

FOREIGN DIRECT INVESTMENT IN INDIA: RECENT DEVELOPMENTS

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Part I: Introduction to FDI in India

Part II: Recent Developments in FDI Regime in India

Section I: Investment by non residents with prior ventures

Section II: Issuance of shares against non cash consideration

Section III: Pricing guidelines – Liberalization

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Section V: Enforceability of Earn out Structures

Section VI: Enforceability of Put Options

Section VII: Pledge of securities

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Part III: Conclusion

1. Regulatory Framework for FDI in India

- Capital Account Transactions under Section 6 of FEMA
- Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (“FEMA 20”) & Circulars issued by RBI
- Consolidated FDI Policy issued by the DIPP on a half yearly basis

2. Sector Specific Policy

- Prohibited Sectors
 - > Multi brand retail
 - > Real estate (not being a construction development)
 - > Gambling etc.
- Sectors in which FDI is permitted subject to caps on foreign investment and/or compliance with conditions
- Other sectors -100% FDI permitted without restrictions

3. Entry Routes for FDI

- **Automatic Route**
- **Approval Route**

> FIPB

> CCEA (INR 1200 Crores and above)

➤ RBI (cases such as deferment of consideration)

No RBI approval is required for transfers of shares from R to NR that require FIPB approval; or made in compliance with SEBI SAST Regulations, or investee company is engaged in financial sector.

4. Types of instruments for FDI

- **Equity Shares**
- **Preference Shares**

> fully and mandatorily convertible permitted

> non-convertible, optionally convertible or partially convertible considered as ECB

- **Debentures**

> fully and mandatorily convertible permitted

- **Warrants & Partly paid shares**

> Approval Route

5. Pricing Guidelines

- **Fresh Issue**

- > Listed companies- SEBI Guidelines
- > Unlisted companies- not less than fair value as per DCF method

- **Preferential Allotment**

- > Listed companies- not less than preferential allotment price under ICDR Regulations
- > Unlisted companies- not less than fair value as per DCF method

- **Rights Issue**

- > Listed companies- Price determined by the company
- > Unlisted companies-not less than the price offered to resident shareholders

- **Transfer of shares**

- > Resident to Non-resident transfers are subject to a floor price
- > Non-resident to Resident transfers are subject to a ceiling

Investment by non residents with prior ventures

Press Note 18 of 1998

- Government approval required for FDI or technology collaborations if the foreign investor has, or had, a JV, technology transfer or trademark agreement in the same or an allied field
- Application to FIPB, explaining why a new venture is necessary
- foreign investor will have to prove the new proposal won't jeopardize the interests of the existing partner
- Implemented through a no objection certificate (NOC) from existing partner
- **Exemptions**
 - > Information Technology sector
 - > Investments by multinational financial institutions
 - > WOS in the mining sector for same area/mineral
- **Rationale**
 - > Protection of interests of Indian companies

Press Note 1 of 2005

- Prior approval of the Government required where the foreign investor has an existing JV or technology transfer / trade mark agreement as on January 12, 2005 in the same field.
- Onus to provide justification that new proposal would or would not jeopardize the interest of existing venture would lie equally on foreign investor and Indian partner
- **Additional exceptions to the rule**
 - > Investments by SEBI registered Venture Capital Funds
 - > Existing investment is less than 3 percent
 - > Existing joint venture/collaboration is defunct or sick

Investment by non residents with prior ventures

Abolishment of the condition: Circular 1 of 2011

- Requirement for prior government approval done away with
- Rationale
 - Promotion of competitiveness of India as an investment destination
 - Attraction of higher levels of investment and technology inflow
 - Reduction of state intervention in the commercial sphere

Commercial implications of the liberalization

- Indian JVs and companies with foreign technology partners need to fend for themselves with no hand-holding by the Government
- Contracts may include appropriate non-compete provisions to protect the interest of the Indian companies

Protection to JV partners under Partnership Act principle

- 2009 Bombay HC judgement in *Novartis Vaccines and Diagnostics Inc. v. Aventis Pharma Ltd.*
- Joint Venture is in the nature of a partnership
- Equitable duty of a partner not to compete
- Lack of negative covenant does not translate into a permission to compete

I. Pricing guidelines for issue and transfer of shares

Issue of shares	Transfer of shares
<p><i>Listed Co</i> – SEBI Guidelines</p> <p><i>Unlisted Co</i> – Fair valuation of shares as per DCF method</p>	<p><u>Transfer by R to NR:</u></p> <p><i>List Co</i> – Not less than the price at which preferential allotment of shares are made under SEBI Guidelines</p> <p><i>Unlisted Co</i> – Not less than fair value of shares as per DCF method</p>
	<p><u>Transfer by NR to R:</u></p> <p><i>List Co</i> – Not more than the minimum price at which preferential allotment of shares are made under SEBI Guidelines</p> <p><i>Unlisted Co</i> - Not less than fair value of shares as per DCF method</p>

Pricing Guidelines

List Co required to comply with different pricing guidelines i.e. under FEMA and relevant SEBI pricing guidelines/ regulations such as pricing for preferential allotment, block deals, buy-back, delisting, takeover regulations etc.

No RBI approval for transfer of shares from R to NR or NR to R if Pricing Guidelines under FEMA not met subject to:

- (a) [Original and] resultant investment in line with FDI Policy;
- (b) Pricing in accordance with relevant SEBI pricing regulations/ guidelines;
- (c) CA certificate to confirm compliance with SEBI pricing regulations/ guidelines.

Issue of shares against non cash considerations

1. Earlier Policy: Since November 2004

- **Issue of shares permitted against ECB from non-resident collaborators provided:**
 - > Activity of the company is under automatic route or Government approval has been obtained
 - > Sectoral cap is complied with
 - > Pricing guidelines are complied with
 - > Compliance with requirements under any other statute/regulation
- **Issue of shares permitted against lump sum technical know-how fee/royalty due for payment provided:**
 - > Activity of the company is under automatic route or Government approval has been obtained
 - > Sectoral cap is complied with
 - > Pricing guidelines are complied with
 - > Compliance with applicable tax laws

Issue of shares against non cash considerations

2. Liberalization: Circular 1 of 2011 as further liberalized by Circular 2 of 2011

- **Issue of shares permitted under the Government route against import of capital goods/machinery/equipment (including second-hand) provided:**
 - > Import is in accordance with the Export/Import policy and FEMA provisions in relation to imports
 - > A third party independent valuation of the capital goods is obtained along with assessment of fair value by the customs authorities
 - > The beneficial ownership and identity of the importer and non-resident entity is clearly indicated in the application
 - The application for capitalisation of import payables is made within 180 days of import
 - Application to be supported with special resolution of the company

Issue of shares against non cash considerations

- **Issue of shares permitted under the Government route against pre-operative/ pre-incorporation expenses provided:**
 - > FIRC for remittance of funds towards such expenditure is submitted by the overseas promoters
 - > The expenses are verified and certified by the statutory auditor
 - > the payments for the expenses are made directly to the company or through a bank account opened by the foreign investor
 - the application for capitalization is made within 180 days from the date of incorporation of the company
 - Application to be supported with special resolution of the company

Opening of Escrow Accounts: Liberalization

1. Liberalization towards providing operational flexibility to NR acquirers- May 2007

- AD Banks were permitted to open non- interest bearing escrow accounts in Indian Rupees on behalf of non-resident corporates without RBI approval for acquisition/ transfer of shares/ convertible debentures through
 - > Open offer
 - > Delisting
 - > Exit offer
- **Conditions**
 - > Compliance with applicable SEBI regulations, FEMA 20 and Companies Act
 - > No fund based / non-fund based facilities permitted
 - > The exchange rate risk for repatriation of any balance in the Escrow Account to be borne by the non-resident
 - > Account to be closed immediately after completion of requirements

Opening of Escrow Accounts: Liberalization

2. Further Liberalization- May 2011

- Non- interest bearing escrow accounts in Indian Rupees may be opened on behalf of residents/ non-residents without RBI approval towards payment of share purchase/ subscription consideration
- AD Banks and SEBI authorized DP may provide escrow facilities for keeping securities to facilitate FDI transactions without RBI approval
- **Conditions**
 - > compliance with applicable SEBI regulations and FEMA
 - > No fund based / non-fund based facilities permitted
 - > The exchange rate risk for repatriation of any balance in the Escrow Account to be borne by the non-resident
 - > Account to be closed immediately after completion of requirements or 6 months from account opening, whichever is earlier unless specific RBI permission has been obtained
 - > Terms of the escrow account to be laid down in the escrow agreement, share purchase agreement, conditions of issue of shares etc.

Opening of Escrow Accounts: Liberalization

Practical Implications: What does the liberalization mean commercially?

- **Ambiguity prior to the May 2007 liberalization**
 - > Lack of clarity as to requirement for RBI approval for opening escrow accounts whether for securities or consideration
 - > AD Category-I banks held differing views on whether RBI approval was required
- **Easier implementation of FDI transactions**
 - > Convenient mode to achieve simultaneous payment of consideration and transfer of shares
 - > Parties' commitment ensured in case of a gap between the agreement and implementation of the transaction due to regulatory approvals or conditions required to be satisfied etc.

Earn Out Structure or Deferred Payment Structure

Investor agrees to pay additional consideration for acquisition of shares subject to fulfillment of specified condition say achievement of agreed EBITA;
Variation to above structure –security / escrow for payment of indemnity;

Case in favour of Earn out structure

Mitigates risk and permits risk allocation in uncertain economic environment;
Necessary for transaction mechanics;
May lead to higher valuations;
Bridges the valuation gap between the parties;
Incentivizes the Seller / promoter to perform;

Legal Position and Structuring

Earn out structures are not permitted except with RBI approval;

Put Option

PE investors attach great significance to exit provisions as PE investors come with a investment horizon of 5-7 years;

Put Options / buy-back provisions are provided in the investment agreements as IPO does not guarantee an exit in uncertain economic conditions;

Even JV agreements contain such options as a fall out/ deadlock resolution method;

Put Option is at times coupled with a minimum rate of return linked to IRR;

Enforceability of Put Options

Under SCRA dealing in options otherwise than on stock exchange is not permitted. Case laws suggest that the provisions of SCRA are applicable to unlisted public companies as well;

Put Options in SHA have not found favour with SEBI – having directed the parties to delete such options in Cairn – Vedanta matter and disallowed in case of Vulcan Engineers matter;

RBI considers such investment as ECB and have issued notices;

Changes introduced in Consolidated FDI Policy

Consolidated FDI policy issued on October 1, 2011 provided that equity shares or convertible securities with 'no in-built options' of any type will only qualify as FDI; Instruments with built in options to be considered as ECB;

Introduction of new clause triggered confusion with respect to its application on clauses governing RoFR, Tag along Rights, Drag Along Rights; No clarity whether the change is retrospective or prospective;

The relevant provisions were, however, deleted after 30 days;

Confusion over RBI stance still prevails;

Comments

Put options in SHA are not independently tradable contracts with no separate consideration;

The investment is made in the company while put option is exercised on Promoters;

Instruments with Put Options exercisable at the valuation prevailing at the time of exercise need to be differentiated from the Options with a guaranteed return linked to IRR;

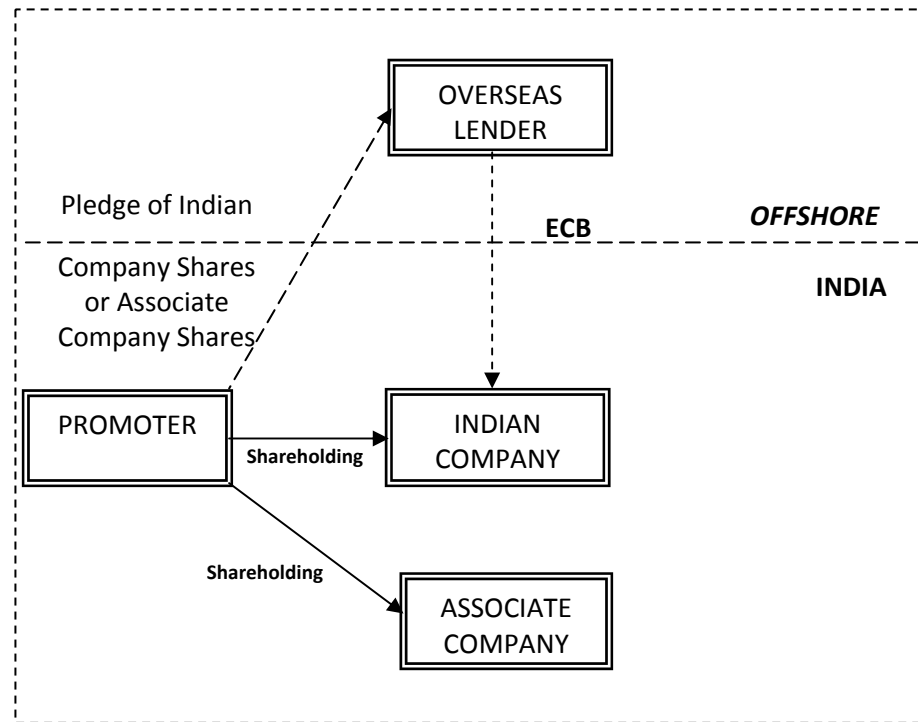
Under FEMA, the term “Transfer” includes sale, purchase, exchange, mortgage, pledge, gift, loan or any other form of transfer of right, title, possession or lien;

General permission is granted by RBI for sale, purchase or gift of shares by NR. Other forms of transfers or acquisitions are not permissible;

However, the following type of pledge have been recently permitted:

- Pledge by Promoter in favour of overseas lender of Indian Company;
- Pledge by Non Resident in favour of Indian Bank to secure credit facilities to Indian Company;
- Pledge by Non Resident in favour of overseas lender to secure credit facilities to Non Resident or its Group Company

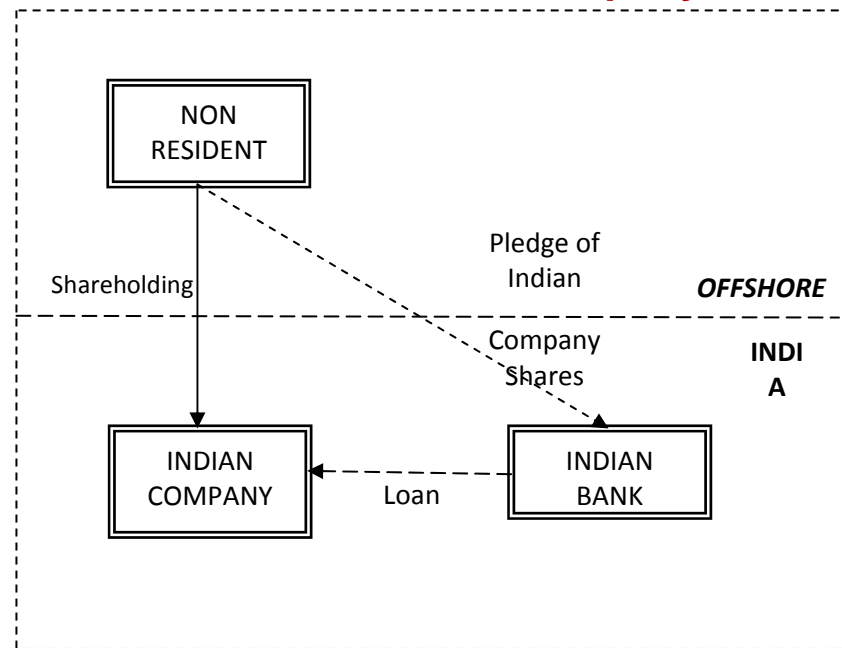
Pledge by Promoter in favour of Overseas lender of Indian Company



Pledge of Indian company or associate company shares is permitted subject to:

- No objection from AD Bank.
- In case of invocation, transfer as per FDI policy / RBI regulations applicable at the time of creation of pledge.
- Certificate from statutory auditor with respect to end use.

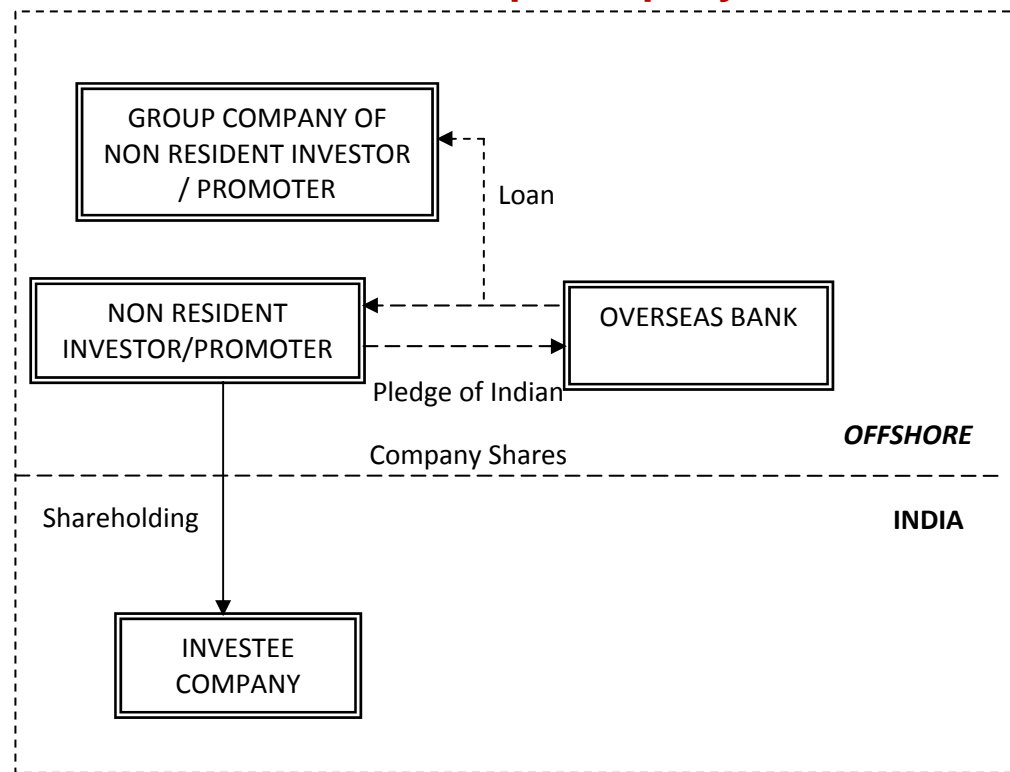
Pledge by Non Resident in favour of Indian Bank to secure credit facilities in favour of Indian Company



Pledge is permitted for bonafide business purposes subject to condition that:

- In case of invocation, transfer of shares to be made in accordance with FDI policy / RBI Regulations applicable at the time of creation of Pledge.
- Certificate from Statutory Auditor with respect to use of loan proceeds for declared purposes.

Pledge by NR in favour of Overseas lender to secure credit facilities to NR or its Group Company



Conditions:

- Loan should not result in capital inflow / investment in India.
- In case of invocation, transfer of shares to be made in accordance with FDI policy / RBI regulations applicable at the time of creation of pledge.
- Certificate from statutory auditor re: use of loan proceeds for declared purposes.

Downstream Investment Policy

- 1. Foreign Investment in companies engaged only in the activity of investing in other Indian companies**
 - Prior FIPB approval regardless of quantum of foreign investment;
 - Foreign investment into NBFCs is subject to minimum capitalization norms as specified depending on extent of foreign investment;
 - Foreign investment in CICs will additionally be subject to RBI's regulatory framework for CICs;

- 2. Foreign Investment in companies which do not have operations or downstream investments**
 - Prior FIPB approval regardless of quantum of foreign investment;
 - As when operations are commenced/ downstream investment made, relevant sectoral conditionalities, entry routes and caps to be complied;

- 3. Foreign Investment in other companies, ie; which have operations and/or downstream investments**
 - Relevant sectoral conditionalities, entry routes and caps to be complied;

Downstream Investment Policy

- 4. Downstream investment by companies owned and/or controlled by NRs**
- **Downstream investment**
 - > Indirect foreign investment by one Indian company into another
 - **Indirect foreign investment**
 - > Company owned and/or controlled by a non- resident
 - > Entire investment in companies other than WOS = indirect foreign investment
 - > Indirect foreign investment in WOS = foreign investment in investing company
 - **Downstream investment subject to compliance with relevant sectoral conditionalities, entry routes and caps**
 - **Conditions**
 - > Notification to SIA, DIPP & FIPB within 30 days of investment
 - > Downstream investment in an existing Indian Company to be supported by a resolution of the Board of Directors as also a shareholders agreement, if any
 - > Pricing to be in accordance with SEBI/ RBI Guidelines
 - > Funds to be brought from abroad and not leveraged from domestic market (downstream companies with operations may raise debt domestically; downstream investment permissible through internal accruals)

Recent amendments have caused more confusion than clarity

Grandfathering of amendments – must

Conflicts between FDI policy and FEMA

FDI in Retail

FDI in One Person Company

Macro Outlook

THANK YOU

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