Capital Markets Hotline

July 23, 2009

RESERVE BANK OF INDIA'S THRUST TO INDIAN DEPOSITORY RECEIPTS (IDRS)

Reserve Bank of India ("**RBI**") *vide* its Circular RBI/2009-10/106 A.P. (DIR Series) Circular No. 05 dated July 22, 2009 ("**Circular**") has provided much needed clarity for foreign companies ("**Issuing Company**") desirous of issuing Indian Depository Receipts ("**IDRs**"). Consequential amendments will be made to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("**TISPRO Regulations**") and the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 ("**ODI Regulations**").

The Circular attempts to align the regulatory framework of RBI governing IDRs with the recent proactive measures taken by the Ministry of Corporate Affairs ("**MCA**") and the Securities and Exchange Board of India ("**SEBI**"). The implications of the Circular are analyzed herein below:

1. Financial/ Banking companies having presence in India, required to obtain prior approval for issuance of IDRs: The extant Companies (Issue of Indian Depository Receipts) Rules, 2004 ("**IDR Rules**") and SEBI (Disclosures and Investor Protection) Guidelines, 2000 ("**DIP Guidelines**") do not require an Issuing Company to seek any specific approval from the sectoral regulator(s) prior to issuance of IDRs. The RBI in the Circular has created an exception for financial and banking companies and requires foreign financial and banking companies having presence in India, either through a branch or subsidiary, to seek prior approval of the sector regulator(s) before the issuance of IDRs.

Implications: RBI has always regarded banking and financial services as a sensitive sector of the Indian economy. In fact, even Indian entities intending to engage in financial services activities in overseas jurisdiction are required to adhere to certain specific requirements and seek prior approval from the concerned sectoral regulator(s). The caution that RBI exercises over financial and banking sector is evident from the Circular, as financial and banking companies would be required to seek prior approval from the sectoral regulator(s) prior to issuance of IDRs. For example, a banking company having a subsidiary/ branch in India and desirous of issuing IDRs would be required to seek prior approval from RBI.

2. Repatriation of IDR Proceeds: Under the IDR Rules, the IDR issue proceeds collected by the Domestic Depository are repatriable in favour of the Issuing Company after conversion into foreign currency, subject to the laws relating to export of foreign exchange. In absence of specific guidelines by RBI in this behalf, the procedure for repatriation of the IDR issue proceeds was imprecise. The Circular provides that the proceeds of the issue of IDRs are to be immediately repatriated outside India by the Issuing Company.

3. Period of redemption: In January 2009, pursuant to amendments to the IDR Rules, the one (1) year lock-in period on redemption of the IDRs into underlying equity shares of the Issuing Company from the date of issue of IDRs was done away with. However, the joy of investors would be a short-lived one, as the Circular has once again provided for lock-in on redemption of underlying equity shares of the Issuing Company into IDRs before the expiry of one (1) year from the date of issue of the IDRs.

Implications: The re-introduction of lock-in requirements for redemption of IDRs for underlying equity shares of the Issuing Company would once again impose restriction on the flexibility and liquidity to the investors.

4. Investment by Persons resident in India / FIIs / NRIs: Initially, under the IDR Rules only resident Indians could invest in IDRs. However, in January 2009, the MCA permitted issuance of IDRs to persons other than persons resident in India. Later, SEBI in June 2009 notified relaxations in favour of Foreign Institutional Investors ("**FIIs**"), Non-Resident Investors ("**NRIs**") and domestic mutual funds and permitted them to invest in IDRs subject to the provisions of Foreign Exchange Management Act, 1999 ("**FEMA**"). The Circular proposes to make express provisions in TISPRO Regulations for permitting FIIs including their sub-accounts and NRIs to invest in IDRs.

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Implications: The relaxations made by SEBI in June 2009 were subject to FEMA, which did not contain explicit provisions providing for IDR as securities in which investments could be made by FIIs and NRIs. The Circular provides the necessary clarity to FIIs and NRIs for making investments in IDRs under automatic route, i.e, without prior approval of the RBI.

5. Fungibility: Under the DIP Guidelines, automatic dual fungibility of IDRs is not permitted i.e., conversion of underlying equity shares of the Issuing Company into IDRs. This requirement of SEBI has been confirmed by RBI in the Circular and has provided a prohibition on automatic fungibility of IDRs.

6. Procedure for transfer and redemption of IDRs: There existed an element of ambiguity as to the exchange control implications upon redemption of IDRs into underlying equity of the Issuing Company.

As per the Circular, the guidelines for holding underlying equity shares of the Issuing Company after redemption of IDRs are provided below:

i. Listed Indian Companies: Under Regulation 6B of ODI Regulations, a listed Indian company is permitted to invest up to 50 per cent of its net worth as of the date of the last audited balance sheet in (i) shares, and (ii) bonds / fixed income securities, rated not below investment grade by accredited/registered credit rating agencies, issued by listed overseas companies. Separately, Regulation 7 of ODI Regulations, impose certain additional requirements on a person seeking to make investment in an entity engaged in the financial service sector.

As per the Circular, a listed Indian Company can sell or continue to hold the underlying equity shares of the Issuing Company subject to the terms and conditions as per Regulations 6B and Regulation 7 of ODI Regulations.

ii. Domestic Mutual Funds: Regulation 6C of ODI Regulations permits investment by domestic mutual funds in certain specified securities of an overseas company listed on a recognized stock exchange or in Exchange Traded Funds. In this regard, SEBI has in June 2009 included IDRs as securities in which investments can be made by domestic mutual funds.

As per the Circular, domestic mutual funds are permitted to sell or continue to hold the underlying shares equity shares of the Issuing Company, subject to the terms and conditions as per Regulation 6C of ODI Regulations.

iii. Other resident persons: The current exchange control regulations provide limited routes for Indian investors to invest in securities of foreign companies through the Liberalized Remittance Scheme ("**LRS**") of RBI and funds paid out of a Resident Foreign Currency Account ("**RFC Account**"). Until now, it was unclear whether a resident person could invest in foreign securities without any prior approval of RBI, by virtue of redemption of IDRs for its underlying equity shares.

As per the Circular, resident individuals are allowed to hold the underlying shares only for the purpose of sale within a period of thirty (30) days from the date of conversion of the IDRs into underlying shares of the Issuing Company.

Further, the Circular clarifies that the TISPRO Regulations would be applicable to FIIs/ sub-accounts only till the time they stay invested in IDRs. Upon redemption of IDRs for the underlying equity shares of the Issuing Company, the FII/ sub-account would be regarded as holders of foreign securities, thus, outside the purview of RBI.

Implications: IDRs have an inherent feature of being redeemed for the underlying equity shares of the Issuing Company at the option of the investor, thus entitling the investor to the equity shares of a foreign company at his will. The Circular provides much needed clarity on the implications of holding equity shares of a foreign company, which an investor would be entitled to hold after its redemption for IDRs.

Conclusion

From the recent amendments it can be said that that Government and regulatory authorities viz., RBI and SEBI have been taking progressive steps to facilitate issuance of IDRs by doing away with several stringent requirements that were applicable to certain category of investors, viz., mutual funds and FIIs. These regulations hitherto prevented them from investing in IDRs and introducing clarity in respect of procedural requirements for redemption of IDRs and repatriation of IDR issue proceeds. The amendment indicates positive steps by the Government and regulatory authorities to make IDRs a reality.

- **Shikhar Kacker** & **Vyapak Desai**

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