

Sebi stance change needed to ensure IDR survival

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The Securities & Exchange Board of India (Sebi) may need to modify its stance on Indian depository receipts (IDRs) to encourage investor appetite for the instrument thereby ensuring more issuances, lawyers, bankers and investors told dealReporter.

This comes after Sebi said last Friday that holders would be able to redeem only the receipts one year following an issuance if the IDR in question was infrequently traded on the Indian stock exchange. That would mean an annualised trading turnover in the preceding six months prior to redemption amounting to less than 5% of the IDR's float size.

Despite IDR regulations having been in force since 2006, to date only Standard Chartered [2888: HK; STAN:LN] has issued IDRs in the country in 2010. Since the annualised turnover of the bank's IDRs in the last six months stood at a little less than 50% of the total number of IDRs it issued, conversion will not be permitted. Other foreign companies, including HSBC Holdings Plc [HSBA:LN; 5:HK] and iGate Corp [IGATE:US] are known to have studied IDRs as a fundraising option, according to dealReporter. However, amid recent developments that have discouraged investor appetite, any interest from such companies could now have died, people familiar with the situation said.

Against this background, experts argue that Sebi's stance may be misguided.

"Considering the outcome of Sebi's recent directive on IDRs in consultation with the Reserve Bank of India, the regulator needs to reconsider the circular or at least make it prospective and not retrospective," said Shikhar Kacker, senior member at Nishith Desai Associates' Funds Practice.

Contrary to the market mantra that any new instrument introduced should provide liquidity to ensure its success and popularity, Sebi's new IDR guideline actually provides an incentive for illiquidity, according to Jagannadham Thunuguntla, strategist & head of research at SMC Global Securities.

End of the line?

Overseas companies considering IDRs as a funding tool already had a host of issues to grapple with, including taxation and fungibility, as well as the one-year lock-in period. With Sebi now permitting conversion only if the receipts are not liquid, IDRs could also be more difficult to price, a banker pointed out.

The consequence could be global companies shying away from issuing IDRs, meaning Standard Chartered's offering may be the first and the last, Thunuguntla said.

The bank's IDR closed 3.75% higher on Tuesday at INR 98.10 on the Bombay Stock Exchange, with Indian fund managers picking up the receipts as overseas investors dumped them on Monday, following Sebi's announcement. In early morning trades on Wednesday, the IDRs were up marginally but, more important, have started to regain earlier price levels and are currently trading at just under INR 100.

This could be a worrying sign for the market as foreign institutional investors (FIIs) had been the driving force behind the IDR trend, with regulation changes enacted last year to encourage their participation in Standard Chartered's IDR.

FIIs accounted for a substantial proportion of Standard Chartered's IDR holders, Kacker pointed out. According to media reports, institutional investors held as much as 69.86% while mutual funds held 10.12% of the total 240m IDRs as at 31 March 2011.

A key feature of depository receipts for international investors is the opportunity they offer to diversify their portfolios and hedge their risks, thereby enhancing returns, a lawyer pointed out. In the case of Standard Chartered, overseas investor demand for the IDRs rather than directly in the bank's shares came largely on account of the arbitrage opportunity offered, two foreign investors said.

However, Sebi's move has restricted the liquidity options and hedging opportunities for investors, Nisith Desai's Kacker said.

Domestic investors are less likely to be perturbed by the Sebi ruling as any conversion would mean being forced to sell the underlying shares within a month, a second banker and an Indian mutual fund manager said. Indian holders would, thus, find greater value in trading in the IDRs with prices based on the movement in underlying shares on the London Stock Exchange, the fund manager added.

Overall, however, Thunuguntla fears Sebi's actions will further discourage investment in IDRs, meaning the market may fizzle out before it has even taken off, with Standard Chartered seen as the victim of experimentation.

Still, Kacker expressed some hope of subsequent amendments being made to IDR guidelines. Two-way fungibility of American and global depository receipts of Indian companies is now permitted, and similar treatment should be accorded to IDRs of foreign companies, he added.

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