

Regulatory Hotline

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FPI INVESTMENT IN UNLISTED CORPORATE BONDS: ARE WE THERE YET?

- Foreign Portfolio Investors may invest in unlisted non-convertible debentures/ bonds issued by public companies: Remove public company restriction!
- End-use restriction imposed on real estate activities and purchase of land: should we stick to 'real estate business'?
- FPIs can invest only in the primary issue of such securities: Drafting miss or intent?

In a potential move to encourage further foreign investment into the debt markets, the Reserve Bank of India ("RBI"), released draft circular on May 16, 2016 ("Draft Circular")¹ proposing to expand the basket of permissible instruments for Foreign Portfolio Investors ("FPI") to include unlisted debt securities as well.

BACKGROUND

Foreign institutional investors ("FII"), under the earlier FII regime were permitted to invest in listed non-convertible debentures ("NCD") issued by Indian corporates. This restricted the ability of FIIs to invest in primary issuances of NCDs, and warehousing of NCDs till the listing of the NCD was done on a stock exchange became common parlance. Realizing this administrative hurdle, the restriction was relaxed in 2012, when the RBI permitted FII investment into NCDs which were listed or to be listed. The issuing company was provided a limited timeframe of 15 days from the date of issuance to an FII, within which the NCD would require to be listed.

This permitted FIIs to invest in primary issuances as well. The same framework was carried forward to the FPI regime as well. Accordingly, the current regulatory framework permits FPIs to invest in listed or to be listed NCDs. An exemption to this restriction was the infrastructure sector, where FPIs were permitted to invest in unlisted NCDs as well.

In his budget speech for 2016-17, the Finance Minister announced the Government's intention of permitting FPI investment in, among other instruments, unlisted debt securities, as a measure to deepen the corporate bond market.

In furtherance of the intent of the government, the RBI has released the Draft Circular for public comments.

PROPOSED CHANGES

The Draft Circular has proposed to make the following changes in relation to the bond market:

- FPIs shall be permitted to invest in the primary issuances by public companies of unlisted NCDs;
- The issuing company cannot use the funds raised by issue of unlisted NCDs for real estate activities, purchase of land, investing in capital market, or on-lending to other entities.

ANALYSIS

Eligible borrower

Under the Draft Circular, registered FPIs can invest in the NCDs issued *only* by a public company. Existing investments by FPIs into listed / to be listed NCDs are governed by Paragraph 1C(b)² and Paragraph 1C(j)³ of Schedule 5 of the Foreign Exchange Management (Transfer or issue of security by person resident outside India) Regulations, 2000⁴ ("TISPRO Regulations"). TISPRO Regulations permit an FPI to purchase listed / to be listed NCDs issued by any Indian company, without creating any distinction between a public company and a private company. In comparison, the Draft Circular prohibits private companies from raising funds through unlisted NCDs. We are of the understanding that extending the ability of private companies to raise funds from FPIs through unlisted bonds would help deepen the bond markets.

Accordingly, the Draft Circular should be revised to provide that any Indian company, whether private or public should be permitted to access funds from FPIs by way of unlisted NCDs.

End use restriction

Under the Draft Circular, an end use restriction has been imposed on proceeds from the issuance of unlisted NCDs for 'real estate activities, purchase of land, investing in capital market or on-lending to other entities'. Investments by FPIs currently into listed/ to be listed NCDs do not impose any such restrictions. TISPRO Regulations restricts investments into 'real estate business', which is defined under Paragraph 11.2, Schedule 1 as 'dealing in land and immovable property with a view to earning profit/ income therefrom, and does not include development of townships, construction of residential/commercial premises, roads, bridges, educational institutions, recreational

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facilities, city and regional level infrastructure, townships'. Here, it would be crucial to create a distinction between speculative activities with an intent to profit from the appreciation of the value of immovable property, and bona fide investments for development activities.

It would be pertinent to note that the proposed restrictions under the Draft Circular are in line with the restrictions under the framework for external commercial borrowings ("ECB")⁵, which has end-use restrictions on, inter alia, '*real estate activities other than for development of integrated township / affordable housing projects*' and '*purchase of land*'. 'Integrated township' is not explained in the framework for raising ECB, but has been explained in Press Note 3 of 2002, wherein the minimum area to be developed for integrated township is 100 acres. The requirement of 100 acres was relaxed subsequently over a period of time, and has recently done away with altogether. Practically, it is almost impossible in the current scenario to identify a contiguous parcel of land admeasuring 100 acres.

Accordingly, the end use restrictions of the proceeds from unlisted NCDs should be aligned to the restrictions under the TISPRO Regulations, and accordingly prohibit the use of the proceeds from the issuance for '*real estate business*' instead of '*real estate activities and purchase of land*'. This would ensure that any borrowing for bona fide developmental activities, including construction of residential/ commercial premises, roads and bridges, etc. are not prohibited under the Draft Circular.

■ **Purchase of Secondary NCDs**

Under the Draft Circular, FPIs can invest only in the primary issuances of unlisted NCDs by Indian companies. Schedule 5 of the TISPRO Regulations permits a registered FPI to invest in both the primary issuances of NCDs (Paragraph 1C(j)) as well as in a secondary purchase of NCDs (Paragraph 1C(b)). The Draft Circular, which aims to expand the basket of eligible instruments for investment by FPIs would, in its current form, limit this opportunity by disallowing investments in the entire secondary market of unlisted NCDs. This would importantly also restrict the ability of an FPI, which has acquired unlisted NCDs, to exit by selling the unlisted NCDs to any other FPI.

To this extent, the Draft Circular should be revised to permit FPIs to invest in both primary issuance of unlisted NCDs, as well as permit secondary purchase of NCDs.

CONCLUSION

At a time when both RBI and the securities regulator, Securities and Exchange Board of India ("SEBI") shall re-look at the existing framework for FPI investment in NCDs, it may be pertinent to reconsider the lock-in restriction that was imposed by RBI and SEBI in early 2015. Under the revised framework, FPIs, going forward were permitted to invest only in corporate bonds with a minimum residual maturity of 3 years⁶. Further, the residual maturity of the NCD when acquired by an FPI is reset upon a secondary acquisition, which has been restricting the ability of the FPI to acquire the NCD, and of the ability of the borrower company to redeem such NCDs.

Such restrictions have proven to be dampening for investment in corporate bonds by FPIs. This is evident from the fact that investment in debt securities by FPIs (and foreign institutional investors, as applicable at the time) in the calendar year 2014 was INR 1,59,156 crores, while in 2015 it was a mere INR 45,857 crores.

While it would be ideal for RBI and SEBI to do away with the restrictions altogether, and allow the parties to determine their commercial terms on their own accord, it would be extremely beneficial if the 3 year maturity be looked at from the perspective of the instrument only, and not from the perspective of the holder, i.e. the 3 year residual maturity period is not reset upon a secondary acquisition of such NCD by an FPI.

While the Draft Circular seeks to give effect to the intent of the government, there are certain aspects which may need to be clarified, as mentioned above. For this to be the law, in addition to the RBI's final circular, the TISPRO Regulations shall also be required to be amended. Additionally, appropriate amendments would also have to be made by SEBI to permit such investments.

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You can direct your queries or comments to the authors

¹ Available at <https://rbidocs.rbi.org.in/rdocs/Content/PDFs/FPI1605201629A9A03D52684A4E87135F6E42D068A3.PDF>

² '*listed non-convertible debentures/bonds issued by an Indian company*'

³ '*with effect from March 1, 2012, primary issues of non-convertible debentures/bonds provided such non-convertible debentures/bonds are committed to be listed within 15 days of such investment.*'

⁴ Foreign Exchange Management (Transfer or issue of security by person resident outside India) Regulations, 2000, being FEMA 20/2000-RB, dated 3-5-2000 [GSR 406(E), dated 3-5-2000]

⁵ Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000, being FEMA 3/2000-RB dated May 3, 2000

⁶ Foreign investment in India by Foreign Portfolio Investors, being A.P.(DIR Series) Circular No. 71, RBI/2014-15/448

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