

Capital Markets Hotline

December 23, 2014

ACCESS TO GLOBAL CAPITAL MARKETS MADE EASIER!

- New Depository Receipts Scheme notified, made applicable from December 15, 2014;
- Depository Receipts may be issued on the back of all securities as defined under the Securities Contract Regulation Act, 1956;
- Issuance of unsponsored Depository Receipts allowed;
- New Depository Receipts Scheme largely based on the recommendations made by the Sahoo Committee. At our webinar conducted recently, M.S. Sahoo (chairman of the Sahoo Committee) and our panel of experts have discussed the various legal, tax, and commercial implications of the Depository Receipts Scheme. To view the event material, please click [here](#).

INTRODUCTION

Depository Receipts (DRs) in India were governed by the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 ("**1993 Scheme**") as amended from time to time. On October 21, 2014, the Ministry of Finance ("**MoF**") notified ("**Notification**"), the **Depository Receipts Scheme, 2014 ("**New Scheme**")** by virtue of which issuance of DRs has been taken out of the 1993 Scheme and is now regulated by the New Scheme. The New Scheme has come into effect from December 15, 2014.

The New Scheme is based on the **recommendations of the Sahoo Committee**, which under the chairmanship of Mr. M.S. Sahoo undertook a comprehensive review of the 1993 Scheme and proposed significant deregulation and rationalisation of the manner in which Indian companies could tap global capital markets.

FRAMEWORK OF THE NEW SCHEME

Broadly, the Scheme has been introduced with the intention to provide the Indian firms, domestic investors and foreign investors freedom to access financial markets within the prevalent foreign investment regime in India. Therefore, the provisions of the New Scheme are aimed at bringing the DR route at par with any other foreign investment. Following are the key provisions introduced under the New Scheme:

I. Requirement for approval for issuance of DR

As per the 1993 Scheme, for issuance of DRs, prior approval of the Ministry of Finance (MoF) was required. The New Scheme has done away with this requirement. However, the issue and transfer of permissible securities to a person resident outside India to form the underlying for DRs would still require approvals, if any, under the Foreign Exchange Management Act, 1999 ("**FEMA**").

II. Eligibility Criteria

a. For Issuer of Underlying Securities

Under the New Scheme, any Indian company, listed or unlisted, private or public or any other issuer or person holding permissible securities is eligible to issue or transfer permissible securities to a foreign depository for the purpose of issuance of DRs. Except for persons barred from accessing international capital markets, no restrictions as such have been set out under the New Scheme as regards Indian issuer of securities.

b. For Issuer of DRs

As per the New Scheme, a regulated entity having the legal capacity to issue DRs i.e. a person which is not prohibited from acquiring permissible securities; is regulated in a permissible jurisdiction; and has the legal capacity to issue depository receipts in the permissible jurisdiction, may issue DRs. As per the 1993 Scheme, only a bank authorized by the issuer of underlying securities could issue DRs.

c. For Custodian of DRs

As per the New Scheme, any regulated entity having legal capacity for underlying securities can act as the custodian. A domestic custodian has been defined to include a custodian of securities, an Indian depository, a depository participant, or a bank and having permission from SEBI to provide services as custodian. Under the 1993 Scheme, only a banking institution could be a domestic custodian of DRs.

III. Kinds of issue of DRs

Under the New Scheme, both the category i.e. sponsored and unsponsored DRs can be issued on the back of permissible securities. Unsponsored DRs can be issued on the back of listed permissible securities *only* if two conditions are fulfilled viz., (i) DRs give the holder the right to issue voting instructions and (ii) the DRs are listed on an international exchange. International exchange as per the New Scheme has been defined to mean a platform for

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trading of depository receipts in a permissible jurisdiction is accessible to the public for trading and provides pre-trade and post-trade transparency to the public.

IV. Permissible Securities

As per the 1993 Scheme, DRs could be issued only on the back of equity shares of Indian companies and were not required to be in dematerialized form. Further, the 1993 Scheme suggested that DRs could be issued on the back of foreign currency convertible bonds ("FCCBs") as well. As per the New Scheme, DRs can be issued on the back of any permissible securities ("Permissible Securities"). Permissible Securities has been defined to include securities as defined in the Securities Contracts (Regulation) Act, 1956 ("SCRA") whether issued by a company, mutual fund, government or any other issuer and similar instruments issued by private companies. All permissible securities are required to be in dematerialized form before they can be used as underlying for a DR issue.

V. Jurisdictions for Issue of DRs

As per the 1993 Scheme, a listed company could issue DRs in any jurisdiction across the world for listed companies and unlisted companies could issue DRs in either FATF or IOSCO compliant jurisdictions. As per the New Scheme, a company, whether listed or unlisted, can issue shares for issue of DRs only in permissible jurisdictions ("Permissible Jurisdictions"). As per the New Scheme, a Permissible Jurisdiction would be a foreign jurisdiction that satisfies twin requirements i.e. the foreign jurisdiction is a member of the FATF **and** the securities regulator of that jurisdiction is a member of IOSCO. The New Scheme provides a list of 34 permissible jurisdictions as on date of the Notification.

VI. Pricing

The New Scheme does not prescribe any specific pricing norms for issuance of DRs. The only restriction imposed under the New Scheme is that Permissible Securities shall not be issued to a foreign depository at a price less than the price applicable to a corresponding mode of issue of such securities to domestic investors under applicable laws. In accordance with FEMA, pricing of ADR/GDR issues shall be done as per guidelines issued by the Reserve Bank of India ("RBI"). For the purpose of issue of depository receipts for listed companies, the minimum pricing norms as applicable under the SEBI Guidelines shall be complied with.

VII. End Use Restrictions

Partial end – use restrictions were specifically imposed on utilization of funds raised from issuance of DRs, these funds being prohibited from being deployed or invested in real estate and stock market. The New Scheme does not provide for any end-use restrictions on the deployment of proceeds from issuance of DRs. Although, there are no restrictions on deployment of proceeds from issue of DR, restrictions as applicable under FEMA shall still be applicable.

VIII. Public Shareholding and Voting Rights

As per the New Scheme, the voting rights should be exercised by the foreign depository in respect of underlying securities; the depository may take instructions from DR holders. If the DR holders have the right to instruct the depository to vote on their behalf, they would have the same obligations as if it is the holder of the underlying equity shares under the SEBI (Substantial Acquisition of Shares and *Takeovers*) Regulations, 2011 ("Takeover Code"). Also, shares of a company underlying the DRs shall form part of 'public shareholding' (i) if the holder of the securities has the right to issue voting instructions and (ii) such DRs are listed on an international stock exchange. The New Scheme has attempted to bring this provision in line with the Takeover Code which includes all depository receipts carrying an entitlement to exercise voting rights in the target company within the definition of 'shares' for the purpose of the Takeover Code. Therefore, this would enable the DRs with voting rights to count for public shareholding as well as have obligations under the Takeover Code.

IX. Market Abuse

Sahoo Committee was conscious of the risk that DR Route may expose the Indian securities market to potential market abuse and money laundering. No explicit provision as the authority which is to be approached in case of market abuse was provided under the 1993 Scheme. To put an oversight mechanism, New Scheme categorically provides that use of DRs or market of DRs which has potential to cause or has caused abuse of securities market in India shall be dealt with by SEBI.

LACK OF TAX CLARITY

As regards, tax treatment, presently under the Income Tax Act, 1961 ("IT Act"), a non-resident to non-resident transfer of DRs is exempt from capital gains tax, whilst a non-resident to resident transfer of DRs is subject to capital gains tax at a 10% rate (exclusive of surcharge and education cess).

However, DRs, as envisaged under the IT Act at present, do not include DRs issued on the back of securities other than ordinary shares. The provisions of the IT Act would need to be amended to also include DRs issued on the back of other Permissible Securities for the above benefits to be carried forward.

Further, at present, there is no specific exemption from capital gains tax contained in the IT Act for conversion of a DR. The Sahoo Committee had recommended conversion of DRs into Permissible Securities and vice versa should not be considered as taxable events in India since DRs since the underlying securities should be treated as the same asset. We await amendments in the next budget adding an exemption similar to the exemption provided to conversion of compulsorily convertible debentures.

Also, clarity would also be needed as regards the computation of holding period for capital gains tax as to whether the period for which the foreign investor holds the DRs should also be taken into account for calculating the capital gains tax arising out of sale of the underlying securities by the foreign investor in the domestic market.

One of the other recommendations of the Sahoo Committee was that tax treatment for tendering shares by shareholders of a listed company for issue of DRs should be aligned with that of sale of shares on a stock exchange. As of now, this recommendation has not been incorporated in the IT Act either.

We await amendments in relation to taxation of transactions in relation to DRs in the next budget.

ANALYSIS

A green flag for unsponsored DRs would mean that present investors in Indian companies can initiate DR programmes without the co-operation of the company. Existing investors will now have a viable exit option along with access to an alternate foreign capital markets. For instance, this will allow private equity and venture capital funds to cash out in case the Indian company delays or resists going public.

The New Scheme has also attempted to plug loopholes in the 1993 Scheme thereby providing filip to the foreign investment regime in India, although some concerns continue to remain unaddressed.

Treating DR Route like any other foreign investment route, Sahoo Committee had recommended that DRs be allowed to be issued on the back of all kinds of securities such as bonds, debentures, government securities, units of mutual fund, ETFs, derivative products and on a range of securities. However, for DRs to be issued on the back of debt, such as non-convertible bonds issues by an Indian company, the depository will need to be qualified as an Foreign Portfolio Investor, for instance besides other challenges. The exchange control regime needs to be amended to allow DRs to go beyond the FDI regime.

However, as detailed above, until there is clarity on the tax treatment of issuance and conversion/transfer of DRs and the Indian tax policy is made compatible with global standards, the New Scheme may not be able to achieve much.

– **Tanya Pahwa, Sriram Govind, Ruchir Sinha & Nishchal Joshipura**
You can direct your queries or comments to the authors

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