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Depository Receipts: Comparison of Regulatory Frameworks in Taiwan, Brazil, Hong Kong, and India

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Student Research Project

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There has been increased internationalisation of various firms through direct as well as indirect cross-listings on international exchanges. Depository receipt (a negotiable certificate issued by a bank in a domestic country that represent ownership of shares in companies of other countries) is a form of indirect listing. The DR regulatory framework in four capital markets—Taiwan, Brazil, Hong Kong, and India--have been analysed and compared in this paper. The analysis shows that the DR regulations in these capital markets can be categorised into two: a strictly regulated one and a sparsely regulated market. The authors conclude that capital markets would need to adopt a middle path in their DR regulations--they should be reasonably issuer-friendly so as to encourage issuer participation, while being strong enough to ensure investor protection.

¹ The authors are currently students at the National Law University, Jodhpur. The views expressed in the paper are those of the author and do not necessarily reflect those of the National Stock Exchange of India Ltd. The authors acknowledge the opportunity as well as the research grant provided by National Stock Exchange of India Limited. The authors also acknowledge the constant support and guidance provided by Prof. Aparajita Bhatt for the preparation of the paper. The authors can be contacted at pallavi1304@gmail.com or shiprapadhi@gmail.com.

Depository Receipts: Comparison of Regulatory Frameworks in Taiwan, Brazil, Hong Kong, and India

I. Introduction

The past few decades have witnessed the increased internationalisation of various firms through cross-listings on international exchanges. This has been facilitated by market liberalisation, which has led to greater integration of global securities markets. Cross-border listing has become one of the avenues for the integration of global securities markets.

There are two forms of cross-border listing, namely, direct listing and indirect listing. Direct listing implies that the firm concerned offers ordinary shares to the public. Indirect listing on exchanges is through Depository Receipts (DRs). Depository receipts is a negotiable certificate issued by a bank in a domestic country that represent ownership of shares in companies of other countries. Cross listing, particularly through DRs such as American Depository Receipts (ADRs) or Global Depository Receipts (GDRs), is a popular way of internationalisation among firms from emerging economies. In addition to Europe and America, International firms are allowed to cross list in other countries through the DR programme.

There could be several reasons for a domestic company to cross-list, such as an expanding investor base, the desire to improve stock liquidity through its highly liquid secondary market, the increasing visibility of the company, a growing customer base, and the wish to take advantage of higher valuations. From the perspective of investors, cross listing mitigates some of the uncertainties and costs involved in making direct purchases in foreign markets (Edison & Warnock, 2003). Cross listing through DRs has more advantages compared to direct listings as it offers an easier and flexible mechanism with less stringent regulations for individual companies to enter foreign markets according to their needs. The listing of a company on a foreign exchange through a DR framework exempts the firm from many stringent regulatory requirements compared to those required for direct listings on foreign exchanges, thereby enabling the investors to realise dividends and capital gains in another market.

Previously, companies from emerging economies listed either on the US exchanges or on the European exchanges through ADRs or GDRs, respectively. However, the phenomenal success of DRs in the US and in European countries combined with the evolving liberal conditions that are conducive for capital market development in Latin American and Asian countries prompted the securities market regulators to allow DR programmes in these countries. Another factor that contributed to the popularity of DRs is that investors are looking beyond their national borders to take advantage of new opportunities for diversifying their portfolio. Even many multinational firms are interested in the local DR programmes to take advantage of the growth prospects of Latin American and Asian countries.

The purpose of this paper is to look at the DR regulatory framework in the capital markets of four countries representing Latin American and Asian economies, namely, Taiwan, Brazil, Hong Kong, and India. The authors compare the DR regulatory frameworks in these countries, analyse the performance of each of them, and discuss the reasons for its success or failure. The authors also attempt to categorise these capital markets into strictly regulated markets or sparsely regulated ones by examining their regulatory frameworks.

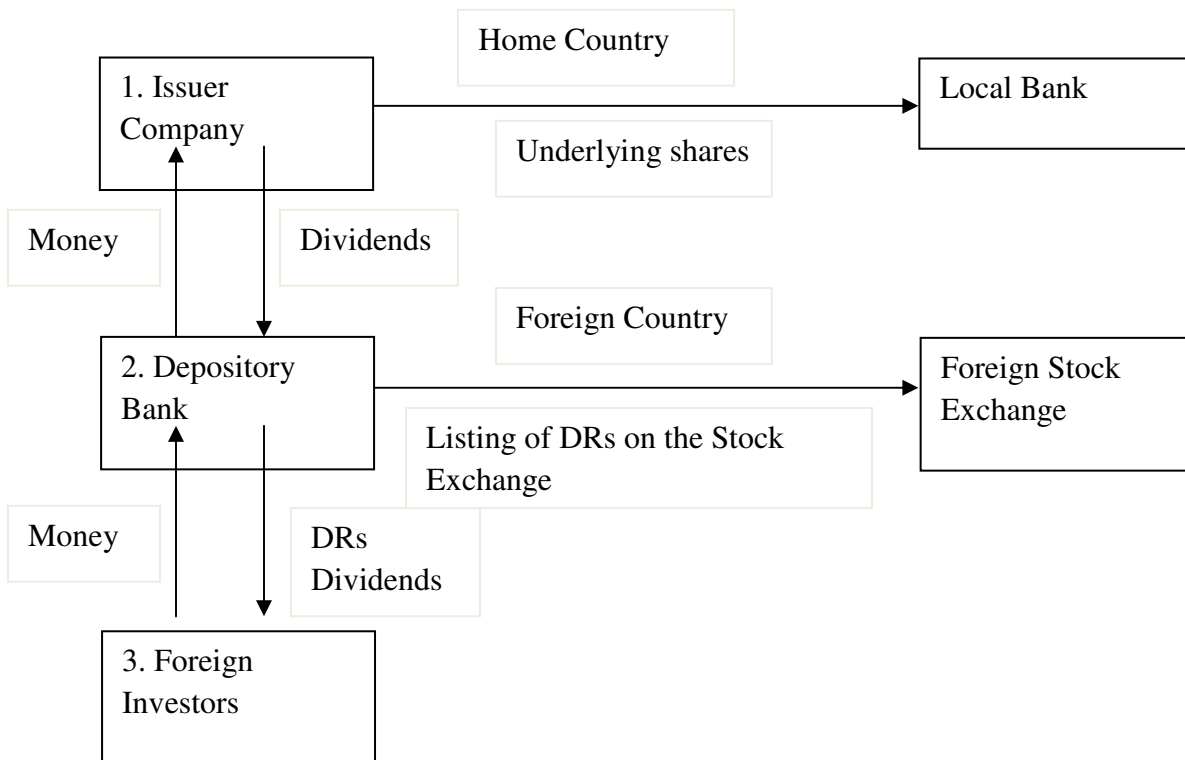
The rest of the paper is organised as follows. Section II explains the concept of depository receipts in further detail. Section III discusses the regulatory framework of DRs in Taiwan, Brazil, Hong Kong, and India. In Section IV, the authors provide a comparative analysis of the DRs of these countries; the regulatory regime prevailing in these countries and the steps taken by them to make it successful are analysed. Annexure I provides a comparison of the key features of the DR programmes in these countries.

II. Depository Receipts

A Depository Receipt (DR) is a negotiable instrument in the form of securities that is issued by a foreign public listed company and is generally traded on a domestic stock exchange. For this, the issuing company has to fulfil the listing criteria for DRs in the other country. Before creating DRs, the shares of the foreign company—which the DRs represent—are delivered and deposited with the

custodian bank of the depository creating the DRs. Once the custodian bank receives the shares, the depository creates and issues the DRs to the investors in the country where the DRs are listed. These DRs are then listed and traded in the local stock exchanges of the other country.² The working of a standard DR programme is illustrated in Figure 1.

Figure 1: Working of a DR Programme



Source: Desai and D'Souza (1998)

DRs have often been used by domestic companies as investment vehicles in the form of American Depository Receipts (ADRs) and Global Depository Receipts (GDRs) for accessing foreign markets and investors. American Depository 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 Depository Receipts.

² What are depository receipts?, Financial Express, <<http://www.financialexpress.com/news/what-are-depository-receipts/161428/5>> last visited on December 10, 2011

Currently, DRs represent about 4% of the total world listing in the equity market.³ The following section discusses the DR regulatory framework in the capital markets of the four countries that are the focus of this paper.

III. Depositary Receipt Framework in Taiwan, Brazil, Hong Kong, and India

Asian countries such as Taiwan, Hong Kong, and India as well as Latin American countries such as Brazil have launched local DR programmes to attract foreign companies with a local presence. The DR programmes and the regulatory frameworks for DRs in these four countries as well as the performance of DRs in these countries are discussed in detail below, starting with the Taiwan Depositary Receipts.

A. Taiwan Depositary Receipts (TDRs)

Foreign enterprises listing DRs on the Taiwanese stock market are called Taiwan Depositary Receipts (TDRs). In recent times, Taiwan has emerged as one of the most favourable destinations for foreign issuers in the Asian region. The liberalisation of the Taiwanese capital market and the change in the regulations governing the listing of foreign enterprises (in 2008) to allow the securities of non-Taiwanese companies to be listed on Taiwanese stock markets have increased the demand for TDRs. Other factors that have made the capital market appealing are its developed high-tech cluster, favourable P/E ratios of the companies listed on it, and high liquidity levels. Moreover, TDRs allows foreign issuers to enter Taiwan's capital market, and gain access to Asia's thriving financial market.⁴

Next, the TDR system is discussed in some detail, with a description of some of the main regulations governing the issue of TDRs.

³ Briefings on Depositary Receipts Framework,
http://www.hkex.com.hk/eng/rulesreg/listrules/listpresent/Documents/HDR_20080917.ppt>

⁴ Taiwan Depositary Receipts, PricewaterhouseCoopers Taiwan,
<http://www.pwc.com/en_TW/tw/publications/assets/TDR.pdf>

TDR System

The Taiwanese securities market regulator, the Securities and Exchange Commission (SEC), promulgated the regulations governing the issuance of Taiwan Depositary Receipts (TDRs) in 1992. The TDRs are listed on the Taiwan Stock Exchange (TWSE)⁵ and are denominated in New Taiwan Dollars (TWD).⁶ Some of the main regulations are briefly discussed here.

The company size should be at least 20 million shares or the company should have a market value of at least TWD 300 million (around USD 10 million). Further, the company must have shareholder equity equivalent to TWD 600 million (around USD 20 million) as depicted in the latest financial reports. Profitability requirements are also defined: the company must show a pre-tax profit of at least 6% of shareholders' equity for the most recent year and 3% of shareholders' equity in each of the last two fiscal years, with profitability in the most recent year being better than in the previous year. Moreover, pre-tax profitability should be TWD 250 million (around USD 8.5 million) each in the last two fiscal years.⁷ At the time of the proposed listing, there should not be less than 1,000 TDR holders in Taiwan, and shareholders (excluding company insiders and any corporate shareholders that are more than 50% owned by such insiders) should own at least 20% of the shares or 10 million shares.

For issuing TDRs, the shares of the foreign issuers are required to be registered shares and they should be listed on a foreign securities exchange or securities market approved by the competent authority.⁸ The underlying shares of the TDR could be either already issued shares or new shares; there is no upper limit on the quantity issued. A TDR holder may request the depository institution to redeem the TDR into shares. On request by a TDR holder, the depository could either redeem the TDR into shares or could sell the TDR in the market where it is listed. However, converting shares into TDRs and

⁵ The TSE is the only exchange in Taiwan for trading securities.

⁶ TDR Listing Criteria, Article 17.

⁷ FN: Eric Wu and Christy LC Lin, Issuing Depositary Receipts in Taiwan by Companies Listed Overseas: An overview of the planning process, <<http://www.pwc.com/tw/en/ipo-in-tw/feature/tdr/feature-tdr-001.jhtml>>

⁸ "Competent authority" in this context does not necessarily mean the domestic exchange of the issuer.

selling the TDR in Taiwan is not permitted. The depository institution may either re-issue TDRs within the original redemption amount or issue new TDRs if the capital increases.⁹

The following section presents the regulatory framework of TDRs.

Regulatory Framework of TDRs

There are seven regulations governing the Taiwan Depositary Receipts; the main regulations are listed in Box 1.¹⁰

Box 1: Regulatory Framework of TDRs

- Taiwan Stock Exchange Corporation Rules Governing Review of Securities Listings
- Supplementary Provisions to the Taiwan Stock Exchange Corporation Rules for Review of Securities Listings
- Taiwan Stock Exchange Corporation Procedures for Verification and Disclosure of Material Information of Listed Companies¹¹
- Taiwan Stock Exchange Corporation Operational Procedures for Review of Taiwan Depositary Receipt Listings¹²
- Taiwan Stock Exchange Corporation Rules Governing Contracts for the Listing of Taiwan Depositary Receipts¹³

⁹Q & A for Listing in Taiwan by Foreign Issuer, Compiled by Taiwan Stock Exchange, <http://www.twse.com.tw/en/listed/alien_business/download/qa.pdf>, last updated on Aug 9, 2010.

¹⁰ The other two regulations are a) the Taiwan Stock Exchange Corporation Procedures for Review of Securities Listings and b) the Operational Procedures for the Review of Foreign Securities for Listing by the Taiwan Stock Exchange Corporation.

¹¹ These rules provide a list of matters that are to be treated as “Material information of listed companies and primary listed companies.”

¹² The TWSE’s review of applications for the listing of securities issued by foreign issuers shall be conducted in accordance with these Operational Procedures.

¹³ These rules govern the contracts between the foreign issuer and the depository institution for the exchange listing of previously issued TDRs.

The regulation governing the disclosure of material information is provided under the Taiwan Stock Exchange Corporation Procedures for Verification and Disclosure of Material Information of Listed Companies. This regulation requires the foreign issuer to disclose such material information as is required by the laws of the home country or the country of listing. The disclosure of other information is regulated by the TWSE Rules Governing Information Reporting by Companies with Listed Securities and Offshore Fund Institutions with Listed Offshore Exchange-Traded Funds. Financial statements and information about directors and supervisors designated by institutional shareholders and about shareholders holding 10% or more of the shares are required to be disclosed periodically. The foreign company is required to meet the requirements prescribed in the TDR Regulations, including profitability requirements.¹⁴

The performance of TDRs since their introduction in 1992 is discussed in the next section.

Performance of TDRs

Although the TDR programme was introduced in 1992, the first TDR was issued in 1999, while the popularity of TDRs rose only after 2006 (Table 1).¹⁵

Table 1: Performance of TDRs

Year	No. of TDRs
2006	5
2007	5
2008	4
2009	14
2010	26

Source: Taiwan Stock Exchange Factbook 2011

In the early years, there was a lack of interest in the TDR programme because the regulations at that time permitted only those foreign companies that were listed on certain major foreign bourses¹⁶ to be

¹⁴ Article 26 of the Taiwan Stock Exchange Corporation Rules Governing Review of Securities Listings.

¹⁵ Taiwan Stock Exchange, Trading Statistics of Taiwan Depository Receipts(TDRs), Annual Statistics, taken from <http://www.twse.com.tw/en/statistics/statistics_list.php?tm=07&stm=005>

listed under the TDR programme. Moreover, the regulations stipulated strong capital and profitability requirements.^{17, 18}

In order to improve the regulatory conditions for the listing of TDRs, the Taiwanese Government has taken various steps from time to time. These include the elimination of restrictions on the remittances of funds from Taiwan or to Mainland China in July 2008, the rescindment of the requirement that companies should have their stock listed on an approved stock exchange or market for six months before they can apply for a TDR listing (in September 2008), and the opening up of Taiwan's securities market to investments from Mainland Chinese corporations (in May 2009).¹⁹ In 2009, the Financial Supervisory Commission²⁰ lowered the threshold for the first listing of foreign technology enterprises on Taiwan's stock markets and over-the-counter (OTC) markets, as a means of attracting more overseas high-tech enterprises to list in Taiwan. This was also done to promote direct listing by foreign companies on the TWSE. In addition to these steps, another factor that contributed significantly to the success of TDRs was the signing of the Cross-Straits Economic Cooperation Framework Agreement (ECFA) with Mainland China on 29 June, 2010. This deepened Taiwan's

¹⁶ The 16 major exchanges specified under these regulations included the NYSE Euronext (US), The American Stock Exchange (US), NASDAQ (US), the London Stock Exchange (UK), Deutsche Börse AG (Germany), the Italian Stock Exchange (the Italian Stock Exchange was acquired by the London Stock Exchange in June 2007), the Toronto Stock Exchange (Canada), the Australian Securities Exchanges (Australia), the Tokyo Stock Exchange (Japan), the Osaka Securities Exchange (Japan), the Stock Exchange of Singapore (Singapore), the Bursa Malaysia Securities Bhd (Malaysia), the Stock Exchange of Thailand (Thailand), the Johannesburg Stock Exchange (South Africa), the Hong Kong Exchanges and Clearing Limited (Hong Kong), and the Korea Exchange (Korea).

¹⁷ TDR Listing Criteria, Article 5, Taiwan Stock Exchange 1993.

¹⁸ TDR Listing Criteria, Article 3 and 4. TDR issuers must have shareholders' equity in excess of TWD 2 billion (around USD 68 million). The issuer's before-tax earnings for the 2 most recent fiscal years must be positive and must not be lower than 8% of the shareholder's equity over the same period (i.e., earnings must be at least USD 6 million over the preceding 2 fiscal years).

¹⁹ Eric Wu and Christy LC Lin, Issuing Depositary Receipts in Taiwan by Companies Listed Overseas: An overview of the planning process, <<http://www.pwc.com/tw/en/ipo-in-tw/feature/tdr/feature-tdr-001.jhtml>>

²⁰ The Financial Supervisory Commission is the government agency responsible for regulating the securities markets in Taiwan.

reach into the Asia-Pacific region rapidly.²¹ Following these changes, various companies from China, Singapore, and Hong Kong issued TDRs.²²

More issuers from China and Singapore are expected to list TDRs on the TWSE. Another notable aspect is that most of the TDRs issued so far were issued by Taiwanese businesses operating in Mainland China. This was due to the promotion of TDRs by the Taiwanese government in order to reverse the migration of Taiwanese capital.²³ A common pattern could be observed among the companies that applied for TDRs. These companies were all established and controlled by Taiwanese merchants conducting business mainly in China. Moreover, the shares deposited by the holding company for the TDRs were typically from companies incorporated in either the Cayman Islands or Bermuda. These holding companies were listed on the Hong Kong Stock Exchange (Wang & Chao-hung, 2011).²⁴

Another factor that has contributed immensely to the popularity of TDRs after 2006 was that the TWSE permitted margin transactions²⁵ of TDRs in 2006; this measure had a positive impact on the TDR market. In 2008, TDRs were aggressively promoted by the Taiwanese government in order to allow prominent Taiwanese businesses operating in Mainland China to enter Taiwan's capital markets and to reverse the migration of Taiwanese capital. Thus, such businesses operating in Mainland China

²¹ This has created unprecedented opportunities for Taiwan's economy.

²² Currently, 24 companies have their TDRs listed on the TWSE—10 from Singapore and 14 from Hong Kong. The Singapore companies, Asian East Technologies Co. Ltd., ASE Test Ltd., and Oceanus Group Ltd. came to Taiwan to issue TDRs, and since then 10 other foreign companies, including Super Coffee (a famous Southeast Asian brand), Hu'an Cable Holdings Ltd., Joint Environmental Technology (Xiamen) Co. Ltd., and Scanteak have expressed their intent to be listed on Taiwan's stock market. A Mainland China company (Jiangsu Yangzijiang Shipbuilding Co. Ltd.) issued TDRs in Taiwan in early September. This level of interest has been unprecedented, and shows that the ECFA has effectively increased the level of interest among foreign businesses in coming to Taiwan for raising capital (http://www.ecfa.org.tw/EcfaAttachment/ECFADoc/1028_ECFA%20Win-in%20Opportunities%20Tracked%20Changes.pdf).

²³ This was especially true following the second half of 2008.

²⁴ "Conditions Relaxed for Taiwan Listing by Foreign Technology Enterprises", *Taiwan New Econ. Newsl.* (Ctr. for Econ. Deregulation and Innovation, Council for Econ. Planning & Dev., Taipei, Taiwan), Mar. 2009, at 10.

²⁵ A margin transaction is one where investors can borrow cash to buy securities and use the same securities as collateral.

could enter the Taiwanese capital markets and gain access to its investor base. This resulted in 20 new listings of TDRs between October 2008 and October 2010.²⁶

However, it is pertinent to note that major companies listed on notable foreign bourses were initially not willing to invest time and resources for listing their shares on the TWSE in the form of TDRs due to the modest amount of capital that could be tapped in an emerging market. Thus, owing to the lack of positive response from these major companies, the government had to lower the requirements for listing to make TDRs successful in the global market (Chen and Huang, 1993).

Overall, the listing of TDRs is a speedy and easy process. For foreign companies to be listed through TDRs, no internal reorganisation of the company is required, and there are fewer investment structures or tax planning issues. Moreover, the TDR review process takes less time than an IPO listing would.

The next section discusses the Brazilian Depositary Receipts.

B. Brazilian Depositary Receipts (BDRs)

As the Brazilian authorities progressively opened up the international markets to domestic investors, they endeavoured to bring more of the international capital markets to Brazil. The Brazilian Depositary Receipts (BDRs) are certificates representing securities issued by publicly listed companies based overseas and issued by a depositary institution in Brazil.

The BDRs were introduced in 1992 to attract domestic investors and foreign companies to the domestic stock exchange. In 1996, the National Monetary Council (CMN) established the BDR regulations and the Brazilian Securities and Exchange Commission (CVM), and the Central Bank of Brazil (Bacen) rendered the BDR operational.²⁷ In 2000, the regulations for BDRs were reformulated with the objective of incorporating best international standards that would make the regulatory framework attractive to international firms.

²⁶ Q & A for Listing in Taiwan by Foreign Issuers, Compiled by Taiwan Stock Exchange

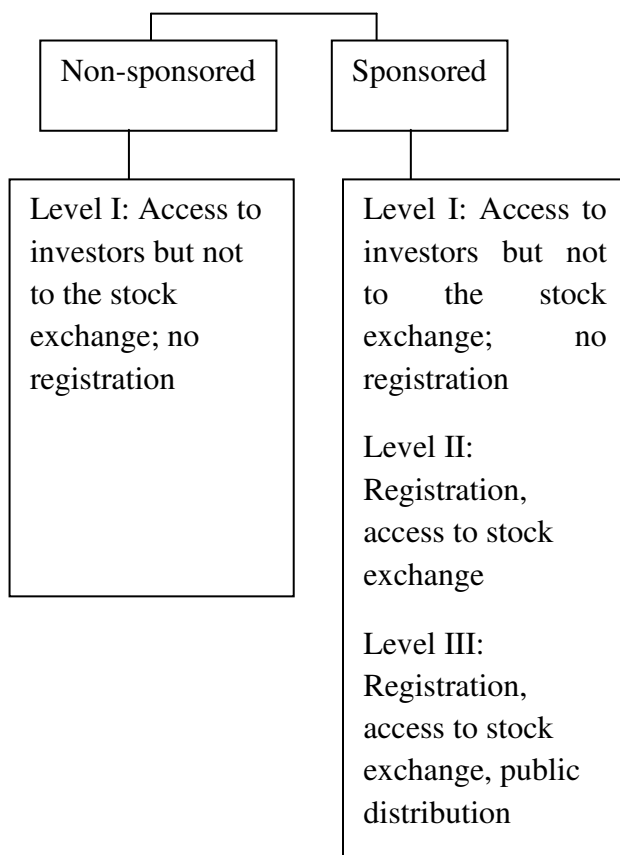
²⁷ The Brazilian capital markets are regulated and monitored by the National Monetary Council (Conselho Monetário Nacional, CMN), the Brazilian Central Bank (Banco Central do Brasil) and the Brazilian Securities and Exchanges Commission (Comissão de Valores Mobiliários, CVM).

The BDR programme is described in detail below, with a discussion of the two categories of the BDR programme.

BDR Programme

The BDR programme is schematically represented in Figure 2. Similar to the ADR programme,²⁸ the BDR programme consists of 3 levels based on the amount of disclosures required to be made by the issuer company. There are two categories of BDR: sponsored (comprising Level I, II, or III) and non-sponsored (comprising Level I), as illustrated in Figure 2.

Figure: 2 Two Categories of the BDR Programme



²⁸ In the ADR programme, there are three levels of DR programmes.

Non-sponsored Level I BDRs are listed at the BM&FBOVESPA's OTC market and are traded on the Mega Bolsa, the Exchange's electronic equities trading platform. (The BM&FBOVESPA, also known as the Sao Paulo Stock Exchange, is the most important Brazilian institution for intermediate equity market transactions, and the only securities, commodities, and futures exchange in Brazil.)²⁹ On the other hand, sponsored Level II and III BDRs are traded at the BM&FBOVESPA on the Mega Bolsa.³⁰ The Mega Bolsa is a high-performance electronic trading platform in which 99.5% of the orders sent to the system take less than a second to be processed. Equities, exchange-traded funds (ETFs) and Brazilian Depositary Receipts (BDRs) are some of the products traded on it.³¹

In the sponsored BDR programme, there is a sole depositary institution (or issuing company), which is contracted by the company issuing the securities mentioned in the depositary receipt. The company issuing the securities is known as the sponsoring company and is responsible for bearing the cost of the DR programme. The sponsored BDR programme is classified into three levels: Level I, II, and III.³²

The non-sponsored BDR programme is instituted by one or more depositary institutions working with the DR certificate and requires no formal agreement with the company issuing the securities. The non-sponsored programme has a single level only (Level I), which is similar to Level 1 in the sponsored BDR program.

The various levels under the sponsored BDR programme are explained below.

²⁹ About BM&FBOVESPA, <<http://www.bmfbovespa.com.br/en-us/intros/intro-about-us.aspx?idioma=en-us>>

³⁰ BDRs: Brazilian Depositary Receipts, taken from <<http://www.bmfbovespa.com.br/en-us/markets/other-markets/bdrs-brazilian-depositary-receipts/bdrs-brazilian-depositary-receipts.aspx?idioma=en-us>>

³¹ Trading Platforms: Equities, ETFs and Brazilian Depositary Receipts, taken from <<http://www.bmfbovespa.com.br/en-us/services/trading-platforms/equities-ETFs-and-brazilian-depositary-receipts.aspx?idioma=en-us>>

³² The depositary institution is responsible for structuring the launch of the programme on the Brazilian market, for obtaining the registration of the BDRs, and, when required, for obtaining the registration of the company with the CVM. The depositary is also responsible for obtaining the registration of the BDRs with the stock exchange, organised OTC market, or electronic trading system (in certain cases), coordinating the distribution of rights on the Brazilian market (dividends, bonuses, or subscriptions), as well as publicising information about the programme and about the company issuing the securities objectified in the BDRs.

Level I BDR Programme: For companies cross listing through Level I of the BDR program, trading is limited to the non-organised OTC market,³³ and is permitted only for qualified investors.³⁴ The companies selecting the Level I BDR programme are exempt from a) registering with the Brazilian securities market regulator (i.e., the CVM), and b) providing information about its company other than whatever is required by law in its country of origin.

Level II BDR Programme: Companies choosing Level II of the sponsored BDR programme are required to be registered with the Brazilian securities market regulator (CVM), and are allowed to trade on stock exchanges, organised OTC markets, or electronic trading systems.³⁵

Level III BDR programme: This programme is only allowed for securities that are simultaneously distributed in Brazil and overseas. Companies applying for this level are required to be registered with the securities market regulator of Brazil and are admitted for trading on stock exchanges, organised OTC markets, or electronic trading systems. The Level III BDR programme also requires the drawing up of a Public Offering Prospectus.³⁶ This is the public distribution characteristic that companies applying for the Level III BDR programme have to meet, and is the distinguishing feature of this programme compared to the Level II BDR programme.

In the following section, the regulatory framework of BDRs is discussed.

³³ In non-organised OTC markets, transactions are not supervised by the securities market manager entities, and are carried out by financial institutions that participate in the securities market system for the distribution/placement of securities.

³⁴ These qualified foreign investors are financial institutions and other institutions authorised by the Central Bank of Brazil, by employees of the sponsoring company or its subsidiary, by insurance brokerage firms and savings capitalisation corporations, by corporate entities having a net worth of over USD 2.8169 million (R\$ 5 million), or by securities portfolios worth more than USD 280426 (R\$ 500,000) (Bovespa Guide, BDR Program).

³⁵ In addition to stock exchange trading, securities are also traded on the OTC market, which includes organised and unorganised markets. Organised OTC markets are supervised by the securities market manager entities such as stock exchanges, whose activities are authorised by the Securities and Exchange Commission of Brazil. The transactions of non-organised OTC markets are not supervised by the securities market manager entities (as discussed in Footnote 33).

³⁶ This is the document containing all of the information regarding the offer in question and the sponsoring company.

Regulatory Framework of BDRs

The BDRs are required to be registered with the regulatory body, the CVM. The CVM often releases instructions and circulars dealing with various capital market instruments. The BDR Programme is regulated by the CVM Instruction No. 331 and No. 332.

Box 2: Regulatory Framework of BDRs

Regulatory Bodies of BDRs

- National Monetary Council (CMN)
- The Brazilian Central Bank
- The Brazilian Securities and Exchanges Commission (CVM)

Laws Governing BDRs

- CVM Instruction No. 331 and CVM Instruction No. 332

The CVM Instruction No. 332 deals with Level II and level III BDRs. Article 3 of this instruction stipulates that company registration requires the appointment of a company officer designated by the depositary institution and a legal representative designated in Brazil. The function of the legal representative includes sending information as mentioned in Article 5 to the CVM, updating the registration data, and disclosing relevant information (regarding Articles of Association, profitability, expenses, etc.) to all the markets in which it participates.³⁷ Article 12 requires the legal representative to furnish consolidated financial statements as disclosed in other countries or markets, annual records, minutes of the annual general meeting, and so on.

Another prerequisite for any company participating in the BDR programme is that its home country's regulatory body has to enter into a Memorandum of Understanding with the CVM.³⁸

The following section outlines the performance of BDRs.

³⁷ This is stipulated in Article 11 of CVM Instruction No. 332.

³⁸ BOVESPA Guide: BDRs Programs, http://www.bmfbovespa.com.br/Pdf/bdr_i_20122001.pdf

Performance of BDRs

Currently, there are only two Level II BDRs³⁹ and seven Level III BDRs.⁴⁰

Typically, BDRs are popular among those international companies that have strong ties with Brazil. An example is the Spanish telecommunications provider Telefónica that owns Teles, which is the telephone service provider for Sao Paulo. It set up the BDR programme to facilitate local trading in the parent company. Some of the companies have operations primarily in Brazil; however, they are incorporated in foreign jurisdictions for tax purposes, and issued BDRs back into Brazil.⁴¹

The early years of the twenty-first century witnessed a great change in the economic policies of the Brazilian Government, the positive effects of which were evident in the growth of the Brazilian capital market. The growth in the Brazilian market has also picked up in BDRs recently.

Coca-Cola, Colgate-Palmolive, Nike, and seven other foreign companies began trading on the BM&FBOVESPA with the issuance of non-sponsored Level I BDRs.⁴² Following a BM&FBOVESPA (Brazil) regulation change in 2010, the first 10 non-sponsored BDRs started trading on 5 October, 2010 and an additional 10 BDRs began trading on 29 November, 2010.⁴³ Currently, there are 70 non-sponsored Level I BDRs, consisting mainly of multi-national companies such as eBay Inc., Ford Motors, Google Inc., Johnson & Johnson, Kraft Foods Inc., Nike Inc., and McDonalds Corp. There are four Level II sponsored BDR programmes: Lan Airline S.A., Pacific Ruviales Energy Corp., Solvay Indupa S.A.I.C, and TGLT S.A. There are seven Level III sponsored BDR programmes including those of Agrenco Ltd., Bco Patagonia S.A., and Cosan Ltd.

The following section discusses the Hong Kong Depositary Receipts.

³⁹ The two Level II BDRs belong to Solvay Indupa S.A.I.C. and TGLT S.A.

⁴⁰ <<http://www.bmfbovespa.com.br/cias-listadas/Mercado-Internacional/Mercado-Internacional.aspx?Idioma=en-us>>

⁴¹ http://www.ftsglobalmarkets.com/index.php?option=com_k2&view=item&id=2360:the-wheels-of-fortune-turn-for-drs

⁴² BM&FBOVESPA: Trading Starts In Coca-Cola, Nike, Mastercard And Seven Other Foreign Companies In Brazil - Trading Of These Foreign Companies On The Exchange Possible After Itaú Unibanco Issued Un-sponsored Level I Brazilian Depositary Receipts (BDRs), July 25 2011, <http://www.mondovisione.com/media-and-resources/news/bmandfbovespa-trading-starts-in-coca-cola-nike-mastercard-and-seven-other-forei/>

⁴³ JPM Depositary Receipts Year in Review 2010, J.P.Morgan, <www.jpmorgan.com/cm/BlobServer?blobcol=urldata...>

C. Hong Kong Depositary Receipts

Hong Kong is strategically situated in the high-growth Asian market and serves as an important financial hub for Hong Kong, Mainland China, and the rest of the Asia-Pacific region. Thus, it becomes interesting to analyse the Hong Kong Depositary Receipts (HDRs). Moreover, the lack of a DR system in China is compensated by the HDRs. (Box 3 provides details about the absence of a DR System in Mainland China.)

Box 3: Absence of a DR framework in Mainland China

Currently, China denies open access to foreign companies. However, recent developments suggest that the authorities may soon allow foreign entities to list on the Shanghai Stock Exchange. The Shanghai Stock Exchange is being eyed by major firms such as Coca Cola, HSBC, Standard Chartered, and Unilever for listing.⁴⁴

In December 2007, during the fourth Sino-US Strategic Economic Dialogue, China agreed to allow qualified foreign companies to issue RMB-denominated stocks and to be listed on a stock exchange in China. In order to allow foreign companies full access to the A-share stock market,⁴⁵ the China Securities Regulatory Commission (CSRC) has been continuously seeking legal reform since the annual session of the National People's Congress in March 2007, in order to establish a pilot programme for Chinese state-owned Red Chips⁴⁶ to sell A-shares. Due to the global economic crisis, the process was delayed. However, the Ministry of Commerce (MOFCOM) recently announced that China would resume its previous goal of allowing foreign companies to sell A-shares on a Chinese stock exchange. The CSRC can go for either listing of China Depositary Receipts (CDRs) modeled after ADRs or for direct A-share listing. There has been speculation that the CSRC is keen on direct listing because CDRs are generally regarded as more complicated to implement; moreover, direct A-share listing will fulfill China's goal of enhancing the prestige of its domestic exchanges.⁴⁷

Currently, China does not have any DR framework in place. However, as the above discussion suggests, China is moving towards developing such a regulatory framework for DRs.

⁴⁴ Dominic Rushe, Coca-Cola plans to list on Shanghai stock exchange, Guardian New York, 1 June 2011, <<http://www.guardian.co.uk/business/2011/jun/01/coca-cola-plans-list-shanghai-stock-exchange>>

⁴⁵ A-shares are shares in Mainland China-based companies that trade on Chinese stock exchanges such as the Shanghai Stock Exchange and the Shenzhen Stock Exchange. A-shares are generally available for purchase only to citizens of Mainland China; foreign investment is allowed only through a tightly regulated structure known as the Qualified Foreign Institutional Investor (QFII) system.

⁴⁶ Red Chips are stocks of Mainland Chinese companies that are incorporated outside Mainland China and listed in Hong Kong.

⁴⁷ <[http://www.broadbright.com/nl/\(No.16\)Foreign%20Company%20Listings%20on%20the%20Shanghai%20Stock%20Exchange\(Perhaps%20Not%20So%20Far-Fetched%20as%20You%20Might%20Think\).pdf](http://www.broadbright.com/nl/(No.16)Foreign%20Company%20Listings%20on%20the%20Shanghai%20Stock%20Exchange(Perhaps%20Not%20So%20Far-Fetched%20as%20You%20Might%20Think).pdf)>

Cross listing in Hong Kong dates back to the 1980s when most of the Mainland-related firms (MRFs)⁴⁸ were listed in Hong Kong.⁴⁹ Chinese stocks listed in Hong Kong can be classified into direct listing and indirect listing (which does not necessarily imply Depositary Receipts).⁵⁰ Direct listing refers to the listing of companies incorporated in Mainland China. They are referred to as H-shares if the companies are incorporated in China and are approved by the China Security Regulatory Commission (CSRC).⁵¹ There are various types of indirect listings prevalent in Hong Kong; Red Chips⁵² are considered typical examples of indirect listing. Red Chips are the stocks of companies that are incorporated outside Mainland China, either in Hong Kong or in tax havens such as the Cayman Islands or Bermuda through backdoor listing by creating a shell company.

The DR framework of Hong Kong was launched in May 2008 and it came into effect in July 2008. The HDR initiative emerged from the Hong Kong Exchanges and Clearing (HKEx) Strategic Plan of 2007-09, with the objective of listing more overseas companies in Hong Kong. Reportedly, the HDR system is likely to change the earlier cross listing framework that relied only on the companies from Mainland China, and would facilitate the diversification of the constituents of its market issuers. The main features of the HDR model are discussed in the next section.

⁴⁸ In this context, Mainland-related firms (MRFs) refer to firms in Mainland China.

⁴⁹ The listing of MRFs in Hong Kong has prevailed since the 1980s through ordinary share offerings.

⁵⁰ The DR mechanism was introduced only in July 2008.

⁵¹ Firms that are incorporated in New York and listed in Hong Kong are referred to as N-shares, while those incorporated in London and listed in Hong Kong are known as L-shares.

⁵² According to Hong Kong Exchange, a Red Chip company is a company that has at least 30% of its shares in aggregate held by Mainland China entities or indirectly through companies controlled by them, with the Mainland China entities being the largest shareholders in aggregate terms. Alternatively, a Red Chip company would have less than 30% but more than 20% of its shares being held directly or indirectly by Mainland China entities, with a strong influential presence of Mainland China-linked individuals on the company's Board of Directors.

HDR Model

According to the Hong Kong Depository Receipts model provided by the Hong Kong Exchanges and Clearing Limited (HKEx), an issuer does not have to be listed on another exchange before it can issue HKEx's Framework for Depository Receipts (HDRs) in Hong Kong. Issuers listing in HDR have to comply with the same listing regime as issuers listing in the form of shares. The features of the HDR model are explained in Box 4.

Box 4: HDR Features

- No change to the basic listing regime. HDR listing requirements equivalent to those for shares.
- Two-tier legal DR structure.
- HDR framework applies only to the Main Board (but not to the Growth Enterprise Market).
- Allows issuers to target retail investors.
- No requirement for the issuer to be already listed on another stock exchange.
- HDRs are freely transferable.
- Trading, clearing, and settlement procedures are the same as for shares.
- Applicable Exchange fees and charges are the same as for shares.
- Stamp duty is the same as for shares (0.1% per side).
- The HDRs will be traded and settled in Hong Kong Dollars or US Dollars; the choice of currency will be left to the HDR issuer.

Next, the regulatory framework of HDRs is described.

Regulatory Framework of HDRs

The regulatory framework governing HDRs is presented in Box 5. For the issue of HDRs, issuers from any jurisdiction who can meet the requirements set out in the Joint Policy Statement Concerning the Listing of Overseas Companies issued by the Exchange and the SFC on 7 March, 2007 as well as the related requirements of the Listing Rules are welcome to apply to the Exchange.⁵³

⁵³ HKEx's Framework for Depository Receipts (HDRs): Frequently Asked Questions (FAQs), Released on 9 May 2008, http://www.hkex.com.hk/eng/rulesreg/listrules/listrulesfaq/Documents/drf_faqs.pdf

Box 5: Regulatory Framework of HDRs

Regulatory Bodies

- The Securities and Futures Commission
- The Hong Kong Exchanges and Clearing Limited (HKEx)
- The Stock Exchange of Hong Kong Limited
- Clearing House

Regulations

- Listing Rules
- General Rules of Clearing and Settlement System (CCASS Rules)
- The CCASS Operational Procedures and Terms
- Conditions for Investor Participants for the Launch of Depositary Receipts

The listing of shares through HDRs requires compliance with the Main Board Listing Rules. Chapter 8 of the Listing Rules lays down the qualification for listing, which states that the issuer company must satisfy the profit test or the market capitalisation/revenue/cash flow test⁵⁴ Chapter 19B of the Listing Rules specifically deals with HDRs; according to this, the rules of the country of origin should be followed with regard to the eligibility criteria of the issuer, obtaining consent, and so on.⁵⁵

Performance of HDRs

One school of thought argues that Hong Kong has benefitted from the capital restrictions imposed by Taiwan on China. Thus, in order to avoid the restrictions imposed by Taiwan, Taiwanese companies list on the Hong Kong Exchange. Considering the number of foreign companies listing on the HKEx, HDRs were introduced as an alternative to secondary listing of ordinary shares in case of differences/incompatibility between the laws and regulations of the listing jurisdiction and the home country.⁵⁶

⁵⁴ Chapter 8, Main Board Listing Rules, Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited: Equity Securities, <http://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/vol1_2.htm>

⁵⁵ Chapter 19B-12-14

⁵⁶ JPM Depositary Receipts Year in Review 2010, J. P. Morgan, <www.jpmorgan.com/cm/BlobServer?blobcol=urldata...>

On analysing the features of HDRs, it can be inferred that the regulatory framework of HDRs is issuer-friendly but has attained only moderate success. The Stock Exchange of Hong Kong published a new Chapter 19B to the Main Board Listing Rules in May 2008, and allowed issuers to list on the Main Board from July 2008. However, the first HDR was issued only in 2010, when J. P. Morgan helped Vale of Brazil launch the first HDR.⁵⁷ The HDRs listed so far are presented in Box 6.

Hong Kong Depositary Receipts will continue to develop as an alternative to ADRs and GDRs, as multinational companies with large existing sales operations in Asia or those that would like to tap into the growing pool of liquidity in Asia seek to list on the Hong Kong Stock Exchange (Morgan Stanley, 2011).

Box 6: HDRs listed so far

- Vale Common DRS COMMON-DRS (Brazil)
- Vale Pref DRS (Brazil)
- SBI Holdings-DRS (Japan)
- Coach DRS RS (USA)

This concludes the discussion about HDRs. The next section discusses the Indian Depositary Receipts.

D. Indian Depositary Receipts

Indian Depositary Receipts (IDRs) were introduced for the listing of foreign companies on Indian stock exchanges in order to attract Indian investors. The IDRs are freely priced. However, in the IDR prospectus, the issue price will have to be justified as is done in the case of domestic equity issues. Each IDR represents a certain number of shares of the foreign company. The shares are listed in the home country. Normally, a DR can be exchanged for the underlying shares held by the custodian and sold in the home country, and vice versa. However, automatic fungibility is not permitted in the case of IDRs. The regulatory framework of IDRs is described below.

⁵⁷ Depositary Receipts Year in Review 2010, J. P. Morgan, taken from <
[22](http://www.jpmorgan.com/cm/BlobServer?blobkey=id&blobwhere=1320534215261&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs&blobheadname1=Content-disposition&blobheadvalue1=attachment;filename=JPM%20DR%20Year%20in%20Review.pdf.></p></div><div data-bbox=)

Regulatory Framework of IDRs

Since 2000, the Indian Government has taken steps to liberalise India's corporate and securities laws to permit foreign companies to raise capital in India. The provision enabling the issue of IDRs was first introduced into the Companies Act, 1956 (henceforward referred to as the Act) a decade ago in the form of Section 605A of the Act by the Companies (Amendment) Act, 2000. This gave the Government of India the power to make rules for the offer of IDRs and related matters. Following this, all the regulators of the Indian corporate sector, namely, the Central Government acting through the Ministry of Corporate Affairs (MCA), the Securities and Exchange Board of India (SEBI), and the Reserve Bank of India (RBI), framed rules and regulations governing IDRs. In February 2004, the Government of India passed the Companies (Issue of Indian Depository Receipts) Rules 2004 (henceforward referred to as the IDR Rules), building on the amendments to the Act issued in December 2000, in order to allow foreign companies to sell securities to Indian investors. The SEBI introduced guidelines to list IDRs on Indian stock exchanges under Chapter VIA of SEBI (Disclosures and Investor Protection) Guidelines, 2000, which were subsequently replaced by the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (ICDR Regulations).

Additionally, the SEBI issued a Circular dated April 30, 2006,⁵⁸ through which it specified the Model Listing Agreement for the listing of IDRs; subsequently, the SEBI simplified the said Listing Agreement vide its Circular dated June 16, 2009. The RBI issued a circular in 2009 that provided some clarifications for foreign companies desirous of issuing IDRs. As per this circular, the regulatory framework under the RBI governing IDRs would be aligned with the recent proactive measures taken by the MCA and the SEBI, by making consequential amendments to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 and the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004. The directions contained in this circular were issued under Sections 10(4) and 11(1) of the Foreign Exchange Management Act, 1999.

⁵⁸ Circular No. CFD/DIL/IDR/1/2006/3/4.

The regulatory framework of IDRs are summarised in Box 7.

Box 7: Regulatory Framework of IDRs

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
- Companies (Issue of Indian Depository Receipts) Rules 2004
- Chapter VIA of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

The following section briefly discusses the model of IDRs, followed by a discussion of the performance of IDRs since their introduction in 2000.

Model of IDRs

In case of IDRs, a minimum of 50% of the issue should be allotted to qualified institutional buyers (QIB),⁵⁹ whereas 30% of the issue should be offered to retail individual investors. The remaining 20%

⁵⁹ As per Regulation 2(1) (zd) of the Securities And Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, a qualified institutional buyer means:

- (i) A mutual fund, venture capital fund, or foreign venture capital investor registered with the Board;
- (ii) A foreign institutional investor or sub-account (other than a sub-account that is a foreign corporate or foreign individual) registered with the Board;
- (iii) A public financial institution as defined in Section 4A of the Companies Act, 1956;
- (iv) A scheduled commercial bank;
- (v) A multilateral or bilateral development financial institution;
- (vi) A state industrial development corporation;
- (vii) An insurance company registered with the Insurance Regulatory and Development Authority;
- (viii) A provident fund with a minimum corpus of INR 25 crore;
- (ix) A pension fund with a minimum corpus of INR 25 crore;
- (x) The National Investment Fund set up by Resolution No. F. No. 2/3/2005-DDII, dated 23 November, 2005 of the Government of India published in the Gazette of India; or
- (xi) Insurance funds set up and managed by the Army, Navy, or Air Force of the Union of India.

is to be apportioned between non-institutional investors (NII)⁶⁰ and employees at the discretion of the issuer company. Undersubscription in any of the categories other than the QIB category can be adjusted against oversubscription in other investor categories.⁶¹ The IDRs can be converted into the underlying equity shares only after the expiry of one year from the date of issue of the IDR, subject to compliance with the related provisions of the Foreign Exchange Management Act and the Regulations issued by the RBI in this regard.

There are several requirements for a foreign company to issue IDRs, as shown below:

- Pre-issue paid-up capital and free reserves of at least USD 50 million, and a minimum average market capitalisation (during the last 3 years) in its parent country of at least USD 100 million;
- A continuous trading record or history on a stock exchange in its parent country for at least three immediately preceding years;
- A track record of distributable profits for at least three of the immediately preceding five years.

The performance of IDRs since their introduction in 2000 and the reasons for the lack of popularity of IDRs are discussed in detail in the following section.

Performance of IDRs

Although IDRs were introduced in 2000, the Indian securities market saw its first IDR from Standard Chartered Plc in May 2010. This IDR is listed on the National Stock Exchange and the Bombay Stock Exchange.⁶² (Box 8 presents a brief case study on Standard Chartered's DR.)

This section analyses some of the reasons for the lack of interest in the IDR market. These include: a) lack of fungibility; b) stringent eligibility criteria; c) lack of clarity on the issue of taxation; d) lack of advertising; and e) concern over the stipulation of allocating 50% of an IDR issue to retail investors.

⁶⁰ As per Regulation 2 (1) (w) of the Securities And Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, a non institutional investor” means an investor other than a retail individual investor or a qualified institutional buyer.

⁶¹ Kayezad E. Adajania, Indian depository receipts and how to make use of them, May 25, 2010 <<http://www.livemint.com/2010/05/25223126/Indian-depository-receipts-and.html>,> last visited on December 23, 2011

⁶² Tania Kishore Jaleel, Regulatory shock for IDR holders, Mumbai June 08, 2011, Business Standard, taken from <<http://www.business-standard.com/sme/storypage.php?autono=438226>> last visited on December 25th, 2011

- a. **No automatic fungibility:** Rule 10 of the Companies (Issue of Indian Depository Receipts) Rules, 2004 deals with the procedure for the transfer and redemption of IDRs. As per this rule, “a holder of IDRs may transfer the IDRs or may ask the Domestic Depository to redeem these IDRs, subject to the provisions of the Foreign Exchange Management Act, 1999 and other laws for the time being in force.” The RBI’s circular dated July 22, 2009 prohibited automatic fungibility of IDRs: “IDRs shall not be redeemable into underlying equity shares before the expiry of one year period from the date of issue of IDRs.” Further, as per Regulation 100 of Chapter X of the SEBI (ICDR) Regulations, “IDRs shall not be automatically fungible into underlying equity shares of issuing company.”

The extant regulatory framework does not permit fungibility, and allows only redemption. Therefore, allowing redemption freely without two-way fungibility could result in the reduction of the number of IDRs listed as per the SEBI, thereby impacting its liquidity in the domestic market. Therefore, the SEBI (in exercise of the powers conferred under Section 11 read with Section 11A of the Securities and Exchange Board of India Act, 1992) issued a circular on June 03, 2011⁶³ to regulate the redemption of IDRs into shares after the expiry of one year from the date of issue. As per this circular, after the completion of one year from the date of issuance of IDRs, the redemption of the IDRs would be permitted only if the IDRs were infrequently traded on the stock exchange(s) in India. The IDRs shall be deemed to be “infrequently traded” if the annualised trading turnover in IDRs during the six calendar months immediately preceding the month of redemption is less than 5% of the listed IDRs.⁶⁴ The issuer company shall test the frequency of trading of IDRs on a half-yearly basis, by the end of June and December every year. Since free fungibility was not allowed, redemption after one year was considered as an incentive. The Standard Chartered IDR faced the risk of currency movement only because they had the right to redeem at will after one year, and this provided them an incentive to hold on.

The addition of the “infrequently traded” clause appears to be unfair. It is likely to discourage companies from listing IDRs in future. The IDR holders redeem IDRs into shares only when

⁶³ CIR/CFD/DIL/3/2011

⁶⁴ <<http://www.sebi.gov.in/circulars/2011/circfddil032011.pdf>>

there is sufficient arbitrage opportunity. If the SEBI exempts this redemption then the arbitrage opportunity will disappear, and the demand for IDRs will rise. This was done in the case of ADRs in the US. By allowing two-way fungibility, the demand for ADRs rose sharply.

This step taken by SEBI could affect the future of IDRs. A stabilised market with insignificant arbitrage would have encouraged more companies to issue IDRs in the future. An IDR investor is denied the opportunity to benefit from arbitrage opportunity and exchange rate fluctuation. A step like this would undermine the confidence of the investors; for instance, the Standard Chartered IDR was down by about 16% soon after the issuance of this circular.⁶⁵

- b. **Stringent Eligibility Criteria:** The stringent eligibility criteria and listing norms for foreign issuers, has been criticised greatly. Such stringent norms regarding disclosure and corporate governance are in the interest of the investors; however, if we compare the norms in India with those in other emerging markets, it becomes apparent that such stringent norms are unfavourable, and would make IDRs unpopular among foreign issuers.

Stringent norms mean higher compliance cost, which discourages mid-sized companies from entering the Indian market. Moreover, India suffers from a multiplicity of norms and governing bodies. For listing in IDRs, companies are required to comply with several rules and regulations issued by various bodies. Thus, in order to ensure an investor-friendly mechanism without compromising the corporate governance norms, a balanced model is required.

- c. **Lack of clarity on the issue of taxation:** The lack of clarity on the issue of taxation is another very important factor that has led to the lack of interest in the IDRs. The IDRs are not subject to securities transaction tax. Dividends received by IDR holders are not subject to dividend distribution tax. Currently, exemption from long-term capital gains tax and concessional short-

⁶⁵ SEBI's bar on IDR redemption irks Standard Chartered's IDR-holders, June 6, 2011 <<http://www.indiabusinessview.com/news/941/sebi%E2%80%99s-bar-idr-redemption-irks-standard-chartered%E2%80%99s-idr-holders>>

term capital gains are not available for secondary sales on the stock exchanges. This issue needs clarity and is expected to be resolved with the implementation of the Direct Tax Code.⁶⁶

Presently, the Income Tax Act and other regulations do not specifically refer to the taxation of IDRs. The IDRs may therefore, be taxed differently from ordinary listed shares issued by other companies in India. If an IDR is sold within a year of purchase, the gains would be taxed at the income tax rates applicable to the seller. For exits made after a year, the tax rate would be 10% without indexation, and 20% with indexation.⁶⁷ However, this is likely to change with the implementation of the Direct Tax Code, which will change the computation period of the assets. Since the IDR does not deduct dividend distribution tax, dividends are taxed your hand as per the seller's income tax rates. In emerging countries like Taiwan, the tax laws for both equity shares as well as depository receipts are the same. This provides clarity to investors as well as issuers. According to the regional CEO of Standard Chartered Plc., "a right tax treatment would have fetched a better retail response."

- d. **Other constraints:** Another constraint is that insurance companies are not allowed to invest in IDRs.⁶⁸ Another factor could be the lack of advertising of IDRs. The IDRs were not marketed aggressively by Indian exchanges. Depository receipts like GDRs and ADRs have offices in various countries, and these offices market their instruments. Any new product needs aggressive advertising to make it popular, which was overlooked by the Indian exchanges. Implementing these two changes will make the IDR a more popular instrument.

⁶⁶ Indian Depository Receipts, <<http://www.kgcindia.com/publication/Overview%20-%20Indian%20Depository%20Receipts.pdf>>

⁶⁷ The adjustment of the various rates of taxation were done in response to inflation and to avoid bracket creep. Indexation is a method of tying taxes to an index in order to preserve the public's purchasing power during periods of inflation.

⁶⁸ Neeraj Swaroop, IDR suffering due to differential tax treatment, April 15, 2011, <<http://www.livemint.com/2011/04/14222359/Neeraj-Swaroop--IDR-suffering.html>>, last visited on January 3, 2012

Box 8: Case Study on the IDR of Standard Chartered Plc.

The first Indian Depository Receipt (IDR) was that of Standard Chartered Plc. (henceforward referred to as StanChart), launched on May 13, 2010. This was done to boost the company's market visibility and brand perception in India. There was an issue of 240 million IDRs where every 10 IDRs represented one share of StanChart. This was their third listing, following their listing on the London Stock Exchange and the Hong Kong Stock Exchange.

The StanChart IDR issue was opened for subscription on May 25, 2010 until May 28, 2010. Though the price band of the IDR was between INR 100 and INR 115, most of the bids were between INR 100 and INR 104.

The bank issued 240 million IDRs (including the anchor investor's share of 36,000,000 IDRs). The total number of bids received at the NSE and the BSE were 312,025,000 and 137,680,000 IDRs, respectively, while the total number of bids received at cut-off price was 15,033,200. At the BSE, the IDR issue of StanChart was subscribed 2.2 times, while at the NSE, the issue was subscribed 1.53 times.

Problems faced by Standard Chartered during the issue

1. The two risks faced by StanChart were:
 - Interest rate risk due to short term borrowing to fund long term assets; and
 - Currency risk due to the strengthening of the US Dollar vis-à-vis local currencies in the countries of its presence.
2. The pricing and price movement in IDRs was directly linked to the share price of StanChart in the London Stock Exchange; this led to apprehension because any slowdown in the European economy would in turn affect the valuation of the bank, which would hamper its price movement in IDRs.
3. Tax issues (as discussed earlier in the paper).

Post-issue Concerns

1. Redemption: The StanChart IDR fell by almost 20% after the issue of SEBI's circular (CIR/CFD/DIL/3/2011) on June 3, 2011 that disallowed redemption after one year except in cases where the shares were illiquid.
2. The bulk of the investor base for StanChart was composed of Foreign Institutional Investors (FIIs). The only reason for FIIs to invest in this IDR was that they could be obtained at lower rates in India compared to London. The purpose of the IDR was to broaden the investor base in India. However, this objective was clearly not achieved because FIIs were allowed to invest in the issue.

To ensure the success of IDRs, India needs to first focus on a smaller region, and then move to the global market depending on its initial success. If the success of TDRs is analysed, it becomes apparent that they first focused on a more realistic short-term goal, which was to attract listings within Taiwan from overseas firms operated by Taiwanese or Chinese individuals. India could first focus on SAARC countries or neighbouring countries. Companies from neighbouring countries would find IDRs an attractive option to raise funds, as it would be easier and cheaper for them compared to the US or European markets.

The stipulation of allocating 50% of an IDR issue to retail investors has also raised some concerns. Such a stipulation would make it difficult to monitor companies in other countries, and it is not right to expose retail investors to such companies initially.⁶⁹

In summary, although Indian laws relating to capital markets are highly comprehensive, various obstacles prevent the issue of IDRs by foreign companies in India, such as tax issues and strict eligibility criteria.

Emerging markets have now adopted the two cornerstones of US securities regulation, i.e., disclosure and registration.⁷⁰ Brazil has introduced the concept of registration for Level II and Level III BDRs. Taiwan has exploited the benefit of its geographical location in making TDRs popular in the Taiwan-strait region. Thus, the emerging markets have now adopted the best practices being practiced in the US securities laws.

However, it should be noted that while adopting these principles, the emerging markets may have laid down stricter criteria for foreign issuers.

The next section presents the analysis of the performance of the DR programmes in the three countries other than India that were discussed so far.

⁶⁹Deeptha Rajkumar, No takers for Indian Depository Receipts, i-bankers blame it on lack of will, January 5, 2008 <http://articles.economictimes.indiatimes.com/2008-01-05/news/28398646_1_indian-depository-receipts-idr-norms-merchant-bankers> last visited on 10th January, 2012

⁷⁰ Frode Jensen, III, The Attractions of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Accessing the U.S. Markets: From a Legal Perspective, 17 *Fordham Int'l L.J.* at S26-27 (1994).

IV. Comparative analysis of performance of DRs

Securities regulation can be considered an offshoot of market failures or corporate scams. However, investor protection can be a deterrent for small cap companies that cannot afford the high costs of listing. Moreover, each company has its own optimal listing venue depending on various factors such as market capitalisation and market conditions at the time of listing. Changes in the Sarbanes Oxley Act and the European law relating to the increase in cost of listing have led to alternate venues for low cost listing.

An alternate view suggests that strict regulation promotes investor protection, thus reducing the minority shareholder expropriation risks. In the case of a lightly regulated securities market, risk-averse investors who desire to choose a disclosure requirement compliant portfolio may be forced to choose a sub-optimal one. Thus, such a scenario would lead to a “race to the bottom” in terms of listing requirements and standards (Glen, 2008).

In this section, the authors analyse the DR programmes of the three markets other than India that are the focus of this paper, and try to classify each programme into a sparsely regulated one or strictly regulated one. This analysis will help to identify the pros and cons of both kinds of regulatory mechanisms.

The earlier discussion related to the depositary regimes in different countries shows that India has the most stringent norms for the issue, listing, and trading of DRs. There are restrictions not only on the eligibility of issuers but also on the eligibility of the investors who can invest in IDRs. Such stringent criteria are not followed in any of the other countries that were studied. The comparative analysis of the various features of the DR programmes of the four countries is presented in Annexure 1.

In the following sections, the authors analyse some of the striking features of the DR programmes in Brazil, Taiwan, and Hong Kong that are lacking in India’s DR programme.

Brazil

Brazil has had a very successful stint with BDRs. Brazil seems to have the least stringent 3-tier BDR programme that provides flexibility and choice to foreign issuers. A foreign issuer issuing BDRs has the option of issuing a Level I BDR that has less stringent norms to be followed. Further, the emphasis

is on disclosure requirements rather than eligibility criteria for the foreign issuers. Another advantage of BDRs is that for unsponsored BDRs, no registration with the securities market regulator (CVM) is required, thus making it an attractive alternative for foreign issuers. There are no eligibility criteria with respect to capital, sales, or turnover of the company issuing BDRs, apart from the fact that it has to be a publicly held company. This makes it possible for any foreign company looking for entry into a new market to issue BDRs. Thus, it is clear that Brazil provides variety to the issuer as well as investor in terms of types of BDR programmes. However, cross-listing of securities is only possible in the case of Level II or Level III BDRs, both of which have higher disclosure standards. Thus, Brazil's DR programme can be classified as a sparsely regulated DR programme.

Taiwan

Another pertinent point is that the cheap listing fees in Taiwan makes it a hot spot for foreign issuers seeking to issue DRs. Taiwan has similar tax laws for equity shares as well as depositary receipts. Moreover, since Taiwan is a global leader in information technology, it provides special treatment to such companies, thereby attracting them for issuing TDRs. The listing process in Taiwan is fast and easy. There are fewer investment structures or tax planning issues in TDRs, which makes the TDR a popular instrument among foreign investors. Moreover, the TDR review process takes less time than an IPO listing. These are some of the factors that make a depositary receipt popular, and these features are lacking in IDRs.

Taking into account the various regulatory requirements pertaining to the profitability of the issuer company, Taiwan's DR programme can be classified as a strictly regulated DR programme. Notably, despite the regulatory hurdles, Taiwan has continued to attract foreign issuers for listing to its stock exchange. This can be attributed to various other factors like geographical location, ties with China, prior experience in cross-listing etc.

Hong Kong

Annexure 1 indicates that Hong Kong is another promising market for the issuance of DRs. The regulations for the issue of HDRs are issuer-friendly and are very similar to the regulation governing the issue of shares. One major advantage of HDRs is that issuers from any jurisdiction who can meet the requirements set out in the Joint Policy Statement Concerning the Listing of Overseas Companies

issued by the Exchange and the SFC on 7 March 2007 and the related requirements of the Listing Rules are welcome to apply to the Exchange. This flexibility is not present in Brazil, as the home country to which the issuer belongs is required to have signed a Memorandum of Understanding with Brazil.

In Hong Kong, there are no restrictions on investor participation. In fact, there is greater retail investor participation (up to 26%).⁷¹ For issuing HDRs, there is an offshore ordinary share register.⁷² This feature is unique to Hong Kong and is not present in other jurisdictions such as India and Brazil. Hong Kong is the only country that permits two-way fungibility for DRs.⁷³ This is not allowed in Brazil, Taiwan, or India, and is unique to HDRs. Moreover, Hong Kong gives the option to a new applicant (foreign issuer) to choose between three tests for eligibility of foreign issuers, namely, the market capitalisation/revenue test, the profit test, and the capitalisation/revenue/cash flow test. Thus, the HDR programme can be categorised as a flexible programme, i.e., a sparsely regulated DR programme, which provides foreign issuers three options to meet eligibility requirements.

These are some of the key features of BDRs, TDRs, and HDRs that are absent in India's current DR programme, which is strictly regulated. India's DR programme could tremendously benefit from the incorporation of these features.

Another point that is of relevance in this context is that country-specific national security laws often create a hurdle to the internationalisation of the securities market.⁷⁴ There are two kinds of approaches that can be followed in a globalised scenario—the commonality approach that requires every country to follow a common set of regulations and disclosure requirements, and the reciprocity approach that calls for mutual recognition of one country's regulatory framework by another.

The main difference between the development of securities markets in developed and emerging economies lies not only in the regulations but also in the disparities in economic development, culture,

⁷¹ Hong Kong Depository Receipts: The Innovation Continues' co-hosted by J.P. Morgan and The Asset on May 13

⁷² Ibid.

⁷³ Ibid.

⁷⁴ Disclosure In Global Securities Offerings: Analysis Of Jurisdictional Approaches, Commonality and Reciprocity, 20 Mich. J. Int'l L.207, Marc I. Steinberg And Lee E. Michaels

and other domestic issues.⁷⁵ All these factors have to be taken into account while developing a DR programme.

V. Conclusion

In recent years, cross-border listing, especially through Depository Receipts (DRs), has become one of the avenues for the integration of global securities markets. A domestic company could want to cross-list for various reasons, including an expanding investor base, the desire to improve stock liquidity through its highly liquid secondary market, the increasing visibility of the company, a growing customer base, and the wish to take exploit higher valuations.

This paper examined and compared the DR programmes and regulatory frameworks in four capital markets—Taiwan, Brazil, Hong Kong, and India. Considering the sheer magnitude of TDRs and BDRs, India lies far behind Taiwan and Brazil in the race to the top as an investor destination.

From the analysis presented earlier, it can be concluded that capital markets can be categorised into two categories: a strictly regulated one and a sparsely regulated market. India was found to have the most stringent norms for the issue, listing, and trading of DRs. There are restrictions not only on the eligibility of issuers but also on the eligibility of the investors who can invest in IDRs. The DR programmes of Brazil and Hong Kong were found to be sparsely regulated, while Taiwan was found to have a strictly regulated DR programme.

Significantly, it was observed that most of the countries studied in this paper relaxed the restrictions and regulations on DRs following the introduction of DRs; this move invariably led to an increase in the popularity of the DRs in these countries.

In order to compete with developed economies and attain the status of a favourable issuer destination, capital markets, especially emerging markets such as India, need to adopt issuer-friendly regulations, without compromising on investor protection. Stringent regulations are required to a certain extent, in order to regulate the market. However, this may lead to a decrease in the confidence of the issuers. Thus, capital markets should adopt a middle path wherein regulations do not deter issuer participation but are strong enough to ensure investor protection.

⁷⁵ Ibid.

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Annexure 1: Comparative Analysis of the DR Programmes in India, Brazil, Taiwan, and Hong Kong

S.No.	Points of difference	India	Brazil	Taiwan	Hong Kong
1.	Issuer Threshold Requirement	Pre-issued paid up capital, and free reserves: USD 50 million Average Market capitalisation (3 years): USD 100 million	Fulfilment of corporate disclosure requirements and public company requirements in country of origin	Number of TDR units to be issued shall be 20 million units or more of TDRs, or shall have a market value of not less than TWD 300 million. Shareholder equity equivalent to TWD 600 million (around USD 20 million). Profitability requirements: Pre-tax profit of at least 6% of shareholders' equity for the most recent year, 3% of shareholders' equity in each of the past 2 fiscal years. Pre-tax profitability should be TWD 250 million (around USD 8.5 million) each in the most recent two fiscal years. Not less than 1,000 TDR holders in Taiwan; shareholders should own at least 20% of the shares or 10 million shares.	One of the 3 tests can be met with: 1. The profit test: Trading record of not less than 3 financial years during which the profit attributable to shareholders must, in respect of the most recent year, be not less than HK\$ 20,000,000, and, in respect of the two preceding years, be in aggregate not less than HK\$ 30,000,000. 2. The market capitalisation/revenue/cash flow test: A trading record and management continuity of not less than 3 financial years; ownership continuity and control for at least the most recent audited financial year; a market capitalisation of at least HK\$ 2,000,000,000 at the time of listing; revenue of at least HK\$ 500,000,000 for the most recent audited financial year; and positive cash flow from operating activities carried out by the new applicant of at least HK\$ 100,000,000 in aggregate for the 3 preceding financial years. 3. The market capitalisation/revenue test: To meet this test, a new applicant must satisfy each of the following, unless waived by the Exchange under rule 8.05A: The requirements are the same as above, except that the market capitalisation requirement is lower, ⁷⁶ and there is no positive cash flow requirement. In addition, there should be at least 1,000 shareholders at the time of listing.
2.	Denomination	Indian Rupees	Reais dollars	NT Dollars (TWD)	Hong Kong Dollars (or US Dollars if

⁷⁶ A market capitalisation of at least HKD 4,000,000,000 is required at the time of listing.

S.No.	Points of difference	India	Brazil	Taiwan	Hong Kong
					the issuer so chooses)
3.	Fungibility	Two-way fungibility not allowed	<p>Cancellation of BDRs can be done in the following ways:</p> <ol style="list-style-type: none"> 1. The Brazilian investor decides to sell the shares underlying the same, on the market where the shares are held in custody. 2. The sponsoring company decides to repurchase the shares underlying the BDRs. 3. Foreign investors are interested in buying the BDRs and taking back the position for trading on the market of origin. 	Redeem the TDRs into shares	Two-way fungibility, provided there are no restrictions on the underlying shares
4.	Structure	No structure as such	Sponsored (Level II and III), non-sponsored (Level I)	Sponsored and non-sponsored Level I	Two-tier DR structure
5.	Cost	Listing fee as specified by the stock exchange	<p>Fees charged by CVM:</p> <p>Registration:</p> <ol style="list-style-type: none"> 1. Level II BDRs Programme: 0.10% 2. Level III BDRs Program: 0.20% <p>Inspection of the public company</p> <p>(Levels II and III):</p> <p>In accordance with net worth</p> <p>Net worth up to R\$ 8,285,000.00: R\$ 1,243.05</p> <p>R\$ 8,287,000.00 to R\$ 41,435,000.00: R\$-2,486.10</p> <p>More than R\$ 41,435,000.00: R\$</p>	<p>The listing review fee payable upon the filing of the TDR listing application is TWD 300,000.</p> <p>The maximum fee for each year is TWD 450,000,</p> <p>while the minimum fee is TWD 50,000.</p>	Listing fees: About 0.15-0.20% of amount raised

S.No.	Points of difference	India	Brazil	Taiwan	Hong Kong
			3,314.80		
6.	Time frame		Decision to list to filing: 60 days Filing to CVM registration: 60 days	Filing with the competent authority will be completed within 10 business days after the application is received	Same as listing of shares
7.	Geographical Factor	-	-	Favourable due to its close ties with China	Favourable due to its close ties with China
8.	Stringent/Non-stringent	Stringent	Non-stringent	Moderately stringent	Non-stringent
9.	Listing Requirement	Any country	Countries having MoU with Brazil	Companies listed on Foreign Stock Markets authorised by the Competent Authority	No requirement for the issuer to be already listed on another stock exchange
10.	Restrictions on investor participation	30% retail investor participation; resident Indian retail (individual) investors can apply up to an amount of INR 2,00,000	Restrictions on investment in BDR Level I. No restriction in Level II and III BDRs	No restrictions	No restrictions