Corpsec Hotline

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NEW CONSOLIDATED FDI POLICY 2013 RELEASED - GOVERNMENT OPTS FOR CONTINUITY!

The Department of Industrial Policy and Promotion ("**DIPP**"), as a feature of the annual revision of the consolidated foreign direct investment ("**FDI**") policy of India, has released the new consolidated FDI policy ("**New FDI Policy**"), being the Circular 1 of 2013, which is made effective from April 5, 2013. The New FDI Policy supersedes the earlier version of the consolidated FDI policy of 2012 i.e. Circular 1 of 2012 ("**Erstwhile FDI Policy**") and also the press notes that were issued by DIPP prior to April 5, 2013.

In this hotline, we analyze the key changes introduced by the DIPP in the New FDI Policy and the opportunities that have been missed by the regulator.

KEY CHANGES BROUGHT BY THE NEW FDI POLICY

1. Downstream investment by a banking company under certain circumstances not to be treated as indirect FDI

   In a welcome move for the foreign owned and/or controlled banking companies in India, the New FDI Policy has introduced the much needed exception. Downstream investments made by banking companies, which are owned and/or controlled by non-residents / non-resident entity(ies), due to / under a "Corporate Debt Restructuring (CDR), or under any other loan restructuring mechanism, or in trading books, or for acquisition of shares due to defaults in loans", will not be treated as an indirect FDI. It is, however, clarified that 'strategic downstream investment' by such banking companies will be taken into account for calculating the indirect FDI. The term 'strategic downstream investment' will mean and cover all the investments made by such banking companies in any subsidiaries, joint ventures and associates.

   This clarification will help foreign owned and/or controlled banking companies in their operations as they will have better options to enforce their interest, in case there is a loan default by the borrower, without running into the risk of crossing the permitted FDI caps, if at all the FDI caps are applicable to the defaulting borrower entity. Although the said move is a breather for the foreign owned and/or controlled banking companies in India, it would have been worthwhile if the same exception was extended for non-banking financial companies (NBFCs) also, especially considering the fact that NBFCs are often involved in such debt restructurings or end up acquiring shares due to defaults and also considering that NBFCs are not treated as secured creditors under the SARFAESI Act (i.e. The Securitization and Reconstruction of Financial Assets and Enforcement of Securities Act, 2002).

2. Additional declaration under Prevention of Money Laundering Act 2002 and Unlawful Activities (Prevention) Act, 1967

   Under the Form FC-GPR, the Erstwhile FDI Policy also required the authorised representative of the Indian company to file a declaration in the prescribed form. Under the Form FC-GPR, the New FDI Policy has introduced the requirement for an additional declaration which has to be made by the authorized representative of the Indian company. They will have to declare, that the foreign investment received will be utilized in compliance with the provisions of the Prevention of Money Laundering Act, 2002 (PMLA) and Unlawful Activities (Prevention) Act, 1967 (UAPA). Further, the said declaration states that the authorized representative confirms that the investment complies with the provisions of all the applicable rules and regulations. Essentially, the New FDI Policy creates an additional responsibility on the Indian company and its authorized representative to ensure that the foreign investment is not in non-compliance with the applicable laws and is in line with the government's drive against money laundering activities and unlawful activities. Hence, any non-compliance thereof, if discovered, can be attributed to be intentionally performed by the Indian company receiving FDI under the garb of a false declaration, thus, providing the regulators a strong case to proceed against.

3. Issue of shares to the subscribers of the memorandum of association of a newly incorporated Indian company

   As per Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, the price at which shares of unlisted companies are issued to non-residents (including NRIs) should not be less than the fair value of the shares, calculated as per the discounted cash flow ("DCF") method. This condition is applicable for all kinds of allotment of shares including issuance of shares to subscribers to the memorandum of association in case of newly set up Indian entity and also in case of subsequent issue of shares to non-residents.

   Due to the position under the Extant FDI Policy, it may be said that it was commercially unjust to put an onus to issue shares to a non-resident subscriber at premium, when the company had not even commenced its business. RBI clarified in its circular dated September 26, 20121, that shares can be issued to subscribers (both non-residents and NRIs) to the memorandum of association at face value of shares subject to their eligibility to invest

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under the FDI scheme. The DIPP has now inserted this provision in the New FDI Policy, in line with the requirement under the Companies Act, 1956, thus, allowing non-residents and NRIs to subscribe to the memorandum of association of Indian companies at face value subject to their eligibility to invest under the FDI scheme.

The aforesaid addition in the New FDI Policy is a great relief to non-resident investors (including NRIs) in allowing them to set up new entities at face value of the shares and in turn reduce the cost and time involved in obtaining a DCF valuation certificate for such newly set up companies. Although, under the Companies Act, 1956, the minimum paid up capital is INR 100,000 for private companies and INR 500,000 in case of public companies, on reading of this new provision in the New FDI Policy, it seems that the said relaxation can even extend to situations where the non-resident investor is infusing a substantial amount of initial capital at the time of subscribing to the memorandum of association of a newly incorporated company. For e.g., it may be possible for a non-resident investor to infuse even USD 1,000,000 at face value by subscribing to the memorandum of association of the Indian company and possibly circumvent the pricing norms which would have been otherwise applicable.

MISSED OPPORTUNITIES

1. FDI in SEBI registered Alternative Investment Funds: The SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations") were notified on May 21, 2012. The AIF Regulations succeeded and repealed the erstwhile SEBI (Venture Capital Funds) Regulations, 1996 ("VCF Regulations"). Although, SEBI registered venture capital funds ("VCFs") under the VCF Regulations, can continue to operate as VCFs (unless transitioned to the new regime under the AIF Regulations), the New FDI Policy, like the Erstwhile FDI Policy, does not contemplate or provide any impact of the various relevant provisions on the alternative investment funds ("AIFs") that have now been registered with SEBI under the AIF Regulations. Amongst others, Clause 3.2.3 and 3.2.4 under the New FDI Policy, regarding FDI in VCFs and trusts, respectively, continue to remain in the same way and do not contemplate SEBI registered AIFs.

   Considering the number of AIFs being registered with the SEBI and the interest shown by non-residents to invest in such AIFs, it is imperative for the DIPP to issue an immediate clarification on this issue.

2. Clarity on put options: On September 30, 2011, DIPP had introduced Clause 3.3.2.1 in the then prevalent FDI policy which posed great uncertainty over a host of rights, including call options, put options, or even tag along and drag along rights or any right that the investor could exercise at a future date, even though these heavily negotiated rights were contractually agreed between sophisticated parties. Although the said addition of the clause was rolled back within 30 days by DIPP, the ambiguity with put options still remains as RBI has been issuing notices on a case to case basis. Industry participants were hopeful to receive clarity on the enforceability and legality of the put options in the New FDI Policy. However, much to the dismay of the industry participants and foreign investors, the New FDI Policy lacks this clarity.

3. Definition of 'Financial Services': The New FDI Policy does not define the term 'Financial Services'. As was the position under the Erstwhile FDI Policy, it is provided under the New FDI Policy also that, in the financial services, other than the services specifically mentioned in the New FDI Policy, FDI can be received only after obtaining the prior government approval. The said broad exclusion or rather categorization without defining the term 'Financial Services' creates ambiguity in determining if a particular company is engaged in the activities that can be classified as 'financial services'. For example, it's not clear if carrying out activities as a trustee should be categorized under the head of 'Financial Services'.

4. Clarity on FDI in multi brand retail trading: FDI up to 51% in multi brand retail trading ("MBRT") was allowed under the Government route and subject to compliance with certain specified conditions vide Press Note 5 (2012 series) that was issued on September 20, 2012. Please refer to our hotline titled 'India Notifies 51% FDI In Multi Brand Retail Trading' whereby we had highlighted the challenges that will be faced in the implementation of the said policy. Despite, the industry participants having consistently highlighted the challenges in the policy for MBRT, the policy with respect to FDI in MBRT is mirrored the way it was introduced in the Press Note 5 (2012 series) without the much needed changes and clarifications.

CONCLUSION

Much was expected from the Government in this new piece of the FDI policy, especially in light of the weakening sentiment for foreign investors which also has been marred because of the 'not so favorable' Budget 2012-13[2]. In light of the insignificant modifications made under the New FDI Policy, barring a few minor ones (as discussed above), most of the changes are in respect to incorporation of the various press notes and circulars that were issued after the Erstwhile FDI Policy was issued on April 10, 2012.

For a detailed analysis on the Press Notes 4, 5, 6, 7 and 8 (2012 Series), please refer to our hotline titled 'India breaks the FDI shackles: Multi Brand Retail Trading and other sectors liberalized'.

Further, various challenges and ambiguities which have been previously prevailing under the Erstwhile FDI Policy have not been addressed by the DIPP in the New FDI Policy such as the uncertainty with respect to FDI in MBRT, for which, till date, no retailer has been able to make an investment despite the fact that FDI in MBRT was allowed since more than six months ago.

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You can direct your queries or comments to the authors

[1] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1337599839661.pdf
[2] Please refer to our Budget 2012-13 analysis here.

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