grant the needed approval (if the new ownership/management meets all criteria) but simultaneously penalize the NBFC for not obtaining approval beforehand. The absence of any reported judicial challenge suggests that NBFCs generally comply with RBI's penalties and directions in these matters, rather than litigating. No notable court precedents are found where an NBFC succeeded in arguing against RBI's refusal of post-facto approval, likely because RBI's powers and the NBFC's obligations are clearly grounded in the law, leaving little room to contest except on very narrow grounds.

That said, **RBI may consider applications for ex-post approval on a case-by-case basis**. This review would focus on the merits (fit-and-proper status of new owners/directors, any supervisory concerns, etc.). If RBI finds no issues with the new stakeholders, it might grant retroactive approval (thus legitimizing the new ownership/management going forward) *but* will concurrently take enforcement action for the breach. On the other hand, if RBI finds the new owner/manager unsuitable or the transaction problematic, it can **refuse approval**, in which case the NBFC would have to reverse the change. In such a scenario, a penalty for the attempt is still likely, and the NBFC could face intensified scrutiny.

4. <u>RBI's intolerance for prior-approval violations</u>:

In summary, past precedents show the regulator has consistently imposed fines for non-compliance, even while sometimes allowing the change to stand if it meets criteria. There is no known precedent of the RBI retroactively approving a change *and/or* forgoing a penalty altogether. Thus, NBFCs should not bank on any leniency – the safer course is always to seek approval upfront rather than hoping for forgiveness later.

5. <u>Remedies and Compliance Measures for NBFCs</u>

When an NBFC finds itself in the unfortunate position of having violated the prior approval requirement (or is at risk of doing so), several legal remedies and corrective measures are available:

(a) Voluntary Disclosure and Post-Facto Approval Application:

The first step should be to **immediately inform RBI** of the situation. Regulators view timely disclosure favorably. The NBFC should submit an application for *ex-post* approval, explaining the change in shareholding or management and the reasons why prior approval was not obtained (e.g., oversight or urgency).

While this does not excuse the violation, it signals good faith. RBI will evaluate the application on merits (just as it would have prior, looking at the credentials of new investors/directors, sources of funds, compliance history, etc.) and decide whether to approve the change or not. In many cases, if the only issue was the timing of approval (and not the suitability of the new owners), RBI may *grant approval retroactively* - subject to the NBFC paying any penalties for the lapse.

(b) Compounding the Offence (Monetary Penalty):

For regulatory contraventions by NBFCs, the chief remedy is **compounding**, which in RBI's context means resolving the violation by payment of a monetary penalty rather than facing prosecution. Section 58G of the RBI Act empowers RBI to impose fines on NBFCs for failure to comply with its directions (such as the prior approval requirement).

An NBFC can **file a compounding application** with RBI admitting the lapse and requesting to compound the contravention.

(c) Remedial Actions and Internal Compliance:

Alongside the formal remedies, the NBFC should take **corrective internal measures** to prevent recurrence. This includes strengthening compliance checks so that any future changes in shareholding or directorship are routed through a legal/ regulatory approval review. The NBFC's board should be promptly appraised of the violation and the steps taken. In any compounding application or post-facto approval request, it bolsters the NBFC's case to mention such remedial steps (e.g. instituting a board-approved policy that no equity transfers or director inductions will be completed without either a compliance officer or counsel certifying RBI approval is in place). Showing repentance and improved controls can sometimes lead to a modest reduction in the penalty amount.

(d) Legal Appeal (if necessary):

If RBI were to impose very severe consequences (say, rejecting an approval and mandating unwinding, or license cancellation) and the NBFC believes this is unjustified, the NBFC's recourse would be to approach the **courts** (since there is no dedicated tribunal for RBI-NBFC matters). Typically, a writ petition in the High Court would be the avenue to challenge RBI's decision on grounds of arbitrariness or misapplication of law. However, such challenges are rare and uphill, given RBI's broad regulatory powers. In most cases, demonstrating compliance and seeking compounding is the more pragmatic solution.

6. **In conclusion**, under the RBI's Scale-Based Regulation framework, NBFCs must vigilantly comply with prior approval requirements for ownership and management changes. The legal consequences of noncompliance are significant – ranging from monetary fines to potential license cancellation – and RBI has not hesitated to enforce these rules. However, by promptly disclosing the lapse, seeking required approvals, and applying for compounding, an NBFC can often regularize its status and mitigate further damage. All NBFCs would be well-advised to treat RBI's prior approval mandates as a **hard stop** in any transaction timeline, thereby avoiding the need for post-facto remedies altogether. Compliance upfront I invariably better than cure later, given RBI's clear stance on the matter.
