ISSUANCE AND COMPLIANCE OF OPTIONALLY CONVERTIBLE DEBENTURES (OCDS) IN INDIA

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1. Background

Optionally Convertible Debentures ("**OCDs**") serve as a significant financial instrument that companies utilize to raise capital from investors. Unlike conventional debentures, which strictly function as debt instruments, OCDs possess a unique feature that sets them apart. Specifically, OCDs provide investors with the option to convert these debentures into equity shares at a predetermined price. This price can be established either at the moment the debentures are issued or at the time the conversion is executed. This flexibility in conversion timing allows investors to make more strategic decisions regarding their investments, potentially enhancing the appeal of OCDs as a versatile capital-raising tool for companies. The option to convert into equity adds a layer of potential growth for investors, distinguishing OCDs from traditional debt instruments and aligning their interests with the company's equity performance.

As provided by the According to the provisions outlined in the Companies Act, 2013 (the "**Act**") , Section 71(1), a company is authorized to issue debentures that come with an option to convert these debentures into shares, either in full or in part, at the time of redemption. It is crucial to emphasize that the process of issuing debentures with such an option to convert them into shares, whether wholly or partially, requires approval. This approval must come in the form of a special resolution passed during a general meeting. This requirement ensures not only transparency but also strict compliance with the existing regulatory framework. By mandating a special resolution, the Act aims to maintain a high standard of corporate governance and investor protection, thereby reinforcing the integrity of the capital-raising process through the issuance of Optionally Convertible Debentures.

In contrast to Compulsorily Convertible Debentures ("**CCDs**"), which require mandatory conversion into equity shares, OCDs offer a discretionary conversion feature. This means that the decision to convert OCDs into equity shares rests entirely with the debenture holder. The

debenture holder can choose to exercise this option at their discretion, allowing for greater flexibility in managing their investment. Additionally, the terms of conversion can also be established through mutual agreement between the company and the investor, fostering a mutual understanding of the conversion conditions. This discretionary aspect of OCDs provides investors with more control over their investment outcomes, making OCDs a versatile financial instrument that can be tailored to meet the specific needs and preferences of both the issuing company and the investor.

OCDs are not entitled to any voting rights. This stipulation is in line with Section 71(2) of the Act, which explicitly states that no company is permitted to issue debentures that carry any voting rights. This legal provision ensures a clear distinction between equity holders and debenture holders, maintaining that the latter do not have a say in the corporate governance or decision-making processes of the company. By prohibiting voting rights for debenture holders, the Act preserves the integrity of shareholder voting power and reinforces the fundamental principles of corporate structure and governance.

2. Non-Requirement for the Creation of Debenture Redemption Reserve ("DRR") for Issue of OCDs:

As per Section 71(4) of the Act, every company issuing debentures is mandated to create a DRR. The DRR amount shall be constituted only from the profits available. The purpose is to minimise the risk of default on repayment of debentures. The DRR ensures the availability of funds for meeting obligations towards debenture-holders.

However, Rule 18(7)(c) of The Companies (Share Capital and Debentures) Rules, 2014 specifies that in the case of partly convertible debentures, the DRR must be created specifically for the non-convertible portion of the debentures. This means that the DRR is required only for that part of the debentures which will not be converted into equity shares. Consequently, based on this provision, the obligation to establish a DRR applies solely to the non-convertible segment of the debentures.

Given the provision that allows debentures to be converted into shares, OCDs are classified as convertible debentures. This classification remains true regardless of whether the debenture holder ultimately exercises the conversion option or not. Essentially, both OCDs and CCDs are

defined as convertible debentures and, as such, are excluded from being categorized as "non-convertible" debentures.

The requirement to create a DRR is mandated specifically for Non-Convertible Debentures ("**NCDs**"). Since OCDs and CCDs are categorized under convertible debentures, they do not fall within the scope of non-convertible debentures. Therefore, OCDs are classified as convertible debentures and not as non-convertible debentures. As a direct consequence, there is no requirement to create a DRR for OCDs, thereby simplifying the financial obligations for companies issuing these instruments.

3. Issuance of OCDs as secured or unsecured:

Section 71(3) of the Act stipulates that companies may issue secured debentures. The Companies Act, 2013 and the Companies (Share Capital and Debentures) Rules, 2014 do not impose any specific restrictions or obligations on companies regarding the issuance of secured or unsecured debentures.

While Section 71(1) of the Companies Act, 2013 allows a company to issue debentures with an option to convert into shares at the time of redemption, the sub-section (3) simply indicates that secured debentures may be issued subject to certain prescribed conditions. Therefore, the Companies Act does not mandate that debentures must be secured or unsecured. Consequently, companies have the flexibility to issue both secured or unsecured OCDs.

4. Applicability of The Companies (Acceptance of Deposits) Rules, 2014

Secured OCDs –

According to Rule 2(c)(ix) of the Companies (Acceptance of Deposits) Rules, 2014, the definition of a deposit explicitly excludes secured debentures, irrespective of their convertibility status. This means that whether the debentures are optionally convertible, compulsorily convertible, or non-convertible, as long as they are secured, they do not fall under the purview of the Companies (Acceptance of Deposits) Rules. Consequently, the regulatory requirements and compliance obligations outlined in the Companies (Acceptance of Deposits) Rules, 2014 do not apply to secured OCDs. This exclusion simplifies the regulatory landscape for companies issuing secured OCDs, ensuring that they are not subjected to the additional deposit-related compliances.

Unsecured OCDs –

According to Rule 2(c)(ix) and Rule 2(c)(ixa) of The Companies (Acceptance of Deposits) Rules, 2014, the definition of a "Deposit" includes specific conditions under which an unsecured debenture can be exempted from being classified as a deposit. These conditions are:

a. An unsecured debenture qualifies for exemption from the deposit regulations only if it is a CCD that will be converted into shares within a period of 10 (Ten) years. This means that the debenture must mandatorily convert into equity shares within the stipulated time frame to avoid being classified as a deposit.

b. An unsecured NCD is exempted from being classified as a deposit only if it is listed on a recognized Stock Exchange. The listing on a stock exchange ensures a certain level of regulatory oversight and investor protection, thereby justifying the exemption.

Consequently, unsecured OCDs do not meet these exemption criteria and thus fall under the definition of "Deposits." As a result, the Companies (Acceptance of Deposits) Rules, 2014 apply to unsecured OCDs, imposing the related compliance requirements and regulatory obligations on companies issuing these instruments. This inclusion underscores the need for companies to carefully consider the classification and terms of their debenture issuances to ensure compliance with the applicable deposit regulations.

5. Procedure for Issue of OCDs on Private Placement Basis

Companies without shares or other securities listed on a recognized stock exchange should issue OCDs in line with Section 62 of the Act read with Rule 13 of the Companies (Share Capital & Debentures) Rules, 2014. Additionally, they must adhere to the conditions set out in Section 42 of the Act and Rule 14 of the Companies (Prospectus & Allotment of Securities) Rules, 2014.

Board Approval: To issue OCDs through private placement, the company must first convene a board meeting to pass the necessary resolutions as required by Section 173 of the Companies Act and the Secretarial Standards-1. This includes approving the issuance of OCDs through private placement, authorizing the issuance of a private placement offer letter, and approving the convening of a general meeting with specific

details regarding the date, time, and venue. Additionally, the board must identify the intended recipients of the private placement offer.

Shareholders' Approval: To initiate the issuance of OCDs through private placement, the company must first convene a shareholders' meeting to obtain special resolution approval as per Section 100 of the Companies Act and Secretarial Standards – 2. Following this, the company must file Form MGT-14 with the Registrar of Companies (ROC) within 30 (Thirty days of obtaining the special resolution approval, in accordance with Section 94(1) and 117(1) of the Act.

Valuation Report: The company must provide the investor with a valuation report, as stipulated by Rule 13(h)(ii) of The Companies (Share Capital and Debentures) Rules, 2014.

Bank Account: The company is required to open a separate bank account in a Scheduled Bank to segregate and manage the funds received from the application, in accordance with Section 42(6) of the Companies Act.

Private Placement Offer Letter: The company must issue an offer or invitation to subscribe to the OCDs by providing a private placement offer letter in Form PAS-4, as mandated by Rule 14(3) of the Companies (Prospectus and Allotment of Securities) Rules, 2014.

R**ecord of Private Placement**: Maintain a complete record of persons to whom offer letter is sent in Form PAS-5 as mandated under Rule 14(4) of Companies (Prospectus and Allotment of Securities) Rules, 2014.

Board Resolution for Allotment: Once the subscription amount is received in the designated bank account, the company must convene a board meeting to pass resolutions for the allotment of OCDs through private placement and authorize the filing of the return of allotment with the Registrar of Companies (ROC). This process is governed by Section 173 of the Companies Act and the Secretarial Standards – 2.

Filing of Return of Allotment: The return of allotment must be filed in Form PAS-3, along with the relevant fees, within 15 days from the date of allotment. This requirement

is stipulated by Rule 14(6) of the Companies (Prospectus and Allotment of Securities) Rules, 2014.

Debenture Certificate Issuance: Debenture certificates must be issued to the allottee as required by Rule 18 of the Companies (Share Capital & Debentures) Rules, 2014

Register Maintenance: The register of debenture holders must be updated using Form MGT-2 to ensure accurate record-keeping, in accordance with Section 88(1)(b) and (c) of the Act and Rule 4 of the Companies (Management and Administration) Rules, 2014.

Filing of e-form CHG-9 (secured OCDs): The company must file E-Form CHG-9 for the registration of a charge within 30 days of its creation, as stipulated by Rule 3(3) of The Companies (Registration of Charges) Rules, 2014.

Annual filing of Form DPT-3 (unsecured OCDs): For unsecured OCDs, Form DPT-3 must be filed annually with the Registrar, in accordance with Rule 16 of The Companies (Acceptance of Deposits) Rules, 2014..

This process outlines the step-by-step actions required for the issuance of debentures on a private placement basis, ensuring compliance with legal provisions and regulations.

6. Issue of OCDs to Foreign Entities

Non-convertible, optionally convertible, or partially convertible debentures, for which funds have been received after June 7, 2007, are classified as debt and must adhere to the External Commercial Borrowing (ECB) guidelines set forth under the Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2018, and as amended from time to time, according to FEMA – Foreign Investments Master Directions dated January 4, 2018, Paragraph 4.6.4.

If an entity raises ECBs, then it shall ensure the following ECB compliances as per the Master Circular on External Commercial Borrowings and Trade Credits dated March 26, 2019 –

a. **Allotment of Loan Registration Number (LRN)**: To secure the Loan Registration Number (LRN), the company must first obtain the LRN from the Reserve Bank of

India. This process involves submitting a duly certified Form ECB, which details the terms and conditions of the External Commercial Borrowing (ECB), in duplicate to the designated AD Category I bank. Following this, the AD Category I bank will forward one copy to the Director, Reserve Bank of India, Department of Statistics and Information Management, External Commercial Borrowings Division, at Bandra-Kurla Complex, Mumbai – 400 051 (Contact numbers: 022-26572513 and 022-26573612). This procedure is outlined in Paragraph 6.1 of the Master Direction on External Commercial Borrowings, Trade Credits, and Structured Obligations dated March 26, 2019.

b. **Changes in terms and conditions of ECB**: Any modifications to the parameters of an External Commercial Borrowing (ECB), including adjustments to repayment terms mutually agreed upon by the company and the foreign entity, must be promptly reported to the Department of Statistics and Information Management (DSIM). This is done by submitting a revised Form ECB. The updated form must be submitted to the DSIM as soon as possible and no later than 7 days from the date the changes are implemented. The specific alterations should be clearly outlined in the accompanying communication when submitting the revised Form ECB. This requirement is detailed in Paragraph 6.2 of the Master Direction on External Commercial Borrowings, Trade Credits, and Structured Obligations dated March 26, 2019

c. **Monthly Reporting of actual transactions:** The company is required to report actual transactions related to External Commercial Borrowings (ECB) using Form ECB 2 Return through the designated AD Category I bank on a monthly basis. This report must be submitted to the Department of Statistics and Information Management (DSIM) within seven working days from the end of the respective month. Additionally, any modifications to the parameters of the ECB, if applicable, should be incorporated and detailed in the submitted Form ECB 2 Return. This requirement is outlined in Paragraph 6.3 of the Master Direction on External Commercial Borrowings, Trade Credits, and Structured Obligations dated March 26, 2019.

d. **Conversion of ECB into Equity:** The pricing of shares must adhere to the guidelines established under FEMA. When reporting to the Reserve Bank of India (RBI), the company must use Form FC-GPR and Form ECB-2 to report the full conversion of

outstanding ECB into equity to the RBI Office and in Form ECB-2 to the Department of Statistics and Information Management (DSIM) at the RBI within seven working days from the end of the relevant month. The form should explicitly state "ECB wholly converted to equity." For partial conversions, the company must report the converted portion using Form FC-GPR to the RBI's Regional Office and Form ECB-2, clearly differentiating between the converted and unconverted portions, with "ECB partially converted to equity" noted. Subsequent reporting in Form ECB-2 is required for the outstanding portion of the ECB. This process is detailed in Paragraph 7.4 of the Master Direction on External Commercial Borrowings, Trade Credits, and Structured Obligations dated March 26, 2019.