UNMASKING ACCOUNTABILITY?
ROLE OF OBSERVERS IN NON-BANKING FINANCIAL COMPANIES

1. INTRODUCTION

The Reserve Bank of India ("**RBI**") has initiated a transformative directive that could reshape the governance landscape of non-banking financial companies ("**NBFCs**"). The directive appears to target the long-standing practice of appointment of 'observers' that has allowed private equity ("**PE**") and venture capital ("**VC**") funds to participate in board meetings of NBFCs without assuming the onerous liability of being a director.[1]

2. A PARADOX: OBSERVERS AND INVISIBLE INFLUENCE

PE/VC investors often structure their involvement in the decision-making activities of their large portfolio of investee companies. In addition to detailed information rights, investors would contractually appoint "*observers*" to board meetings – people who could observe the affairs and give advice but lacked any voting rights and were not officially designated directors of the company. The appointment of such observers by PE/VC companies has been a sophisticated way to maintain strategic oversight while carefully avoiding direct legal and statutory liability, albeit the lack of voting rights often reflects a smaller stake and correspondingly smaller say, and as such observer seats are typically negotiated on a 'pay to play' basis.

The observers may, through active participation, influence the decisions of the board, without being legally responsible for those decisions. It was a comfortable position that allowed investors to have participation and visibility in the dealings of the NBFC, without taking on real statutory risk.

With an apparent concern for 'no skin in the game' for the observers, the RBI has reportedly[2] mandated that the participation of PE/VC investors in the affairs of investee NBFC should be accompanied with full responsibility for such participation and decisions made pursuant thereto. The RBI has reportedly directed that the 'observers' appointed by investors now need to be appointed as directors in the NBFC to continue their attendance at board meetings.

3. DIRECTORS' LIABILITY VS. OBSERVERS' IMMUNITY

The directive significantly increases the risk profile of investors in the investee NBFC. The far-reaching impact and consequence of directorship is pertinent to consider in this scenario since directors, by nature of their position, have associated liabilities beyond financial services regulatory framework, which spans their fiduciary duties under Section 166 of the Companies Act, 2013 ("**Companies Act**") as well as substantial liability under tax laws and even potential liability for dud cheques under Negotiable Instruments Act, 1881 – which altogether may be collectively disproportionate in view of the limited role intended to be fulfilled by the observers, and the limited shareholding the appointing investor typically enjoys.

The intent and purpose of an observer may not align fully with the obligations and liability that accompanies the directorship role. Depending on the size, activities and operations of the NBFC, taking up a directorship role may be construed as more onerous and not a fair trade for the benefits that an investor looks to achieve through such

[1] This directive is not available in the public domain and appears to have been shared by the RBI directly with NBFCs. A copy of the directive has not been released publicly as yet.
[2] View relevant article here.

observers. Directors are bound by statutory obligations and are also at risk of facing personal liability for fraud, misappropriation, non-compliance, and harmful decisions, while observers have historically maintained attendance and participation rights with minimal legal exposure through contractual protections. It is pertinent to acknowledge that this insulation from liability is also owing to the lack of voting rights of the observers, as well as their limited participation. Conversion of observers to directors may upset the apple cart for the investee company as well since, as mentioned earlier, rights in relation to information, board seats and observer seats are carefully negotiated at the time of the investment and are customarily subject to thresholds.

4. THE SHADOW DIRECTOR DILEMMA

The rationale behind the RBI's directive may also reopen discussion on the concept of the "de facto" or "shadow" directors. While Indian jurisprudence is nascent on shadow directors, the Companies Act (based substantively on the UK Companies Act, 2006) provides a broader definition of an "officer" that can include individuals exercising substantial influence without any formal directorship.

Section 2(59) of the Companies Act defines an "*officer*" to include any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act.[3] Further, Section 2(60) of the Companies Act defines an "*officer in default*" as a company officer who is liable to punishment or penalty for non-compliance with the Act's provisions.[4] This definition creates a potential legal trap for those board observers who might be more influential than they appear.

The line between a legitimate observer and a shadow director becomes critically important. An observer might believe they are merely providing strategic advice, when in reality, their consistent participation in management discussion, coupled with a significant shareholding in the company could potentially make them liable as an officer in default in case regulators start considering directors and observers as interchangeable in terms of role and power.

To this end, it also becomes important to consider the roles that observers can play on a case-by-case basis as per the shareholder agreement bestowing the right on the investor to appoint observers. Prudent investee companies for strategic reasons insist on shareholder agreements which only permit investor observers to attend the board meetings, without (in many cases) speaking rights, the observers' presence in such cases remains largely neutral, with no real influence on the investee NBFC's affairs. In view of this nuanced position that an observer may hold, RBI's directive imposing a blanket prohibition on appointment and involvement of observers appears to lack acknowledgment of the varied arrangements and investments that may exist in the market, depending on the purpose and rationale for appointment of observers.

While stricter regulation of participating observers aligns with the risk management objectives of the RBI, applying the same standards uniformly to non-participating observers may create an undue burden for investors in NBFCs where the intent of the investors is not for their appointed observers to play director-like role. The directive could benefit from recognising this, as non-participating observers pose fundamentally different risks compared to the participating observers or indeed directors.

5. STRICTER REGULATION OF SYSTEMICALLY IMPORTANT NBFCs

PE/VC investors invest in varied kinds of NBFCs, which may not always be systemically important NBFCs. VC firms by their very nature invest in higher-risk NBFCs or indeed fintech companies that are yet to be regulated by the RBI. These companies are often in the early stage and may be struggling to access traditional credit and

[3] The Companies Act, 2013, Section 2(59).
[4] The Companies Act, 2013, Section 2(60).

comply with myriad legal requirements. In such instances, observer roles help in balancing risk for investors by limiting personal liability for their employees and advisors.

This is where it may have been a more balanced approach for the regulator to mandate the director appointments in cases where the shareholding of the appointing investor exceeds a certain threshold or where the NBFC itself engages in activities that carry greater systemic risk, such as systemically important NBFCs.

6. PRACTICAL IMPLICATIONS AND FUTURE OUTLOOK

The RBI in the recent past has intensified its focus on NBFC regulation as the sector itself has become vastly more complex compared to its moneylending origins. This is all the more relevant given the substantial and sizeable investments seen in financial companies over the last few years.[5] This was evidenced by the RBI taking active steps in relation to violative NBFCs, where the RBI directed such NBFCs to cease and desist from disbursal of loans or onboarding of customers, due to material violations of the RBI regulations including the fair practices code.[6] Separately, the RBI also recently warned NBFCs about the potential dangers of pursuing overly aggressive growth tactics that have the potential of compromising the overall stability of the financial system.[7]

This RBI's directive appears to be a move intended to further eliminate any ambiguity in the governance framework of NBFCs. By mandating that observers transition to formal director roles, RBI is effectively closing a significant governance flexibility that has existed for years. The RBI's directive also raises several questions that demand thoughtful exploration. It gives rise to a debatable question as to whether the increased accountability and lowered visibility (in case an investor is denied a board seat) will deter or attract sophisticated investors.

The RBI's directive could serve as a blueprint for regulatory reforms in other sectors as well. India has long struggled with governance challenges – from family-controlled businesses to closely held companies with opaque governance structures - this approach can be adopted by regulators across sectors in an attempt to create a more accountable and transparent corporate environment across divisions.

Regardless of future outcomes, the directive puts current PE/VC backed NBFCs in a tough spot where there may be plenty of renegotiation in the days to come, and a revamping of the approach to governance and board representation. Since the directive doesn't appear to be prospective, in that it applies to existing shareholder agreements and articles of association and not just future investments, investors and investees would require a reasonable period to actually transition and be able to adopt any solutions.

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[5] As per article available here, between 2020 and 2023, over 160 deals saw approximately INR 88,000 crore invested in finance companies, with local banking and financial services companies attracting INR 2.59 lakh crore from PE and VC investors.
[6] https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=58921.
[7] https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=58851.

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