

Corpsec Hotline

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INDIAN DEPOSITORY RECEIPTS HAVE ARRIVED!

The Securities and Exchange Board of India ("SEBI") has issued guidelines paving the way to the issue of Indian Depository Receipts ("IDRs") on April 3, 2006. The guidelines enabling the issuance of IDRs were introduced by way of an addition of a new **Chapter VI A in the SEBI (Disclosure and Investor Protection) Guidelines, 2000** (the "IDR Guidelines").

A Brief History of IDRs

The history of the IDRs can be traced back to the amendment brought about to the Companies Act, 1956 by way of the introduction of section 605-A in the year 2000, which envisaged that certain rules would be framed by the Department of Company Affairs ("DCA") in relation to the IDRs. Four years hence, the DCA did finally issue the **Companies (Issue of Indian Depository Receipts) Rules, 2004** (the "Rules") on February 23, 2004 (our Corpsec Hotline *Advent of Indian Depository Receipts* dated March 5, 2004 had analyzed the implications of the Rules). The Rules had contemplated that SEBI will be issuing guidelines stipulating conditions for the issuances of IDRs, which were issued on April 3, 2006. The IDR Guidelines have come into effect from April 3, 2006 and seek to supplement the Rules.

IDR Guidelines

As is the case with any depository receipts mechanism, IDR Guidelines contemplate that a company incorporated outside India can issue IDRs through a domestic depository against the underlying equity shares of the issuing company, which are kept with a custodian in the home country.

The main aspects of the IDR Guidelines have been examined below:

■ Eligibility for issue of IDRs

The IDR Guidelines have stipulated certain eligibility criteria that are in addition to the eligibility criteria set out in the Rules, the most important one being the requirement that the issuing foreign company has to be listed in its home country. The two additional criteria are more of a consequential in nature to the first one, these are, good track record with respect to compliance under their respective securities market and that the issuer should not have been prohibited by any regulatory authority from issuing securities.

Implications: The criteria that required that the issuer has to be listed in its home country seems to be quite stringent. This is especially so, in light of the fact that when one sees the kind of companies which would want to list in India would be small and mid-cap foreign companies, which are familiar with Indian markets or have promoters of Indian origin and are likely to be in the emerging sectors such as, technology, pharma, auto-components, etc., looking for a better valuation that what it would be getting in its home country or looking for a lower cost of compliance.

Further, many companies who are looking for issuing IDRs would be doing so because they want to 'flip' their current structure and would like to make the Indian company as the parent company with the global operations under the Indian company and this Indian company could then be listed to capture the value of the global operations.

■ Investors

It has been clarified that Non-Resident Indians and Foreign Institutional Investors cannot invest in IDRs unless it has obtained the approval of the Reserve Bank of India ("RBI"). The minimum application amount for an IDRs issue is Rs.200,000 (approx. USD 4,500 at current rates).

Further, a IDRs issue can only be subscribed by **Qualified Institutional Buyers** and that Indian companies investing in IDRs cannot exceed the investment limits, if any, prescribed under their respective applicable laws.

Implications: This would mean that individuals would not be able to buy IDRs, which is a set back to individuals who wish to participate in this new instrument.

Interestingly, the IDRs are not automatically fungible, which means that for the investors to convert the IDRs into the underlying shares would require the regulatory approvals.

Implications: The fact that automatic fungibility has been disallowed is a set back for the investors, who will not be able to access the underlying security without the permission of the authorities in India.

■ Disclosures requirements for IDR issues

The IDR Guidelines, have provided an option for filing the draft prospectus through public filing or through a confidential filing, interestingly this option is not currently available for domestic companies accessing the capital

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markets. The filing of both, the draft and the final prospectus has to be made through a merchant banker registered with SEBI and a copy of the final prospectus has also to be filed with the Registrar of Companies at New Delhi.

Implications: The fact that SEBI and the main stock exchanges (BSE and NSE) are located in Mumbai and only one filing has to be made with the Registrar of Companies at New Delhi, is a minor irritant and should not be an impediment.

■ General Information

In addition to a long list of disclosures and information which needs to be made, the name, address and contact information of the overseas custodian bank needs to be provided along with the address of its office in India.

Implications: Whether intended or not, this seems to suggest that the Overseas Custodian Bank has to have an office in India.

The IDR Guidelines stipulate that the capital raised from the issue of IDRs has to be transferred to a separate domestic bank account.

Implications: The above requirement seems to suggest that the issuer has to open a bank account in India and the issue proceeds have to be transferred to the same. As per the current laws, any foreign person seeking to open a bank account in India requires the prior permission of the RBI. It would normally take around 3-4 weeks to obtain such an approval. However, since opening of a bank account for issue of IDRs is uncharted territory, there is no estimation that can be provided as to the time that would be taken by the RBI in granting such an approval.

■ Foreign Investment and Exchange Controls of the country of incorporation

As per the IDR Guidelines, information relating to the foreign investment laws and the exchange control regulations of the country of incorporation of the issuer or where the underlying equity shares are listed should be set out.

■ Financial Information

As per the IDR Guidelines, a report of the statutory auditor on the financial results and status of the foreign company issuing the IDRs, for five financial years preceding the issue of the prospectus is to be provided. Such information should be in Indian Rupees in addition to the home country currency and has to be prepared in Indian GAAP or IFRS or US GAAP. If the financial information is prepared in IFRS or US GAAP, then such information has to be accompanied with a reconciliation statement vis-a-vis Indian GAAP and the IFRS or US GAAP results have to be audited by a professional accountant or a certified public accountant or an equivalent in accordance with the International Standards on Auditing.

Further, the domestic depository is required to prepare a report, which has to be certified by a chartered accountant practicing in India, and such report has to be for five financial years preceding the issue. This seems to be quite an onerous responsibility given to a depository.

The IDR Guidelines also mandate that in case of the proceeds of the issue are used for investing in other entities, then the names and addresses of such entities and a the financial reports as stated above would be required to be furnished for such entities.

Implications: The requirement for the disclosure of an investee company seems to be quite a stringent stipulation since in many a times the issuer company may not have ascertained the particular entity in which they would be investing funds and in some situations such information, especially the financial reports, etc. may be confidential, either due to commercial considerations or statutory compulsions.

■ Basis of Issue price

The basis of pricing of IDRs would need to be disclosed in the prescribed format and shall have to contain, among others, information such as, earnings per share for the last three years, P/E pre-issue, minimum return on increased net worth required to maintain pre-issue EPS, etc.

The said basis of issue is conditional upon the premise that the projected earnings are not used as a justification for the issue price in the prospectus and that the accounting ratios disclosed in the prospectus should support the basis of the issue price.

■ Other Information

The issue of IDRs would be subject to the provisions of the SEBI (Disclosure and Investor Protection) Guidelines, 2000 ("DIP Guidelines"), except for Chapter VI of the DIP Guidelines.

The additional disclosure requirements cover the customary disclosure of information which *inter alia* include information relating to Industry, Business, details of the Issuer, Subsidiaries and associates of the issuer, Management Discussions and Analysis, Litigations, Information about the IDRs, management of the issuer, etc.

The IDR Guidelines also prescribe the requisite information and contents to be disclosed for an abridged prospectus for an IDR issue.

Listing Agreement

As per the Rules, the issuer is required to obtain an in-principle listing permission from one or more stock exchanges having nation wide trading terminals in India. Currently there are only the BSE (Bombay Stock Exchange Limited) and the NSE (National Stock Exchange Limited) have nation wide terminals, therefore, these stock exchanges would be the only ones to qualify under this requirement.

In light of the above and in line with the stipulations for the domestic companies listing their securities, the SEBI has, along with the IDR Guidelines also issued a Listing Agreement, which will have to be entered between the issuer and the respective Stock Exchanges on which the IDRs would be listed. The agreement contains various stipulations and requirements of on-going disclosures, filings, conduct, corporate governance, etc. which have been prescribed.

Conclusion

The IDRs route is attractive for small and mid-cap foreign companies, which are familiar with Indian markets or have promoters of Indian origin. Typically, these companies would be based in USA and South East Asia. With the cost of compliance increasing for companies that want to be listed or raise further capital in USA and other markets, listing in India may be an attractive option for foreign companies that view India as a potential market. Since the IDR Guidelines have just been introduced, it would take some time for the dust to settle and for picture to get sharper on the IDR scenario in India.

- Reuben Chacko & Ruetvej Pandya

You can direct your queries or comments to the authors

Source:

1) *Sebi circular on the new Chapter VI A of DIP Guidelines dated April 3, 2006*

2) *The IDR Rules*

3) *Sebi circular on the IDR Listing Agreement, dated April 3, 2006*

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