

Indian Depository Receipt- A gateway to overseas entities into the Indian capital markets.

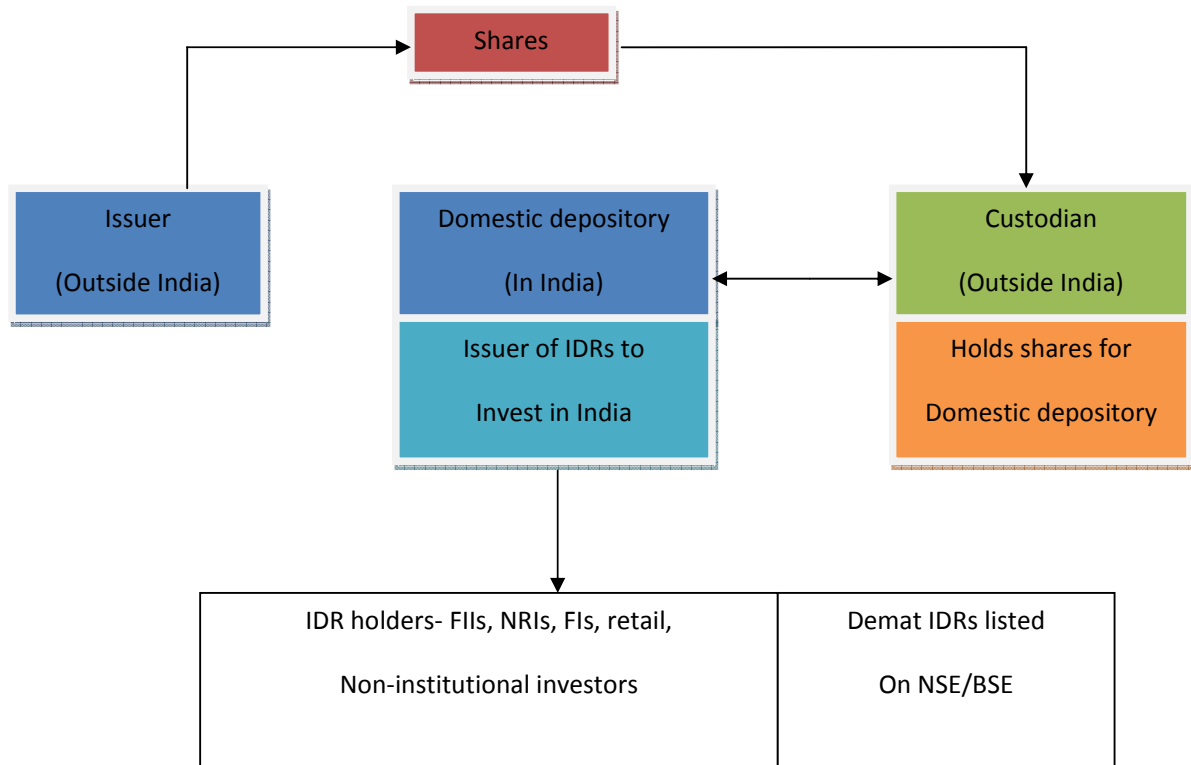
Background

History is about to be created with Standard Chartered Bank coming up with the maiden Indian Depository Receipt (IDR) issues on the 25th day of May this year. The issue size is worth \$ 750 million and it will be open for 2 days time. Till now we used to be proud of our companies going overseas with American Depository Receipt (ADR) and Global Depository Receipt (GDR) for raising capital abroad but it is really heartening to see that even gigantic banks and companies abroad has started taking note of Indian market as a source of capital raising and not only a place where they throw their short term surplus for making speculative gains and pulling out of their investments caring least about the impact on the health of capital markets in the country. Right now it would be too early to predict anything but if the issue becomes a success and the trend continues for some more time then it will certainly open new doors for Indian investors and both primary and secondary markets would become more global in nature imbibing great practices being followed the world over.

IDR- What it is?

According to FAQs issued by SEBI in this regard an IDR is defined as “an instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository (custodian of securities registered with the SEBI) against the underlying equity of issuing company to enable foreign companies to raise funds from Indian securities markets”. In a sense IDRs are a kind of derivatives which derive their values from the underlying assets in this case the foreign companies’ shares.

The workings of an IDR is shown in the following diagram



Legal Provisions Governing an IDR

The issue of IDRs is governed by Companies Act, 1956, SEBI (Issue of Capital and Disclosure Requirements), Regulations 2009 and RBI Circular on the same. Apart from these the regular requirements applicable to any issue and listing of shares are applicable in this case also.

Companies (Issue of Indian Depository Receipts) Rules, 2004: There are some very relevant and mandatory provisions to be complied for issue, listing, transfer and disclosure purpose in case of an IDR. Some of important among them are as follows-

1. **Applicability:** These rules shall apply only to those companies incorporated outside India, whether they have or have not established any place of business in India. Thus these rules are extra territorial in nature.
2. **Eligibility for issue of IDRs:** Without prejudice to anything contained in the Securities and Exchange Board of India Act, 1992, an issuing company may issue IDRs only if it satisfies the following conditions-
 - a) Its pre-issue paid-up capital and free reserves are at least US\$ 100 million and it has had an average turnover of US\$ 500 million during the 3 financial years preceding the issue.
 - b) It has been making profits for at least five years preceding the issue and has been declaring dividend of not less than 10% each year for the said period.
 - c) Its pre-issue debt equity ratio is not more than 2:1.
 - d) It shall fulfil the eligibility criteria laid down by SEBI from time to time in this behalf.
3. **Procedure for making an issue of IDRs:**
 - a) No issuing company shall raise funds in India by issuing IDRs unless it has obtained prior permission from the SEBI. An application seeking permission shall be made to the SEBI at least 90 days prior to the opening date of the issue, in such form furnishing such information as may be notified from time to time with a non-refundable fee of US \$10,000. Provided that, on permission being granted, an applicant shall pay an issue fee of half a percent of the issue value subject to a minimum of Rs.10 lakhs where the issue is up to Rs.100 crore in Indian rupees. Provided further where the issue value exceeds Rs.100 crore, every additional value of issue shall be subject to a fee of 0.25 percent of the issue value. The SEBI may, on receipt of an application seeking permission call for such further information, and explanations, as may be necessary, for disposal of such application.
 - b) The issuing company shall obtain the necessary approvals or exemption from the appropriate authorities from the country of its incorporation under the relevant laws relating to issue of capital, where required.
 - c) The issuing company shall appoint an overseas custodian bank, a domestic depository and a merchant banker for the purpose of issue of IDRs and deliver the underlying equity shares or cause them to be delivered to an Overseas Custodian Bank and the said bank shall authorize the domestic depository to issue IDRs.

- d) The issuing company shall file through a merchant banker or the domestic depository a due diligence report with the Registrar and with SEBI in the form specified.
 - e) The issuing company shall, through a merchant Banker file a prospectus or letter of offer certified by two authorized signatories of the issuing company, one of whom shall be a whole-time director and other the Chief Accounts Officer, stating the particulars of the resolution of the Board by which it was approved, with the SEBI and Registrar of Companies, New Delhi, before such issue.
 - f) The draft prospectus or draft letter of offer shall be filed with SEBI, through the merchant banker, at least 21 days prior to the filing the prospectus or letter of offer. Provided that if within 21 days from the date of submission of draft prospectus or letter of offer, SEBI specifies any changes to be made therein, the prospectus shall not be filed with the SEBI/Registrar of Companies unless such changes have been incorporated therein.
 - g) The issuing company, seeking permission under sub-rule (i) above, shall obtain in-principle listing permission from one or more stock exchanges having nationwide trading terminals in India.
4. IDRs shall not be redeemable into the underlying equity shares before the expiry of one year period from the date of the issue of the IDRs.
5. IDRs issued by any issuing company in any financial year shall not exceed 15 per cent of its paid-up capital and free reserves.
6. The Merchant Banker to the issue of IDRs shall deliver for registration the following documents or information to the SEBI and Registrar of Companies at New Delhi, namely:-
- a) instrument constituting or defining the constitution of the issuing company;
 - b) the enactments or provisions having the force of law by or under which the incorporation of the issuing company was effected, a copy of such provisions attested by an officer of the company be annexed;
 - c) if the issuing company has established place of business in India, address of its principal office in India;
 - d) if the issuing company does not establish principal place of business in India, an address in India where the said instrument, enactments or provision or copies thereof are available for public inspection, and if these are not in English, a translation thereof certified by a responsible officer of the issuing company shall be kept for public inspection;
 - e) a certified copy of the certificate of incorporation of the issuing company in the country in which it is incorporated;
 - f) copies of the agreements entered into between the issuing company, the overseas custodian bank, the domestic depository, which shall inter alia specify the rights to be passed on to the IDR holders;
 - g) if any document or any portion thereof required to be filed with the SEBI/ Registrar of Companies is not in English language, a translation of that document or portion thereof in English, certified by a responsible officer of the company to be correct and attested by an authorised officer of the Embassy or Consulate of that country in India, shall be attached to each copy of the document.

- h) The prospectus to be filed with the SEBI and Registrar shall contain the particulars as prescribed in Schedule and shall be signed by all the whole-time directors of the issuing company and by the Chief Accounts Officer.

7. Conditions for the issue of prospectus and application are as follows:

- a) No application form for the securities of the issuing company shall be issued unless the form is accompanied by a memorandum containing the salient features of prospectus in the specified form.
- b) An application form can be issued without the memorandum as specified in clause (i) above if it is issued in connection with an invitation to enter into an underwriting agreement with respect to the IDRs.
- c) The prospectus for subscription of IDRs of the issuing company which includes a statement purporting to be made by an expert shall not be circulated, issued or distributed in India or abroad unless a statement that the expert has given his written consent to the issue thereof and has not withdrawn such consent before the delivery of a copy of the prospectus to the SEBI and Registrar of Companies, New Delhi, appears on the prospectus.
- d) The person(s) responsible for issue of the prospectus shall not incur any liability by reason of any non-compliance with or contravention of any provision of this rule, if-
 - i. as regards any matter not disclosed, he proves that he had no knowledge thereof; or
 - ii. as regards any matter not disclosed, he proves that he had no knowledge thereof; or

8. Listing of Indian Depository Receipt: The IDRs issued under this Rule shall be listed on the recognized Stock Exchange(s) in India and such IDRs may be purchased, possessed and freely transferred by a person resident in India as defined in section 2(v) of Foreign Exchange Management Act, 1999, subject to the provisions of the said Act.

9. Procedure for transfer and redemption:

- i. A resident holder of IDRs may transfer the IDRs or may ask the Domestic Depository to redeem these IDRs, subject to the provisions of the Foreign Exchange Management Act, 1999 and other laws for the time being in force.
- ii. In case of redemption, Domestic Depository shall request the Overseas Custodian Bank to get the corresponding underlying equity shares released in favour of the Indian resident for being sold directly on behalf of Indian resident, or being transferred in the books of issuing company in the name of Indian resident and a copy of such request shall be sent to the issuing company for information.
- iii. In case of redemption, Domestic Depository shall request the Overseas Custodian Bank to get the corresponding underlying equity shares released in favour of the Indian resident for being sold directly on behalf of Indian resident, or being transferred in the books of issuing company in the name of Indian resident and a copy of such request shall be sent to the issuing company for information.

10. Continuous Disclosure Requirements:

- i. The Issuing company shall furnish to the Overseas Custodian Bank and Domestic Depository, a certificate obtained by it from the statutory auditor of the company or a Chartered Accountant about utilization of funds and its variation from the projections of utilization of funds made in the prospectus, if any, in quarterly

intervals and shall also publish it or cause to be published in one of the English language newspapers having wide circulation in India.

- ii. The quarterly audited financial results should be prepared and published in newspapers in the manner specified by the listing conditions.
11. **Distribution of corporate benefits:** On the receipt of dividend or other corporate action on the IDRs as specified in the agreements between the issuing company and the Domestic Depository, the Domestic Depository shall distribute them to the IDR holders in proportion to their holdings of IDRs.
12. **Penalty:** If a company or any other person contravenes any provision of these rules for which no punishment is provided in the Act, the company and every officer of the company who is in default or such other person shall be punishable with the fine which may extend to twice the amount of the IDR issue and where the contravention is a continuing one, with a further fine which may extend to five thousand rupees for every day, during which the contravention continues.
13. **Repeal and savings:** On the commencement of these rules, all rules, orders or directions in force in relation to any matter for which provisions are made in these rules shall stand repealed, except as respects things done or omitted to be done before such repeal.
14. **Power of Central Government to decide certain Questions:** If any question arises on the applicability and interpretation, such question shall be decided by the Central Government.

Companies Act, 1956:

Apart from the above mentioned provisions under the Companies (Issue of Indian Depository Receipt) Rules 2004, the provisions in Companies Act with regards to Foreign Companies as mentioned in Sections 591 to 608 shall continue to be applicable. This is to be noted that the above Rules itself are issued by the Central Government through Ministry of Corporate Affairs taking power from Section 605A [inserted by Companies (Amendment) Act, 2000] of the Companies Act 1956. Also Sections 603, 604, 605, 606 and 607 specifically deal with the issue of Prospectus by a Foreign Company offering its shares or debentures for subscription by the public. Let us see some of the points in Companies Act, 1956 which attract or are likely to attract an issue of IDR:

1. **Obligation of Foreign Company as to state certain things in its prospectus-** As per Clause (a) Section 595 *“every Foreign Company shall in every prospectus inviting subscriptions in India for its shares or debentures, state the country in which the company is incorporated”*. Also sub-section (i) of Clause (d) of Section 591 states that *“if the liability of the members of the company is limited, cause notice of that fact to be stated in every such prospectus as aforesaid and in all.....”* As per Section 598 *“If any foreign company fails to comply with any of the foregoing provisions of this part, the company, and every officer or agent of the company who is in default, shall be punishable with fine which may extend to ten thousand rupees, and in the case of a continuing offence, with an additional fine which may extend to one thousand rupees for every day during which the default continues.”*
2. **Provisions relating to Prospectuses- its form and contents-** Section 603 deals in details about the form and contents of the prospectuses issued by a foreign company. Some of the salient features of these are discussed below-

No person shall issue, circulate or distribute in India any prospectus of a foreign company with or without its place of business in India, unless the same is dated and contains following information-

- a) The instrument constituting or defining the constitution of the company
- b) The enactments or provisions having the force of enactments, by or under which the incorporation of the company was effected
- c) An address in India where the said instrument, enactments, or provision, or copies thereof, and if the same are not in English, a translation thereof certified in the prescribed manner, can be inspected
- d) The date on which and the country in which the company was incorporated
- e) Whether the company has established a place of business in India, and if so, the address of its principal office in India

3. Provisions as to expert's consent and allotment- A prospectus issued by a foreign company for raising share capital shall not include a statement purporting to be an expert's comment if the same is not given, in writing, by the expert, or has withdrawn the same before delivery of the prospectus for registration. An "expert" includes an engineer, a valuer, an accountant or any other person whose profession gives authority to a statement made by him. [Section 604]

4. Registration of prospectus- A prospectus to be valid for a foreign company must be before its issue, circulation or distribution be certified by the chairman and two other directors of the company as having been approved by resolution of the managing body and delivered for registration to the Registrar. It should state on its face that the same has been delivered for registration and it is attached with any expert consent and any contract which is not reduced in writing as per Part II of Schedule II. [Section 605]

5. Penalty and Civil Liability- Section 606 mentioned below under the *italics* states the provisions regarding imposition of penalty.

"Any person who is knowingly responsible-

- a) *for the issue, circulation or distribution of prospectus; or*
- b) *for the issue of a form of application for shares, debentures or **Indian Depository Receipts;***

in contravention of any of the provisions of sections 603, 604, 605 and 605A shall be punishable with imprisonment for a term which may extend to six months or with fine which may extend to fifty thousand rupees, or with both."

Section 606 talks about the civil liability for mis-statements in prospectus. It is to be noted that provisions of section 62 are equally applicable with a mis-statement in prospectus offering an IDR by a foreign company.

SEBI (Issue of Capital and Disclosure Requirements) 2009:

The principal requirements for a public issue of securities as per clause 26 of Chapter III of SEBI (Issue of Capital and Disclosure Requirements), Regulations 2009 are as below-

1. It has net tangible assets of at least INR 3 Crores in each of the preceding three full years (of twelve months each), of which not more than fifty percent are held in monetary assets; provided that if more than fifty percent of of net tangible assets are held in monetary assets,

- the issuer has made firm commitment to utilise such excess monetary assets in its business or projects,
2. It has a track record of distributable profit under section 205 of Companies Act, 1956, for at least three out of immediately preceding five years provided that extra-ordinary items shall not be considered while calculating the distributable profits,
 3. It has a net worth of at least INR One crore in each of the preceding three full years (of twelve months each)
 4. The aggregate of the proposed issue and all the previous issues made in the same financial year in terms of the issue size does not exceed five times its pre-issue net worth as per the audited balance sheet of the preceding financial year;
 5. If it has changed its name within the last one year, at least fifty percent of the revenue for the preceding one full year has been earned by it from the activity indicated by the new name.

Apart from these following additional requirements are envisaged under eligibility criteria for IDR issue under SEBI Rules and Guidelines-

The foreign issuing company shall have-

1. pre-issue paid-up capital and free reserves of at least US\$ 500 million and has a minimum average market capitalisation (during the last three years) in its parent country of at least US\$ 100 million;
2. a continuous trading record or history on a stock exchange in its parent country for at least three immediately preceding years;
3. a track record of distributable profits for at least three out of preceding five years;
4. listed in its home country and not prohibited to issue securities by any Regulatory Body and has a good track record with respect to compliance with securities market regulations.

Apart from above, SEBI has also issued Model Listing Agreement for an IDR.

RBI Circular:

According to Circular No. 5 dated 22nd July, 2009 issued by RBI for IDRs compliances, following are main requirements and provisions to be looked upon-

1. The FEMA Regulations shall not be applicable to persons resident in India as defined under section 2(v) of FEMA 1999, for investing in IDRs and subsequent transfer arising out of transaction on a recognised stock exchange in India.
2. FIIs including SEBI approved sub accounts of FIIs, registered with SEBI and NRIs may also invest, purchase, hold and transfer IDRs of eligible companies resident outside India and issued in the Indian capital market, subject to the Foreign Exchange Management (Transfer or issue of Security by persons resident outside India), Regulations, 2000.
3. Further NRIs are allowed to invest in the IDRs out of funds held in their NRE/FCNR(B) Accounts maintained with an authorised dealer/authorised bank.
4. Fungibility- Automatic fungibility of IDRs is not permitted. Fungibility refers to the process of conversion of a derivative into its underlying assets. A person can get an IDR converted into the share of foreign company only with the prior approval of RBI. An investor can get his IDR

converted into its underlying share of foreign company just for the purpose of selling it off and he can keep the same for more than 30 days.

5. Redemption- The IDRs shall not be redeemable into underlying equity shares before the expiry of one year period from the date of issue of the IDRs.
6. At the time of redemption / conversion of IDRs into underlying shares, the Indian holders (persons resident in India) of IDRs shall comply with the provisions of the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 as amended from time to time.
7. The proceeds of the issue of IDRs shall be immediately repatriated outside India by the eligible companies issuing such IDRs.
8. The IDRs issued shall be denominated in Indian Rupees.

Expected advantages and disadvantages from an IDR issue

When we talk about the advantages or disadvantages involved in an issue of IDR we can only foresee or try to predict something based on some genuine and valid logic since this is going to be the maiden IDR issue. But everything in this world has to start at some point of time or the other and perhaps change is the only factor which is constant. And what can be a better example of imbibing change than the capital market and financial sector. We have seen some of the radical changes and reforms in capital market- not only in the regulatory mechanism but also in the types of instruments, players and intermediaries involved. The change and reform are more a matter of survival than choice. If we do not change we will perish and die away in the new changed world order.

Some of the advantages of an IDR issue can be pointed out as below:

- I. Integration of Indian capital market with the world market
- II. Scope of the increased arbitrage opportunity
- III. Opportunity before Indian investors to buy a foreign stock without attracting restrictive provisions of FEMA (Discussed above)
- IV. Exposure of Indian stock exchanges to the best practices being followed worldwide
- V. Increased chances of Indian corporate sector being more efficient due to global competition in the primary market
- VI. Foreign companies will become more regulated and monitored due to attracting several legal provisions pursuant to the issue and listing of an IDR

Some of the disadvantages or apprehensions attached with an IDR are as follows:

- I. Indian domestic companies will have to compete with the overseas players for the funds in the primary market
- II. There is an apprehension of negative capital flow
- III. It may give rise to Indian investors being exposed to the malpractices by foreign players and hence more stringent norms are required which seems to be missing at present

Conclusions

Long back the great Chinese philosopher, Lao Tse Tung said, *“Even a march of civilization starts with a single step”*. This IDR issue is just a little first step towards a new era of Indian capital market the picture of which is not clear yet. But what is clear at this point is the fact that if India has to be an Economic superpower then it will certainly have to integrate with the world of today. An IDR issue is just an example of the confidence shown by world in our economy. For full faith to be proved we need many of such IDRs. Right now we can just wait and watch with our fingers crossed the upcoming IDR issue by Standard Chartered Bank.