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Indian Depository Receipts | Limited Two Way Fungibility | A Step Ahead…

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Date: September 15, 2012

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India is in a very different position now from what it was 50 or even 20 years ago because the Government of India has always been promoting globalization to reduce the geographical boundaries with new initiatives every now and then.

As of today's scenario, we all know how rapidly the instruments traded at the stock exchanges are changing the world economy. This is a sign of a developing country that Securities and Exchange Board of India (SEBI) is also not ignorant about this fact and they have come up with change that we all have been waiting for i.e. ***limited two way fungibility*** in case of **Indian Depository Receipts (IDRs**).

The circular CIR/CFD/DIL/10/2012[1], dated August 28th, 2012 from SEBI has paved the way for limited two-way fungibility for the IDRs. This circular states that after the completion of one year from the date of issuance of IDRs, redemption of the IDRs shall be permitted only if the IDRs are infrequently traded on the stock exchange(s) in India. This circular seems to have given the investors an added advantage, as they can now redeem the IDRs with fewer hassles. However since SEBI being at an apex level have to take a balanced decision, it has further added that in order to retain the domestic liquidity, it would allow only partial fungibility of IDRs (i.e. redemption/conversion of IDRs into underlying equity shares) in a financial year to the extent of 25 % of the IDRs originally issued.

$ 5 Billon is the limit for raising capital through IDR route as quoted in **RBI notification RBI/2012-13/178[2], dated August 28th, 2012**. The positive factor behind this said limit is that, it would cap the amount that the foreign companies may raise through IDR issuances, which would help RBI to avoid fluctuation in foreign exchange.

In order to know more about this amendment let us start from the scratch:

What exactly is IDR?

"As per the definition given in the Companies (Issue of Indian Depository Receipts) Rules, 2004, IDR is an instrument in the form of a Depository Receipt created by the Indian depository in India against the underlying equity shares of the issuing company. In an IDR, foreign companies would issue shares, to an Indian Depository (say National Security Depository Limited – NSDL), which would in turn issue depository receipts to

[1] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1346153584231.pdf
[2] http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7530&Mode=0

investors in India. The actual shares underlying the IDRs would be held by an Overseas Custodian, which shall authorize the Indian Depository to issue the IDRs".

IDR is an instrument denominated in Indian Rupees in the form of a depository receipt by a Domestic Depository. IDR is a good medium for Indian investor to take part in the foreign company's growth and also foreign company can raise funds from domestic market. Standard Chartered PLC is the first foreign company who issued IDR, and same was listed on BSE and NSE on June, 2011.

Eligibility for issue of IDRs:

The eligibility criteria for issue of IDR are as follows:

1. Pre-issue paid up capital and free reserves of foreign company should be at least US $ 50 million and should have minimum average market capitalization in its parent country of at least US $ 100 million during the last 3 years.
2. There should be continuous trading record in its parent country for at least 3 immediately preceding years.
3. There should be a track record of distributable profit for at least 3 out of immediately 5 preceding years.
4. Company should be listed in its home country and should have good track record with respect to compliance with securities market regulation.
5. The size of an IDR issue shall not be less than Rs. 50 crores.

Relevant Circular and amendments

As we all know Rome was not built in a day, the same way in order to come up with such a drastic change the law makers also went through different stages of amendments.

Initially, the **Ministry of Corporate Affairs** came up with a notification **G.S.R. 131 (E), dated 23rd Feb, 2004**[3] to create the initial framework for the issuance of IDR.

When it was noticed that the lock in period of 1 year was not very feasible, **MCA** introduced an amendment vide **notification G.S.R.35 (E) dated, 19th Jan, 2009**[4] for the removal of 1 year lock-in period for conversion of IDR into equity share.

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[3] http://www.mca.gov.in/Ministry/notification/Notifications_2004/noti_23022004_GSR131E.html
[4] http://www.mca.gov.in/Ministry/notification/pdf/GSR35(E)_20jan2009.pdf

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Due to increase in fluctuation in the redemption of IDR, RBI decided to re introduce the lock in period of 1 year for conversion of IDR into equity shares vide through **RBI notification RBI/2009-10/106 dated, 22nd July, 2009[5].**

Further **SEBI** came up with additional requirement for redemption of IDR through its **circular CIR/CFD/DIL/3/2011, dated 3rd June, 2011[6]**

28th Aug, 2012 came up with dual amendments, one through **SEBI circular CIR/CFD/DIL/10/2012[7]** stating the limited two way fungibility and the other through **RBI notification G.S.R. 131 (E)** [8] stating the limit of 5$ billion for investment

Detailed analysis and implications of current circular:

Opportunity for the domestic investors:

For the Indian investors who invest in IDRs, gives them an opportunity to invest in a foreign company. Now investor will take keen interest for investment in IDRs as they have an option of two way fungibility.

Encouragement of foreign participation in Indian capital market:

Day by day the Indian capital market is becoming more and more attractive for the foreign company. Such initiative will definitely give encouragement for the foreign company to participate in Indian Capital market.

Exit route for investors for infrequently traded IDRs:

Earlier there was one year lock in period for redemption of IDRs, but now that SEBI has removed this lock in period, the investor can redeem IDRs not only after 1 year but also at their own convenience as well. This will be a beneficial move for infrequently traded IDRs.

Tax implications – no clarity on tax implication:

If we look from the tax point of view the only place where this circular lacks behind is that

[5] http://rbidocs.rbi.org.in/rdocs/notification/PDFs/APDIR5220709.pdf
[6] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1308552299671.pdf
[7] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1346153584231.pdf
[8] http://www.mca.gov.in/Ministry/notification/Notifications_2004/noti_23022004_GSR131E.html

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- If there is no specific exemption on gain arising from redemption of IDR into equity shares then it is assumed that it is taxable under Income Tax Act, 1961under the head capital gain tax.
- Dividend received would be subject to tax as income from other source and tax at regular tax rate applicable to tax payer.

We have positively accepted this move of the SEBI and RBI and this move should make the IDRs more marketable as they have been only in the list of means of raising funds but barely in use; however it would be more appreciable if the limit of US $5 billion will be removed, as it would be a welcome note for both the foreign company and the domestic investor to reduce the geographical boundaries in capital market.