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CAPITAL MARKETS

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» Amendments to the Guidelines Governing Euro Issues

Indian companies have been permitted to issue equity and equity related instruments to international investors by virtue of the Government of India's 'Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993' (the "Scheme"). Such instruments are usually in the form of American Depository Receipts ("ADRs"), Global Depository Receipts ("GDRs") or Foreign Currency Convertible Bonds ("FCCBs").

With the view of aligning the Scheme with the guidelines on domestic capital issues, as issued by the Securities and Exchange Board of India ("SEBI"), Indian securities market regulator, the Government has announced the latest round of amendments to the Scheme. This article seeks to briefly list and examine these amendments.

Eligibility:

Henceforth, any listed Indian entity that is ineligible to raise funds from the Indian Capital Market, including those being restrained by SEBI from accessing the securities market will not be able to issue such instruments.

In the case of unlisted Indian companies, those that have already issued Depository Receipts or FCCBs will have to compulsorily list in the domestic market on the earlier of making profit beginning financial year 2005-06 or within three years of such issue. Unlisted companies that have not yet raised funds from the international market through such instruments will now have to go for a prior or simultaneous listing in the domestic market.

It is felt that this amendment could hurt start-up ventures. Owing to a lack of profitability record to go

in for a domestic issue, companies in the knowledge sector largely depend on foreign funds for their initial capital, which is raised frequently through FCCB issues.

Further, the amendments provide that entities prohibited to buy, sell or deal in securities by SEBI and the erstwhile Overseas Corporate Bodies ("OCBs"), being ineligible to invest in India through the portfolio route will no longer be able to subscribe to FCCBs or Depository Receipts.

Voting:

It has now been provided that voting rights will be as per the Indian Companies Act, 1956, especially so in case of GDR issues. It is felt that this may impact restrictions on voting rights, provided in some DR issuances, where such restrictions are not strictly in terms with the Companies Act.

It has been provided that the regulations stipulated by the Reserve Bank of India ("RBI") relating to voting rights of banking companies will remain applicable to all shareholders exercising voting rights.

This might have a bearing on certain telecommunication companies. Certain telecom companies accessed the international market after the Indian Government recently raised the cap for Foreign Direct Investment ("FDI") in the telecom sector, however streamlining of voting rights in line with the provisions of the Companies Act may in certain circumstances conflict with telecom license provisions.

Pricing:

It has now been stipulated that the minimum price for a FCCB / ADR / GDR will have to be the higher of the following two averages: (i) the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during six months preceding the relevant date, or (ii) the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during two weeks preceding the relevant date {the relevant date being thirty days before the shareholders meeting in terms of Section 81(IA) of the Indian Companies Act, 1956 held to consider the issue}. It should be pointed out however that in case an unlisted Indian company seeks to go for a Euro Issue there may be certain issues as to the pricing of the issue. The company would probably at best have a two-week average on which it can price the said issue.

This will in effect probably prevent Indian companies from tapping the international markets at discounted prices. Further, the now almost common place 'reset' clause in FCCB issues, that seeks to protects FCCB investors against share price falls by entitling them to convert the bonds at a lower price (a sweetener used largely by smaller companies that commanded a lower premium), may also now be difficult to structure into the issue.

However, an argument may be made that since there could be a possible equity dilution in case of FCCBs the pricing should not be to the detriment of the existing shareholder. And hence there would be justification to linking such issue prices to the prevailing market price.

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» Amendments In Indian Securities Laws:

We all know that the Indian stock markets are witnessing unprecedented and sustained bull run from past few months. The increased activity has attracted attention of the regulators and Securities and Exchange Board of India ("SEBI") has recently made couple of press releases recommending certain changes to the existing securities laws and listing agreement. The proposed changes could have substantial influence on the securities market and are briefly discussed below:

Minimum public shareholding

Presently there are no uniform norms for listed companies regarding minimum public shareholding to be maintained on a continuous basis. Existing companies are required to maintain their public shareholding at a level that was required at the time of initial listing. This requirement could therefore be different for different listed companies depending on the point of time when they were listed and the then existing minimum public shareholding requirements. SEBI is aiming to achieve a single level of minimum public shareholding for all listed companies. Although, SEBI has not suggested any time frame, it has proposed following changes:

- All listed companies will now be required to maintain at least **25%** shareholding with public for the purpose of continuous listing.

  However, this will not be applicable to companies which are permitted to make an Initial Public offer (IPO) of atleast 10% to public in terms of Rule 19(2)(b) of Securities Contracts (Regulation) Rules, 1957 (which provide for certain conditions such as size of the offer, securities offered to public, allocation to qualified institutional buyers, etc). Such companies will be permitted to maintain at least **10%** public shareholding for the purpose of continuous listing.

  Further, Government companies, infrastructure companies and companies registered with Board for Industrial Financial Restructuring (BIFR) will also exempted from the aforesaid minimum public shareholding requirement.

- Listed companies, which are not presently complying with the minimum public holding requirement as mentioned above, will be given a period of **two years**, for compliance, from the date of issuance of a circular in this regard.

- Listed companies which may in future fall short of the requisite minimum level as mentioned above on account of reasons like Corporate Debt Restructuring (CDR) packages etc. will be given a period of one year, for compliance, from the date of non - compliances.

Separate window for 'block deals'

Block deals were been intensely monitored by SEBI. On July 14 SEBI had issued a vague warning that implied – 'Be warned. We are not saying block deals are bad, but we may say so anytime in future.' Further, stock exchanges had also warned "trading members to ensure compliance in large transactions

that are in the form of block deals," and threatened "strict action" against those negotiating deals in advance and executing synchronized trades.

SEBI now believes that it is a '*need of the market to execute large trades through a single transaction easily without putting either the buyer or the seller in a disadvantageous position*.' In order to facilitate execution of such large trades, the SEBI proposes to direct stock exchange to permit a separate trading window. The 'block deals' will include a trade, with a minimum quantity of 500,000 shares or minimum value of Rs. 5 crores executed through a single transaction on this separate trading window. Important related changes will include:

- Keeping the said window open for trading for a **limited time period** of 35 minutes from the beginning of trading hours i.e. from 9.55 a.m. to 10.30 a.m.

- A single block deal order in this window has to be for a **minimum quantity** of 5 lakh shares or minimum value of Rs. 5 crore.

- Orders may be placed in this window **at a price** not exceeding +/- 1% from the ruling market price/previous day closing price.

- Every trade in this window **must result in delivery** and shall not be squared off or reversed.

- **Disclosure** of all trades in this window and its dissemination to general public will be made by stock exchange after close of market hours.

- The existing regulations for 'bulk deals' will continue to apply and there are not changes in the same.

Participation of QIB's in book built

It has been decided in respect of participation of Qualified Institutional Buyers ("QIB's") in book built issues that following measures should, henceforth, be implemented:

- QIBs shall bring at least 10% margin while submitting the bids.

- The allotment of shares to QIBs shall be on proportionate basis.

- Out of the existing 50% portion available for QIBs, 5% thereof shall be specifically available for Mutual Funds registered with SEBI. However, these Mutual Funds participating in QIB category will also be eligible for allotment in the remaining portion, i.e 45%, available to QIBs.

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» Foreign Direct Investment in Retail Trade

This article briefly analyses the current FDI policy in India in the retail sector. It also discusses how foreign players are entering the Indian market.

Prior to 1997, there was no specific regulation restricting Foreign Direct Investment (FDI) in the retailing sector. In 1997, it was decided that FDI would not be allowed for mere trading as it would lead to the outflow of foreign exchange, drive out the domestic unorganized retailers from business and increase unemployment.

The Government is now considering easing FDI norms in retail trading and the first step towards opening up the retail sector to foreign direct investment (FDI) has already been initiated. The Prime Minister has directed the Planning Commission and the Finance Ministry to prepare a strategy paper on FDI in retail.

However, the Government is facing stiff opposition from the Left parties (CPM) on opening the retail sector for investment. The Left is of the view that the negative effects in terms of job loss and the displacement of traditional supply chains by the monopoly power of multinational retailers far outweigh the supposed benefits of development of the organized retail sector. The Left parties have however softened their earlier stand of an outright rejection of FDI in retail and are now willing to consider the same if the Government comes up with a specific proposal.

Several policy options are being considered by the Government to address the concerns of the Left, including stipulating locational and size guidelines. Further, multinational retail chains may not be allowed to open stores occupying less retail space than a specified area. Also, their presence may initially be confined to commercial hubs or outskirts of big cities so that they do not pose a threat to neighborhood shops.

Current Regulatory Framework

Under the current regulatory framework, FDI in retail trading is prohibited. Trading is permitted under the automatic route (without prior approval) with FDI up to 51 % provided it is primarily towards export activities, and the undertaking is an export house/trading house/super trading house/star trading

house.

Manufacturing companies are allowed 100% FDI to carry out wholesale trading on "a cash and carry basis". The approvals granted are subject to the condition that the companies cannot undertake domestic retail trading in any form and imports would have to be in accordance with the export import policy in force now.

The Government also permits 100% FDI in trading companies, with the prior approval of the Foreign Investment Promotion Board (FIPB), for exports, bulk imports with export/ ex-bonded warehouse sales, cash and carry wholesale trading and other import of goods or services provided at least 75% is for procurement and sale of the same group and not for third party use or onward transfer/ distribution/sales.

Certain kinds of trading are also permitted, subject to provisions of EXIM Policy, such as domestic trading of products of JVs is permitted at the wholesale level for such trading companies who wish to market manufactured products on behalf of their Joint ventures in which they have equity participation in India, trading of hi-tech items/ items requiring specialized after sales service, trading of items for social sector, test marketing of such items for which a company has approval for manufacture.

Although FDI in retail is prohibited, several foreign players are operating in the Indian market. Some of the entry routes through which such foreign players have entered India have been discussed below:

Wholesale Trade on Cash and Carry Basis

Cash and Carry wholesale trading means sale on cash basis to an entity having valid sales tax registration. Such entity cannot be the end user under any circumstances. This is the route though which large international retailers such as Metro Cash & Carry GmbH and Shoprite Checkers of South Africa are operating in the Indian market. The Indian retailer organisations have raised significant protests against the entry of Metro and Shoprite. It has been alleged that Metro is trying to gain a backdoor entry into the Indian market and that it has been selling directly to retail customers

Franchising

Franchising is the most preferred mode through which foreign players have entered the Indian market. For setting up a franchise in India, the foreign players are required to take prior approval of the Reserve Bank of India (RBI).

Test Marketing

The FIPB permits foreign companies to test market products for a two-year period by the end of which they are required to set up manufacturing facilities in India. This route permits the foreign players to test the demand for their products in Indian markets before undertaking investment.

Distribution

Under this route, foreign players set up distribution offices in India and these offices supply the

products to local Indian retailers.

Manufacturing and Local Sourcing

Companies that set up manufacturing facilities are allowed to sell the products in the domestic market. Due to high labour cost in their own countries, many international brands are setting up manufacturing bases in India and/or sourcing products from local manufacturers.

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» Foreign Direct Investment in Print Media

After prolonged debate and lobbying, the print media sector has recently seen the Government taking some steps towards facilitating foreign direct investment ("FDI") in print media. The following are some of the key developments:

Non-news publications

In June 2005 the Government removed the 74% cap on foreign investment in Indian entities publishing scientific/technical/specialty magazines/periodicals and journals and permitted:

- Publication of Indian editions of foreign scientific, technical and specialty magazines/periodicals/journals; and

- Foreign investment up to 100% in Indian entities publishing scientific/technical and speciality magazines/periodicals/journals.

The above is however not under the automatic route but subject to clearance and approval of the Ministry of Information and Broadcasting ("MIB"). FDI and portfolio investments by Foreign Institutional Investors ("FIIs") would require seeking approvals from the Foreign Investment Promotion Board ("FIPB") and/or the Reserve Bank of India ("RBI").

News & Current Affairs publications

The new guidelines issued by the MIB in July 2005 set out new norms for foreign investment in news and current affairs publications up to 26%, permitting publication of facsimile edition and relaxing the syndication norms.

26% FDI in Indian entities publishing newspapers and periodicals dealing with news and current affairs include investments by foreign entities, Non-Resident Indians, Persons of Indian Origin and portfolio investments by recognized FIIs. At least 50% of the investment would have to be inducted by issue of fresh equity the balance, could be inducted through transfer of existing equity.

The MIB is also concerned about the element of control exercised by the Indian promoters of the

publication and has therefore mandated that the largest Indian shareholder should hold at least 51% of the paid up equity of the company and at least 3/4th of the board of directors and all key executives and editorial staff of the company should be resident Indians.

Other conditions include making a full disclosure, at the time of application, of Shareholders' Agreements and Loan Agreements that are finalized or proposed to be entered into, including any subsequent changes, reporting obligations regarding alteration in the foreign shareholding pattern as on 31st March of every year and within 15 days of the end of the financial year and prior MIB permission before effecting any changes in the shareholding of the largest Indian shareholder. Changes in the composition of the Board of Directors or key executives and editorial staff has to be informed to the MIB within 15 days and is subject to its post-facto approval.

Facsimile Editions of foreign newspapers and periodicals

Any Indian entity, with or without foreign investment, desirous of publishing a facsimile editions edition of a foreign newspaper, newspapers and periodicals, or any foreign company owning the original foreign newspaper/ periodical will be permitted to publish the facsimile edition of its newspaper / periodical in whole or in part(s), provided that:

- It is incorporated and registered as a company with the Registrar of Companies under the Companies Act, 1956.

- It has a commercial presence in India with its principal place of business in India.

- At least 3/4th of the Board of Directors and all key executives and editorial staff are resident Indians. The MIB shall be intimated within 15 days, of a change in composition of the Board of Directors or key executives and editorial staff and . The change would be subject to post-facto MIB approval.

Other applicable conditions include:

- The original foreign newspaper, whose facsimile edition is to be brought out in India, is being published with the approval of the regulatory authority of the country of origin and is a standard publication in that country and not specially designed for Indian readers.

- The facsimile edition cannot carry any advertisements aimed at Indian readers in any form.

- The facsimile edition cannot carry any locally generated content/India specific content, not

being simultaneously published in the original edition.

- Prior permission from MIB will be needed and the title must be registered with the Registrar of Newspapers for India ("RNI").

- The publication shall also clearly indicate that it is a facsimile edition, in whole or in part(s), and shall prominently carry the masthead, the editorial page and the place of publication of the original foreign newspaper.

Conclusion

The present Government remains wary about "control" issues regarding news and current affairs publications or television channels as is evidenced by the July 2005 norms and by the Uplink Guidelines for news and current affairs channels. Both the guidelines run along similar lines requiring a 51% single largest shareholding criterion, issues regarding key executives and composition of the Board, review of shareholder agreements and articles of the company (possibly from the perspective of contractual veto or affirmative rights of the foreign party board composition) etc.

Given the ability of an entity to exercise control over a company through contractual rights and protections, there has also been an on-going debate regarding the need to dilute the 51% shareholding requirement for largest Indian shareholder in order to enable the promoters to have greater flexibility to trade on their shares (listed companies) and/or facilitate corporate restructuring. The Government's response is awaited.

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» Legal Snapshots

Foreign companies not covered by the takeover code:

In a landmark judgment, Technip v SMS Holding, the Supreme Court has ruled that the acquisition of a foreign company, which holds a stake in an Indian company, by another foreign company may not trigger SEBI's [Substantial Acquisition of Shares and Takeover Regulations], 1997 ("Takeover Code"). This decision is expected to have a major impact on foreign-owned listed companies in India. The main issue before the court was to decide whether French law could be applied to determine a change in control of the Indian company after a certain French corporate was acquired by another French corporate.

RBI modifies norms for External Commercial Borrowings (ECBs)

The Reserve Bank of India ("RBI") has modified the norms for External Commercial Borrowings

(“ECBs”) vide A.P. (DIR Series) Circular No. 5 dated August 1, 2005. As per the new norms,

- NBFCs will be permitted to raise ECB from multilateral financial institutions, reputable regional financial institutions, official export agencies and international banks under the approval route to finance import of infrastructure equipment for leasing to infrastructure projects with a minimum average maturity of 5 years.
- Foreign Currency Convertible Bonds (“FCCBs”) by housing finance companies with strong financials satisfying the criteria to be notified by RBI will also be permitted under the approval route.
- RBI has granted permission to NGOs engaged in micro finance activities to raise ECBs upto USD 5 million during a financial year under the automatic route subject to conditions. The ECB proceeds must be utilised for lending to self-help groups or for micro-credit or for bonafide micro finance activity including capacity building.
- Prepayment of ECBs will be permitted upto USD 200 million, subject to minimum average maturity of 5 years. Prepayment of ECB for amounts exceeding USD 200 million or prepayment of ECBs with minimum average maturity of 3-5 years would be under the approval route.
- Provision has now been made for "foreign equity holders". For them to be eligible as "recognized lender" under the automatic route they would require a minimum holding of equity in the borrower’s company as under:

    1. ECB up to USD 5 million – minimum equity of 25 per cent held directly by the lender,
    2. ECB more than USD 5 million – minimum equity of 25 per cent held directly by the lender and debt-equity ratio not exceeding 4:1(i.e. the proposed ECB not exceeding four times the direct foreign equity holding).

    Additionally, the norms also provide measures to check incidents of money laundering. The RBI said that overseas organizations planning to extend ECBs will have to furnish a certificate of due diligence from an overseas bank, which complies with host-country regulations and adheres to Financial Action Task Force guidelines. As for individual lenders, a certificate of due diligence from an overseas bank would be mandatory to indicate that the lender maintains an account with the bank for a minimum of 2 years. However, individual lenders from countries where banks are not required to adhere to Know you Customer Guidelines are not permitted to extend ECBs.

RBI issues directions to banks not to sell bad loans

In a bid to prevent the misuse of bilateral sale of bad loans, the Central Bank of India, the Reserve Bank of India (“RBI”) has issued Guidelines on purchase/sale of Non Performing Assets (NPAs) vide Notification no. RBI/2005-06/54 DBOD.NO.BP. BC. 16 / 21.04.048/ 2005-06 dated July 13, 2005. The RBI has indicated that the Guidelines would apply to banks, Financial Institutions (FIs) and Non Banking Financial Companies (NBFCs) purchasing or selling NPAs, from or to other banks/FIs/NBFCs with the exclusion of securitisation companies and reconstruction companies. Now, banks will be prevented from resale of assets to the bank from whom the loans were purchased. The norms stipulate, inter alia certain salient features such as;

- A bank can sell a bad loan only if the asset is classified as a NPA for two years, while a purchasing bank has to hold the assets in it’s books for at least 15 months before it is sold to

another bank.

- The estimated cash flows are normally expected to be realised within a period of three years and not less than 5% of the estimated cash flows should be realized in each half year.
- Each bank will make its own assessment of the value offered by the purchasing bank for the financial asset and decide whether to accept or reject the offer.

Foreign Direct Investment in Petroleum Sector and Air Transport Services

The Foreign Direct Investment ("FDI") limit in the Petroleum sector and Air Transport Services (Domestic Airlines) under the Automatic Route, has been further liberalised by the Government of India.(RBI/2005-06/83 AP (DIR Series) Circular No. 04) Accordingly, FDI upto 100% has been permitted under the Automatic Route in petroleum product marketing, oil exploration in both small and medium sized fields and petroleum product pipelines. In Air Transport Services (Domestic Airlines) sector, FDI upto 100% has been permitted under the Automatic Route by Non-Resident Indians (NRIs) and upto 49% by others. However, no direct or indirect equity participation by foreign airlines would be allowed.

FDI hike in Construction Development Sector

The Government of India, (Ministry of Commerce & Industry), vide Press Note 2 (2005) dated March 3, 2005, had decided to permit FDI upto 100 per cent under the automatic route, in townships, housing, built-up infrastructure and construction development projects which would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure subject to meeting with the guidelines mentioned in Press Note 2. The Foreign Exchange Management (Transfer or issue of Security by a Person Resident outside India) Regulations has now been suitably amended to reflect the same.

RBI hikes risk weights on loans for real estate, capital markets

In order to regulate unrestricted flow of bank funds to real estate and capital markets, the Reserve Bank has decided to increase the risk weight in these sectors from 100% to 125%. notified vide RBI No. 2005-06/ 78 DBOD. BP.BC. 20 / 21.01.002/ 2005-06 and RBI/2005-06/ 79 DBOD.No.BP.BC 21. / 21.01.002/2005-06 dated July 26, 2005 respectively. Bank's exposure to commercial real estate includes loans to commercial premises, office buildings, multi family residential houses, warehouses, hotels and for land developments and constructions. Similarly, exposure to capital markets includes direct investment by banks in equity shares, convertible bonds and debentures and units of equity oriented mutual funds.

Clause 49 of the Listing Agreement effective from 1 Jan '06

The Indian securities market regulator, Securities and Exchange Board of India ("SEBI"), has stated that Clause 49 of the Listing Agreement will come into effect from 1st January 2006. Clause 49 specifically details corporate governance rules for listed companies. SEBI has added that strict action would be taken against those companies that flout these rules.

Press Note 4 of 2005

The Department of Industrial Policy and Promotion has released Press Note 4 of 2005 which clarifies the position in Press Note 4 of 2001. Previously, investments made by NRIs were convertible to repatriable basis while investments in Indian rupees continued to be non-repatriable.

Henceforth, all proposals of NRIs would qualify for conversion of non-repatriable equity into repatriable equity under the automatic route provided:

- Housing the original investment by the NRI was made in foreign exchange under the FDI Scheme; and
- Financethe sector/activity in which the investment is proposed to be converted into repatriable equity is on the automatic route.

No prior approval for offering internet banking services

The Reserve Bank of India ("RBI") has on July 20, 2005 (RBI/2005-06/71 DBOD No. Comp.BC.14/07.03.29/2005-06) issued Guidelines on Internet Banking in India whereby banks are no longer required to seek RBI approval for offering transactional services on the internet. However, banks must ensure compliance with the following indicators;

- The Internet Banking policy must have been approved by the Bank's Board.
- The policy fits into the bank's overall Information Technology and Information Security policy and ensures confidentiality of records and security systems.
- The policy takes into account operational risk.
- The policy clearly lays down the procedure to be followed in respect of 'Know Your Customer' requirements

Unique Client Code for Mutual Fund Schemes/Plans

In order to facilitate unit holders of Mutual Funds to claim the tax benefit associated with payment of the Securities Transaction Tax ("STT"), the Securities and Exchange Board of India ("SEBI") has vide SEBI/IMD/CIR. No. 2/46603/05 dated August 10, 2005 decided to allow mutual funds to share the Unique Client Code ("UCC") of their schemes/plans with their unit holders. Debt restructuring mechanism for Small and Medium Enterprises ("SME").

No RBI approval for appointment of foreign national as director

The Reserve Bank has clarified in accordance with the Foreign Exchange Management Act, 1999 that the appointment of a foreign national on the Board of Directors of an Indian company will not warrant prior RBI approval. In the Press Release (2005-2006/142) dated August 2, 2005, the RBI also clarified that it has granted general powers to Indian companies to facilitate payment in rupees towards sitting fees for it's non-whole time director, who is a resident outside India but on a visit to India for business purposes.

Gold trading in Demat form

The Multi Commodity Exchange (MCX), in association with the World Gold Council, has launched the Gold Weekly Delivery Contract – a gold contract that is settled in a week (T+7). Prior to the launch of this product, investors could only get exposure to gold through commodity exchanges by buying gold futures. Now, they can get exposure to gold through a one-week contract, which is closer to a spot market. The MCX is to be linked to National Security Depository Ltd ("NSDL") for this product.

Debt restructuring scheme for Small and Medium Enterprises (SMEs)

The Reserve Bank (RBI) has indicated guidelines DBOD.BP.BC.No.34/21.4.132/2005-2006 dated September 8, 2005 based on which banks may after obtaining their Board approval devise, a debt restructuring scheme for Small and Medium Enterprises ("SME"). The guidelines lay down norms for the restructuring of the principal and interest elements and the treatment of such loan accounts subjected to the restructuring. The restructuring would follow a receipt of the request for such restructuring from the concerned enterprise. The time frame prescribed for banks to work out the restructuring package and implement the same is a maximum period of 60 days from date of receipt of requests.

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