THE DEPOSITORY RECEIPTS SCHEME, 2014: LESSONS IN POLICY IMPLEMENTATION

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Contemporary financial policy making in India is undergoing a sea-change. Hitherto opaque processes are becoming more transparent. More lawyers are involved at the policy formulation stage and in converting them into precise legal drafts. This article illustrates the various factors affecting contemporary financial policy making in India and its implementation, in light of the experience from the recent depository receipt reforms. It analyses the political economy that shaped the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993, and argues that the skewed sectoral preference evident therein was not based on sound economic and regulatory policies. Finally, it concludes that the conceptualisation of the policy behind the Depository Receipts Scheme, 2014 through an expert committee has been extremely transparent and progressive. However, a major challenge in the co-ordination of a multi-pronged implementation strategy remains in the form of a diffused governmental and regulatory set-up, which creates obstacles in the implementation of policies.

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INTRODUCTION

Capital markets across jurisdictions are segmented from each other by various barriers like capital controls, legal restrictions, information costs, and transaction costs. Finance literature shows that there is much to be gained by overcoming these barriers.[1] The depository receipt is a time-tested tool to overcome these barriers and integrate capital markets internationally.

Originally developed to raise equity funding off-shore, a depository receipt is a security issued in a foreign jurisdiction on the back of domestic securities in the home jurisdiction. Domestic securities are deposited with a domestic custodian on-shore and depository receipts are issued off-shore by a depository bank against such deposited domestic securities. Being foreign securities, depository receipts are traded and settled in the foreign jurisdiction like any other security in that jurisdiction.[2] At the same time, they are but mirror-images of the domestic securities deposited with the domestic custodian. Foreign investors can invest in depository receipts like any other security in their home jurisdiction, while simultaneously reaping the benefit of investing in a security outside their home jurisdiction. Domestic entrepreneurs can use depository receipts to tap these foreign investors and markets.

India's tryst with depository receipts can be traced back to the balance of payments crisis in 1991 and the consequent gradual liberalisation of the capital account.[3] The depository receipt mechanism was one of the earliest areas of post-liberalisation reform.[4] The Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 ("1993 Scheme") focussed on off-shore listings – it allowed Indian firms to issue depository receipts off-shore against their domestic equity shares on-shore.[5] The recent reforms in off-shore depository receipts, leading up to the Depository Receipts Scheme, 2014 ("2014 Scheme"), go beyond equity underlying, thereby greatly expanding the scope and utility of these instruments.[6] From a wider perspective, these ongoing reforms are crucial because they throw

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[1] The price of stocks of a domestic listed firm may get enhanced if it cross-lists in a completely segmented foreign capital market. *See* R.C. Stapleton & M.G. Subrahmanyam, *Market Imperfections, Capital Market Equilibrium and Corporation Finance*, 32(2) JOURNAL OF FINANCE(1977); the expected return of a pure domestic security with a dual listing may be greater than the expected return of the same security without a dual listing. *See* Cheol S. Eun Gordon, J. Alexander, and S. Janakiramanan, *Asset Pricing and Dual Listing on Foreign Capital Markets: A Note*, 42(1) JOURNAL OF FINANCE (1987).

[2] The Supreme Court has recently held that such depository receipts are "*securities*" as defined under Section 2(h) of Securities Contracts (Regulation) Act, 1956. Therefore, the Securities and Exchange Board of India has adequate powers under the Securities and Exchange Board of India Act, 1992 to investigate and pass orders in suspected cases of market abuse. See *Securities and Exchange Board of India v. Pan Asia Advisors Ltd.*, Civil Appeal No. 10560/2013, order dated 06/07/2015 (SC).

[3] For a detailed account, *see* SUMIT GANGULY & RAHUL MUKHERJI, INDIA SINCE 1980 (2011).

[4] *See* REPORT OF THE COMMITTEE TO REVIEW THE FCCBS AND ORDINARY SHARES (THROUGH DEPOSITORY RECEIPT MECHANISM) SCHEME*,* 1993 (Ministry of Finance, 2013) [hereinafter "Sahoo Committee Report"].

[5] *See* Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993, GSR 700(E) (Nov. 12, 1993) [hereinafter "1993 Scheme"]; although beyond the scope of this article, it may be worthwhile to note that the on-shore depository receipt reforms began in 1996 when the Finance Minister set up a working group to re-draft company law, culminating in the introduction of the Indian Depository Receipt (IDR) in Section 605A of the Companies Act, 1956 and the Companies (Issue of Indian Depository Receipts) Rules, 2004.

light on the financial policy-making process in India and the hardships faced in a multi-pronged policy implementation strategy. The purpose of this article is to analyse these reforms and understand the hurdles faced, at an institutional level, in the implementation of new policies in the Indian financial sector.

Part I of this article examines the political economy that shaped the 1993 Scheme from its inception and across the two decades of its existence. It argues that the skewed sectoral preference evident in the 1993 Scheme was not based on sound economic and regulatory policies. This was a major shortcoming in the scheme, which led to its review and ultimately, the notification of the 2014 Scheme. Part II explains the committee process followed by the Indian government to review the policy framework on off-shore depository receipts and the philosophy that guided these reforms. Part III analyses the 2014 Scheme from this new perspective along with the implementation challenges ahead. The article concludes that the conceptualisation of the policy behind the 2014 Scheme through an expert committee has been extremely transparent and progressive. However, policy implementation in India remains diffused across various government departments and regulators, which renders the coordination of a multi-pronged implementation strategy difficult and time-consuming.

I. THE 1993 SCHEME

It is no coincidence that the 1993 Scheme, the first post-liberalisation reform in financial law, was itself overtly biased towards equity investment into Indian companies.[7] The Indian political economy at the time preferred equity market reform.[8] The balance of payments crisis in 1991 led to the devaluation of the rupee coupled with substantial reduction in import controls after 1991. This gave a major boost to the export-oriented services sector, especially information technology and other knowledge-based industries.[9] In the absence of substantial collateral necessary for debt financing, firms in the services sector tend to prefer equity investment. Given the high growth potential of the Indian services sector at that time, it was easier for such firms to raise capital through equity rather than debt. Further, the international capital market was more suitable than the domestic capital market for raising such equity capital since the former was likely to have more sophisticated analysts for new sectors like information technology. Consequently, Indian technology stocks could obtain a better valuation in off-shore equity markets. Moreover, the consumer-commercial market bonding theory would suggest that Indian services sector firms catering to the outsourcing

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[6] *See* Depository Receipts Scheme, 2014 (Oct. 21, 2014).

[7] The 1993 Scheme treated investments in depository receipts on underlying Indian equity shares as Foreign Direct Investment (FDI). Such FDI could not exceed 51% of the company's issued and subscribed capital. Investment by Foreign Institutional Investors (FIIs) was excluded from this 51% cap on FDI. *See* Schedule I, Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, Notification No. FEMA 20/2000-RB dated 3rd May 2000 (2000).

[8] *See* Vikramaditya Khanna & Umakanth Varottil, *Developing the market for corporate bond in India*, (National Stock Exchange, Working Paper, 2012), http://www.nseindia.com/research/content/WP_6_Mar2012.pdf.

[9] *See* GANGULY & MUKHERJI, *supra* note 2, at 91.

demands of developed western economies would prefer to be listed on their stock exchanges, particularly in the United States.[10]

On the other hand, the Indian manufacturing sector already had well-established firms from the socialist regime, which had the necessary collateral for debt financing, as well as the reputation required to attract equity investors. In contrast, new entrants into the manufacturing sector may have the requisite collateral for debt-financing but would never have the reputation to attract equity investments. Therefore, the crucial players in both the services and manufacturing sector in India stood to benefit from equity market reforms rather than debt market reforms.[11] Consequently, the political economy preferred equity market reforms, with a focus on off-shore listings. The 1993 Scheme was the product of these undercurrents.

This skewed sectoral preference continued to manifest in the form of amendments to the 1993 Scheme. For example, on June 23, 1998, Indian software companies were permitted to issue depository receipt-linked employee stock options. In March 2000, other knowledge-based sectors like pharmaceuticals and biotechnology were also extended similar benefits. On June 16, 2000, the benefit was extended to employees of subsidiary companies. Companies generating 80% of their turnover (for the previous three financial years) from these sectors were permitted to offer depository receipts to resident or non-resident permanent employees (including directors) of those companies and of subsidiaries incorporated in India or abroad.[12]

Although the 1993 Scheme was the first piece of financial legislation of the liberal Indian economy, it bore clear imprints of the socialist legal drafting style.[13] The scheme allowed the issue of depository receipts by way of either public issue or private placement, subject to the prior approval of the Department of Economic Affairs of the Ministry of Finance. The criteria for such approval closely resembled the philosophy behind merit-based regulation. The government would approve companies which had a track record of good performance (financial or otherwise) – a purely subjective test left to the complete discretion of the government.[14]

As stated earlier, depository receipts help overcome market segmentation by integrating the issuer's capital market with the capital market in which the depository receipts are traded. These markets are said to be perfectly integrated if the 'law of one price' holds across them. Any price differential between similar financial instruments traded in two different geographical locations leads to entry of arbitrageurs who profit out of this differential and ultimately help restore the law of one price and integrate the markets.[15] In fact, this phenomenon actually played out, once depository receipt programs on Indian equity shares were in place, motivating

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[10] This theory has been recently propounded. *See* Nicholas C. Howson & Vikramaditya Khanna, *Reverse cross-listings – The coming race to list in emerging markets and an enhanced understanding of classical bonding*, (Nov. 19, 2014), http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1219&context=law_econ_current.

[11] *See* Khanna & Varottil, *supra* note 7.

[12] *See* 1993 Scheme, *supra* note 4, at ¶ 3C.

[13] Legal drafting suffers from inertia. *See generally*, Umakanth Varottil, *The Evolution of Corporate Law in Post-Colonial India: From Transplant to Autochthony* (Working Paper, 2015), http://law.nus.edu.sg/wps/pdfs/001_2015_Umakanth_Varottil.pdf.

[14] *See* 1993 Scheme, *supra* note 4, at ¶ 3(2).

[15] *See* Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L L 563, 590 (1998).

the amendment to the 1993 Scheme in March 2001 to allow two-way fungibility in an effort to remove the impediments to the free play of the law of one price.[16]

On July 29, 2002, Indian companies were permitted to sponsor depository receipt issues against underlying shares at a price determined by a lead manager. However, this required prior or simultaneous listing on a domestic stock exchange and the facility to offer underlying shares against which the depository receipts were to be issued *pari passu* to all categories of shareholders. Unlisted Indian companies were thus prevented from raising capital abroad.[17] Consequently, Indian stock exchanges enjoyed a *de facto* monopoly on account of the 1993 Scheme, at the cost of promoting healthy competition. Some relaxations were made to the simultaneous listing requirement on September 14, 2005, and unlisted companies were permitted to issue depository receipts, if they took verifiable and effective steps to list domestically. On October 11, 2013, unlisted companies were allowed to raise capital abroad without prior or subsequent listing for a period of two years, subject to certain conditions.[18]

On August 31, 2005, the 1993 Scheme was amended to prevent companies, which were otherwise ineligible to access Indian capital markets, from accessing the depository receipt route. Moreover, pricing norms were introduced – the issue price could not be less than the higher of (*a*) the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the six months preceding the relevant date, and (*b*) the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date. On November 27, 2008, the pricing formula was aligned with the formula applicable to Qualified Institutional Placements (QIPs).

A. Need for review

Reliance Industries was the first Indian corporation to avail the 1993 Scheme by setting up a depository receipts program in 1992.[19] Since then, over 330 Indian companies have created depository receipt programs, of which 13 are listed either on the New York Stock Exchange (NYSE) or NASDAQ stock market, 24 are listed on the London Stock Exchange (LSE), and the vast majority have approached the Luxembourg Stock Exchange or the Singapore Exchange to raise capital.[20]

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[16] *See* 1993 Scheme, *supra* note 4, at ¶ 7(1A).

[17] This position is in stark contrast with Israel, where unlisted companies took full advantage of the opportunity to list on United States exchanges. Ultimately, with the intent of promoting dual listing on the Tel Aviv Stock Exchange (TASE), the Israeli Securities Authority (ISA) amended its securities law to exempt domestic firms already traded in the United States from the burden of reporting to the ISA in addition to the US reporting requirements. *See* Shmuel Hauser, Rita Yankilevitz, and Rami Yosef, *The effects of dual listing on share prices and liquidity in the absence of registration costs*, 4 JOURNAL OF SERVICE SCIENCE AND MANAGEMENT 15, 21 (2011).

[18] *See* Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Mechanism) (Amendment) Scheme, Ministry of Finance, Notification No. GSR 684(EF.No.4/13/2012-ECB (Oct. 11, 2013).

[19] It is interesting to note that the 1993 Scheme came into effect retrospectively from April 1, 1992. *See* 1993 Scheme, *supra* note 4, at ¶ 1(2).

[20] This was the position in 2013. *See* BNY Mellon, *India: Easing Conditions for investors, Non Capital-Raising Depository Receipts for Indian Corporates are a Strategic Opportunity*, http://www.adrbnymellon.com/files/PB37020.pdf (Last visited May 23, 2015).

Nevertheless, the volume of FDI through the depository receipt route did not increase substantially during this time, compared to the increase in the volume of FDI in Indian equity during 2000-2014.[21] This disparity may have resulted due to additional eligibility criteria for issuers of depository receipts over and above capital controls on foreign investment in domestic securities.[22]

Beside the economic implications, two decades of legal development in financial and corporate laws also required a relook at the 1993 Scheme.[23] For example, the Companies Act, 2013 for the first time gave statutory recognition to depository receipts by defining 'global depository receipt' (GDR),[24] albeit in language different from that of the 1993 Scheme. Moreover, the same depository receipt was treated differently under two different regulatory regimes. While depository receipt holders having the right to give voting instructions have obligations under the *Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011* ("Takeover Regulations, 2011"), such depository receipts themselves were not calculated as part of the public shareholding under the 1993 Scheme.[25]

The policy thinking in Indian finance has also undergone a sea change in the last two decades. State intervention in financial markets is now focussed solely on addressing market failures.[26] The next section will elaborate the influence of this approach on the recent reform in off-shore depository receipts.

II. THE REFORMS PROCESS

The Indian Government set up a committee in September 2013, under the chairmanship of Mr. M.S. Sahoo, to comprehensively review the 1993 Scheme, keeping in view the 'needs of the Indian companies and foreign investors' as well as the 'need for simplification and legal clarity.'[27] The Committee consulted stakeholders including some Indian issuers, depository banks, exchanges and trading platforms, and the financial market regulators, to delineate the relevant policy issues which were subsequently debated and deliberated upon by Committee members internally. Based on these deliberations, the Committee prepared a report with its policy recommendations ("Sahoo Committee Report (Phase I)") along with a draft legal scheme,

[21] *See* Sahoo Committee Report, *supra* note 3, at 17.

[22] *See* 1993 Scheme, *supra* note 4, at cl. 3.

[23] *See* Sahoo Committee Report, *supra* note 3, at 14-16.

[24] *See* S. 2(44), Companies Act, 2013.

[25] *See* Reg, 2(1)(v), SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, (2011); *see also* Sahoo Committee Report, *supra* note 3, at 42.

[26] *See generally*, REPORT OF THE FINANCIAL SECTOR LEGISLATIVE REFORMS COMMISSION (Government of India, 2013) http://finmin.nic.in/fslrc/fslrc_index.asp.

[27] *See* CONSTITUTION OF A COMMITTEE TO REVIEW THE FCCBS AND ORDINARY SHARES (THROUGH DEPOSITORY RECEIPT MECHANISM) SCHEME 1993 (Ministry of Finance F.No.9/1/2013- ECB, Sept. 23, 2013).

and submitted it to the Government of India. The Government accepted the recommendations, and based on the draft scheme provided by the Committee, notified the 2014 Scheme.[28]

The 2014 Scheme is a reflection of the broad economic and regulatory philosophy behind the Sahoo Committee Report (Phase I). This philosophy is well-reflected in the following passage:

> "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. (sic)"[29]

The Financial Sector Legislative Reforms Commission (FSLRC) had identified four potential areas of market failure in the field of finance: *(a)* consumer protection; *(b)* micro-prudential regulation; *(c)* systemic risk; and, *(d)* resolution.[30] After discussing these four areas in the context of depository receipts, the Sahoo Committee Report (Phase I) concluded:

> "DRs [(depository receipts)] 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."[31]

In other words, state intervention (regulation) should only ensure that depository receipts issued abroad on the back of underlying Indian securities do not in any way compromise the interests of Indian investors investing in those underlying domestic Indian securities in India.[32] This clear economic and regulatory rationale forms the backbone of the 2014 Scheme.

III. THE 2014 SCHEME

The Sahoo Committee Report (Phase I) observed that "*the law should be neutral to a foreign investor's choice of the mode of purchasing Indian securities and to the Indian issuer's choice of*

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[28] *See* Sahoo Committee Report, *supra* note 3.

[29] *See* Sahoo Committee Report, *supra* note 3, at 29.

[30] The FSLRC was set up by the Indian Government to comprehensively review the entire Indian financial legislative framework. The FSLRC report made major policy recommendations for the Indian financial sector and also provided a draft Indian Financial Code (IFC) to replace the archaic legislative framework. In his 2015 Budget speech, the Indian Finance Minister has categorically stated the intention of the Government to table the IFC in Parliament soon. For the report, *see generally*, *supra* note 26; for the 2015 Budget Speech, *see Full text of Budget 2015-16 speech*, THE HINDU 2015, http://www.thehindu.com/news/resources/full-text-of-budget-201516-speech/article6945026.ece.

[31] *See* Sahoo Committee Report, *supra* note 3, at 30.

[32] In the past, Global Depository Receipts (GDRs) have been misused for committing market abuse in India. However, precedents show that this kind of market abuse requires presence of a colluding party in India and cannot be done solely by investors in GDRs abroad. *See Securities Appellate Tribunal, PanAsia Advisors and Anr. v. Mr. Arun Panchariya* Civil Appeal No. 10560/2013, order dated 06/07/2015 (SC).

mode of raising capital as long as the basic capital controls are complied with. (sic)"[33] It recommended that if, under the capital controls regime, a foreign investor can invest in "*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*," depository receipts should be allowed to be issued against them.[34] Accordingly, the 2014 Scheme defines a 'depository receipt' only with reference to 'permissible securities'.[35] The definition avoids any reference to the issuer of such 'permissible securities'. This allows depository receipts to be issued on the back of any domestic Indian security in which a foreign investor can invest. Unlike the 1993 Scheme, the 2014 Scheme does not restrict the potential underlying securities to domestic equity shares alone.[36] For example, Indian debt instruments can now be used as underlying to the extent that foreign investors can invest in them under the FDI route. Moreover, this approach allows the possibility of unsponsored depository receipts being issued on the back of Indian shares without the involvement of the company whose shares are being used for the program. Any person holding 'permissible securities' can transfer the same to a depository bank for issuance of depository receipts.[37] This would enhance the liquidity of the underlying domestic Indian securities by further integrating the Indian and foreign capital markets.[38]

The Sahoo Committee Report (Phase I) was of the view that "*businesses should be free to structure financial products as per their business needs*." Business prudence may demand depository receipts "*with the right to instruct voting or with a right to the underlying cash flows without voting rights*." Accordingly, it recommended that "*the law should not prescribe anything about voting rights or exercise of such rights*" in respect of depository receipts as long as the Takeover Regulations, 2011 are complied with.[39] However, minimum public float is a unique requirement under Indian securities law, aimed at maintaining reasonable liquidity of listed shares in the domestic market. This ensures that the shares are widely held, resulting in better price discovery and reduced possibility of manipulation. Listed shares used for the issue of depository receipts were originally excluded from the calculation of this public float.[40] The rationale was that such underlying listed shares, being deposited with the domestic custodian, go out of circulation, thereby reducing the liquidity in the domestic market. However, the Sahoo Committee Report (Phase I) showed that this assumption was incorrect. It used an event study to show that an issue of depository receipts did not have any impact on domestic trading

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[33] *See* Sahoo Committee Report, *supra* note 3, at 35.

[34] *See* Sahoo Committee Report, *supra* note 3, at 35.

[35] *See* 2014 Scheme, *supra* note 5, at cl. 2(1)(a).

[36] *See* 2014 Scheme, *supra* note 5, at cl. 2(1)(h).

[37] *See* 2014 Scheme, *supra* note 5, at cl. 3(1)(c).

[38] Recent research across India, Australia, and Israel shows that listing of American Depository Receipts (ADRs) has helped improve liquidity of the underlying securities in the domestic capital market. *See* Sahoo Committee Report, *supra* note 3, at 42-43; also *see generally*, Alex Frino, Elisa Di Marco and Andrew Lepone, *The impact of ADR listing on liquidity*, MARKET INSIGHTS: AUSTRALIAN SECURITIES EXCHANGE 28 (2009), https://otcquote.com/content/doc/asx-adr-whitepaper.pdf; Hauser, Yankilevitz, & Yosef, *supra* note 17.

[39] *See* Sahoo Committee Report, *supra* note 3, at 43-44.

[40] *See* rr. 19(2) and 19A, Securities Contracts (Regulation) Rules, 1957 (as they stood before February 25, 2015).

volume of the Indian securities in the short run.[41] Moreover, the Sahoo Committee Report (Phase I) observed that there was a mismatch in the treatment of the same depository receipt under two different regulations. While depository receipt holders having right to give voting instructions have obligations under the Takeover Regulations, 2011, such depository receipts themselves were not calculated as part of the public shareholding.[42] Based on these observations, the Securities Contracts (Regulation) Rules, 1957 was amended on February 25, 2015, to include listed shares underlying depository receipts within the ambit of 'public shareholding.'[43]

However, this measure alone was not sufficient; three issues persisted. *First*, the board of an Indian listed company could issue depository receipts without any voting instruction rights, instead retaining the voting rights for themselves.[44] This could go against the spirit of the minimum public float norm, and yet the company could continue to enjoy the status of a public listed company.[45] To avoid such abuse, the law was amended on February 25, 2015, such that, holders of depository receipts are required to have the right to issue voting instructions, for such depository receipts to form part of public shareholding.[46]

Second, minimum public float raised another unique challenge for unsponsored depository receipts on listed shares of Indian companies. Since the company would not be involved in the issue of depository receipts, it would be unfair to let its shares be used for depository receipts leading to a breach of the minimum public shareholding. Therefore, it was essential to mandate that holders of unsponsored depository receipts on listed securities be given the right to issue voting instructions so as to ensure that all such unsponsored depository receipts form part of the public shareholding.[47]

Third, the Committee was divided in its opinion on whether depository receipts on listed shares should be permitted to be traded in Over-The-Counter (OTC) markets abroad that may include dark pools *inter alia*. Although the majority of the members took the view that depository receipts 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, they agreed that the listing of depository receipts on international exchanges would carry certain privileges.[48] Accordingly, it was recommended that depository receipts issued on the back of listed Indian equity shares form part of the minimum public shareholding only if the depository receipts entitle the holders to give voting instruction to the foreign depository, and if such depository

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[41] *See* Sahoo Committee Report, *supra* note 3, at 42-43. This position is also supported by recent research in this field. *See* Frino, Di Marco, & Lepone, *supra* note 37; Hauser, Yankilevitz, & Yosef, *supra* note 17.

[42] *See* Reg. 2(1)(v), Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, (2011) (see n. 24).

[43] Currently, this benefit is available only if the holder of such depository receipts has the right to issue voting instruction and such depository receipts are listed on an international exchange. *See* Securities Contracts (Regulation) (Amendment) Rules, (2015).

[44] *See* Securities and Exchange Board of India, *Agenda and decision of the SEBI Board on Voting Rights of GDR / ADR holders*, ¶¶ 12-16 (May 19, 2010).

[45] *See* Sahoo Committee Report, *supra* note 3, at 42-43.

[46] *See* R. 2, Securities Contracts (Regulation) Rules, 1957 (*see* n. 42).

[47] *See* 2014 Scheme, *supra* note 5, at cl. 3(2)(a).

[48] *See* Sahoo Committee Report, *supra* note 3, at 40.

receipts are listed on an international exchange. Further, it was clarified that 'international exchange' for this purpose would mean any platform in a foreign jurisdiction for the trading of depository receipts which is accessible to the public and which provides pre-trade and post-trade transparency.[49] This position is reflected in the 2014 Scheme as well as the amended Securities Contracts (Regulation) Rules, 1957.[50]

A. Implementation challenges

The implementation of any new policy measure is fraught with challenges,[51] and the 2014 Scheme is no exception. It was notified in the official gazette on October 21, 2014 but came into force on December 15, 2014. This time-lag was intended to give the various other agencies like the Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) adequate time to make the necessary legal changes before the 2014 Scheme came into effect.[52] Nevertheless, implementation challenges persist. This part will focus on the implementation challenges specifically with respect to capital controls and taxation.

1. Capital controls

Pursuant to the 2014 Scheme, the RBI amended the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("FEMA 20") with effect from December 15, 2014. The terms 'domestic custodian' and 'depository receipt' have now been specifically defined.[53] Major changes have also been made to Schedule I of FEMA 20. It now clarifies that the foreign investment limit in companies engaged in activities in which FDI is permitted include depository receipts issued on the back of equity shares, compulsorily and mandatorily convertible preference shares, compulsory and mandatorily convertible debentures, warrants, or any other security in which FDI can be made in terms of Schedule I.[54] A new schedule, Schedule X, has also been added to FEMA 20.

However, some aspects of the amendments to FEMA 20 have caused much confusion in the market. For example, Schedule I previously permitted a registered broker in India to purchase shares of an Indian company on behalf of a person resident outside India for the purpose of converting the shares into depository receipts.[55] This provision has been deleted from Schedule I, and instead Schedule X allows only a domestic custodian to purchase eligible securities for the same purpose.[56] This is clearly an inadvertent error since custodians are not in the business

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[49] *See* Sahoo Committee Report, *supra* note 3, at 43.

[50] *See* 2014 Scheme, *supra* note 5, at cl. 2(1)(f); R. 2, Securities Contracts (Regulation) Rules, 1957.

[51] Most statutes provide powers to the Government to remove difficulties during implementation. *See* Pratik Datta, *Amendments by Stealth: MCA resurrects Henry VIII's legacy*, ECONOMIC AND POLITICAL WEEKLY (Dec. 27, 2014), http://www.epw.in/commentary/amendments-stealth.html.

[52] *See* 2014 Scheme, *supra* note 5, at cl. 1(2).

[53] *See* Reg. 2, Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) (Seventeenth Amendment) Regulations, (Notification No. FEMA 330/2014-RB, Dec. 15, 2014) [hereinafter "FEMA 20 Amendment"].

[54] *See* FEMA 20 Amendment, *id*, reg. 3(c).

[55] *See* FEMA 20, *supra* note 6, cl. 4A of Schedule 1 (as it stood before Dec. 15, 2014).

[56] *See* FEMA 20 Amendment, *supra* note 53, cl. I(c) of Schedule 10.

of purchasing securities. Further, Schedule X states that the domestic custodian must report to the RBI regarding the issue of any depository receipts in such manner as may be prescribed.[57]

Accordingly, on January 22, 2015, the RBI prescribed Form DRR which must be filed by the domestic custodian who has arranged the issue or transfer of depository receipts.[58] Curiously, although the Form DRR clearly envisages the possibility of 'unsponsored' depository receipts, it still requires certification from the 'company' that all conditions laid down by the Government of India and the RBI have been complied with. Some custodian banks have been interpreting this to mean that even in 'unsponsored' programs, the consent of the issuer company is required, effectively going against the very notion of 'unsponsored' depository receipts.[59] Moreover, for depository receipt issues resulting in an increase of equity capital of a company or a sponsored issue, Form DRR requires details of the equity capital.[60] It is submitted that not all sponsored issues involve a fresh capital raising exercise. Therefore, for sponsored non-capital raising depository receipts, these details required by Form DRR are superfluous. Moreover, this may actually amount to duplication of work over and above the filing of Form FC-GPR.[61]

2. Taxation

Another major challenge in the implementation of the 2014 Scheme is taxation. The Sahoo Committee Report (Phase I) made some far reaching recommendations in respect of the taxation of depository receipts.[62] It noted that depository receipts are foreign securities that are traded beyond the territorial jurisdiction of India. Therefore, there is no reason to tax capital gains from such transactions. Moreover, on cancellation of depository receipts, the foreign investor who was holding the depository receipt becomes the owner of the underlying domestic Indian security. The records show a change in ownership of the underlying domestic Indian security from the depository bank to the foreign investor. However, there is no actual transaction in the underlying security. A similar situation arises in the case of re-conversion of domestic Indian securities into depository receipts. Therefore, the Sahoo Committee Report (Phase I) recommended that such transactions ought not to be treated as a taxable event.[63] Further, a shareholder selling listed shares on a recognised exchange is exempt from long-term capital gains tax and need only pay Securities Transaction Tax (STT). However, if the same shareholder intends to make an off-market tendering of the shares for the purpose of issuing depository receipts, the benefit of long-term capital gains tax exemption is not available.[64] This

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[57] *See* FEMA 20 Amendment, *supra* note 53, cl. III of Schedule X.

[58] *See* Reserve Bank of India, Depository Receipts Scheme (A.P. DIR Series Circular No. 61, Jan. 22, 2015), http://rbidocs.rbi.org.in/rdocs/notification/PDFs/AP61DIR220115DRR.pdf [hereinafter "Circular 61"].

[59] *See* Circular 61, *supra* note 58, cl. 6 of Form DRR.

[60] *See* Circular 61, *supra* note 58, cl. 12 of Form DRR.

[61] *See* Annex–I, Reserve Bank of India, Foreign Direct Investment – Reporting under FDI Scheme: Amendments in form FC-GPR (A.P. DIR Series Circular No. 102, Feb. 11, 2014), http://rbidocs.rbi.org.in/rdocs/notification/PDFs/102APD110214.pdf.

[62] *See* Sahoo Committee Report, *supra* note 3, at 46.

[63] Essentially, this should not be regarded as a 'transfer' for the purposes of computing capital gains. *See* S. 47, Income Tax Act, 1961.

[64] *See* S. 10(38), Income Tax Act, 1961.

differential tax treatment results in a limited appetite for transferring shares to a foreign depository towards the issue of depository receipts.[65]

The Finance Bill, 2015 not only fails to implement these recommendations but lags behind contemporary financial reform. Clause 28 proposes some cosmetic amendments to Section 115ACA of the Income Tax Act, 1961. It replaces the words 'non-resident investors' with 'investors' recognising that resident Indians may also invest in depository receipts under the Liberalised Remittance Scheme.[66] However, it fails to recognise the concept of 'unsponsored' depository receipts, sponsored non-capital raising depository receipts, as well as the economic advantages of allowing unlisted Indian companies to access international capital markets. Consequently, it only envisages the possibility of issuing depository receipts against 'ordinary shares of issuing company, being a company listed on a recognised stock exchange in India.'[67] Further, when a foreign investor cancels a depository receipt and transfers the underlying domestic Indian securities, he has to pay capital gains tax in India. To compute the same, the cost of acquisition of the underlying domestic Indian securities must be ascertained. The Finance Bill, 2015 fails to provide any guidance on this aspect as well.

CONCLUSION

Expert committee reports have played an important role in the evolution of financial economic policy in India.[68] However, most of these policy recommendations need to be implemented through precise legal instruments. If the drafter of these legal instruments is not involved in the committee process, there is a risk of divergence between the intended policy and the subsequent draft law. To overcome this risk, recent expert committees set up by the Ministry of Finance have started involving lawyers who can draft the necessary legal instruments. This helps the committee submit a comprehensive policy report along with a draft legal instrument that the government or regulator can implement.[69] The Sahoo Committee Report (Phase I) is one such example. Its recommendations on off-shore depository receipts were shaped by economics, finance, and law. The final recommendations were collated and translated into a precise legal instrument to reduce the risk of ambiguity to the maximum extent possible.

However, implementation remains a bottleneck. Policies once accepted by the government may need to be implemented by different departments and regulators. Co-ordination among them is difficult. Moreover, policy recommendations that are not aligned with the incentives of

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[65] *See* Sahoo Committee Report, *supra* note 3, at 46.

[66] *See* Reserve Bank of India, *Liberalised Remittance Scheme*, 2014, http://www.rbi.org.in/scripts/FAQView.aspx?Id=66

[67] *See* Cl. 28, Finance Bill, 2015.

[68] *See* Ajay Shah, *Expert Committee Reports in Indian Finance* (Feb. 5, 2015), http://ajayshahblog.blogspot.in/2015/02/expert-committee-reports-in-indian.html

[69] In Indian finance, the FSLRC was probably the first expert committee to comprehensively review the entire financial legal framework and submit a policy report along with a draft law based on the proposed policy recommendations. *See generally* Financial Sector Legislative Reforms Commission, Indian Financial Code (Mar. 2013), http://finmin.nic.in/fslrc/fslrc_report_vol2.pdf%E2%80%8E.

an agency may not find favour with it, and consequently, implementation suffers. For example, if meeting the revenue target is the sole criterion for measuring the performance of the tax department, it is difficult to see how that department will be inclined to implement a policy that apparently reduces tax collection.[70] Similarly, a securities regulator will not be keen to let domestic companies directly list abroad. This would clearly show its failure in developing the domestic market for capital raising, and increase competition for the intermediaries in the domestic market from which the regulator earns its fees. Therefore, the interests of the securities regulator are also misaligned with these reforms.[71]

The ongoing off-shore depository receipt reforms stand testimony to these various factors influencing the formulation and implementation of financial policies in India. On one hand, it shows how the involvement of stakeholders and lawyers at the policy formulation stage can help in drafting an actionable policy report along with the necessary legal instruments. On the other hand, it illustrates how a diffused governmental set-up, with multiple departments and regulators with misaligned incentives, can delay the implementation of even the most precisely drafted policy recommendations. Although the institutions may not be broken, evidently, the institutional structures have become obsolete and incapable of smoothly implementing necessary policy changes. It is time to rethink the entire institutional architecture to streamline the financial policy implementation process,[72] acknowledge the present institutional weaknesses and muster the political will necessary to initiate institutional reform.

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[70] *See* Tax Administration Reform Commission, First Report of the Tax Administration Reform Commission, tech. rep., 12-13 (Ministry of Finance, May 30, 2014).

[71] From early 2015, SEBI has taken various initiatives to facilitate listing of Indian start-ups on domestic Institutional Trading Platforms (ITPs). The idea is to ease capital raising by Indian start-ups in the knowledge-based sectors like information technology, pharmaceuticals *inter alia*. Moreover, after being listed on the ITP, the companies can move on to the main board as and when they mature. These initiatives by SEBI are in the right direction and, if implemented, would be a worthwhile reform in the Indian capital markets. However, these reforms seem to be a direct consequence of the Depository Receipts Scheme, 2014 – a last ditch effort by the securities regulator to lure Indian start-ups in the knowledge based sectors to list in India rather than venture abroad in search of greener pastures.

[72] The FSLRC report recommended overhauling the present financial regulatory architecture and replacing it with a modern one. For the report, *see generally*, Financial Sector Legislative Reforms Commission, Justice B.N. Srikrishna Report (see n. 25).