

## Paper 17

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### Legal and Tax Considerations Confronting Indian Companies Issuing GDRs/ADRs© - Nishith M. Desai

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#### Synopsis

#### Legal and Tax Considerations Confronting Indian Companies Issuing GDRs/ADRs©

- Introduction
- Basic definitions
  - Euroissue
  - Depository Receipts
- Parties involved in a GDR/ADR issue
  - Issuer Company
  - Lead Manager
  - Co-Managers/Underwriters
  - Depository
  - Custodian
  - Legal Advisors
  - Auditors
- Structure
- GDRs/ADRs
- Agreements to be executed and related documents
  - Prospectus
  - Subscription agreement between the investors and the Underwriters
  - Underwriting agreement between the Issuer Company and the Underwriters
  - Custodian agreement between the Depository and the Custodian
  - Depository agreement between the Issuer Company and the Depository
  - Listing agreement with the overseas stock exchange filed by the Issuer Company
  - Domestic listing agreement filed by the Issuer Company
  - Lock-up agreements
- Procedural requirements for a GDR/ADR issue
  - U.S. Generally Accepted Accounting Principles ("**GAAP**")
  - Preliminary meetings
  - Authorization by the board of directors
  - Organizational meetings
  - Legal and accounting due-diligence on the Issuer Company
  - Authorization by the shareholders
  - Statutory approvals

- Application for listing the additional shares on an Indian stock exchange
- Filings
- Pricing
- Taxation of GDRs/ADRs
  - Taxation of shares issued under GDR/ADR mechanism
  - Application of avoidance of double taxation agreement in case of GDRs/ADRs and underlying shares after redemption
  - Gift tax and wealth tax
- Stamp duty and transfer tax
- Estate duty
- Exchange control regulations
  - Foreign direct investment
    - Foreign direct investment in preference shares
  - Transfer of GDRs/ADRs
  - Transfer of shares underlying GDRs/ADRs
  - Investment by NRIs and OCBs
  - Investment by FIIs
    - Ownership restrictions
    - Taxation
  - Restrictions on deposit of underlying shares into the ADS facility
- Company law issues
  - Shares held in trust
  - Preferential allotment of shares
  - Acquisitions
  - Liquidation rights
  - Buy-back of shares
  - Transfer of shares
- Listing issues
- Takeover regulations
- Indian depository issues

## Legal and Tax Considerations Confronting Indian Companies Issuing GDRs/ADRs©

### Introduction

Since the onset of globalization and internationalization of the Indian economy in 1991, India has attracted foreign investment worth Rs. 179 billion<sup>1</sup> and is fast emerging as an important business destination for western capital ventures.

In 1994, the total inflow of foreign investment was Rs. 29.8 billion and the corresponding amount for 1995 was Rs. 63.7 billion. During the first half of the financial year ending September 30, 1996, the total foreign investment in to India was Rs. 57.1 billion<sup>2</sup>. As regards Indian Global Depository Receipt (“**GDR**”) programs, in 1995, only USD 235 million was raised from four such programs, as compared to 1994’s forty GDR programs worth USD 3 billion<sup>3</sup>.

### Basic definitions

#### ***Euroissue***

Euroissue (from the Indian perspective) is a method or mode by which Indian companies raise funds outside India in foreign currency. The word ‘Euro’ denotes an issue of securities which are listed on a European stock exchange for which the subscription to the issue can come from any part of the world.

#### ***Depository Receipts***

Depository receipts are basically negotiable instruments denominated in U.S. dollars, representing a non-U.S. company’s publicly-traded local currency equity shares (“**Depository Receipts**”). They are created when the local currency shares of an Indian company are delivered to the overseas depository bank’s domestic custodian bank, against which, the Depository issues Depository Receipts in U.S. dollars. Each Depository Receipt may represent one or more underlying shares. Through these issues, market companies in India have been able to tap the global equity market to raise foreign currency funds by way of equity. The Depository Receipts may be traded freely on an exchange or an over-the-counter market.

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<sup>1</sup> Source: “Actual FDI inflow shows a decline: SIA”, The Financial Express, November 2, 1996.

<sup>2</sup> *Id.*

<sup>3</sup> Source: “Funds more choosy on Indian GDR/ADR offers”, The Times of India, March 21, 1996.

Depository Receipts can be either GDRs which are usually listed on a European stock exchange, or American Depository Receipts ("**ADRs**") which are usually listed on an U.S. stock exchange.

### **Parties involved in a GDR/ADR issue**

To make a successful global issue, an Issuer Company requires the wholehearted cooperation and sincere efforts of many persons and agencies, each having a definite role to play. The roles of the various persons involved in a GDR/ADR issue can be explained as follows:

#### ***Issuer Company***

It is the company that plans to tap the foreign market through the global issue mechanism. It is responsible for the formulation of issue proposals (the "**Issuer Company**").

#### ***Lead Manager***

The lead manager is the person responsible for marketing the issue (the "**Lead Manager**"). The Lead Manager advises the Issuer Company on the type of security to be issued *i.e.* equity, Bonds, Foreign Currency Convertible Bonds ("**FCCBs**") and the rate of interest, price of the security, *etc.* The Lead Manager decides also on the nature of investment *i.e.* GDR/ADR/FCCB, coupon rate on bonds, conversion price, *etc.*

#### ***Co-Managers/Underwriters***

They assist the Lead Manager in fulfilling its obligations to the Issuer Company (the "**Co-Managers/Underwriters**").

#### ***Depository***

It is the bank authorized by the Issuer Company to issue GDRs/ADRs against issue of FCCBs or ordinary shares of the Issuer Company (the "**Depository**")<sup>4</sup>. It is the overseas agent of the Issuer Company who issues the GDR/ADR to the investors in lieu of shares allotted to him/her. The physical possession of the shares rests with the Custodian (as defined below) although the ownership of the shares vests with the investors. The Depository is the registered owner of the shares and its name appears in the Register of Members of the Issuer Company.

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<sup>4</sup> Paragraph 2(e) of the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993.

### **Custodian**

It is the banking company (situated in India) which acts as a custodian for the ordinary shares or FCCBs of an Indian company, issued by it against GDRs/ADRs or certificates (the "**Custodian**")<sup>5</sup>. The Issuer Company appoints the Custodian. The Custodian acts in coordination with the Depository. The physical possession of the shares is given to the Custodian.

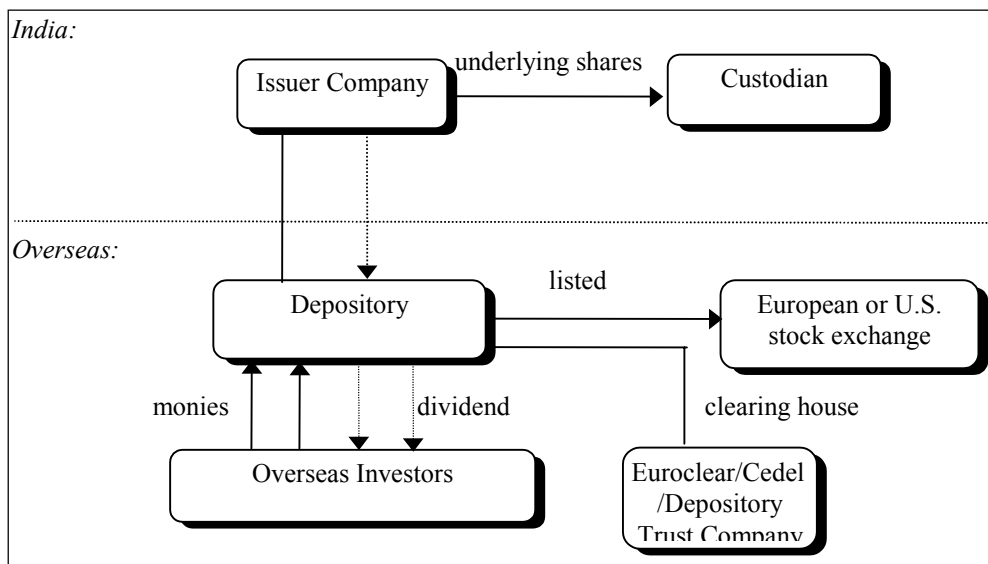
### **Legal Advisors**

They assist the Issuer Company, Lead Manager, Co-Managers and the Underwriters in the preparation of the prospectus, depository agreement, indemnity agreement and subscription agreement (the "**Legal Advisors**").

### **Auditors**

The Issuer Company must appoint auditors who will prepare the auditor's report for inclusion in the prospectus, provide requisite consent and comfort letters and reconcile the Issuer Company's accounts with international accounting standards (the "**Auditors**"). More importantly, the Auditors participate in the due diligence meetings for enabling the Issuer Company to comply with proper disclosures relating to the issue.

### **Structure**



<sup>5</sup> Paragraph 2(a) of the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993.

## GDRs/ADRs

A GDR/ADR means any instrument in the form of a Depository Receipt or certificate (by whatever name it is called) created by a Depository outside India and issued to non-resident investors against the issue of ordinary shares of the Issuer Company<sup>6</sup>. The issue of GDRs/ADRs are governed by the provisions of the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993 (the "**Scheme**")<sup>7</sup>.

### *Salient features of GDRs/ADRs*

- *Track-record.* The Issuer Company seeking permission for raising foreign funds by issue of GDRs/ADRs would be required to have a consistent track record of good performance (financial or otherwise) for a period of at least three years<sup>8</sup>. However, Issuer Companies making GDR/ADR issues to fund export projects or infrastructure projects (in sectors such as power, oil exploration, telecommunication, railways, etc.) need not have a past track record of financial performance<sup>9</sup>.
- *GDSs/ADSs.* A GDR or ADR may evidence one or more Global Depository Shares ("**GDSs**") or American Depository Shares ("**ADSs**") respectively and each GDS or ADS represents one underlying share of the Issuer Company.
- *Underlying shares.* The underlying shares are issued by the Issuer Company to the Depository (who is the registered owner of the shares), in whose name the shares are registered. It is the Depository which subsequently issues the GDRs/ADRs to the Underwriters for the final placement with the investors, whereas, the physical possession of the equity shares is entrusted to the Custodian, who is an agent of the Depository.
- *Denomination.* GDRs/ADRs are denominated in dollars or in some other freely convertible foreign currency and gives its holder the right to get equity shares of the Issuer Company against the GDR/ADR as per the terms of the offer. The underlying equity shares are however, denominated in Rupees. This removes the exchange risk for the Issuer Company.
- *Listing.* It is issued abroad and is listed and traded on a foreign stock exchange. GDRs are listed on the Luxembourg Stock Exchange, London Stock Exchange or on the over-

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<sup>6</sup> Paragraph 2(c) of the Scheme.

<sup>7</sup> Issued by the Department of Economic Affairs, Ministry of Finance. GSR No. 700(E), dated November 12, 1993.

<sup>8</sup> Paragraph 3(2) of the Scheme.

<sup>9</sup> Paragraph 4 of the Guidelines for Euro-Issues.

the-counter market in London<sup>10</sup>. Indian GDRs are usually listed on the Luxembourg Stock Exchange because of the minimum of formalities for listing and admission as well as relatively lower listing fees. ADRs are listed on the New York Stock Exchange (the "NYSE"), or on the American Stock Exchange (the "AMEX"), or quoted in the National Association of Securities Dealers Automated Quotation System (the "NASDAQ") in the U.S.

- *Settlement.* GDRs/ADRs are usually settled on a book entry basis through the system of Euroclear or Cedel in Europe and the Depository Trust Company in the U.S.
- *Lock-in.* There is no lock-in-period for the GDRs/ADRs issued pursuant to the Scheme<sup>11</sup>.
- *Dividend.* The dividend paid by the Issuer Company is in Rupees only, but the Depository converts these Rupees and pays the dividend (after withholding tax) to the ultimate investor, in U.S. dollars. Thus, there will be no exchange rate risk for the Issuer Company.
- *Voting.* GDR/ADR holders are not entitled to any voting rights, so the Issuer Company need not fear about losing management control. GDRs/ADRs are not shares. Therefore, GDR/ADR holders are not the Issuer Company's shareholders. Only Issuer Company's shareholders (members) are entitled to attend and vote at general meetings in terms of section 87 of the Companies Act, 1956 (the "**Companies Act**"). Since the underlying shares are held by the Depository, the Depository is entitled to vote at the general meetings of the Issuer Company<sup>12</sup>. Till redemption, the GDRs/ADRs do not carry any voting rights. However, once redemption takes place the holder of the underlying shares has the right to vote with regard to such shareholding.
- *Transfer.* GDRs/ADRs may be purchased, possessed, and are freely transferable by the non-resident (within the meaning of section 2(q) the Foreign Exchange Regulation Act, 1973 (the "**FERA**") subject to the provisions of that Act)<sup>13</sup>. GDRs/ADRs are freely tradable in the overseas market like any other dollar denominated security. The record of ownership in India does not change with every transfer of GDRs/ADRs and as such, the Issuer Company is in no position to control the registration of transfers.

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<sup>10</sup> Paragraph 6 of the Guidelines for Euro-Issues, Press Note F. No. S-II(25)/CCI-II/89/NRI, dated June 19, 1996, Issued by the Department of Economic Affairs (FT & Investment Division) Ministry of Finance ("**Guidelines for Euro-Issues**").

<sup>11</sup> Paragraph 5(5) of the Scheme.

<sup>12</sup> The Issuer Company regulates the voting by the Depository through the Depository Agreement entered into between the Depository and the Issuer Company.

<sup>13</sup> Paragraph 6 of the Scheme.

- *Redemption and sale.* The GDR/ADR holder has an option to redeem the GDRs/ADRs into the equity shares underlying it. In the case of redemption, the Depository will request the Custodian to get the corresponding underlying shares released in favor of the non-resident investor<sup>14</sup>. A copy of the same will be sent to the Issuer Company for information and record. The shares will then be handed over to the non-resident directly and such person will become a member of the Issuer Company and its name will be entered in the Register of Members of the Issuer Company<sup>15</sup>. If an investor desires to sell the shares represented by the GDR/ADR held by him/her, he/she can request the Depository who will forward the same to the Custodian to release and sell such shares and remit the sales proceeds to the investor.
- *Listing of underlying shares.* Once redemption takes place, the underlying shares are listed and traded on a domestic stock exchange. The underlying shares are denominated in Indian currency only.

#### *Advantages to investors*

- GDRs/ADRs are designated in foreign currency which is more acceptable to global investors.
- Global investors/holders of GDRs/ADRs do not need to be registered with the Securities and Exchange Board of India (the "**SEBI**").
- The identity of GDR/ADR holders is kept confidential since they are freely transferable.
- Quick settlement of GDRs/ADRs due to the existence of international systems like, Euroclear and Cedel in Europe and the Depository Trust Company in the U.S.

#### *Advantages to the Issuer Company*

- The Issuer Company collects the issue proceeds in foreign currency and is thus able to utilize the same for meeting the foreign exchange component of project cost, repayment of foreign currency loans, etc.
- Large amounts can be raised in the global market without much of a problem.
- The issue proceeds may be retained outside India and used for "approved end-uses" (which have been relaxed further), as and when the Issuer Company requires. The "approved end-uses" are detailed below<sup>16</sup>:
  1. Financing the import of capital goods;
  2. Domestic purchase of capital goods, including, purchase of plant, equipment, and buildings and investments in software development;
  3. Prepayment or scheduled repayment of earlier external borrowings;

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<sup>14</sup> Paragraph 7(2) of the Scheme.

<sup>15</sup> Paragraph 7(1) of the Scheme.

<sup>16</sup> Paragraph 7 of the Guidelines for Euro-Issues.



4. Approved investments abroad; and
  5. Equity investments in joint ventures/wholly-owned subsidiaries in India. Investments in stock markets and real estate are however, not permitted<sup>17</sup>.
- There is certainty of raising new capital and the issue terms are much better than those which can be obtained in the local market.
  - Dividend payable by the Issuer Company is in Rupees only.
  - Owing to the restrictive voting rights in the Depository agreement, control is not affected immediately.
  - It is possible for the Issuer Company to float more than one foreign equity issue in a year<sup>18</sup>.
  - The Issuer Company can use up to 25% of the total proceeds for general corporate restructuring, including working capital requirements<sup>19</sup>.
  - Banks, financial institutions, and non-banking finance companies can raise funds through equity issues abroad and use such funds for domestic lending. They are exempt from the end-use conditions stated above, however, they cannot use the GDR/ADR proceeds to invest in either, the stock market or real estate<sup>20</sup>.
  - Issuer Companies may retain the GDR/ADR proceeds abroad or remit the funds into India in anticipation of the use of funds for "approved end-uses"<sup>21</sup>.
  - Issuer Companies making a GDR/ADR issue to fund export projects or infrastructure projects (in sectors such as power, oil exploration, telecommunication, railways, etc.) need not have a past track record of financial performance which is otherwise, mandatory for companies seeking to raise equity funds from abroad<sup>22</sup>.

#### **Main agreements to be executed and related documents**

- Prospectus
- Subscription agreement between the investors and the Underwriters
- Underwriting agreement between the Issuer Company and the Underwriters
- Custodian agreement between the Depository and the Custodian
- Depository agreement between the Issuer Company and the Depository
- Listing agreement with the overseas stock exchange filed by the Issuer Company
- Domestic listing agreement filed by the Issuer Company
- Lock-up agreements

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<sup>17</sup> Paragraph 8 of the Guidelines for Euro-Issues.

<sup>18</sup> Paragraph 6 of the Guidelines for Euro-Issues.

<sup>19</sup> Paragraph 10 of the Guidelines for Euro-Issues.

<sup>20</sup> Paragraph 11 of the Guidelines for Euro-Issues.

<sup>21</sup> Paragraph 16 of the Guidelines for Euro-Issues.

<sup>22</sup> Paragraph 4 of the Guidelines for Euro-Issues.

## **Procedural requirements for a GDR/ADR issue**

The procedural requirements for issue of GDRs/ADRs are briefly set out herebelow:

- U.S. Generally Accepted Accounting Principles ("**GAAP**")
- Preliminary meetings
- Authorization by the board of directors
- Organizational meetings
- Legal and accounting due diligence on the Issuer Company
- Authorization by the shareholders
- Statutory approvals
- Application for listing the additional shares on an Indian stock exchange
- Filings

### ***U.S. GAAP***

In order to comply with the listing norms of an overseas stock exchange, the Issuer Company should get its balance sheet verified or overhauled by an internationally recognized firm of chartered accountants. Companies planning an issue of securities in the U.S. would have to ensure that their accounts for the past at least three years are reconciled with U.S. GAAP. This process generally takes between nine months to a year to complete.

### ***Preliminary meetings***

The Issuer Company generally holds preliminary discussions and meets with different global merchant/investment bankers (who would act as the Lead Manager, Co-Managers, Underwriters), Legal Advisors (Indian and foreign), Auditors, printers and other intermediaries before deciding to float a GDR/ADR issue.

### ***Authorization by the board of directors***

- The Issuer Company is required to pass a board resolution approving the proposed GDR/ADR issue.
- The Issuer Company's board should also approve the notice calling for a General Meeting of the shareholders for the purpose.
- It is advisable to constitute a Committee of Directors and confer on it necessary powers for approving various matters/documents connected with the Euroissue, once the Board of Directors of the Issuer Company has decided to float GDRs/ADRs in the global market. The following matters/documents could then be approved by the Committee of Directors namely:
  - (a) Prospectus
  - (b) Fixation of the issue price

- (c) Subscription agreement
  - (d) Depository agreement
  - (e) Custodian agreement
  - (f) Allotment of shares in favor of the Depository
  - (g) Opening of bank account outside India and operation of the said account
  - (h) Approval of Underwriters' green-shoe option
  - (i) Making/filing the necessary application with the Securities and Exchange Commission, U.S., and or making applications to Luxembourg Stock Exchange or other exchanges
  - (j) Signing and executing any deed, document, writing, confirmation, undertaking, indemnity in favor of any party including, Lead Manager, Co-Managers, Underwriters, Legal Advisors, accountants or others who may be related to the issue.
- As per the listing agreements of the stock exchanges, the Issuer Company should notify the stock exchange, the date of the board meeting at which the proposal will be considered as also inform it of the decision of the board.

### ***Organizational meetings***

The Issuer Company formally appoints the Lead Manager, Co-Managers, Underwriters to market the issue and organize the road shows, printers, Legal Advisors (Indian and foreign), Depository (to issue GDRs/ADRs to the Underwriters who arrange to place them with the ultimate investors), the Custodian (who physically holds the shares of the Issuer Company on behalf of the Depository) and the overseas bankers only after the application is filed with the Government of India, Ministry of Finance, Department of Economic Affairs.

The Issuer Company gives the necessary details about the Issuer Company to the Lead Manager, Co-Managers and other intermediaries. It also provides the relevant clarifications to the Indian and foreign Legal Advisors relating to legal matters of the company and the issue.

The Issuer Company will, along with the Lead Manager to the issue decide the following issues, namely<sup>23</sup>:

1. Public or private placement
2. The number of GDRs/ADRs to be issued
3. The issue price
4. The rate of interest payable on FCCBs
5. The conversion price, coupon, and the pricing of the conversion options of the FCCBs.

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<sup>23</sup> Paragraph 5(4) of the Scheme.

### ***Legal and accounting due diligence on the Issuer Company***

A team consisting of legal, technical, and financial key persons from the Lead Managers, Co-Manager, Underwriters, Legal Advisors and Auditors would visit the Issuer Company for carrying on legal and accounting due diligence. During the due diligence, the team usually collects various documents which assist them in preparing the prospectus. The Lead Managers/Legal Advisors generally interview the senior directors/executives and Auditors of the Issuer Company to ensure the accuracy of the description of the Issuer Company in the prospectus.

### ***Authorization by the shareholders***

- The shareholders must approve the proposed foreign issue of GDRs/ADRs by a special resolution<sup>24</sup> passed at a general meeting according to the provisions of section 81(1A) of the Companies Act. The special resolution is valid for a period of three months only.
- Approvals should be also taken from the Issuer Company's shareholders as per section 94 (increase in authorized share capital) section 16 (alteration of capital clause of the Memorandum of Association for change in Authorized share capital) and section 31 (alteration of share capital clause in Articles of Association) of the Companies Act, if required.
- Modify the main objects clause of the Issuer Company's Memorandum of Association and obtain shareholders approval<sup>25</sup>, if required.

### ***Statutory Approvals***

#### ***(i) Foreign Investment Promotion Board (the "FIPB")***

In May 1994, the Government announced that purchases by foreign investors of GDRs/ADRs and FCCBs of Indian companies will be treated as foreign direct investment<sup>26</sup> in the equity issued by Indian companies for such offerings. Therefore, issue of GDRs/ADRs by Issuer Companies in excess of 50%, 51% and 74% (depending upon the industry) in certain high priority industries listed in Annexure III to the New Industrial Policy, 1991 (which was expanded during January 1997) and any GDR/ADR issue by Issuer Companies not falling in the Annexure III list of industries would require FIPB approval.

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<sup>24</sup> Section 189 of the Companies Act defines special resolution as a resolution in which the number of votes cast in favour of the resolution exceed three time the number of votes cast against it.

<sup>25</sup> By way of a special resolution.

<sup>26</sup> Also see paragraph 4 of the Scheme.

(ii) *Government of India, Ministry of Finance, Department of Economic Affairs*

- An 'in-principle' approval has to be obtained from the Government, Department of Economic Affairs, Ministry of Finance<sup>27</sup> by furnishing full details in the prescribed form and receiving the necessary approvals. The Issuer Company must have a consistent track record of good performance (financial or otherwise) for a minimum period of three years<sup>28</sup>. However, no track record of financial performance is required for export projects, or infrastructure projects including power, telecommunications, oil exploration and railways. Approval of the Government is valid for a period of three months.
- Government approval is sought *inter alia* for issue size, terms of issue, issue price, payment of interest, conversion, redemption, payment of fees and expenses of the issue, appointment of Lead Manger, Depository, Custodian, and where listing of securities will be made including trading provisions and settlement provisions.
- Companies applying for GDR/ADR approval must specify the proposed end-use of the issue proceeds.
- Approval to the effect whether the issue proceeds should be kept outside India or remitted to India.
- Direction to the effect that the company shall submit within two weeks of the closing of the issue, a statement giving the following particulars namely:
  - (a) Full particulars of the issue price;
  - (b) Listing arrangements completed; and
  - (c) Total amount realized.
- After the issue structure is finalized with the Lead Manager to the issue, the Issuer Company must obtain the final approval from the Government, Department of Economic Affairs, Ministry of Finance<sup>29</sup>. The final approval is valid for a period of three months.

(iii) *Department of Company Affairs*

Approvals/clarification of the Department of Company Affairs should be sought *inter alia* for the following:

- Approvals to the effect that provisions of the Companies Act relating to issue of prospectus are not applicable.
- Clarification as to non-applicability of provisions of section 108 of the Companies Act for GDRs/ADRs issued.

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<sup>27</sup> Paragraph 3(1) of the Scheme.

<sup>28</sup> Paragraph 3(2) of the Scheme.

<sup>29</sup> Paragraph 3(3) of the Scheme.

- Clarification that section 187B and section 187C of the Companies Act do not apply.

(iv) *Reserve Bank of India (the "RBI")*

After obtaining the approval of the Government, Department of Economic Affairs, Ministry of Finance and the FIPB (if required), the Issuer Company would have to obtain the approval of the RBI<sup>30</sup>. Approval/general permission of the RBI is required for:

- foreign investors acquiring GDRs/ADRs<sup>31</sup>
- paying interest on the due date
- exporting certificates to the non-resident holders<sup>32</sup>
- appointing Lead Managers, Co-Managers to the issue
- appointing Depository and Custodian for the purpose of GDR/ADR
- paying issue related expenses
- remitting and pay for filing, listing, agency and other fees on-going basis in respect of any international stock exchange
- maintaining a foreign Register of GDR/ADR holders if required
- opening an account abroad to receive subscription monies in foreign currency and repatriate funds through banking channels to India
- paying any foreign tax in the nature of sales or value added tax in respect of services provided/reimbursements of out-of-pocket expenses
- paying/remitting dividends on shares
- issuing securities by way of rights/bonus that may accrue
- appointing trustees, agents, and registrar to the issue and payment of fees to them for services rendered
- remitting the proceed of any sale of rights or bonus issue
- free transfer of GDRs/ADRs outside India.

The RBI's approval will be valid for a period of three months from the date of the RBI's approval letter.

(v) *SEBI*

The Issuer Company would require SEBI approval to the effect that the provisions of rule 19(2)(b)<sup>33</sup> of the Securities Contracts (Regulation) Rules, 1957 would not be applicable.

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<sup>30</sup> According to Section 19(1)(d) of the FERA, approval of the RBI is required to make an issue to foreign investors.

<sup>31</sup> Section 29(1)(b) of the FERA.

<sup>32</sup> Section 19(1)(a) of the FERA.

<sup>33</sup> Rule 19(2)(b) required at least 25% of the fresh issue that is made by a listed company to be offered to the public.

*(vi) Other Approvals*

Prior to the launch of its issue, the Issuer Company must obtain the consent of the financial institutions/banks if it has obtained any financial facilities (term loans, guarantees etc.).

***Application for listing the additional shares on an Indian stock exchange***

The Issuer Company would be required to make an application for listing underlying shares on an Indian stock exchange on which shares of the Issuer Company are listed.

***Filings with***

(i) SEBI

Issue of shares requires the filing of the prospectus with SEBI for its information and records. The Prospectus must contain all disclosures and must comply with all accounting requirements. It must state that the equity shares issued upon conversion of GDRs/ADRs would be listed and admitted to dealings on the exchange and that the usual pre-listing requirements relating to purely Indian/domestic issue are not applicable.

(ii) Indian stock exchanges on which the shares of the Issuer Company are listed

A copy of the prospectus must be filed with the Indian stock exchanges on which the shares of the Issuer Company are listed.

(iii) Registrar of Companies

A copy of the prospectus must also be filed with the Registrar of Companies.

(iv) Department of Economic Affairs, Ministry of Finance

Issuer Companies must submit to the Department of Economic Affairs, Ministry of Finance, a quarterly statement of the utilization of the funds for the approved end-use.

**Pricing**

The marketing of a GDRs/ADRs issue is done by the Lead Manager, Co-Managers and the Underwriters who organize road shows (presentations made to potential investors). The road shows give the Issuer Company a clear indication of the investor response, thereby, enabling the Issuer Company to decide on the issue price.

The Issuer Company needs to carefully consider the pricing of the equity shares underlying the GDRs/ADRs. A good company's shares commands a premium in the stock market. The price of equity shares offered through the GDR/ADR route is usually determined with reference to the market prices prevailing during the week and the day prior to the date of issue. If there is a demand for such securities abroad, the pricing may be at a premium over the market price. Finalisation of the price of the equity shares is done in consultation with the Lead Manager who knows the pulse of the European/American investment market.

## Taxation of GDRs/ADRs

### *Taxation of shares issued under GDR/ADR mechanism*

- *Dividend.* Under the provisions of the Indian Income-tax Act, 1961 (the "ITA"), income by way of dividend on the underlying shares will not be subject to any withholding tax<sup>34</sup>. However, the Issuer Company would have to pay an additional tax of 10% on the total amount of dividend it declares, distributes or pays after June 1, 1997<sup>35</sup>. On receipt of these dividend payments, the Depository will distribute them to the non-resident investors proportionate to their holdings of GDRs/ADRs evidencing the relevant shares.
- *Transfer of GDRs/ADRs and shares outside India.* All transactions of trading of GDRs/ADRs and the shares underlying them outside India, among non-resident investors, will be free from any liability to income-tax in India on capital gains therefrom<sup>36</sup>.
- *Redemption.* No tax is payable on the redemption of GDRs/ADRs into underlying shares.
- *Cost of acquisition.* On redemption, the cost of acquisition of the underlying shares will be reckoned as the cost on the date on which the Depository advises the Custodian for redemption. The price of the ordinary shares of the Issuer Company prevailing on The Stock Exchange, Mumbai (the "BSE") or the National Stock Exchange (the "NSE") on the date of the advice of redemption shall be taken as the cost of acquisition of the underlying shares<sup>37</sup>.
- *Capital gains.* After redemption of the GDRs/ADRs into the underlying shares if the underlying shares are held by the redeeming non-resident foreign investor who has paid for these shares in foreign exchange at the time of purchase of the GDRs/ADRs for a period of more than 12 months from the date of advice of their redemption by the Depository and if the redeeming non-resident foreign investor transfers the shares to a resident of India or in India, the capital gains arising on the sale thereof will be treated as

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<sup>34</sup> Section 10(33) of the ITA.

<sup>35</sup> Section 115-O of the ITA.

<sup>36</sup> Section 47(viia) of the ITA and Paragraph 9(3) of the Scheme.

<sup>37</sup> Paragraph 7(3) of the Scheme. No provision in the ITA.



long-term capital gains and will be subject to income-tax at the rate of 10%<sup>38</sup>. If such shares are held for a period of 12 months or less than 12 months from the date of redemption advice, the capital gains arising on the sale thereof will be treated as short-term capital gains and will be subject to tax at the normal rates of income-tax (maximum rate of 30% for individuals and maximum rate of 48% for companies) applicable to non-residents under the provisions of the ITA.

- *Transfer of shares purchased in Rupees.* When the redeemed shares are sold on the Indian stock exchanges against payment in Rupees, these shares would go out of the purview of the section 115AC of the ITA and income therefrom would not be eligible for the concessional tax treatment provided thereunder. After the transfer of shares for which consideration is in Rupee terms, the normal tax rates would apply to the income arising or accruing on these shares<sup>39</sup>. Withholding of tax on the amount of capital gains accruing on transfer of the shares would be made in accordance with the ITA<sup>40</sup>.
- *Rights and bonus issues.* Distributions to non-resident holders of GDRs/ADRs or shares ("**Bonus Shares**") or rights to subscribe for shares ("**Rights**") made with respect to GDRs/ADRs or shares are not subject to Indian tax.

#### ***Application of avoidance of double taxation agreement in case of GDRs/ADRs and underlying shares after redemption***

During the period, if any, when the redeemed underlying shares are held by the non-resident investor on transfer from fiduciary ownership of the Depository, before they are sold to resident purchasers, India's treaty with the country of residence of the non-resident investor will be applicable in the matter of taxation of income by way of capital gains arising out of the transfer of the underlying shares to a resident of India or in India.

#### ***Gift tax and wealth tax***

The Scheme<sup>41</sup> provides that the holding of the GDRs/ADRs in the hands of non-resident holders and the holding of the underlying shares by the Depository in a fiduciary capacity and the transfer of GDRs/ADRs between such non-resident holders and the Depository will be exempt from Indian gift tax and Indian wealth tax.

Other than above, gift tax may apply to transfers by way of gift of shares or GDRs/ADRs at a rate of 30% to the extent the difference between the market value of the shares or GDRs/ADRs and the consideration received for such shares or GDRs/ADRs exceeds Rs.

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<sup>38</sup> Section 115AC(1)(b) read with section 115AC(1)(ii) of the ITA.

<sup>39</sup> Paragraph 9(6) of the Scheme.

<sup>40</sup> Section 195 and 196C of the ITA and paragraph 9(7) of the Scheme.

<sup>41</sup> Paragraph 11 of the Scheme.

No specific provisions are included in the Gift-tax Act, 1958 and the Wealth-tax Act, 1957 in this regard.

30,000. Though gift tax is not liable to be withheld at source, it may be recovered from the transferee if it cannot be recovered from the transferor.

### **Stamp duty and transfer tax**

Upon issuance of the GDRs/ADRs, the Issuer Company is required to pay a stamp duty of 0.1% on the value (par value plus premium) of each underlying share. A transfer of GDRs/ADRs is not subject to Indian stamp duty.

However, upon the acquisition of shares from the Depository in exchange for ADRs, the holder will be liable for Indian stamp duty at the rate of 0.5% of the market value of the ADRs or shares exchanged. Sale of shares by a registered holder will also be subject to Indian transfer tax at the rate of 0.5% of the market value of the shares on the trade date, although customarily such tax is borne by the transferee<sup>42</sup>.

### **Estate duty**

Under current Indian law, there is no estate duty applicable to a non-resident holder of GDRs/ADRs or shares.

### **Exchange control regulations**

Foreign investment in Indian securities is regulated by the FERA. No person resident outside India and no company that is not incorporated in India (other than a banking company) can purchase the shares of any company carrying on any trading, commercial or industrial activity in India without the general or prior permission of the RBI<sup>43</sup>. Also, the transfer and issuance of any security of any Indian company in favor of or to a person resident outside India requires the permission of the RBI<sup>44</sup>. Furthermore, no transfer of shares in a company registered in India by a non-resident to a resident of India is valid unless the transfer is confirmed by the RBI upon application filed by the transferor or the transferee<sup>45</sup>. The issuance of rights and other distributions of securities to a non-resident also requires the prior consent of the RBI. However, the RBI generally grants an exemption from application of certain of these provisions in connection with the issue of GDRs/ADRs by the Issuer Company.

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<sup>42</sup> The rate of stamp duty varies from state to state. The rate of 0.5% detailed above is the rate applicable if the Issuer Company's registered office is situated in the state of Maharashtra.

<sup>43</sup> Section 29(1)(b) of the FERA.

<sup>44</sup> Section 19(1)(d) of the FERA.

<sup>45</sup> Section 19(5) of the FERA.

### ***Foreign direct investment***

In July 1991, the Government of India raised the limit on foreign equity holdings in Indian companies from 40% to 51% in certain high-priority industries listed in Annexure III to the New Industrial Policy, 1991. Pursuant to the July 1991 reforms, the RBI used to give automatic approval for foreign investment up to 51% in the high-priority industries. The FIPB, currently under the Ministry of Industry, was thereafter formed to negotiate with large foreign companies wishing to make long term investments in India.

In order to expedite approvals, during January 1997, the Department of Industrial Policy and Promotion, a part of the Ministry of Industry, expanded the list of high priority industries that are eligible for automatic approval of the RBI and included further industries eligible for foreign investment up to 50%, 51% or as high as 74% (depending on the category of industry). Generally, the foreign investor is required to obtain the prior approval of the RBI for investing in Annexure III industries. However, during January 1998, the RBI issued a notification<sup>46</sup> stating that no prior permission of the RBI would be required. However, within 30 days of the issue of shares to the foreign investor, a declaration on Form FC(RBI) is required to be filed with the RBI.

Foreign equity participation in excess of 50%, 51% and 74% (as the case may be) in the high-priority industries or foreign equity participation in any other industry up to Rs. 6 billion is currently allowed only with the approval of the FIPB, which gives its approval on a case-by-case basis. Proposals in excess of Rs. 6 billion require the approval of the Cabinet Committee on Foreign Investment. Proposals involving the public sector and other sensitive areas require the approval of Cabinet Committee on Economic Affairs. These facilities are designed for direct foreign investments by non-residents of India ("**Foreign Direct Investors**") who are not individuals of Indian nationality or origin resident India ("**NRIs**"), overseas corporate bodies owned to the extent of at least 60% by NRIs ("**OCBs**") or Foreign Institutional Investors ("**FIIs**").

In May 1994, the Government of India announced that purchases by foreign investors of GDRs/ADRs and FCCBs of Indian companies will be treated as foreign direct investment in the equity issued by Indian companies for such offerings<sup>47</sup>. Therefore, offerings that involve the issuance of equity that results in Foreign Direct Investors holding more than the stipulated percentage of foreign direct investment (which depends on the category of industry) would require approval of the FIPB. In addition, in connection with offerings of any such securities to foreign investors, approval of the FIPB is required for Indian companies

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<sup>46</sup> Press note no. 14 (1997 series), Government of India, Ministry of Industry, Department of Industrial Policy & Promotion.

<sup>47</sup> See also paragraph 4 of the Scheme.

whether or not the stipulated percentage limit would be reached, if the proceeds therefrom are to be used for investment in non-high priority industries.

### ***Transfer of GDRs/ADRs***

No RBI approval would be required for the transfer of GDRs/ADRs between non-residents.

### ***Transfer of shares underlying GDRs/ADRs***

Transfer of shares of an Indian company between non-residents generally requires the confirmation of the RBI, in which case the non-resident transferee is required to apply to the RBI<sup>48</sup>. The RBI does not in such cases regulate the price at which the transfer takes place.

The sale and transfer of the shares received on the redemption of GDRs/ADRs by a person not resident in India to any person resident in India would require additional approvals to be obtained from the RBI<sup>49</sup>. The RBI will generally permit such transfers provided the sale is made on stock exchanges through a registered merchant banker or broker and at prevailing market rates<sup>50</sup>. The proceeds from such transfers may be transferred outside India after payment of applicable taxes and stamp duty. The RBI will also consider applications for transfer of shares by private arrangement (*i.e.* other than through a stock exchange) to a person resident in India. In such cases, the RBI will consider the application if the shares are proposed to be sold at a price that is arrived at by taking the average quotations (average of the daily highs and lows) for one week preceding the date of application with a provision for variation up to 5%, either side. In such cases the RBI will need to satisfy itself that the shares are proposed to be sold at a price arrived at by taking the average of quotations on the date of application or the price paid by the applicant whichever is lowest.

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<sup>48</sup> On Form FNC-7.

<sup>49</sup> Section 19(5) of FERA.

<sup>50</sup> An application on Form TS1 which requires information as to the transferor, transferee, the shareholding structure of the Indian company whose shares are to be sold, the highest and lowest quotation of the shares on the stock exchange where the shares have been listed during each of the preceding three calendar years and the latest available quotation, the proposed sale price per share and other information. The RBI is not required to respond to a Form TS1 application within any specific time period, and may grant or deny the application at its discretion. In October 1996, the RBI issued a circular (A.D. (M.A. Series) Circular No. 20 dated, October 28, 1996) stating that it would clear the transfer at a price not lower than that arrived at by taking the average of the highs and lows of the shares as listed on the stock exchange during the period of one month prior to the application to the RBI or the price prevailing market price on the date of application or the price sought by the applicant, whichever is the lowest.

### ***Investment by NRIs and OCBs***

A variety of special facilities for making investments in shares of Indian companies is available to NRIs and to OCB. These facilities permit NRIs and OCBs to make portfolio investments in shares and other securities of Indian companies on a basis not generally available to other foreign investors. These facilities are different and distinct from investments by Foreign Direct Investors described above.

### ***Investment by FIIs***

There is uncertainty as to how the FII regulations would apply to registered FIIs holding ADRs or shares withdrawn from the depository facility, including uncertainty as to whether the shares represented by ADRs will be included as part of an FII's holding for the purpose of applying the 10% individual limit imposed by the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995. Also, there is uncertainty about the tax regime applicable to FIIs which hold and deal in ADRs.

### ***Restrictions on deposit of underlying shares into the ADS facility***

Under current Indian laws and regulations, a holder of ADSs who surrenders ADSs and withdraws shares is not permitted subsequently to deposit such shares and obtain ADSs nor is a holder to whom such shares are transferred permitted to deposit such shares and obtain ADSs.

### **Company law issues**

#### ***Shares held in trust***

Section 187C of the Companies Act requires beneficial owners of shares of Issuer Companies who are not holders on record to declare to the Issuer Company details of the holders on record and the holder on record to declare details of the beneficial owner. Persons failing to make the required declaration within 30 days may be liable for a fine of up to Rs. 1,000 for each day such failure continues. Any charge, promissory note or any other collateral agreement created, executed or entered into in relation to any share, by the registered owner thereof, or any hypothecation by the registered owner of any share in respect of which a declaration is required to be made under Section 187C, but not so declared, cannot be enforceable by the beneficial owner or any person claiming through him. Failure to comply with Section 187C would not affect the obligation of the Company to register a transfer of shares or to pay any dividends to the registered holder of any shares in respect of which such declaration has not been made.

GDRs/ADRs as also GDR/ADR holders are outside the purview of the Companies Act. As a result, there is some confusion on the duty of the Depository (which is a registered member of the company) to declare the identity and address of the person on whose behalf it is holding the shares under section 187C of the Companies Act. A GDR/ADR holder may however, have to comply with the requirements of section 187C of the Companies Act if he seeks to exercise his right to vote on the strength of his beneficial interest in the underlying shares.

While it is unclear whether section 187C applies to holders of GDRs/ADRs of an Issuer Company, investors who exchange GDRs/ADRs for shares are subject to this section. The Issuer Company would have to apply to the Department of Company Affairs for an exemption from the application of the requirement of section 187C with respect to the ADRs and the shares represented thereby.

### ***Preferential allotment of shares***

The issuance of shares by the Issuer Company pursuant to the GDR/ADR mechanism would have to be cleared by a special resolution of the shareholders in a general meeting. Furthermore, the issuance of the shares is generally subject to shareholder preemptive rights<sup>51</sup>, except to the extent that such preemptive rights have been excluded or limited by a special resolution being passed in the general meeting of shareholders.

As per the SEBI guidelines for preferential allotment, any preferential allotment of shares by an Indian company is required to be completed within 90 days from the shareholder meeting held under section 81(1A) of the Companies Act. It is unclear as to whether this would apply in case of GDRs/ADRs issue. The SEBI guidelines for preferential allotment also govern the price at which the shares can be issued on a preferential basis<sup>52</sup>.

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<sup>51</sup> Section 81(1A) of the Companies Act.

<sup>52</sup> The issue of shares on a preferential basis can be made at a price not less than the higher of the following:

- The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date; or
- The average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date.

Relevant date is the date thirty days prior to the date on which the meeting of general body of shareholders is convened, in terms of section 81(1A) of the Companies Act to consider the proposed issue.

### ***Acquisitions***

Under the Companies Act<sup>53</sup>, acquisition of shares of any company beyond a certain percentage limit (30%) of the equity share capital of the target company would require members' and government approval.

### ***Liquidation rights***

Subject to the rights of the Issuer Company's creditors, employees and the holders of any other shares entitled by their terms to preferential repayment over the shares underlying the ADSs/GDSs, in the event of the winding up of the Issuer Company, the holders of the underlying shares are entitled to be repaid the amounts of capital paid up or credited as paid up on such shares. All surplus assets after payments due to the holders of any preference shares will be paid to the holders of the underlying shares in proportion to the amount paid up or credited as paid up on such shares, respectively, at the commencement of the winding up<sup>54</sup>.

### ***Buy-back of shares***

The Companies Act prohibits companies incorporated in India from buying-back their own shares<sup>55</sup>.

### ***Transfer of shares***

Following the introduction of the Depositories Act, 1996 (discussed hereinbelow), and the repeal of section 22A of the Securities Contracts (Regulation) Act, 1956, which enabled companies to refuse to register transfers of shares in certain circumstances, the shares of a company are freely transferable, subject only to the provisions of section 111A of the Companies Act. In accordance with the provisions of section 111A(2) of the Companies Act, the directors may refuse to transfer the shares if they have "sufficient cause" to do so. Pursuant to section 111A, if the transfer of shares is in contravention of any of the provisions of the Securities and Exchange Board of India Act, 1992 or the regulations issued thereunder, the Sick Industrial Companies (Special Provisions) Act, 1985 or any other law for the time-being in force, the Company Law Board (a statutory body which administers the Companies Act as it affects companies in India) may, on application made by an investor, the SEBI or certain other parties, direct the rectification of the register of records. The Company Law Board may, in its discretion, issue an interim order suspending the voting

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<sup>53</sup> Section 372 of the Companies Act.

<sup>54</sup> Section 511 read with section 529A and 530 of the Companies Act.

<sup>55</sup> Section 77 of the Companies Act.

rights attached to the relevant shares, before making or completing its enquiry into the alleged contravention. Pending such inquiry, the rights of a holder to transfer the shares would not be restricted, although the voting rights attached to the shares may remain suspended if the Company Law Board so orders.

Under the Companies Act, a transfer of shares is effected by an instrument of transfer in the form prescribed by the Companies Act and the Rules thereunder coupled with delivery of the shares certificates. However, with the advent of the Depositories Act, 1996 it is now possible to dematerialize shares, in which case transfers would be recorded on a book-entry basis.

### **Listing issues**

Clause 40A of the listing agreements that the Issuer Company may have entered into with Indian recognized stock exchanges on which the shares of the Issuer Company are listed provide that if an acquisition of listed company's equity shares results in the acquirer and its associates holding more than 5% of the Issuer Company's outstanding equity shares, the acquiror must report its holding to the relevant stock exchange(s). If an acquisition results in the acquiror and its associates holding equity shares that have 10% or more of the voting rights, then the acquiror must, before acquiring such shares, make an offer (in accordance with clause 40B of the listing agreements) on a uniform basis to all remaining shareholders of the Company to acquire a minimum of a further 20%, of the total shares of the Issuer Company at a prescribed price. The acquisition of shares of a company listed on an Indian stock exchange beyond certain threshold amounts is subject to regulations governing takeovers of Indian companies (described hereinbelow). Clauses 40A and 40B and such regulations will not apply to the shares represented by GDRs/ADRs.

### **Takeover regulations**

Under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 approved by the SEBI and promulgated by the Government of India in February 1997 (the "**Takeover Code**"), which replaced the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1994 (the "**1994 Takeover Code**"), upon the acquisition of more than 5%, of the outstanding shares of a listed company, a purchaser is required to notify the company and all the stock exchanges (on which the shares of the company are listed). Furthermore, upon acquiring 10% or more of such shares or a change in control of the company, the purchaser is required to make an open offer to the other shareholders, offering to purchase at least 20% of the total shares of the company at a minimum offer price as determined pursuant to the rules of the Takeover Code. The Takeover Code would not apply to persons holding



GDRs/ADRs but it will apply to holders of the underlying shares once the GDRs/ADRs are redeemed.

### **Indian depository issues**

During August 1996, the Indian Parliament enacted the Depositories Act, 1996, which governs the functioning of depositories, depository participants and beneficial owners (of the securities held in fungible form by the depository). It is possible for the shares underlying the GDRs/ADRs issued by the Issuer Company to be held by the Custodian in dematerialized form.

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**The contents of this paper should not be construed as legal opinion or professional advice.**