Depository Receipts: IDR and its Legal Framework

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Introduction

With the advent of globalization Indian companies have entered into raising funds from foreign markets. The trend still continues but it is time to flip the coin and witness the other side. With the advent of globalization, there is a need amongst the investors to expand their horizons beyond their local security markets. In keeping with India's ongoing popularity as a preferred investment destination among international entities and India's aspirations to become a financial hub internationally, the Union government together with other regulatory bodies has consistently introduced and modified various instruments through which investments can be made.

In the recent years there has been an increased internationalization of various firms through cross listings on international exchanges, which has been supported by the process of market liberalization that has therefore provided greater integration of global securities markets. Globalization has affected every industry, every sector, every nation and every economy, giving rise to the concept of the world being a global village, which is having no boundaries. Cross-border listing by the various companies has become one of the important avenues for the integration of global securities markets. There are namely direct listing and indirect listing as two forms of cross-border. The meaning of the direct listing implies that the firm concerned offers ordinary shares to the public while on the other hand Indirect listing on exchanges is through Depository Receipts (DRs).

One such instrument which has been introduced is the Indian Depository Receipts (IDRs). IDRs are depository receipts denominated in Indian Rupees and transferable securities listed on Indian stock exchanges in the form of depository receipts issued by a foreign investor. IDRs are similar to the Global Depository Receipts (GDRs) and American Depository Receipts (ADRs), which allow companies to raise funds from European and American markets, respectively. Therefore through IDR foreign companies can directly raise capital in India rather than take recourse to GDRs/ADRs and to improve the liquidity in the secondary market in India.

To encourage foreign issuers to raise funds from the Indian capital markets through IDRs and enable investors in the domestic market to have investment opportunities in the securities of major multi-national companies listed on well- developed markets, a legal framework was created by the Ministry of Corporate Affairs (MCA), Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI).

In the Indian context, a Depository Receipt is referred to as an Indian Depository Receipt. Conceptually, the IDRs shall be issued by the Issuing Company, i.e., a foreign corporation desirous of raising capital in the Indian markets through an Indian financial institution

The term IDR has been defined under the Companies (Issue of Indian Depository Receipts) Rules, 2004. It states that:

"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."[1]

This paper is divided into four parts. The first part discusses the evolution and concept of IDRs and the need for IDRs in the Indian capital market. The second part discusses the working of IDR and the participants involved in the issuance of IDRs. The third part talks about the benefits to the issuing company, the employers, the investors and the regulators. Further it also discusses the challenges faced by IDRs in India. The last part goes on to elaborate the regulatory and legal framework, taxation, working, advantages and the challenges with respect to IDR's. This new instrument presents to the issuer as well as the Indian retail investor acquire an economic interest in a foreign company. IDRs are proposed to be listed on the Indian stock exchanges and will derive their value from the equity shares of the foreign company listed on their home jurisdiction stock exchange.

[1] Rule 3(i)(d), Companies(Issue of Indian Depository Receipts) Rules 2004

Depository receipts

The Globalization of Indian capital markets has accelerated in the past decade. Increasing numbers of Indian firms have chosen to raise capital by issuing and listing their Depositary Receipts (DRs) on the foreign markets.

A Depository Receipt contains characteristics of equity shares and therefore carries certain rights, The Depository Receipt holder, thus, enjoys the right to appropriate disclosures by the foreign company issuing Depository Receipts; the right to corporate benefits/ dividends attached to the Depository Receipts; and the right to vote under certain circumstances.

Companies that trade with the public by issuing shares get their shares listed and traded on various stock exchanges. Therefore, Indian companies which are already trading on Indian stock exchanges like the Bombay Stock Exchange (BSE) or National Stock Exchange (NSE) issue shares in the foreign market. These companies can be listed on foreign stock exchanges provided they comply with the legal framework of the foreign country. Therefore, most of the companies refrain from entering the capital market of a foreign country directly.

The Depository Receipts is a mechanism through which a company can enter the capital market in a foreign country indirectly. The company deposits a large number of its share with the bank situated in foreign country. This bank which we call overseas depository bank (ODB) then issues receipts which contain a fixed number of shares as an underlying. Then these receipts are listed on the stock exchange, which are therefore purchased by the investors in the respective foreign country. They behave exactly like regular stocks – their prices fluctuate depending on their demand and supply, and depending on the fundamentals of the underlying company. These receipts, which are traded like ordinary stocks, are called Depository Receipts. Each receipt amounts to a claim on the predefined number of shares of that company.

A depositary receipt is thus a type of negotiable transferable financial security that is traded on a local stock exchange but represents a security, usually in the form of equity that is issued by a foreign publicly listed company.[2] The Depository Receipt is a physical certificate which allows investors to hold shares in equity of other countries. One of the most common types of Depository Receipts is the American Depository Receipt (ADR), which has been offering companies, investors and traders global investment opportunities since the 1920s.[3] The other common type of Depository Receipt is the Global Depository Receipt (GDR).

DRs have often been used by domestic companies as investment vehicles in the form of American Depositary Receipts (ADRs) and Global Depositary Receipts (GDRs) for accessing foreign markets and investors. American Depositary Receipts are typically traded on US stock exchanges while the DRs that are traded on exchanges in other parts of the world are known as Global Depositary Receipts. Currently, DRs represent about 4% of the total world listing in the equity market.[4]

Thus, instead of being faced with impediments to foreign investment, as is often the case in many emerging markets, the DR investor and company can both benefit from investment abroad.[5]

In the Indian context, a Depository Receipt is referred to as an Indian Depository Receipt. IDRs are transferable securities listed on Indian stock exchanges in the form of depository receipts. Conceptually, the IDRs are issued by foreign corporation desirous of raising capital in the Indian markets through an Indian depository participant. The last mile issuance of actual instrument is done by an Indian depository participant. The Indian depository participant will issue depository receipts against the underlying equity shares of the foreign corporation. The introduction of IDR has created a new route for foreign companies to advantageously tap into Indian sources of capital at better valuations and cheaper administrative costs.

A. American Depository Receipt (ADR)

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[2] "What are depository receipts?", accessed from http://www.financialexpress.com/news/what-are-depository-receipts/161428/1

[3] *Id.*

[4] HDR, Mathew Harrison, http://www.hkex.com.hk/eng/rulesreg/listrules/listpresent/Documents/HDR_20080917.ppt>

[5] An introduction to depository receipts", http://www.investopedia.com/articles/03/091003.asp#axzz1c0SQRFhj

American Depositary Receipts have been introduced to the financial markets as early as April 29, 1927, when the investment bank J. P. Morgan launched the first-ever ADR program for the UK's Selfridges Provincial Stores Limited (now known as Selfridges plc.), a famous British retailer.

The American Depository Receipt (ADR) and Global Depository Receipt (GDR) are depository receipts which Indian companies can issue to raise funds. An American Depositary Receipt is a U.S. Dollar – denominated security that trades in the American market. The ODB situated in US issues ADR on behalf of the foreign company wishing its shares to be traded in the US stock market. Each ADR can represent one, more than one, or a fraction of underlying ordinary shares. The relationship between the ADR and the ordinary share is referred to as the ADR ratio.

The certificates issued by the bank are known as American Depository Receipts. Therefore, one American Depository Receipt represents a fixed number of shares in the parent company. The voting rights, if any, lie with the depository bank on behalf of the share holder.[6]

An ADR is a dollar denominated negotiable certificate that represents a non US company's publicly traded equity. It falls within the regulatory framework of the USA and requires registration of the ADRs and the underlying shares with the Securities and Exchange Commission. Non US companies have a choice of five types of ADRs-unsponsored, three levels of sponsored ADRs and one type of private ADR facility.

The ADRs can be listed only at the stock exchanges in the United States of America such as NASDAQ and Newyork Stock Exchange (NYSE). It is important to note that ADRs and GDRs are not for investors in India because they can invest directly in the shares of various Indian companies. However, through ADR and GDR foreign nationals can invest in the shares of Indian companies having them listed in their domestic stock exchange, meaning thereby, that the investors are rescued from the hassle of understanding the rules and functioning of Indian financial market.

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[6] Neshwin Noel, "Depository Receipts: The Indian Perspective" http://www.scribd.com/doc/26807815/Depositary-Receipts-The-Indian-Perspective

B. Global Depository Receipt (GDR)

A negotiable certificate held in the bank of one country representing the specific number of shares of a stock traded on an exchange of another country. It is a global finance vehicle, which allows an issuer to raise capital simultaneously in two or more markets through a global offering. GDR certificate are issued by the international bank which can be worldwide circulated on capital markets.

A Global Depositary Receipt is a security that is traded mostly in the European markets. The only difference between ADR and GDR is the location where they are traded. While the ADR's are traded in the American capital market, the GDR's are traded in any other country apart from United States of America. Wipro is one of the Indian companies which have issued both ADR's and GDR's.

Indian companies can raise foreign currency resources abroad through the issue of ADRs/ GDRs, in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Government of India thereunder from time to time.[7] ADRs / GDRs can be issued by the company if it is eligible to issue shares to investors outside India under the FDI Scheme. But company listed in Indian stock market, which is not eligible to raise funds from the Indian Capital Market including a company which has been restrained from accessing the securities market by the Securities and Exchange Board of India (SEBI) will not be eligible to issue ADRs/GDRs.[8]

Unlisted companies, which have not yet accessed the Global Depositary Receipt / Foreign Currency Convertible Bond route for raising capital in the international market would require prior or simultaneous listing in the domestic market, while seeking to issue such overseas instruments. Unlisted companies, which have already issued ADRs/GDRs in the international market, have to list in the domestic market on making profit or within three years of such issue of ADRs/GDRs, whichever is earlier.[9]

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[7]No.15/4/2004-NRI, A.P. (DIR Series) Circular No. 11 dated September 5, 2005, Ministry of Finance
[8] http://www.rbi.org.in/scripts/faqview.aspx?id=26
[9]*Id.*

Based on the success of ADRs and GDRs, the concept of Indian Depository Receipts was laid down to mark India's impact in the global market

C. Indian Depository Receipts (IDR)

This concept of IDRs has been derived from the American Depository Receipts and Global Depository Receipts which were already introduced in the 1920's.

The Department of Company Affairs (DCA), constituted the Joshi Committee, to identify the left over items of provisions of the Companies Bill, 1997.[10] Therefore the Companies Act, 1956 was amended on the recommendations of the Joshi Committee and Section 605 A was inserted which empowers the Central Government to make rules applicable for offer of Indian Depository Receipts:

"Notwithstanding anything contained in any other law for the time being in force, the Central Government may make rules applicable for—

(a) the offer of Indian Depository Receipts;
(b) the requirement of disclosures in prospectus or letter of offer issued in connection with Indian Depository Receipts;
(c) the manner in which the Indian Depository Receipts shall be dealt in a depository mode and by custodian and underwriters;
(d) the manner of sale, transfer or transmission of Indian Depository Receipts,
by a company incorporated, or to be incorporated outside India, whether the company has or has not been established or, will or will not establish any place of business in India."

The provisions in Companies Act with regards to Foreign Companies as mentioned in *Sections 591 to 608* shall continue to be applicable. Apart from the express provision of Section 605A, the Companies Act, 1956 also has 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.

[10]Press note, Joshi Committee, http://www.mca.gov.in/Ministry/pdf/press_release/press_joshi.html

The **Companies Act, 2013** has also incorporated the concept of Indian Depository Receipt which is identical to the Companies Act, 1956.[11]

Legal Framework Regulating Indian Depository Receipts

Regulatory Bodies

- The Securities and Exchange Board of India
- The Ministry of Corporate Affairs
- The Reserve Bank of India

Statutes Governing IDRs

- Section 605A of the Companies Act, 1956 or Section 390 of the Companies Act 2013
- Companies (Issue of Indian Depository Receipts) Rules 2004
- Chapter X of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

Chronological evolution of IDR Provisions:

Since 2000, the Indian Government has taken steps to liberalize India's corporate and securities laws to permit foreign companies to raise capital in India. As the ADR and GDR instruments became popular among investors globally, the Indian Government amended the Companies Act, 1956 by implementing Section 605-A which permits a foreign company to make a public offer of its shares to Indian investors in the form of IDRs. This amendment gives the Central Government the power to create the rules, regulations and conditions governing:

- The offer and issue of IDRs by a foreign company;

- The disclosure requirements in the prospectus issued for IDRs;

[11] Section 390, Companies Act, 2013

Additionally, the SEBI introduced guidelines to list IDRs on Indian stock exchanges under Chapter VIA of SEBI (Disclosures and Investor Protection) Guidelines, 2000 ("**DIP Guidelines**"), which have recently been replaced by the by SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR Regulations**"). Since then various amendments have been made in the regulatory framework of IDRs , including the recent Circular dated July 22, 2009 ("**RBI Circular**") issued by the RBI, the exchange control regulator in India, which renders clarity on the exchange control implication for investment in IDRs.