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Insight

Analysis of Recent Developments in Indian Corporate Law

In this issue:

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Foreword

Welcome to the 27th issue of "*Insight*".

The last three months have witnessed numerous regulatory developments as well as important court rulings. This issue of "*Insight*" covers the Supreme Court judgment in the Subhkam Ventures case, the ruling of the authority of advance rulings on overseas transfer of shares of a foreign holding company and other policy initiatives relating to foreign investment in the pharma sector and liberalization of transfer of shares involving non-residents.

We hope that you will find this issue of "*Insight*" useful. Any feedback or suggestions would be valuable in our pursuit to constantly improve "*Insight*" and ensure its continued success amongst readers. Please feel free to send any feedback, suggestions or comments to insight@amarchand.com.

Regards,

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Takeover Regulations – Some Recent Judicial Interpretations

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The last quarter saw significant developments in India's takeover regime, including the notification of the new Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("**2011 Takeover Regulations**") issued by the Securities and Exchange Board of India ("**SEBI**"). Please refer to our special issue of *Insight* (Issue No. XXV) for an overview of the key provisions of the 2011 Takeover Regulations.

In addition to the notification of the 2011 Takeover Regulations, two important judicial decisions on the interpretation of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 ("**1997 Takeover Regulations**") were pronounced during the period under review.

Subhkam Ventures – Question of Law remains Open

In what can only be termed as an anti-climax, on November 16, 2011 the Supreme Court accepted an out of court settlement in the much anticipated case of *SEBI* v. *Subhkam Ventures (I) Private Limited*. It was hoped and expected that the Supreme Court would lay down some much needed jurisprudence as to the scope of the definition of 'control' under the 1997 Takeover Regulations - in particular, on whether the right to say *no* (through the exercise of veto rights) would constitute 'control' and thereby trigger mandatory tender offer obligations.

An earlier issue of *Insight* (Issue No. V) carried a detailed note on the decision of the Securities Appellate Tribunal (the "**SAT**") in this matter. In summary, the SAT had held that 'control' meant positive control, i.e. the ability to cause a company to perform certain actions, and that it did not cover rights constituting 'negative control', i.e. the right to prevent the company from doing certain actions.

Being a key and fundamental issue, the SEBI had appealed the aforesaid SAT decision before the Supreme Court. It was the SEBI's position that the definition of 'control' (which includes "*the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner*") would include veto rights since such negative control would effectively control the management and policy decisions of a company.

The Supreme Court's one-page order accepting the out of court settlement between SEBI and the respondents, specifically states that the <u>question of law (i.e., whether negative control is control) remains open and that the SAT decision would not be treated as precedent</u>. This observation has far reaching ramifications.

Generally, a decision of the SAT on the interpretation of the SEBI regulations would bind the SEBI. However, the Supreme Court ruling that the SAT decision in *Subhkam* would not constitute precedent has cleaned the slate on the interpretation that was laid down by the SAT. The SEBI may, therefore, continue to apply its position that the acquisition of rights constituting negative control would amount to an acquisition of 'control' under the 2011 Takeover Regulations and thereby trigger mandatory tender offer obligations. Uncertainty, therefore, is back in the game.

Investors may acquire up to 24.9% of a listed company without attracting mandatory tender offer obligations under the 2011 Takeover Regulations. The definition of 'control' under the new regulations is identical to the definition that was the subject matter of the *Subhkam* litigation. In the absence of a clear Supreme Court ruling, and without the benefit of relying upon the SAT decision in *Subhkam*, special or minority protection rights that may be obtained by an investor would need to be reviewed on a case-by-case basis.

Accordingly, each veto right would need to be reviewed from the commercial parameters underlying such right, as well as the impact it would have on the general management and policy decisions of the target company, in order to determine whether such right would constitute 'control'.

However, a 24% shareholding in a listed target company would often translate into effective voting rights in excess of 25% (owing to limited attendance at shareholders' meetings) and would, therefore, result in an effective veto right on special resolution matters without requiring any separate special or veto rights under an agreement. On this basis, Investors may be able to block major decisions of the company such as a dilution pursuant to a further issuance of shares, corporate re-organisations, amendments to constitutional documents, commencement of new businesses and delisting (a number of which form part of the list of the 22 veto rights that were contended in the *Subhkam* case). Investors may therefore rely on their rights under company law.

In any event, given that the Supreme Court has consciously said that the question of law remains open, this is *not a SEBI win*. While the SEBI may continue to extend its interpretation, this would depend upon the relevant facts of each case, and the law will hopefully be constituted in other cases where the SAT's decision, though not binding, will be cited for persuasive value. The Supreme Court is bound to be faced with the issue again.

Passive Acquisition Not Acquisition under 1997 Takeover Regulations

Another interesting decision worth noting is the scope of the term 'acquisition' under the 1997 Takeover Regulations in the decision of the SAT dated November 21, 2011, in *Raghu Hari Dalmia and Ors.* v. *SEBI* [MANU/SB/0128/2011] ("**Raghu Hari Dalmia case**"). The case involved an increase in the voting rights of the promoters of OCL India Limited ("**OCL**") in excess of the threshold triggers following a buyback by OCL wherein the SEBI held that the promoters had triggered a mandatory tender offer.

On appeal, the SAT reversed the decision of the SEBI, holding that an increase in shareholding pursuant to a buyback was only an incidental consequence of the buyback and was not an 'acquisition' for the purposes of the 1997 Takeover Regulations. The SAT relied on the definition of the term "acquire" in the Black's Law Dictionary which defines 'acquire' as: "*to gain by any means, usually by one's own exertion; to get as one's own; to obtain by search, endeavour, investment, practice or purchase*". Relying on this definition, SAT held that a *positive* act was required on the part of an acquirer for it to make an *acquisition* for the purposes of the 1997 Takeover Regulations. A mere increase in shareholding without such positive act would not, therefore, constitute an *acquisition*.

The SAT further reasoned that any other interpretation would lead to absurd consequences – giving the illustration of the requirement to make a public announcement of an open offer within four working days of a triggering event under the 1997 Takeover Regulations. SAT observed that non-promoters who do not participate in a buy-back would not know if their shareholding has increased to an extent that requires the making of a public announcement under the 1997 Takeover Regulations (because they would not have access to the change in shareholding as a result of such events) and cited an instance where a non-promoter shareholder's shareholding may increase to a level where he triggers the 1997 Takeover Regulations owing to his non-participation in a buyback process over which he has no control.

The SAT also rejected the contention of the SEBI that a passive acquisition was an 'indirect' acquisition and was, therefore, an *acquisition* for the purposes of the 1997 Takeover Regulations.

However, unlike the definition of 'control', the acquisition of voting rights under the 2011 Takeover Regulations would not necessarily follow the SAT decision above since the new regulations contain specific conditionalities that are attached to the acquisition of voting rights in excess of the threshold triggers pursuant to a buyback, and the relevant provisions of the new regulations contemplate and address the "absurdities" identified by the SAT in *Raghu Hari Dalmia Case*.

Foreign Investment

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There have been a number of key regulatory developments in the period from September to November 2011, in the policy on foreign direct investment ("**FDI**") and external commercial borrowings ("**ECBs**"), as set forth below:

Liberalization of Process of Transfer of Shares

Under the existing regulatory framework, per the extant FDI policy, the following instances of transfer of shares required the prior approval of the Reserve Bank of India ("**RBI**"):

(a) Resident to non-resident transfers:

(i) Where the share transfer did not conform to the pricing guidelines as stipulated by the RBI from time to time. Note that under the prevailing pricing guidelines, which were prescribed by the RBI in terms of A. P. (DIR Series) Circular No. dated May 4, 2010 (the "**May 4 Circular**"), the minimum price for transfer of shares from a resident to non-resident: (A) in case of listed companies, is to be not less than the price computed in accordance with the regulations framed by SEBI for preferential allotment (i.e. Chapter VII of the SEBI (Issue of Capital and Disclosure Requirements), 2009 ("**ICDR**")) ; and (B) in case of unlisted companies, is to be not less than the fair value to be determined by a SEBI registered category I merchant banker or a chartered accountant as per the discounted cash flow method; or

(ii) Where the share transfer required the prior approval of the Foreign Investment Promotion Board ("**FIPB**") per the extant FDI policy; or

(iii) Where the Indian company whose shares were being transferred, was engaged in rendering any financial service; or

(iv) Where the share transfer fell under the purview of the provisions of the 2011 Takeover Regulations.

(b) Non-resident to resident transfers: Share transfers from a non-resident to a resident required the prior approval of the RBI, in the event that the concerned transfer of shares did not conform to the pricing guidelines as stipulated by the RBI from time to time. Note that in terms of the May 4 Circular, the transfer of shares from non-resident to a resident cannot be at a price higher than the minimum price for transfer of shares computed in accordance with: (i) in case of listed companies, is to be not less than the price computed in accordance with the regulations framed by SEBI for preferential allotment (i.e. Chapter VII of the ICDR); and (ii) in case of unlisted companies, is to be not less than the fair value to be determined by a SEBI registered category I merchant banker or a chartered accountant as per the discounted cash flow method.

The RBI *vide* circular dated November 4, 2011 (the "**November 4 Circular**"), has liberalized and rationalized the procedures and policies with respect to transfer of shares from residents to non-residents and *vice-versa*, under the FDI policy, by providing that the following instances of transfer of shares shall not require the prior approval of the RBI:

(a) Non-resident to resident transfers: Under the FDI scheme, where the pricing guidelines under the Foreign Exchange Management Act, 1999 ("**FEMA**") are not met, provided that the following conditions are satisfied:

(i) The original and resultant investment are in line with the extant FDI policy and FEMA regulations, in term of sectoral caps, conditionalities (such as minimum capitalization, reporting requirements, documentation, etc.);

(ii) The pricing for the transaction is compliant with the specific / explicit, extant and relevant regula-

tions of the SEBI/ guidelines (such as an initial public offering, book building, block deals, delisting, exit, open offer/substantial acquisition/2011 Takeover Regulations, buy back); and

(iii) Chartered accountants certificate to the effect that the compliance with the relevant SEBI regulations / guidelines as indicated above is attached to the Form FC-TRS to be filed with the authorized dealer ("**AD**") bank.

(b) Resident to Non-resident transfers:

(i) Where transfer of shares require the prior approval of the FIPB as per the extant FDI policy provided that:

(A) the requisite approval of the FIPB has been obtained; and

(B) the transfer of shares adheres with the pricing guidelines and documentation requirements as specified by the RBI from time to time.

(ii) Where the 2011 Takeover Regulations are attracted, subject to adherence to the pricing guidelines and documentation requirements as specified by the RBI from time to time.

(iii) Where the pricing guidelines under the FEMA are not met, provided that:

(A) The resultant FDI is in compliance with the extant FDI policy and FEMA regulations in terms of sectoral caps, conditionalities (such as minimum capitalization, etc.), reporting requirements, documentation etc.;

(B) The pricing for the transaction is compliant with the specific/explicit, extant and relevant SEBI regulations / guidelines (such as Initial Public Offering ("**IPO**"), book building, block deals, delisting, exit, open offer / substantial acquisition / 2011 Takeover Regulations); and

(C) Chartered Accountants certificate to the effect that compliance with the relevant SEBI regulations / guidelines as indicated above is attached to the Form FC-TRS to be filed with the AD bank.

(iv) Where the investee company is in the financial sector, provided that:

(A) No-objection certificates are obtained from the respective financial sector regulators / regulators of the investee company as well as the transferor and transferee entities and such NOCs are filed along with the Form FC-TRS with the AD bank; and

(B) The FDI policy and FEMA regulations in terms of sectoral caps, conditionalities (such as minimum capitalization, etc.), reporting requirements, documentation etc., are complied with.

Under the existing regime, as set out hereinabove, in relation to transfer of shares of listed and unlisted companies, a pricing floor has been prescribed for transfer of shares from residents to non-residents, and a pricing cap has been prescribed with respect to transfer of shares from non-residents to residents. The liberalization from compliance with pricing norms under the November 4 Circular appears to be limited to transfer of shares of public listed companies in case of block deals, open offers, delisting etc. and public unlisted companies which are to be listed and are in the process of going in for an initial public offering, in accordance with prevailing relevant SEBI regulations. Wherever SEBI has stipulated pricing norms, once such pricing norms are complied with, there may not be a requirement to further adhere to the RBI pricing norms if such norms are either not applicable or at variance with the SEBI norms.

However, there seems to be no dilution in the application of RBI's pricing guidelines with respect to private limited companies and public unlisted companies, which will continue to have to comply with the pricing guidelines providing under the May 4 Circular i.e. the pricing cap/pricing floor in relation to the price at which such shares are transferred from non-residents to residents and residents to non residents respectively.

The November 4 Circular has also sought to remove procedural difficulties towards foreign investment including doing away with approvals from multiple regulators as far as possible. In this connection the following specific areas of liberalization in relation to transfer of shares from a resident to a non-resident, which will no longer require prior RBI approval, may be noted:

(a) Where transfer of shares requires the prior approval of the FIPB (subject to FIPB approval being obtained and pricing norms being followed);

(b) Where the 2011 Takeover Regulations are attracted (subject to adherence with pricing guidelines and other documentation requirements);

(c) Where the pricing norms are not met (only applicable for listed companies undertaking offer for sale or block deals or other transactions on the exchange in accordance with SEBI regulations); and

(d) Where the investee company is in the financial sector (subject to NOCs being obtained from respective financial sector regulators as well as the transferor and transferee).

Foreign Direct Investment in Multi Brand Retail

In terms of the prevailing policy framework on FDI into India, as set out in the Consolidated Policy on FDI dated September 30, 2011 ("**Consolidated FDI Policy**"), FDI is permitted in all sectors (subject to certain specified sectoral caps and conditionalities) except certain sensitive sectors such as atomic energy, gambling, real estate business, retail trading etc. Please refer to our special issue of *Insight* (Issue No. XXVI) for an overview of the key provisions of the Consolidated FDI Policy.

Despite the various changes to the policy on FDI post liberalization, FDI in retail trading i.e. sale of goods/ merchandise for personal or household consumption either from a fixed location such as a store/kiosk or away from a fixed location and related subordinated services, remains prohibited and any proposal to liberalize the retail sector has been the subject matter of intense political debate.

In view of the changing economy and pursuant to the discussion paper on July 6, 2010 ("**Retail Discussion Paper**") issued by the Department of Industrial Policy & Promotion ("**DIPP**") which proposed a phased opening up of the multi-brand retail sector, a Committee of Secretaries **("COS"**) was constituted by the Government to examine the issues concerning FDI in multi brand retail. On July 22, 2011, taking into account the various recommendations made in the Retail Discussion Paper, the COS recommended permitting FDI up-to 51% in the multi brand retail sector (i.e. retail trading) subject to compliance with the following conditions:

(a) Minimum investment amount should be US$ 100 million;

(b) 50% of the FDI funds would need to be invested in the development of back-end infrastructure;

(c) The foreign retailers shall have to procure a minimum of 30% of their supplies/ raw materials from SMEs;

(d) The foreign multi brand retailers should only be allowed to operate in Indian cities which have a population of more than 1 million and with prior approval of the relevant state government.

In late November 2011, it was reported that the Union Cabinet had approved the abovementioned recommendations made by the COS. It was also reported that the Union Cabinet has decided to permit 100% FDI in single-brand retail which would give the existing foreign investors the flexibility to engage into retail trading independent of their existing joint venture arrangements.

This move of opening up of the multi-brand retail sector to FDI was aimed at reducing inflationary pressures, increasing competition and improving efficiencies in the retail sector whose growth has traditionally been impeded by middlemen in the supply chain.

Given that FDI in retail remains a politically sensitive subject the Government is facing significant opposition from several fronts on opening up the retail sector to FDI. Recent news reports suggest that the Government is considering rolling back its proposal and it is likely that the opening up of the retail sector may be postponed until the Government is able to build consensus on the issue. Furthermore, it is also likely that the Government may impose more stringent conditions than those recommended by the COS.

While the various stakeholders await the outcome of the final policy, it should be emphasized that the decision of the Government to permit FDI in multi brand retail, although premature, underscores its commitment towards its policy of liberalization and opening up of the market to FDI.

FDI Policy in the Pharma Sector Reviewed

The pharmaceutical sector has been open to FDI of up to 100% under the automatic route (i.e., without approval of the FIPB). The last 2 years have seen several acquisitions of Indian pharmaceutical companies by large multinational pharmaceutical companies, raising concerns that the Indian generic medicine-manufacturing companies, upon being acquired by foreign companies, would not seek to avail of compulsory licensing, which would have a long term adverse effect on the price and availability of essential medicines. However, recently, due to recommendations by certain ministries and non-governmental organizations, that the sectoral cap for FDI be reduced to 49%, the DIPP has undertaken a review of the FDI policy in the pharmaceutical sector.

Pursuant to the aforementioned review, on November 8, 2011, the DIPP has *vide* press note 3 of 2011, amended the FDI policy relating to the pharmaceutical sector, which press note, effective as of November 8, 2011, stipulates the following changes:

(a) FDI up to 100% under the automatic route, would continue to be permitted for greenfield investments (i.e., a form of direct investment where a parent company starts a new venture in a foreign country by constructing new facilities from scratch) in the pharmaceutical sector; and

(b) FDI up to 100%, would be permitted for brownfield investments (i.e., investments in existing companies), in the pharmaceutical sector, under the approval route (i.e., with the prior approval of the FIPB).

This change is aimed at addressing certain concerns in relation to the availability and price of medicines. A better approach, instead of introducing multiple tiers of approvals by bringing in the requirement of FIPB approval for brownfield investment, would have been for the Competition Commission of India, under an already-existing regulatory framework for merger control, to regulate the adverse impact on competition and prices due to acquisitions, and address this issue.

DIPP Proposes 26% FDI in Domestic Airlines

According to news reports, the DIPP has, on November 22, 2011, circulated a draft cabinet note (the "**Cabinet Note**") among key ministries (including the civil aviation, finance, home and law ministries), to allow 26% FDI by foreign airlines in domestic carriers, on the basis of the rationale that private airlines in the country are in dire need of funds for their operations and service upgradation, to compete with other global carriers.

The proposal in the Cabinet Note is contrary to the proposed move by the Civil Aviation Ministry, which has proposed to 24% FDI in domestic carriers. In terms of the prevailing FDI regime, FDI up to 49% under the automatic route is currently allowed in domestic airlines, but the policy currently bars foreign airlines from investing. Media reports suggest that the government is likely to take a final decision on

this matter in the near future.

A 26% FDI cap would allow a foreign investor to have strategic voting rights, i.e., have the rights to block special resolutions, with respect to the board of an Indian carrier. News reports suggest that the DIPP feels that allowing foreign airlines to invest in domestic carriers would help them raise the much-needed equity funding.

Union Cabinet Approves 26% FDI in Pension Sector, Pending Parliament Approval

According to news reports, the Union Cabinet on November 16, 2011, has mooted the proposal to open up the Indian pension sector to private and foreign investment, by approving changes in the Pension Fund Regulatory and Development Authority (PFRDA) Bill (the "**Pension Bill**"), and permitting FDI of up to 26% in the pension sector, similar to the sectoral cap in the insurance sector. The Pension Bill still needs to be passed by the Parliament in its Winter Session.

The Pension Bill has been scrutinized by the Parliamentary Standing Committee on Finance (the "**Standing Committee**") in August, 2011. Media reports suggest that the Union Cabinet, disagreeing with certain recommendations of the Standing Committee, has decided that: (a) the FDI limit with respect to the pension sector, will not be mentioned in the Pension Bill, but will be incorporated in the revised regulations (due to the fact (as suggested by media reports) that the government would like to retain the flexibility of changing the FDI sectoral cap through an executive order); (b) the flexibility of withdrawals by subscribers, from funds, would be tightened; and (c) there would be no guarantee of assured returns on schemes by pension funds. However, according to news reports, the government has upheld the Standing Committee's suggestion for greater participation of employees and stakeholders in the Pension Advisory Committee.

The amendments in the Pension Bill and the approval of 26% FDI in the pension sector have been touted as a move that would provide access to foreign firms to India's growing, but under-penetrated pension market, and diversify the product basket to enable its rapid growth.

Modifications to the ECB Policy

On a review of developments in the global financial markets and the fact that borrowers are experiencing difficulties in raising ECBs, and with a view to increase forex inflows into India, the RBI has made certain modifications to its extant ECB policy by issuing 8 circulars in the period between September to November, 2011. The salient changes to the ECB policy are as follows:

(a) *Enhancement of All-in-Cost Ceiling*: On November 23, 2011, the all-in-cost ceilings for ECBs have been enhanced from 300 bps, to 350 bps over the 6 month LIBOR (for the respective currency of borrowing or applicable benchmark) for ECBs with the average maturity period of 3-5 years. The ceiling for ECBs with the average maturity period over 5 years remains unchanged at 500 bps.

(b) *Parking of Proceeds*: Under the extant ECB policy, borrowers had been permitted to either park the ECB proceeds abroad or remit these funds to India, pending utilization for permissible end-uses. However, on November 23, 2011, the RBI has issued a circular modifying the extant ECB policy, providing that the proceeds of the ECB raised abroad meant for Rupee expenditure in India (such as local sourcing of capital goods, on-lending to self-help groups or for micro credit, payment for spectrum allocation etc.) should be brought immediately for credit to their Rupee accounts with AD Category I banks in India, while ECB proceeds meant for foreign currency expenditure can be parked overseas.

(c) *Foreign Equity Holder*: Under the extant ECB policy, ECB can be availed of by an Indian company from a foreign shareholder provided that such a foreign shareholder is a 'recognized lender'. In order for a foreign shareholder to be construed as a 'recognized lender', such foreign shareholder needs to directly hold

minimum paid-up equity of 25% in the Indian company in case of ECB up to USD 5 million, or in case the ECB exceeds USD 5 million, in addition to the minimum 25% equity shareholding requirement the debt equity ratio shall not exceed 4:1 (i.e. the proposed ECB must not exceed four times the direct foreign equity holding in such Indian company). To further rationalize the policy, on September 26, 2011, the RBI has issued a circular which has modified the following aspects relating to a "foreign equity holder":

(i) The term "debt" in the debt-equity ratio will be replaced with "ECB liability" and the ratio will be known as "ECB liability"-equity ratio to enable the term to signify clearly that other borrowings/debt are not considered in working out this ratio;

(ii) In addition to the paid-up capital contributed by the foreign equity holder, the free reserves (including the share premium received in foreign currency) as per the latest audited balance sheet shall be reckoned for the purpose of calculating the equity of the foreign equity holder. Where there is more than one foreign equity holder in the borrowing company, the portion of the share premium in foreign currency brought in by the lender(s) concerned shall only be considered for reckoning quantum of permissible ECBs; and

(iii) For calculating the ECB liability, not only the proposed borrowing, but also the outstanding ECB from the same foreign equity holder lender, should be reckoned.

Additionally, the following guidelines with respect to consideration of ECB proposals from direct or indirect foreign equity holders and group companies under the approval route, have also been provided:

(i) Service sector units, in addition to those in respect of hotels, hospitals and software, could also be considered as eligible borrowers if the loan is obtained from foreign equity holders (thus enabling borrowing by training institutions, R&D units, miscellaneous service companies etc);

(ii) ECB from indirect equity holders may be considered provided the indirect equity holding by the lender in the Indian company is at least 51%;

(iii) ECB from a group company may also be permitted provided both the borrower and the foreign lender are subsidiaries of the same parent; and

(iv) At the time of submitting the aforementioned ECB proposals, the total outstanding stock of ECBs (including the proposed ECBs) from a foreign equity lender should not exceed 7 times the equity holding (either directly or indirectly) of the lender. In the case of lending by a group company, equity holdings by the common parent would be reckoned.

(d) <u>*Change of lender*</u>: Under the extant ECB policy, any changes in the terms and conditions of the ECB after obtaining the loan registration number from the RBI, including a request for change of the lender for an existing ECB required the prior approval of the RBI. On September 7, 2011, the RBI simplified the existing procedure by delegating powers to the AD bank to approve request for change in the recognized lender, subject to the following conditions:

(i) the original lender is an international bank, a multilateral financial institution, a regional financial institution, a government owned development financial institution, an export credit agency or supplier of equipment;

(ii) the new lender also belongs to any one of the abovementioned categories and is a recognized lender as per the extant ECB policy;

(iii) there is no change in the other terms and conditions of the concerned ECB;

(iv) the concerned ECB is in compliance with the extant ECB policy;

(v) any changes in respect of recognized lenders in case of a foreign equity holder and a foreign collaborator, will continue to be examined by the RBI;

(vi) all other aspects of the extant ECB policy shall remain unchanged; and

(vii) the changes in the recognized lender shall be promptly reported to the RBI.

(e) *Liberalization in relation to ECBs to the Infra Sector*: Considering the specific needs of the infrastructure sector, the RBI issued a set of 3 circulars on September 23, 2011:

(i) Enhancement of ECB limit: The aggregate ECB limit for the real sector-industrial sector-infrastructure sector has been enhanced to USD 750 million per financial year from the present limit of USD 500 million and the specified service sectors i.e. hotel, hospital and software sector can avail of USD 200 million per financial year as against the earlier limit of USD 100 million per financial year.

(ii) ECB designated in INR: ECBs designated in INR, from foreign equity holders under the automatic / approval route, as the case may be, as per the extant ECB policy. Non-governmental organizations engaged in the microfinance sector will be permitted to avail of ECBs designated in INR, from overseas organizations and individuals as per extant guidelines, under the automatic route.

(iii) ECB for Interest During Construction (IDC): ECB for Interest During Construction ("**IDC**") will be considered as a permissible end-use for the Indian companies in the infrastructure sector, under the automatic/approval route, as the case may be, subject to the conditions that: (A) the IDC is capitalized; and (B) is part of the project cost.

(iv) Structured Obligations to the Infra Sector: Under the extant ECB policy, credit enhancement was permitted to be provided under the approval route i.e., with the prior approval of the RBI, by multilateral / regional financial institutions and government-owned development financial institutions for domestic debt raised through issue of capital market instruments (such as debentures and bonds) by Indian companies engaged exclusively in the development of infrastructure and by infrastructure finance companies ("IFCs"), which had been classified as such by the RBI. On September 26, 2011 the RBI issued a circular which has modified the extant ECB policy in relation to structured obligations as follows:

(A) Credit enhancement by all eligible non-resident entities will henceforth be permitted under the automatic route and no prior approval will be required from the RBI;

(B) Direct foreign equity holder(s) (i.e., those enjoying a minimum holding of 25% of the paid up capital) and indirect foreign equity holder (i.e., holding atleast 51% of the paid-up capital) are now permitted to provide credit enhancement to Indian companies engaged exclusively in the development of infrastructure, and by the IFCs as classified by the RBI; and

(C) All the other terms and conditions as specified earlier by the RBI in paragraph 4 (ii) to (viii) of circular issued on March 2, 2010, containing restrictions in relation to average maturity period, guarantee fee, all-cost-ceiling, prepayment and use of call / put options etc., will remain unchanged.

(v) Refinancing of ECBs in the Infra Sector: Under the extant ECB policy, the repayment of an existing Rupee loan had not been a permissible end use for an ECB. The RBI has now permitted Indian companies in the infrastructure sector to utilize 25% of the fresh ECBs raised by corporates towards refinancing of the Rupee loans availed by them from the domestic banking system, under the approval route, subject to the following conditions:

(A) At least 75% of the fresh ECB proposed to be raised should be utilized for capital expenditure towards new infrastructure project(s);

(B) In respect of the remaining 25%, the re-finance shall only be utilized for repayment of the Rupee loan availed of for capital expenditure of earlier completed infrastructure project(s);

(C) The re-finance shall be utilized only for the Rupee loans which are outstanding in the books of the financing bank concerned; and

(D) The designated AD - Category I bank shall monitor the end-use of funds. Banks in India will not be permitted to provide any form of guarantee(s).

(vi) Bridge Financing: Indian companies in the infrastructure sector are permitted to import capital goods by availing of short term credit (including buyers' / suppliers' credit) in the nature of "bridge finance", under the approval route, subject to the following conditions:

(A) the bridge finance shall be replaced with long term ECB;

(B) the long term ECB shall comply with all the extant ECB policy;

(C) prior approval shall be sought from the RBI for replacing the bridge finance with a long-term ECB;

(D) the designated AD - Category I bank shall monitor the end-use of funds and evidence the import of capital goods by verifying the bill of entry; and

(E) Bank(s) in India will not be permitted to provide any form of guarantee(s); and

(F) All other conditions of the extant ECB policy shall be complied with.

Insider Trading Regulations

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Two important judicial decisions on the interpretation of the SEBI (Prohibition of Insider Trading) Regulations, 1992 ("**Insider Trading Regulations**") were pronounced during the period under review.

'Price sensitive information' does not include decisions taken in the Ordinary Course of Business

The Securities Appellate Tribunal ("**SAT**") has in an order dated November 18, 2011, in the matter of *Gujarat NRE Minerals Resources Ltd. V. SEBI*, ruled that every decision by an investment company to buy or sell its investments, would not amount to 'price sensitive information' in terms of the Insider Trading Regulations.

In the instant case, the board of directors of FCGL Industries Ltd. ("**FCGL**"), a listed core investment company with more than 90% of its assets being investments in associated or group companies, had decided in a meeting held on July 4, 2005 to sell a part of its investment in Gujarat NRE Coke Ltd., ("**Gujarat NRE**") to raise funds for the acquisition of coal mining leases in Australia. As on June 30, 2005, FCGL held 1,67,09,824 shares in Gujarat NRE constituting 17.7% of its total paid-up equity capital and pursuant to the board decision, in the period between July 18, 2005 and September 29, 2005, FCGL sold 84,79,709 shares for the purpose of raising requisite funds.

Whilst the corporate announcement made by FCGL to the stock exchange provided information pertaining to the decision to acquire coal mining leases in Australia and the cost of the acquisition and development of the mines, there was no disclosure of the decision of FCGL to dispose of its shareholding in Gujarat NRE to raise funds for the acquisition. This non-disclosure was held by SEBI to be a serious violation of the Insider Trading Regulations and the Code of Corporate Disclosure Practices specified in Schedule II of the Insider Trading Regulations, as such information was held to constitute unpublished price sensitive information.

Additionally, in the course of its investigation in the shares of FCGL, SEBI also found that two entities, namely, Matangi Traders and Investors Ltd. and Marley Foods Private Ltd. (subsequently merged with Gujarat NRE Mineral Resources Ltd.) having common directors with FCGL, had traded in the shares of FCGL during the quarter ending September, 2005. Thus, the SEBI adjudicating officer held that the trades in the scrip of FCGL were executed on the basis of unpublished price sensitive information and imposed monetary penalties on the companies and the directors.

While reversing the decision of the SEBI adjudicating officer, the SAT order specifically held that "*FCGL is an investment company whose business is only to make investments in the securities of other companies. It earns income by buying and selling securities held by it as investments. This being the normal activity of an investment company, every decision by it to buy or sell its investments would have no effect, much less material, on the price of its own securities.*"

The SAT order noted that the SEBI adjudicating officer had relied upon clause (vi) of Regulation 2 (ha) of the Insider Trading Regulations, which states that "*disposal of the whole or substantial part of the undertaking*" would be deemed to be price sensitive information. However, the SAT order clarified that the clause referred to a situation where a "*company decides to dispose of the whole or substantial part of its business activity or project in which it is engaged*" and also ruled that "*The word 'undertaking' cannot possibly mean investments held by an investment company which are its stock-in-trade.*"

The SAT concluded that the decision of the board of FCGL to disinvest its holdings in Gujarat NRE to fund the acquisition of mining leases amounted only to a switching of investments, which was a normal business activity of an investment company.

The SAT order indicates that any commercial activity that is carried out by a company in the course of its normal business and operations would not amount to 'price sensitive information' that would be required to be disclosed to the stock exchange. In this regard, a parallel can also be drawn with entities such as broking companies, which are in the business of buying and selling securities on a regular basis. In this connection it would be important to ascertain the nature of the business of the listed Company in question and whether the action is question may be considered to be "in the ordinary course of business". This analysis would need to be done on a case by case basis.

Whilst in the instant case the investment company under scrutiny, i.e., FCGL, was a listed company, it must be noted that in most cases, the investment holding company of conglomerates are unlisted entities, and therefore not required to make any disclosures under the Insider Trading Regulations.

Having said that, the SAT order clarifies that a listed investment company would also not be required to make disclosures under the Insider Trading Regulations for any investment or disinvestment activity, which is in the ordinary course of its commercial activity.

Capital Markets

Applicability of Insider Trading Regulations to Employee Stock Option Purchase scheme controlled by a trust

On October 21, 2011, SEBI *vide* its 'No-Action letter' ("**Informal Guidance**") to KPIT Cummins Infosystems Limited ("**KPIT Cummins**") clarified that a trust formed by KPIT Cummins which would administer its proposed Employee Stock Option Purchase scheme would attract the provisions of the Insider Trading Regulations and that the said trust would have to comply with the provisions of the Insider Trading Regulations since it was holding and trading in securities of the company on the instructions of the employees of the Company on whose behalf it was holding the options/ shares.

Regulation 13 of the Insider Trading Regulations requires directors, officers and substantial shareholders who hold more than 5% shares or voting rights in the company to disclose to the company the number or shares or voting rights on becoming holders of such shares and any change in shareholding or voting rights, or positions taken in derivatives by such persons. The said information is to be disclosed by the listed company receiving such information to all stock exchanges on which the company is listed within two working days of receipt of the same.

Responding to a request for informal guidance, SEBI observed that since the trust formed by KPIT Cummins Infosystems is to undertake activities of trading in securities, on behalf of employees exercising options, both the employees as well as the trust shall be required to abide by the code of internal procedures and conduct, restriction on trading outside the transfer window, and disclosure requirements including disclosures under Regulation 13 (4) of the Insider Trading Regulations.

Capital Markets

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Key updates for the period September to November 2011 in relation to the capital markets practice are set forth below:

Processing of Investor Complaints against depository participants in SEBI Complaints Redress System

SEBI has commenced the process of receiving complaints against depository participants through its centralized online database, the SEBI Complaints Redress System ('**SCORES**'). Any complaints received against depository participants will be electronically filed with the depositories and the depository is expected to take up the matter with the relevant depository participant. The depository participant is required to redress any grievances received within one month of receipt of such complaint. The depositories are required to put in place suitable systems to ensure that complaints received against the depository participants are redressed in a timely manner.

Disclosure of Price Information of Past Issues Handled by Merchant Bankers

SEBI has prescribed a format for disclosure of price information of past issues handled by merchant bankers, which is required to be enclosed with the due diligence certificate submitted by merchant bankers at the time of filing offer documents with SEBI. This information is required to be disclosed for a period of 3 years and is also required to be included in the offer documents. This requirement is applicable for draft red herring prospectus/red herring prospectus filed with SEBI or the Registrar of Companies from November 1, 2011.

Contents of Application-cum-Bidding Form and Manner of Disclosure Abridged Prospectus

SEBI has revised the structure, design, format, contents and order of information of the Application-cum-Bidding Form in order to make it more investor friendly and ensure uniformity in bidding and accuracy. The form has been standardised for ASBA and Non-ASBA applications. The revised format is applicable to all red herring prospectus filed with Registrar of Companies from November 1, 2011. SEBI has also notified related amendments to the ICDR.

Guidelines for Issue and Listing of Structured Products/Market Linked Debentures

SEBI has by way of Guidelines for Issue

and Listing of Structured Products and Market Linked Debentures enhanced the disclosure norms and other requirements to be specified in offer documents regarding structured products and market-linked debentures which are proposed to be listed on stock exchanges, other than 'principal non-protected' securities. These Guidelines prescribe specific disclosures in addition to disclosures required under the SEBI (Issue and Listing of Debt Regulations), 2008 and provide for rules that endeavour to safeguard interests of retail investors. The following are some of the salient requirements prescribed under the Guidelines:

- *Eligibility*: Entities proposing to issue structured products or market-linked debentures shall be required to have a minimum net worth of Rs.100 crore.
- *Minimum Ticket Price*: The minimum ticket size for these securities has been fixed at Rs.10 lakh each.
- *Third Party Valuation Agency*: The issuers would be required to appoint a third-party valuation agency, which has to be a credit rating agency registered with SEBI. The valuer shall publish on its website and provide to the issuer the value of the securities, at a frequency not less than once in a calendar week. The issuer shall also provide an investor with the value whenever asked for by the investor, the cost of which shall be borne by the issuer.

Amendments to the ICDR

SEBI has notified certain amendments to the ICDR. Key amendments are set forth below:

- *Eligibility criteria:* The limit of 50% of net tangible assets being monetary assets for issuers eligible for a public offer under Regulation 26(1) of the ICDR Regulations will not apply to public offers made entirely through an offer for sale. Further, the track record of distributable profits should be achieved on a stand-alone and consolidated basis for at least 3 out of the immediately preceding 5 years.
- *Indian Depositary Receipts (IDRs):* Regulations have been prescribed for rights issues of IDRs. These regulations provide for various requirements by an IDR issuer including eligibility, renunciations, record date, filing and disclosures in the offer document, subscription period and funds utilisation.

Amendments to the Equity Listing Agreement

SEBI has made certain amendments to the Equity Listing Agreement. Key amendments are as follows:

- *Mode of Supplying Annual Reports to Shareholders:* Listed companies have been permitted to provide (a) soft copies of full annual reports to all shareholders who have registered their e-mail address for this purpose, (b) hard copies of the abridged annual reports to other shareholders, and (c) hard copies of full annual reports to shareholders who have requested for such reports.
- *Quarterly Shareholding Pattern:* The format for filing quarterly shareholding pattern by listed companies has been amended in accordance with requirements under the 2011 Takeover Regulations.
- *Disclosure of voting results:* Listed companies are required to disclose their voting results in a prescribed format to stock exchanges on where they are listed and are also required to place these results on their websites within 48 hours from the conclusion of a shareholders' meeting. This requirement is applicable currently to the top 500 listed companies based on market capitalization and will apply to shareholders meetings for which notices are issued on or after January 1, 2012.
- *Disclosure and submission of quarterly financial statements*: Listed companies are required to comply with the following requirements in relation to quarterly financial statements filed from December 31, 2011:

(a) Disclosure of figures in respect of the immediately preceding quarter;

(b) Submission of last quarter results together with the annual audited annual accounts;

(c) Submission of auditor's review report along with the interim unaudited financial statements.

SEBI Board Meeting

The SEBI Board met on November 24, 2011 and took the following decisions:

- *Business Responsibility Reports*

  Listed companies will be required to submit Business Responsibility Reports, as part of their Annual Reports, describing measures taken by them in accordance with key principles enunciated in the *'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business'* framed by the Ministry of Corporate Affairs. This requirement at the first instance will apply only to top 100 companies in terms of market capitalization and would be extended to other companies in a phased manner.

- *Tenure of conversion of warrants issued along with public/rights issue*

  Warrant issued on a public/rights basis will have a maximum tenure of 12 months. Disclosures about utilisation of funds raised through the offer would be required to be made by the issuer both in the offer document as well as on a continuous basis.

- *Anchor Investors*

  The Board has prescribed a minimum allotment size of Rs. 5 crores for Anchor Investors and has also decided to specify maximum number of Anchor Investors in a particular slab.

- *Disclosures where funds are shown as promoters*

  A separate set of disclosures are proposed to be prescribed by SEBI for funds (such as venture capital funds, etc.), in offer documents where such funds are proposed to be disclosed as promoters of the investee company.

- *Review of net worth for debenture trustees*

  The net worth requirements of Debenture Trustees will be increased from Rs. 1 Crore to Rs. 2 Crores. The existing debenture trustees shall be granted a time period of two years from the date of notification, to comply with this requirement.

IRDA issues Listing Regulations for Life Insurance Companies

On December 1, 2011, the Insurance Regulatory and Development Authority ("**IRDA**") issued the IRDA (Issuance of Capital by Life Insurance Companies) Regulations, 2011 ("**IRDA Listing Regulations**") that will govern public offerings by life insurance companies in a bid to help them raise capital from the public.

Some of the key provisions of the IRDA Listing Regulations are as follows:

- The IRDA Listing Regulations are applicable to life insurance companies proposing to raise capital by (i) issue of capital under the ICDR; and (ii) divestment of equity by one or more promoters through public offer of sale under the ICDR.

- A life insurance company which proposes to raise capital by way of an Initial Public Offer (IPO) or through a subsequent issue of shares, needs to obtain the prior approval of the IRDA before approaching SEBI for its approval under the ICDR.

- The approval granted by the IRDA under the IRDA Listing Regulations will be valid only for a year, within which the company should file the draft red herring prospectus with SEBI. This is in line with listing norms laid down by SEBI for companies wanting to raise capital through public markets.

- Only such life insurance companies that have completed 10 years of operations, as insurance companies, will be allowed to float IPOs.

- While granting approval under the IRDA Listing Regulations, the IRDA will *inter alia* consider the following (i) the embedded value of the applicant company, (i.e. the future value of the current business of a company based on present assets and liabilities, and net value of future income flows) as prepared and reviewed by independent actuarial experts, which embedded value should be at least twice the paid-up equity capital of the company, (ii) maintenance of prescribed regulatory solvency margins, and (iii) record of policyholder protection for the past 5 years.

- The IRDA retains the right to prescribe the extent of dilution of stake by promoters, the maximum subscription that can be allotted to foreign investors and the minimum lock-in period for promoters after the issue and the disclosures to be made in the offer document in addition to the requirements set out in the ICDR.

- The IRDA Listing Regulations set out detailed disclosure requirements to be made by life insurance companies seeking to raise capital from the public which *inter alia* include risk factors specific to insurance companies, compliance with corporate governance guidelines, disclosures of financial statements etc.

In the recent past, various life insurance companies have evinced interest in tapping the public markets to raise capital and it is expected that the new regulatory framework would encourage life insurers to tap the Indian capital markets for raising equity capital.

Tax Update

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During the period from September to November 2011, there have been some important judicial decisions on the taxability of transactions pertaining to direct and indirect transfer of shares of Indian companies which would have far reaching implications on structuring cross-border transactions. The key takeaways from the recent decisions are set out below.

Taxability of overseas transfer of shares of a foreign company holding shares in an Indian company

On November 28, 2011, the Authority of Advance Rulings ("**AAR**"), in the case of *Merieux Alliance* ("**Merieux**") *and Groupe Industrial Marcel Dassault* ("**Groupe Industrial**") (AAR No 846 and 847 of 2009) held that overseas transfer of shares of a foreign company which holds shares in an Indian company is taxable in India.

In the instant case, Merieux and Groupe Industrial (the "**Applicants**") transferred their stake in ShanH, a company based at France to another France based company named Sanofi Pasteur Holding ("**Sanofi**"), in 2009. The Applicants sought the opinion of AAR on whether the "capital gains" arising on transfer of shares in French company, which in turn held shares in Shantha Biotechnics Ltd. ("**Shantha Biotech**"), an Indian company, are taxable in India. It is pertinent to note that the sellers had approached the AAR, for seeking this ruling, subsequent to the Indian Revenue Authorities ("**Revenue Authorities**") issuing a show cause notice to Sanofi, to treat it as an assessee in default for not withholding taxes before paying to Merieux and Groupe Industrial.

The Revenue Authorities contented that by virtue of transfer of shares of ShanH, what was really transferred was the underlying assets and control of an Indian company, Shantha Biotech, and accordingly such transaction was taxable in India and that the transfer of shares of ShanH was a preordained scheme to avoid capital gains tax in India and the AAR would be debarred from answering the questions raised by the Applicants.

The Revenue relied upon the *inter alia* following arguments in support of their contentions:

- ShanH was created merely for the purpose of dealing with the assets of Shantha Biotech and it was only a front, a paper company since it did not have any offices or employees. The Director of Merieux was also a Director of ShanH and ShanH had no other

Tax Update

Taxability of overseas transfer of shares of a foreign company holding shares in an Indian company

Capital gains earned by Mauritius company on sale of shares of an Indian company are not subject to tax in India

Non-resident is not entitled to the beneficial rate of 10 % on capital gains business except to hold shares of Shantha Biotech.

- At the time of acquisition of shares of Shantha Biotech in 2006, it was Merieux that had entered into Share Purchase Agreement and carried out the due diligence of Shantha Biotech. ShanH was shown as a permitted assignee and the amount payable was shown as loan by Merieux to ShanH. The funding required at the first instance to acquire shares of Shantha Biotech was provided by Merieux and the stamp duty was paid by Merieux and then reimbursed by ShanH.

- Domestic tax laws and the DTAA permit a 'see through' of the transaction to ascertain its true purpose. In the instant case, it was evident that the payment made by Sanofi was for acquisition of control and management and other bundle of rights in the Indian company.

- The word "*alienation*" used in Article 14.5 of the India- France DTAA is a word of wide import and when read with the words "*participation of atleast 10% in a company*", it would mean that conveying of such rights of participation would also attract tax in India, if the interest of participation is of an Indian company. Participation in a company, according to the revenue would mean the right to vote, the right to nominate directors, control and management, day to day decision making and right to get distribution of profits in an Indian company.

- The Applicants contended that the transaction was taxable in France and not in India as per India-France DTAA and further no avoidance of tax was involved in the transaction. The Applicants relied upon the *inter alia* following arguments in support of their contentions:

- Under Article 14.5 of the DTAA, gains arising from alienation of shares representing a participation of atleast 10% in a company which is a resident of France, were taxable in France.

- Setting up of a subsidiary company for making fresh acquisitions was a legal, permissible and known method of business and there was nothing illegal in forming a subsidiary for the purpose of acquiring shares in Shantha Biotech.

- The Applicants held a valid Tax Residency Certificate ("**TRC**") of France and there is no avoidance of tax. This was not a case of treaty shopping since the tax payable in France on long-term capital gains was to the disadvantage of the Applicants since in France the shares had to be held for 2 years before sale, for qualifying as long-term capital gains, whereas it was only 1 year in India.

- In the light of the decision of the Supreme Court in Azadi Bachao Andolan [2003] 263 ITR 706 (SC), there was no question of going behind the transaction to ascertain its so-called real nature especially in cases governed under DTAA.

Considering the facts of the case and the arguments raised, the AAR held that the sale of shares of a French company was taxable in India on account of the following reasons:

- Though the shares being transferred were that of a French company, the situs of the underlying assets and controlling interest cannot be ignored. The essence of the transaction takes within its sweep various rights, including a change in the controlling interest of an Indian company having assets, business and income in India

- The transfer of shares of ShanH may have commercial and business efficacy or validity, but that does not prevent the AAR from looking at the transaction in the context of the domestic tax laws and/or the DTAA and assess its efficacy from the point of view of taxation

- The decision of Azadi Bachao Andolan would not act as an obstacle for an AAR, since under the domestic tax laws the AAR is entitled to reject the application if the question raised therein, relates to a transaction which

is prima facia designed for the avoidance of income-tax

- The transaction is not one to be taken at its face value by the taxing statute, since the series of steps shows that the intention was to avoid payment of tax on capital gains in India. If the transaction was accepted at face value, control over Indian assets and businesses can pass from hand to hand without incurring any liability to tax in India. Hence, such transactions are subject to tax in India.

While this ruling is applicable only in the case of the applicant, it will have persuasive value for other similar transactions where the shares of a foreign holding company, which holds shares of an Indian company, are transferred. The Vodafone case, which is a matter with a similar factual matrix, is pending before the Supreme Court, although in the Vodafone case, the determination of tax liability is under the domestic tax laws in India.

Capital gains earned by Mauritius company on sale of shares of an Indian company are not subject to tax in India

On November 14, 2011, the AAR in the case of *Ardex Investments Mauritius Limited* ("**Ardex Mauritius**") (AAR No. 866 of 2010) held that the applicant, Ardex, a Mauritius company, transferring shares of an Indian company is entitled to the benefit of India-Mauritius DTAA and the capital gains arising on the said sale are not subject to tax in India.

Ardex Mauritius was originally formed by the Norcos group in the year 1998. Thereafter, in the year 2001, Ardex UK acquired the entire stake in Ardex with a view to expand its business. Its former name Norcos Investments (Mauritius) Limited was changed to "Ardex Investments Mauritius Limited". Ardex Mauritius held 50% of the equity shares of the Indian company, Ardex Endura (India) Pvt Ltd ("**Ardex India**").

Ardex Mauritius proposed to sell its stake to another group company (incorporated in Germany) at a fair market value and hence applied before the AAR, for the ruling on the tax implications on the proposed transaction in India.

The Revenue Authorities contended that the capital gains did not actually accrue to Ardex Mauritius, but to Ardex UK (the UK parent of Ardex) and hence the gains should be subject to tax in India as per India- UK DTAA, read with the domestic tax laws. The Revenue relied upon the *inter alia* following arguments in support of their contentions:

- Ardex Mauritiuswas a wholly-owned subsidiary of Ardex UK and was created solely for the purpose of taking the advantage of capital gains exemption under the India-Mauritius DTAA. The funding for the investment in the Indian company had been done by Ardex UK and the decision for selling the shares was also taken by the Ardex UK. The corporate veil had to be pierced and the Ardex UK was the real owner and therefore, the taxability would be governed under the India-UK DTAA.

- Ardex Mauritius had not earned any income in last two years and its only assets were investment in the Indian company;

Ardex Mauritius contended that the transaction was governed by the India-Mautirius DTAA and further that no avoidance of tax was involved in the transaction. The Applicants relied upon the *inter alia* following arguments in support of their contention:

- Ardex Mauritius was formed by the Norcos group and not by the Ardex group. The Ardex group had invested in Ardex Mauritius only subsequently;

- Ardex Mauritius was a separate legal entity and was a beneficial owner of shares of the Indian company;

- The Board of directors of Ardex Mauritius had taken the decision to transfer the shares of the Indian company;

- Ardex Mauritius held a valid TRC and relied upon the decision of Azadi Bachao Andolan [2003] 263 ITR 706 (SC) ("**Azadi Bachao Andolan Case**")

and E-trade Mauritius [2010] 324 ITR 1 (AAR) ("**E Trade Case**") for benefit under the India- Mauritius DTAA.

Considering the facts of the case and the arguments raised, the AAR held as under:

- The AAR observed that Ardex Mauritius had made the initial investment almost 10 years back which was steadily increased. Hence, it was not the case of a sudden arrangement before the proposed transfer of shares.
- Even if it was accepted that the formation of Ardex Mauritius was an attempt to take the advantage of the India-Mauritius DTAA, the same cannot be characterised as objectionable treaty shopping, replying upon the decision of Azadi Bachao Andolan case , wherein it was held that even treaty shopping was not a taboo. The AAR distinguished the instant fact circumstances from the decision in McDowell and Co [[1985] 154 ITR 148 (SC)], sine the McDowell decision did not specifically deal with treaty shopping.
- Also, the transaction was not that of a gift or transfer of shares without consideration, but sale of shares at market value. It concluded that the capital gains arising to Ardex Mauritius would not be chargeable to tax in India and Ardex Mauritius would be entitled to receive the sale proceeds without deduction of tax at source.

It would be pertinent to note that a similar matter is pending before the Supreme Court, in the case of E-Trade Case.

Non-resident is not entitled to the beneficial rate of 10 % on capital gains

On August 1, 2011, the AAR in the case of Cairn UK Holdings Ltd ("**Cairn UK**") [[2011] 337 ITR 0131(AAR)] held that a non-resident is not entitled to the beneficial rate of 10% on capital gains.

Cairn UK, a company based in Scotland had sold the shares of Cairn India Limited ("**CIL**"), an Indian company to another Indian company. While the shares of CIL were listed on an Indian stock exchange, the present transaction was effected by way of an off market share sale. The shares transferred were held by Cairn UK for more than 12 months period, and consequently were treated as a long-term capital asset.

Cairn UK, filed an application for advance ruling with the AAR, claiming that it was entitled to the benefits of the lower rate of tax of 10 % on the long term capital gains earned on sale of shares of the Indian listed company.

Proviso to Section 112 of the Income Tax Act, 1961 ("**IT Act**") provides that tax on the capital gains derived by a tax payer from the transfer of listed securities/ units/zero coupon bonds would not exceed 10 % of the capital gains computed before giving benefit of Cost Inflation Index ("**CII**").

On interpretation of the provisions of the IT Act, the AAR held that under the existing computation mechanism, the non-resident tax payers were eligible to claim the benefits of foreign exchange fluctuations for the capital gains earned by them and hence they were not entitled to claim the benefit of CII, as prescribed under the IT Act. The benefit of the lower rate of tax of 10 % is only allowed to tax payers who are entitled to CII benefit. Since non-resident tax payers are not entitled to CII benefits, they should also not be entitled to the benefit of lower rate of tax of 10 % on long term capital gains.

Aggrieved by the ruling, Cairn UK has filed a special leave petition ("**SLP**") with the Supreme Court against the AAR ruling.

It is pertinent to note that similar issue has been dealt in the past by several courts (including AAR), wherein it was generally held that the benefit of lower rate of tax of 10 % would be available to non-resident tax payers. While, this ruling by AAR, in this specific case, is unfavourable, finality on this issue will be reached on obtaining a verdict from the Supreme Court.

From the Bench

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Amounts Payable under EPF Act to be paid in Priority to All Other Debts

The Supreme Court, in the case of *Employees Provident Fund Commissioner v/s. O.L of Esskay Pharmaceuticals Limited* [SLP No. 7642-7646/2011], recently decided on the question of priority of the dues payable by an employer under Section 11 of the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 (the "**EPF Act**") and whether the same was subject to Section 529A of the Companies Act, 1956 (the "**Companies Act**"), in terms of which, workmen's dues, and debts due to secured creditors are required to be paid in priority to all other debts. In the instant case, the concerned company, Esskay had failed to pay certain balance provident fund amounts payable by it under the EPF Act. It came to the notice of the Provident Fund Commissioner (the "**Commissioner**") that the High Court of Gujarat had ordered the winding-up of Esskay and had also appointed the Official Liquidator. A company application was filed by the Commissioner for payment of the balance EPF amounts, which was dismissed by the single judge of the relevant high court and the appeal rejected, on the basis that the provident fund amounts do not constitute a first charge on the assets of the employer.

The Supreme Court held that in the winding up of a company, dues payable by an employer under Section 11 of the EPF Act shall have priority over security created in favour of every secured creditor, and such dues shall not be subject to Section 529A of the Companies Act.

This decision impacts the rights of the secured creditors of a company since the outstanding dues and contributions under the EPF Act would have priority over dues payable to secured creditors.

"Public Policy" under the Arbitration Act vis-à-vis the Setting Aside of a Foreign Award

The Supreme Court, in the case of *Phulchand Exports Ltd. v. OOO Patriot* [(2011) 11 Scale 475], examined the scope of the expression 'public policy' under Section 48 (2) of the Arbitration and Conciliation Act, 1996 (the "**Arbitration Act**"), in relation to the setting aside of a foreign arbitral award on the grounds of 'public policy'. The instant case involved a dispute between Phulchand Exports Ltd., Mumbai ("**Phulchand**") and OOO Patriot, Moscow, Russia ("**Patriot**") in relation to a contract for sale of rice, in respect of which, Phulchand filed a claim for damages with the International Court of Commercial Arbitration at the Chamber of Commerce and Industry of the Russian Federation (the "**Arbitral Tribunal**"). The Arbitral Tribunal found both Phulchand and Patriot, to be in breach of the contract and passed an award, splitting the losses equally between the parties. The Arbitral Tribunal also directed Patriot to make payment of a specified amount with interest to Phulchand for registry and arbitrage fees. Phulchand sought enforcement of the award in India by filing an arbitration petition in the Bombay High Court under Sections 47 and 48 of the Arbitration Act. The enforcement of the same was resisted by Patriot on the ground that the award was opposed to the public policy of India. After being dismissed by a single judge and division bench of the Bombay High Court, Patriot approached the Supreme Court of India by way of special leave petition.

The Supreme Court, while importing the wider meaning given to this term in its previous decision in *Oil and Natural Gas Corporation Limited v Saw Pipes Limited* [(2003) 5 SCC 705] (the "**Saw Pipes Judgment**"), which dealt with the issue of the setting aside of a domestic award under Section 34 of the Arbitration Act on the grounds of 'public policy', wherein the court had given an expansive interpretation to the term 'public policy' by ruling that 'patent illegality' would be included as being violative of 'public policy. In the instant case, the Supreme Court held that a foreign award challenged under Section 48 of the Arbitration Act can be set aside "if it is patently illegal", though it dismissed Patriot's petition on merits due to the award not being 'patently illegal'.

The Supreme Court appears to have overlooked the fact that in the Saw Pipes Judgment patent illegality was included as a ground of challenge on the basis that 'public policy' is required to be interpreted

broadly in case of challenges to domestic arbitral awards, as the awards are yet to become final and executable. However the Supreme Court has now extended the interpretation of the Saw Pipes Judgment of 'public policy', to foreign arbitral awards, which have already been conclusively determined in the countries that they were made in. This may spark a dangerous trend in future cases where courts may be inclined to allow the parties to re-agitate their disputes in respect of awards that have already been conclusively determined. Additionally, a foreign award brought to India for enforcement, may be based on a substantive law other than Indian law. Thus, under the amorphous concept of 'patent illegality', we may see a scenario where Indian courts are called on to rule on a foreign award by applying a foreign legal system.

Yograj Infrastructure v Ssang Yong Engineering & Construction Co. Ltd.

The Supreme Court, in the case of *Yograj Infrastructure v Ssang Yong Engineering & Construction Co. Ltd.* (2011 (9) SCALE 567), dealt with the issue of implied exclusion of Part I of the Arbitration and Conciliation Act, 1996 (the "**Arbitration Act**") in case of international commercial arbitration. In the instant case, the National Highways Authority of India awarded a contract to the respondent, Ssang Yong Engineering & Construction Co. Ltd. ("**Ssang Yong**"), a Korean Company, to upgrade an existing highway. Ssang Yong had sub-contracted the work to Yograj Infrastructure Limited ("**Yograj**"). Thereafter, there was a dispute regarding the sub-contract between Ssang Yong and Yograj, which was referred to arbitration. Though the contract was governed by Indian law, Yograj and Ssang Yong both filed applications for interim reliefs under Section 17 of the Arbitration Act, before the sole arbitrator, who passed an interim order in favour of Ssang Yong. Aggrieved by the order, Yograj filed an appeal under Section 37(2)(b) of the Arbitration Act before the district judge, to set aside the interim order, which Ssang Yong challenged on the ground of maintainability. The district court ruled against Yograj, who after unsuccessfully filing a civil revision appeal, appealed to the Supreme Court.

The Supreme Court has held that where there is a foreign seat of arbitration, the curial law (i.e. the law that governs the arbitration / the procedural law governing the arbitration) being Singaporean law and procedural rules being the Singapore International Arbitration Centre ("**SIAC**") Rules (the "**SIAC Rules**") were foreign law / rules, due to which, Part I of the Arbitration Act would be excluded by implication. The Supreme Court noted that Rule 32 of the SIAC Rules, expressly states that where the seat of arbitration is Singapore, the law of the arbitration under the SIAC Rules, shall be the International Arbitration Act, 2002 (of Singapore). This judgment is one in a long line of decisions, starting from *Bhatia International v. Bulk Trading S.A & Anr.* [(2002) 4 SCC 105] (the "**Bhatia International Judgment**"), including its recent ruling in *Videocon Industries v. UOI* [2011 (5) SCALE 678] (the "**Videocon Judgment**"), which tries to clarify the instances when Part I of the Arbitration Act, would be deemed to be 'impliedly' excluded, in respect of international commercial arbitrations held outside India.

Though the Supreme Court has ruled in this judgment and its other recent ruling in the Videocon Judgment, that where there is a foreign seat of arbitration, the curial law and rules of procedure were foreign law / rules, Part I of the Arbitration Act would be excluded by implication. However, in view of the differing interpretations in the several judgments following the Bhatia International Judgment, it is advisable while drafting a contract, to consider the "express exclusion" of Part I of the Arbitration Act, if that is the intention of the parties.

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