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INVESTING IN LISTED NON-CONVERTIBLE DEBENTURES - HERE IS WHAT YOU NEED TO KNOW

"Investment" in layman's terms has always been synonymous with "investment in equity" only and that's the way most of us even perceive it to be. However, with the changing market dynamics, investment in "debt instruments" appear to be gradually becoming the mantra for investors' quest for ensuring high yields with moderate risks in a limited span of time. Investment in debt market in particular Non-Convertible Debentures (NCDs) is the flavor of the season with trending fondness of the market players! This proposition is very well strengthened by the Prime Database data recording that out of the total funds raised in H1FY17, INR 2.73 trillion was via NCDs raised on a private placement basis. This News Letter analyses and attempts to highlight key issues and risk mitigators that an Investor should keep in mind when investing in listed NCDs."

The broad regulatory and legal framework applicable to issuance of listed debentures largely consists of the Companies Act, 2013 (Companies Act) read with the Companies (Share Capital and Debentures) Rules, 2014 (Share and Debenture Rules), the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR Regulations) and the SEBI (Issue and Listing of Debt Securities) Regulations, 2008. Depending on the sector and the nature of investors other RBI and SEBI regulations would also apply.

Eligible Investors: The primary consideration for an investor is to determine whether it qualifies as an eligible investor. Various categories of domestic and foreign investors are permitted to invest in listed NCDs, subject to their respective regulatory regime. In terms of domestic investors resident individuals, corporates, Alternate Investment Funds (AIF), Mutual Funds (MF) and Non-Banking Financial Institutions (NBFC) are permitted to make investments. As for non-resident investors, Non-Resident Indians, Foreign Portfolio Investors (FPI) (the FPI regulations have subsumed the Foreign Institutional Investor and the Qualified Foreign Investor regime) and Foreign Venture Capital Investors (FVCI) are permitted to invest in listed NCDs. Some of the commonly used routes to infuse foreign debt (other than external commercial borrowings) includes purchase of listed NCDs under the FPI route and NCDs which may not necessarily be listed under the FVCI route. The FPI regulations also prescribe a minimum maturity period of three (3) years for investments in listed NCDs.

Investment Limits: Corollary to the above, eligible investors will also have to be mindful about investment limits applicable to them. The limit for total foreign investment in corporate debt in India has been set at USD 51 billion which was redefined as the Combined Corporate Debt Limit. However,

specific limits are also applicable to certain investors, for instance, the FPI regulations limits a single FPI or an investor group from purchasing above 10% of the total issued capital of an Issuer. Similarly, limits on investments have also been prescribed for MFs and AIFs and minimum capitalization conditions also apply to FVCIs. Investee companies will not necessarily have the knowledge regarding eligible investors, therefore regulatory awareness about the everchanging regime regarding limits and pre-conditions is essential, even before chalking out the investment strategy.

Credit Risk: One of the prime factors that should be considered is the creditworthiness of the Issuer and its ability to service the debt through its cash flow. There can be various factors affecting the financial health of the Issuer that can have an impact on the creditworthiness of the Issuer. A business due diligence on the Issuer can be done to identify such factors, relating to the assets, debt equity ratio, receivables, valuation of assets, profitability, cash flow, bad credit history, net worth, inventory, other market conditions etc., which should help ease concerns with respect to any credit risks.

Security Risk: Listed NCDs are usually secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee who holds the position in fiduciary capacity on behalf of the NCD holders. Typically, it is not uncommon that the charge created is a second charge on the assets of the Issuer, from an enforceability perspective, this is a riskier option with respect to seniority of debt, if possible a first and/or a pari passu charge should be created over the assets of the Issuer (a charge can also be created over the assets of the company's subsidiaries or its holding company or its associate companies) as this provides priority to the investor's debt, at the time of liquidation. Creating an English mortgage would be the preferred option, since the assets remain in possession of the debenture trustee, until the repayment of the principal amount.

Enforceability Risks: Under the Insolvency and Bankruptcy Code, 2016 (IBC Code) any financial creditor to whom financial debt is owed, including an FPI, can seek recourse under the IBC Code. However, once an Insolvency Resolution Process (IRP) has been initiated, an Adjudicating Authority (AA) can by order, prohibit the institution of suits for recovery of any property or enforcement of security interest by a debenture holder, including any action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. If the IRP fails or is not completed within the prescribed period, the AA can by an order direct the Issuer to be liquidated. As mentioned earlier, adequate security cover at a first charge and/or pari passu basis becomes imperative during the liquidation process, as secured creditors are placed higher on priority, over preference and equity shareholders.

Risk of Improper or Inadequate Documentation: When speaking about enforceability, the documentation and drafting of the Debenture Trust Deed (DTD)/Debenture Subscription Agreement, Debenture Trustee Agreement (DTA), and the security documents becomes critical. It is important to ensure that the agreements are carefully crafted and adequately stamped and registered, to protect the investor's interest and to ensure a smooth transition at the enforcement stage. The DTA/DTD should clearly outline the intention, purpose and creation of the trust, rights, duties, responsibilities, also ensuring good corporate governance policies along with liability of and indemnity towards a trustee. The documentation primarily needs to be sound in terms of the Indian Contract Act, 1872, Transfer of Property Act, 1982 and the Indian Trust Act, 1882 (Indian Trust Act). For instance, certain provisions of the Indian Trust Act are required to be incorporated into the DTD, while also being mindful about arbitrability of the DTD, as the recent Supreme Court judgement has shown, disputes arising out of Trust Deeds and the Indian Trusts Act cannot be referred to arbitration.

Regulatory Risks: Along with the requisite SEBI Regulations and provisions of the Companies Act that are mandatorily required to be adhered to by the Issuer, entities in highly regulated sectors are additionally required to comply with multiple regulations, restrictions and regulatory bodies overseeing their functioning (ex. NBFCs, entities in pharmaceuticals and healthcare). A prior legal due diligence of the Issuer is paramount, to understand the regulatory regime that it operates under and to ensure that the company is compliant and has been complying with regulatory and statutory obligations.

A legal, business and a financial due diligence becomes mandatory in relation to additional risks, that become incurable to the investor's investment at a later stage, including ongoing litigation either against the Issuer or its promoters/directors, restrictive covenants/prior consent requirements from existing lenders for creation of security/ accepting additional debt, contingent liabilities, ability to sustain positive and profitable growth, inflation, and inadequate insurance coverage against default/losses. The diligence exercise ensures that the investor is aware of all the contingent liabilities and non-compliances before the investment is made. The Issuer can then be directed towards remedying such risks/issues. For instance, ongoing disputes due to non-payment of income tax dues can have an adverse effect on the security created, in the event that the income tax authorities attach the assets of the Issuer.

Liquidity Risk: Most NCDs are listed on the stock exchanges and are available in demat form. Although this means they are liquid, the fluctuating interest rates make exiting/selling NCDs through the secondary market difficult, wherein, if the interest rates are high, the value of the NCDs will consequently fall below its face value at times. Due to challenges relating to liquidity, there are also few buyers of listed NCDs on the market. It is difficult to control and predict the markets and its consequent effect on the listed NCDs, however, other risks associated with listed NCDs can easily be mitigated with the measures mentioned above, to ensure that unavoidable risks such as liquidity risks do not cumulate with other risks.

Tax Implications:Tax implications play an important role in determining one's investment strategy. Under the present Indian tax regime there is no tax deduction at source on payment of interest for listed NCDs (except payments/ issuance under Section 193 of the Income Tax Act, 1961). Also, any interest so earned will be taxable as per the relevant tax slabs of the investor. Any sale of listed NCD within a year of subscription will be subject to Short Term Capital Gains Tax (STGT) and sale after one year will attract Long Term Capital Gains Tax (LTGT) at 20% with indexation and 10% without indexation. For NRI investors, NCDs purchased in convertible foreign currency is taxable at 20% and the LTGT is taxable at 10% of the capital gains arising without indexation of the acquisition cost. However, STGT are taxed at normal tax rates.

Foreign investors should structure their investments based on tax feasibility, keeping in mind implications and advantages in various tax jurisdictions, to mitigate tax leakage with regard to capital gains tax and tax withholding on interest payments. The recent changes to the Double Taxation Avoidance Agreement (DTAA) with Singapore and Mauritius, shows a shift towards source based taxation of capital gains from April 1, 2017 at 7.5% and the same will be completely done away with from 2019 onwards. Further, Netherlands seems to be emerging as the next favorable destination for investors in search of tax benefits, as the DTAA with Netherlands has not been amended and also local tax is only levied on business income and not on capital gains (subject to conditions of course!).

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Along with the mitigation of risks through adequate documentation and due diligence exercises, investors can also rely on the provisions of the Companies Act and SEBI Regulations to protect their investments. For instance, the LODR Regulations mandates for maintaining a 100% asset cover, sufficient to discharge the principal amount for the NCDs, at all times and prior approval from the stock exchange is required for any changes concerning the structure of the listed NCDs in terms of redemption, or otherwise. Listed entities issuing NCDs are required to submit yearly/half yearly financial results and disclosures relating to credit rating and change in credit.

Issuance of NCDs can be beneficial for both parties involved, from an Issuer's perspective they offer advantages such as the interest paid on NCDs can be claimed as an expense against its profits and it also maintains the shareholding pattern of the Issuer without diluting shareholding, while also raising capital. If the risks are pre-mitigated with proper measures taken before and during the investment, from an investor perspective, the prime advantage of investing in debentures are the fixed and stable return with preferential rights of payment at the time of liquidation. Given the

volatility which equity markets have consistently witnessed coupled with the advantages that NCDs offer both to the Issuer and the investor, listed NCDs are fast emerging as a safe and a viable investment alternative.

SNAPSHOTS

LEGISLATIVE SNAPSHOTS

RESERVE BANK OF INDIA (RBI) CAN DIRECTLY INTERVENE IN SETTLING BAD LOAN CASES In light of the stressed assets reaching unacceptably high level the President promulgated the Banking Ordinance of 2017 ("Ordinance") dated 4th May 2017. The Ordinance gives power to RBI can intervene and direct banks to sit down

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COMPANIES (AMENDMENT) BILL, 2017 The Companies (Amendment) Bill, 2017 (the "Bill"), which was passed by the Lok Sabha on July 27, 2017, seeks to make a number of changes to the current form of the Companies Act, 2013 (the "Act"), the same is yet to be passed by the Upper House

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REGULATORY SNAPSHOTS

RBI ISSUED MASTER DIRECTION ON LENDING TO MSME SECTOR In exercise of the powers conferred by Sections 21 and 35 A of the Banking Regulation Act, 1949, the Reserve Bank of India, issued the Master Directions on Lending to Micro, Small & Medium Enterprises ("MSME") Sector on July 21, 2016.

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SECURITIES AND EXCHANGE BOARD OF INDIA (LISTING OBLIGATIONS AND DISCLOSURE REQUIREMENTS) REGULATIONS, 2015 DATED SEPTEMBER 2, 2015 AS AMENDED AS ON MARCH 6, 2017 In exercise of the powers conferred by section 11, sub- section (2) of section

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JUDICIAL SNAPSHOTS

DEDUCTION OF EXPENSES OF ISSUANCE OF NCD ALLOWED IN THE YEAR IN WHICH THEY WERE INCURRED BY THE ASSESSE The Income Tax Appellate Tribunal of Ahmedabad in the case of Gruh Finance Ltd. vs. JCIT, Range-4 [MANU/IB/0325/2016], decided on 17.08.2016 held that the entire expenses in

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LOSS ARISING OUT OF WRITING OFF IS A PART OF BAD DEBTS Recently on 24.01.2017 in the case of Axis Bank Ltd. vs. Additional Commissioner of Income Tax [(2017)185TTJ (Ahd.) 722, MANU/IB/0058/2017] the Income Tax Appellate Tribunal, Ahmedabad held that losses

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