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SEBI TEMPORARILY SUSPENDS MASALA BONDS AND FLAGS CORPORATE DEBT LIMITS TO FPIs

1. INTRODUCTION

Suggesting that the Indian corporate bond market's exposure to foreign investors may be overheating, the Securities Exchange Board of India ("SEBI") issued a circular on 20 July 2017 (the "Circular")¹ temporarily suspending the overseas issue of Rupee denominated debt in a cautionary measure to stem Indian corporate debt exposure to foreign investors, which is fast approaching a legal limit.

The Circular sets out an auction mechanism to bid for *free* limits available after India's combined corporate debt limit of INR 2,44,323 crores (approximately USD 38 billion) (the "Overall Limit") is utilized over and above 95 per cent.

The Overall Limit applies to the aggregate of foreign subscription for Rupee denominated bonds issued by Indian corporates onshore and offshore.

As of July 21, 2017 the available *free* limits stood at INR 15,909 crores (6.51 per cent of the Overall Limit) thereby suggesting that the Overall Limit has been utilized to the extent of 93.49 per cent.²

Buried in the detail of the Circular, SEBI temporary restricts the overseas issuance of Rupee denominated bonds until utilization limits fall below 92 per cent of the Overall Limit.

2. EFFECT OF THE CIRCULAR

While the Circular does not outright restrict the issue of unlisted (or Indian listed) Rupee denominated debt to foreign portfolio investors ("FPIs") or eligible foreign investors, it is quite clear that the headspace available before the auction mechanism gets triggered is narrowing and Indian corporates and FPIs have to take a cautious and calculated step forward on deciding whether to bid for the *free* limits once the 95 per cent threshold is reached, or think of alternate structures for raising foreign debt.

Pursuant to a notification dated August 4, 2016,³ SEBI had earlier clarified that the Overall Limit (which was the legal limit for overall investments by FPIs in the Indian corporate debt market) will include investments made by eligible foreign investors in rupee denominated bonds issued *overseas*. As a result thereof, the Circular will have an effect on the investment strategies of both Indian corporates raising debt and FPIs and other eligible foreign investors investing in such debt instruments.

The situation in relation to the overseas issue of Rupee denominated bonds is particularly tricky, since the Circular suggests that the overseas issuance of Rupee denominated bonds has been temporarily suspended and Indian corporates will only be eligible to issue overseas Rupee denominated bonds when the utilization of the Overall Limit falls *below* 92

¹ IMD/FPIC/CIR/P/2017/81 available at http://www.sebi.gov.in/legal/circulars/jul-2017/investments-by-fpis-in-corporate-debt_35362.html last accessed on July 24, 2017.

² Please see <https://www.fpi.nsdli.co.in/Reports/ReportDetail.aspx?RepID=1> last accessed on July 24, 2017.

³ SEBI/HO/IMD/FPIC/CIR/P/2016/67 available at http://www.sebi.gov.in/sebi_data/attachdocs/1470299109414.pdf last accessed on July 24, 2017.

per cent.

It therefore suggests that Indian corporates will not be permitted to use the available headspace (up to the threshold of 95 per cent of the Overall Limit) with respect to the issuance of overseas Rupee denominated bonds and by this, we infer that the listing of Rupee denominated debt on international exchanges, such as the London Stock Exchange, stands suspended until further notice.

3. AUCTION MECHANISM

Should the aggregate of Indian corporate debt held by foreign investors exceed 95 per cent of the Overall Limit, SEBI has set out an auction mechanism permitting Indian corporates interested in issuing rupee denominated bonds to bid for the *free* limits available. We assume that the bid auction process will apply to Indian corporate debt denominated in Rupees which will be listed on Indian exchanges as well as unlisted Rupee denominated debt issued to FPIs, in accordance with the terms of the Circular.

What is important to keep in mind in the context of the auction process is that the minimum bid size shall be at least of INR 1.0 crore and the maximum bid size shall be *one-tenth* of the free limit being auctioned. The auction process shall be subject to an available free limit of at least INR 100 crores.

However, in the event that the free limit remains less than INR 100 crores for 15 (fifteen) consecutive trading days, then an auction shall be conducted on the 16th (sixteenth) trading day to allocate the free limits.

As of 21 July 2017, the available *free* limit for subscription stood at approximately INR 15,909 crores.

4. THE WAY FORWARD

The Circular makes it clear that FPIs and eligible foreign investors shall be again free to invest into the Indian corporate debt market by way of Rupee denominated bonds issued overseas, only after the utilization of the Overall Limit falls below 92 per cent, which may take a considerable amount of time depending on the repayment or redemption terms of such overseas Rupee denominated bonds already issued.

The Circular will take the markets by surprise, with SEBI essentially attempting to restrict the issue of Rupee denominated corporate debt, notwithstanding that Rupee-denominated bonds have recently gained significant traction among corporates as a fund-raising option.⁴

As an alternate structure, Indian corporates and foreign investors will now need to look at other convertible instruments and equity securities, or the more traditional external commercial borrowing (“ECB”) route⁵ to raise funds, though generally, it should be noted that the returns on investment enjoyed by FPIs and other eligible foreign investors under the ECB route are considerably lower when compared to the advantages of structuring debt through non-convertible debentures and Rupee denominated bonds.

⁴ Please see <http://timesofindia.indiatimes.com/business/india-business/temporarily-halt-rupee-denominated-bond-issuance-sebi/articleshow/59686622.cms> accessed on July 24, 2017

⁵ Please see, “*Master Direction - External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorised Dealers and Persons other than Authorised Dealers*” updated as of June 9, 2017 available at https://rbi.org.in/scripts/BS_ViewMasDirections.aspx?id=10204.

IndusLaw View:

As of the date hereof, there has been surprisingly little mainstream market reaction to the Circular, suggesting that the implications of it have not yet filtered through. Obviously it will put debt-raising plans on hold while Indian corporates and foreign investors assess the implications of the Circular and consider the *pros* and *cons* of alternative funding routes. It will no doubt severely impact those corporates planning issues of Rupee denominated debt on foreign exchanges such as the London Stock Exchange, and in particular, those corporates and investors who may be in the final stages of negotiating such debt funding.

It will be interesting to see how the market regulators deal with market reactions to the Circular, in the context of the growing interest by foreign investors in Rupee denominated bonds and other similar debt instruments as an attractive option for raising debt, compared to availing bank loans in the domestic market or through the ECB route.

Further, we anticipate that there will be a number of issues in the Circular that will need to be clarified by SEBI, including:

- (a) Whether it is applicable for both *listed* and *unlisted* securities?
- (b) Will FPIs investing in *unlisted* securities be exempted from the Circular?
- (c) Will *unlisted* Rupee bonds fall within the purview of the Circular?
- (d) Whether foreign investors interested in subscribing for *unlisted* Rupee denominated bonds can take benefit of the headspace available between 92% and 95%?

While the market and stakeholders in general await these clarifications to fully gauge the impact of the Circular, there are certain stakeholders who seem to support this move by SEBI as a prudent move to ensure that new inflows do not push foreign holdings over the Overall Limit, necessitating still more drastic action by the authorities in the future.⁶

The Rupee denominated bond market until this point had seen rapid growth. If foreign interest in Indian corporate bonds is going to be sustainable, and if the regulators are convinced that the money invested is likely to remain in the medium to long term, then they could decide to increase the Overall Limit,⁷ subject to increasing the minimum average maturity of the debt instrument. How the market will respond and how the regulators will react, for now, remains to be seen.

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⁶ For further background, see <https://www.ft.com/content/596c9406-6e25-11e7-bfeb-33fe0c5b7eaa> last accessed on July 24, 2017.

⁷ *Ibid.*