Hybrid Instruments & FOCCs: Decoding OCDs and OCPS Under FEMA

The article explores the regulatory complexities surrounding investments by Foreign Owned or Controlled Companies (FOCCs) in hybrid instruments like Optionally Convertible Debentures (OCDs) and Optionally Convertible Preference Shares (OCPS) under FEMA. It clarifies that while these instruments blend debt and equity features, they are treated as debt under Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, as amended from time to time, and governed by External Commercial Borrowings (ECB) regulations. The Supreme Court's ruling in IDBI Trusteeship v. Hubtown Ltd. emphasized that assured returns violate FEMA norms and downstream investments by FOCCs must be in equity instruments. The article concludes that FOCCs may invest in non-equity instruments without triggering FDI conditions, but conversion into equity reclassifies the investment as downstream, requiring compliance with pricing and sectoral norms. Company Secretaries are advised to monitor conversion terms and regulatory triggers closely to ensure compliance.

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INTRODUCTION

The regulatory treatment of investments made by Indian entities classified as FOCCs into hybrid instruments such as Optionally Convertible Preference Shares (OCPS) and Optionally Convertible Debentures (OCDs) of another Indian entity has long been mired in uncertainty. Despite the existence of a broader framework under the Foreign Exchange Management Act, 1999 (FEMA) and the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, the specific nuances surrounding FOCCs investing in such instruments within India are addressed in this article. This article seeks to critically analyse the regulatory areas, focusing exclusively on the issuance and investment in hybrid instruments by FOCCs. To provide a structured and comprehensive understanding, the discussion is divided into six distinct parts, each exploring a key facet of the issue and culminating in a reasoned conclusion.

TERMINOLOGIES AND THEIR LEGAL DEFINITIONS

1. **Debentures**: As per Section 2(30) of the Companies Act, 2013, "debenture" includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

   Provided that:

   a. the instruments referred to in Chapter III-D of the Reserve Bank of India Act, 1934; and

   b. such other instrument, as may be prescribed by the Central Government in consultation with Reserve Bank of India, issued by a company, shall not be treated as debenture.

2. **Preference Shares:** As per Section 43 of the Companies Act, 2013 –

   Clause (ii) "preference share capital", with reference to any company limited by shares, means that part of the issued share capital of the company which carries or would carry a preferential right with respect to—

   a. payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and

b. repayment, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.

Clause (iii) capital shall be deemed to be preference capital, notwithstanding that it is entitled to either or both of the following rights, namely:

- that in respect of dividend, in addition to the preferential rights to the amounts specified in sub-clause (*a*) of clause (*ii*), it has a right to participate, whether fully or to a limited extent, with capital not entitled to the preferential right aforesaid.
- that in respect of capital, in addition to the preferential right to the repayment, on a winding up, of the amounts specified in sub-clause (*b*) of clause (*ii*), it has a right to participate, whether fully or to a limited extent, with capital not entitled to that preferential right in any surplus which may remain after the entire capital has been repaid.

3. **Foreign Owned or Controlled Company (FOCC)**

A Foreign Owned or Controlled Company (FOCC) in any business that is owned or managed by an individual who does not reside in India.

- **Ownership:** A company where more than 50% of its paid-up capital (on a fully diluted basis) is owned by a Person resident outside India. A person who resides outside of India owns more than half of the capital and the majority of the profit share in an LLP.
- **Control:** In business, control refers to the power to make crucial decisions or influence the company's direction. This can happen through:
  - Appointing a majority of the directors.
  - Managing or influencing company policies and decisions.
  - Holding a significant number of shares or voting rights.
  - Having rights through shareholder or voting agreements.

In case of LLP, control refers to the authority to appoint the majority of designated partners, where these designated partners; to the exclusion of others, exercise control over all the policies of the LLP.

HYBRID INSTRUMENT

Hybrid instruments are financial securities that combine features of both debt and equity. They offer fixed returns like debt but also provide the potential for ownership and capital appreciation like equity. In the evolving landscape of corporate finance, hybrid instruments have gained prominence for their ability to blend the characteristics of debt and equity. Among these, OCPS and OCDs stand out as versatile tools for raising capital while offering flexibility to both issuers and investors.

Optionally Convertible Debentures (OCDs) are hybrid debt instruments that provide the holder with two distinct options: they can either convert the debentures into equity shares of the issuing company at a later date based on predetermined terms or redeem them for cash. Until the holder exercises one of these options, OCDs carry a fixed rate of interest, offering predictable returns.

Similarly, Optionally Convertible Preference Shares (OCPS) grant the holder the flexibility to either convert the preference shares into equity shares or redeem them, depending on their investment strategy. These instruments typically offer fixed dividends until conversion or redemption, making them attractive to investors seeking both income stability and potential equity participation.

> Hybrid instruments offer fixed returns like debt but also provide the potential for ownership and capital appreciation like equity.

Both OCDs and OCPs exemplify hybrid financial instruments, blending the characteristics of debt and equity to provide flexibility in corporate financing and investment planning.

COVERAGE UNDER FDI

The Foreign Exchange Management Act, 1999 (FEMA), in conjunction with the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, provides a comprehensive framework for foreign investments in India. These rules define the scope of equity instruments and clearly delineate which instruments fall within the ambit of non-debt instruments and which do not.

Let us examine how the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, framed under FEMA, address the regulatory treatment of OCPS and OCDs.

- 'Equity Instruments' are equity shares, convertible debentures, preference shares and share warrants issued by an Indian company.
- Non-convertible/ optionally convertible/ partially convertible debentures, funds for which have been received after June 07, 2007, shall be treated as debt and shall conform to External Commercial Borrowing (ECB) guidelines framed under Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2018, as amended from time to time.

- Non-convertible/ optionally convertible/ partially convertible preference shares funds for which have been received after April 30, 2007 shall be treated as debt and shall conform to guidelines framed under Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2018, as amended from time to time.

It has been observed that OCDs and OCPS reflecting their hybrid nature and conditional treatment are explicitly treated as debt and excluded from the scope of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019. Instead, these instruments fall under the purview of the Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2018, and therefore, are not treated as downstream investments under FEMA.

EXTERNAL COMMERCIAL BORROWINGS AND HYBRID INSTRUMENTS

As per the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 certain hybrid instruments such as OCDs and OCPS are treated as debt instruments and are therefore governed by the Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2018 i.e., External Commercial Borrowings (ECB) guidelines. In order to ascertain whether investments made by a FOCC in OCDs and OCPS fall within the ambit of the ECB framework, it is imperative to examine the statutory definition of ECB, the permissible forms of ECB, and the eligibility criteria prescribed for recognized lenders under the applicable regulatory regime.

a) **Meaning:** External Commercial Borrowings are commercial loans raised by eligible resident entities from recognised non-resident entities and should conform to parameters such as minimum maturity, permitted and non-permitted end-uses, maximum all-in-cost ceiling, etc.

b) **Forms of ECB:** The Forms of ECBs through which eligible resident entities can borrow funds from recognised non-resident entities are as follows:

c) **Foreign Currency (FCY) Denominated ECBs:** These are borrowings raised in currencies other than Indian Rupees and include the following instruments:

    - Loans, including bank loans from foreign lenders.
    - Floating or fixed rate notes, bonds, or debentures (excluding fully and compulsorily convertible instruments).
    - Trade credits with a maturity period exceeding 3 years.
    - Foreign Currency Convertible.
        - Bonds (FCCBs).
        - Foreign Currency Exchangeable Bonds (FCEBs).

d) **Indian Rupee (INR) Denominated ECBs:** These borrowings are raised in Indian Rupees and include:

    - Loans, including bank loans from foreign lenders.
    - Floating or fixed rate notes, bonds, debentures, or preference shares (excluding fully and compulsorily convertible instruments).
    - Trade credits with a maturity period exceeding 3 years.
    - Financial leases.
    - Plain vanilla Rupee-denominated bonds issued overseas, which may be privately placed or listed on foreign exchanges as per host country regulations.

e) **Definition of Recognized lenders:** The lender should be resident of FATF or IOSCO compliant country, including on transfer of ECB. However:

    - multilateral and regional financial institutions where India is a member country will also be considered as recognised lenders;
    - individuals as lenders can only be permitted if they are foreign equity holders or for subscription to bonds/debentures listed abroad; and
    - foreign branches/subsidiaries of Indian banks are permitted as recognised lenders only for FCY ECB (except FCCBs and FCEBs). Foreign branches/ subsidiaries of Indian banks, subject to applicable prudential norms, can participate as arrangers/ underwriters/market-makers/traders for Rupee denominated Bonds issued overseas. However, underwriting by foreign branches/subsidiaries of Indian banks for issuances by Indian banks will not be allowed.

Upon examining the prescribed forms of External Commercial Borrowings (ECB), it is evident that instruments such as Non-Convertible Debentures, Non-Convertible Preference Shares, and Optionally Convertible Debentures and Optionally Convertible Preference Shares are governed under the ECB framework. However, the applicability of ECB regulations is contingent upon the source of funds.

Specifically, ECBs must be raised from non-resident entities recognized as eligible lenders under the relevant RBI guidelines. Accordingly, while direct lending of funds by foreign residents in the form of OCDs and OCPS in the Indian entities may fall within the scope of ECB regulations, investments made by a FOCC, being an Indian resident entity, do not qualify as ECBs. Such investments, therefore, lie outside the purview of the ECB framework.

SUPREME COURT CASE LAW ON HYBRID INSTRUMENTS

In the landmark case of *IDBI Trusteeship Services Ltd. v. Hubtown Ltd.,* the Supreme Court of India addressed critical questions surrounding the legality of hybrid instruments—specifically Compulsorily Convertible Debentures (CCDs) and Optionally Convertible Debentures (OCDs)—in the context of Foreign Direct Investment (FDI) and downstream investment under the Foreign Exchange Management Act, 1999 (FEMA).

a) **Background**

The case involved a foreign investor, FMO, investing in CCDs issued by an Indian company, Vinca Developers Pvt. Ltd., which was classified as a Foreign Owned or Controlled Company (FOCC). Vinca, in turn, made downstream investments into two Indian companies—Amazia Developers and Rubix Trading— through OCDs. The structure raised concerns about compliance with FEMA and FDI norms, particularly regarding the assurance of fixed returns.

b) **Key Judicial Findings**

- **Assured Returns Violate FEMA:** The Court emphasized that FDI must not carry an assured return. Any structure that guarantees a fixed rate of return—such as OCDs with back-ended coupons or fixed interest payouts—violates FEMA regulations. Such instruments are treated as debt, not equity, and are therefore impermissible under the automatic route for FDI in sectors where only equity investment is allowed.
- **Downstream Investment Must Be in Equity Instruments:** The judgment clarified that downstream investment by a FOCC must be in equity instruments, including CCDs, which are treated as equity under FDI norms. However, OCDs, unless mandatorily convertible and devoid of fixed returns, do not qualify as equity instruments and may attract regulatory scrutiny.
- **Implications for Corporate Structuring:** This ruling serves as a cautionary tale for companies structuring FDI-linked transactions. It underscores the importance of:
    - ensuring compliance with FEMA and FDI norms;
    - avoiding assured returns in hybrid instruments; and
    - using mandatorily convertible instruments for downstream investments by FOCCs.

CONCLUSION AND PRACTICAL SUGGESTIONS FOR COMPANY SECRETARIES

It has been observed that neither the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 nor the External Commercial Borrowings (ECB) Regulations explicitly govern investments made by a Foreign Owned or Controlled Company (FOCC) into hybrid instruments—such as redeemable preference shares or debentures of another Indian entity.

The Reserve Bank of India (RBI) has clarified that ECB conditions would be triggered only if such investments are made using borrowed funds. Furthermore, the RBI has stated that if the terms of these redeemable instruments are subsequently modified to allow conversion into equity shares, such modification would be treated as a contravention of downstream investment norms, effective from the original date of investment.

Hence, it can be argued that FOCC is permitted to invest also in non-equity instruments of an Indian company without complying with FDI conditions. Also, such investments are generally permissible under the Companies Act, 2013 being a primary legislation for issuance of securities. However, upon conversion of such securities into equity instruments, it becomes downstream investment and FDI conditions need to be complied with. Going by this approach, pricing guidelines should apply only on conversion and not at the time of original investment in non-capital instruments.

Another issue rises regarding the pricing norms, and it has been concluded that if investment in OCPS and OCDs is not a downstream investment, pricing guidelines would not be applicable at the time of subscription rather it will be applicable at the time of conversion. However, once these instruments are converted into equity, the transaction is deemed to be a downstream investment, thereby triggering the requirement to comply with FDI conditions, including sectoral caps, entry routes, and pricing norms.

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