

Primer

A Primer on 'Debentures'



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1. What exactly does the word “debenture” mean?

Literally, it means an indenture, that is, a legal instrument. Historically, debentures were devised as acknowledgement of floating charge. However, as the practice has evolved over time, debentures are taken to be marketable debt instruments.

2. Is there a legal difference between bonds and debentures?

No – the difference is only in the language of the two instruments.

3. Is a commercial paper also a debenture?

No, commercial paper is issued in form of a promissory note – so, it is a negotiable instrument.

4. What are the main differences between a loan and a debenture?

A loan is a bilateral instrument, and is therefore a contract. A debenture is a securitised loan. It becomes marketable. The contract between a debenture holder and debenture issuer is inherent in the terms of issue of a debenture.

5. Where are the terms of issue of a debenture incorporated?

Appropriately, all terms of issue should be incorporated at the back of the debenture certificate.

6. Is a debenture certificate required by law?

Prima facie, the very meaning of a debenture is a certificated instrument, as a debenture is defined as acknowledgement of debt. Section 113 also requires issue of certificate in case of debentures within 3 months from allotment/issue. Further, the Central Government, on an application made to it in this behalf by the Company, may provide extension for a further period not exceeding 9 months.

However, the current prevailing practice is to issue debentures in demat format. In that case, the certificates are implicitly deposited with the depository.

7. Is there any additional requirement in case of debenture certificate issued for secured debentures?

Yes, in terms of section 133 of the Act, a Company issuing secured debentures is needed to ensure that every certificate of registration of charge, received by the Company under Section 132 of the Act, is endorsed on every such debenture or



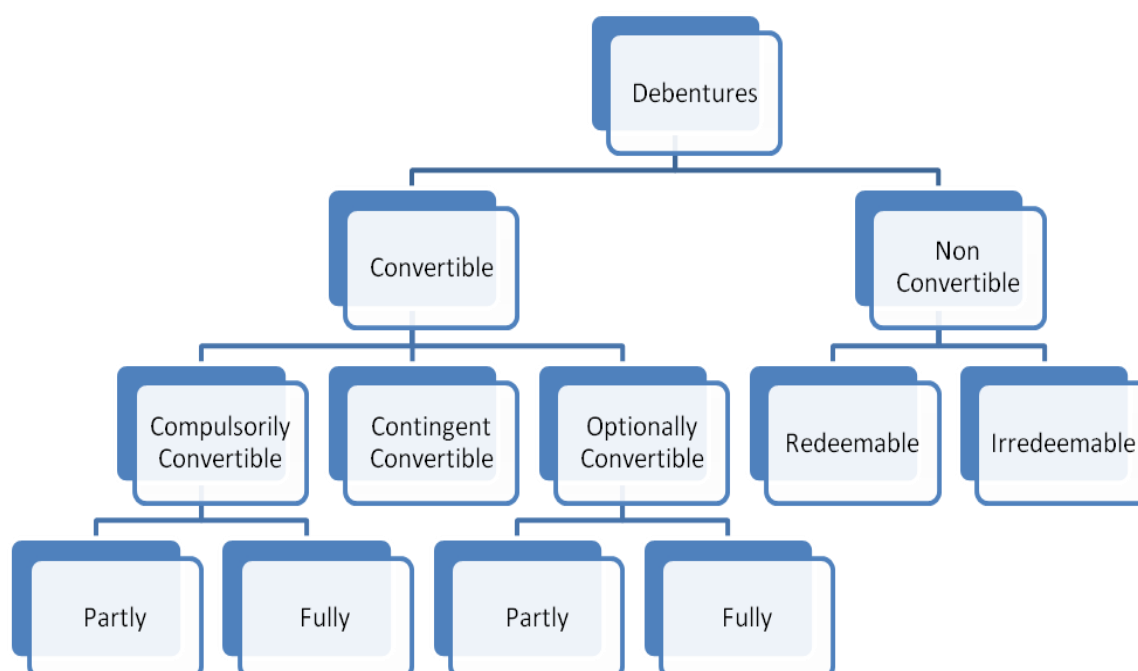
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certificate of debenture stock the payment of which is secured by the charge so registered.

8. Is it that a debenture has to be a transferable instrument? Is a completely non-transferable instrument also a debenture?

We are of the view that given the definition of “security” under Section 45AA of the Companies Act, 1956, a debenture will not be treated as a security unless it is transferable. A pure bilateral debt is not a debenture.

9. What are different types of debentures?



10. What are the basic laws applicable to the issue of debentures?

Apart from the Companies Act, debenture issue is regulated by SEBI and RBI Regulations. Debentures issues by listed companies which want to get the debentures listed are also required to comply with debt listing agreements.

- Issue of debentures by listed companies:

- Issue of convertible debentures: SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009
- Issue of short term non-convertible issue: Issuance of Non-Convertible Debentures (Reserve Bank) Directions, 2010 (NCDs having an initial maturity up to 12 months)
- Issue of other non-convertible:



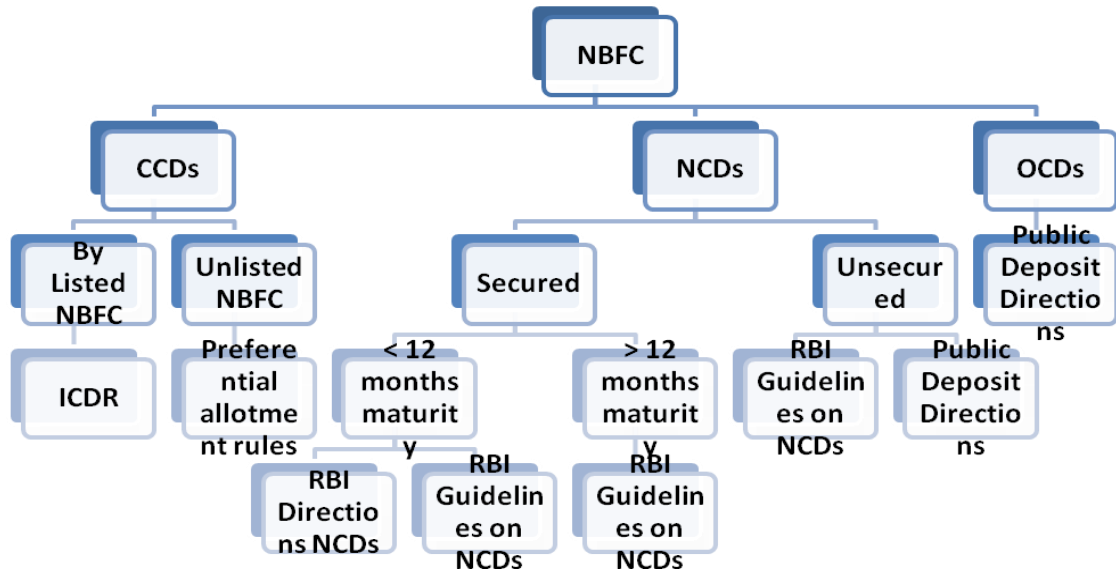
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- Public issue of debentures: SEBI (Issue and Listing of Debt Securities) Regulations, 2008
- Listing of debentures issued through public issue or private placement basis: SEBI (Issue and Listing of Debt Securities) Regulations, 2008
- Private placement issue: No regulations prescribed
- **Issue by unlisted public companies:**
 - Issue of convertible debentures (on preferential basis): Unlisted Public Companies (Preferential Allotment) Rules, 2003
 - Issue of short term non-convertible issue: Issuance of Non-Convertible Debentures (Reserve Bank) Directions, 2010 (For NCDs having an initial maturity up to 12 months)
 - Long term non convertible issue:
 - Public issue of debentures: SEBI (Issue and Listing of Debt Securities) Regulations, 2008
 - Listing of debentures issued through public issue or private placement basis: SEBI (Issue and Listing of Debt Securities) Regulations, 2008
 - Private Placement issue: No regulations prescribed
- **Issue by private companies:**
 - No regulation for private companies
 - For listing of debentures issued through private placement basis: SEBI (Issue and Listing of Debt Securities) Regulations, 2008

11. What are the regulations applicable for issue of debentures by NBFCs?

Apart from compliance with applicable regulations as mentioned in the preceding answer, 'Guidelines on Private Placement of Debentures by NBFCs' issued by RBI on June 27, 2013 regulate issue of NCDs. The present applicable regulations can be explained by way of following graph:

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12. What is the law applicable to foreign investment in debentures issued by a company?

In case of convertible debentures, FDI norms are applicable. Non convertible debentures are treated at par with ECBs and ECB Guidelines will be applicable.

13. What are the provisions of Companies Act applicable to investment in debentures by a company?

Sections 372A and 295 will be applicable in case of investment in non convertible debentures.

14. Can a private company issue debentures to public?

No, a private company cannot issue debentures to public. Definition of a 'private company' as laid down by Section 3 restricts a private company to raise funds from public by issue of shares or debentures. However, debentures may be transferred to public as Section 3(1)(iii)(a) of the Companies Act, 1956 restricts *transfer of shares only*.

15. What are the rules about listing of debentures?

Listing of debentures is governed by SEBI (Issue and Listing of Debt Securities Regulations), 2008. In addition, companies are also required to comply with the debt

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listing agreements of respective stock exchanges on which the debentures are to be listed.

16. Can a private company come up with listed debentures?

Yes, a private company can get its debentures listed.

17. What are the rules about changes in the terms of issue of debentures, or any other matter requiring the consent of the debenture holders?

Terms of issue of debentures may be altered in a meeting of debenture holders.

18. What rules apply to meeting of debenture holders?

The Debenture Holders shall be eligible to attend the meetings where the matters of their interests and rights are to be discussed or are dealt with. For this purpose, the company shall be holding a separate meeting of Debenture Holders. Meetings of Debenture holders shall be governed by the provisions of Annexure C to the Companies (Central Government) General Rules and Forms.

19. What are the rules applicable to debenture redemption reserve (DRR)?

Section 117C requires creation of separate reserve called DRR by every company issuing redeemable debentures so that sufficient amount may be gathered for paying off the liabilities of paying the value of debentures plus accrued interest (if not already paid) before the redemption liability actually arises. For this, an adequate amount of profit is required to be transferred till the debentures are redeemed and/or cancelled.

20. What is the meaning of 'adequate' for transferring profits to DRR annually?

The General Circular 9/2002 issued by MCA (the first circular in this regard) states that *'the quantum of DRR to be created before the redemption liability actually arises in normal circumstances should be 'adequate' to pay'* the value of debentures plus accrued interest (if not already paid), till the debentures are redeemed and cancelled.

Further, in terms of Circular February 11, 2013, the adequate amount of DRR has been specified for all class of companies as 'adequate' if maintained before and at the time of the redemption liability (See answer 19 below). However, section 117C requires transfer of some profits every year during the tenure of the debentures. Hence, in our view, the quantum of 25% is to be distributed equally during the tenure and such amount of profits may be parked every year for DRR. Also note that there is nothing wrong if company transfers more profits (being more than the equal



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share as calculated by dividing the tenure and the 25% of value of debentures) as the condition is satisfied if parking is done annually.

21. What should be the quantum of profits to be transferred to DRR?

The quantum of DRR has not been prescribed anywhere. The quantum of money to be transferred to DRR may be calculated by dividing the value of debentures with the life of the debentures.

Vide General Circular No: 9/2002 dated 18th April, 2002, MCA clarified that:

- No DRR is required for debentures issued by All India Financial Institutions (AIFIs) regulated by RBI and Banking Companies for both public as well as privately placed debentures.
- For other FIs within the meaning of Section 4A, DRR will be as applicable to NBFCs registered with RBI.
- For NBFCs, DRR will be 50% of the value of debentures issued through public issue and no DRR is required in the case of privately placed debentures.
- For manufacturing and infrastructure companies, DRR will be 50% of the value of debentures issued through public issue and 25% for privately placed debentures.

In supersession of its 2002 circular, Ministry has issued another circular on February 11, 2013 which in addition to maintaining DRR as per the table below also requires 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.

DRR to be maintained by company as per 2013 circular is as follows:

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

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Companies	
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.

22. Whether the notification issued in 2003 requiring creation of DRR for HFCs still valid after issue of circular in 2013?

There exists a clarification of 'adequate amount' of DRR for HFCs as issued by MCA vide its General Circular 4/2003, however, this circular is in continuation of 2002 circular and we are of the view that as 2013 circular overrides the 2002 circular, it will have the same impact on the 2003 circular which is nothing but a continuation of 2002 circular.

23. What is a debenture trustee? When is a debenture trustee needed?

Creation of security means mortgaging or charging the property in favor of Debenture Trustee for the benefit of debenture holders. This is an incidence of ownership of property and creation of security has to be done by the owner of the property. However, the debenture holders are beneficiaries and they have no access to mortgaged property. The Debenture Trustee holds the secured property on behalf of issuer of security and for benefit of debenture holders. In the event of default by



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the issuer of security, the Debenture Trustee will have the power and authority to bring the secured property to sale following the procedure in the Transfer of property Act, 1882 and the proceeds of sale will have to be applied to redeem the debentures.

24. Who can be appointed a Debenture Trustee?

To act as debenture trustee, the entity should either be a scheduled bank carrying on commercial activity, a public financial institution, an insurance company, or a body corporate. The entity should be registered with SEBI to act as a debenture trustee.

25. If a company fails to redeem debentures or pay interest on debentures, what are the consequences as per the law?

The directors of defaulting company will be disqualified under section 274(1)(g). Penalty under section 117C(4) will also be attracted. If debenture holders are banks and financial institutions, relief under SARAFESI Act shall also be available to them.

26. If the terms of issue of debentures can be changed, can a convertible debenture become non-convertible, or vice versa?

The terms of issue of debentures can be amended in any manner if so agreed by the debenture holders. In other words, if debenture holders agree, non convertible debentures can be converted into convertible debentures or vice versa subject to compliance with law.

27. Is there any requirement to create DRR for partly convertible and partly redeemable debentures?

Vide General Circular No: 9/2002 dated 18th April, 2004, MCA has clarified that Section 117C will apply to non-convertible portion of debentures issued whether they are fully or partly convertible.

28. Does a Company need to create DRR for debentures redeemable within a period of one year (within the financial year of the company)?

DRR is to be created out of profits of the company which will be calculated at the time of finalisation of accounts. As the liability will not even exist at the end of the financial year, there is no need to create DRR.

29. Is the company required to transfer a sum of money to DRR even in case of losses?



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General Circular No: 9/2002 dated 18th April, 2002 issued by MCA clearly mentions that there is no need to transfer any money to DRR in the year company is having losses as the section requires transfer of money to DRR only out of the 'profits'.

30. Is there any requirement to file any form with RoC or any other authority for issuing debentures?

Unlike allotment of shares, allotment/issue of debentures does not require any form filing with any department. In case, security is created on the issue, registration of such charge is required under section 125 in eform 8 and eform 10.

31. What are the documentations and formalities required for issuing debentures?

The Articles of a company must authorise it to issue debentures. A board resolution in terms of Section 292 passed at a meeting of board of directors of the company is required. The issuing company also needs to comply with the borrowing limits specified by section 293(1)(d).

32. Can debentures be issued with call/put option?

Yes, call option shall be with the issuing company and put option may be with the debenture holder. However, if debentures are issued as sub-debts by NBFCs, no call can be provided to issuer company in terms of RBI notification dated June 27, 2013. If such option is given to issuer, the instrument shall qualify as public deposit.

33. What are the rights available to a debenture holder at the time of default by the issuing company?

Debenture holders can seek relief under section 117C(4) of the Companies Act, 1956. If banks and financial institutions are the holders, rights under SARAFESI Act can be reckoned.

34. Can the redeemed debentures be re-issued?

Yes, Section 121 of the Companies Act, 1956 empowers a company to re-issue the redeemed debentures unless cancelled or specifically prohibited by Articles.

35. How to settle excess amount in DRR after redemption of debentures?

The excess amount in DRR after redeeming the debentures shall be transferred to General Reserves of the issuing company.

36. Should debentures always carry interest?



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No, debentures can be zero coupon also.

37. What are the records to be maintained by the issuing company after issue of debentures?

The issuing company is required to maintain a register and index of debenture holders in terms of section 152 of the Companies Act, 1956.

38. Is the issuing company required to pay any stamp duty on the issue of debentures?

As per Article 246, Seventh Schedule, Entry 91 of the List I (Union List), Parliament has exclusive powers to make laws with respect to debentures and therefore, stamp duty on debentures is governed by Indian Stamp Act and not the respective state stamp acts.

As per Article 27 of First Schedule to the Indian Stamp Act, stamp duty on debentures is as follows:

<p>27. Debenture (whether a mortgage debenture or not), being a marketable security transferable -</p> <p>(a) by endorsement or by a separate instrument of transfer</p> <p>(b) by delivery</p> <p>Explanation- The term "Debenture" includes any interest coupons attached thereto but the amount of such coupons shall not be included in estimating the duty.</p> <p>Exemption</p> <p>A debenture issued by an incorporated company or other body corporate in terms of a registered mortgage-deed, duly stamped in respect of the full amount of debentures to be issued thereunder, whereby the company or body borrowing makes over, in whole or in part, their property to trustees for the benefit of the debentures holders:</p> <p>Provided that the debentures so issued are expressed to be issued in terms of the said mortgage-deed."</p>	<p>0.05% per year of the face value of the debenture, subject to the maximum of 0.25% or rupees twenty five lakhs whichever is lower.</p>
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However, in case of non-marketable, non-transferable debentures, no stamp duty is payable.



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39. What kinds of debentures are exempted from public deposit rules?

In terms of Rule 2(b)(x) of the Companies (Acceptance of Deposits) Rules, 1975, convertible debentures are exempted from the definition of deposit. NCDs secured by mortgage of immovable property of the company having market value equal or more value as of the issue of NCDs are also exempted under the said Rule.

Vide its notification dated November 21, 2013, MCA has amended the existing Rule and allowed NCDs to be secured by mortgage of *any fixed asset* as referred to in Schedule VI of the Act excluding intangible assets of the company having market value equal or more value as of the issue.

In other words, presently, following are exempted from the Public Deposit Rules:

- a) convertible debentures; and
- b) NCDs secured by mortgage of *any fixed asset* having market value equal or exceeding the value of issue (excluding security of intangible assets)

40. Are the public deposit rules same for a general company and an NBFC?

No, companies are required to see Companies (Acceptance of Deposits) Rules, 1975 and NBFCs are required to adhere by Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998

41. What kinds of debentures are not treated as 'public deposit' for an NBFC?

Following issue of bonds or debentures are exempted under NBFC Acceptance of Public Deposits (RBI) Directions, 1998:

- Debentures secured by the mortgage of any immovable property of the company or by any other asset (*provided that in the case of such bonds or debentures secured by the mortgage of any immovable property or secured by other assets, the amount of such bonds or debentures shall not exceed the market value of such immovable property/other assets*); or
- Debentures issued with an option to compulsorily convert them into equity of the company; or
- Any hybrid debt or subordinated debt instrument with a minimum maturity of 5 years (*provided no call option is given to issuer*)

42. Can a company issue debentures to 50 or more persons?



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In terms of proviso to sec. 67 (2), any issue of securities to 50 or more persons amounts to a public offer. Hence, all formalities of a public offer, including prospectus, SEBI ICDR Regulations, etc. will apply.

43. Is the rule about deemed public offers, as per sec 67 (2) of the Companies Act, not applicable to NBFCs?

In our view, it is a wrong interpretation to say that the provisions of sec. 67 (2) do not apply to an NBFC. The deeming provision, that is, an offer of securities to 50 or more persons to be deemed to be a public offer, does not apply to NBFCs. However, that does not for NBFCs, the concept of public offers does not apply at all. As per general definition of a public offer, where an offer may result into securities being available to a person other than the one to whom the offer was made is regarded as public offer, applies to all companies.

However, the RBI has issued guidelines on Private Placement of securities by NBFCs on June 27, 2013 which has overriding effect on the provisions of sec 67(3) of the Companies Act. Accordingly, the Guidelines have restricted the issue of debentures on private placement basis to a maximum of 49 people and all such subscribers are to be identified upfront.

44. What are the conditions applicable to an NBFC for issue of debentures?

Debentures can be issued to public or on preferential basis. Apart from the compliances required under Regulations mentioned under answer to question no.10 above, an NBFC is required to comply with following for its issue of debentures on preferential or private placement basis:

- Private placement by all NBFCs shall be restricted to not more than 49 investors, identified upfront by the NBFC.
- NBFCs shall ensure that at all points of time the debentures issued, including short term NCDs, are fully secured. If the security is not sufficient at the time of issue, full security cover needs to be created within one month of issue and till then subscription money is to be kept in an escrow.
- The offer document for private placement should be issued within a maximum period of 6 months from the date of the Board Resolution authorizing the issue.
- The offer document may be printed or typed "For Private Circulation Only".
- An NBFC shall only issue debentures for deployment of funds on its own balance sheet and not to facilitate resource requests of group entities/ parent company / associates with an exemption to CICs.
- The minimum subscription amount for a single investor shall be Rs. 25 lakh and in multiples of Rs.10 lakh thereafter.



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Also see our other related write-ups:

- Article RBI takes the wind out of NBFCs sails: Imposes restrictions on private placement of debentures at [https://india-financing.com/RBI takes the wind out of NBFC sails imposes restrictions on private placement of debentures.pdf](https://india-financing.com/RBI%20takes%20the%20wind%20out%20of%20NBFC%20sails%20imposes%20restrictions%20on%20private%20placement%20of%20debentures.pdf)
- RBI spreads its net to unregulated private placement of debentures by NBFCs at: [https://india-financing.com/Private Placement of Debentures by NBFCs.pdf](https://india-financing.com/Private%20Placement%20of%20Debentures%20by%20NBFCs.pdf)
- Article on 'MCA Circular widens scope for secured corporate debentures, grants exemption from Public Deposit norms' at [http://india-financing.com/MCA Circular widens scope for secured corporate debentures grants exemption from Public Deposit norms.pdf](http://india-financing.com/MCA%20Circular%20widens%20scope%20for%20secured%20corporate%20debentures%20grants%20exemption%20from%20Public%20Deposit%20norms.pdf)
- Article on 'Corporate Bond Market-Removing the Bottlenecks' at [http://india-financing.com/Corporate Bond Market-Removing the Bottlenecks.pdf](http://india-financing.com/Corporate%20Bond%20Market-Removing%20the%20Bottlenecks.pdf)
- Article on 'New DRR provisions- will they promote or demote the Bond Market' at [http://india-financing.com/New Debenture Redemption Reserve Provisions- %20Will they promote or demote the Bond Market.pdf](http://india-financing.com/New%20Debenture%20Redemption%20Reserve%20Provisions-%20Will%20they%20promote%20or%20demote%20the%20Bond%20Market.pdf)
- Article on 'Understanding Compulsory Convertible Debentures' at [http://india-financing.com/Understanding Compulsory Convertible Debentures.pdf](http://india-financing.com/Understanding%20Compulsory%20Convertible%20Debentures.pdf)
- Other articles on bonds and debentures at other articles on bonds and debentures at <http://india-financing.com/staff-publications.html/capital-markets.html>