

## **Consultation paper on Review of the Regulatory Framework for Corporate bonds and Debenture Trustees**

### **1. Objective**

The objective of the consultation paper is to seek comments/ views from the public on the proposals that are expected to strengthen the regulatory framework for Corporate bonds, secure the interest of the debenture holders, enhance the role of the Debenture Trustees (DTs) and empower them to effectively discharge their responsibilities towards the debenture holders of listed debt issues / proposed to be listed debt issues.

### **2. Background**

SEBI recently, increased the minimum net worth of DTs to raise the bar for financial entities entering the trusteeship business, put in place the provisions of penalizing issuers for non-creation of charge on security, e-voting mechanism for consent taking etc. in its on-going efforts to enhance the role debenture trustees play in the market ecosystem. However, it has been observed that still there have been cases of delay in enforcing the security in the event of default, which is detrimental to the interests of the investors. The increased events of default by a few financial institutions and the lapses/ complications on the part of debenture trustees in the expeditious enforcement of the security has brought to the fore the need for a review of the present regulatory framework for Debenture Trustees.

According to the data received from the Trustee Association of India (TAI), it is observed that in past 5 years, around 2.3 % of the issues have defaulted (93% of which are secured debentures) out of which DTs have been able to enforce the security successfully in around 10 % of the secured issues, recovery proceedings are pending at different stages in around 60% of the issues and in around 30% of the issues recovery is pending due to non-communication from debenture holders. It is observed that Non-Banking Financial Companies (NBFCs) are the frequent bond issuers. Based on the outstanding long term borrowings of NBFC (for top 100 based on long term outstanding borrowings) as on March 2019, it is noted that largely NBFCs borrow through bonds (approximately 56%) in comparison to loans (approximately 44%). In last 5 Financial Years the bond issuances were largely secured (approximately 76%).

DTs facilitate in holding the assets by creating lien on it without the transfer of title or possession of those assets. This protects investors from the risk of non-payment, and allows possession and sale of the assets if the borrower defaults or enters insolvency/ liquidation. In Indian bond market, secured bonds are issued by way of creating fixed or floating charge on the assets of borrower.

In the case of manufacturing companies, fixed charge is created in favour of trustees on Pari-Passu basis on underlying tangible assets (namely plant and machinery) for borrowing through debt and bank loan while in case of NBFCs floating charge is created on the existing and future receivables which are dynamic and intangible in nature and includes the entire balance-sheet of the company. Since, the charge is created on the entire balance sheet of the company, for any future issuances, further charge is created on a Pari-Passu basis on the entire assets (Receivables) of the company. Such a Pari-Passu charge does not specify a certain identified portion of the assets to each specific lender, but treats all lenders to have the same claim (in the respective proportion of the amounts borrowed from them) on the assets charged.

While the security is enforced by DT without any major complications in the case of manufacturing companies at event of default (EoD), the same is not true in the case of NBFCs due to floating charge and absence of identified security.

Vide June 07, 2019 circular, RBI introduced Inter Creditor Agreement (ICA) for resolution of stressed assets in banking industry. While signing of ICA is applicable on lender banks, the lender banks have in recent case of default by DHFL, invited DTs to be a part of ICA as majority of the lending was done by debenture holders. Debenture Trustees sought consent from the debenture holders for joining and acceding to the terms of the ICA. However, since the debenture holders were unaware of the terms and the functioning of the ICA, there was a mixed response from the debenture holders to the DTs regarding joining the ICA. Further, there was apprehension by the debenture holders that ICA process being dominated by banks may primarily focus on the interest of the banks. The debenture holders also feared that the introduction of ICA could lead to increase in the instances of the process of enforcement of security getting delayed, in case of creditors not being able to come out with a concrete resolution plan within the given timeframe.

Meanwhile, it was also perceived that attractive loan portfolios were sold by the NBFCs in order to pay existing dues post default and this probably led to DTs being left with lower quality assets

for security enforcement. In spite of periodic confirmation being sought by the DT in regard to maintenance of adequate security cover, lot of issues were faced by the DT in enforcement of security as they were unaware of the specificity of the underlying security which were known only to the issuer since a floating charge was created on the entire assets, i.e. present and future receivables of the NBFC. The floating charge in case of NBFCs gets crystallized only at the time of default.

The recovery proceedings in the said default of the NBFC was filed in Debt Recovery Tribunal (DRT) after following the process of seeking consent for joining ICA and then for going with recovery, in issues where no consent for joining the ICA was received. The delay faced by the debenture holders in receiving their due and absence of any identified security, led to the concern whether the debentures were truly secured.

With the given challenges observed in charge creation, enforcement of security of the secured debentures, ICA process and other related issues in the recent cases of default, SEBI intends to review the regulatory framework for DTs and put in place provisions that would further secure the interests of the debenture holders of listed debt issues, enable the DTs to perform their duties in the interest of the investors more effectively and promptly. It is therefore proposed to seek public comments on the following issues:

### **3. Proposals**

#### **3.1. Creation of Identified Charge by the NBFCs:**

NBFCs, for every issue shall create charge on the identified assets that may include identified receivables, investment and cash instead of floating charge on the entire books of the NBFC. A debenture issued by an NBFC shall be treated as secured only on creation of identified charge. A transition period of 3-5 years shall be provided to shift from floating Pari-Passu charge to identified charge.

#### **Rationale:**

While the NBFCs are always required to maintain the prescribed asset cover during the tenure of secured debentures, what assets lie under the given asset cover is known only to the issuer (NBFCs) due to the floating charge. It is known neither to the lenders nor to

the DTs, as the charge gets created on the entire assets/ receivables and the asset cover submitted to DT certified by the independent CAs just mentions the value of the entire assets and a statement that 100% of cover on the balance-sheet is maintained.

At the time of default, there is a possibility that good assets of NBFCs are enforced as security by the banks and the debenture holders may be left with sub-par assets due to the uncertainty and opacity of the floating charge subjecting debenture holders to the risk of non-realization of the full value of the security. This opacity makes it difficult for the DT to monitor the quality of the asset cover as well.

Accordingly, it is proposed to continue having Pari-Passu charge in case of manufacturing concerns/ companies having fixed charge on the assets and creation of identified charge in case of NBFCs/ companies having receivables as assets.

### **3.2. Enhanced due diligence of identified assets and Granular Asset cover certificate**

**3.2.1.** The asset cover certificate duly certified by the statutory auditor shall be required to be submitted on a half-yearly basis instead of annual basis. The asset cover certificate format shall be more granular providing a list of identified assets/receivables, identified investment or cash etc. as security. If the quality of one or more of the identified receivables/ assets deteriorates or the receivable/ asset is pre-paid, the issuer shall identify further receivables to replace the bad/ matured/ pre-paid ones and maintain the asset cover in accordance with the terms of Trust Deed.

**3.2.2.** Further, for maintaining the quality of underlying assets, following parameters are being proposed:

- a) A delinquency rate benchmark shall be fixed by the DT at the time of signing of Debenture Trust Deed (DTD). This delinquency rate in assets will be used by DT as one of the factor for monitoring the asset quality.
- b) If the delinquency rate in assets breaches the proposed threshold, issuer will be asked to replace those assets with other standard assets within a given time frame.
- c) Issuer shall disclose the covenants of maintaining the quality of assets, conditions of replacing the bad/ delinquent assets in Investment Memorandum (IM) and DTD

to create transparency and reduce the information gap regarding the covenants of the charge creation and the process thereafter.

- d) The asset cover shall also certify the compliance with all the covenants mentioned in the IM or DTD, as applicable.

**Rationale:**

Charge creation mechanism enables creditors to control credit risks and consequently lowers the cost of credit to debtors. To ensure that the security interests of the lenders remain more effective and enforceable in the insolvency/liquidation process, asset cover certificates are currently provided by the issuer on a quarterly/ half-yearly basis.

Asset cover certificate is used for the purpose of monitoring the adequacy of assets charged against the debt obligations of the issuer. Presently the asset cover certificate is submitted to the Debenture Trustee duly certified by an independent auditor on a quarterly basis by the issuer and duly certified by statutory auditor on a yearly basis.

It has been observed that the format of asset cover certificate varies from DT to DT. A few debenture trustees ask for detailed list of assets on which charge is created along with CA certificate whereas most of them receive only a statement that the 100% cover is maintained along with the asset cover ratio, making it difficult for them to understand the nature and quality of assets.

Accordingly, it is proposed to make the asset cover certificate more granular establishing the above mentioned parameters to enhance the monitoring of the quality of the underlying assets.

**3.3. Calling of Event of Default (EoD) at ISIN level**

DTs shall call EoD at ISIN level, which shall also include breach of any covenant mentioned in the IM/ DTD.

**Rationale:**

It was observed that the practice of issuance of debenture in the market varies from issuer to issuer. The debentures are sometimes issued in multiple tranches under an umbrella

DTD. Often it is observed that there are multiple International Securities Identification Numbers (ISINs) in an IM. With regard to the calling of EoD also, it was observed that the current market practices are inconsistent and differ from DT to DT. Some DTs call EoD at DTD level whereas some do it at ISIN level. Considering the fact that if a single investor is invested in a debenture under an ISIN, he has full right to enforce the security under that ISIN. Accordingly, it is proposed that EoD shall be called at ISIN level.

#### **3.4. Mechanism/ Conditions of joining Inter-Creditor Agreement (ICA)**

Debenture Trustees shall join ICA subject to approval of debenture holders and following conditions:

- i. Signing of ICA and agreeing to the Resolution Plan should be in best interest of the investors.
- ii. DTs shall ensure that the following conditions are part of ICA before signing the ICA:
  - a) If Resolution Plan imposes condition(s) on the DTs which are not in accordance with the provisions of SEBI Regulations and circulars issued, then DTs shall be free to exit ICA altogether with the same rights as if never signed ICA. In such a circumstance, Resolution Plan would not be binding on the DTs.
  - b) Resolution Plan shall be finalized within 180 days from the end of review period. If not, the DTs shall be free to exit the ICA altogether with the same rights as if never signed the ICA. In such a circumstance, Resolution Plan would not be binding on the DTs. However, if ICA extends beyond 180 days, DTs can take extension beyond 180 days' subject to approval of debenture holders with total timeline not exceeding 1 year from commencement period of ICA.
  - c) If any of the terms of the approved Resolution Plan are contravened by any party to the ICA, DTs shall be free to exit the ICA and take legal recourse or take any other action as deemed fit in the interest of the debenture holders.

Further, a Debenture holder representative committee consisting of debenture holders having majority investment may be formed after default by the issuer, to Fast Track the ICA process and consent seeking by Debenture Trustee during the course of ICA.





**Rationale:**

Corporates borrow by way of debentures and in many of the cases, the security offered on that debenture is on pari-passu basis with the other lenders (banks). Recently, in the case of default by DHFL, Debenture trustees have been approached by the consortium of banks to sign the ICA to consider the resolution plan. However, there lie multiple challenges in respect of the interest of the debenture holders in case of Debenture trustee joining the ICA framework, which are as follows:

- i. After the signing of the ICA during the review period, the resolution plan must be finalized under the 180-day period provided under the RBI's new rules. However, there can be a further extension of 6 months for finalization of Resolution Plan, resulting into delay for debenture holders in case no plan is finally agreed by lenders.
- ii. The notice period to receive the consent for further action in case of default has been stipulated as 21 days, which makes it difficult to sign ICA within the review period of 1 month.
- iii. As part of the ICA, the lenders (including the dissenting lenders) are not allowed to initiate any legal action or proceedings (including proceedings under Insolvency and Bankruptcy Code, 2016) against the borrower or any other person that may jeopardize the successful implementation of the Resolution Plan.
- iv. The resolution plan in respect of the Facilities availed by the Borrower may involve, amongst other, any action/plan/reorganization including without limitation the following:
  - a) Infusion of additional money by all lenders.
  - b) Conversion of debt into equity.
  - c) Transfer of all or part of the assets of the Borrower to one or more persons.
  - d) Rollover of debt.

Most of the possible Resolution Plan listed above may not be acceptable to DTs as most of the debenture holders are debt MF schemes.

- v. The Resolution Plan provides for payment of "not less than liquidation value" to dissenting lenders. The liquidation value will be decided by an independent valuer. The dissenting lender can also agree to sell or transfer their loan facilities to any other lender as part of the resolution plan at a mutually agreed-upon price. Since,



debt holders have less probability of getting favourable Resolution Plan, the above scenario might be the treated path for them in every case, which can be achieved through DRT itself and without the delay of 6 months.

- vi. The Resolution Plan approved by the majority lenders is final and binding on all the lenders and each lender (including the dissenting lender) agrees and undertakes to be bound by the Resolution Plan. Since it is a bank-led process, debenture holders might be at a disadvantage most of the times.

While it is important that investors have an option to recover their entire money albeit with a delay, however, dissenting lenders should be free to decide and take action in their best interest rather than be forced to take liquidation value. Accordingly, it is proposed to allow the DTs to join the ICA subject to the approval of the debenture holders and the conditions proposed as above.

### 3.5. Voting mechanism

- i. Time period sought for seeking consent shall be reduced to 15 days from 21 days.
- ii. For public and private placement, DT shall enforce the security by taking negative consent in the event of default (EoD).
- iii. The consent of debenture holders for enforcement of security and for joining ICA shall be taken simultaneously in the same letter
- iv. Negative consent for enforcement of security and positive consent for joining ICA shall be taken in the same letter.
- v. Proof of dispatch and delivery shall be maintained by the Debenture Trustee.
- vi. Providing E-Mail IDs shall be compulsory for Debenture holders in case of Private Placement.

#### **Rationale:**

It was observed that the Debenture Trustees face various procedural problems in seeking consent for future course of action which leads to delay in enforcing the security. In case of an ICA formed under RBI guidelines, taking consent twice - first for joining ICA and then for Enforcement of security can cause further delay in enforcement of security. Further, the



notice period to receive the consent for further action in case of default has been stipulated as 21 days, which makes it difficult to sign ICA within the review period of 1 month.

It is also observed that the contact details received from Registrar and Transfer Agents (RTAs) are not updated most of the times, making it difficult for DTs to communicate with debenture holders when needed. Since providing E-mail IDs is not mandatory for Debenture holders, DTs face problem in conducting E-Voting as well.

Accordingly, it is proposed to reduce the timeline for seeking consent to 15 days. The proposal on taking negative consent for enforcement of security will ensure prompt filing for recovery by DT. Also, simultaneous approval in the same letter for joining ICA and enforcement of security shall prevent repetition of the same consent seeking process and will reduce the time lag for enforcement of security.

### **3.6. Creation of a recovery fund**

- i. A fund shall be created by the issuer at the time of issuance of debt that shall be used by DT in the event of default towards recovery proceedings expenses.
- ii. The value of such fund shall be 0.01% percentage of the issue subject to the cap of 25 lakhs per issuer.
- iii. The above shall not be applicable on AAA rated bonds. However, in case of rating downgrade of a AAA rated bond, the issuer shall be obligated to create such fund within a fixed timeframe.
- iv. Disclosure to such affect shall also be made in the IM. Such fund shall be overseen by the DT.
- v. The amount shall be returned to the issuer at the time of maturity in case there is no default by the company.

#### **Rationale:**

In the event of default, while the DTs are not able to recover their dues/ fees from the issuer, they are still obligated to act in the interest of the investors and work towards enforcement of security. Currently Debenture Trustees call for meeting of Debenture holders in case of default to discuss the further course of action along with an estimate of cost to be borne by debenture holders for the recovery proceedings. In most of the cases debenture holders bear this cost. However, delays have been observed in the enforcement proceedings as the

money is not always received on time. If the DTs are adequately funded in advance, then the filing of recovery proceedings can be expedited.

Accordingly, in order to have a prompt enforcement of security, it is proposed to create a fund beforehand towards recovery proceeds, which shall be used by Debenture Trustee in case of default only.

### **3.7. Minimum Disclosures on the website by DTs**

DT shall mandatorily make the following minimum disclosures on their website:

- i. Quarterly Compliance Reports received from the issuers.
- ii. Compliance status on the receipt of asset cover from the issuers, maintenance of various funds by the issuers.
- iii. Defaults by the company.
- iv. Status of the proceedings of the cases under default.
- v. Compliance status of each covenant- issue wise on a half yearly basis.
- vi. Repayment schedule calendar/ calendar of interest and redemptions issuer wise (already mandated)

#### **Rationale:**

Regulation 15 of SEBI (Debenture Trustees) Regulations, 1993 has mandated certain set of duties on DTs which they are required to discharge throughout the maturity of the bond. Based on the complaints received from the investors in the recent default cases, it appears that the investors are not aware of the monitoring by the DTs and the compliance status of the issuers regarding various covenants disclosed in the IM.

Accordingly, in order to enhance the transparency, it is proposed to mandate minimum disclosures as above.

### **3.8. Disclosures regarding Performance of DTs**

Disclosure on the following parameters may be made by DTs which would be reflective of their promptness in discharging their duties:

- i. Timeliness on action taken (adhering to the time-lines specified by regulations/ transaction documents).

- ii. Monitoring of covenants / security cover
- iii. Timely intimation of a breach in covenants (if any).
- iv. Timely raising of red-flags if the issuer response is unsatisfactory.
- v. Effectiveness in enforcing security/ remedial actions in case of default.
- vi. Promptness in convening debenture holder's meeting and aiding in decision making as and when requested or required.

**Rationale:**

Currently, there are no performance indicators of DTs that can enable/ allow the investors to ascertain the performance of the particular DT.

While the disclosures are required for enhancing the transparency, few parameters are also required to enable the investors to discern the performance of the DTs in expeditious enforcement of the security and effective monitoring of the covenants. Accordingly, it is proposed to have disclosures on certain parameters by DTs in order to enable the investors to discern the performance of the DTs.

**3.9. Public Disclosure of all covenants by the issuer in IM**

All covenants including the accelerated payment covenants whether given by way of side letter or otherwise shall be incorporated in the IM by the issuer at the time of issuance of debentures and disclosed on the stock exchange. The issuer shall also be obligated to inform the DT of such covenants for monitoring of the same by DT on behalf of the investors.

**Rationale:**

SEBI (Issue and Listing of Debt Securities) Regulations, 2008 provide for disclosures to be made in the offer document. The offer document shall contain all material disclosures which are necessary for the subscribers of the debt securities to take an informed investment decision.

However, it has been observed in the recent cases of defaults by Reliance Capital, Altico and DHFL that issuers and investors at the time of issuance of debt securities sign specific documents which contain certain covenants. These are generally called "side letters." One

of the common covenants that has been observed is an “accelerated payment clause” which states that if the borrower violates the terms of the covenant(s), including default or downgrade of debt, such lender is entitled to demand immediate repayment. This accelerated repayment exercised by one lender may have a bearing on other lenders and may have a cascading effect on the liquidity and operations of the borrower, leading to insolvency. It was observed that in recent times, the use of such covenants by lenders has become more frequent which may have pushed firms into financial difficulty increasing the probability of default.

Accordingly, the use of such covenants affects the interest of all the other investors in that issue. It is, therefore proposed that all such covenants shall be publicly disclosed in the IM and on the stock exchanges.

### **3.10. Standardization of Debenture Trust Deed (DTD)**

DTD shall be bifurcated into two parts:

- i. Part A of DTD shall contain generic/standard clauses common to all DTDs.
- ii. Part B of DTD shall contain specific and customized clauses/covenants relevant to the particular issue for which the DTD is executed.

#### **Rationale:**

The DTD signed between the issuer and the DT includes standard covenants given in DT Regulations and form SH12 of the Companies Act. Such DTDs also include customized clauses specific to the issue. However, DTDs are lengthy, legal documents running into hundreds of pages sometimes. Therefore, a need is felt to standardize the DTD to make it more comprehensible and easy to read and understand by the debenture holders.

Accordingly, it is proposed to standardize the DTD and bifurcate it into two parts along the lines of the offer document of the Mutual Funds.

### **3.11. Enhanced Disclosures**

Following additional disclosures shall be made by the issuer in IM:



- i. A risk factor to state that while the debenture is secured against a charge to the tune of 100% of the principal and interest amount in favour of DT, the possibility of recovery of 100% of the amount shall depend on the market scenario prevalent at the time of enforcement of the security.
- ii. The issuer has no side letter with any bond holder except the one(s) disclosed in the IM and on the stock exchange website where the debt is listed.
- iii. About Pari-Passu charge and the entitlement of the investor in such cases.
- iv. The rights and duties of the DT.
- v. The detailed procedure to be followed at the time of default by the DT including relevant procedures of ICA, DRT / National Company Law Tribunal (NCLT) and IBC.
- vi. The procedure and manner of calling meeting of debenture holders.

Following additional disclosures shall be made by the issuer in DTD as well:

- i. The rights and duties of the DT.
- ii. The detailed procedure to be followed at the time of default by the DT including relevant procedures of ICA, DRT / NCLT and IBC.
- iii. The procedure and manner of calling of meeting of debenture holders, responsibility of debenture holders in such situations etc.
- iv. Bearing of recovery expenses in case of default.

**Rationale:**

The details about the terms of the debentures, duties of debenture trustees and redressal mechanisms in case of default are not known to the investors. The investors, therefore, are not fully aware of the risks undertaken while investing. In order to enhance transparency about the roles of various players and the provisions of the market structure, it is proposed to have the adequate disclosures in the IM and DTD.

**3.12. A framework for imposing fines and Standard Operating Procedure (SOP) for the same**

An SOP shall be prepared that shall list out the penalties for specific violations by the issuer company for the listed debt.

**Rationale:**

At the time of signing of DTD by the Debenture Trustee and issuer company, duties and responsibilities of the issuer are laid out in detail in DTD which includes cooperation with Debenture Trustee and dissemination of information to Debenture Trustee and Stock exchanges on a timely basis. However, lot of cases of non-cooperation with the DT have been noticed. SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR Regulations) also impose certain obligations upon the issuer with regard to the submissions made to the debenture trustee. Adjudication proceedings are initiated against such issuers which are in violation of the provisions of the LODR Regulations. However, such actions usually take time, during which, the non-compliance may continue. Accordingly, in order to improve compliance and discourage the non-cooperation it is proposed to develop an SOP in this regard. This SOP shall act as a deterrent and instill better cooperation and compliance by the issuers.

**4. Public Comments:**

Public comments are invited on the proposals contained in the Consultation Paper in the following format:

Name of entity/ person/ intermediary/ organization: _____			
Sr. No.	Pertains to Point No.	Comments/ suggestions	Rationale

Comments/ suggestions may be forwarded by email to [comments@sebi.gov.in](mailto:comments@sebi.gov.in) or sent by post to the following address latest by March 17, 2020:

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