The new FDI policy: signs of progressive liberalization

By Arun Madhu and Hemant Krishna V, Phoenix Legal

PHOENIX LEGAL

New Delhi
Second Floor,
254, Okhla Industrial Estate,
Phase III, New Delhi 110020
India
Tel: +91 11 4983 0000
Fax: +91 11 4983 0099
Email: delhi@phoenixlegal.in

Mumbai
First Floor, CS-242,
Mathuradas Mill Compound,
NM Joshi Marg, Lower Parel
Mumbai 400 013, India
Tel: +91 22 4340 8500
Fax: +91 22 4340 8501
Email: mumbai@phoenixlegal.in

The eagerly awaited new consolidated FDI policy was released by the Department of Industrial Policy & Promotion (DIPP) on 31 March. We round up the major highlights of this document, which is commonly known as circular 1 of 2011.

Foreign partners unfettered

Press note 1 of 2005 has often been the bane of foreign investors in India. It required foreign investors who had invested in India before 12 January 2005 to obtain prior governmental approval for any further investments in India (except in a few limited circumstances). To add to the difficulties, this approval, in practice, was only granted if a no-objection certificate was obtained from the existing Indian joint venture partners, which was more often than not used as a bargaining chip by the Indian partner.

However, as a sign of things to come, the government in late 2010 introduced a discussion paper on the eventual abolition of press note 1. The provision incorporating press note 1 (clause 4.2.2.2 of circular 1's predecessor issued in October 2010) has been completely dropped from circular 1 of 2011, thereby abolishing the statutory non-compete of press note 1 of 2005.

A welcome side effect of this change is likely to be that the Foreign Investment Promotion Board will now have the ability to consider and clear a greater number of foreign investment proposals in hopefully a shorter time period.

Reviving convertibles

Convertible instruments such as preference shares and debentures have been a traditional favourite with certain classes of financial investors – notably private equity players. This is because the conversion price can be tied in with the performance of a company, thus offering investors a buffer against the perils of poor performance by the company, while also giving the company and its promoters a compelling incentive for better performance.

Foreign investors in convertible instruments had a cross to bear since the previous versions of the consolidated FDI policy required the pricing of capital instruments to be fixed upfront at the time of issue of the instruments. 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 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 a fillip to private equity investments in India.

Shares without cash

In September 2010, the government issued a discussion paper 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 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 from entities – specifically, 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 is perhaps an indication that the government will be more open to permitting such transactions in the future.

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 the changes discussed above.

However, investors concerned with FDI in multi-brand retail, limited liability partnerships and the insurance sector among other things, will have to wait a little longer for their day in the sun.

This article has been co-authored by Arun Madhu, a senior associate at the Mumbai office of Phoenix Legal, and Hemant Krishna V an associate in the same office. They can be reached at arun.madhu@phoenixlegal.in and hemant.krishna@phoenixlegal.in.