

LEGAL UPDATE: INDIA

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FEMA and Prevention of Money-Laundering Bill

The much awaited Foreign Exchange Management Bill, 1998 (FEMA) has finally been placed before the Indian Parliament. The FEMA, once approved, would replace the existing Foreign Exchange Regulation Act, 1973 (FERA).

The introduction of FEMA is aimed at liberalising the foreign exchange regime. The Government has attempted to simplify the present draconian provisions of the FERA.

Restrictions over dealings with non-residents and by non-residents in India have been substantially diluted. Only a few foreign exchange transactions would, under FEMA, be violative of the law, and even such violations would be civil rather than criminal offences.

The Prevention of Money-Laundering Bill, 1998 (MLB) has also been tabled in the Parliament. The objective of the MLB is to prevent money-laundering and to provide for confiscation of property derived from or involved in money-laundering and for matters connected therewith.

Derivatives trading in India

The Securities and Exchange Board of India (SEBI) issued a circular on June 16, 1998, laying down the regulatory framework for derivatives trading. The contents of the circular are based on the recommendations of the Dr. L. C. Gupta Committee.

Trading will commence only after the necessary amendments to the

Securities Contracts (Regulation) Act, 1956 that will treat derivative instruments as "securities" is made.

According to the circular, derivatives trade should be settled by a separate clearing-house for derivatives.

The SEBI has prescribed the definition of net worth for a clearing member. This would require a clearing member to maintain a liquid capital of Rs. 30 million as a risk containment measure. The minimum value of a derivative contract shall not be less than Rs. 100,000.

ADR/GDR sale norms eased

The Reserve Bank of India (RBI) is now permitting ADR/GDR holders to sell the underlying shares received on the conversion of ADRs/GDRs without its prior permission. Such sale should however be made through a recognized stock exchange or in an open offer made by acquirers under the Indian Takeover Code.

Previously, prior permission of the RBI was required for such sale.

Dhanuka Committee reviews securities laws

In February 1997, the Securities and Exchange Board of India (SEBI) appointed a committee under the chairmanship of Justice D. R. Dhanuka (Committee) to examine areas of deficiency in the Securities and Exchange Board of India Act, 1992 (SEBI Act), the Securities Contracts (Regulation) Act, 1956 (SCRA) and the Depositories Act, 1996 (DA).

The Committee was to also examine the provisions of the Companies Act, 1956 and make recommendations for amendments to it in order to enable the SEBI to better regulate capital issues, listing of securities, transfer of securities and to protect the interest of investors.

The Committee has submitted its recommendations to the SEBI. Some of the important recommendations are detailed below:

HIGHLIGHTS

- **FEMA and Prevention of Money-Laundering Bill**
- **Derivatives trading in India**
- **ADR/GDR sale norms eased**
- **Dhanuka Committee reviews securities laws**
- **Enhancement of existing limits for FIIs**
- **Amendments to the SEBI FII Regulations**
- **Negotiated Deals**
- **RBI simplifies investments by NRIs**
- **Guidelines for domestic mutual funds investing abroad**
- **Automatic approval for electricity projects**
- **Foreign store chains can set up warehouses**
- **SEBI registers Central Depository**
- **Holding cos. Likely to get automatic clearance**
- **India gives tax incentives to IT sector**
- **Telecom**

- Consolidation of the SEBI Act and the SCRA into a composite securities legislation and repeal of the SCRA and the SEBI Act.
- SEBI to be the sole regulatory agency for the securities market, including in relation to provisions of the Companies Act.
- The scope of SEBI's powers to issue directions to be expressly extended to investors or any other person, rather than merely intermediaries.
- Parameters are prescribed for de-listing of securities. Voluntary de-listing to be permitted by stock exchanges and the SEBI only with the consent of the prescribed majority of the shareholders and also upon specific conditions.
- Compulsory dematerialization for new issues of securities exceeding Rs. 100 million.
- Contravention of a direction of the SEBI to be made punishable.

FIIIs

Enhancement of existing limits for FIIIs

The aggregate ceiling for investments by Foreign Institutional Investors (FIIIs) currently pegged at 24% (30%, if the company's shareholders have passed a special resolution approving the enhancement of the limit) will not henceforth include investments made by NRIs/OCBs under the portfolio investment scheme.

Earlier, the 24%/30% limit applied to the total investments by NRIs, OCBs and FIIIs in an Indian company.

Amendments to the SEBI FII Regulations

The Securities and Exchange Board of India (SEBI) has issued a notification amending the Securities and Exchange Board of India (Foreign Institutional Investors)

Regulations, 1995. The amendments will be effective upon their notification in the Official Gazette.

The following amendments have been made:

- Foreign Institutional Investors (FIIIs) investing through the 100% debt route will be permitted to invest in unlisted securities.
- FIIIs will be permitted to participate in open offers made in terms of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.
- The FII sub-account registration process has been simplified and a registration fee of US\$ 1000 is required to be paid at the time of application. The SEBI is expected to clear such applications in around three days.
- FIIIs will be permitted to buy and sell derivative contracts traded on a recognized stock exchange without requiring to take or give delivery.

Negotiated Deals

A negotiated deal is a transaction executed at a price not formed through the stock exchange price and order matching mechanism. The following are the important recommendations made by the committee, constituted by the Securities and Exchange Board of India (SEBI) for making negotiated deals more transparent and fair:

- A negotiated deal would be one where the transaction value is at least Rs. 2.5 million or the transaction volume is 10,000 shares or more.
- All negotiated deals must result in delivery.
- A negotiated deal should be reported to the stock exchange within 15 minutes of the trade being negotiated.
- The negotiated deal may be settled either through the

clearinghouse of the stock exchange or clearing corporation, or bilaterally as prescribed by the concerned exchange.

RBI simplifies investments by NRIs

The Reserve Bank of India (RBI) has decided to grant general permission under the Foreign Exchange Regulation Act, 1973 to Non-Resident Indians and persons of Indian origin (NRIs) and overseas corporate bodies owned to the extent of at least 60% by such persons (OCBs) in respect of the 100% scheme.

Under the existing 100% scheme, NRIs/OCBs can invest up to 100% in any Indian company falling within the high-priority list of industries under the automatic route with the prior approval of the RBI.

Due to the relaxation, henceforth it will no longer be necessary for Indian companies to approach the RBI for permission to receive remittances from NRIs/OCBs and issue shares there against. However, within 30 days of the issue of the shares to NRIs/OCBs, the required declaration must be filed with the RBI.

Guidelines for domestic mutual funds investing abroad

In October 1997 the Reserve Bank of India (RBI) had announced that Securities and Exchange Board of India (SEBI) registered Indian fund managers including mutual funds (MFs) will be allowed to invest in the overseas markets within the overall limit of US\$ 500 million and a ceiling of US\$ 50 million for an individual mutual fund.

The SEBI subsequently set up a committee to draft guidelines for such overseas investments. A few important recommendations are as follows:

- MFs could make overseas investments under their existing schemes provided they are consistent with the investment objectives of the schemes.
- If there is no provision in the offer document to the effect that the monies of the scheme may be invested overseas then MFs must seek the approval of the unit holders before proceeding with such investments.
- The trustees must provide for the appointment of the investment advisors/sub-advisors and must enter into tripartite sub-advisory agreements with the asset management company.
- MFs may not invest in securities not listed or traded on any exchange unless such investments are through primary/secondary offerings.
- MFs may not purchase securities of any foreign issues if it results in owning more than 10% of any class of the securities.
- MFs may be permitted to enter into forward currency contracts or currency futures in foreign currency only for hedging currency risks provided the aggregate value of such contracts does not exceed the total value of assets of the MF.
- MFs may enter into interest rate future contracts, deal in options on interest rates or enter into interest rate swap transactions for hedging the risk of the portfolio's assets or for efficient portfolio management provided the aggregate value of the contract does not exceed the total value of the MF's assets.
- MFs may invest in American Depository Receipts/Global Depository Receipts or such other securities issued by an Indian issuer overseas, as and when permitted by the government and the RBI. MFs may also invest in mutual funds, unit trusts and such vehicles, overseas which in turn have invested in ADRs, GDRs or

such other securities issued overseas by Indian issuers, provided the vehicle overseas has a well diversified portfolio.

Automatic approval for electricity projects

Under the present industrial policy, Indian companies undertaking generation and transmission of electric energy produced in hydro-electric power plants and other specified plants are eligible for automatic approval up to 74% foreign equity.

The government has decided to increase this limit to 100%. Accordingly, foreign equity participation up to 100% in projects for electric generation, transmission and distribution will now fall under the automatic route provided the foreign equity in such projects does not exceed Rs. 15 billion.

The categories falling in the automatic route are, hydro-electric power plants, coal/lignite based thermal power plants, oil based thermal power plants and gas based thermal power plants.

Foreign store chains can set up warehouses

Foreign departmental store chains have been allowed to set up their own warehouses in India subject to certain conditions. They can now easily source goods for export directly from Indian manufacturers instead of going through middlemen. The facility is expected to encourage them to buy goods from Indian producers to retail in their branches worldwide.

This has been made possible because the revenue department has notified foreign departmental stores of repute as being eligible for the warehousing scheme which was earlier restricted to super star trading houses and star trading houses.

SEBI registers Central Depository

The Securities and Exchange Board of India (SEBI) has granted a certificate of registration to the Central Depository Services Limited (CDSL), a depository company promoted by the Stock Exchange, Mumbai (BSE) and the Bank of India. The only other depository that is currently operational is the National Securities Depository Limited (NSDL).

The SEBI will however, issue CDSL with a certificate of commencement of business only after thoroughly inspecting its systems and being convinced that CDSL has fulfilled the capital requirement criteria.

Holding cos. likely to get automatic clearance

The government may allow foreign holding companies to invest through the automatic route if the investment limits or level of equity is within the sectoral limit for automatic approvals. Thus, such companies will only have to inform the Reserve Bank of India (RBI) or the Foreign Investment Promotion Board (FIPB) about such investment.

RBI has recently clarified that foreign companies violating foreign investment norms cannot be prosecuted under the Foreign Exchange Regulation Act, 1973 ("FERA"). This clarification was in respect of Hindustan Lever Limited ("HLL"), which made downstream investments in Kimberly Clark Levers, without seeking a clearance from the Foreign Investment Promotion Board ("FIPB"). FIPB had sought RBI's opinion on whether downstream investments without its clearance could be prosecuted under FERA rules. RBI opined that this would not tantamount to any violation of FERA and hence would not attract punitive action.

Until now, the downstream investments by foreign holding companies were not permitted by FIPB without its prior clearance.

Information Technology

India gives tax incentives to IT sector

The Indian Finance Minister, Mr. Yashwant Sinha, while moving the Finance Bill in the Parliament, announced major tax incentives for the Information Technology (IT) sector. The incentives are based on the recommendations of the National Task Force on IT (Task Force). The Prime Minister set up the Task Force on May 22, 1998 and the Task Force submitted its initial recommendations on July 6, 1998.

The incentives announced include, exemption from custom duties for import of IT software. It seems that this exemption would also include the import of non-embedded telecom software. At present, there is no duty on import of computer software. However, import of telecom software attracts customs duty of a minimum of 23%. A notification will bring out the exact intentions of the government. Provision for depreciation on all IT products has been increased from 25% to 60%. Also, there will be no withholding tax on royalty paid for transmission of IT data.

The scope of section 80HHE of the Income-tax Act, 1961 has also been widened. Section 80HHE provides for a deduction in respect of profits from export of computer software. Now, this definition has been widened to include data transmission. Thus, section 80HHE will now permit 100% deduction on export earnings from transmission of IT data. The benefits of section 80HHE have also been extended to support software developers. Domestic companies will benefit from the concession as they can now

transmit software to their clients abroad through telecom networks and claim benefits of section 80HHE for that portion of their income.

The Finance Minister has also indicated that more incentives are likely to follow. According to a decision taken by the government software firms will now be allowed to use a part of their export proceeds for acquiring Information Technology (IT) companies abroad. At present, these companies have to fund such acquisitions through the proceeds of ADRs/GDRs floated abroad. An inter-institutional group formed by the government has endorsed this decision. The norms are applicable to software exporters who have a cumulative export realization of over US\$ 25 million in the past three years. They will be allowed to retain abroad, US\$ 25 million or 50% of their cumulative actual export earnings of the previous three years. For approvals beyond this limit, the RBI plans a mechanism for quickly processing applications from this sector.

The guidelines for Export Earners' Foreign Currency (EEFC) Accounts is also being revised. 20% of the EEFC balance can now be used for:

- Advance remittances for downloading software (up to US\$ 100,000 per transaction);
- Purchase of equipment and related expenditure; and
- Miscellaneous expenses not detailed in the EEFC guidelines.

The government will also permit the infotech sector to use international credit cards for a variety of purposes.

Telecom

Cellular telephone operators in Delhi have filed a petition in the Delhi High Court, saying that Mahanagar Telephone Nigam Limited's (MTNL) bid to enter cellular business in Delhi and Mumbai will violate their fundamental right to equality.

According to the Cellular Operators Association of India (COAI), while cellular telephone operators in Delhi and Mumbai are required to pay a license fee every year, per subscriber, MTNL has not been asked to pay any such fee. Secondly, while the license period for private operators is ten years, MTNL's license would be valid for fifteen years. Thirdly, metro operators like BPL, Essar, etc. have to pay the MTNL interconnection charges. The COAI has filed the petition in the Delhi High Court due to the unfair advantage that MTNL will have over its competitors.

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