

Article

New Debenture Redemption Reserve Provisions: Will they promote or demote the Bond Market?



CS Nidhi Ladha

nidhiladha@vinodkothari.com

CS Vinita Nair

vinita@vinodkothari.com

Vinod Kothari & Company

March 6, 2013

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Analytical Speaking

Section 117C of the Companies Act, 1956 (the “**Act**”) requires every company issuing debentures to create a debenture redemption reserve (“**DRR**”) for the redemption of such debentures and transfer an ‘adequate’ amount from its profits every year to such DRR until the issued debentures are redeemed. Hence, every issue of redeemable debentures requires creation of DRR. The said Section, however, does not provide the meaning of the word ‘adequate’. In the year 2002, the Ministry of Corporate Affairs (“**MCA**”) issued a circular clarifying the meaning of ‘adequate’ and provided the percentage which is mandatorily required to be transferred to DRR by certain class of companies (the “**Circular 2002**”)¹. However, to develop the bonds market, MCA has issued another clarification circular on February 11, 2013 (the “**Circular 2013**”)².

Requirements under Circular 2002:

Category	Amount of DRR to be maintained
All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies	No DRR required for both public as well as privately placed debentures.
Other Financial Institutions within the meaning of Section 4A of the Act	As applicable to NBFCs registered with the RBI.
NBFCs registered with the RBI under Section 45-IA of the RBI (Amendment) Act, 1997	<ul style="list-style-type: none"> • 50% of the value of debentures issued through public issue as per SEBI (Disclosure and Investor Protection) Guidelines 2000. • No DRR in case of privately placed debentures.
Manufacturing and Infrastructure companies	<ul style="list-style-type: none"> • 50% of the value of debentures issued through public issue. • 25% for privately placed debentures.

Requirements under Circular, 2013:

The Circular 2013 has the following effect:

Category	Amount of DRR to be maintained
All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies	No DRR required for both public as well as privately placed debentures.

¹ Text of the Circular, 2002 is available here:

http://www.mca.gov.in/Ministry/circulars/cir2002/cir_18042002.html

² Text of the Circular, 2013 is available here:

http://www.mca.gov.in/Ministry/pdf/General_Circular_04_2013.pdf



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Other Financial Institutions within the meaning of Section 4A of the Act	As applicable to NBFCs registered with the RBI.
NBFCs registered with the RBI under Section 45-IA of the RBI (Amendment) Act, 1997	<ul style="list-style-type: none">• 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities) Regulations, 2008.• No DRR in case of privately placed debentures.
Other companies including manufacturing and infrastructure companies	<ul style="list-style-type: none">• 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities) Regulations, 2008.• 25% in case of privately placed debentures by listed companies.• 25% of the value of debentures in case of privately placed debentures by unlisted companies.

In addition to imposing the condition of creation of DRR by every company for every issue of debentures; whether public or privately placed, the Circular 2013 further requires every such company to park, on or before 30th day of April each year, a sum of at least 15% of the amount of its debentures, maturing during the year ending on the 31st day of March next following, in any one or more of the following methods:

- a) in deposits with any scheduled bank, free from charge or lien;
- b) in unencumbered securities of the Central Government or of any State Government;
- c) in unencumbered securities mentioned in clauses (a) to (d) & (ee) of Section 20 of the Indian Trusts Act, 1882;
- d) in unencumbered bonds issued by any other company which is notified under clause (f) of Section 20 of the Indian Trusts Act, 1882.

The money so parked can be utilized only for the purpose of repayment of debentures maturing during the year. The amount remaining deposited /invested shall not at any time fall below 15% of the amount of debentures maturing during that year ending 31st March.

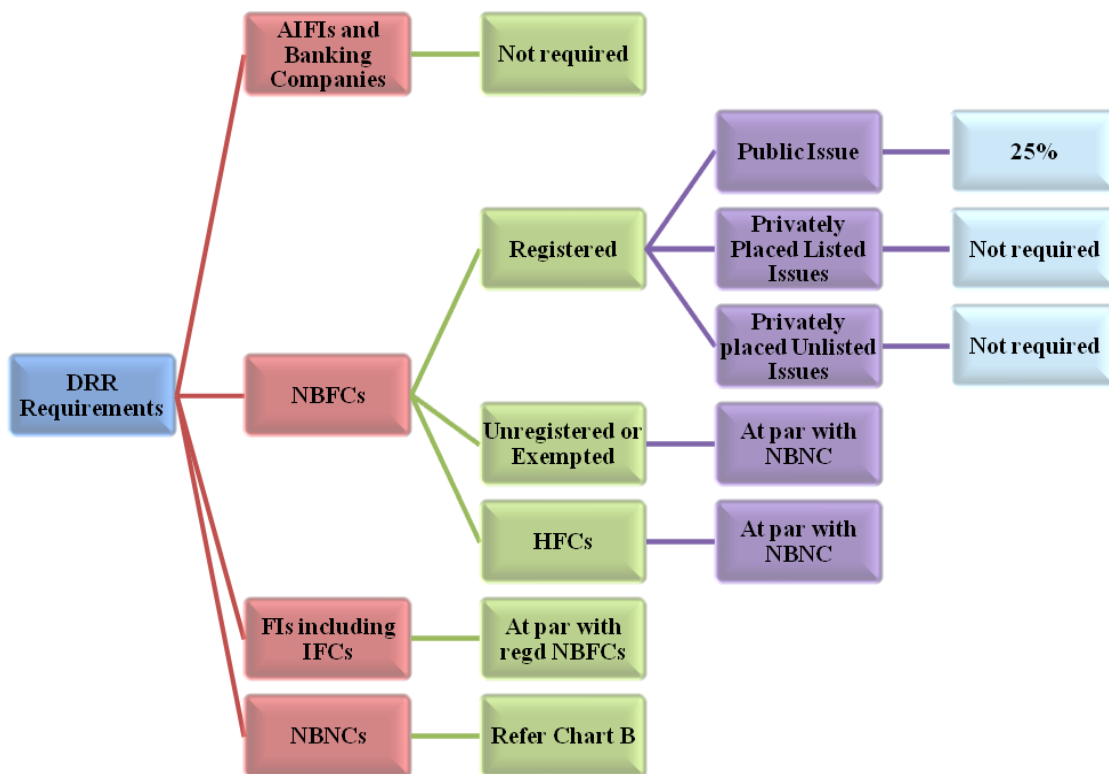


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Our Analysis:

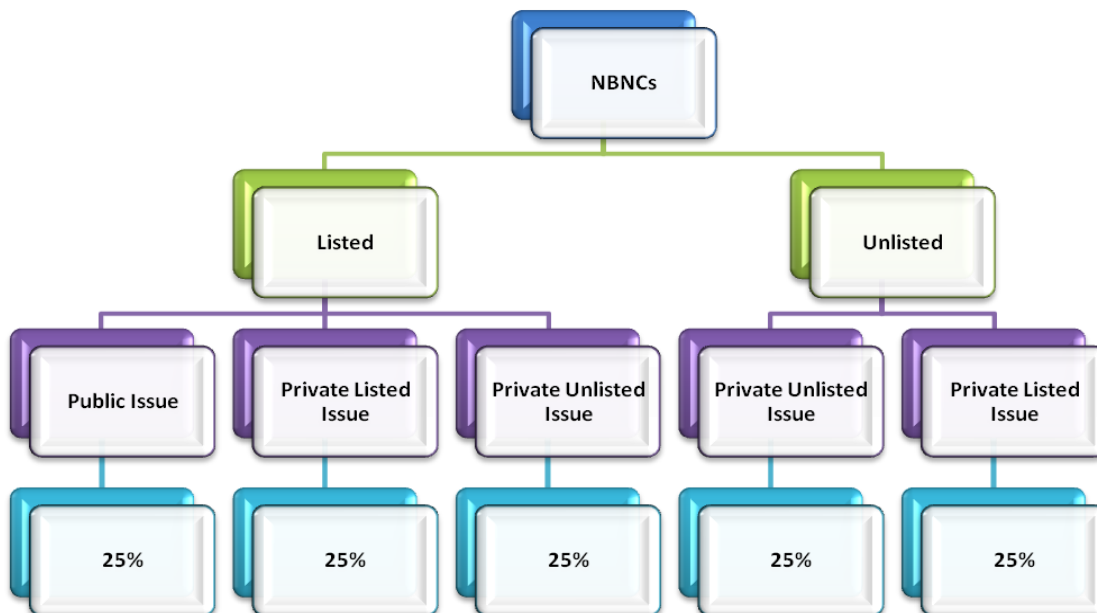
The unclear language of Circular 2013 mandates not only every company; whether listed or unlisted, private or public, to create a DRR for their issues; whether public or private, listed or unlisted, it also imposes a stringent condition of parking a sum equal to 15% of the value of debentures maturing during the year separately in the beginning of the year itself. The impact of the Circular, 2013 on the companies issuing debentures, with respect to maintenance of DRR, can be explained better through the following chart:

CHART A



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CHART B



Status of Housing Finance Companies (“HFCs”):

The Circular 2013 issued in response to the need for development of corporate bonds/debentures, does not clearly state any specific amount of DRR to be maintained by HFCs registered with National Housing Bank (“NHB”). It provides an exemption to privately placed issues of debentures by NBFCs registered with RBI only. However, the HFCs which are registered with NHB will not get any exemption and accordingly, the Circular intends to treat HFCs at par with the Non Banking Non Financial Companies (“NBNCs”) and hence, HFCs will also be required to maintain a DRR of 25% of the value of debentures in case of their public as well as privately placed issues of debentures. Representations will surely be made before the MCA to treat the HFCs at par with the registered NBFCs.

Status of NBFCs³

The only benefit from the Circular 2013 is that it has reduced the DRR requirements for registered NBFCs from 50% to 25%. However, at the time of issue of Circular 2002, concept of Core Investment Companies (“CICs”)⁴ was not in the picture. CICs are the class of NBFCs which does not require registration with RBI if they fulfill the prescribed

³ To know more about NBFCs, click <http://india-financing.com/staff-publications-nbfc.html>

⁴ See our write ups on CICs at <http://india-financing.com/core-investment-companies.html>



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conditions. Such companies are NBFCs but not registered. The Circular 2013 covers only registered NBFCs, hence, it would mean that the CICs has also been treated at par with NBFCs.

Status of Private Companies

In Circular 2002, the last category included manufacturing and infrastructure companies only. Service and other companies were not specifically required to create any DRR under the Circular 2002. However, the vague language of Circular 2013 uses the terms '*other companies including manufacturing and infrastructure companies*' which would mean that the Circular 2013 covers every company. The Circular 2013 further covers issue of debentures on private placement basis by '*unlisted companies*' and hence, it would cover private companies also within its ambit. Though the intent of the issuing authority would have to cover unlisted public companies only, the vague language now would cover private companies unless another clarification is issued by the MCA.

Stringent condition of earmarking 15% of the maturing amount of debentures every year

The Circular 2013 requires the companies issuing debentures to ear mark an amount not less than 15 % of the amount maturing in a particular year by way of investment and deposits in specified way. This is a new requirement inserted by the Circular 2013 as neither the Section 117C of the Act nor the Circular 2002 stipulates such requirement. Companies issuing short term debentures with a maturity of less than may not require to park such funds, however, other issues of debentures will require such ear marking of funds and the HFCs and unlisted and private companies may face trouble.

Circular 2013- Whether Prospective or Retroactive?

The Circular 2013 nowhere specifies the effective date of such drastic amendment. It is not clear whether the new requirements of DRR will be applicable only to the debentures issued after the date of this Circular or will it be applicable even on all the issues standing in the books of the companies. As the Circular 2013 is providing clarification to Circular 2002 read with the Section 117C of the Act, in our view it should come into effect with immediate effect and companies may require ear marking a sum equal to 15% of value of debentures by April 30, 2013 for the debentures maturing during the year 2013-14.

Whether the Circular 2013 is superseding Circular 2002 and the Act?

Apparently, yes. The Circular 2002 was issued as a clarification to Section 117C of the Act and Circular, 2013 has been issued to provide further clarification to both the Circular 2002 and the Section 117C.



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Whether MCA has authority to impose such conditions?

Article 246 of the Constitution of India empowers the Parliament exclusively to make laws in the country with regard to matters included in Union List and State Legislature to frame laws for matters stated in State List. Corporate Laws being one of the matters of Union List can be framed and made by the Parliament only.

Section 117C does not delegate any power to MCA to issue any binding circular. However, MCA had issued a clarification circular in 2002 and now another clarification has been issued in 2013. With due respect, the authors raise a question that in absence of any such power delegated by the Section 117C, can MCA issue such circulars which is more in nature of law than a clarification?

Conclusion:

While the intent of the Government seems to be benign, it seems that the issuing authority has ended up creating confusions: (a) in case of HFCs, and (b) more importantly, by adding a requirement for creating a reserve fund, which was nowhere there in the Circular, 2002 issued by MCA and is nowhere therein the Act itself. Most companies retire debentures by issuing another set of debentures, hence, most companies don't park funds for retiring debentures by creating any fund as envisaged in the Circular 2013. The Circular 2013 may act as hindrance to such companies. The bond market will surely get affected negatively by such a move of MCA.

See our Primer on Debentures at: http://india-financing.com/Primer_on_debentures.pdf