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Limited Two-Way Fungibility Allowed For Indian Depository Receipts

*By Aditya Shukla, Ruchi Biyani, and Vyapak Desai, of
Nishith Desai Associates, Mumbai.*

The Securities and Exchange Board of India (SEBI), the Indian securities market regulator, and the Reserve Bank of India (RBI), the Indian central bank, through respective circulars (SEBI Circular No. CIR/CFD/DIL/10/2012 and Reserve Bank of India A.P. (DIR Series) Circular No. 19, both dated August 28, 2012), have paved the way for limited two-way fungibility for Indian Depository Receipts (IDRs). Fungibility in this context refers to the ability of the holder of an IDR to convert it into the underlying equity security and *vice versa*.

Previously, the existing regulations did not allow holders of underlying equity shares to convert such equity shares into IDRs. However, redemption of an IDR into underlying equity shares was permissible subject to the fulfillment of certain conditions, such as a minimum holding period of one year from the date of issue of the IDRs and such IDR qualifying as an infrequently traded security on the stock exchange(s) in India. This regulatory position has now being modified by SEBI and RBI to provide for limited two-way fungibility for IDRs, similar to the fungibility available in the case of an American Depository Receipt (ADR) or a Global Depository Receipt (GDR).

Background

An IDR is basically a security listed on an Indian stock exchange, with its underlying being a listed security of a foreign incorporated and listed entity. The introduction of IDRs in the Indian securities market and the legal framework governing them was put in place with the objective to facilitate capital raising by foreign investors from the domestic market, and at the same time providing domestic investors an opportunity to make investments in securities of well-recognized multinational companies listed on developed markets. So far, there is only one foreign company, Standard Chartered Bank Plc, whose IDRs have been listed on an Indian stock exchange.

The regulatory position with respect to IDRs has been evolving ever since the regulatory framework governing IDRs was introduced by the Ministry of Corporate Affairs in 2004.

The previous Indian regulatory framework allowed redemption/conversion of IDRs into the underlying foreign security only after fulfillment of the prescribed conditions. The regulatory change will now enable even the conversion of equity shares of a foreign issuer into IDRs, to the extent of IDRs that have been redeemed/converted into underlying shares and sold.

The regulatory development allowing limited two-way fungibility flows from the announcement made by the then finance minister in his budget speech earlier this year.

The following are some of the key highlights of this regulatory development:

Redemption/Conversion of IDRs into Equity Shares

Redemption Capped at 25 Percent of Originally Issued IDRs in a Financial Year

The circulars have now put in place a cap of 25 percent of the originally issued IDRs as a maximum limit for redemption/conversion in a given financial year. This limit means that, in any given financial year, not more than 25 percent of the originally issued IDRs may be redeemed/converted into underlying equity shares of the foreign issuer whose IDRs are listed, subject to the requirement of holding such IDRs for a period of at least one year from their issuance. Prior to this regulatory change, there was no ceiling on the number of IDRs that could be redeemed/converted into equity shares subject to fulfillment of eligibility criteria (discussed below).

The introduction of this ceiling in light of allowing limited two-way fungibility appears to be logical so that the IDR market is not adversely impacted due to substantial redemptions.

Eligibility Criteria for Redemption/Conversion

- **Minimum period of holding:** One of the prerequisites for redemption of IDRs into underlying equity shares is expiry of one year from the date of issue of the IDRs (the “Lock-in Period”) (Reserve Bank of India A.P. (DIR Series) Circular No. 19 dated July 22, 2009). The recent circulars have retained this eligibility criterion of minimum holding period of at least one year from the date of issue of the IDRs, as prescribed in RBI’s Circular No. 19 dated August 28, 2012 (para 2(i)), to be eligible for redemption/conversion of the IDRs into underlying equity shares.
- **No requirement for IDRs to be “infrequently traded”:** SEBI, through its circular dated June 3, 2011, had prescribed an additional requirement for IDRs to be “infrequently traded” on stock exchange(s) in addition to the requirement of Lock-in Period for the IDRs to be eligible for redemption. (SEBI Circular No. CIR/CFD/DIL/3/2011 dated June 3, 2011, explains “infrequently traded” to mean that the annualized trading turnover in IDRs during the six calendar months immediately preceding the month of redemption is less than 5 percent of the listed IDRs.) This requirement for an IDR to be “infrequently traded” has now been removed, as SEBI has now rescinded its Circular No. CIR/CFD/DIL/3/2011 dated June 3, 2011.

In this regard, our firm, on behalf of many investors, had made representation to SEBI for removal of this requirement, which restricted the ability of IDR holders to freely redeem their IDRs into the underlying equity shares even after the expiry of the statutory Lock-in Period of one year.

The removal of this requirement comes as a big relief to

investors looking to exit, who were hitherto restricted because of this requirement.

Implication: The regulatory change of allowing two-way fungibility is a welcome move in the right direction towards increasing the viability of IDRs in the Indian markets. Additionally, the removal of the requirement for an IDR to be “infrequently traded” will go a long way in providing the required impetus to the IDR market.

Conversion of Equity Shares of the Foreign Issuer into IDRs Allowed to a Limited Extent

The regulatory framework governing IDRs now enables the conversion of equity shares into IDRs, which was previously not allowed. Such conversion will be limited to the pool of IDRs which were redeemed/converted into underlying equity shares by the original holders of IDRs. This condition appears to have been borrowed from the ADR/GDR guidelines, which allow dual fungibility to the extent of headroom created through redemption of these depository receipts, and thus creates a level playing field from a regulatory perspective between ADRs/GDRs and IDRs.

U.S.\$5 Billion Capital Raising Limit Introduced for Raising Capital through IDR Route

RBI has now put in place an overall limit of U.S.\$5 billion for the raising of capital through the issuance of IDRs. Although a separate limit in itself, this limit is similar to the limit which exists for foreign institutional investors investing in debt securities. Adherence to this limit will be monitored by SEBI.

Implication: Until now, there was no cap on the overall amount that could have been raised under IDR issuances. The now prescribed overall cap of U.S.\$5 billion through the IDR route appears sufficient for the time being, considering that so far only one foreign issuer has used this route to raise capital from the Indian markets.

The rationale for introducing such a limit could be to cap the amount foreign companies may raise from the domestic market, as well as to cap the outflow of capital through IDR issuances and/or to address systematic risk. However, such externally forced artificial limits are not efficiency-enhancing. Therefore, going forward, this limit should gradually be done away with or at least be continuously expanded in order to accommodate the capital raising needs of businesses.

Implications for Holders of Underlying Equity Shares Following Redemption/Conversion of IDRs

It is important to note that the recent RBI circular retains the requirement to comply with the condition enumerated in Regulation 7 of the earlier circular dated July 22, 2009, which provides the guidelines for holding underlying equity shares of the issuing company after the redemption of IDRs by listed Indian companies, domestic mutual funds and other persons resident in India.

Tax Implications

Currently, there are no specific tax provisions under the Income Tax Act, 1961 with respect to tax implications at the time of redemption of IDRs into underlying equity shares. While SEBI and RBI have provided for limited two-way fungibility, there exists no provision providing incentives under the tax laws to make the IDR regime attractive, *i.e.*, 1) any gains arising on redemptions of IDRs into the underlying equity shares, if not specifically exempt, would lead to the situation of the holder being subjected to tax in the absence of any realised gains, and hence making a redemption unattractive; and 2) dividends received would be subject to tax as income from other sources and taxed at the regular tax rates applicable to the taxpayer.

Conclusion

The rise of global finance has removed geographic boundaries for companies, enabling them to raise capital in markets across the world. Issuance of depository receipts is an innovative mechanism, especially for companies that are targeting to raise capital from a market other than the market of their primary listing.

Depository receipts provide mutual benefits to issuers, investors and the host market. Companies get to raise capital from willing investors, diversify their investor

base and fulfill strategic objectives, such as brand recognition. Investors get to invest in companies in which they otherwise could not have easily invested, diversifying their portfolios in the process. Ultimately, markets tend to become more efficient as increased access for investors through multiple listings enhances liquidity and improves price discovery.

The regulatory change brought about to allow limited two-way fungibility is a step in the right direction, and it should make IDRs relatively more marketable. However, the results are more likely to be visible only when the other challenges faced by the Indian capital market are addressed.

The text of SEBI Circular No. CIR/CFD/DIL/10/2012, dated August 28, 2012, in English, can be accessed at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1346153584231.pdf.

The text of Reserve Bank of India A.P. (DIR Series) Circular No. 19, dated August 28, 2012, in English, can be accessed at <http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=7530>.

Aditya Shukla and Ruchi Biyani are Associates, and Vyapak Desai is a Senior Associate and Head of the Capital Markets Practice, at Nishith Desai Associates, Mumbai. They may be contacted at aditya.shukla@nishithdesai.com, ruchi.biyani@nishithdesai.com, and vyapak.desai@nishithdesai.com.