Are foreign investors running out of options?

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In the minds of foreign investors, doing business in India used to conjure up images of long queues, tedious paperwork and dealing with an endless bureaucratic maze. Much water has flowed under the bridge over the past decade with the Indian government's initiatives to create an investor-friendly clime yielding rich dividends.

The publication of the biannual consolidated foreign direct investment (FDI) policy, which acts as a one-stop guide on foreign investment in India, is one such recent initiative. In this column, we sum up the highlights of Circular 2 of 2011.

Good news and bad news

Education and real estate: FDI up to 100% is currently permitted under the automatic route in townships, housing and built-up infrastructure, subject to certain conditions. That means there is no requirement to obtain prior approval from the Reserve Bank of India (RBI) if the conditions are fulfilled.

However, certain projects are exempted from these conditions, to which list construction in the education sector and old-age homes have been added. Besides increasing the projects which need not comply with the conditions, limitations on FDI in the education sector have been eased.

Since 2008, the construction and development of industrial parks had to meet a separate set of conditions. The definition of "industrial activity" in an industrial park has now been expanded to include "research and development in bio-technology, pharmaceutical and life sciences", thereby indirectly providing a boost to the real estate sector.

Multi-brand retail: Circular 2 comes as a damp squib, dashing hopes that the government would finally open the multi-brand retail sector to FDI, which has been allowed only in cash-and-carry wholesale trading and conditionally permitted in single-brand product retailing. The sole change is the imposition of an additional condition requiring a foreign investor to own the brand in case of single-brand retail.

Consideration for shares: The previous FDI policy, under the approval route, conditionally permitted a company to issue equity against the import of capital goods and machinery as well as pre-operative and pre-incorporation expenses payable to non-residents. Circular 2 has clarified certain procedural aspects of this process by stating that an application for such capitalization needs to be filed with the Foreign Investment Promotion Board (FIPB) within 180 days from the date of shipment of goods or incorporation of the company, as the case may be.

This ends confusion over whether the importer needed to obtain ex post facto approval from the FIPB, which persisted because such a condition was not expressly stated even in the RBI circular issued on this matter.

Escrow accounts: The circular states that non-interest-bearing rupee-denominated escrow accounts may be opened by AD Category-I banks on behalf of non-residents without the prior sanction of the RBI. This reflects changes effected by the RBI in a circular dated 2 May, which liberalized India's escrow account mechanism. Reduction of procedural formality for this vital element in tranched investment structures is welcome news for foreign investors.

Threat to options

While the press release from the Ministry of Commerce and Industry accompanying Circular 2 highlighted the less-than-remarkable changes discussed above, it remained silent on the one change which has grave ramifications for FDI in India.

It was recently reported that, in response to an investor query, the RBI had taken the view that foreign investment agreements containing exit options at a fixed price would be classified as debt rather than equity. Circular 2 goes one step further by stating that only equity instruments not linked to in-built options of any kind will qualify as eligible instruments under FDI. This places all instruments carrying an option under the umbrella of debt and requires them to be compliant with the external commercial borrowing regulations.

Options are not one-dimensional tools used to facilitate investor exit. In sectors where FDI is capped, investor agreements often include clauses which reserve the right of the foreign investor to acquire shares of the domestic company upon a future policy change (e.g. a rise in the permissible ceiling of investment in the terrestrial broadcasting/FM radio sector to 26% from its previous level of 20% made by Circular 2). However, the wording of Circular 2 suggests that even such options will be ineligible as FDI instruments.

While the overall sentiment in FDI circles is still predominantly optimistic, the government must act fast to clarify the exact meaning and scope of the term "in-built options" in Circular 2. Otherwise, in addition to the economic risk faced by foreign investors, they will also lose their recourse to any kind of options, which may be a serious setback for FDI inflows into the country.

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