IDRs

A home visit

Clarity on capital gains and dividend tax and two-way fungibility will be required for successful take-off

The last fortnight was very significant in the history of the primary market. Standard Chartered Plc of United Kingdom, which operates one of the largest foreign banks in India, came out with a 100% book built issue of 24,00,00,000. Indian Depository Receipts (IDRs) in the price band of Rs 100 to Rs 115 per IDR. Every 10 IDRs represent one share of Standard Chartered Plc of US$ 0.50 nominal value. Till the writing of this article, the response to the issue was not very encouraging. This may be due to the turmoil in global markets on the sovereign debt crisis in the euro zone and also lack of awareness among investors about IDRs.

The Ministry of Corporate Affairs had mooted the idea of IDRs around a decade ago. Necessary amendments were also made in the Companies Act, 1956, in 2000 through introduction of a new Section 605A. But this is first time that any foreign company has come out with an IDR issue.

Basically, IDRs are Indian counterparts of American depository receipts (ADRs) and global depository receipts (GDRs), through which several Indian companies have raised funds from overseas investors. Thus, the IDR issue by Standard Chartered has marked a reversal of the last decade's trend, when many Indian companies had rushed to the New York Stock Exchange and Nasdaq with their ADR offerings.

IDRs enable foreign companies to raise funds from Indian investors. Simultaneously it is also possible for Indian investors to invest in the equity shares of well known foreign companies. IDRs have equity shares of the overseas issuer company as underlying assets. The shares issued by overseas company are held by an overseas custodian bank. On the basis of these underlying shares, Indian depositories — NSDL and CDSL — will issue IDRs to Indian investors. IDRs would be listed on the stock exchanges in India and denominated and traded in Indian rupees.

The regulatory framework for IDRs comprises rules notified by the Central government under Section 605A of the Companies Act, 1956. These rules are known as the Companies (Issue of Indian

Tapping Indian investors

Depository Receipts) Rules, 2004. In addition to them, Chapter X of the Sebi (Issue of Capital & Disclosure Requirements) Regulations, 2009, also prescribes certain conditions to be fulfilled by foreign companies before issuing IDRs.

Sebi has also framed a model listing agreement that is to be entered into between the stock exchanges and the foreign issuer. The listing agreement prescribes conditions to be fulfilled for continuous listing of IDRs on Indian stock exchanges. These rules and regulations contain adequate safeguards to ensure that companies raising funds through IDRs are financially sound. The eligibility criteria for issue of IDRs specify that the foreign issuing company must have:

- Pre-issue paid-up capital and free reserves of at least US$ 50 million as well as a minimum average market capitalisation in the last three years in its parent country of at least US$ 100 million.
- Continuous trading record or history on a stock exchange in its parent country for at least immediately three preceding years.
- Track record of distributable profit for at least three out of immediately preceding five years.
- The company must have not been prohibited by any regulatory body to issue further securities.
- Good track record on compliance with securities market regulations.

The size of IDR issue must not be less than Rs 50 crore. The number of underlying equity shares offered in a financial year through IDR offering shall not exceed 25% of the post-issue number of equity shares of the company. At least 50% of the issue is to be allocated to qualified institutional buyers (QIBs), 30% must be reserved for retail individual investors, and the balance 20% for non-institutional investors and employees. The ratio of non-institutional investors and employees is at the discretion of the issuing company. Post-issue of IDRs, no single individual or single entity or group of entities in India, other than QIBs, shall hold, directly or indirectly, IDRs exceeding 5% of the issue. No single QIB or a group of QIBs shall hold IDRs exceeding 15% of the issue.

IDRs can be held, purchased or transferred by retail individual bidders, non-institutional bidders and qualified institutional bidders including persons resident in India, NRIs and foreign institutional investors (FIIs) including Sebi approved sub-accounts of FIIs registered with Sebi. Insurance companies are not permitted to invest in IDRs. Commercial banks may invest in IDRs subject to compliance with applicable prudential limits specified by the RBI from time to time.

If the minimum subscription equivalent to 90% of the size of the issue is not received, including devolvement of underwriters, or if the subscription level falls below 90% after the bid/issue closing date on account of cheques having being returned unpaid or withdrawal of applications within 60 days from the bid or issue closing date, the issuer company has to forthwith refund the entire subscription amount together with interest of 15% per annum for the period of the delay beyond 60 days. If at least 50% of the issue cannot be allotted to QIBs, then too the entire application money has to be refunded forthwith.

IDRs can be purchased by any Indian resident. The minimum application amount in an IDR issue is Rs 20000. The Foreign Exchange Management Act (Fema), 1999, imposes restrictions on investment in shares of foreign companies by Indian residents but

such restrictions are not applicable for an IDR issue because IDRs are issued by foreign companies in Indian rupees. As per the provisions of Fema, a resident individual cannot invest more than US$ 200000 in foreign securities. This limit, however, is not applicable to an IDR issue. In addition, the problems involved in investing in foreign securities such as having a demat account outside India to hold the foreign securities, share trading account with a foreign broker, and foreign bank account to hold foreign currency do not come in the way of investing in IDRs. Thus, IDRs provide a golden opportunity for Indian residents to invest in shares of listed foreign entities.

The RBI has stipulated that the issuer will be mandatorily required to immediately repatriate the funds raised through IDR issue to the home country. Only time will tell whether this is a right decision because repatriation of funds involve conversion of Indian rupees raised from issue of IDRs into US dollars or any other hard currency and, thereafter, their repatriation. This will not only exert pressure on the rupee but the country's foreign exchange reserves will also start depleting. It would have been better if an option had been given to the foreign companies either to repatriate the funds to their home country or to utilise them for their Indian operations.

The market price of IDRs after listing will depend on the price of equity shares of the issuing company prevailing in the home country or on other international stock exchanges. Therefore, fluctuations in foreign exchange rates will also impact the price of IDRs. This may pose some risk for Indian investors because movements in global markets and forex rates will impact the price of IDRs. The rights of the holders of IDRs will be just like the rights enjoyed by the overseas equity shareholders of the foreign company: right to vote on the shareholders' resolutions, right to receive dividend in Indian rupees, and entitlement to rights and bonus issues in the form of IDRs.

Every coin has two sides. There are few contentious issues also. First is the lack of clarity on taxation. The Indian Income Tax (IT) Act, 1961, does not contain any provision to tax the income earned by Indian residents through investment in IDRs. It is not clear whether IDRs will be exempt from long-term capital gain tax if the holding period is more than one year. If the shares issued by Indian companies are sold by the resident investors before the completion of one year period from the date of investment, the gain is subject to short-term capital gains tax of 15%. Will the same rate of tax be applicable on short-term capital gain made through investment in IDRs?

A step forward

IDRs will integrate Indian capital markets with global markets

Benefits to the issuing company:
- Raising of funds from Indian market.
- Enhancement of brand image.
- As the financial results of the issuing company will be published in India, it may ultimately boost the company's business in India.
- A portion of the issue can be reserved for Indian employees. Post-issue also, employees can be granted stock options in the form of IDRs.

Benefits to investors:
- Opportunity to invest directly in the equity shares of global companies.
- Diversification of portfolio.
- Convergence of Indian capital markets with global markets.

Based on the current provisions of Chapter VII of the Finance (No.2) Act, 2004, pertaining to the securities transaction tax (STT), it seems that IDRs will not be subject to STT. Accordingly, the corresponding exemption from long-term capital gains tax under Section 10(38) of the IT Act, and the concessional tax rate for short-term capital gain under Section 111A of the IT Act will also not be available to IDR holders on transfer of IDRs.

Thus, it is necessary that the tax rates must be clarified immediately so that investors have absolute clarity in their mind as to when to exit. Treating IDRs at par with the shares issued by the Indian companies for taxation purposes will be a welcome move to promote IDRs.

It is also not clear if dividends paid by foreign companies to the IDR holders through the domestic depository will be taxable in India. Dividends paid by Indian companies are tax-free in the hands of their shareholders as Indian companies have to pay dividend distribution tax on the entire amount. This exemption of dividend income from tax under Section 10(34) of the IT Act will not be applicable to dividends received by the IDR holders.

Another issue relating to taxation of dividend on IDRs is that if the taxes are withheld from dividend payment by foreign companies under the tax laws of their home country, then will IDR holders be granted any credit in India for the amount so withheld? If no such credit is given and, over and above, tax is also levied by the Indian income tax authorities on the dividend received by the holders of IDRs, then it will simply mean double taxation .

The last, but not the least, issue is the availability of two-way fungibility option. Foreign investors who invest in the ADR / GDR issues of Indian companies enjoy the option of two-way fungibility, i.e, they can convert their ADRs / GDRs into the underlying equity shares of Indian companies and vice a versa. On the other hand, Indian investors investing in IDRs can exercise the two-way fungibility option only after one year from the date of allotment. Each IDR holder will have to individually approach the RBI for approval at his own expense. An IDR holder will have to make a general application pursuant to the provisions of Fema. There is no surety that such approval will be granted by the RBI in a timely manner or at all.

Even after the conversion, retail individual investors will be under obligation to sell such foreign shares within 30 days on the international stock exchanges. Two-way fungibility enables investors to benefit not only in terms of arbitrage opportunities arising due to foreign exchange rate fluctuations but also through difference in share prices prevailing on the domestic and international stock exchanges. Thus, retail individual investors will be denied the potential benefits that may flow to them through arbitrage opportunities. At the moment, it is also not clear whether such conversion will be regarded as a taxable transfer in the hands of the Indian investors.

With the introduction of IDRs in Indian financial markets, the dream of Indian investors to own shares of global companies has become a reality. It will be interesting to see if other foreign companies will also follow the path of Standard Chartered Plc. However, there is urgent need to resolve the contentious issues, lest these become a stumbling block in the way of future IDR issues.

—*Rajesh Relan*