Zoom In

Progressive Changes in FDI Policy

Some positive moves by the government, such as its recent decision to allow FDI in LLPs, indicate its seriousness about attracting foreign investors. However, the onward march of India's FDI bandwagon would depend on India's ability to tackle critical roadblocks such as poor infrastructure, high oil prices and the pitfalls of our judicial system.

In recent times, India's foreign direct investment (FDI) policy has consistently mirrored the changing economic trends. The evolutionary trait of India's FDI policy has endeared it to the investor community across the globe. This year has witnessed fresh initiatives aimed at making the Indian FDI terrain more investor-friendly. We trace the contours of a few key changes in India's FDI policy – some already in effect and others still on the anvil.

Breather for Foreign Partners: Press Note 1 of 2005 scrapped

Press Note 1 of 2005 was often considered a thorn in the side of foreign investors in India. It required foreign investors who had invested in India before January 12, 2005 to obtain prior governmental approval for any further investments in India (except in a few limited circumstances). As an added burden, this approval, in practice, was only granted if a no-objection certificate was obtained from the existing Indian joint venture partners, which was often used as a bargaining chip by the Indian partner.

However, in late 2010, as a sign of things to come, the government introduced a discussion paper on the eventual abolition of Press Note 1. The FDI policy, as consolidated in Circular 1 of 2011 (Circular 1 of 2011), released on March 31, 2011, has done away with the provision incorporating Press Note 1 entirely, thereby abolishing the statutory non-compete of Press Note 1. Consequently, the Foreign Investment Promotion Board is now likely to consider and clear a greater number of foreign investment proposals in hopefully a shorter time period.

Convertibles: A New Lease of Life

In allowing the conversion price to be tied to the performance of a company, convertible instruments such as preference shares and debentures not only offer investors a buffer against the perils of poor performance by the company but also give the company and its promoters a compelling incentive for better performance. As such, convertibles have traditionally been the darling of private equity players.

In India, however, foreign investors could not reap the benefits of convertible instruments since the previous versions of the consolidated FDI policy required the pricing of capital instruments to be fixed upfront at the time of their issue. This requirement nearly dealt a death blow to the use of convertibles in India given that the above requirement destroyed the fundamental rationale for the use of such instruments by investors.

Circular 1 of 2011 has now amended the policy and offered the flexibility for investors and investees to prescribe a conversion formula upfront as opposed to providing a fixed conversion price or ratio. The amendment comes with a rider that the eventual conversion price should not in any event be lower than the minimum floor price determined according to the applicable pricing norms at the time of the

Arun Madhu
Senior Associate

Hemant Krishna V.
Associate

Phoenix Legal

This year has witnessed fresh initiatives aimed at making the Indian FDI terrain more investor-friendly. We trace the contours of a few key changes in India's FDI policy – some already in effect and others still on the anvil.

These new avenues give Indian companies a certain degree of leverage to buy equipment and machinery – specifically, from foreign collaborators – without being stymied by cash concerns.

issue of the convertible instrument. By reverting to the position that was considered to be the norm prior to 2010, Circular 1 of 2011 is likely to revive foreign investors' interest in convertibles and provide fillip to private equity investments in India.

Shares Without Cash Consideration

The government had issued a discussion paper in September 2010 inviting views on the issue of shares against consideration other than cash.

The discussion paper proposed to permit issue of shares against a whole host of additional items other than cash and Circular 1 of 2011 has included two of them:

(i) Issue of shares against import of capital goods, machinery, equipment (including second-hand machinery); and

(ii) Issue of shares against pre-operative, pre-incorporation expenses (including payments of rent, etc.)

These new avenues give Indian companies a certain degree of leverage to buy equipment and machinery – specifically, from foreign collaborators – without being stymied by cash concerns. While governmental approval is nevertheless necessary for such share issues, the explicit mention of the above forms of consideration in Circular 1 of 2011 is perhaps an indication that the government will be more open to permitting such transactions in the future.

LLPs: A New Window for FDI

After paving the way for creation of limited liability partnerships (LLPs) in 2009, the government has recently decided to allow FDI in LLPs, albeit in a restricted manner.

FDI has been permitted in LLPs in sectors and activities where 100 percent FDI is allowed through the automatic route and where there are no FDI-linked performance related conditions. LLPs with FDI will not be allowed to operate in agricultural or plantation activity, print media or real estate business or make any downstream investments. Indirect FDI in LLPs would also be permitted under the approval route, if both the investor company and the LLPs are operating in sectors where 100% FDI is allowed under the automatic route and where there are no FDI-linked performance related conditions.

The conversion of a company with FDI into an LLP will be allowed upon meeting all the requisite conditions and after obtaining approval of the Foreign Investment Promotion Board.

Although some issues in relation to FDI in LLPs remain unresolved at this point of time (e.g., valuation norms to be followed in valuing FDI into an LLP), it is likely that the government and the Reserve Bank of India will act in tandem to plug the existing loopholes and make LLPs an attractive avenue for foreign investors.

FDI in Multi-brand Retail: Changes in the Offing

The discussion about opening of the multi-brand retail space for foreign investment has been raging for some time. Even though 100 percent FDI is allowed in wholesale trade, multi-brand retail is closed to foreign direct investment and a number of conditions have been stipulated for wholesale trading in an attempt to ensure that there is no indirect violation of the prohibition of FDI in multi-brand retail.

The government aims to frame a comprehensive policy on the issue of FDI in multi-brand retail by the end of 2011 and to this end a discussion paper was issued last year to discuss the rationale for FDI in the retail sector. Boost to agriculture sector is one of the driving forces behind this drive for foreign investments in front-end retailing. It would provide the large scale funds needed by organized retailers and help derive the full advantage of the value chain for the producer and the consumers. It would bring in the much needed technology, management know-how, and efficiency into the market. The investment would help strengthen the back-end infrastructure, with the development of post-harvest and cold-chain infrastructure nearer to the farmers' field, reduce wastage (only 5-6 percent of the perishable food products are processed) and result in increased productivity.

India is one of the largest users and importers of conventional defence equipment and ranks among the top ten countries in the world in terms of military expenditure. Presently, FDI in the defence sector is capped at 26 percent. On account of this cap, India has failed to attract state-of-the-art technology in the defence sector.

FDI in Defence Sector: Under Consideration

India is one of the largest users and importers of conventional defence equipment and ranks among the top ten countries in the world in terms of military expenditure. Presently, FDI in the defence sector is capped at 26 percent. On account of this cap, India has failed to attract state-of-the-art technology in the defence sector.

The Department of Industrial Policy and Promotion (DIPP) had issued a discussion paper in early 2011 inviting views on the pros and cons of permitting higher FDI in the defence sector. Since increase of the cap from 26 percent to 49 percent will not give any additional say to the foreign investor in the affairs of the company as per the provisions of the company law, the discussion paper mulls raising the FDI cap to anything between 50 percent to 100 percent, which, if implemented, has the potential to attract significant know-how, technology and expertise to the Indian defence industry.

However, the inherent sensitivities of the defence sector mean that even if higher FDI were to be permitted in the sector, it is likely to be made subject to stringent licensing requirements, not to mention eligibility criteria and other conditions that are intended to ensure significant value addition in India.

On Course

In the backdrop of news reports in February announcing a 30% year-on-year slump in FDI, the government has done well to put increased FDI on course with the introduction of changes discussed above. Investors will be hoping that the immediate focus now shifts to facilitating FDI in multi-brand retail, limited liability partnerships and increase of the FDI limit in the insurance sector. However, at a more fundamental level, the onward march of India's FDI bandwagon would depend on India's ability to tackle critical roadblocks such as poor infrastructure, high oil prices and the pitfalls of our judicial system. If these challenges are dealt with effectively, India would be well on its way to becoming the most attractive FDI destination globally.

●