Non-convertible Debentures: Entry Routes for Foreign Investors

A. INTRODUCTION

Since January 2020, there have been more than 10[1] public issues of non-convertible debentures (***NCDs***) and over 1,600[2] private placements of corporate bonds in India, which is encouraging given the COVID-19 pandemic and brief loss of investor appetite in the initial phase of the pandemic. An increasing number of M&A transactions also now involve NCDs as a form of consideration/funding. As such, the rising popularity of NCDs as a preferred mode of structured debt in India is not surprising given the potential return they could provide in times where market conditions have been uncertain.

NCDs are essentially debt instruments with a specified redemption or repayment timeline. NCDs provide certain benefits to foreign investors, e.g., unlike equity instruments, NCDs are not subject to valuation and pricing requirements, lock-in requirements applicable to equity instruments with optionality clauses or limitations regarding rate of return/coupon. Bankruptcy laws in India have further contributed towards making a case in favor of NCDs as a preferred route. Under the Insolvency and Bankruptcy Code, 2016, as amended (***IBC***), NCDs are treated as a financial debt and accordingly, an NCD holder enjoys the status and benefit of a financial creditor, including the power to initiate corporate insolvency resolution process under the IBC upon a default and the right to representation and voting rights in the committee of creditors. Further, the IBC specifies the order of priority for distribution of assets of a company in the event of liquidation, in which NCD holders (secured and unsecured) rank higher than equity shareholders. Although NCD holders do not have shareholder voting rights, affirmative/negative covenants could provide some degree of control and other features such as statutory seniority in recovery (as a creditor), flexibility to structure upside and flexibility to structure security interest have made NCDs a popular choice among foreign investors, including foreign portfolio investors registered under the

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[1] https://www.sebi.gov.in/statistics/corporate-bonds/publicissuedata.html (last accessed on December 10, 2020).

[2] https://www.sebi.gov.in/statistics/corporate-bonds/privateplacementdata.html (last accessed on December 10, 2020).

Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019 (***SEBI FPI Regulations***, and such entities, ***FPIs***).

B. ENTRY ROUTES FOR FOREIGN INVESTORS

This note provides an overview of the investment routes for foreign (or non-resident) investors in NCDs; however, the scope of this note does not extend to acquisition or subscription of NCDs by foreign venture capital investors, non-resident Indians or overseas corporate bodies or acquisition or subscription of any debt securities other than NCDs.

1. ECB Route v. FPI Route

As a general matter, NCDs are governed by the Companies Act, 2013 and the rules thereunder (together, the ***Companies Act***), the Foreign Exchange Management (Debt Instruments) Regulations, 2019 (***DI Regulations***), the Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008 (the ***SEBI Debt Securities Listing Regulations***) and the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (if the NCDs are listed/proposed to be listed) and other requirements issued by the Reserve Bank of India (***RBI***) from time to time.

Acquisition or subscription of NCDs by foreign parties other than FPIs is considered an external commercial borrowing (***ECB***) and is regulated under the Foreign Exchange Management (Borrowing and Lending) Regulations, 2018, read with the Master Direction on External Commercial Borrowings, Trade Credits and Structured Obligations dated March 26, 2019, as amended (together, the ***ECB Framework***).

FPIs are subject to a separate regulatory framework in respect of acquisition or subscription of NCDs, which offers certain advantages as compared to the ECB route, e.g., proceeds of listed NCDs issued on a private placement basis can be used for equity investments in India, the minimum maturity period is lower and interest rate and other costs are not capped. However, the introduction of single/group investor limits in April 2018 limited the flexibility available to individual FPIs or groups to satisfy funding requirements in India by subscribing to NCDs.

FPIs with a more long-term view may also acquire NCDs through the Voluntary Retention Route for FPI investment in debt instruments (***VRR***), which is discussed separately in paragraph B.2 below. The key advantage of investment under the VRR route is that the minimum residual maturity requirement, concentration limit and single/group investor-wise limits, which are applicable to the general investment route for FPI investment in corporate bonds, are not applicable in respect of the VRR route.

Key differences in the regulatory framework for NCDs under the ECB route and the FPI general investment route are described below.

S.No.	Criterion	ECB Route	FPI General Investment Route
1	**Eligibility to lend/acquire NCDS**	Lenders/NCD holders must be resident of a Financial Action Task Force (***FATF***) or International Organisation of Securities Commission (***IOSCO***) compliant country. In addition, multilateral and regional financial institutions where India is a member country are also considered as recognized lenders.	Registration with SEBI under any one of the categories below pursuant to the SEBI FPI Regulations, subject to the eligibility criteria specified therein: • Category I FPIs – Central banks, sovereign wealth funds, pension funds, insurance and reinsurance entities, asset management companies, etc. • Category II FPIs – endowments and foundations, charitable organizations, corporate bodies, individuals, family offices, limited partnerships, etc. Foreign companies and individuals can subscribe to listed or unlisted NCDs as Category II FPIs. The FPI registration process generally takes approximately six (6) weeks.
2	**Minimum Maturity Period**	Minimum average maturity period (***MAMP***) is three (3) years, except as specified in respect of certain sectors, types of lenders and end-uses, where the MAMP ranges from one (1) year to 10 years. For example: the MAMP is one (1) year for an ECB of up to USD50 million raised by manufacturing companies, five (5) years for an ECB raised from a foreign equity holder for working capital purposes, general corporate purposes or repayment of Rupee loans and 10 years in respect of ECB raised from other lenders for working	FPIs are permitted to invest in corporate bonds with minimum residual maturity (***MRM***) of above one (1) year, subject to the condition that short-term investments in corporate bonds (i.e., investments with residual maturity up to one (1) year) by an FPI shall not exceed 30% of the total investment of that FPI in corporate bonds (such 30% limit to be determined daily on an end of day basis). The above is not applicable to Exempted Securities, i.e., security receipts and debt instruments issued by asset reconstruction companies and

S.No.	Criterion	ECB Route	FPI General Investment Route
		capital purposes or general corporate purposes.	debt instruments issued by an entity under the corporate insolvency resolution process under the IBC.
3	**Interest rate; Costs**	All-in-cost ceiling per annum capped at benchmark rate plus 450 bps spread. This includes rate of interest, other fees, expenses, charges, guarantee fees, export credit agency (ECA) charges, whether paid in foreign currency or INR but will not include commitment fees and withholding tax payable in INR. Benchmark rate in case of Rupee denominated ECB will be the prevailing yield of the Government of India securities of corresponding maturity.	No cap on interest, however, it cannot be exorbitant.
4	**Prohibited end-uses**	• Real estate activities • Investment in capital market • Equity investment • Working capital purposes, except where the ECB is raised for such purposes subject to MAMP and other conditions • General corporate purposes, except where the ECB is raised for such purposes subject to MAMP and other conditions • Repayment of Rupee loans, except where the ECB is raised for such purposes subject to MAMP and other conditions • On-lending to entities for the above activities except as expressly permitted in case of ECBs raised by non-banking financial companies.	<u>Listed NCDs issued pursuant to private placement</u>: No end-use restrictions. <u>Listed NCDs issued pursuant to public issue</u>: Proceeds of NCDs issued pursuant to a public issue cannot be used to provide any loans to or acquire any shares of any person who is part of the same group or under the same management as the issuer company. <u>Unlisted NCDs</u>: Proceeds of unlisted NCDs cannot be utilized for: • Real estate business • Capital market • Purchase of land
5	**Overall Limit; Concentration Limit**	Eligible borrowers can raise ECB up to USD750 million or equivalent per financial year under the automatic route.	The overall limit for FPI investment in corporate bonds for the current financial year ending

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			March 31, 2021 is 15% of the unutilized investment limit. Investment by FPIs (including investments by Related FPIs) in the three categories of debt (i.e., Central Government securities, state development loans and corporate debt securities) is subject to the following concentration limits: • Long-term FPIs: 15% of prevailing investment limit for that category • Other FPIs: 10% of prevailing investment limit for that category. "Related FPIs" means the term "investor group" as defined in Regulation 22(3) of the SEBI FPI Regulations, which provides that multiple entities registered as FPIs and directly or indirectly, having common ownership of more than 50% or common control, shall be treated as part of the same "investor group" and the investment limits of all such entities shall be clubbed at the investment limit as applicable to a single FPI.
6	**Single/group Investor Limit**	No single/group investor limit prescribed, however, overall limit has to be adhered to under the automatic route.	Investment by any FPI, including Related FPIs, cannot exceed 50% of any issue of a corporate bond. Practically, this means that any issue of NCDs by an Indian company targeted at FPIs will need to have a minimum of two (2) FPIs that are not Related FPIs. The above requirement is not applicable to investments by multilateral financial institutions and investments by FPIs in Exempted Securities.

S.No.	Criterion	ECB Route	FPI General Investment Route
7	**Security**	The following security is permitted subject to approval of the authorized dealer Category I bank (***AD***) and other conditions prescribed in the ECB Framework: • Security over immovable assets • Security over movable assets • Security over financial securities • Corporate and/or personal guarantees	While the DI Regulations and RBI circulars do not provide for any general permission for creation of security, as a practical matter, security is typically created in favor of a domestic security/debenture trustee, who holds such security for the benefit of the FPIs. The Companies Act specifies certain requirements for secured NCDs, including that a debenture trustee must be appointed and the value of the security must be sufficient for repayment of the amount of the NCDs (including interest).
8	**Exit; Transferability**	• Call and put options are not exercisable prior to completion of MAMP • The ECB Framework specifies that the prescribed MAMP will have to be strictly complied with under all circumstances, which implies that regulatory approval will be required for prepayment. • Refinancing of existing ECB by fresh ECB permitted, provided the outstanding maturity of the original borrowing (weighted outstanding maturity in case of multiple borrowings) is not reduced and all-in-cost of the fresh ECB is lower than the all-in-cost (weighted average cost in case of multiple borrowings) of the existing ECB.	• Put/call options may be contractually agreed with third parties for sale/purchase of the NCDs (subject to compliance with MRM and other applicable regulations in case of FPI buyers).

2. VRR Route for FPI Investment

In an effort to encourage offshore debt funding and liberalize the framework for FPI investments, the RBI introduced the VRR route for FPIs in May 2019. FPIs investing under the VRR route are required to voluntarily commit to retain a required minimum percentage of their investments in India for a time period of their choice. The objective of the VRR route is to attract long-term and stable FPI investments in the Indian debt market, while providing

FPIs with certain operational flexibility to manage their investments. As mentioned above, the minimum residual maturity requirement, concentration limit and single/group investor-wise limits, which are applicable to the general investment route for FPI investment in corporate bonds, are not applicable in respect of the VRR route.

Salient features of the VRR route for FPI investment in debt securities are set forth below:

(a) Investment under this route shall be in addition to the general investment limit and shall be capped at Rs.1,500 billion or higher, which amount shall be allocated among applicable categories by the RBI from time to time and released in one or more tranches. Allocation of investment amount to FPIs under the VRR framework is made on tap or through auctions, subject to conditions specified by the RBI and no FPI (including its Related FPIs) is allotted an investment limit greater than 50% of the amount offered for each allotment by tap or auction in case there is a demand for more than 100% of the amount offered.

(b) The minimum retention period under the VRR framework is three (3) years or as decided by the RBI for each allotment (by tap or auction). The retention period will commence from the date of allotment of limit.

(c) FPIs investing under the VRR route are required to invest the amount allocated, referred to as the Committed Portfolio Size (***CPS***) in the relevant debt instruments and remain invested at all times during the voluntary retention period, subject to specified relaxations, e.g., the minimum investment of an FPI during the retention period shall be 75% of the CPS (the flexibility for modulating investments between 75%-100% of CPS is intended to enable FPIs to adjust their portfolio size as per their investment philosophy) and FPIs may transfer investments under the general investment limit to the VRR route. Subject to relaxations issued in view of the COVID-19 pandemic, successful allottees are required to invest at least 75% of their CPS within three (3) months from the date of allotment.

(d) Income from investments through the VRR route may be reinvested, even in excess of the CPS.

(e) Prior to the end of the committed retention period, an FPI may opt to continue investments under this route for an additional identical retention period.

(f) Exit (in full or in part) prior to the end of the retention period is permitted only pursuant to transfer of such investment to another FPI, subject to compliance with VRR conditions by the buyer. However, repatriation from the cash accounts of an FPI is not permitted, if such transaction leads to the FPI’s assets falling below 75% of CPS during the retention period.

(g) If an FPI decides not to continue under the VRR route at the end of the retention period, it may: (i) liquidate its portfolio and exit; or (ii) shift its investments to the general investment route, subject to availability of limit; or (iii) hold its investments until its date of maturity or until it is sold, whichever is earlier.

(h) FPIs are required to open special non-resident rupee accounts in India for investment through the VRR route – however, the general investment route offers more flexibility in this regard.

C. CONCLUSION

Based on the data available on the website of National Securities Depository Limited, the net investment of FPIs in the debt segment has been negative in the financial years ended March 31, 2019 and March 31, 2020 as well as the current financial year ending March 31, 2021.[3] However, the VRR segment has witnessed an increase from Rs.73.31 billion in the financial year ended March 31, 2020 to Rs.154.76 billion in the current financial year ending March 31, 2021 (as of December 10, 2020).[4] Based on SEBI's bulletin (as of November 2020), we note that while most of the emerging markets such as Brazil, Taiwan, South Korea, Thailand, South Africa and Malaysia have witnessed FPI outflows in the calendar year 2020 so far, India has witnessed net FPI inflows (on the equity side) during the same period and on the debt side, funds raised through corporate bonds in this financial year until September 2020 (around Rs.3,800 billion) are around 25% higher than the funds raised in the corresponding period last year.[5] Given the number of entry routes available to foreign investors, careful consideration of regulations and tax treatment will be required to determine the best route, keeping in mind the investors' risk appetite, investment outlook, expectation of returns, deal commercials, end-use, etc.

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[3] https://www.fpi.nsdl.co.in/web/Reports/Yearwise.aspx?RptType=5 (last accessed on December 10, 2020).

[4] https://www.fpi.nsdl.co.in/web/Reports/Yearwise.aspx?RptType=5 (last accessed on December 10, 2020).

[5] Paragraphs 17 and 20, SEBI Bulletin, Volume 18, November 2020, available at https://www.sebi.gov.in/reports-and-statistics/publications/dec-2020/sebi-bulletin-november-2020_48362.html (last accessed on December 10, 2020).