Circular 2 - clarity, concision and key changes

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True to its word, the Department of Industrial Policy and Promotion ushered in the second half of the financial year with a new edition of the consolidated foreign direct investment (FDI) policy in India – Circular 2 of 2010. The document appears to be a concentrated effort at streamlining regulations and also providing clarity to foreign investors on the framework for investments.

Some key changes brought about by Circular 2 are worth highlighting.

Warrant'ing change?

The issuance of warrants (i.e. instruments that are convertible into shares of a company at the option of its holder) to non-resident entities has been an issue which has long dogged the foreign investor community. Warrants as an instrument are highly beneficial to investors. They offer investors the ability to garner shares at a significant discount to the market price by merely making a part payment of the consideration upfront and in advance. This payment is not a premium for the option but is adjusted against the final purchase price.

Warrants and the foreign investors have had a chequered history. Prior to the release of the first consolidated FDI policy in March 2010, warrants were permitted to be issued to non-residents so long as the prior approval of the nodal agency for foreign investment in India, the Foreign Investment Promotion Board (FIPB), was obtained. However, Circular 1 quite ominously and categorically prohibited the issue of any instrument other than vanilla equity shares, compulsorily convertible debentures and preference shares. The circular went on to give examples of prohibited instruments (i.e. warrants, partly paid shares, etc) effectively displacing a hitherto settled position.

However, despite the on-paper ban investors continued to approach the FIPB for the issue of such instruments and received conditional approvals. Examples of conditions include: foreign investors subscribing to warrants being necessarily required to pay a fair sum of upfront consideration and to convert the warrants within 18 months of their issuance. Both these conditions were typically associated only with warrants issued by publicly listed Indian companies. However, Circular 2 now clarifies the position by expressly stating that warrants may be issued as long as governmental approval is obtained. Although, not a change from a practice perspective, for the unitiated and those not in the know, this is a welcome clarification.

Cashing in on 'cash and carry'

The Indian wholesale cash and carry sector is perhaps one of India's most infamous sectors. This has been especially true in the past couple of years with several multinational companies in the sector being in the news for all the wrong reasons. The Bharti-Walmart JV is an example that pops up due to the rumours around it being a pioneer in entering in the Indian retail market indirectly through the cash and carry route. (For a detailed analysis read our column *Retail roulette puts investors on edge*, in the July/August 2010 issue of *India Business Law Journal*).

The Indian government however thwarted such attempts by introducing drastic changes to the conditions for setting up a wholesale venture. The government struck at the very roots of such transaction structures by various means including imposing limits on sales by wholesale cash and carry companies to group companies and putting restrictions on end use of such products by group companies. Persistent lobbying has now marginally improved the situation for players in the cash and carry sector, their efforts evident in Circular 2.

Circular 2, while retaining the restriction that not more than 25% of a company's sales should be to group companies, does away with the restriction that such group companies should source products from the wholesale cash and carry entity only for their "internal use". As such it does away with the prohibition on sales to end-use consumers. This move too should partially ease concerns surrounding the business models of several foreign ventures.

Certainty for all

On the whole, Circular 2 appears to be a step in the right direction as far as providing clarity and conciseness is concerned. It provides clarifications on several long-standing issues, some of which will be welcomed by foreign investors (e.g. removing the prohibition on issuance of warrants, easing up norms in the wholesale cash and carry sector and the setting up of subsidiaries by non-banking financial companies) and some not (e.g. repatriation of foreign investments in the real estate sector). However, the key message for foreign investors is the fact that Circular 2 is one step closer to achieving the underlying objective of a consolidated FDI policy, which is, certainty for all.

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