Listing on Nasdaq – Indian legal and tax considerations©

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A. Introduction

It is immensely satisfying to see Indian companies listed on American stock exchanges and attracting good buying interest among U.S. investors. Infosys Technologies Limited ("**Infosys**") was the first Indian company to get listed in the U.S. in March 1999. With ICICI Limited listing on the New York Stock Exchange ("**NYSE**") in September 1999 and Satyam Infoway Limited ("**Satyam**") following close behind and getting listed on the National Association of Securities Dealers Automated Quotation System ("**Nasdaq**") in October 1999, now there is no looking back for Indian corporates. There are several Indian companies waiting in the wings today to go in for an ADR issue.

Infosys, listed on Nasdaq, has not failed to surprise investors and continues to be the hot favorite among U.S. as well as Indian stock holders. The American Depositary Receipts ("**ADRs**") are currently quoting at around USD179[1]. Satyam, India's first private Internet Service Provider's, ADRs are currently quoting at around USD57[2] per ADR.

Indian corporates and advisers are quite familiar with GDR programs. Though ADRs, by nature are similar to Global Depositary Receipts ("**GDRs**"), the process involved in an ADR program is markedly different. The disclosures required under the securities legislation in the U.S. are far more onerous as compared to those in Europe and other parts of the world. In the best interest of the investors, the U.S. Securities and Exchange Commission ("**SEC**") places on the issuer, its officers and directors, the burden to prove that the statements made in the prospectus are correct and that the prospectus contains no misstatement or omission of a material fact. The issuer, the underwriter, counsel for the issuer and the underwriter and the issuer's independent public accountants generally spend hours discussing the required disclosures that need to be made in the issuer's prospectus.

In case of *Escott v. BarChris Construction Corporation*, BarChris was found liable as its prospectus was materially misleading and the 'due-diligence defense' was not available to it. The case involved over sixty plaintiffs and ten law firms, and took nearly five and a half years to reach a final decision.

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[1] Source: www.nasdaq.com, quote on November 12, 1999. Each underlying share of Infosys is represented by two ADRs.

[2] Source: www.nasdaq.com, quote on November 12, 1999. Each underlying share of Satyam is represented by one ADR.

Third generation companies with dynamic and forward looking management who have voluntarily adopted strict disclosure and corporate governance standards, have found ADRs as a more fundamental source of raising funds. I will cover in this presentation, the Indian legal and tax considerations in an ADR issue.

B. What is an ADR?

An ADR means any instrument in the form of a depository receipt or certificate created by an overseas depository bank ("**ODB**") outside India and issued to non-resident investors against the issue of ordinary shares of the issuer company[3].

C. Legal regime governing the issue of ADRs by an Indian company

Any issue of ADRs or GDRs by an Indian company is governed by the provisions of Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 ("**Guidelines**") which was announced by the Government of India on November 12, 1993.

Salient features of the Guidelines

Track record

The issuer company seeking permission for raising foreign funds by issue of ADRs would be required to have a consistent track record of good performance (financial or otherwise) for a period of at least three years. However, an exception has been in case of companies seeking an ADR issue to finance investments in infrastructure industries.

Approvals

Approval of the Department of Economic Affairs, Ministry of Finance: An issuing company will have to first obtain an in-principle approval from the Department of Economic Affairs approving the finalization of the ADR issue and on the finalization of the issue structure in consultation with the lead managers to the issue, a final approval will be obtained from the Department of Economic Affairs.

[3] 2(c), Guidelines, GSR No. 700(E), dated 12-11-1993.

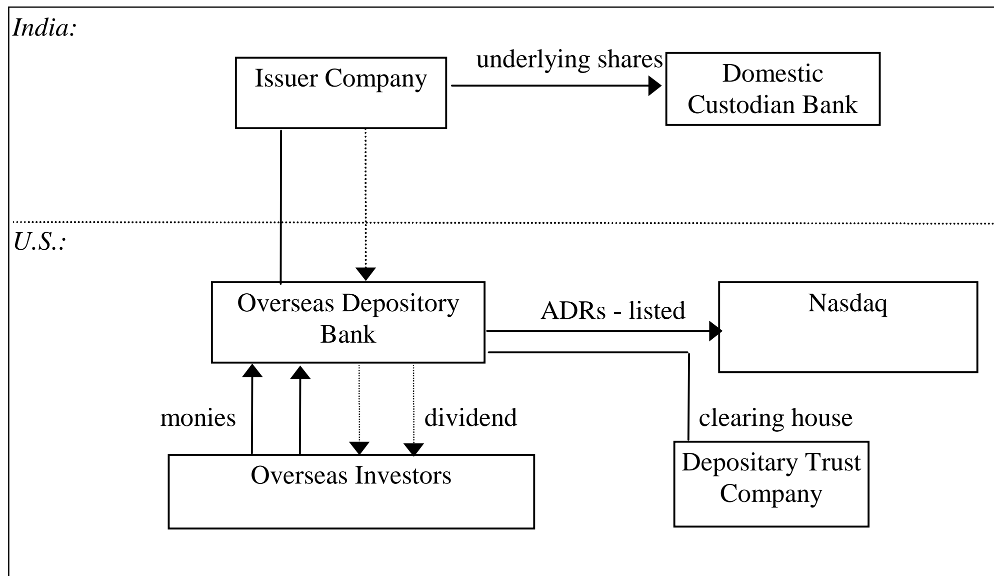
Approval of the FIPB (if required): The ordinary shares issued against the ADRs shall be treated as direct foreign investment in the issuing company and such investment will be governed by the foreign direct investment guidelines issued by the Foreign Investment Promotion Board. Therefore, if a company in which the direct foreign investment post the ADR issue exceeds the limits specified in Annexure III to the New Industrial Policy, 1991, then the company will have to obtain the prior approval of the FIPB.

In addition to the approvals detailed in the Guidelines, the following approvals would also be required:

Approval of the Department of Company Affairs: After obtaining the in-principle approval from the Ministry of Finance, the issuer company would be require to apply to the Department of Company Affairs seeking an exemption from the provisions of section 56(3) of the Companies Act, 1956 relating to the issue of an Indian prospectus since the prospectus would be distributed only among investors abroad, the applicability of section 108 of the Act relating to the transfer of shares from the depositary to the holders of ADRs upon redemption of ADRs.

Reserve Bank of India approval: The Company would be required to obtain approvals from the Exchange Control Department of the Reserve Bank of India ("**RBI**") under the Foreign Exchange Regulation Act, 1973 ("**FERA**"). Once the approval has been obtained, the ADRs purchased are freely transferable by non-residents (within the meaning of section 2(q) of the FERA subject to the provisions of that Act). The record of ownership in India does not change with every transfer of ADRs and as such, the issuer company is in no position to control the registration of transfers.

D. Structure



- A ADR may represent one or more shares of the issuer company. The issuer company issues shares to an intermediary (*i.e.* the ODB), in whose name the shares are registered. The ODB subsequently issues the ADRs to the underwriters for the final placement with the investors. The physical possession of the securities is entrusted to the domestic custodian bank ("**DCB**"), who is an agent of the ODB.

- ADRs are denominated in dollars or in some other freely convertible foreign currency. The underlying equity shares are however, denominated in rupees. ADRs are usually settled on a book entry basis through the system of the Depositary Trust Company in the U.S.

- The dividend paid by the Indian issuer company is in rupees only, but the ODB converts these rupees and pays the dividend (after withholding tax) to the ultimate investor, in US dollars. This eliminates the exchange rate risk for the issuer company.

E. Amendments to the Guidelines

The Ministry of Finance, Department of Economic Affairs, government of India, has been revising the Guidelines from time to time. The highlights of the revised guidelines are as follows:

- Companies can float more than one foreign equity issue in a year.

- In May 1998, the Ministry of Finance issued a notification stating that there would be no end-use restrictions on the proceeds of an ADR issue. As a result, issuer companies are now free to use the proceeds of an ADR issue for any purpose other than investment in the real estate or investment in the stock market.

- In an attempt to increase liquidity in the economy, the government is allowing banks, financial institutions and Non-Banking Finance Companies ("**NBFCs**") to raise funds through equity issues abroad and to use such funds for domestic lending.

- Companies may retain the ADR proceeds abroad or remit the funds into India in anticipation of the use of funds for approved end-uses.

- Greater priority has been given to export projects and infrastructure projects in sectors such as power, oil exploration, telecommunication, railways, *etc.* Accordingly, companies making an ADR issue to fund infrastructure projects need not have a past track record of financial performance which is otherwise, mandatory for companies seeking to raise equity funds from abroad.

- ADR holders can tender the shares (they receive after redemption of the ADRs) in a public offer made by an acquirer under the Takeover Code.

- The Reserve Bank of India has vide a notification dated August 7, 1998 allowed resident employees of Indian offices of foreign companies to remit up to USD 10,000 for the acquisition of the shares of the parent foreign company. Indian IT software and IT services companies have also been allowed to offer ADR linked stock option schemes to their non-resident/resident permanent employees.

- Issuer companies that have already issued ADRs would be permitted to further offer shares (through a bonus or a rights issue) to the depositary bank (who in turn would issue ADRs to the overseas investors) without obtaining the prior approval of the Reserve Bank of India.

F. Requirements in an ADR issue

Before a company decides to go public in the U.S., there are several important issues that must be considered by the management of the company, such as complying with U.S. GAAP requirements, certain corporate governance requirements, *etc*. It is indeed a fact that issues by non-U.S. entities in the U.S. domestic markets require to comply with stringent SEC disclosure and reporting requirements. However, under the SEC laws, a 'foreign private issuer' is subject to somewhat narrower disclosure obligations than U.S. issuers.

Complying with U.S. GAAP

A non-U.S. issuer company can choose to prepare its financial statements either in accordance with the U.S. GAAP or in accordance with any other comprehensive body of generally accepted accounting principles. If financial statements are not prepared in accordance with U.S. GAAP, the registration statement must disclose the basis of preparation, discuss the material differences in accounting principles between U.S. GAAP and the principles used, and provide a table which reconciles the primary financial statements to U.S. GAAP. However, U.S. advisers to the issue generally prefer the company to translate its accounts into U.S. GAAP so as to make it convenient for the investors to compare the accounts of the issuer company to other U.S. companies.

Nasdaq corporate governance requirements

- The Nasdaq corporate governance requirements specify that the issuer company should have a minimum of two independent directors on its board.

- The issuer company should appoint an audit committee the majority of the members of which should be independent directors.

- The issuer company should hold an annual meeting of its shareholders and should provide notice of such meeting to the Nasdaq. Quorum for such meetings should not be less than 331/3% of the paid up share capital.

- Distribution annual and interim reports to the shareholders.

Due diligence investigation

Underwriters of the US public offering must conduct a due diligence investigation of the company if they are to claim the benefit of certain defenses to civil liability under the Securities Act, in the event of material misstatements or omissions in the prospectus.

Registration Statement

Any non-U.S. issuer that issues securities for sale in the U.S. is required to register the sale of those securities with SEC under the 1933 Act. An important advantage that a foreign private issuer enjoys *vis-a-vis* an U.S. issuer is the fact that it can opt for confidential filing with SEC. This would allow non-U.S. issuer not to disclose the information that it submits with SEC in its registration statement till such time as it is approved by SEC.

In order to register with SEC, the non-U.S. issuer must file a disclosure document, known as the registration statement (Form F-1), which contains a Prospectus containing detailed description of the issuer's business, financial position, results of operations and management, as well as a description of the securities offered. The sections of the registration statements are to be very carefully drafted so as to avoid, as far as possible, any forward-looking statements or misleading statements in the registration statement. SEC actually analyzes the registration statement threadbare and comes up with some very intelligent queries. Replying to these queries in itself is an intellectual exercise.

The company's material contracts must be filed with the SEC as exhibits to the registration statement. Once they are filed, these exhibits are publicly available. A company may request confidential treatment for certain portions of the exhibits.

Managing Publicity

It is very important for the issuer company to manage publicity during the pre-filing and post-filing period. Prior to the time that a company has filed a registration statement with the SEC in connection with a public offering of its stock, *offers to sell,* and *solicitations of offers to buy* the company's stock are forbidden. However, during the pre-filing period the company may continue to issue press releases with respect to the factual business and financial developments, provided that:

- Such disclosures are consistent with prior practice
- Such disclosures are in customary form

- Such disclosures do not contain projections, forecasts or valuations
- The contents do not suggest a selling effort for the company's stock

Continuing Disclosure

A non-U.S. issuer that lists its securities on a U.S. national securities exchange or NASDAQ, or registers an offering under the 1933 Act, may be subject to some or all of the ongoing compliance obligations. Each of these non-U.S. Private Issuers are required to file with SEC Annual Reports (on Form 20-F) within six months after the end of each financial year. Though a foreign private issuer is legally not required to file quarterly reports with SEC, most underwriters insist that the company file such quarterly reports (on Form 6-K) to provide investors with same level of information as would be provided by a U.S. issuer. In addition to these disclosures, an issuer is also required to comply with the disclosure standards as specified by the securities exchanges, which may vary from exchange to exchange.

G. Tax considerations

Taxation of shares issued under the ADR mechanism

- *Dividend.* Under the provisions of the ITA, income by way of dividend on the underlying shares will not be subject to any withholding tax[4]. However, the Issuer Company would have to pay an additional tax of 10% on the total amount of dividend it declares, distributes or pays after June 1, 1997[5]. On receipt of these dividend payments, the Depository will distribute them to the non-resident investors in proportion to their holdings of ADRs evidencing the relevant shares.

- *Transfer of ADRs and shares outside India.* All transactions of trading of ADRs and the shares underlying them outside India, among non-resident investors, will be free from any liability to income-tax in India on capital gains therefrom[6].

- *Redemption.* No tax is payable on the redemption of ADRs into underlying shares.

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[4] Section 10(33) of the ITA.
[5] Section 115-O of the ITA.
[6] Section 47(viia) of the ITA and Paragraph 9(3) of the Guidelines.

- *Cost of acquisition.* On redemption, the cost of acquisition of the underlying shares will be reckoned as the cost on the date on which the Depository advises the Custodian for redemption. The price of the ordinary shares of the Issuer Company prevailing on the BSE or the NSE on the date of the advice of redemption shall be taken as the cost of acquisition of the underlying shares[7].

- *Capital gains.* After redemption of the ADRs into the underlying shares if the underlying shares are held by the redeeming non-resident foreign investor who has paid for these shares in foreign exchange at the time of purchase of the ADRs for a period of more than 12 months from the date of advice of their redemption by the Depository and if the redeeming non-resident foreign investor transfers the shares to a resident of India or in India, the capital gains arising on the sale thereof will be treated as long-term capital gains and will be subject to income-tax at the rate of 10%[8]. If such shares are held for a period of 12 months or less than 12 months from the date of redemption advice, the capital gains arising on the sale thereof will be treated as short-term capital gains and will be subject to tax at the normal rates of income-tax (maximum rate of 30% for individuals and maximum rate of 48% for companies) applicable to non-residents under the provisions of the ITA.

- *Transfer of shares purchased in Rupees.* When the redeemed shares are sold on the Indian stock exchanges against payment in Rupees, these shares would go out of the purview of the section 115AC of the ITA and income therefrom would not be eligible for the concessional tax treatment provided thereunder. After the transfer of shares for which consideration is in Rupee terms, the normal tax rates would apply to the income arising or accruing on these shares[9]. Withholding of tax on the amount of capital gains accruing on transfer of the shares would be made in accordance with the ITA[10].

- *Rights and bonus issues.* Distributions to non-resident holders of ADRs or shares ("**Bonus Shares**") or rights to subscribe for shares ("**Rights**") made with respect to ADRs or shares are not subject to Indian tax.

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7 Paragraph 7(3) of the Guidelines. No provision in the ITA.
8 Section 115AC(1)(b) read with section 115AC(1)(ii) of the ITA.
9 Paragraph 9(6) of the Guidelines.
10 Section 195 and 196C of the ITA and Paragraph 9(7) of the Guidelines.

Application of avoidance of double taxation agreement in case of ADRs and underlying shares after redemption

- During the period of fiduciary ownership of shares in the hands of the Depository, the provisions of India's double tax avoidance treaty with the country of residence of the Depository will be applicable in the matter of taxation of income by way of interest on FCCBs.

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

Gift tax and wealth tax

Gift tax has been abolished in October 1998 and hence there would be no incidence of gift tax on the transfer of ADRs without consideration. The Guidelines[11] provide that the holding of the ADRs in the hands of non-resident holders and the holding of the underlying shares by the Depository in a fiduciary capacity and the transfer of ADRs between such non-resident holders and the Depository will be exempt from Indian wealth tax.

Stamp duty and transfer tax

- Upon issuance of the ADRs, the Issuer Company is required to pay a stamp duty of 0.1% (under the Bombay Stamp Act, 1948) on the value (par value plus premium) of each underlying share.

- A transfer of ADRs is not subject to Indian stamp duty.

- However, upon the acquisition of shares from the Depository in exchange for ADRs, the holder will be liable for Indian stamp duty at the rate of 0.5% of the market value of the ADRs or shares exchanged.

[11] Paragraph 11 of the Guidelines.
No specific provisions are included in the Gift-tax Act, 1958 and the Wealth-tax Act, 1957 in this regard.

- Sale of shares by a registered holder will also be subject to Indian transfer tax at the rate of 0.5% of the market value of the shares on the trade date, although customarily such tax is borne by the transferee[12].

Estate duty

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

H. Issues

Despite of the various amendments to the Guidelines, there are still several lacuna in the Guidelines as they exist today. These are set forth below:

No two-way fungibility

There is no two-way fungibility of ADRs permitted under the existing guidelines. This means that an ADR holder having once redeemed his ADRs into underlying shares cannot obtain ADRs by submitting the underlying shares to the Depository Bank. It is high time government reviews its position in this regard. Two-way fungibility, in our opinion, would provide necessary liquidity to the ADR market the lack of which was one of the main reasons for the fall of the GDR market. In addition, it would give ADR holders an opportunity to arbitrage between the U.S. and the domestic market thereby balancing the stock prices in both these markets.

Companies not listed in India may not be permitted to list abroad

In a recent press release, the Ministry of Finance is reported to have proposed to the Ministry of Law that Indian companies that have not listed their securities on an Indian stock exchange should not be permitted to list their stock abroad. This, could be a major disadvantage, especially for infotech companies.

Furthermore, Indian companies that do not have a three year profit making track record are not permitted to price their shares at a premium to the par value. Hence, if the Ministry of Law implements the proposal of the Ministry of Finance referred to above, it would hinder Indian IT companies from seeking a high valuation of their stock through an overseas listing.

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[12] The rate of stamp duty varies from state to state. The rate of 0.5% detailed above is the rate applicable if the Issuer Company's registered office is situated in the state of Maharashtra.

I. Conclusion

The most obvious benefit of quoting a company's stock on NASDAQ or on any other exchange is the establishment of a public market in the US for the company's stock which provides an avenue to liquidity for existing investors. Of course, this liquidity may be delayed due to certain lock-up provisions under which managing underwriters typically require officers, directors, and major shareholders to sign agreements not to sell their shares for a certain period after the offering.

The company will also have greater access to financial markets. An established public market for the company's stock provides the advantages of name recognition, and a readily ascertainable market value. These factors will make the stock more attractive to potential investors in future financings. The company may also be able to access a broader base of potential investors through increased exposure of the company to the public eye.

The increased liquidity of shares and heightened exposure may attract alliance partners. Particularly in capital intensive industries, the financial power of a listed company can be a significant competitive factor.

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