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Analysing developments impacting business

POST ISSUE SECURITY CREATION BROUGHT UNDER THE SEBI NET FOR BONDS

11 August 2022

Introduction

Previously, the Securities and Exchange Board of India (SEBI) vide Circular No. SEBI/ HO/ MIRS/ CRADT/ CIR/ P/ 2020/218 dated 03 November 2020 ([November 3 Circular](#)), had prescribed the manner in which debenture trustees (Trustee) shall carry out due diligence for creation of security at the time of issuance of non-convertible debt securities (NCS). However, neither the SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 (NCS Regulations) or the operational circular dated 10 August 2021, as amended (Operational Circular), nor the November 3 Circular legislate the process or diligence for conversion of unsecured issue to secured issue or supplementing additional security for an existing secured issue. After the introduction of the distributed ledger technology for secured issuance on April 1 this year, SEBI for better investor protection, widened its net to cover due diligence and security creation for security offered after the issue date. Accordingly, the provisions in the November 3 Circular have been revised vide circular no. SEBI/HO/DDHS/DDHS_Div1/P/CIR/2022/106 dated 4 August 2022 (Circular) to ensure that the guidelines for due diligence which were prescribed for the primary security apply similarly to additional security or when an unsecured issue is converted to a secured issue.

- A. Roadmap for change in security or creation of additional security or conversion of unsecured to secured in case of already listed NCS
 - i. Amendment to Debenture Trustee Agreement: The trustee and the issuer, issuing the NCS (Issuer) are required to enter into an amended debenture trustee agreement to incorporate (a) the obligations arising out of the November 3 Circular *inter alia* to capture the details of new security, encumbrance on such security, terms and conditions of exercising due diligence; (b) periodical monitoring and disclosure requirements under the SEBI circular dated 12 November 2020 (November 12 Circular); and (c) any other circular or stipulation by SEBI pertaining to due diligence and continuous monitoring by trustee.
 - ii. Due diligence by debenture trustee: The trustee will conduct due diligence in accordance with the process laid down under the November 3 Circular *inter alia* verifying that the fresh security being offered is free from any encumbrances or necessary permissions or consents have been obtained from existing charge holders. Pursuant to the initial due diligence, trustee shall issue a no-objection

certificate (NOC) to the Issuer to proceed with the proposed change in structure of NCS and creation of security.

- iii. Amendment of debenture trust deed and perfection of charge: The Issuer and the trustee shall enter into a supplemental debenture trust deed to incorporate all the terms and conditions of the (a) due diligence conducted by the trustee; and (b) security created by the Issuer.

Thereafter, the Issuer shall create the charge over such security and the charge shall be registered in favour of trustee with the sub-registrar, registrar of companies, Central Registry of Securitisation Asset Reconstruction and Security Interest (CERSAI), Depository etc., as applicable, within 30 days of creation of charge.

Any encumbrance created on shares and other securities for securing the NCS shall be through the depository system only, which necessarily means that such securities need to be in dematerialised form. 'Encumbrance' for this purpose, has been widely defined and includes: (a) pledge, hypothecation, lien, negative lien, non-disposal undertaking or non-disposal agreement; (b) any restriction on the free and marketable title to securities; and (c) any covenant, transaction, condition or arrangement in the nature of encumbrance.

- iv. Approval of stock exchange where NCS is listed: The Issuer is required to submit the following documents to the depositories and stock exchanges:

- (a) NOC issued by the trustee for change in security or creation of security;
- (b) executed supplemental debenture trust deed;
- (c) undertaking from the trustee that the security has been created and registered; and
- (d) documents and consents required to be submitted to stock exchanges and depositories for obtaining prior approval under Regulation 59 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR Regulations) for change in structure of NCS (which includes *inter alia* approval from board of directors of the Issuer and the trustee; consent in writing from existing debenture holders).

- v. New ISIN: Post receipt of documents as mentioned above, the depository shall assign a new ISIN to the NCS and share the information with respect to change in ISIN of NCS, with the recognized stock exchanges.

B. Aligning the due diligence certificate (DD Certificate) at the draft stage and shelf/tranche stage

- i. DD Certificate for secured issuances at draft stage: In the event security is not confirmed at the time of filing draft shelf prospectus/ placement memorandum, the trustee is required to provide a due diligence certificate as per the format provided in Schedule IV of NCS Regulations and Annexure A of November 3 Circular, for the clauses other than security related clauses.
- ii. DD Certificate for secured issuances at tranche memorandum/prospectus stage: The trustee shall provide a due diligence certificate as per the format provided

in Schedule IV of NCS Regulations and Annexure A of November 3 Circular, covering all the clauses specified in the formats since the issue structure including the terms related to security has been finalized at shelf stage.

Accordingly, the trustee, is required to provide the due diligence certificate, in the format prescribed under Annexure A (as stated above) twice: at the draft and tranche stage, respectively. Further, Annexure B of November 3 Circular is required to be provided by the trustee to the Issuer, as a re-requisite to final listing of NCS.

C. Board approved policy for empanelment of external agencies by trustees

To appoint external agencies for due diligence purposes as per the November 3 Circular and November 12 Circular, the trustees are required to:

- i. adopt an empanelment policy, approved by their board of directors and disclose the same on their website; and
- ii. formulate a policy on conflict of interest and disclose the same on their website. Policy on conflict of interest shall include a requirement that the empanelled agency would have no pecuniary relationship with the Issuer 3 years prior to the issue.

D. Compliance with SEBI Circulars on 'Security & Covenant Monitoring System'

Stakeholders viz. issuers, depositories, trustees and credit rating agencies shall ensure compliance with the SEBI circular dated 13 August 2021 and 29 March 2022, respectively and various circulars issued by SEBI from time to time in respect of the distributed ledger technology system, to ensure efficient recording of details regarding creation of security and monitoring of covenants.

Comments:

SEBI has now resolved another set of operational challenges faced by market participants in complying with certain provisions of the November 3 Circular by trustees for security creation after completion of primary issue which had not been prescribed earlier. Further, provisions have been introduced for certification of security related provisions after the draft stage when security is finalized, hence resolving the practical difficulties faced by trustees.

With the coming into effect of distributed ledger technology and due diligence of additional collateral, some would argue that the procedure for issuance of listed NCS has become too rigid and prescriptive. However, the additional provisions introduced by the Circular for monitoring the quality of the collateral with effective due diligence at all stages of security creation, will reduce the risk of defaults and will definitely be welcomed by the domestic and foreign investors. Consequently, these enhanced guidelines are a welcome move and will help deepen investor confidence and the overall corporate bond market.

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