"Foreign Currency Exchangeable Bonds: Exploring the New Route for Corporate Debt"

Vivek Kohli, Senior Partner, ZEUS Law Associates

Rishi Jain, Associate, ZEUS Law Associates

Published in Journals/Magazines/News Letters

1. Banking Cases in September, 2009 Edition
2. Manupatra E-Book http://www.manupatra.in/etc/e-Book/e-Newsline/Aug09_newsline/upload/default.htm

The menu of choices available to an Indian Company desirous of raising foreign currency debt has till recently been limited to either raising external commercial borrowings ("ECBs") in accordance with the Master Circular on external commercial borrowing and trade credits or issuing foreign currency convertible bonds ("FCCBs") convertible into shares.

A recent addition in the list of choices has however, opened the doors for Indian Companies to explore a third option for raising foreign currency debt through the issuance of foreign currency exchangeable bonds ("FCEBs") which are exchangeable into shares of their group companies.

The formulation of the "Issue of Foreign Currency Exchangeable Bonds Scheme, 2008" in February 2008 (the "Scheme") provides Indian promoters, looking to raise funds overseas for meeting their financing needs, with a unique and flexible opportunity to unlock value in their group Companies, without immediate dilution of voting power or control in such Companies.

The Scheme was operationalised pursuant to A P (DIR Series) Circular No. 17 dated September 23, 2008 issued by the Reserve Bank of India (the "RBI") to facilitate the issuance of foreign currency exchangeable bonds ("FCEBs").

A. Definition and Key Terms

FCEB has been defined in the Scheme as a *"bond expressed in foreign currency, the principal and interest in respect of which is payable in foreign currency, issued by an Issuing Company and subscribed to by a person who is a resident outside India in foreign currency and exchangeable into equity share of another company, to be called the Offered Company, in any manner, either wholly, or partly or on the basis of any equity related warrants attached to debt instruments".*

Under the Scheme, the term "Issuing Company" has been defined to mean an Indian Company incorporated under the Companies Act, 1956. The term "Offered Company" has been defined to mean an Indian Company whose shares shall be offered in exchange of the FCEB. As per the Scheme both the Issuing Company and the Offered Company are required to be part of the same "Promoter Group".

Promoter Group has been assigned the same meaning as under the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000 ("DIP Guidelines"). As per the DIP Guidelines, in the case of a Company, 'Promoter Group' includes (i) a subsidiary or holding Company of that Company; (ii) any Company in which the promoter holds 10% or more of the equity capital or which holds 10% or more of the equity capital of the promoter; and (iii) any Company in which a group of individuals or Companies or combinations thereof who holds 20% or more of the equity capital in that Company also holds 20% or more of the equity capital of the issuer Company.

B. Eligibility Criteria of the Players

Issuing Company

The Issuing Company in order to be eligible for issuance of FCEBs should be:

i. A Company incorporated and registered in India in accordance with the (Indian) Companies Act, 1956; and

ii. Form part of the Promoter Group of the Offered Company; and

iii. At the time of issuance of the FCEBs and until redemption or exchange should hold the shares of the Offered Company into which the FCEBs are exchangeable; and

iv. Be eligible to raise funds in the Indian securities market and should not have been restrained by the Securities and Exchange Board of India ("SEBI") from accessing the securities markets.

Offered Company

The Offered Company must be:

i. A listed Company engaged in a sector eligible to receive foreign direct investment; and

ii. Eligible to issue or avail of FCCBs or ECBs.

It is important to note that while the Scheme specifically requires the Offered Company to be a listed Company, no such requirement has been prescribed for Issuing Companies. In this context it may be useful to refer to Regulation 3(3) of the Scheme which states that *"an Indian company which is not eligible to raise funds from the Indian securities market, including a company which has* *been restrained from accessing the securities market by the SEBI, shall not be eligible to issue FCEBs".*

The language of Regulation 3(3) of the Scheme is similar to that used in Regulation 3(1)(A) of the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 (the "FCCB Scheme"). Regulation 3(1)(A) of the FCCB Scheme, has been interpreted by the RBI to mean that only listed Indian companies are eligible to issue FCCBs. A similar view may be adopted in the case of FCEBs and Regulation 3(3) of the Scheme may be interpreted to mean that the Issuing Company should be listed.

However, in the absence of an express clarification from the RBI, an additional requirement that the Issuing Company should also be listed should not be read into the Scheme. The requirement is therefore, for the present restricted only to a Company that is eligible to be listed and which may not for the present be a listed Company.

Subscribers of FCEBs

The Scheme provides that only '*person residents outside India*' can subscribe to FCEBs subject to compliance with the FDI Policy at the time of issuance of FCEBs and sectoral caps provided therein and entities prohibited by SEBI from buying, selling or dealing in securities are not eligible to subscribe to FCEBs.

C. Approvals Required

An FCEB issue would require the following approvals:

i. <u>RBI Approval</u>: Prior approval of the RBI is required to be obtained by the Issuing Company for any issuances of FCEBs.

ii. <u>FIPB Approval</u>: Prior approval of the Foreign Investment Promotion Board ("FIPB") should be obtained by the Subscriber, if the activities of the Offered Company do not fall under the automatic route for foreign direct investment.

D. Pricing and Maturity Conditions

Maturity: As per the Scheme, the minimum maturity period for the FCEBs is five (5) years. In contrast to the Scheme, as per the ECB guidelines circulated vide Master Circular No.07/2008-09 dated July 1, 2008 issued by the RBI, the minimum maturity for borrowings less than US$ 20 million is three (3) years and for borrowings in excess of such amount is five (5) years. It is quite incomprehensible why a similar distinction has not been incorporated in the Scheme.

Redemption: FCEBs may be exchanged, in part or full, into equity shares of the Offered Company any time prior to redemption. Upon exercise of the option to exchange, the Issuing Company is required to deliver the shares of the Offered Company to the subscribers i.e., cash (net) settlements are not permitted.

All-in-Cost Ceiling: The rate of interest payable on FCEBs and the issue expenses incurred in foreign currency by the Issuing Company must be within the all-in-cost ceiling set forth in the ECB guidelines. At present, the all-in-cost ceiling is LIBOR + 200 bps for FCEBs with tenure of 3-5 years, LIBOR + 350 bps for tenure of more than 5 years.

Pricing: The exchange price of the listed shares of the Offered Company at the time of issuance of the FCEBs must not be less than the higher of the two prices, given below, of the shares of the Offered Company on the stock exchange:

(a) the average of the weekly high and low closing prices for the 6 months preceding the relevant date; and

(b) the average of the weekly high and low closing prices for the 2 weeks preceding the relevant date.

For the purposes of the Scheme, "relevant date" means the date on which the Board of Directors of the Issuing Company authorises the issuance of the FCEBs.

E. Utilization of FCEB Proceeds

The proceeds of the FCEBs may be invested by the Issuing Company as follows:

(1) by way of direct investments, including in joint ventures or wholly-owned subsidiaries abroad in accordance with the existing guidelines on investments in joint ventures or wholly-owned subsidiaries abroad; and

(2) in promoter group Companies, which, in turn, may utilize such amounts in accordance with the ECB guidelines then in force, which currently restrict end-uses to the following activities:

investment, e.g., import of capital goods, by new or existing production units, in real sector - industrial sector, including small and medium enterprises, and in the infrastructure sector which is defined as power, telecommunications, railways, roads including bridges, sea ports and airports, industrial parks and urban infrastructure (water supply, sanitation and sewage projects).

(3) Retention and/or deployment of FCEB proceeds is to be in accordance with applicable ECB guidelines.

(4) The utilization of FCEB proceeds for investments in the capital markets or in the real estate sector in India has been expressly prohibited under the Scheme.

F. FCCBs versus FCEBs

There is a fundamental difference between FCCBs and FCEBs, whereby, in the case of an FCCB offering, the bonds convert into shares of the Company that issued the bonds, while in the case of FCEBs, the bonds are convertible into shares of another Company, i.e., the Offered Company, which forms part of the promoter group of the Company issuing the bonds.

Further, in the case of FCCBs, when the holder exercises the option to convert, the issuer Company issues fresh shares to the holder upon conversion of the FCCB. However, in the case of FCEBs, when the exchange option is exercised, there is no issuance of fresh shares by the Offered Company. What occurs in the case of an FCEB issue is a transfer by the Issuer Company of shares it holds in the Offered Company to the bond holder in exchange for the bonds.

G. Tax Implications on FCEBs

Interest payments on the FCEBs, until the exchange option is exercised, are subject to deduction of tax at source as per the provisions of sub-section (1) of section 115 AC of the Income Tax Act, 1961.

Tax on dividend on the exchanged portion of the FCEBs shall be in accordance with the provisions of sub-section (1) of section 115 AC of the Income Tax Act, 1961.

Exchange of FCEBs into shares will not give rise to any income-tax on capital gains in India. Transfers of FCEBs between non-residents will not give rise to any income-tax on capital gains in India.

H. Mandatory Requirements

The Issuing Company and the Offered Company are required to comply, inter-alia, with the provisions of (i) the (Indian) Companies Act, 1956, with respect to authorisations required and (ii) the SEBI Act, 1992, and the rules, regulations and guidelines issued thereunder with respect to disclosure of the Issuing Company's shareholding in the Offered Company.

The Issuing Company is prohibited from transferring, mortgaging, offering as collateral, trading in, or creating any encumbrance on, the shares of the Offered Company which are exchangeable for the FCEBs.

I. The Positives vis a vis The Negatives

In conducting a pros and cons analysis of the FCEB Scheme, one finds several unique advantages in the Scheme. Firstly, the Scheme provides an additional avenue for Indian Companies raising funds from overseas. Secondly, the Scheme provides Indian promoters the flexible option of raising money overseas by leveraging on and unlocking the value of their holdings in other "Promoter Group" Companies, without causing equity dilution. Thirdly, there seems to be no perceived disadvantages of the FCEB Scheme from a taxation standpoint.

On the other hand the principal shortcoming of the Scheme lies in its limited scope. The eligibility of a Company whose shares are being offered in pursuance of an FCEB offering is confined to 'listed companies' in certain sectors where FDI is permitted and only to the extent that ECBs and FCCBs are permitted. The restrictions pertaining to minimum maturity period, all-in-cost ceiling etc. further restrict the benefits of the Scheme. The use of FCEB proceeds also appears to be quite limited on account of the fact that the Issuing Company may only use such proceeds for direct investments abroad or in Promoter Group Companies. It is the Promoter Group companies that may, in turn, use such proceeds in the manner set forth in the ECB guidelines.

Further, the requirement of prior RBI approval in all cases has proved to be a huge roadblock in the way of success of the Scheme. While under the ECB guidelines, certain borrowings that fall under the "automatic route" do not require the prior approval of the RBI, no such dispensation has been made under the Scheme. A similar exemption under the Scheme in respect of FCEBs that comply with the requirements, including end-use restrictions, specified in the ECB guidelines would have paved the way for a smooth implementation of the Scheme. Prior approval should have been mandated only where the specifications set forth in the Scheme were not met.

Further, when analyzed from a bankruptcy standpoint, the Scheme appears to be on a weaker ground. Though the FCEBs are issued on the strength of the underlying shares of the Offered Company held by the Issuing Company, it does not automatically follow that such shares are pledged in favour of the FCEB holder. The position of an FCEB holder, in the event of bankruptcy of the Issuing Company prior to conversion, would only be that of an unsecured creditor and to that extent the structure does not seem bankruptcy proof.

J. Conclusion

The Scheme undoubtedly is a welcome step and is likely to increase the flexibility of Indian promoters to raise financing for their business needs. The success of the Scheme however, largely depends on the prevailing market conditions and therefore, in view of the depressed market conditions, positive changes to the policy on foreign currency borrowing are required to spring this route into action.

*[**ZEUS Law Associates** is a full service corporate law firm with a group of committed professionals having specialization and extensive experience in Corporate and Commercial laws, Mergers & Acquisitions, Joint Ventures, Private Equity, Real Estate, Capital Markets, Litigation & Arbitration, Banking and Finance, Indirect Taxation, Energy and Infrastructure Projects practice areas. Its principal office is in New Delhi, India and has network / associate offices in Mumbai, Bangalore, Chandigarh and Jaipur. The firm is in the process of establishing an overseas office in Dubai which will be operational shortly. Authors can be contacted at vivek.kohli@zeus.firm.in; rishi.jain@zeus.firm.in]*