Report of the Committee to Review the FCCBs and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993

Ministry of Finance
Government of India

November, 2013

COMMITTEE ON REVIEW OF THE FCCBS AND ORDINARY SHARES (THROUGH DEPOSITORY RECEIPT MECHANISM) SCHEME, 1993

New Delhi
26th November, 2013

Shri P. Chidambaram
Hon'ble Finance Minister
Government of India
New Delhi – 110 001

Dear Finance Minister,

The Committee to review the FCCBs and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993, constituted vide order F. No. 9/1/2013 – ECB dated September 23, 2013, presents its Report to the Government of India. The Report is accompanied by a draft scheme.

Yours sincerely,

M. S. Sahoo
(M.S. Sahoo)
Chairman

(G. Padmanabhan) Member	(Pratik Gupta) Member	(S. Ravindran) Member
(Ajay Shah) Member	(Somasekhar Sundaresan) Member	(P.R. Suresh) Member

S. Kaushik
(Sanjeev Kaushik)
Convenor

Contents

Acronyms

ADR	American Depository Receipt.
CDSL	Central Depository Services (India) Limited.
DIPP	Department of Industrial Policy and Promotion.
DR	Depository Receipt.
ECB	External Commercial Borrowing.
ED	Enforcement Directorate.
EGM	Extraordinary General Meeting.
EIC	Economic Intelligence Council.
ETF	Exchange Traded Fund.
FATF	Financial Action Task Force.
FCCB	Foreign Currency Convertible Bond.
FDI	Foreign Direct Investment.
FEMA	Foreign Exchange Management Act, 1999.
FII	Foreign Institutional Investor.
FIPB	Foreign Investment Promotion Board.
FIU	Financial Intelligence Unit.
FMC	Forward Markets Commission.
FSLRC	Financial Sector Legislative Reforms Commission.
GDP	Gross Domestic Product.
GDR	Global Depository Receipt.
ICSI	Institute of Company Secretaries of India.
IDR	Indian Depository Receipt.

IOSCO	International Organization of Securities Commissions.
IPO	Initial Public Offering.
IST	Indian Standard Time.
KYC	Know Your Customer.
MMoU	Multilateral Memorandum of Understanding.
NIPFP	National Institute of Public Finance and Policy.
NSDL	National Securities Depository Limited.
NYSE	New York Stock Exchange.
OCB	Overseas Corporate Body.
OTC	Over The Counter.
PAN	Permanent Account Number.
PMEAC	Economic Advisory Council to the Prime Minister.
PMLA	Prevention of Money Laundering Act, 2002.
QFI	Qualified Foreign Investor.
QIB	Qualified Institutional Buyer.
QIP	Qualified Institutional Placement.
RBI	Reserve Bank of India.
SEBI	Securities and Exchange Board of India.
SEC	U.S. Securities and Exchange Commission.
STT	Securities Transaction Tax.
TASE	Tel Aviv Stock Exchange.
TRAC	Takeover Regulations Advisory Committee.
UK	United Kingdom.
US	United States of America.

Acknowledgement

The present *Scheme* governing issue of Depository Receipts (DRs) was designed in 1993, at a time when India's capital markets were substantially closed to foreign capital. In addition, the domestic financial system was fairly weak at the time. In the last two decades, the equity market has developed sophisticated market infrastructure with electronic trading, netting by novation at the clearing corporation, dematerialised settlement and derivatives trading. Capital controls have been substantially eased in this period. Many aspects of the Indian legal system have changed substantially. These developments warranted a fresh look at the *Scheme* governing DRs. The Committee thanks the Ministry of Finance, Department of Economic Affairs for the opportunity to do so.

I am grateful to each member of the Committee for his sincere and valuable contribution which made a difference to the Committee's work: Mr. G. Padmanabhan, Executive Director, Reserve Bank of India (RBI), Mr. S. Ravindran, Executive Director, Securities and Exchange Board of India (SEBI), Dr. Ajay Shah, Professor, National Institute of Public Finance and Policy (NIPFP), Mr. P. R. Suresh, Consultant, Economic Advisory Council to the Prime Minister (PMEAC), Mr. Pratik Gupta, Managing Director, Deutsche Bank, Mr. Somasekhar Sundaresan, Partner, JSA, and Mr. Sanjeev Kaushik, Director, Ministry of Finance.

I am thankful to Mr. Ashok Khurana from the Association of Power Producers, Mr. Debashish Purohit from BAML, Mr. Neil Atkinson, Mr. Vinu Kurian, Mr. Arun Chatterjee and Ms. Aparna Salunke from BNY Mellon, Mr. Abhishek Agarwal from Citi, Mr. S. Nagnath from Blackrock Investments, Mr. P.V. Krishna and Mr. Sanjiv Shah from Goldman Sachs, Mr. Vinay Menon and Mr. Vijay K. Bhojwani from JP Morgan, Mr. Alastair Walmsley and Mr. Darko Hajdukovic from the London Stock Exchange, Mr. J.N. Tikku from the Ministry of Corporate Affairs, Mr. Manu J.Vettickan and Mr. Jitendra Asati from the Ministry of Finance, Mr. H.S. Mohanty from RBI, Mr. V.S. Sundaresan, Mr. Amit Tandon and Mr. Anjan Patel from SEBI, Mr. Shailesh Pathak from SREI Infrastructure Finance Ltd., Mr. Ashok Pareek from SREI Capital Markets Limited as well as Mr. Suresh Senapaty and Mr. Partha Guha Patra from Wipro for

engaging with the Committee and sharing their experiences, concerns and perspectives.

The Secretariat for the Committee, the NIPFP Macro/Finance Group, delivered outstanding research support as it has been doing to numerous other government projects. Mr. Pratik Datta, the leader of this team put in tireless efforts and brought in significant insights into the issues. Mr. Shubho Roy, Mr. Vikram Bahure, Mr. Arjun Rajagopal, Mr. Suyash Rai, Mrs. Radhika Pandey and Mr. Anirudh Burman of the team brought knowledge into the work and helped in flawless execution. Mr. Gautam Chand, CEO, Instanex Capital, helped the research team in understanding the micro-structure of the DR market. Mrs. Neena Jacob of NIPFP managed the process smoothly and flawlessly.

I acknowledge the support from SEBI, RBI and Institute of Company Secretaries of India (ICSI) for making their facilities available to the Committee for holding extensive meetings and extending warm hospitality.

November 26, 2013 M.S. Sahoo

Executive Summary

In India's liberalisation of the capital account, one of the first areas of reform was DRs. In the early 1990s, it became possible for Indian firms to connect with foreign investors by DR issuance. In the early years, DRs made up the bulk of foreign investment into Indian equities.

When the onshore market was opened up to Foreign Institutional Investors (FIIs), DR issuance was particularly important as the Indian equity market at that time had many shortcomings. From 1994 to 2013, key problems of the Indian equity market were progressively addressed, and in most respects, the onshore equity market is now world class. It could be argued that the importance of DRs has subsided, now that the onshore market is of high quality and that FIIs have significant access to it.

DRs, however, remain important for two reasons: competitive neutrality and home bias. There are two mechanisms through which foreign investors can connect with Indian firms: foreign investors can come to India and buy shares of Indian firms on the onshore market, or Indian firms can go to overseas financial centres and sell shares to foreign investors. From an Indian policy viewpoint, there is no reason to favour one mechanism over another. Practitioners have views about circumstances under which one mechanism is more efficient than the other, but there is no reason for policy to favour either.

The second consideration is home bias. A well established fact of international finance concerns the excessive weightage given by investors to their own country in portfolio formation. Indian firms are, on average, at a disadvantage in attracting investment by global investors on account of home bias. There is significant academic evidence that overseas listing can reduce home bias against the securities issued by a firm.

There are multiple ways to access international capital markets, the most prominent being the direct listing route and the DR route. There are concerns about whether the use of overseas capital markets could adversely impact the domestic capital market. The extent to which overseas listing could adversely impact upon the domestic capital market can be debated.

However, regardless of the outcome of that debate, the Committee believes that all financial policy should be designed so as to assist the requirements of the real sector including firms and households. If, hypothetically, the requirements of firms are better served by the global capital market, there is no case for protectionism. Capital controls could, hypothetically, be used in forging a protectionist response, through which foreign investors are forced to interact with Indian firms through the onshore market only. This Committee recommends against such policy strategies. Financial policy should be made in pursuit of the interests of the economy at large and not the interests of the financial sector.

On the contrary, this report argues that financial development in India will be *fostered* by exposing the Indian financial system to greater competition. The Ministry of Finance has established two formal mechanisms on these concerns: the Standing Council of Experts on the International Competitiveness of the Indian Financial System, and the Financial Stability and Development Council, a statutory collegium of regulators which works on financial development. These two institutional mechanisms will be able to better diagnose and solve many problems of the Indian financial system by keenly observing the outcome of competition between DRs and the onshore financial system, and by undertaking studies that measure differences in cost as seen by end-users.

Improved competitiveness as a response to global competition has come about in numerous parts of the Indian economy, and the financial sector is no exception. Indeed, a small number of firms and investors who use DRs could potentially generate substantial positive externalities for the Indian economy at large, if policy makers carefully benchmark the costs imposed by the Indian financial system against global best practice, and undertake policy reforms that result in domestic financial development.

The main strategy of this report is rooted in the principle of competitive neutrality. The basic structure of Indian capital controls consists of a set of rules about foreign ownership of equities, corporate bonds, government bonds, etc. As an example, all foreign investors (put together) are permitted to hold \$30 billion of government bonds through FII investment. This report suggests that DR issuance should be permissible as long as the grand total foreign investment into Indian government bonds – whether through DRs or through FII investment – does not exceed \$30 billion.

If firms find issuance and trading at overseas venues is beneficial, a substantial scale of this activity will come about. If this takes place, an analysis of the consequences of issuance and trading abroad for the work of financial agencies in India is required. This requires anticipating how the market failures of finance are modified in a world with issuance and trading overseas, through which the appropriate and minimal interventions can be structured. Consumer protection of Indian consumers is not generally a concern for the Indian authorities as the buyers of DRs are generally foreigners. The areas of concern lie in corporate governance and market abuse.

Rules about corporate governance need to be broadened to accommodate the possibility of issuance and trading overseas. This matters for issues such as the takeover regulations, measurement of public shareholding, etc. The report provides detailed analysis, and the text of the draft scheme, covering each of these issues.

In a similar fashion, financial agencies that are required to combat market abuse and financial terrorism need to work in new ways to reflect the continually changing geography and mechanisms of financial trading. Some recent SEBI orders have highlighted the possibility of cross-border malfeasance that results in market abuse within India. The

Committee recommends the strategy of understanding the modus operandi of violators, and devising new kinds of detection and investigation capabilities in response to the changes in the economy. This is a superior path for India rather than trying to prevent changes in the economy. The report has a detailed treatment of how these problems need to be addressed.

The Committee has evaluated an array of other present or potential restrictions upon DR programs and does not recommend their use, as they do not address market failures. Through this, the proposals of this report focus the resources and attention of financial agencies towards market failures.

The Committee believes that there is no potential market failure as long as the DRs are issued within the extant capital control regime and in jurisdictions which are Financial Action Task Force (FATF) and International Organization of Securities Commissions (IOSCO) compliant. These can be issued on the back of any securities issued by any issuer, and can be sponsored or unsponsored, they can be for capital raising or otherwise, they can be through public offer, private placement or any other manner prevalent overseas, subject only to the condition that Indian investor does not suffer in any manner and that all the participants have a level playing field.

Two members of the Committee, namely, Mr. G. Padmanabhan and Mr. S. Ravindran have different views on some aspects. Their views have been presented at appropriate places in the report.

Chapter 5 of the report concludes with 10 principles and 21 recommendations. The recommendations are substantially implemented by the draft Depository Receipts Scheme, 2013 which is placed at Annexure-D. Chapter 5.4 gives an implementation plan of the 21 recommendations and is followed by adjacent areas where the Ministry of Finance needs to undertake the next stage of policy reform.

1 — Introduction

1.1 Constitution of the Committee

The Ministry of Finance constituted a Committee, vide Office Order dated September 23, 2013 (Annexure-A), to review comprehensively the Foreign Currency Convertible Bonds and Ordinary Shares (Through Deposit Receipt Mechanism) Scheme, 1993 ('the Scheme'). The Committee initially consisted of seven members, namely, Mr. M.S. Sahoo, Secretary, ICSI as Chairman of the Committee, and Mr. G. Padmanabhan, Executive Director, RBI, Mr. S. Ravindran, Executive Director, SEBI, Dr. Ajay Shah, Professor, NIPFP, Mr. P. R. Suresh, Consultant, PMEAC, Mr. Pratik Gupta, Managing Director, Deutsche Bank, and Mr. Sanjeev Kaushik, Director, Ministry of Finance, as Members. The Committee subsequently co-opted as a member, Mr. Somasekhar Sundaresan, Partner, JSA, who was initially a permanent invitee.

1.2 Process followed

The Committee had three meetings when it consulted the concerned stakeholders, and delineated the relevant policy issues and deliberated extensively on the same. The deliberations of the Committee were informed by the research conducted by its secretariat, the NIPFP Macro/Finance Group. The research was based on relevant data collected by the NIPFP Macro/Finance Group from various sources, including some of the stakeholders, and the contemporary thought as reflected in recent policy decisions and committee reports. The list of stakeholders who had engaged with the Committee is at Annexure-B.

1.3 Scope of work

Based on the data obtained, the research conducted, the views of the stakeholders and the consequent deliberations, the Committee decided that in the first phase it will confine its review of the *Scheme* in respect of DRs. It decided to engage in a second phase of research and deliberation on Foreign Currency Convertible Bonds (FCCBs) and refrained from making any comments on FCCBs in this report. It strongly felt that the extant *Scheme* was set in an environment which no more exists today. Hence it decided to draft a contemporary scheme to replace the extant *Scheme*.

1.4 Structure of the report

The report is divided into four substantive chapters. The second chapter provides a background of the *Scheme*:

- The modes of accessing international capital markets, including through DRs.
- The classification of DRs and their commercial necessity.
- The origin and evolution of the *Scheme* and how DRs are issued.
- The linkage between DRs and the domestic market.

The chapter concludes with explanations for the need to review the *Scheme* and alternative policies regarding the modes of accessing international capital markets prevailing in other comparable economies.

The third chapter discusses the principles which guided the reasoning of the Committee:

- The need to harmonise with contemporary financial policy thinking in India.
- The capital markets should support the real economy.
- In the presence of various barriers to foreign investment, DRs are an attractive route for foreign investment into India.
- All market regulation must be informed by an analysis of market failures.
- Appropriate regulatory response to potential violations of the law is not prohibiting market access, but improving detection and investigation capabilities.
- DRs should be subjected to the same capital controls that are applicable to the underlying securities.

The fourth chapter identifies the primary policy issues relevant to the *Scheme* and frames each issue as a question. The Committee's corresponding recommendations are stated in the form of answers, accompanied by an explanation for the same.

The fifth chapter summarises the recommendations of the Committee in respect of DRs. It encloses a brand new scheme relating to DRs at Annexure-D. It suggests a plan for implementation of those recommendations that require regulatory modifications.

2 — Background

Financial markets connect capital from investors to the most productive applications in firms. Firms seek the lowest possible cost of capital for financing projects. When low cost capital is available, a larger set of projects are financially viable, and greater investment takes place. Equity capital from global investors is likely to be cheaper when compared with domestic sources, as global investors are internationally diversified.

There are two alternative mechanisms through which foreign investors can connect with firms in India. The first mechanism involves direct participation by foreign investors in the Indian financial markets. The second mechanism involves participation by Indian firms in overseas financial markets. Each of these two methods has strengths and weaknesses. The local market is likely to be more liquid and better at capturing information about the firm raising capital. The overseas market is easier to access for many overseas investors.

One important mechanism through which investment in Indian securities takes place in overseas markets is through DRs. The DR route is attractive to investors because it offers a combination of simplicity, protection and flexibility, as compared to direct investment in a foreign market.

Globally, the market for DRs is over 80 years old.[1] DRs are now traded on major international markets, with large investment banks running DR programs. Today, DRs are no longer used for capital-raising purposes alone. DRs provide a number of strategic, reputational and risk-mitigation benefits to issuers and investors, and there are markets for "unsponsored" DRs issued by depository banks without the participation of issuing companies. DRs may also be created against a variety of other underlying securities including bonds, Exchange Traded Funds (ETFs) and mutual funds.

This chapter provides some background to the current *Scheme*. It includes a brief overview of the role of international capital markets in allocating resources to domestic firms and modes of accessing international capital markets. Then it looks into the mechanism of the DR route in details and the motive behind issuing or investing in DRs. In this context, it summarises the need for review of the present *Scheme* and concludes

[1] The first DR was introduced by JP Morgan in 1927 for the British retailer Selfridges.

with alternative policy options from other comparable economies.

2.1 Access to international capital markets

Firms access international capital markets usually in either of the following ways:

1. **Direct listing**: A firm can directly list its shares on a foreign stock exchange abroad. Direct listing can be:
   - *Primary*: A firm not listed on any domestic exchange lists its shares on a foreign stock exchange. It is subject to only the foreign jurisdiction listing rules.
   - *Secondary*: A firm listed on a domestic exchange subsequently lists its shares on a foreign stock exchange. It is principally regulated by the rules of its domestic jurisdiction.
   - *Dual primary listing*: A firm listed on a domestic exchange subsequently lists its shares on a foreign stock exchange and is equally subject to the listing rules of both jurisdictions.
2. **Depository receipts**: Securities of a firm are deposited with a domestic custodian in the firm's domestic jurisdiction, and a corresponding "depository receipt" is issued abroad, which can be purchased by foreign investors. DRs of a firm can be listed on an exchange or traded in the Over The Counter (OTC) market abroad. Where the firm has already listed the securities on a domestic exchange, the listing of its DRs on a foreign exchange is referred to as "cross-listing".

When considering which of these options to pursue, a firm will consider:

- The legal restrictions the firm faces in the home jurisdiction including exchange controls, capital controls and corporate laws.
- The legal restrictions in the international capital market.
- The economic costs of each mode of access.

In the Indian context, firms are constrained by the capital controls regime and non-convertibility of the Indian Rupee. In addition, due to legal uncertainty, Indian companies do not directly list their shares on foreign stock exchanges. Therefore, at present the DR route is the only viable option for Indian firms to participate in the international capital markets. This route can be further facilitated and made more accessible to Indian firms by suitably modifying the regulatory framework and market micro-structure regulating the DRs.

2.2 Depository Receipts

A DR is a negotiable security issued outside India by a foreign depository on the back of an Indian security deposited with a domestic Indian custodian in India.

2.2.1 Classification of Depository Receipts

DRs are generally classified as under:

- **Sponsored**: Where the Indian issuer enters into a formal agreement with the foreign depository for creation or issue of DRs. A sponsored DR issue can be classified as:

- **Capital Raising**: The issuer issues new securities which are deposited with a domestic custodian. The foreign depository then creates DRs abroad for sale to foreign investors. This constitutes a capital raising exercise, as the proceeds of the sale of DRs go to the Indian issuer.
- **Non-Capital Raising**: In a non-capital raising issue, no fresh underlying securities are issued. Rather, the issuer gets holders of its existing securities to deposit these securities with a domestic custodian, so that DRs can be issued abroad by the foreign depository. This is not a capital raising exercise for the Indian issuer, as the proceeds from the sale of the DRs go to the holders of the underlying securities.

- **Unsponsored**: Where there is no formal agreement between the foreign depository and the Indian issuer. Any person other than the Indian issuer may, without any involvement of the issuer, deposit the securities with a domestic custodian in India. A foreign depository then issues DRs abroad on the back of such deposited securities. This is not a capital raising exercise for the Indian issuer, as the proceeds from the sale of the DRs go to the holders of the underlying securities.

Based on whether a DR is traded in an organised market or in the OTC market, the DRs can be classified as *listed* or *unlisted*.

- **Listed**: Listed DRs are traded on organised exchanges. The most common example of this are American Depository Receipts (ADRs) which are traded on the New York Stock Exchange (NYSE).
- **Unlisted**: Unlisted DRs are traded OTC between parties. Such DRs are not listed on any formal exchange.

The most common DR programs internationally are:

- ADRs: DRs issued in United States of America (US) by foreign firms are usually referred to as ADRs. These are further classified based on the detailed rules under the US securities laws. The classification is based on applicable disclosure norms and consists of:
  1. *Level 1*: These programs establish a trading presence in the US but cannot be used for capital raising. They may only be traded on OTC markets, and can be unsponsored.
  2. *Level 2*: These programs establish a trading presence on a national securities exchange in the US but cannot be used for capital raising.
  3. *Level 3*: These programs can not only establish a trading presence on a national securities exchange in the US but also help raise capital for the foreign issuer.
  4. *Rule 144A*: This involves sale of securities by a non-US issuer only to Qualified Institutional Buyers (QIBs) in the US.[2]
- Global Depository Receipts (GDRs): GDR is a collective term for DRs issued in non-US jurisdictions and includes the DRs traded in London, Luxembourg, Hong Kong, Singapore.

[2] Rule 144A of the Securities and Exchange Commission, *General Rules and Regulations, Securities Act of 1933*, 17 CFR 230.114A, 1933.

2.2.2 Why issue DRs?

Firms may decide to venture beyond their domestic capital market, and seek international sources of capital. They might choose to do so through DRs for various reasons. These include:[3]

1. *Capital raising*: In some cases the size of the offering may be too big for the domestic market to absorb. For example, YPF, an Argentine oil company, issued a $3 billion global offering in 1993 as part of its privatisation plan. Since the Argentine equity market was too small to raise the capital, the firm raised $500 million locally, $2 billion from the US and $500 million from Europe.[4] Table 2.1 shows that even firms in advanced economies with developed financial markets and no capital controls, avail of the DR mechanism.

Table 2.1: Issue of DRs by select advanced economies

Country	ADR	GDR	Others	Total
United Kingdom	391	27	0	418
Japan	340	1	1	342
Australia	298	8	0	306
Hong Kong	248	4	0	252
Germany	119	1	2	122

Source: JP Morgan

2. *Improved liquidity*: Cross-listing broadens and diversifies the pool of investors who are able to access the securities. This increases the liquidity of the securities, which in turn may improve their price.[5]
3. *Valuation*: By submitting to higher disclosure standards in a foreign jurisdiction, the company signals that it is of a higher quality than its domestic peers who have not listed abroad. This may improve the value of the company.
4. *Shareholder protection*: Listing in a jurisdiction with higher standards of corporate governance and minority shareholder protection signals the commitment of the company to protect interests of minority shareholders. This, in turn, lowers the cost of capital for the company.
5. *Bonding*: By listing in a jurisdiction where it is more difficult to capture private benefits of corporate control, promoters and managers signal that they have "bonded" themselves with the long term interests of the shareholders.[6]
6. *Visibility*: Trading on international capital markets provides greater visibility and has a potential positive effect on the sales of the company's products.
7. *Analysts' opinion*: A firm that is not subject to regular sophisticated analysis by the market may be undervalued. Some jurisdictions may not have specialised

[3]For further literature on this, see G. Andrew Karolyi, "Why do Companies List Shares Abroad?: A Survey of the Evidence and Its Managerial Implications", in: *Financial Markets, Institutions and Instruments* 7 (1998); Abed Al-Nasser Abdallah and Christos Ioannidis, "Why do firms cross-list? International evidence from the US market", in: *Quarterly Review of Economics and Finance* 5 (2010), pp. 202–213; Evangelos Benos and Michael S. Weisbach, "Private benefits and cross-listings in the United States", in: *Emerging Markets Review* 5 (2004), pp. 217–240.

[4]See, Joseph Velli, "American Depository Receipts: An Overview", in: *Fordham International Law Journal* 17 (1994).

[5]See, Karolyi, see n. 3.

[6]See generally, John C. Coffee Jr., "Racing Towards the Top: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance", in: *Columbia Law Review* 102 (2002).

analysts for the industry in which the firm operates. Thus, some firms may benefit from exposure to a larger pool of specialised analysts operating in the international market. This is particularly so for technology stocks.

2.2.3 Why invest in DRs?

From the foreign investor's perspective, DRs are a viable option for investment for the following reasons:

1. *Convenience*: DRs trade and settle in the same manner as any other security in the investor's jurisdiction. The investors pay the same commission rates, and dividends on the DRs are paid in the currency of the investor. In addition, it is easier for an investor in London or New York to place orders during regular trading hours in their own jurisdiction, as opposed to having to place orders in India. As a result, there is little difference in buying and selling DRs and buying and selling any other security in the investors' own jurisdiction.
2. *Pooling custody fees and foreign exchange costs*: Individual foreign investors may face high custody fees and foreign exchange conversion fees for directly holding securities in a foreign jurisdiction. By pooling together a number of foreign investors, the DR issuer can obtain whole-sale rates. This may reduce the transaction fees that a DR holder pays.
3. *Market infrastructure*: The financial market system in emerging economies may suffer from problems, and an investor may feel safer operating in the US or in London.
4. *Capital controls*: A foreign investor operating in the US or the United Kingdom (UK) does not face capital controls or source-based taxation, or other impediments that are featured in many emerging markets.
5. *Legal responsibility*: An investor in New York may feel more comfortable relying on the legal protections available in the investor's own jurisdiction. These may be more accessible and effective than protections available abroad.

DRs thus offer advantages to both issuers and investors, relative to other instruments. They are a useful vehicle for efficiently channeling capital from international investors to domestic companies, and may provide additional reputational and risk mitigation benefits to both.

An important problem that DRs help address is that of *home bias*. The most basic fact about financial globalisation is the extent to which it is, as yet, incomplete. Most investors around the world over-invest in their home country and under-invest overseas. To the extent that DRs alleviate home bias, they help companies in emerging markets access lower cost capital.

2.3 Understanding the Scheme

The *Scheme* was introduced on November 12, 1993, as one of several moves to open the country's capital account and generate inflow of foreign currency. The *Scheme* has evolved over time, tightening and clarifying some restrictions while easing others, but overall following a trend of gradual liberalisation. This section traces the evolution of the *Scheme* through various stages of modification and liberalisation, to its current version.

2.3.1 Legal basis of the Scheme

Section 6(3)(b) read with section 47 of the *Foreign Exchange Management Act, 1999* empowers the RBI to prohibit, restrict or regulate the transfer or issue of securities by a person resident outside India. Accordingly, RBI issued *FEMA 20* which permits an Indian company to issue its rupee denominated shares to a depository (person resident outside India) for the purpose of issuing GDRs or ADRs, subject to meeting the following requirements:[7]

1. The Indian company has approval from Ministry of Finance to issue DRs or is eligible to issue DRs in terms of the relevant scheme in force or notification issued by Ministry of Finance.
2. The Indian company is not otherwise ineligible to issue shares to persons resident outside India under *FEMA 20*.
3. The DRs are issued in accordance with the scheme and guidelines issued by the Central Government thereunder from time to time.

The *Scheme*, framed by Ministry of Finance derives its legal force today from requirements 1 and 3 above.[8]

Some other laws governing the DR market are:

- *Companies Act, 2013*: defines 'global depository receipt' to mean any instrument in the form of a depository receipt, by whatever name called, created by a foreign depository outside India and authorised by a company making an issue of such depository receipts.[9] It gives the Central Government the power to make rules regarding the manner and condition of issue of such DRs in any foreign country.[10] This provision is an additional source of legal authority governing the issue of DRs.
- *Income Tax Act, 1961*: provides for tax on income of a non-resident assessee from:[11]
  1. interest on bonds of an Indian company;
  2. dividends on DRs.

  It specifically mentions that such DR issue must in be in compliance with any scheme notified by the Central Government. This creates an additional power for the Central Government to make regulations on DRs.

[7] See Regulation 4, Schedule I, of Reserve Bank of India, *Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000*, Notification No. FEMA 20/2000-RB dated 3rd May 2000, May 17, 2000.

[8] The issue of legal validity of the *Scheme* after its issue in 1993 till before the *Foreign Exchange Management Act, 1999* came into force may be merely of pedantic interest today. However, the origin of the legal power to issue this Scheme during this period can be traced back to Article 73 of the *Constitution of India* which makes the executive power of the Union co-extensive with the legislative powers of the Parliament, subject to restrictions mentioned therein. For further discussions on the executive power of the Union under this Article, please refer to Supreme Court of India, *Rai Sahib Ram Jaway Kapur v. The State of Punjab*, All India Reporter 1955 Supreme Court 549.

[9] See section 2(44), *Companies Act, 2013*.

[10] See sections 2(66), 41 and 469(1), ibid.

[11] See section 115AC(1), *Income Tax Act, 1961*.

2.3.2 Evolution of the Scheme

Table 2.2 traces the major changes that have been made to the *Scheme* since its inception. These changes were primarily aimed at:

- Expanding or contracting the pool of companies that could issue DRs for capital raising purposes.
- Harmonising the DR regime with the broader regulatory system in the country, in particular the Foreign Direct Investment (FDI) policy and existing capital controls.
- Developing the linkages between the international market for DRs and the domestic capital market.

Table 2.2: Evolution of the *Scheme*

Date	Events
November 12, 1993	The *Scheme* was notified with effect from April 1, 1992. Companies required a track record of good performance.
May 22, 1998	Unlisted companies to comply with domestic listing conditions within three years of making profit.
June 23, 1998	DR linked employee stock options permitted for software companies.
March 2, 2001	Two-way fungibility permitted subject to guidelines to be announced by RBI.
July 29, 2002	Companies permitted to sponsor DR issue at a price determined by lead manager. All shareholders of a company would get opportunity to offer shares against which the DRs would be issued. Such issues need to conform with FDI policy.
August 31, 2005	Companies ineligible to access capital markets made ineligible to issue DRs. Unlisted companies issuing DRs to simultaneously list underlying shares on Indian exchange. Introduced pricing guidelines for such DR issue based on prevailing price of the underlying share on the Indian exchange. Erstwhile Overseas Corporate Bodies (OCBs) prohibited from buying DRs. Pricing of DRs against shares of unlisted companies as per RBI regulations.
September 14, 2005	Exempted unlisted companies from simultaneous listing if they had taken verifiable effective steps and completed issue by December 31, 2005.
November 17, 2005	Companies doing a domestic offering and a simultaneous follow on DR offering abroad exempted from pricing norms. Such companies must price DRs at or above domestic price. Such companies needed approval for such issue from SEBI.
November 27, 2008	Pricing norms for issue of DRs aligned with pricing norms by SEBI for Qualified Institutional Placements (QIPs).
October 11, 2013	Unlisted companies allowed to raise capital abroad by issuing DRs without undergoing simultaneous listing. Such DRs must be listed in IOSCO and FATF compliant jurisdictions. Such companies must comply with SEBI disclosure norms. Raising of capital abroad must be complaint with FDI norms.

2.3.3 Issue process

The *Scheme* operates in a framework comprising of laws on companies, securities, foreign exchange, taxation, money laundering and market abuse. Over time, this framework has resulted in the creation of a market micro-structure around the issue of DRs. This section explains the steps involved in the issue of capital raising ADRs or GDRs by an Indian issuer company against its shares, under the present *Scheme* in conjunction with the existing market micro-structure:

1. The Indian issuer company must:
   (a) convene a board meeting to approve the proposed DR issue not exceeding a certain value in foreign currency;
   (b) convene an Extraordinary General Meeting (EGM) for the approval of the shareholders for the proposed DR issue under section 81(1A) of the *Companies Act, 1956*;
   (c) identify the agencies whose participation or permission it would require for the DR issuance;
   (d) convene a board meeting to approve the agencies;
   (e) appoint the agencies and sign the engagement letters.
2. The Indian legal counsel must undertake the due diligence.
3. The Indian issuer company must draft the information memorandum in consultation with the Indian legal counsel and submit the same to various agencies for their comments and then finalise it.
4. The listing agent must submit the information memorandum to the overseas stock exchange for their comments and in principle listing approval.
5. The Indian issuer company must simultaneously submit the draft information memorandum to the Indian stock exchanges where the issuing company's shares are listed for in principle approval for listing of the underlying shares.
6. The Indian issuer company must hold a board meeting to approve the issue.
7. Pursuant to steps 4 and 5, on receipt of the comments on the information memorandum from the overseas and Indian stock exchanges, the Indian issuer company must incorporate the same and file the final information memorandum with the overseas and Indian stock exchange and obtain final listing.
8. The Indian issuer company can open the issue for the DR on receipt of the in principle listing approval from the overseas and the Indian stock exchanges.
9. The Indian issuer company must open the escrow account with the escrow agent and execute the escrow agreement.
10. The Indian issuer company, in consultation with the lead manager (merchant banker), must finalise:
    (a) Whether the DRs will be through public or private placement.
    (b) The number of DRs to be issued.
    (c) The issue price.
    (d) Number of underlying shares to be issued against each DR.
11. On the day of the opening of the issue, the Indian issuer company must execute the deposit and subscription agreements.
12. The issue should be kept open for a minimum of three working days.
13. Immediately on closing of the issue, the Indian issuer company must convene a board or committee meeting for allotment of the underlying shares against the

issue of the DRs.

14. The Indian issuer company must deliver the share certificate to the domestic custodian bank who will in terms of the deposit agreement instruct the overseas depository bank to issue the DRs to non-resident investors against the shares held by the domestic custodian bank.
15. On receipt of listing approval from the overseas stock exchange, the Indian issuer company must submit the required documents for final in principle listing approval from the Indian stock exchange.
16. After DRs are listed, the lead manager must instruct the escrow agent to transfer the funds to the Indian issuer company's account.
17. The Indian issuer company can either remit all or part of the funds, as per its discretion.
18. On obtaining the final approval from the Indian stock exchange, the Indian issuer company can admit the underlying shares to the depository, that is, National Securities Depository Limited (NSDL) or Central Depository Services (India) Limited (CDSL).
19. The Indian issuer company must obtain trading approval from the stock exchange.
20. The Indian issuer company must intimate the custodian for converting the physical shares into dematerialised form.
21. Within 30 days of the closing of the DR issue, details of the DR issue along with the information memorandum should be submitted to various authorities.
22. Return of allotment is to be filed with Registrar of Companies within 30 days of allotment.
23. Indian issuing company is to file a specified format annexed to Schedule I, *FEMA 20* with RBI, Central Office within 30 days of closure of the DR issue.
24. The Indian issuing company is to file a quarterly return in a specified format annexed to Schedule I, *FEMA 20* within 15 days of the close of the calendar quarter.

2.4 Market for depository receipts and the domestic market

As tradeable financial instruments, DRs cannot be considered in isolation but must be evaluated in the context of the broader financial market and the existing market micro-structure. Like any other asset, DRs create strategic opportunities for issuers and investors, and may induce larger structural changes in the market itself. These potential effects are described below.

2.4.1 Law of one price

The law of one price should hold for DRs and their underlying shares, since they represent the same asset. This is achieved through an active arbitrage business which notices failure of the law of one price and prompts arbitrage transactions to reduce the pricing error. The establishment of a vibrant arbitrage business is the work of the private sector.

Policy makers need to establish the enabling framework through which arbitrage is frictionless and delivers efficient pricing. Capital controls and other trading frictions can interfere with arbitrage and result in violations of the law of one price.[12] As an example, rules about two-way fungibility of DRs have a major impact upon the feasibility of arbitrage. In addition, expanding the pool of investors who have access to the asset and can trade it, makes the market for the asset more liquid, and allows smaller pricing errors to be arbitraged.

2.4.2 Competition

Allowing Indian firms to list on foreign exchanges will expose Indian capital markets to global competition. Indian exchanges and financial intermediaries will be under greater pressure to provide Indian firms with world-class platforms, in which transaction costs are low, with rules that are predictable and enforceable. Doing so will attract and benefit investors and issuers, both domestic and foreign, who seek to conduct business with clarity and confidence, while minimising opportunities for regulatory arbitrage.[13] A more detailed discussion of this is presented in Chapter 3.2.

The entire Indian financial market system will come under competitive pressure. This includes private firms and the government. Rational rules, enforced in efficient ways, will encourage business to take place in India. This is similar to the evolution of tradeables after Indian trade reform.

2.4.3 Market abuse

Recent incidents have shown that the DR route may be used to commit market abuse in India. At the same time, imposing stricter regulations on Indian firms who wish to participate in the international capital market will increase their cost of capital. The regulations must strike a balance between these two. A more detailed discussion of the principles for dealing with market abuse is presented in Chapter 3.5.

2.5 Need for review of the Scheme

The analysis above shows how the *Scheme* has evolved since its inception to meet the demands of Indian firms in participating in the international capital markets. However several developments suggest that the *Scheme* needs a comprehensive review keeping in view, as per the terms of reference of the Committee:

- the new company law and recent legislations in the financial markets.
- the current state of the macro economy and the financial markets.
- the needs of the Indian companies and foreign investors.
- the need for simplification and legal clarity of the *Scheme*.

2.5.1 Recent legislative developments affecting financial markets

There have been considerable changes in the legal and regulatory environment in recent years. The *Scheme* has not kept pace with these developments. This section highlights

[12] For an analysis of violations of the law of one price with ADRs issued by Indian companies, see, Matthew Stigler, Ajay Shah, and Ila Patnaik, "Understanding the ADR premium under market segmentation", in: *NIPFP Working Paper Series* (July 29, 2010), URL: `http://www.nipfp.org.in/media/medialibrary/2013/04/wp_2010_71.pdf`.

[13] See generally, Ministry of Finance, *Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre*, tech. rep., Feb. 10, 2007.

some areas where review and harmonisation are required.

Companies Act, 2013

The philosophy of the new company law has shifted its discourse from control to self-regulation. It presents a paradigm shift in the way every stakeholder in a corporation has to think, act and perform. The statute being mostly principle based is intended to have longer shelf life.

The new law gives statutory status to DRs issued by Indian companies abroad. It defines 'global depository receipt' to mean any instrument in the form of a depository receipt, by whatever name called, created by a foreign depository outside India and authorised by a company issuing such depository receipts.[14] Moreover, it permits creation of a DR outside India by a 'foreign depository'. It gives the Central Government the power to issue rules regarding the manner and conditions for issue of depository receipts in any foreign country.[15] Draft rules have been issued under this provision by the Ministry of Corporate Affairs for issuance of GDRs by an Indian company. These rules will lay down the framework for issue of DRs on the back of the shares of such an Indian company. Under the draft rules, DRs are allowed to be issued by way of public offering or private placement or in any other manner prevalent abroad. DRs may be listed or traded in overseas listing or trading platform.[16]

Securities Ordinance, 2013

The *Securities Laws (Amendment) Second Ordinance, 2013* which is also principle based inserts clause (ib) into section 11(2) of the SEBI Act, 1992 giving SEBI the power to call for 'information from, or furnishing information to, other authorities, whether in India or outside India, having functions similar to those of the Board, in the matters relating to the prevention or detection of violations in respect of securities laws'. It also empowers SEBI to enter into arrangements or agreements of understanding with such authority with the prior approval of the Central Government. SEBI has, in fact, entered into bilateral and multilateral agreements with its counterparts in several jurisdictions.

Takeover Regulations, 2011

DRs issued against equity shares of an Indian company may entitle the holder the right to give voting instructions. Acquisition of such rights beyond a prescribed limit may trigger various obligations under the provisions of the *Takeover Regulations*. Currently, *Takeover Regulations* treat DRs carrying an entitlement to give voting instructions in the target company as 'shares'.[17] It is necessary to know the identity of owners of such DRs beyond specified thresholds of voting rights. In this context, the effect of DRs on the public float needs to be seen. While calculating the minimum public shareholding of a listed company, the DRs on the back of equity shares are excluded.[18]

[14] See n. 9, at Section 2(44).

[15] Sections 41 and 390, ibid.

[16] See Rule 4, Ministry of Corporate Affairs, *Draft Rules under section 41 of Companies Act*, 2013.

[17] See Regulation 2(v), SEBI, *(Substantial Acquisition of Shares and Takeovers) Regulations*, 2011.

[18] See Clause 40A(i), National Stock Exchange, *Model Listing Agreement*, May 13, 2013, URL: `http://www.nseindia.com/content/equities/eq_listagree.zip`; read with Rules 19(2) and 19A of the *Securities Contracts (Regulation) Rules*, 1957.

Indian Financial Code

The Indian Financial Code proposed by the Financial Sector Legislative Reforms Commission (FSLRC) has brought modern thinking about regulation into the Indian discourse. The main strategy of the draft Code envisages financial regulations as addressing market failures and only addressing market failures. This is consistent with the strategy adopted in this report.

While the draft Code is only a proposal, some elements of this have started being implemented. The press release dated October 24, 2013 of the Ministry of Finance states:[19]

> "Based on the deliberations made today, it has been decided that all the financial sector regulators (including Forward Markets Commission (FMC)) will finalise an action plan for implementation of all the FSLRC principles relating to regulatory governance, transparency and improved operational efficiency that do not require legislative action."

2.5.2 The current state of the macroeconomy and financial markets

There has been a gradual increase in the integration of financial markets in India. After the opening of the capital account in 1991, globalisation has helped companies in India to access foreign capital. This inflow has helped Indian companies to grow, and this is visible in the four fold increase of the domestic capital markets after 1991.

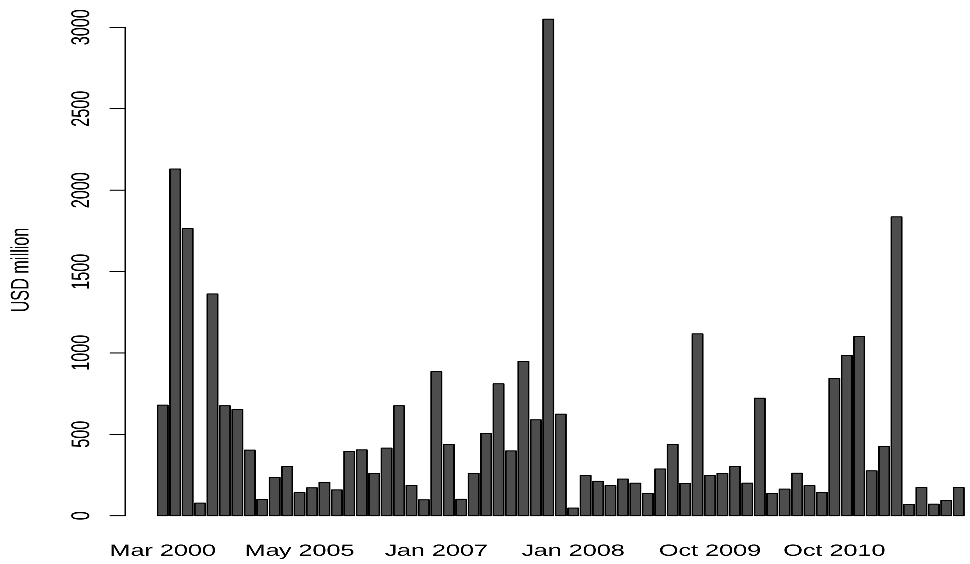

Figure 2.1: Capital raised in ADR-GDR: India

Policy thinking in India on DR has gone through three phases:

[19]See, Press Information Bureau, Government of India, *Finance Minister's Speech*, Oct. 24, 2013, URL: `www.finmin.nic.in/press_room/2013/FMspeech_8thFSDC24102013.pdf` (visited on 11/24/2013).

1. At first, in the early 1990s, there was a sense that foreign investors require DRs in order to avoid the poor market infrastructure in India.
2. By 2001, when the equity market reforms were substantially completed, it was felt that the importance of the DR route had subsided.
3. It is now becoming clear that even though India has world class infrastructure, home bias against investing in Indian securities persists. Foreign investment in almost all Indian securities is vastly below what it should be in a financially integrated world. This motivates fresh efforts at finding institutional mechanisms that connect global investors with Indian securities.

The incremental changes made to the *Scheme* have failed to keep up with economic realities. FDI into India increased from $2.3 billion to $27.3 billion over the last decade. However, Figure 2.1 shows that the quantum of capital raised through DR issues have not increased substantially during this time. This divergence strongly indicates a need for review of the *Scheme*.

Concerns have been expressed about two way fungibility of DRs. Two way fungibility allows DRs to be converted into the underlying securities and the underlying to be bundled into DRs. It is seen from Table 2.2, that two way fungibility was a later addition to the *Scheme*. It allowed re-issue of DRs to the extent to which DRs have been converted into the underlying shares. The concern is that free fungibility should not dilute the legal framework for capital controls. On the other hand, since the DRs and the underlying securities are the same asset, there is no justification in restricting free fungibility. Such restriction will hamper liquidity and price arbitrage. The *Scheme* needs to be reviewed to examine if free fungibility can be permitted without diluting the FDI policy framework.

2.5.3 Market abuse and money laundering

Like other financial instruments, DRs must be viewed in the context of the broader financial markets. Modifying the rules for creation or issue of DRs may have broader effects, including the possibility of market abuse and money laundering.

Concerns have been expressed that relaxing the norms on issue of DR will increase market abuse.[20] Recent events have shown the possibility that inter-convertibility between DRs and the underlying securities may be misused to commit market abuse in India.[21] Another pressing concern is the potential of money laundering using the DR route if DRs are allowed to be issued in jurisdictions with strict banking secrecy law.

These concerns need to be balanced against the recent policy initiative allowing unlisted Indian companies to access the international capital market.[22] This requires a

[20] Supreme Court of India, *N. Narayanan v. Adjudicating Officer, SEBI*, (2013) 178 Company Cases 390, explained 'market abuse' as 'use of manipulative and deceptive devices, giving out incorrect or misleading information, so as to encourage investors to jump into conclusions, on wrong premises, which is known to be wrong to the abusers'. The Court used this formulation in the specific context of the facts of this case involving non-disclosure of true information and disclosure of false information when there was a statutory duty to disclose.

[21] See paragraphs 53 to 59, SEBI, *In the Matter of Market Manipulation Using GDR Issues*, WTM/PS/ISD/02/2011, Sept. 21, 2011.

[22] See generally, Reserve Bank of India, *Amendment to the 'Issue of Foreign Currency Convertible Bonds and Ordinary shares (Through Depository Receipt Mechanism) Scheme, 1993'*, A.P. (DIR Series) Circular No. 69, Nov. 8, 2013.

thorough review of the present *Scheme* to plug any existing legal loophole. Simultaneously, the safeguards in the *Scheme* need to be balanced with the legitimate needs of unlisted Indian firms desirous of participating in the international capital markets.

IOSCO

IOSCO was established in 1983 to bring together the world's securities regulators and set international standards for the securities market. In 2002, the IOSCO established the Multilateral Memorandum of Understanding (MMoU) which provides a global framework for enforcement co-operation between securities regulators, thereby helping to ensure effective regulation and to preserve the strength of securities markets. In 2005, IOSCO required all its members (with primary responsibility for securities regulation within their jurisdiction) to become MMoU signatories, or to demonstrate their commitment towards becoming signatories. In 2010, IOSCO required the later category to become signatories by January 1, 2013. As of now there are 97 signatories to the MMoU and they represent approximately 95% of global securities markets.

SEBI is an ordinary member of the IOSCO. It is a signatory to the MMoU. Therefore, it can request information from other signatories of the MMoU relating to the following activities:[23]

1. insider dealing and market manipulation;
2. misrepresentation of material information and other fraudulent or manipulative practices relating to securities and derivatives;
3. solicitation and handling of investor funds, and customer orders;
4. the registration, issuance, offer, or sale of securities and derivatives;
5. the activities of market intermediaries, including investment and trading advisers who are required to be licensed or registered, collective investment schemes, brokers, dealers, and transfer agents; and
6. the operations of markets, exchanges, and clearing and settlement entities.

The scope of assistance that SEBI can expect from other signatories of the MMoU includes:[24]

1. to enable reconstruction of all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to these transactions;
2. that identify the beneficial owner and controller of an account;
3. the details such as the time of the transaction; the price of the transaction; and the individual and the bank or broker and brokerage house that handled the transaction for transactions, including the amount purchased or sold; and
4. providing information identifying persons who beneficially own or control companies;
5. taking or compelling a person's statement or, where permissible, testimony under oath, regarding the potential offence.

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[23] See paragraph 4, The International Organization of Securities Commissions, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information*, May 2002 (version revised upto May 2012).

[24] See paragraph 7, ibid.

FATF

In the 1989 G-7 Summit at Paris, FATF was established as an inter-governmental body in response to mounting concern over money laundering. Over time, the FATF has developed a series of Recommendations that are recognised as the international standard for combating of money laundering and the financing of terrorism and proliferation of weapons of mass destruction.

The FATF monitors the progress of its members in implementing necessary measures, reviews money laundering and terrorist financing techniques and counter-measures, and promotes the adoption and implementation of appropriate measures globally. Presently FATF comprises of 34 member jurisdictions and 2 regional organisations.

The anti-money laundering regime in India is relatively young. The Government of India set up the Financial Intelligence Unit (FIU) on November 18, 2004 as the central national agency responsible for receiving, processing, analysing and disseminating information relating to suspect financial transactions. It is an independent body reporting directly to the Economic Intelligence Council (EIC) headed by the Finance Minister. It collects cash transaction and suspicious transaction reports, analyses them and shares the information with law enforcement agencies.

The *Prevention of Money Laundering Act, 2002* came into force in 2005 and was amended in 2009. Under the *Prevention of Money Laundering Act, 2002*, the Enforcement Directorate (ED) is empowered to investigate offences of money laundering. The *Unlawful Activities (Prevention) Act, 1967* was first amended in 2004 to criminalise terrorist financing and again in 2008 to broaden its net on terrorist financing. India held observership status at FATF since July 2006. In June 2010, she became a full member of FATF.[25]

The *FATF Recommendations, 2012* specifically impose duties on the member countries:

1. to ensure that financial institution secrecy laws do not inhibit implementation of the FATF Recommendations.[26]
2. to prohibit financial institutions from keeping anonymous accounts or accounts in obviously fictitious names. Extensive customer due diligence obligations have been imposed on financial institutions as adequate safeguards against money laundering.[27]
3. to require financial institutions to keep necessary records of transactions, both domestic and international, for at least five years and report suspicious transactions to the FIU.[28]
4. to extend international cooperation for sharing of information including exchange of information between FIUs, financial supervisors and law enforcement authorities of member countries.[29]

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[25] See, Financial Action Task Force (FATF), *FATF Annual Report*, tech. rep., Financial Action Task Force, 2009-10, URL: `www.fatf-gafi.org/media/fatf/documents/reports/2009\%202010\%20ENG.pdf` (visited on 10/19/2013), at pg. 30.

[26] See Recommendation 9, Financial Action Task Force (FATF), *FATF Recommendations, 2012*, tech. rep., Financial Action Task Force, 2012, URL: `http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf` (visited on 10/19/2013).

[27] See Recommendation 10, ibid.

[28] See Recommendation 11, ibid.

[29] See Recommendation 40, ibid.

2.5.4 Needs of Indian companies and foreign investors

DRs offer advantages relative to other financial instruments to both issuers and investors, but they also present challenges. The current *Scheme* has evolved over time to meet the capital raising needs of Indian firms, but various other commercial requirements of both issuers and investors remain unmet. The following concerns were articulated before the Committee:

1. Firms are unable to issue non-capital raising DRs as this is not explicitly permitted under the present *Scheme*, and issuers are thus unable to take advantage of the reputational and strategic benefits offered by DRs.
2. Restrictions on issuers who are not listed in India, from accessing overseas markets through the DR route shrinks the pool of capital available to Indian firms.
3. The burden of compliance with additional regulations will drive up the cost of creating or issuing DRs, diminishing their attractiveness in the eyes of investors. This will reduce their effectiveness as capital raising tools.
4. In sponsored DRs the number of administrative steps required delays the process. The fact that some of these steps have not yet been automated or computerised, exacerbates these delays.
5. The rules on computation of public shareholding does not treat DRs at par with equity shares. But for the purposes of the *Takeover Regulations*, the DRs are treated as shares and all the obligations of an acquirer apply on the DR holder.
6. The vesting of voting rights, either with the holders of the DRs, or with the issuing company, combined with opacity in shareholding patterns, may impact the market for corporate control. This may be of concern to investors as well as to issuers who want to anticipate takeover bids.
7. Under the current mechanism, an overseas investor is required to purchase shares from the market to be delivered to the depository. For overseas investors with existing holding in the underlying Indian shares, this results in an additional sell trade leading to additional transaction costs and higher volatility in the underlying stock price.
8. The present pricing norms for DRs are set out in the *Scheme*. The two week floor price formulae typically results in floor price which is at a marginal premium or discount to existing market price. Since the book building of a DR follow on is for a period of 2-3 days, the floor price based on the last two weeks prices leaves a very small discount to counter market volatility during the book building period.
9. Under the present law of taxation, sale or purchase of equity shares on a recognised stock exchange attracts Securities Transaction Tax (STT) for both the buyer and the seller. This exempts such transactions from long term capital gains tax. However, the long term capital gains exemption is not available for domestic tender offer for a sponsored DR issue. For such transactions, long term capital gains tax at the rate of 10% (plus applicable cess and surchage) and short term capital gains tax at the maximum marginal rate (plus applicable cess and surchage) is payable. This differential tax treatment distorts the incentives of the shareholders in favour of selling the shares directly in the stock market rather than tendering them for a sponsored DR program.
10. Both issuers and investors are affected by weaknesses in the Indian financial system. When systems, rule-making and enforcement lag behind other jurisdictions,

there are opportunities for regulatory arbitrage, and disincentives for high-quality firms and investors to participate.

The above concerns justify the need for review of the present *Scheme*.

2.5.5 Need for simplification and clarity of the Scheme

One of the foremost facets of rule of law is clear and certain regulations. Having undergone numerous amendments since its inception, the *Scheme* has become cluttered with ancillary provisions, leading to confusion among market participants. There are conflicting opinions on the legal interpretation as to whether unsponsored DR programs are permitted or if non-capital raising DR programs are permitted. It is also not clear as to which law or authority is responsible for laying down the provisions and enforcing the same. This is particularly because the *Scheme* has elements embedded in company law, *Foreign Exchange Management Act, 1999*, securities laws, taxation and money laundering.

Till recently, unlisted companies issuing DRs were required to list simultaneously on the Indian stock exchange. This has now been dispensed. Now an unlisted company can raise capital abroad without listing in India if it lists DRs only on exchanges in IOSCO/FATF compliant jurisdictions. From this deletion, it is not clear whether an unlisted company can issue DRs if it lists its securities on an Indian exchange simultaneously. The new provision says that listing on Indian exchanges is not required. However, the *Scheme* no where now requires such listing. Further, the *Scheme* now requires unlisted companies to list abroad in IOSCO/FATF jurisdiction. It is not clear whether a listed company can issue DRs in a non-IOSCO/FATF compliant jurisdiction. The *Scheme* also has many redundant provisions. For example, it provides that an unlisted company which has taken verifiable effective steps before August 31, 2005 would be exempted from the requirement of simultaneous listing if it completes the issue by December 31, 2005. This provision remains in the *Scheme* even though it has become redundant since 2005, and more so, when an unlisted company issuing DRs is no more required to list simultaneously on Indian exchanges.

The above developments call for a comprehensive review of the *Scheme*.

2.6 Policies in overseas jurisdictions

The legal framework and the existing market micro-structure may be unique to India, but DRs are a global phenomenon. In reviewing the present *Scheme* it may be prudent to take note of alternative policy and legal frameworks around DRs and other modes of accessing international capital markets.

A number of developing countries have used the DR mechanism to address their domestic capital market constraints. The analysis below shows that comparable emerging economies have effectively used DRs to address capital raising requirements across a spectrum of situations. These range from very large capital raising exercises (which the domestic market may not be able to absorb) to small scale capital raising for specialised sectors or purposes (which a domestic market may undervalue).

Table 2.3 shows the number of DRs issued for India alongside the numbers for other large emerging economies. The data show that India has issued fewer ADRs than those in other emerging economies. This could be due in part to India's regulatory framework, which is more restrictive with regard to DR issues than many other jurisdictions. India is one of the few jurisdictions for which there are fewer ADR issues than GDR issues.

Table 2.3: Number of DR issues by select emerging economies

Country	ADR	GDR	Others	Total
India	17	352	0	369
China	286	9	0	295
Russia	56	177	0	233
Brazil	117	65	2	184
South Africa	120	7	0	127
Mexico	65	18	0	83
Turkey	31	38	0	69
South Korea	21	45	0	66
Philippines	49	9	0	58
Indonesia	54	4	0	58
Malaysia	20	0	0	20

Source: JP Morgan

- **China**: Until 2001 the US market played a major role in raising capital for Chinese companies. Between 1993 to 2001, Chinese companies raised approximately $24 billion from the U.S. markets. However, this amount fell to $5 billion in the period 2001-2003 when listing in Hong Kong became popular. Until 2005, Chinese companies would often choose to list in Hong Kong and New York, but many now use Hong Kong to list DRs.[30] Hong Kong listed companies from China are referred to as 'red chips' and have attracted the interest of many global investors.[31] There seems to be no restriction on Chinese companies listing in the US. The only restrictions are those placed by the laws of US.
- **Israel**: Israel has always allowed its companies to list abroad and there is a history of Israeli companies listing in US. In order to promote listing in Israel, a 'dual-listing law' was added to the securities law of Israel in 2000. The amended law exempts firms already traded in the US from the burden of reporting to the Israeli securities regulator. Following this amendment more than 30 Israeli companies, traded on NASDAQ, decided to dual list their shares on the Tel Aviv Stock Exchange (TASE). The trading volume of these companies grew by about 123%. The domestic Israeli stock exchange continued to hold about 42% of the trading volume without adversely affecting the trading volume on the NASDAQ. As a consequence of the dual listing, share prices of these companies went up by about 9%.[32]

  In its interim report in June 2013, Israel's Committee for Promotion of Investments in Publicly Traded Research and Development Companies suggested greater alignment and harmonisation of the Israeli securities disclosure and reporting norms with those in US. This includes full exemption from disclosure requirements for certain US-listed companies.[33]

[30] See, James Bo Howell, "SEC Rule 144 and the Global Market", in: *Asper Review of International Business and Trade Law* 7 (2007), pg. 199.

[31] See "Red Chips Rising", in: *Business Week (International Edition)* (June 8, 1997), URL: http://www.businessweek.com/stories/1997-06-08/red-chips-rising-intl-edition.

[32] See, Shmuel Hauser, "The effects of dual listing on share prices and liquidity in the absence of registration costs", in: *Journal of Service Science and Management* 4 (2011), pp. 15–21.

[33] See, Committee for Promotion of Investments in Publicly Traded Research and Development Companies, *Interim Report*, tech. rep., Israel Securities Authority, 2013.

- **Brazil**: Brazilian companies accessing the DR route need approval from the Central Bank and the Securities and Exchange Commission of Brazil. Brazil allows both sponsored Level I and unsponsored Level I ADR issues. A number of large Brazilian companies launched ADRs in the 1990s. Many smaller Brazilian companies prefer to launch an Initial Public Offering (IPO) at home before going international.
- **Indonesia**: Indonesia allows both sponsored Level I and unsponsored Level I DRs issue. Domestic companies do not need any regulatory approval but must report to the Indonesian securities regulator.

3 — Guiding principles

The Committee's review of the *Scheme* has been informed by the strategy for financial reforms articulated by recent expert committees, including the Percy S. Mistry Committee Report (2007), Raghuram Rajan Committee Report (2008), U.K. Sinha Committee Report (2010) and the Justice B.N. Srikrishna Commission Report (2013). The general policy direction adopted by the Committee also broadly conforms to the general policy approach underpinning the *Companies Act, 2013* and the draft rules issued under it, recent financial sector legislations and the development in international cooperation under the auspices of FATF and IOSCO.

3.1 Contemporary policy thinking

1. *Indian policy makers agree that foreign participation in Indian economy is deep-rooted.*
2. *Clear, certain and effective regulations are necessary to facilitate foreign participation in Indian financial markets. The Companies Act, 2013 further facilitates this participation.*
3. *Therefore, the policy objective of the Committee conforms to contemporary policy thinking in India.*

India's foreign investment framework has been influenced by perceptions that foreign investment is volatile and could respond sharply to adverse domestic events, thus exacerbating a domestic crisis. However, with time, there has been a major shift in policy thinking. Recent studies suggest that Indian actors have embraced and internalised foreign participation in the economy and that foreign participation is deep-rooted. It is, therefore, essential for the Indian regulatory set up to respond to the needs of foreign investors and smoothen their interactions with Indian regulations. Present policy makers strongly feel that if attention is paid to the organisation of regulations, it would yield strong dividends to the economy in the form of more clear, certain and effective regulations.[1]

A successful effort in this direction has been the enactment of the *Companies Act, 2013*. This legislation is informed by the international developments in the field of company law as well as the growing internationlisation in the functioning of Indian corporates. For the first time, the Indian company law has given statutory recognition to DRs issued abroad on the back of shares of Indian companies.[2] Draft rules in this regard have also been published for public comments under the *Companies Act, 2013* and are expected to be notified soon.

Drawing from the broader policy objectives suggested by the previous expert bodies, the Committee endeavoured to simplify the regulations governing DRs issued abroad on the back of Indian securities. The Committee has taken efforts to harmonise the *Scheme* with the overall regulatory framework for DRs including the relevant provisions of the *Companies Act, 2013* and the rules under it, the *Takeover Regulations*, *Foreign Exchange Management Act, 1999*, the consolidated FDI policy, securities and taxation laws. This harmonisation will provide the much needed clarity and certainty of legal regulations in the DR market. It will be a step forward in enhancing India's commitment to rule of law in foreign participation in the financial sector as has been advocated by the earlier expert committees.

3.2 Capital markets to support the real economy

1. *In an open economy, real sector firms that compete internationally require inputs that have international characteristics on price and quality.*
2. *The cost of capital, and the price and quality of financial services, influences the competitiveness of the real economy.*
3. *Hence, real sector firms in India must access capital and financial services at levels of price and quality which match those faced by global firms.*

Trade liberalisation opens the real economy of a nation to global competition. This competition is good for consumers as domestic firms have to compete with international firms to provide goods and services. This competition spurs productivity growth by Indian firms and thus augments Indian Gross Domestic Product (GDP) growth. India has made considerable advances in the area of trade liberalisation in the last two decades.

The primary area of competition between firms is *price*, and *price* in turn is a function of input costs and efficiency. All inputs are relevant here, including raw materials, capital, financial services, labour, etc.[3]

In a competitive market, if different firms face different input costs, the firm with higher input costs is at a disadvantage. When domestic firms are not allowed to access international capital markets, they are at a disadvantage.

Protectionist policies force firms in India to buy inputs made in India even if they are inferior to the best inputs available worldwide (on price and/or quality). These

[1] See generally, Working Group on Foreign Investment, *Report of the Working Group on Foreign Investment*, tech. rep., Department of Economic Affairs, Ministry of Finance, July 30, 2010.

[2] See sections 2(44) and 41, see n. 9.

[3] See, Committee on Financial Sector Reforms, *Report of the Committee on Financial Sector Reforms*, tech. rep., Planning Commission of India, Sept. 12, 2008, at pg. 107.

policies perpetuate inefficiency by the producers of inputs, and act as a drag upon the competitiveness of the firms which are buyers.

As an example, India no longer forces Indian firms to buy steel that is made within India. This deregulation had two impacts. Firms that *consume* steel were more able to operate in India and compete globally, as they had access to steel of global quality and price. In addition, Indian producers of steel were placed under competitive pressure.

Capital, like steel, is an input and comes at a cost. If Indian firms are to compete successfully at a global level, they need to have access to capital at the cost at which their competitors can raise capital. Just as compelling Indian firms to use Indian steel irrespective of its cost and quality is inefficient, similarly compelling Indian firms to raise capital only from the Indian capital market is inefficient. A firm should be free to raise capital from any investor whoever gives it at the best price. Therefore, Indian laws must be neutral to a firm's choice of accessing capital from global investors.

3.3 Barriers to accessing global capital

1. *There are various regulatory constraints that inhibit foreign investment in India.*
2. *Foreign investors suffer from 'home bias'.*
3. *Therefore, DRs are an attractive route for foreign investment into India.*

3.3.1 Regulatory constraints

At present, investment in securities in India, by global investors, is hampered by the following problems:

1. **Source-based taxation**: India uses source-based taxation which attempts to tax all income of residents of the nation and any income of a non-resident which is attributable to any activity in the nation where the tax is applied. On the other hand, most other economies use residence-based taxation which follows the principle of only taxing the residents of a nation for their income (irrespective of where such income arises) and exempting all non-residents from taxation. There is extensive literature in economics which suggests that residence-based taxation would reduce distortion of allocation of investment in the global market. Since India still follows the source-based method of taxation, there are higher chances of double taxation for foreign investors.[4]
2. **Securities Transaction Tax**: The STT is one component of India's attempts at source-based taxation. STT is levied on purchase and sale of shares and other securities of a company, carried out on a stock exchange. Although the STT was imposed as a substitute for capital gains, the former is an indirect tax while the latter is a direct tax. Irrespective of whether the investor is a resident in India or not, STT is payable when the investor sells or purchases securities through an Indian stock exchange. For a foreign investor transacting on an Indian stock exchange, STT makes the securities more expensive and less attractive.[5]

[4] See, Working Group on Foreign Investment, see n. 1, pg. 119-121.

[5] See, Ministry of Finance, *Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre*, see n. 13, at pg. 164.

Table 3.1: Median foreign holding in size deciles of Indian firms

Decile	Median market capn. (Million rupees)	FII holding (Per cent)
0-10	6	0
10-20	15	0
20-30	29	0
30-40	49	0
40-50	83	0
50-60	152	0
60-70	320	0
70-80	797	0
80-90	2999	0.3
90-100	25073	9.6

Source: CMIE Prowess

3. **Trading time**: The Indian market closes at 3.30 PM Indian Standard Time (IST) and the New York market opens at 8 PM IST. This prevents the foreign traders from effectively participating in the Indian equities markets.[6]
4. **Law on Gate-keepers**: The Indian laws on liabilities of gate-keepers (auditors, merchant bankers and others) are not clear. As a consequence, foreign investors view the ADR market as far safer. This disparity in legal regimes on gate-keepers was evident in the Satyam episode. The auditors involved in that case settled legal proceedings with the PCAOB and the U.S. Securities and Exchange Commission (SEC) for the alleged negligence. By contrast, in India, the very jurisdiction of SEBI on auditors was called into question and the Bombay High Court had to rule on the issue.[7]
5. **Capital controls**: Indian capital controls distort the market for foreign investment. The existing policy framework for capital flows creates a complex, overlapping web of law marked by administrative bottlenecks, and contradictory and sometimes duplicate processes.[8] While inflows into listed equity are fairly open, individuals and corporations are faced with unnecessary complexity in the form of separate regulations for different categories of investors and sub-account holders. These investments are in turn regulated by RBI, SEBI, Department of Industrial Policy and Promotion and the Ministry of Finance. Specific capital flows management regulations apply to specific types of investors such as private equity and venture capital. Procedures are complicated and delays are possible even under the 'automatic' route.

3.3.2 Home bias

'Home bias' is the tendency of foreign investors to disproportionately allocate their funds in favour of their domestic jurisdiction. There is strong evidence that home bias affects the Indian capital markets. While foreign investment may be beneficial, the empirical evidence shows that very few firms in India are able to attract foreign investment. Less than a thousand companies have over 1% investment by FIIs. In 2011 there were only 703 firms where foreign investors owned above 5% of the publicly traded market value.

Table 3.1 shows the median value of FII percentage holding in size deciles amongst

[6] See, Stigler, Shah, and Patnaik, see n. 12.

[7] See, Bombay High Court, *Price Waterhouse and Co. v. Securities and Exchange Board of India*, [2010] 160 Company Cases 324.

[8] See, Committee on Financial Sector Reforms, see n. 3, at pg. 105.

all Indian listed firms. This evidence shows that FIIs are substantially absent in a large swathe of Indian firms. A recent paper finds that both foreign and domestic institutional investors focus on a small set of firms with high stock market liquidity and large size.[9] Most firms fail to obtain capital from institutional investors.

Given that home bias is a serious problem, policy makers need to modify rules so as to foster a deep engagement between global investors and a diverse array of Indian securities. This requires rethinking capital controls, rules about 'permanent establishment' through which global firms can establish operations in India, fully operationalising world class information and accounting systems, etc. The recommendations of this report constitute one element of a larger strategy for combating home bias.

At present, India's financial architecture prevents firms from interacting freely with investors in other markets, and exacerbates the home bias that prevents foreigners from investing in India.

The alternative means available to the foreign investors have their own limitations:

- ETFs based on an index cannot provide exposure to individual stocks.
- Participatory notes involve taking counter-party default risk.
- Under Qualified Foreign Investor (QFI) scheme, investors need to obtain a Permanent Account Number (PAN) for tax purposes, establish relationships with local brokers, and have to pre-fund their trades.

As a consequence, the DR route is relatively more attractive than the other available routes. Therefore, the DR route has the potential to successfully integrate the present Indian financial system with the international capital market.

3.4 Market regulation to address market failure

1. *All market regulation must be informed by an analysis of market failures.*
2. *All financial regulation must be motivated by the concerns of consumer protection, micro-prudential regulation, systemic risk regulation and resolution.*
3. *Therefore, appropriate regulatory strategies for DRs must be informed by this analysis.*

Considering the crucial role that DRs can play in integrating the Indian financial system with the international capital market, devising the ideal regulatory framework for DRs assumes importance. These regulations must ideally be aimed at addressing 'market failures' in the DR market.

Some markets left to themselves may fail to produce efficient allocation of resources. Such an event is referred to as 'market failure'. Regulations exist in order to address such market failures. This framework for thinking about market failures, when translated into the field of finance, induces a clear categorisation of the tasks of the government, as has been clarified by the Financial Sector Legislative Reforms Commission.

The systematic strategy to financial regulation consists of analysing the market processes and identifying interventions that fall within the following areas, identified by

[9] See, Ila Patnaik and Ajay Shah, "The investment technology of foreign and domestic institutional investors in an emerging market", in: *Journal of International Money and Finance* 39 (2013), pp. 65–88.

the FSLRC:[10]

1. *Consumer protection*: Without the trust of the consumers, the financial market cannot perform its primary function of allocation of resources from savers to spenders. At the same time, financial firms may have perverse incentives to exploit the trust of consumers in an unfair manner. Most consumers are in an unequal bargaining position and sometimes financial firms stand to gain out of monopolies and related rent-seeking behaviour. In this context a 'buyer beware' approach is not adequate. Regulators must place the burden upon financial firms of doing more in the pursuit of consumer protection. This perspective shapes interventions aimed at prevention (inducing financial firms towards fair play) and cure (redress of grievances).
   DRs are foreign securities. They are purchased and traded by foreign investors in a foreign jurisdiction. When underlying Indian securities are bundled into DRs or the DRs are cancelled and converted into the underlying Indian securities, the Indian investor or the securities market in India may be affected. Regulations should be framed accordingly.
2. *Micro-prudential regulation*: When financial firms make promises to consumers, regulators are required to monitor the probability of the financial firm failing to honour that promise and undertake interventions that reduce this probability. The higher the intensity of promise, the stricter should be the regulations. Otherwise, if financial firms are allowed to go back on their promises with impunity, consumers' faith in the financial system will be hampered. An example is the faith reposed by consumers depositing money with regulated banks.
   DRs are issued on the back of domestic securities. Firms issuing these domestic securities are regulated by different micro-prudential regulations. Securities law do not provide for micro-prudential requirements of the issuer. Similarly, laws governing DRs should not provide for any micro-prudential requirements of the issuer.
3. *Systemic risk*: Micro-prudential regulation addresses the possibility of collapse of one financial firm at a time. A very different point of view is required when addressing the possibility of the collapse of the entire financial system. This calls for measurement of systemic risk, and undertaking interventions at the scale of the entire financial system (and not just one sector) that diminish systemic risk.
   As explained above, the law on DRs is not concerned with the micro-prudential requirements of the issuer. Similarly, it need not be concerned with systemic risk aspects either.
4. *Resolution*: Micro-prudential regulations reduce the probability of firm failure. However, eliminating all failure is neither feasible nor necessary. At the same time, failure of large private financial firms can be highly disruptive for households that were customers of the failing firm. This requires a specialised 'resolution mechanism' to ensure orderly resolution of troubled firms before they reach the stage of insolvency. The resolution of issuers of DRs is a general resolution issue. It need not be addressed in the law on DRs.

[10]See, Financial Sector Legislative Reforms Commission, *Report of the Financial Sector Legislative Reforms Commission*, tech. rep., Government of India, 2013.

3.5 Enforcement over prohibition

1. *New markets create additional opportunities for violation of laws.*
2. *However, an appropriate regulatory response is not prohibiting market access, but improving detection and investigation capabilities.*

Overseas issue and trading of DRs on the back of Indian securities exposes the Indian securities market to potential market abuse and money laundering. The appropriate regulatory response is to ensure effective enforcement of the law, which may require co-operation with foreign investigative authorities. Academic literature also shows that greater information about DR issue might reduce opportunities to manipulate underlying stock price return.[11]

India is a member of the FATF and has a FATF compliant money laundering legislative framework in place. RBI and SEBI have a major role to play in this framework.

SEBI is a member of IOSCO. This allows Indian regulators to co-operate with foreign regulators in investigating market abuse and money laundering. Most other jurisdictions use this same mechanism and do not prohibit issue of DRs. Indian regulators need to adopt international best practises which promote rather than prohibit capital flows.

3.6 Harmonising depository receipts with capital controls

1. *Capital controls are a part of Indian economic regulation.*
2. *DRs should be subjected to the same capital controls that are applicable to the underlying securities.*

India uses capital controls as part of its macroeconomic policy tool-kit to regulate capital flows. The DR route is treated as FDI. The Department of Industrial Policy and Promotion (DIPP) issues a circular on consolidated FDI policy which is updated every year. The DIPP makes policy pronouncements on FDI through press notes or press releases, which are notified by the RBI as amendments to the *FEMA 20*. The procedural instructions are issued by the RBI through circulars. The regulatory framework of FDI consists of Acts, regulations, press notes, press releases, clarifications etc.

Under the existing legal framework different limits have been provided for FDI in different sectors. Depending on the sector, FDI can flow in through automatic route or the approval route. Under the automatic route, the foreign investor or the Indian firm does not require any approval from the Government of India for the investment. Under the approval route, prior approval of the Foreign Investment Promotion Board (FIPB) is required.

The DR and the underlying security are one and the same asset. The FDI framework should be equally applicable to both the instruments. This approach will rationalise and harmonise the issue of DRs with the broader overarching FDI policy of the country.

[11] See, Ajay Shah, *The Tale of One Market Inneficiency, Abnormal Returns around GDR Issues by Indian Firms*, Apr. 14, 1995, URL: `http://128.118.178.162/eps/fin/papers/9507/9507001.pdf` (visited on 10/19/2013).

4 — Issues and policy directions

Based on internal deliberations as well as consultation with the stakeholders, the Committee identified the policy issues relevant to DRs and analysed them in depth keeping in view the principles of law, economics and regulations enunciated in earlier chapters. In this section, each policy issue is framed as a question, and the Committee's corresponding recommendations are stated, accompanied by an explanation for the same.

4.1 Who can provide the underlying securities?

The Committee recommends that any Indian issuer of securities should be able to issue fresh securities on the back of which DRs may be issued abroad by a foreign depository. However, a person barred by SEBI or any other court of law from accessing Indian capital market should not be allowed to access international capital markets using the DR route. It further recommends that any person holding Indian securities should be able to transfer those securities which may be deposited with a domestic Indian custodian and on the back of such securities, DRs may be issued abroad by a foreign depository.

In an open economy, real sector firms that compete internationally require inputs that have international characteristics regarding price and quality. In a competitive market, if different firms face different input costs, the firm with higher input cost is at a disadvantage. For Indian firms to be globally competitive, it is essential that they have access to capital as well as quality financial services at the lowest cost. Therefore, there is no reason to deny any domestic firm access to international capital markets.

The present framework prohibits any company ineligible to access the capital market in India from accessing this route. The Committee, however, notes that no company per se is ineligible to access Indian capital market. For example, the SEBI *(Issue of Capital and Disclosure Requirements) Regulations* allow every company to access capital markets. It only states that if a company does not meet particular requirements, it can still make a public offer through a book building route. It has prescribed different standards for issuers for using different modes of accessing capital market. Therefore, the Committee is of the view that Indian law should not restrict an issuer from accessing the international capital market through DR route. However, the Committee is conscious of the reputational risk of the country. Equally, once a DR is issued, it can be converted into the underlying permissible securities and, therefore, the ban on accessing the Indian capital market can get circumvented. Therefore, it recommends that persons who have been barred by the SEBI or any other Court of law from accessing the Indian capital market should not be permitted to issue permissible securities for the purpose of issue of DRs.

Every country has domestic laws to safeguard the interests of investors within its own jurisdiction. For example, the *IDR Rules, 2004* provide eligibility criteria for the companies that can issue Indian Depository Receipts (IDRs) in India. The eligibility criteria includes minimum paid up capital and turnover, track record of making profits, minimum debt equity ratio and also any eligibility criteria that may be laid down by SEBI from time to time. Therefore, the laws and authorities of the foreign jurisdiction would screen the issuers of underlying securities on the back of which DRs can be issued. And the laws and authorities of different jurisdictions would have different eligibility criteria for issuers of Indian securities. Therefore, the Committee is of the view that Indian law should not prescribe any eligibility criteria for issuers.

In a fresh issue, the issuer of the securities may directly issue the securities to the foreign depository against which DRs may be issued abroad. In an unsponsored issue, the holders of the securities may transfer them to the foreign depository against which DRs may be issued abroad. In a sponsored issue, the holders of the securities may transfer them, with the approval of the issuer concerned, to the foreign depository against which DRs may be issued abroad. The transfer may happen on exchange, off-exchange or through a public tender process.

4.2 Who can subscribe to depository receipts?

The Committee recommends that any person should be able to subscribe to the DRs issued on the back of underlying Indian securities.

Since DRs represent essentially the same asset as the underlying securities, the capital controls regime applies equally to both. The capital controls regime is adhered to by allowing DRs to be issued only on the back of those securities in which a person resident outside India can invest. Over and above these restrictions applicable to the underlying securities, there is nothing further to be gained by restricting subscription to DRs.

The present Indian laws do not allow certain categories of persons to invest in Indian securities. These restrictions will apply equally to permissible securities underlying DRs. For example, the underlying securities cannot be issued to or purchased by a foreigner who is not allowed to purchase Indian securities. The existing laws also allow a person resident in India to take a limited amount of funds outside India and invest in foreign securities. These funds may be invested in DRs and may flow back into India. Since detecting these inflows will impose huge compliance and monitoring costs, the Committee is of the view that these funds should be treated as foreign investment.

This would enable both foreign and domestic investors to buy both DRs as well as their underlying securities on the same level playing field and would provide excellent arbitrage opportunities and thereby improve price efficiency.

4.3 What should be the underlying securities?

The Committee recommends that if a foreign investor is permitted under the existing capital controls / foreign investment regime to hold any securities in India, DRs should be allowed to be issued abroad on the back of all such securities. It further recommends that any securities against which DRs may be issued must be in dematerialised form. It does not recommend DRs on the back of FCCBs.

The Indian legislative framework provides for various capital controls. For inbound investments, these can be broadly classified into the FDI scheme and the portfolio investment scheme. The proceeds from foreign investors through the DR route are treated as FDI. FDI can be through automatic route or approval route. In the automatic route, FDI is allowed without any approval of the Government or the RBI in all activities or sectors specified in the consolidated FDI policy. In the approval route, FDI is allowed in activities not covered under the automatic route subject to prior approval of the Government through the FIPB. FDI is completely prohibited in certain sectors like atomic energy, gambling and betting etc.[1]

Keeping this overarching framework of capital controls intact, there is nothing further to be gained by distorting a foreign investor's choice of investing in Indian securities or an issuer's choice of using the DR route in comparison to other modes of participating in the international capital markets. The Committee is of the view that the law should be neutral to a foreign investor's choice of the mode for purchasing Indian securities and to the Indian issuer's choice of mode of raising capital as long as the basic capital controls are complied with. Therefore, the Committee recommends DRs on the back of any securities as defined in the *Securities Contracts (Regulation) Act, 1956* whether issued by a company, mutual fund, government or any other issuer and the similar instruments issued by private companies. For convenience, the Committee chose to refer to these securities as permissible securities.

The present *Scheme* suggests that it may be possible to issue DRs on the back of FCCBs. The Committee, however, does not envisage a FCCB to be permissible securities since it is issued to persons resident outside India in foreign currency and there is no practical utility to issue a DR on the back of FCCBs.

It is further clarified that the Committee intends all permissible securities to be in dematerialised form before they can be used as underlying for a DR issue. This is necessary for convenience in gathering data and information regarding DR issues and for reconciliation and investigation purposes. This would enable the depositories the disseminate the extent to which permissible securities have been used for DRs and the headroom available for conversion from DRs to securities and vice versa.

[1] See, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, *Consolidated FDI Policy*, Apr. 5, 2013, URL: `dipp.nic.in/English/Policies/FDI_Circular_01_2013.pdf`.

4.4 What is the limit on issue of depository receipts?

The Committee recommends that DRs should be allowed to be issued to the full extent to which foreign investors can hold such securities in India. There should be no restriction on the amount of money for which DRs can be issued, as is the present position.

The underlying securities and the DRs issued against them are essentially one and the same asset.[2] For all practical and economic purposes, capital controls should equally apply to both. Under the existing capital controls regime, foreign investors have access to the underlying Indian securities subject to some restrictions like sectoral limits, percentage limits on foreign participation, quantitative restrictions etc. Subject to the limitations applicable to the underlying securities, DRs may be issued abroad to foreign investors. For example, the foreign investment in a company is ordinarily permissible up to x%. However, it can be increased up to y% with the approval of the company in the general body meeting. If no such approval has been granted, the permissible securities on which DRs may be issued, whether sponsored or unsponsored, cannot exceed x%. This will be in consonance with the capital control rules. Therefore, the Committee recommends that if a foreign investor is permitted under the existing capital controls regime to hold any securities in India, DRs should be allowed to be issued abroad on the back of such securities to the same extent to which foreign investors can hold such securities in India.

The current capital control framework allows foreign exposure to domestic securities up to limits specified under the *Foreign Exchange Management Act, 1999*. Within that limit, the issuer should be free to allocate capital. Similarly, the foreign investor should also be free to invest within that limit. The elements of capital allocated and the elements of capital invested should be freely fungible among themselves subject only to the overall limit of foreign exposure as mandated by the capital controls regime. This position is reflected in the current laws, which do not impose any monetary limit to which DRs may be issued by an issuer.[3] The Committee is of the view that this position should be retained.

4.5 Who can issue depository receipts?

The Committee recommends that any person permitted under the laws of a foreign jurisdiction to carry on the business of issuing DRs in that jurisdiction should be able to act as a foreign depository for issue of DRs on the back of Indian securities. Indian law should not go into regulating any eligibility requirements for a foreign depository to meet.

The mandate of the Indian authorities is to protect the interests of Indian investors against market abuse. Every country has domestic laws to safeguard the interests of investors within its own jurisdiction. For example, the *IDR Rules, 2004* provide that IDRs could be issued only by domestic depositories registered as custodian of securities with SEBI in India. Besides, the regulators have entered into international co-operation

[2] See, Stigler, Shah, and Patnaik, see n. 12.

[3] See, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, see n. 1, paragraph 3.3.4(iv).

agreements to facilitate investigation and enforcement activities. Imposing additional eligibility requirements on foreign depositories issuing DRs abroad without an effective mechanism to monitor or enforce against off-shore service providers would be redundant. Therefore, the Committee is of the view that Indian law should not provide any additional eligibility requirement for a foreign depository, particularly when the domestic custodian has responsibility to ensure compliance with Indian laws.

Nevertheless, the committee feels that only a person from a FATF and IOSCO compliant jurisdiction and who is not prohibited from acquiring Indian securities and has permission to issue DRs can act as a foreign depository. This would enable Indian authorities to gather information from the authorities who have permitted the foreign depository to issue DRs. This is an improvement over the earlier *Scheme* which allowed any bank authorised by the issuer of Indian securities to act as foreign depository.

4.6 Who can be a domestic custodian?

The Committee recommends that a regulated market intermediary having permission from SEBI to provide services as custodian of Indian securities underlying the DRs should be the custodian.

Protection of Indian investors requires that safeguards be placed on custodians of the underlying Indian securities in India. The Committee is of the opinion that the standard applicable to any custodian of securities in India should also apply to any domestic custodian in a DR issue. Specifically, a domestic custodian should be :

- A fit and proper person
- Prudentially sound
- Capable to effectively discharge its duties
- Capable to manage the business of custodian of securities

The above safeguards presently apply to any custodian of securities in India.[4] Accordingly, a domestic custodian for DR issue must be a custodian of securities under the *SEBI Act, 1992* or any other person, such as depository, depository participant or bank, meeting the above requirements.

4.7 What should be the conversion ratio?

The Committee recommends that the parties should be free to choose the ratio of DRs to the underlying permissible securities.

In a sponsored issue, this ratio may be determined by the depositary agreement between the issuer and the foreign depository. In an unsponsored issue, this ratio may be determined by the foreign depository. The Committee is of the view that this ratio, being guided by commercial realities prevailing in the domestic and international markets, is best left to the prudence of the parties involved. The Committee could not envisage a market failure arising out of a freely determined conversion ratio. Therefore, the Committee recommends that the parties should be free to choose any ratio of DRs to the underlying permissible securities.

[4] See Regulation 6, SEBI, *(Custodian of Securities) Regulations*, 1996.

4.8 For what purpose can depository receipts be issued?

The Committee recommends that DRs should be allowed to be issued for non-capital raising as well as capital raising purposes. It also recommends that there should be no end use restrictions on the funds raised through the issue of DRs per se and the restrictions, if any, for an issuer should apply.

There are various commercial reasons for setting up a DR program. As long as such a program is not detrimental to the interests of the Indian investors and the integrity of the Indian capital market, there is no reason to restrict it.

The present *Scheme* permits capital raising DRs to be issued by both listed as well as unlisted companies.[5] This route should be kept open. We should not be limiting capital raising to any specific sectors. Any issuer in a sector, which can access foreign investment, should be able to use DR route for accessing international capital market.

There is lack of clarity regarding permissibility of non-capital raising DRs under the present *Scheme*. Under the *Scheme* though an Indian company can sponsor an issue of DRs against the shares held by its shareholders, this has not taken off. Non-capital raising DR programs present no greater risk of money laundering than capital raising DRs do. Nor do they expose the Indian investor or Indian capital market to any higher risk of market abuse. Therefore, non-capital raising DRs should be allowed to be issued on the back of permissible securities in a sponsored as well as unsponsored issue.

Currently, the funds raised through issue of DRs are not permitted for deployment or investment in real estate and stock market. This position does not conform to the principle that DRs and the underlying securities are the same asset and the rules of capital control should apply equally to both. The same end use restrictions in terms of cap and/or purpose, as are applicable to the underlying securities, must apply to the DRs and no more. Therefore, the Committee is of the view that there should not be any end use restriction on DRs themselves.

4.9 Where can depository receipts be issued?

The Committee recommends that DRs may be issued only in a foreign jurisdiction that satisfies both the following requirements:

- *The foreign jurisdiction is a member of the FATF, and*
- *The securities regulator of that jurisdiction is a member of IOSCO.*

There are concerns that DRs may be used for money laundering and market abuse purposes. Investigations carried out by SEBI have thrown light on the kinds of violations that can happen in the DR market. One such example is the 'structured transactions' which combined money laundering and market abuse to artificially inflate the prices of the underlying securities in India. However, the money laundering and market abuse concerns do not require absolute ban of issue or trading of DR in other jurisdictions.

[5] Unlisted companies, even without simultaneous listing on domestic exchanges, are allowed after the recent amendment to the present *Scheme.* See paragraph 3, Ministry of Finance, *Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Mechanism)(Amendment) Scheme, 2013*, Notification No. GSR 684(E) [F.No.4/13/2012-ECB], Oct. 11, 2013.

Concerns regarding market abuse and money laundering should be addressed adequately if the Indian regulators have appropriate powers to carry out investigations concerning cross border transactions. For this it is essential that DRs be allowed to be issued only in jurisdictions which are under legal obligations to extend cooperation to Indian investigative agencies. This policy position is also reflected in the recent amendment to the *Scheme* which limits listing of DRs on the back of securities of unlisted companies to FATF/IOSCO compliant jurisdictions.[6]. The international capital markets use FATF and IOSCO standards to deal with money laundering and market abuse and that should be adequate for DRs issued on Indian securities.

Under the extant *Scheme*, a listed company can issue shares for issue of DRs in any jurisdiction and an unlisted company can do so in either FATF or IOSCO compliant jurisdiction. In contrast, the Committee recommends that a company, listed or unlisted, can issue shares for issue of DRs in a jurisdiction which complies with both FATF and IOSCO standards.

4.10 Should depository receipts necessarily be listed?

The Committee recommends that the law should not require DRs to be listed on any international exchange.

The *Scheme* allows DRs to be transacted on exchanges, OTC exchanges and book-entry transfer systems. The present formulation reads:[7]

> "The Global Depository Receipts issued under this Scheme may be listed on any of the Overseas Stock Exchanges, or over the counter exchanges or through Book Entry Transfer Systems prevalent abroad and such receipts may be purchased, possessed and freely transferable by a person who is a non-resident within the meaning of section 2(q) of the Foreign Exchange Regulation Act, 1973 (46 of 1973), subject to the provisions of that Act."

While there was a general agreement to continue the present dispensation, the Committee had a detailed discussion on the desirability and feasibility of limiting issue and trading of DRs issued on the back of listed securities to an 'exchange' platform. It noted that the extant *Scheme* allows DRs to be listed on overseas stock exchanges and OTC exchanges and the term 'exchange' has varied meanings in different jurisdictions. While the vast majority of listing in India happens on the two national 'standardised' exchanges, this is not true for the rest of the world. Even India has about twenty exchanges which have different standards of listing and trading of securities. It is, therefore, possible that some 'exchanges' may have standards inferior to those prevalent in OTC markets. It would not be possible to grade exchanges internationally and limit issue of DRs on select exchanges. Further, listing on an exchange itself does not prevent risks of market abuse. The solution lies in improving the capacity to handle market abuse.

[6]See paragraph 3, ibid.

[7]See paragraph 6, Department of Economic Affairs, Ministry of Finance, *Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993*, GSR 700(E), Nov. 12, 1993.

Developed financial markets have a wide array of exchanges depending on technology used, participants allowed and information and trade matching rules. These exchanges have played an important role in providing niche financing needs. Restricting Indian firms to public 'exchanges' will deny them the benefits of such niche markets. The *Report of the Financial Sector Legislative Reforms Commission* has also recommended that the law should be neutral in its treatment of organised financial trading facilities.[8] The Committee believes that restricting listed Indian companies from issuing DRs in foreign OTC markets will be a step backwards. Prohibiting multiple avenues of trading in securities will also inhibit the development of a rich competitive environment in which securities are priced efficiently and exchanges are forced to maintain high standards of integrity and service. Therefore, DRs issued on the back of any Indian securities, listed or unlisted, may be listed on international exchanges as well as traded on OTC systems abroad. This conforms to the present legal position. However, the listing of DRs on an international exchange would carry certain privileges which the Committee believes would encourage companies to prefer listing.

Two members of the Committee, namely, Mr. G. Padmanabhan and Mr. S. Ravindran, are strongly of the view that the DRs on listed securities must be listed only on an international stock exchange of comparable standard of major exchanges in India, for the following reasons:

- Care should be taken to ensure that only genuine companies access funds abroad. If many dubious companies are permitted to list abroad it will lead to eventual increase in cost of capital for the Indian companies in future. Overseas regulators will be concerned about the quality and genuineness of the issues only when retail investors of their jurisdictions are permitted to participate. This will also enable trading by overseas retail investors, thus, ensuring a level playing field between the Indian and overseas markets.
- The stock exchanges for this purpose should be at least of the comparable standards with the major stock exchanges of India to ensure an acceptable level of transparency, disclosures and accounting standards.
- The benefits envisaged, like higher valuation, greater shareholder protection, greater visibility, greater analyst coverage, etc. on account of higher disclosure standards, higher standards of corporate governance, better minority shareholder protection, presence of sophisticated analysts, etc. prevailing in international capital markets, shall accrue to the companies only by listing on public platforms which are accessible to retail investors and not in OTC markets.
- As fungibility is allowed between DRs and the underlying Indian securities, an act of manipulation in case of listed companies on account of lax regulatory regime with respect to overseas OTC markets would ultimately have a bearing on the integrity of market in India as has been seen by SEBI in recent GDR investigation cases. Thus, DR programs in OTC markets should not be permitted for Indian listed companies and listing on retail platform is imperative. This will also prove to be a preventive measure for market abuse.
- The regulatory world is putting in checks and balances to restrict OTC markets in respective jurisdictions and the G-20 recommendation is to move standardised

[8]See Clause 182, Financial Sector Legislative Reforms Commission, *Indian Financial Code*, Mar. 2013, URL: `http://goo.gl/rInW6RâĂŐ`.

OTC trades to exchange platforms.

4.11 How should underlying securities be priced?

The Committee recommends that permissible securities should not be issued to a foreign depository for the purpose of issuing DRs at a price less than the price applicable to a corresponding mode of issue of such securities to domestic investors under the applicable laws. It believes that the floor price norm currently applicable to unlisted companies, involving computation of the floor price based on discounted cash flows does not serve any realistic purpose. This norm should be reviewed by the RBI.

The issue price of the fresh securities, against which DRs are proposed to be issued, needs to be regulated to the extent necessary to protect Indian investors. Otherwise, DRs against securities may be issued to a foreign investor at a price below the corresponding issue price for the underlying securities offered to investors. Such under-pricing may have the aim of unfairly diluting the investors' holding in the listed company. The law must prevent such unfair practices. But beyond this, there is no reason for prescribing any pricing norms for the underlying securities on the back of which DRs may be issued.

The present *Scheme* provides that for unlisted companies, the pricing should be according to the *Foreign Exchange Management Act, 1999*.[9] *FEMA 20* provides that in such cases, the fair valuation of shares should be carried out by a SEBI registered Category-I Merchant Banker or a Chartered Accountant 'as per the discounted free cash flow method'.[10] The Committee is of the opinion that discounted free cash flow method may be used to subvert the purpose of the valuation itself. For this reasons, the RBI should consider reviewing this provision. Further, the Committee is of the view that any pricing norms can be subverted. Therefore, neither the law nor the regulations should prescribe any specific pricing norm.

4.12 Is approval necessary for issue of depository receipts?

The Committee recommends that no specific approval should be necessary for issue or creation of DRs on the back of any Indian securities. However, it does not recommend dispensing with any approval that may be required under the Foreign Exchange Management Act, 1999 *for issue or transfer of underlying securities to any foreigner, including a foreign depository for issue of DRs.*

As explained above, DRs issued abroad do not in themselves compromise the market integrity in India. If market abuse in India is suspected, the Indian authorities have sufficient powers to investigate cross-border transactions across other FATF and IOSCO compliant jurisdictions or in jurisdictions that have agreements with SEBI. Therefore, no additional approval for issue or creation of DRs on the back of Indian securities should be imposed by Indian laws.

DRs issued abroad are a source of foreign direct investment into the country. Depending on whether the industry comes within the approval route or automatic route,

[9] See, DEA, see n. 7, paragraph 5(4)(e)(ii).

[10] See, Reserve Bank of India, *FEMA 20*, see n. 7, Schedule 1.

FIPB approval may be necessary.

It is, however, clarified that issue, creation, tendering or deposit of underlying Indian securities may require approvals under other Indian laws. These approvals are applicable irrespective of whether such securities are utilised for issue of DRs or for other purposes.

4.13 Should depository receipts form part of public shareholding?

The Committee recommends a two-phase approach. In the first phase, the Committee recommends that DRs with underlying shares listed on a recognised stock exchange in India should form part of public shareholding if such DRs entitle the holders of such DRs to give voting instruction to the foreign depository and are listed on an international exchange. In the second phase, based on the experience gathered, DRs in the OTC system may also form part of public shareholding of a listed Indian company.

The reason for mandating a minimum level of public shareholding is to maintain the minimum free-float and consequently reasonable liquidity of the shares in the domestic market. This ensures that the shares are widely held, resulting in better price discovery and reduced possibility of manipulation.

In case of DRs, the underlying shares are deposited with the domestic custodian. It can be argued that removing the underlying shares from circulation reduces liquidity on the domestic stock exchange. If so, the underlying shares must be excluded from the minimum public shareholding of a listed company. But since the DRs can be cancelled at any time and the underlying shares unlocked, liquidity might, in fact, not be affected. If this is the case, then the underlying shares are no different from the other listed shares and should form part of the minimum public shareholding.

The Committee commissioned a study to determine whether issue of DRs affects the liquidity of the underlying listed shares on Indian stock exchanges. An event-study analysis was carried out in which change in domestic trading volume of each firm was measured during a period spanning ten days before and after the DR issue. The bold line in the Figure 4.1 represents the average response of domestic volume for all firms during the DR issue while the DR issue day was taken at day 0. The dotted lines are the confidence interval.[11]

Figure 4.1 shows no significant change in the domestic volume after the issue of DRs. From this it can be inferred that DR issue does not have any impact on domestic trading volume in the short run. This study is supported by other studies carried out in Australia and Israel.[12]

Based on these studies, the Committee concluded that the evidence supports the proposition that issue of DRs does not negatively affect the liquidity in the shares of a listed company in the domestic market. It is of the view that generally there is no need to exclude shares on the back of which the DRs have been issued from numerator and denominator, while calculating the public float of the company.

Further, there is a mismatch in the treatment of DRs under two different regulations. While the DR holders have right to give voting instructions and have obligations under

[11] The basic assumption is that DR issue take place by creating new shares.

[12] See, Frino Alex and et. al., "The impact of ADR listing on liquidity", in: *Market Insights* (Sept. 2009); and Hauser, see n. 32.

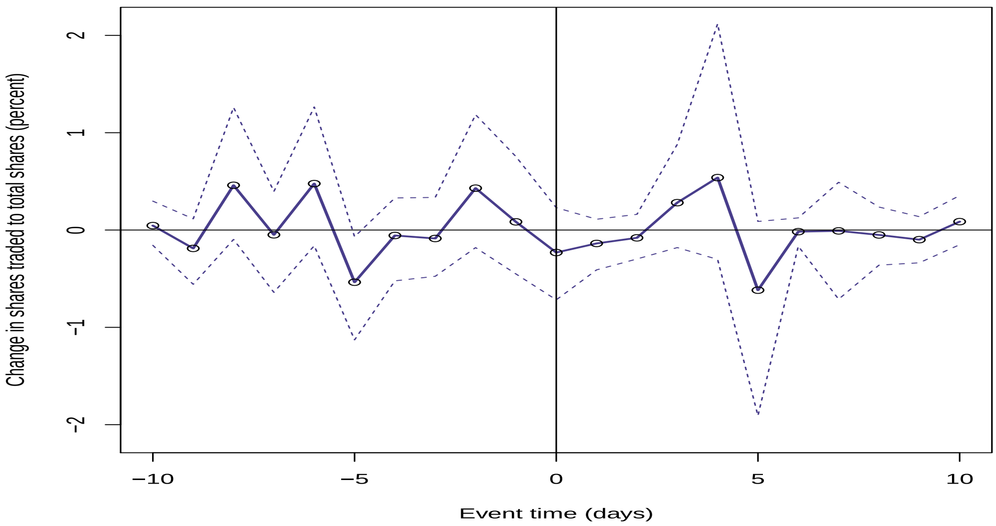

Figure 4.1: Event on DR issue and response of domestic trade

the *Takeover Regulations*, their holding do not form part of public shareholding.

In the first phase, for Indian companies with shares listed on an Indian stock exchange, DRs issued on the back of equity shares must form part of its minimum public shareholding if the DRs entitle the holders to give voting instruction to the foreign depository and if such DRs are listed on an international exchange. By 'international exchange', the Committee means any platform in a foreign jurisdiction for trading of DRs which is accessible to public and which provides pre-trade and post-trade transparency to public.

Mr. S. Ravindran, one of the members of the Committee, is strongly of the opinion that DRs should be included in public shareholding only if the following conditions are satisfied:

- voting rights are available on such DRs;
- information regarding identity of ultimate beneficial owners and natural persons who control is available;
- such DRs are listed and traded on stock exchanges' public platforms which are accessible to retail investors of the jurisdiction; and
- there is instant fungibility between DRs and underlying shares.

4.14 Should depository receipts have voting rights?

The Committee recommends that the law should not prescribe anything about voting rights or exercise of such rights in respect of DRs. It, however, notes that the DR holders need to comply with the Takeover Regulations *if they have the right to instruct the foreign depository to vote on their behalf.*

Under the company law, the shareholder is a member of the company and has voting rights associated with the shares. The foreign depository being holder of shares underlying the DRs is a member in the books of the company concerned. However, the exercise of such voting rights is usually governed by terms of issue / depository agreement. It may provide that the DR holders have the right to instruct the foreign depository to vote on their behalf. It often provides that the depository would vote as per instruction from the board of the issuer.

In 2010, SEBI noted that there were different types of voting arrangements. These included:[13]

- The right to give instructions to the custodian bank for exercise of voting rights vests with the Board of Directors of the issuer company.
- The right vests with the DR holders.
- A combination of the two above, in which; in the first instance, the right to instruct is with the holders of the DRs and in the event of their failure to exercise the said right, it is deemed to have been vested with the Board of Directors of the issuer company.

It was noticed that the DR holder has no control over the terms of the deposit agreement and has to accept them if she is interested in subscribing to the DRs.

Further, the SEBI Board considered whether it is advisable to restrict issuers from inserting clauses which empower the management to exercise voting rights on DRs at the expense of DR holders. The SEBI Board recommended to the Government/RBI to modify the DR Guidelines to provide that the 'terms of issue' should not curtail the voting rights of DR holders and empower the management to exercise voting rights on DRs.[14] The present *Takeover Regulations* have built on this experience and include 'depository receipts carrying an entitlement to exercise voting rights in the target company' within the definition of 'shares'.[15]

The Committee is of the view that businesses should be free to structure financial products as per their business needs. Therefore, it may be commercially plausible to have DRs with the right to instruct voting or with a right to the underlying cash flows without voting rights. Further, a DR holder, not being a member of the company, cannot directly exercise voting rights in the company.[16] According to the draft rules issued under section 41 of the *Companies Act, 2013*, a DR holder may become a member of the company and be entitled to vote only on conversion of the depository receipts into the underlying shares.[17] Therefore, the Committee recommends that it is not necessary to mandate anything about the voting rights on DRs.

For the growth of a sustainable market in corporate control it is essential to have knowledge of the ownership structure of a company. In case of DRs, the identity of the ultimate natural owner of DRs is not known, though only a Know Your Customer (KYC) compliant person can hold DRs in a FATF jurisdiction. The Committee is of the view that it is not necessary that the identity of the ultimate natural beneficial owner of a DR be disclosed, except in cases of potential change in control or takeover of a company. This position is in alignment with the present Indian laws that do not require disclosure

[13] See, SEBI, *Agenda and decision of the SEBI Board on Voting Rights of GDR / ADR holders*, May 19, 2010, URL: `http://www.sebi.gov.in/cms/sebi_data/boardmeeting/1299139899141-a.pdfcq` (visited on 10/10/2013).

[14] See, ibid.

[15] See Regulation 2(v), SEBI, *Takeover Regulations*, see n. 17.

[16] See, SEBI, *Agenda and decision of the SEBI Board on Voting Rights of GDR / ADR holders*, see n. 13, paragraphs 5.0 to 10.0.

[17] See, Ministry of Corporate Affairs, *Draft Rules under section 41 of Companies Act*, see n. 16, Rule 5.

of the identity of the ultimate natural owners of Indian securities. Since identity of the ultimate natural person having beneficial ownership is not available even for Indian rupee denominated equity shares and other securities, it will not be appropriate to highlight DRs as a special concern.

However, the Committee notes that a recent amendment to the *(Issue of Capital and Disclosure Requirements) Regulations* on August 26, 2013 requires an issuer to disclose the identity of natural persons who would be ultimate beneficial owners of the shares proposed to be allotted in preferential allotment.[18] Though this is not strictly comparable to issue of DRs, such a requirement in case of DRs cannot be monitored. What is material is the cognisance of voting rights. The Committee understands that if the DR holder has voting rights, this opacity may be misused for hostile takeover of corporate control leading to unpredictablity. This issue is adequately addressed by the *Takeover Regulations*. Therefore, the Committee has taken note that DR holders are already subject to applicable disclosure norms and other obligations under the *Takeover Regulations*.

Mr. S. Ravindran, a member of the Committee, is strongly of the view that in absence of availability of information regarding identity of ultimate beneficial owners and natural persons who control, the voting DRs would potentially expose the corporates to unpredictability in the ownership structure which may not be in the interest of the shareholders of such listed companies.

4.15 How to deal with public shareholding for unsponsored issues?

The Committee recommends that if listed shares are used for an unsponsored DR program, such DRs must give the holders the right to instruct the foreign depository to vote on their behalf and must be listed on an international exchange.

The Committee notes that there can be sponsored as well as unsponsored DRs. In case of sponsored DRs, the company has given the consent and is, therefore, aware of the consequences of issue of DRs on public shareholding. However, in case of unsponsored DRs, the company has not given the consent. It is possible that when a public shareholder transfers underlying shares to a foreign depository, the public shareholding of the company would reduce if the underlying with the foreign depository does not constitute part of public shareholding. In such cases, a company which is otherwise complying with the public shareholding requirement can face concerns. It is, therefore, necessary that the underlying shares transferred to a foreign depository should form part of public shareholding. The Committee is, however, conscious that this facility can be misused. A promoter can transfer the underlying shares from his holding to a foreign depository and as a consequence, the company would meet public shareholding requirement.

To balance these concerns, the Committee recommends that the shares underlying the DRs shall form part of public shareholding if the DRs holders have the right to give voting instructions and such DRs are traded on an international exchange. And, unsponsored DRs on underlying listed shares can be issued only if these are listed on an international exchange and DR holders have the right to give voting instruction.

[18] See Regulation 73, SEBI, *(Issue of Capital and Disclosure Requirements) Regulations*, 2009.

4.16 How should depository receipts be taxed?

The Committee recommends that the following should not be taxable events in India:

- *issue of permissible securities to a foreign depository;*
- *issue of depository receipts on the back of permissible securities;*
- *conversion of DRs into permissible securities;*
- *conversion of permissible securities into DRs;*
- *transfer of DRs in permissible jurisdictions.*

The Committee recommends that the tax treatment of returns and transactions on securities underlying DRs should be similar to that of any other underlying securities. It, however, recommends that the tax treatment of transfer of underlying listed shares through a public tendering process to a foreign depository for issue of DRs should be aligned with that of sale of shares on a stock exchange.

The Committee further recommends that the Ministry of Finance should research the desirability and feasibility of residence-based vs. source based taxation.

As explained earlier, DRs and the underlying securities are one and the same asset. The creation of DRs on the back of underlying securities and conversion of DRs into the underlying securities and vice versa, do not involve any transfer of asset and hence should not attract any tax in India. Further, transactions in DRs do not involve transfer of underlying securities from one person to another and hence should not attract any tax in India. However, the transactions in DRs outside India may attract taxes, if any, at applicable rates in those jurisdictions. This would ensure that use of DR route for capital raising does not involve any additional tax and thereby does not distort investor preference for the same asset.

Under the *Income Tax Act, 1961*, capital gains can be of two types:

1. *'Long-term capital gain'*: Gains arising on the sale of shares held for more than 12 months.
2. *'Short-term capital gain'*: Gains arising on the sale of shares held for 12 months or less.

Under the present law, with respect to a sale or purchase of equity shares on a recognised stock exchange, both the buyer and seller are required to pay STT on the total transaction value. Long-term capital gains realised upon sale of equity shares is exempt from tax.[19] Any short-term capital gain is taxed at 15% (plus applicable cess and surcharge).[20] The capital gains tax exemption is not available for an off-market transaction. The differential tax treatment results in limited appetite for transferring shares to a foreign depository for issue of DRs.

The Committee looked into the tax treatment provided to shareholders in an open offer. It was noted that the Takeover Regulations Advisory Committee (TRAC) under the Chairmanship of Mr. C. Achuthan had observed that open offers being a highly regulated activity in the interest of investors, cannot be considered as off-market deal. Therefore, the TRAC had recommended that the there should be parity in the tax treatment given to the shareholders, who tender their shares in an open offer and those who are selling the same in the open market.[21]

[19] See section 10(38), see n. 11.

[20] See section 111A, ibid.

[21] See paragraph 17, Takeover Regulation Advisory Committee, *Report of the Takeover Regulation*

The Committee observed that tendering of shares by shareholders of a company in a sponsored DR issue is also an investor friendly activity and is different from an off-market transaction. It is, therefore, desirable to align the tax treatment of tendering of shares by shareholders of a listed company for issue of DRs with that of sale of shares on a stock exchange.

DRs are convertible into the underlying securities. Since both are essentially the same asset, the holder of the DRs also holds the underlying securities. Therefore, ideally the period for which the foreign investor holds the DRs should be taken into account in calculating the capital gains tax arising out of sale of the underlying securities by the foreign investor in the domestic market. However, the foreign investor, who has converted DRs into underlying securities, has bought the DRs in a foreign jurisdiction. Therefore, it is recommended that, for the purposes of calculating capital gains tax under Indian laws, the time for which the investor held the underlying securities will start from the date on which the DR is converted into the underlying securities.

DRs being foreign securities traded in foreign jurisdictions will attract taxes in those jurisdictions. If Indian laws impose tax on such transactions, it would amount to source based taxation leading to double taxation. The present law provides that trading in DRs outside India should not be amenable to tax in India. The Committee is of the view that the present position be retained.

A deeper problem lies in the problem of source-based taxation. As has been emphasised by the *Report of the Working Group on Foreign Investment*, India's penchant for source-based taxation is problematic. It is advantageous for an Indian firm to list in a jurisdiction like Singapore, London or New York, as these countries practice residence-based taxation, and make no attempt at taxing the financial income of non-residents. Until Indian tax policy is made compatible with globalisation, on-shore financial intermediation will be at a disadvantage.[22] The Committee, therefore, endorses the recommendation of *Report of the Working Group on Foreign Investment* that the Ministry of Finance must embark on the technical studies about residence-based taxation.[23]

4.17 How to deal with market abuse?

The Committee recommends that any use, intended or otherwise, of DRs with a potential to cause market abuse in the Indian securities market would need to be dealt with as a market abuse in India. For this purpose, 'market abuse' shall mean any action prohibited under Chapter VA of the SEBI Act, 1992. SEBI has adequate legal powers to address issues concerning potential market abuse in DRs in jurisdictions that are FATF and IOSCO compliant.

Since 2009 investigations carried out by SEBI have thrown light on the kinds of market abuse that can happen in the DR market. Broadly, the entities involved have been divided into three groups by SEBI:[24]

Advisory Committee, tech. rep., July 19, 2010.

[22] See, Working Group on Foreign Investment, see n. 1, at pg. 125.

[23] See, ibid., at pg. 125.

[24] See paragraphs 53 to 59, SEBI, *In the Matter of Market Manipulation Using GDR Issues*, see n. 21.

- Entities located overseas, which subscribe and deal in the DRs.
- FIIs or sub-accounts which buy DRs overseas, convert them into normal equity and thereby bring these DRs to India in a form that is tradable in Indian bourses.
- Entities trading in Indian stock markets as majority counterparties to FIIs or sub-accounts.

The steps involved in the 'structured DR transactions' are claimed as follows:

- An arranger facilitates issue of capital raising DRs to particular foreign entities.
- Such issuances are typically for substantially large components of the pre-issue paid up capital of the issuer company - in some instances, one-half to one-third of the prior capital was issued as DRs, and typically such issues are by companies having very poor traded volumes in the stock market.
- Certain FIIs related to the arranger convert a substantial volume of DRs into the underlying securities.
- The underlying securities are sold in India to a set of related counterparties on domestic stock exchanges.
- The related counterparties in turn manipulate the price and volumes and sell down to retails domestic investors after which the market volumes go back to erstwhile minuscule levels, leaving retail investors holding illiquid stock.

The Committee observed that because of fungibility, the market for DRs in a foreign jurisdiction is intricately linked to the domestic market for the underlying Indian securities. Any market abuse having an effect on the Indian market using the DRs abroad will impact the Indian securities market. Therefore, the Committee is of the view that any market abuse of the Indian securities market, merely because it may involve DRs in the foreign jurisdiction, would not got out of the jurisdiction of the *SEBI Act, 1992*. A contrivance or a device using DRs to manipulate price or volume and conduct fraudulent securities transactions in India would fall foul of section 12A in Chapter VA of the *SEBI Act, 1992*. It would be indeed be open to SEBI to use its ample powers to pursue such cases and bring regulatory action if facts make out a violation.

The Committee believes that SEBI indeed has jurisdiction in such events and no further provision is currently required for conferring jurisdiction. The Committee also noted that the Supreme Court has ruled in favour of SEBI having jurisdiction even where fraud or violations are found in unlisted securities of public companies. In *Bhagwati v. Peerless*, the Supreme Court categorically stated:[25]

> "...shares of Public Limited Company not listed in the stock- exchange is covered within the ambit of Regulation Act."[26]

In *Sahara v. SEBI*, the Supreme Court observed:[27]

> "The power vested with SEBI, is not limited in any manner, and shall therefore, be deemed to extend to both "listed" and "unlisted" public companies."

It would indeed be open to SEBI to use its ample powers to pursue such cases and bring regulatory action if facts make out a violation.

[25] See, Supreme Court of India, *Bhagwati Developers Pvt Ltd v. Peerless General Finance and Investment Company Ltd and Anr*, (2013) 3 Company Law Journal 241, *per* Prasad, J.

[26] 'Regulation Act' here refers to the *Securities Contracts (Regulation) Act, 1956*.

[27] See, Supreme Court of India, *Sahara India Real Estate Corporation Ltd. v. Securities and Exchange Board of India*, (2013) 1 Supreme Court Cases 1, *per* Khehar, J.

The Committee, therefore, believes that SEBI has adequate means of investigating potential market abuse in cross-border transactions involving DRs. If such DRs are issued only in jurisdictions compliant with IOSCO and FATF, it would be easier to have engagement with regulators in these jurisdictions to get information necessary in aid of such investigations. New financial instruments and markets will require more effort from SEBI and other regulators for effective oversight. Under such circumstances, the Committee is of the view that SEBI, being the regulator of market for securities, is the appropriate authority to investigate market abuse related to DRs on the back of securities, as defined in the *Securities Contracts (Regulation) Act, 1956*.

Mr. S. Ravindran, a member of the Committee, however, feels that SEBI can exercise jurisdiction only over companies whose securities are listed or are proposed to be listed on Indian stock exchanges.

4.18 How to deal with money laundering?

The Committee is of the view that the powers available to the enforcement directorate and the FIU under the present law are adequate to collect necessary information and investigate potential money laundering using DRs in FATF compliant jurisdictions. Therefore, it recommends that DRs on underlying Indian securities should not be issued in non-FATF compliant jurisdictions.

Concerns have been raised that the DR route provides new opportunities for money laundering. Jurisdictions with weaker anti-money laundering regimes and financial institution secrecy laws may be used to launder funds by investing in the DRs through related parties. The conversion of these DRs could lead to laundering of proceeds of crime.[28]

The Committee deliberated on the chances of money laundering using the DR route through jurisdictions with financial institution secrecy laws. The Committee is of the view that as far as FATF countries are concerned, this should not be an issue. It was noted that under the present laws FDI can come from non-FATF jurisdictions. The *FATF Recommendations, 2012* specifically impose a duty on the member countries to 'ensure that financial institution secrecy laws do not inhibit implementation of the FATF Recommendations'.[29] It further prohibits financial institutions 'from keeping anonymous accounts or accounts in obviously fictitious names'. Extensive customer due diligence obligations have been imposed on financial institutions as adequate safeguards against money laundering.[30] The recommendations mandatorily require financial institutions to keep necessary records of transactions, both domestic and international, for at least five years and report suspicious transactions to the FIU.[31] There are extensive provisions for international cooperation for sharing of information including exchange of information between FIUs, financial supervisors and law enforcement authorities of member countries.[32] Therefore, the Committee is of the view that allowing DRs to

[28]See paragraph 62, SEBI, *In the Matter of Market Manipulation Using GDR Issues*, see n. 21.

[29]See Recommendation 9, Financial Action Task Force (FATF), *FATF Recommendations, 2012*, see n. 26.

[30]See Recommendation 10, ibid.

[31]See Recommendation 11, ibid.

[32]See Recommendation 40, ibid.

be issued in any FATF compliant jurisdiction should be an adequate measure to check potential money laundering.

The Committee notes that *Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Mechanism)(Amendment) Scheme, 2013* enjoins upon SEBI the duty to exercise oversight on unlisted companies related to *Prevention of Money Laundering Act, 2002* in respect of DRs sponsored by them. It requires the companies to file a copy of the return which they submit to the proposed exchange/regulators also to SEBI for the purpose of Prevention of Money Laundering Act, 2002 (PMLA).[33] The Committee notes that under the *Prevention of Money Laundering (Maintenance of Records) Rules, 2005*, financial market regulators, such as SEBI and RBI, have specified roles.[34] It is for the Government to define and redefine the responsibilities among the FIU, financial market regulators and others depending on exigencies.

4.19 What should be the enforcement mechanism?

The Committee is of the view that SEBI can use appropriate powers available under the present law to get necessary data about DRs issued on the back of Indian securities from the domestic custodian. This data can be used by the RBI to enforce compliance with the capital controls regime.

The Committee is of the view that under the existing laws SEBI has adequate powers to investigate suspicious instances of market abuse using the DR route by coordinating with the securities regulators of the corresponding foreign jurisdiction under the aegis of IOSCO. It is of the view that under the existing laws the Enforcement Directorate along with the FIU has adequate powers to investigate suspicious instances of money laundering using the DR route by coordinating with the appropriate regulators in the corresponding foreign jurisdictions under the FATF framework.

When the *Scheme* was notified in 1993, both IOSCO and FATF were fledgling institutions. Then the international capital markets did not have to meet FATF and IOSCO standards. The *Scheme*, therefore, allowed an issuer to sponsor DRs in any jurisdiction. However, the amendment to the *Scheme* in 2013 clearly recognises the power of FATF and IOSCO and limits the issue of DRs by unlisted companies to FATF/IOSCO compliant jurisdictions. The international capital market uses the FATF and IOSCO mechanism to deal with money laundering and market abuse respectively. There is no reason why these two standards should not be adequate from the perspective of India or why India should look for additional cover.

4.20 Which law/authority should govern issue of depository receipts?

The Committee acknowledges that the issue of depository receipts abroad can not be governed by an authority in India. RBI, SEBI, Ministry of Corporate Affairs and Ministry of Finance, all have a role and can use appropriate powers available under the present law to get necessary data about DRs issued on the back of Indian securities from

[33]See paragraph 3, Ministry of Finance, *Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Mechanism)(Amendment) Scheme, 2013*, see n. 5.

[34]See Rules 3, 4, 5 and 7, *Prevention of Money Laundering (Maintenance of Records) Rules, 2005*.

the domestic custodian.

DR is a superstructure. Its foundations lay in the matters which are governed under company law, securities law, foreign exchange law, capital controls and money laundering and these matters are administered by various authorities. The *Scheme* merely synchronises the various provisions of these laws to make issue of DRs possible. Whether DRs are issued or not, these matters in any case would need to be governed adequately. If such matters are well governed, the DRs as such do not create any concern. Besides, no single authority has jurisdiction over all these matters.

As explained before, there is no need for any approval or oversight over the issue of DRs abroad against Indian securities. However, it is prudent to have necessary legal powers to extract necessary data for regulatory purposes. In every issue of DRs, the domestic custodian will provide custodial services for the Indian securities and should ensure compliance with Indian laws before agreeing to provide custodial services. Therefore, the Committee is of the view that SEBI and other authorities can use appropriate powers available under the present law to get necessary data from the domestic custodian.

5 — Conclusion

This Chapter summarises the principles guiding the recommendations of the Committee and its recommendations based on the same. It uses the relevant recommendations to draft a brand new DR scheme which may replace the extant 1993 *Scheme*. It explains the draft scheme in common parlance. It ends with suggestions for further areas of work which would complement this work.

5.1 Principles

The principles guiding the recommendations of the Committee are:

1. The recommendations are circumscribed by the foreign investment regime in vogue in India. Without seeking any change in the said regime, the Committee has attempted to reform the framework for depository receipts, though it believes that the foreign investment regime presents ample scope and need for reforms.
2. The Indian firms, domestic investors and foreign investors must have full freedom to access financial services, including capital, within the prevalent foreign investment regime. The State should be agnostic if a firm uses DR route or FDI route to secure investment from overseas or if a foreign investor invests in the country / a firm through DR route or FII route as long as the total investment in Indian firms is within the permissible limits. Therefore, DRs should not suffer any additional restriction or enjoy any privilege compared to any other route of foreign investment.
3. There should not be any intervention that can distort the freedom of choice of the Indian firms, domestic investors or foreign investors unless there is likelihood or evidence of market failure.
4. The potential for misuse of a particular mode of participation or access should not prohibit the mode. The solution lies in addressing the misuse by upgrading capability to prevent, detect and penalise the misuse.
5. While protection of domestic investors in securities is a primary concern for the State, the protection of foreign investors in DRs is not. The Committee believes

that the regulator of the relevant jurisdiction would screen the DRs in the interest of investors in those jurisdictions as Indian authorities do before allowing issue of IDRs in India.

6. The taxation regime should be neutral between domestic investors in securities and foreign investors in securities or DRs on securities.
7. The issue of DRs should not inconvenience or adversely affect the interests of existing holders of securities.
8. FATF concerns are real and should be addressed while allowing foreign investment.
9. FCCB is a type of instrument distinct from the securities and, therefore, FCCBs or DRs on the same needs to be dealt with separately.
10. The provisions which have lost utility or have become irritants in course time should give way to contemporary provisions in the changed environment.

5.2 Recommendations

The Committee recommends as under:

1. Any person permitted under the laws of a foreign jurisdiction, which is FATF and IOSCO compliant, to carry on the business of issuing DRs in that jurisdiction and not prohibited from acquiring securities in India should be able to act as a foreign depository for issue of DRs on the back of Indian securities. Indian law should not regulate any eligibility requirement for a foreign depository.
2. A custodian of securities, a depository, a depository participant, or a bank having permission from SEBI to provide services should act as custodian of underlying securities.
3. The custodian should have the obligation to provide various information to the authorities in respect of issue and redemption of DRs and ensure compliance with the law before agreeing to provide custodial services in respect of permissible securities.
4. Irrespective of its track record or performance, any Indian issuer should be able to issue fresh securities on the back of which DRs may be issued abroad by a foreign depository. This would be issue of DRs for capital raising purposes. Only exception to this is an issuer who has been specifically prohibited by an Indian authority to issue capital or access capital market. The regulatory prohibition is sacrosanct and must not be circumvented. Otherwise, a prohibited issuer would issue permissible securities based on which DRs would be issued and such DRs would be converted back in course of time into permissible securities tradeable in India. Thus, the issuer can do something indirectly which it could not have done directly.
5. Any person holding Indian securities should be able to transfer the securities on the back of which DRs may be issued abroad by a foreign depository. This means that DRs should be allowed to be issued for non-capital raising purposes also. Such person may transfer securities with or without approval of the issuer of such securities. She may transfer the securities to the foreign depository on exchange, off exchange or through a tender process. If it does not have approval of the issuer, it would be called unsponsored DRs. If such DRs have listed securities as

underlying, these need to be listed on an international exchange and DR holders must have the right to give voting instructions, that is, the right to direct the foreign depository to vote in a particular manner on their behalf in respect of such securities.

6. The DRs should be allowed to be issued on any kind of securities and not on equity shares only. These securities could be issued by any entity, company - public or private, listed or unlisted - mutual funds, government or any other issuer. However, these securities should be available in dematerialised form and should be accessible to residents outside India under the extant Foreign Exchange Management Act, 1999 (FEMA).
7. The DRs should be subject to the same capital controls as are applicable to underlying securities. If foreign investment is permitted under the extant FEMA in any securities in India, DRs should be allowed to be issued abroad on the back of such securities to the extent foreign investment is allowed in such securities in India. Therefore, there should be no restriction on the amount up to which DRs can be issued, as is the present position. Similarly, the DRs should be allowed to be converted to underlying securities and vice versa within the limits under the FEMA. The conversion ratio of DRs to permissible securities should be left to commercial considerations of the parties.
8. Any person should be able to subscribe to the DRs issued on the back of underlying securities. This means that a foreigner as well as an Indian should have the option to buy both Indian securities as well as the DRs on them. However, the underlying securities cannot be issued to or purchased by a foreigner who is not allowed to deal in Indian securities.
9. The DRs should be issued only in a foreign jurisdiction that satisfies twin requirements, namely, the foreign jurisdiction is a member of the FATF and the securities regulator of that jurisdiction is a member of IOSCO.
10. The law should not require the DRs to be necessarily listed on a formal international exchange. Two members of the Committee however insist that the DRs issued on the back of listed securities must be listed on international stock exchange of comparable standards of major stock exchanges in India.
11. In case of a listed company, fresh securities on the back of which DRs may be issued, should be issued at a price not less than the price applicable to corresponding mode of issue to domestic investors.
12. The price norm currently applicable for issue of unlisted securities for the purpose of issuing DRs, which uses discounted cash flows method based on so many assumptions about uncertain future, does not serve any realistic purpose. This requirement should be dispensed with.
13. There should be no end use restrictions on the funds raised through the issue of DRs. The end use restrictions as are applicable to issue of permissible securities under FEMA should apply to DRs also.
14. No approval should be necessary for issue or creation or redemption of DRs on the back of any Indian securities. However, no approval required for issue of underlying securities to a foreign depository under the FEMA should be dispensed with.
15. The DRs based on equity shares of a listed company should form part of public

shareholding if such DRs entitle the holders the right to issue voting instructions and are listed on an international exchange. For this purpose, international exchange would mean a trading platform which is accessible to public and which provides pre-trade and post-trade transparency. Based on the experience gathered, if considered appropriate, the DRs in the OTC system may be included in public shareholding. However, one of the members is of the view that to form part of public shareholding, such DRs should meet two additional requirements, namely, the identity of ultimate beneficial owners and natural persons who control such DRs are available and there is instant fungibility between the underlying shares and the DRs.

16. While the voting rights should be exercised by the foreign depository in respect of underlying securities, the depository may take instruction from DR holders. If the DR holders have the right to instruct the depository to vote on their behalf, they should have obligations under the *Takeover Regulations*. This would enable the DRs with voting rights to count for public holding as well as have the obligations under the *Takeover Regulations*.
17. The tax treatment of DRs should be similar to that of the underlying securities.
18. The conversion of a DR into the underlying securities and vice versa should not be taxable events. The trading of DRs outside India should not attract any tax in India.
19. The tax treatment of transfer of securities by holders of such securities through a public tendering process to a foreign depository for issue of DRs should be aligned with that of transfer of shares on a stock exchange.
20. The use of DRs or market of DRs which has potential to cause abuse of the Indian market for underlying securities should be considered as abuse of the Indian securities market and should be dealt with accordingly. SEBI should be able to gather relevant information from domestic custodian directly and through its counterpart in foreign jurisdiction from foreign depository. It should be able to deal with market abuse adequately.
21. The powers available to the enforcement directorate and the FIU under the present laws are adequate to collect necessary information and investigate suspicious money laundering using DRs in FATF compliant jurisdictions. SEBI should continue to play the same role as it has been assigned under the *Prevention of Money Laundering (Maintenance of Records) Rules, 2005* in coordination with FIU and enforcement directorate. One of the members however feels that monitoring of compliance of unlisted companies with PMLA may not be feasible under the existing legal framework.

5.3 The Depository Receipt Scheme, 2013

Based on the analysis in the preceding chapters and the recommendations crystallised at Chapter 5.2, the Committee has drafted the Depository Receipts Scheme, 2013 which is at Annexure-D. The scheme provides a comprehensive framework for issue and redemption of depository receipts based on Indian securities within the extant foreign investment regime, while each of the economic agents, namely, the issuers of securities, the holders of securities, and the holders of DRs have full freedom to participate in the market for DRs. The scheme does not lay down a stringent framework to protect the interests of DR holders, which the Committee feels, is the responsibility of the regulators in those jurisdictions. It, however, treats the investors in securities and the foreign investors in DRs at par in terms of taxation and ensures that the permissible securities are not issued to a foreign depository on favourable terms. The salient features of the scheme are:

1. A DR is a foreign currency denominated instrument which can be subscribed by any person, including an Indian, albeit within his outward remittance entitlement.
2. DRs can be issued in a foreign jurisdiction which is a member of FATF and the regulator of securities market of that jurisdiction is a member of IOSCO. This jurisdiction is called permissible jurisdiction in the scheme. Under the earlier *Scheme*, the listed companies could sponsor DRs in non-FATF/non-IOSCO jurisdictions also.
3. These can be issued by a foreign depository which is regulated in a permissible jurisdiction and has permission to issue DRs in the permissible foreign jurisdiction. Under the earlier *Scheme*, it was any bank authorised by the issuer.
4. These can be issued on the back of securities issued or transferred to a foreign depository and deposited with a domestic custodian. Such custodian is a regulated entity in India and has the permission to provide services as a custodian for these securities.
5. These can be issued on the back of securities, as defined under the securities laws (earlier it was limited to equity of companies) and similar instruments issued by private companies, which are in dematerialised form (demat was not a requirement earlier) and which can be acquired by persons resident outside India under the FEMA. These securities are called permissible securities under the scheme. However, DRs can not be issued on FCCB which was allowed under the earlier *Scheme*.
6. These can be issued by the foreign depository by way of public offering or private placement or in any other manner prevalent in the permissible jurisdiction.
7. These may be listed or traded on a platform in a permissible jurisdiction which is accessible to public for trading and which provides pre-trade and post-trade transparency. Such a platform is called international exchange under the scheme. It is not necessary to list or trade DRs on an international exchange. If these are listed on such an exchange, the underlying permissible securities would enjoy certain privileges.
8. These can be issued on the back of permissible securities with or without the approval of the issuer of such securities. The DRs issued without the approval of the issuer concerned are called unsponsored DRs. Under the earlier *Scheme*, unsponsored DRs were not explicitly allowed.
9. Unsponsored DRs on listed securities as the underlying can be issued only if such DRs give the holders the right to issue voting instruction and are listed on an international exchange so that these form part of public shareholding.
10. The issue of DRs as such shall not require any approval under any law from any authority in India. However, the issue or transfer of permissible securities to a person resident outside India to form the underlying for DRs would require the approvals, if any, under the FEMA.

11. The issuer of permissible securities could be a company - listed or unlisted, private or public - of varying standards. The scheme does not lay down any standard for issuers of permissible securities for issue of DRs and believes that this is best decided by the authorities of the permissible jurisdictions. This is similar to the provisions in the rules relating to IDRs, which prescribes eligibility for issuers for sponsoring DRs in India.
12. The permissible securities underlying the DRs can be issued to the foreign depository by any mode permissible for issue of such securities to domestic investors.
13. The permissible securities underlying the DRs can be issued to the foreign depository at a price not less than the price, if any, applicable to the corresponding mode of issue of such securities to domestic investors under the Indian law.
14. The permissible securities underlying the DRs can be transferred to the foreign depository by holders of such securities through transactions on an Indian stock exchange, on OTC or on tender through a public platform. The DRs issued on the back of permissible securities transferred by holders of such securities is called non-capital raising DRs.
15. The permissible securities can be issued or transferred to a foreign depository for issue of DRs up to the limit such securities can be allotted to persons resident outside India under the FEMA.
16. The DRs can be converted back to permissible securities and vice versa within the permissible limits.
17. The foreign depository shall exercise voting rights, if any, in respect of permissible securities. The terms of issue of DRs may give a right to the DR holder to issue voting instructions.
18. If the DR holders have the right to instruct the depository to vote on their behalf and the DRs are listed on an international exchange, the shares underlying such DRs will form part of public shareholding in case of listed companies. Such holders of DRs shall have the same obligations as if they are holders of the underlying permissible securities. For example, a holder of DR shall comply with the *Takeover Regulations* if applicable to the underlying permissible securities. In any other case, such shares shall not be part of total holding or public shareholding.
19. The persons issuing or transferring permissible securities to the foreign depository and the custodian holding such securities shall be responsible for compliance with the scheme.
20. The depositories and custodians shall have the obligation to maintain certain records and disseminate certain information. The custodian shall file with SEBI the document issuing the DRs on the back of securities (not permissible securities) in a permissible jurisdiction. The Indian depositories shall disseminate the details of outstanding DRs and the extent to which permissible securities may be converted to DRs.
21. The use of DRs or market of DRs to abuse the Indian market for underlying securities shall be considered as abuse of the Indian securities market and should be dealt accordingly. The abuse for this purpose would mean insider trading, fraudulent and unfair trade practices and takeover irregularities to the extent applicable to permissible securities. Though this is clarificatory, this would serve as a strong deterrent for potential miscreants in the market for DRs.

22. The issue of permissible securities to the foreign depository, issue of DRs, conversion of DRs into permissible securities and vice versa and transfer of DRs would not attract any tax under Indian law.
23. The transfer of permissible securities from holders of securities to a foreign depository will be taxed in the same manner as that kind of transaction is taxed. However, if such transfer happens through a public tendering process, it would be taxed at par with a transaction on stock exchange in India.
24. The returns on permissible underlying securities to a foreign depository and transfer of permissible securities after conversion from DRs shall be taxed as domestic investors are taxed in such events.
25. The various provisions of the scheme shall be implemented by the respective authorities, namely, Ministry of Finance, Ministry of Corporate Affairs, RBI and SEBI.
26. This scheme will replace the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipts) Scheme, 1993 except to the extent relating to FCCBs.

The major changes in the framework for issue of DRs by companies are summarised in Table 5.1. A detailed comparison of the extant Scheme and the proposed scheme is presented in Table 5.2.

Table 5.1: Eligible companies and jurisdictions

Company	DRs	Purpose	Mode of Issue of DRs	Permissible			
				Extant Framework		Proposed Framework	
				FATF/IOSCO[a]	Others	FATF and IOSCO[b]	Others
Listed Company	Sponsored	Capital Raising	Listing	Yes	Yes	Yes	No
			No Listing	Yes	Yes	Yes	No
		Non-Capital raising	Listing	Yes	Yes	Yes	No
			No Listing	Yes	Yes	Yes	No
	Unsponsored	Non-Capital raising	Listing	Doubtful	Doubtful	Yes	No
			No Listing	Doubtful	Doubtful	Yes	No
Unlisted Company	Sponsored	Capital Raising	Listing	Yes	No	Yes	No
			No Listing	No[c]	No	Yes	No
		Non-Capital raising	Listing	Yes	No	Yes	No
			No Listing	No[d]	No	Yes	No
	Unsponsored	Non-Capital raising	Listing	No	No	Yes	No
			No Listing	No	No	Yes	No

[a] The jurisdiction has to be either FATF compliant or IOSCO compliant.
[b] The jurisdiction has to be both FATF and IOSCO compliant.
[c] It was allowed till October 10, 2013.
[d] It was allowed till October 10, 2013.

Table 5.2: Detailed comparison of the 1993 *Scheme* and the proposed scheme

Sl. No.	Parameter	1993 *Scheme*	Proposed Scheme
1	Approval for issue of DRs from authorities	Required from MoF	Not required
2	Issuer of DRs (foreign depository)	A bank authorized by issuer of underlying securities	A regulated person having legal capacity to issue DRs
3	Custodian of DRs (domestic custodian)	A bank which acts as a custodian	A regulated entity having legal capacity to act as custodian for underlying securities
4	Jurisdictions for issue of DRs	Anywhere for listed companies; FATF/IOSCO jurisdiction for unlisted companies	FATF and IOSCO compliant jurisdictions
5	Purpose of issue of DRs	Capital raising and non-capital raising	No change
6	Quantity / Limit on issue of DRs	No limit	No change
7	Kind of issue of DRs	Sponsored	Both sponsored and unsponsored
8	Mode of issue of DRs	Public offer, private placement or any other manner prevalent	No change
9	Listing of DRs	Not required	No change
10	End Use	Restricted	No restriction
11	Securities underlying DRs	Equity shares and FCCB	Any securities which are available to persons resident outside India and in demat form
12	Subscribers of DRs	Any person	No change
13	Mode of issue of underlying shares	Any mode permissible under law	No change

14	Mode of transfer of underlying securities to foreign depository	Not applicable	On Exchange, Off Exchange and tender process
15	Pricing of underlying securities at issue	Listed shares as per SEBI rules;	Listed shares as per SEBI rules;
		Unlisted shares as per discounted cash flow method	No restriction on other securities
16	Issuer of underlying securities	Any company - listed or unlisted	Any issuer - listed or unlisted
17	Whether underlying shares form part public holding	No	Yes subject to certain conditions
18	Conversion from underlying securities to DRs and vice versa	Permissible	No change
19	Voting rights associated with underlying securities	Foreign depository	No change
20	Obligations	No explicit provision	Custodian, depository, issuer and transferor of underlying securities, holders of DRs
21	Market Abuse	No explicit provision	To be dealt by SEBI
22	Oversight on PMLA	FIU, Enforcement Directorate and SEBI	No change
23	Taxation	More than those applicable to domestic investors / domestic securities	At par with domestic investors / domestic securities

5.4 Implementing the scheme

For convenience of the agencies which are required to implement the above recommendations, the Committee identified the various agencies which would be responsible for implementation of the various paragraphs in the scheme as in Table 5.3.

Table 5.3: Implementation of the Scheme

Paragraph in scheme	**Agency to implement**	**Instrument for implementation**
Entire scheme	Ministry of Finance	Gazette Notification
2.1(a)	SEBI	*Custodian Regulations*; *Depositories Regulations*
2.1(g) Explanation	Ministry of Finance	Schedule to be notified
2.1(h)(ii)	SEBI	SEBI to specify instruments issued by private companies as 'security' for dematerialisation
3.1	RBI	FEMA Notification
3.2	SEBI and stock exchanges	Listing agreement
4 and 5	RBI	FEMA Notification
6	RBI and SEBI	FEMA Notification; *(Issue of Capital and Disclosure Requirements) Regulations*
7.1	Ministry of Corporate Affairs	Clarification under the *Companies Act, 2013*
7.2	Ministry of Finance	*Securities Contracts (Regulation) Rules*
7.3	Ministry of Finance, SEBI and Stock Exchange	Listing Agreement; *Securities Contracts (Regulation) Rules*
7.4	SEBI	Provided in *Takeover Regulations*
8.1	SEBI	*Custodian Regulations*; *Depositories Regulations*
8.2	SEBI	*Depositories Regulations*
8.3	RBI	FEMA Notification
9	Ministry of Finance	Taxation laws
10	RBI	FEMA Notification
11	SEBI	Respective Regulations
12	RBI	FEMA Notification
Schedule	Ministry of Finance	Gazette Notification

5.5 Further areas of work

The Committee feels that reforms in a niche segment like DRs would not yield full benefits. The entire framework governing capital controls and foreign investment need to be reviewed comprehensively. This would include in particular review of framework relating to:

- External Commercial Borrowings (ECBs) and FCCBs;
- Direct listing of Indian companies abroad;
- Dual listing of Indian companies;
- FII-FDI regime;
- Residence-based taxation vis-a-vis source based taxation; and
- Relationship between authorities in India and in foreign jurisdictions.

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Annexure-A

F.No.9/1/ 2013-ECB
MINISTRY OF FINANCE
Department of Economic Affairs
(Capital Markets Division)

North Block, New Delhi,
Dated September 23, 2013

ORDER

Subject: Constitution of a Committee to Review the FCCBs and Ordinary Shares (Through Depository Receipt Mechanism) Scheme 1993.

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The Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 has undergone several amendments in piecemeal to meet the emerging needs of the economy. It has been decided to constitute a Committee to review the Scheme comprehensively keeping in view:

i. the new company law and the recent legislations in the financial markets;

ii. the current state of the macro economy and the financial markets;

iii. the needs of the Indian companies and foreign investors; and

iv. the need for simplification and legal clarity of the Scheme.

2. The Committee shall have the following composition:

i.	Shri M. S. Sahoo, Secretary, ICSI	- Chairman
ii.	Shri G. Padmanabhan, Executive Director, RBI	- Member
iii.	Shri S. Ravindran, Executive Director, SEBI	- Member
iv.	Prof. Ajay Shah, NIPFP	- Member
v.	Shri P. R. Suresh, Consultant, PMEAC	- Member
vi.	Shri Pratik Gupta, Managing Director, Deutsche Bank	- Member
vii.	Shri Sanjeev Kaushik, Director (External Markets) Convener	- Member

3. The Chairman may co-opt any such additional person (s) as invitees as necessary for any of the meeting (s) of the Committee.

3. The Chairman may co-opt any such additional person (s) as invitees as necessary for any of the meeting (s) of the Committee.

4. The Committee would meet as frequently as necessary for fulfillment of its objectives.

5. The NIPFP-DEA program team will be the secretariat for the Committee and all expenses related to the Committee's activities will be met from the budget of the NIPFP-DEA program supplemented as and when necessary.

6. The committee will finalise a draft scheme within 3 weeks from the date of its constitution and submit the same for further consideration.

7. This issues with the approval of competent authority.

23/09/2013

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Copy to:

1. All Members of the Committee.
2. Director (RE&C)
3. PPS to Secretary (EA)
4. PS to AS(DEA-K)

Annexure-B

Stakeholders who engaged with the Committee

Sl. No.	Name	Designation	Organisation
1.	Mr. Ashok Khurana	Director General	Association of Power Producers
2.	Mr. Debashish Purohit	Head, Equity Capital Markets	BAML
3.	Mr. Neil Atkinson	Vice-President, Depository Receipts	BNY Mellon
4.	Mr. Vinu Kurian	Vice-President, Depository Receipts	BNY Mellon
5.	Mr. Arun Chatterjee	Vice President, Depository Receipts – Investment Services	BNY Mellon
6.	Ms. Aparna Salunke	Vice-President, Depository Receipts	BNY Mellon
7.	Mr. Abhishek Agarwal	Vice President, Issuer Services – Sales Securities & Fund Services	Citi
8.	Mr. S. Nagnath	President and Chief Investment Officer	DSP Blackrock Investment Managers Pvt. Ltd.
9.	Mr. P.V. Krishna	Managing Director	Goldman Sachs
10.	Mr. Sanjiv Shah	Co-Chief Executive Director	Goldman Sachs
11.	Mr. Vinay Menon	Managing Director, Equity Capital & Derivatives Market	JP Morgan
12.	Mr. Vijay Bhojwani	Vice President, Depository Receipts	JP Morgan
13.	Mr. Alastair Walmsley	Head, Primary Markets	London Stock Exchange
14.	Dr. Darko Hajdukovic	Senior Manager, Primary Markets	London Stock Exchange
15.	Mr. J.N. Tikku	Joint Director	Ministry of Corporate Affairs
16.	Mr. Manu J. Vettickan	Deputy Director	Ministry of Finance
17.	Mr. Jitendra Asati	Assistant Director	Ministry of Finance
18.	Mr. H.S. Mohanty	DGM	RBI
19.	Mr. V.S. Sundaresan	CGM	SEBI
20.	Mr. Amit Tandon	DGM	SEBI
21.	Mr. Anjan Patel	AGM	SEBI
22.	Mr. Shailesh Pathak	President	SREI Infrastructure Ltd.
23.	Mr. Ashok Pareek	Executive Director	SREI Capital Markets Limited
24.	Mr. Suresh C. Senapaty	Executive Director & Chief Finance Officer	Wipro
25.	Mr. Partha Sarathi Guha Patra	Vice-President & Head-Corporate Affairs	Wipro

Annexure-C

MINISTRY OF FINANCE
(Department of Economic Affairs)
Notification

New Delhi, 11th October, 2013

Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism)(Amendment) Scheme, 2013

G.S.R. 684(E). — Central Government hereby amend the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993, namely: -

1. This Scheme may be called the issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) (Amendment) Scheme, 2013.
2. The Scheme shall be deemed to have come into force from the date of publication of Notification; and
3. In the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993;

   In Paragraph 3(1)(B) the words "Unlisted Indian Companies Issuing Global Depository Receipts/Foreign Currency Convertible Bonds shall be required to simultaneously list in the Indian stock Exchanges(s)" shall be replaced by the following

"Unlisted companies shall be allowed to raise capital abroad without the requirement of prior or subsequent listing in India initially for a period of two years subject to the following conditions.

a. Unlisted companies shall list abroad only on exchanges in IOSCO/FATF compliant jurisdictions or those jurisdictions with which SEBI has signed bilateral agreements;
b. The Companies shall file a copy of the return which they submit to the proposed exchange/regulators also to SEBI for the purpose of PMLA. They shall comply with SEBI's disclosure requirements in addition to that of the primary exchange prior to the listing abroad;

c. While raising resources abroad, the listing company shall be fully compliant with the FDI Policy in force;

d. The capital raised abroad may be utilised for retiring outstanding overseas debt or for operations abroad including for acquisitions;

e. In case the funds raised are not utilised abroad as stipulated at d above, such companies shall remit the money back to India within 15 days and such money shall be parked only in AD category banks recognised by RBI and may be used domestically.

[F.No.4/13/2012-ECB]

SHARMILA CHAVALY, Jt. Secy.

Annexure-D

The Depository Receipts Scheme, 2013

November 26, 2013

Contents

The Central Government hereby notifies the following Scheme for facilitating issue of depository receipts outside India, namely:-

1 Preliminary

1. This Scheme may be called the Depository Receipts Scheme, 2013.
2. This Scheme shall come into force on such date as the Central Government may specify by notification in the official gazette.
3. The provisions of this Scheme shall be implemented by the respective authorities, namely, the Reserve Bank of India, the Securities and Exchange Board of India, Ministry of Corporate Affairs and Ministry of Finance.

2 Definitions

1. In this Scheme, unless the context otherwise requires:-
   (a) 'depository receipt' means a foreign currency denominated instrument, whether listed on an international exchange or not, issued by a foreign depository in a permissible jurisdiction on the back of permissible securities issued or transferred to that foreign depository and deposited with a domestic custodian and includes 'global depository receipt' as defined in section 2(44) of the Companies Act, 2013;
   (b) 'domestic custodian' means a custodian of securities, an Indian depository, a depository participant, or a bank and having permission from SEBI to provide services as custodian under this Scheme;
   (c) 'foreign depository' means a person which:
      i. is not prohibited from acquiring permissible securities;
      ii. is regulated in a permissible jurisdiction; and
      iii. has legal capacity to issue depository receipts in the permissible jurisdiction;
   (d) 'ICDR' means the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

(e) 'Indian depository' means a depository under the Depositories Act, 1996;

(f) 'international exchange' means a platform for trading of depository receipts, which:

   i. is in a permissible jurisdiction;

   ii. is accessible to the public for trading; and

   iii. provides pre-trade and post-trade transparency to the public;

(g) 'permissible jurisdiction' means a foreign jurisdiction:

   i. which is a member of the Financial Action Task Force on Money Laundering; and

   ii. the regulator of the securities market in that jurisdiction is a member of the International Organisation of Securities Commissions;

   Explanation: The list of permissible jurisdictions as on the date of notification is at Schedule 1 (Schedule to be developed).

(h) 'permissible securities' mean 'securities' as defined under section 2(h) of the Securities Contracts (Regulation) Act, 1956 and include similar instruments issued by private companies which:

   i. may be acquired by a person resident outside India under the Foreign Exchange Management Act, 1999; and

   ii. is in dematerialised form.

(i) 'right to issue voting instruction' means the right of a depository receipt holder to direct the foreign depository to vote in a particular manner on its behalf in respect of permissible securities.

(j) 'SEBI' means the Securities and Exchange Board of India.

(k) 'unsponsored depository receipts' mean depository receipts issued without specific approval of the issuer of the underlying permissible securities.

2. Words and expressions used and not defined in this Scheme but defined in the Securities Contracts (Regulation) Act, 1956 or the Securities and Exchange Board of India Act, 1992 or the Depositories Act, 1996 or the Companies Act, 2013 or the Reserve Bank of India Act, 1934 or the Foreign Exchange Management Act, 1999 or Prevention of Money

Laundering Act, 2002 and rules and regulations made thereunder shall have the meanings respectively assigned to them, as the case may be, in those Acts.

3 Eligibility

1. The following persons are eligible to issue or transfer permissible securities to a foreign depository for the purpose of issue of depository receipts:
   (a) any Indian company, listed or unlisted, private or public;
   (b) any other issuer of permissible securities;
   (c) any person holding permissible securities;

   which has not been specifically prohibited from accessing the capital market or dealing in securities.
2. Unsponsored depository receipts on the back of listed permissible securities can be issued only if such depository receipts:
   (a) give the holder the right to issue voting instruction; and
   (b) are listed on an international exchange.

4 Issue

1. A foreign depository may issue depository receipts by way of a public offering or private placement or in any other manner prevalent in a permissible jurisdiction.
2. An issuer may issue permissible securities to a foreign depository for the purpose of issue of depository receipts by any mode permissible for issue of such permissible securities to investors.
3. The holders of permissible securities may transfer permissible securities to a foreign depository for the purpose of the issue of depository receipts, with or without the approval of issuer of such permissible securities, through transactions on a recognised stock exchange, bilateral transactions or by tendering through a public platform.

5 Limits

1. The aggregate of permissible securities which may be issued or transferred to foreign depositories for issue of depository receipts, along with permissible securities already held by persons resident outside India, shall not exceed the limit on foreign holding of such permissible securities under the Foreign Exchange Management Act, 1999.

   Explanation: For example, foreign investment in a company is ordinarily permissible up to x%. However, it can be increased up to y% with the approval of the company in the general body meeting. If no such approval has been granted, the permissible securities on which depository receipts may be issued, whether sponsored or unsponsored, cannot exceed x%.

2. The depository receipts may be converted to underlying permissible securities and vice versa, subject to the limit in sub-paragraph 1.

6 Pricing

The permissible securities shall not be issued to a foreign depository for the purpose of issuing depository receipts at a price less than the price applicable to a corresponding mode of issue of such securities to domestic investors under the applicable laws.

Explanation 1: A company listed or proposed to be listed on a recognised stock exchange shall not issue equity shares on preferential allotment to a foreign depository for the purpose of issue of depository receipts at a price less than the price applicable to preferential allotment of equity shares of the same class to investors under the ICDR.

Explanation 2: Likewise, where a listed company makes a qualified institutional placement of permissible securities to a foreign depository for the purpose of issue of depository receipts, the minimum pricing norms for such placement as applicable under the ICDR shall be complied with.

7 Rights and duties

1. The foreign depository shall be entitled to exercise voting rights, if any, associated with the permissible securities, whether pursuant to voting instruction from the holder of depository receipts or otherwise.

2. The shares of a company underlying the depository receipts shall form part of the public shareholding of the company under the Securities Contracts (Regulation) Rules, 1957, if:

   (a) the holder of such depository receipts has the right to issue voting instruction; and

   (b) such depository receipts are listed on an international exchange.

3. In the cases not covered under sub-paragraph 2, shares of the company underlying depository receipts shall not be included in the total shareholding and in the public shareholding for the purpose of computing the public shareholding of the company.

4. A holder of depository receipts issued on the back of equity shares of a company shall have the same obligations as if it is the holder of the underlying equity shares if it has the right to issue voting instruction.

8 Obligations

1. The domestic custodian shall:

   (a) ensure that the relevant provisions of the Scheme related to the issue and cancellation of depository receipts is complied with;

   (b) maintain records in respect of, and report to, Indian depositories all transactions in the nature of issue and cancellation of depository receipts for the purpose of monitoring limits under the Foreign Exchange Management Act, 1999;

   (c) provide the information and data as may be called upon by SEBI, the Reserve Bank of India, Ministry of Finance, Ministry of Corporate Affairs and any other authority of law; and

   (d) file with SEBI a copy of the document, by whatever name called, which sets the terms of issue of depository receipts issued on the back of securities, as defined under section 2(h) of the Securities Contracts (Regulation) Act, 1956, in a permissible jurisdiction.

Explanation: This obligation under sub-paragraph 1d is in respect of securities, and not permissible securities.

2. Indian depositories shall coordinate among themselves and disseminate:
   (a) the outstanding permissible securities against which the depository receipts are outstanding; and,
   (b) the limit up to which permissible securities can be converted to depository receipts.
3. A person issuing or transferring permissible securities to a foreign depository for the purpose of issue of depository receipts shall comply with relevant provisions of the Indian law, including the Scheme, related to the issue and cancellation of depository receipts.

9 Taxation

1. The following shall not be considered as transfer under the Income Tax Act, 1961:
   (a) issue of permissible securities to the foreign depository;
   (b) issue of depository receipts on the back of permissible securities;
   (c) conversion of depository receipts into permissible securities;
   (d) conversion of permissible securities into depository receipts;
   (e) transfer of depository receipts in permissible jurisdictions.
2. The transfer of permissible securities from a holder to a foreign depository for the purpose of issuing depository receipts will be taxed at the same rate and in the same manner as a transfer of such permissible securities in India.

   Provided that if such transfer relates to listed securities and are tendered to a foreign depository in pursuance to a public tendering process, such transfer shall be deemed to be a transaction on stock exchange for the purpose of taxation.

3. Any return on the permissible securities to a foreign depository from the issuer shall be taxable in the manner in, and at the rate at which such return to domestic investors are taxed.
4. Any transfer of permissible securities after conversion from depository receipts shall be taxed at the same rate and in the same manner as transfer of permissible securities.

10 Approval

1. Any approval necessary for issue or transfer of permissible securities to a person resident outside India shall apply to the issue or transfer of such permissible securities to a foreign depository for the purpose of issue of depository receipts.
2. Subject to sub-paragraph 1, the issue of depository receipts shall not require any approval from any government agency if the issuance is in accordance with the Scheme.

Explanation: If the issue of permissible securities underlying the depository receipts does not require approval under the Foreign Exchange Management Act, 1999, no approval will be required for issue of such depository receipts.

11 Market Abuse

1. It is clarified that any use, intended or otherwise, of depository receipts or market of depository receipts in a manner, which has potential to cause or has caused abuse of the securities market in India, is market abuse and shall be dealt with accordingly.
2. For the purpose of this paragraph, 'market abuse' means any activity prohibited under Chapter VA of the Securities and Exchange Board of India Act, 1992.

12 Repeal and savings

1. The Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 shall be repealed except to the extent relating to foreign currency convertible bonds.

2. Notwithstanding such repeal, anything done or any action taken under the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993, shall be deemed to have been done or taken under the corresponding provisions of this Scheme.

Schedule 1: Permissible Jurisdictions