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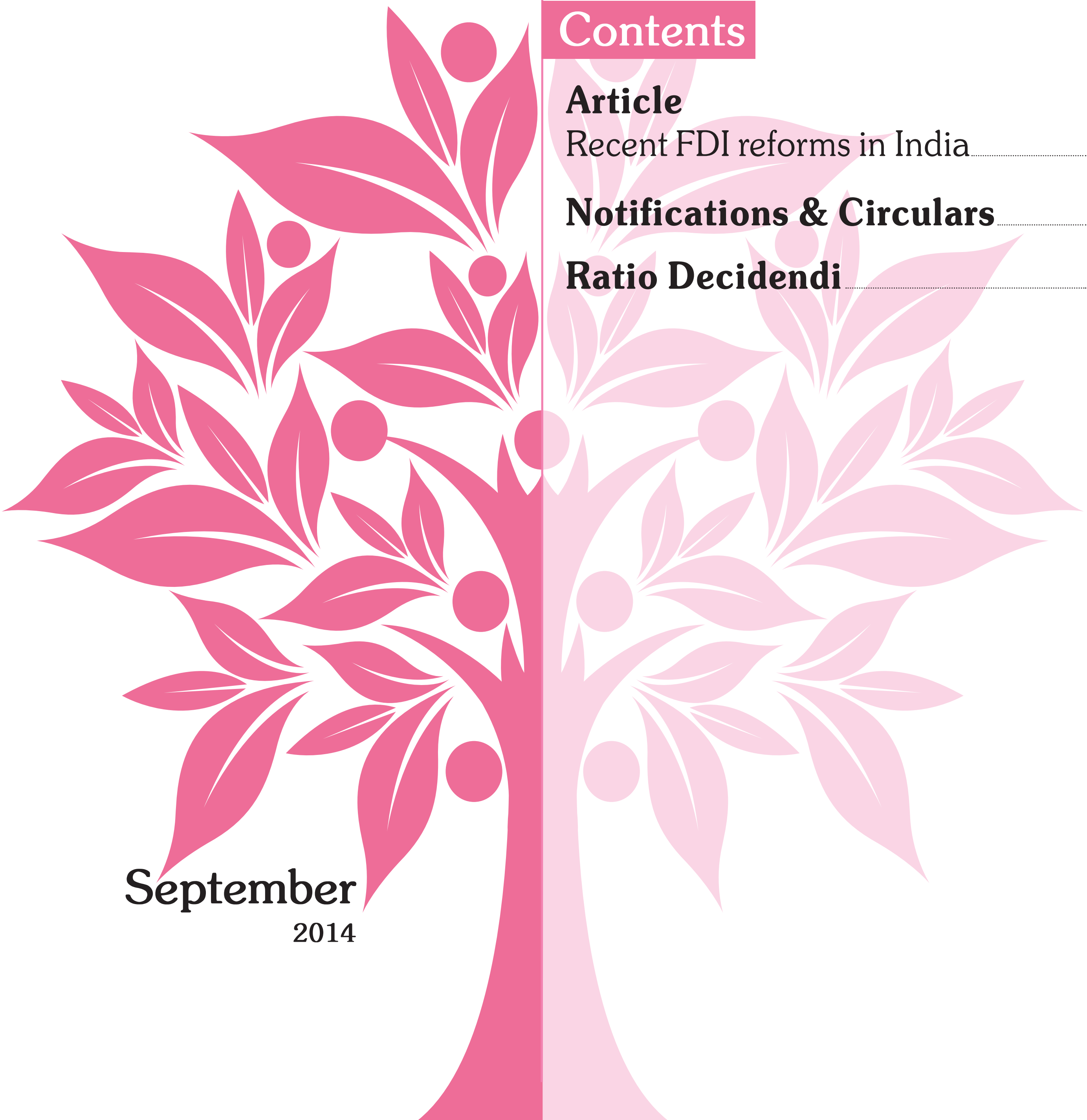

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Recent FDI reforms in India

By **Sonia Abrol**

Foreign funding is important to bridge the huge fund gap of investment in infrastructure in India, which in turn will spur economic growth. According to a recent report, the inflow of foreign direct investment ("FDI") was US $ 28 billion in 2013, an increase of 17% over the previous year. The services sector attracted the highest FDI inflows in FY14 with US$ 2.25 billion, followed by the construction & development and telecommunication industries, but this is still a drop in the ocean.

Based on the recommendations of the Foreign Investment Promotion Board ("FIPB") in its meeting held on 4th July, 2014, the Indian Government has approved 14 proposals of FDI, several in the pharmaceutical sector, amounting to Rs. 1528.38 crores. The Cabinet has recently announced increase in the sectoral caps in defense and is doing its utmost to increase the cap on insurance to 49%. This year, the government has announced a slew of policy reforms besides introducing certain new and amended definitions.

Control and group company

The concept of the term 'control' has been broadened. Earlier, the parameter for determining "control" was *"the power to appoint a majority of directors in a company.* The definition of "control" is now inclusive and *"includes the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreement"* bringing it closer, if not exactly in line with, the Companies Act, 2013 and the Takeover Code.

The phrase 'Group company' has been newly added to the extant FDI policy of India ("FDI Policy") and means *"two or more enterprises which, directly or indirectly, are in a position to (i) exercise twenty-six percent or more of voting rights in other enterprises; or (ii) appoint more than fifty percent of members of board of directors in the other enterprise"*.

Revision in sectoral caps

Several sectoral caps in important sectors under the FDI Policy have been revisited and some of them currently stand as in the following paragraphs.

Pharmaceuticals

FDI up to 100% is permitted in Pharma but through automatic route only in cases of greenfield investment or a new venture and through the government approval route in cases of brownfield or existing companies. The government has decided not to permit 'non-compete clauses' in the agreements to be entered into by foreign investors with Indian entities, except in special circumstances with the prior approval of the FIPB. Additionally, the FDI Policy stipulates submission of a certificate by the prospective investor and the prospective investee (a brownfield entity) to the FIPB, providing a complete list of all agreements entered into between such investor and investee.

Defence

FDI up to 49% has been permitted in the defence sector under the government approval route with control and ownership in Indian hands. Approvals even beyond 49% will be permitted on a case to case basis, wherever it is likely to result in access to modern and 'state-of-art' technology in the country. Foreign investment limit is composite and includes FDI, foreign institutional investors ("FII"), foreign portfolio investors ("FPI"), non-resident Indians, Qualified Foreign Investors and Foreign Venture Capital Investors. Portfolio investment is under the automatic route and total of all such non strategic foreign investment is capped at 24% cumulatively.

Telecom

FDI in this crucial sector has been enchanced up to 100% with 49% under the automatic route beyond which prior approval of the government will be required, subject to observance of licensing and security conditions by licensee as well as investors as notified by the Department of Telecommunications from time to time, except "Other Service Providers", which are allowed 100% FDI on the automatic route.

Single brand product retail trading

FDI up to 100% under the government route was permitted earlier in this sector. The cap has been revised and now FDI up to 49% is permitted under the automatic route beyond which prior approval of the government will be required.

Multi-brand retail trading

The government has announced its in principle opposition to foreign investment in multi-brand retail trading but has not vetoed the earlier policy of the previous government in this sector.

Backend infrastructure - The earlier condition requiring at least 50% of total FDI brought in to be invested in 'backend infrastructure' of the company receiving FDI within three years of receiving the first tranche of FDI has been modified and now at least 50% of total FDI brought in the first tranche of US $ 100 million is to be invested in 'back-end infrastructure' within three years. Subsequent investment in backend infrastructure would be made by the multi-brand retail trading retailer on a need basis depending upon its business requirements.

Mandatory sourcing - The other significant change in this sector addresses the issue of minimum mandatory sourcing requirement. Under the erstwhile regime, companies with FDI in this sector were required to source at least 30% of the value of procurement of the manufactured or processed products from 'small industries' that have a total investment of not more than USD 1 million in plant and machinery. The aforesaid requirement has been revised with respect to the limit of total investment by 'small industries' in plant and machinery, which has now been increased to a maximum of USD 2 million.

Railway infrastructure

This is the most recently opened sector under the FDI Policy and in terms of the revised FDI Policy, 100% FDI in the automatic route has been permitted in several segments of railway infrastructure including high speed train projects, dedicated freight lines, railway electrification, signaling systems and passenger terminals. FDI in these activities open to private sector participation including FDI is subject to sectoral guidelines of Ministry of Railways and proposals involving FDI beyond 49% in sensitive areas from security point of view, will be brought by the Ministry of Railways before the Cabinet Committee on Security (CCS) for consideration on a case to case basis.

Tea plantation

The earlier onerous condition of compulsory divestment by the foreign investor of 26 per cent equity of the company in favour of the Indian partner or Indian public within a period of 5 years has been dispensed with.

Test marketing

FDI in the test marketing industry was permitted up to 100% under the government route. Recently, FDI in this sector has been brought under the automatic route and the very sectoral cap in the FDI Policy has been done away with.

Unlisted companies to raise capital and partly paid equity shares and warrants

Some of the other major reforms brought about in the FDI Policy include unlisted companies being allowed to raise capital abroad through depository receipts or convertible bonds without the requirements of the prior or subsequent listing in India, subject to certain conditions and timelines and partly paid equity shares and warrants issued by an Indian company in accordance with the provision of the Companies Act, 2013 and the SEBI guidelines, as applicable, being eligible instruments for the purposes of FDI and FPI by FIIs or Registered Foreign Portfolio Investors, subject to compliance with FDI and FPI schemes.

Pricing guidelines

The Reserve Bank of India has also issued new pricing guidelines applicable on Indian companies for providing greater freedom and flexibility to the parties concerned under the FDI framework, wherein the fair value in respect of both transfer and issue of shares and exit from investment will be worked out as per guidelines different from those applicable under the earlier regime.

In case of listed companies, the issue and transfer of shares including compulsorily convertible preference shares and compulsorily convertible debentures shall be as per the SEBI guidelines and the pricing guidelines for FDI instruments with optionality clauses shall continue to be in accordance with the existing regime wherein the non-resident investor shall be eligible to exit at the market price prevailing on the recognised stock exchanges, subject to lock-in period as stipulated, without any assured return.

In case of unlisted companies, the issue and transfer of shares including compulsorily convertible preference shares and compulsorily convertible debentures with or without optionality clauses shall be at a price worked out as per any internationally accepted pricing methodology on arm's length basis. Accordingly, the guiding principle will be that the non-resident investor is not guaranteed any assured exit price at the time of making such investment or entering to an agreement and shall exit at a fair price computed as above at the time of exit subject to lock-in period requirement as applicable in terms of the existing conditions on the subject.

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Notifications & Circulars

FDI permitted in railway transport sector: 100% Foreign Direct Investment through automatic route has been permitted in specified areas of railway transport sector. As per Press Note No. 8 (2014 series), dated 27-8-2014 construction, operation and maintenance of, suburban corridor projects through PPP, high speed train projects, dedicated freight lines, passenger terminals, mass rapid transport systems, and various other railway infrastructure have been opened up. FDI beyond 49% of the equity of the investee company in sensitive areas is however required to be brought before Cabinet Committee on Security for consideration on case to case basis.

Slum area development included under CSR activities: Schedule VII of the Companies Act, 2013 listing activities which may be included by the companies in their Corporate Social Responsibility Policies has been amended by Ministry of Corporate Affairs. Notification G.S.R. 568(E), dated 6-8-2014 issued for the purpose inserts a new item and entry as 'slum area development'. The term 'slum area' has also been explained as any area declared as such by the Central Government or any State Government or any other competent authority under any law for the time being in force.

Accounting Standards – Clarifications on capitalization of cost: Ministry of Corporate Affairs has issued a clarification regarding capitalization of cost in case of power projects. It has been clarified that cost incurred during the extended delay in commencement of commercial production after the plant is otherwise ready cannot be capitalized., since does not increase the worth of fixed assets. In case of projects where part of the project is ready for commercial production while construction continues for other part, costs are to be capitalized in relation to that part which is ready for commercial production. Further, General Circular No. 35/2014, dated 27-8-2014 issued in this regard clarifies that AS 10 and AS 16 are applicable irrespective of whether the power projects are 'Cost Plus projects' or 'Competitive Bid projects'.

Useful Lives for computing depreciation – Schedule II to Companies Act, 2013 amended: Amendments in Schedule II of the Companies Act relating to 'Useful Lives to Compute Depreciation' have been made by Ministry of Corporate Affairs by notification dated 29-8-2014. As per the amendment in Part A, useful life of an asset shall not ordinarily be different from the useful life specified in Part C of the Schedule while the residual value shall not be more than 5% of the original cost of the asset. According to the new provisions, if a company adopts a useful or residual life different from what is specified, the financial statements of the company shall also disclose such difference and provide justification in this behalf duly supported by technical advice. Further, paragraph 4 of Part C of this Schedule providing for determination of useful life of significant part of the asset separately, has been amended to provide for mandatory determination in financial year commencing from 1-4-2015.

Refinancing of ECB at lower all-in-cost – Procedure simplified: AD Category – I banks have been delegated power to approve refinancing cases where the Average Maturity Period (AMP) of the fresh ECB exceeds the residual maturity of the existing ECB under the automatic route, subject to certain conditions. RBI A.P. (DIR Series) Circular No.21, dated 27-8-2014 issued for this purpose, also prescribes certain conditions like, both the existing and fresh ECBs should be in compliance with the applicable guidelines, and consent of the existing lenders should be available.

External Commercial Borrowings (ECB) in Indian Rupee: Recognized non-resident ECB lenders have been allowed to extend loans in Indian Rupees subject to conditions. RBI Circular A.P. (DIR Series) Circular No. 25, dated 3-9-2014 issued in this regard states that for this purpose such lender should mobilise Indian Rupees through swaps undertaken with an Authorised Dealer Category-I bank in India and the ECB contract should comply with all other conditions applicable to the automatic and approval routes as the case may be. All-in-cost of such ECBs should also commensurate with the prevailing market condition.

NBFCs - Lending against shares: All Non-Banking Financial Companies (NBFCs) with asset size of Rs.100 crore are now required to report on-line to stock exchanges, information on the shares pledged in their favour, by borrowers for availing loans. As per RBI Notification RBI/2014-15/186 DNBS (PD).CC.No. 408/03.10.001/2014-15, dated 21-8-2014, NBFCs are further required to maintain loan-to-value ratio of 50% and accept only Group 1 securities as collateral for loans of value more than Rs. 5 lakh. The notification also prescribes format for reporting as required by SEBI.

Hedging facilities for FPIs: Foreign Portfolio Investors (FPIs) have been permitted to hedge the coupon receipts arising out of their investments in debt securities in India falling due during the following twelve months. RBI A.P. (DIR Series) Circular No. 28, dated 8-9-2014 also states that though such hedge contracts shall not be eligible for rebooking on cancellation, such contracts can be rolled over on maturity provided the relative coupon amount is yet to be received.

Ratio Decidendi

Competition law – Requirement of notice when directing 'further' investigation: Notice before directing further investigation under Section 26(7) of the Competition Act is not required to be given to the person against whom information was provided. Delhi High Court in this case was of the view that reasons given by Supreme Court in the case of *Steel Authority of India* for holding that no notice/hearing is required to be given to the person informed against, before forming a *prima facie* opinion and directing investigation under Section 26(1), would also apply to the stage under Section 26(7) wherein Commission directs for further investigation after a negative report of the DG.

Reliance in this regard was also placed on various precedent decisions of the Apex Court holding that there is no right of the accused to be heard, before the Magistrate or the Sessions Judge directs further investigation, even where the investigation carried out has found him to be not guilty. It was also noticed that function of CCI under said section is not adjudicatory and that this stage is also an initial stage. The court further upheld the single judge's decision that legislature's use of the words 'parties concerned' in Section 26(5) cannot be meant to cover person informed against. Absence of any such intention of the legislature, while amending Section 26 by Competition (Amendment) Bill, 2007 in 2009, was also noticed by the court in this regard while it laid down procedure to be followed by CCI after Section 26(1) stage i.e. when it directs investigation. [*South Asia LPG Company Private Limited* v. *CCI* - LPA No. 857/2013, dated 3-9-2014, Delhi High Court]

Status of 'employee' under Factories Act not sufficient to claim regularization of employment: Workers engaged by a contractor to work in the statutory canteen of a factory would be the workers of the said factory, but only for the purposes of Factories Act, 1948, and not for other purposes, according to the Supreme Court of India. It was also held that for the said workers to be called the employees of the factory for all purposes, they would need to satisfy the test of employer-employee relationship and it must be shown that the employer exercises absolute and effective control over the said workers. Reliance in this regard was placed on earlier decision in the case of *Indian Petrochemicals* [(1999) 6 SCC 439], wherein it was held that the Factories Act, 1948 does not govern the rights of employees with reference to recruitment, seniority, promotion, retirement benefits, etc. and that these are governed by other statutes, rules, contracts or policies. It was accordingly held that solely by virtue of this deemed status under the Factories Act, the said workers would not be able to claim regularization in their employment from the respondent-Air India. [*Balwant Rai Saluja* v. *Air India Ltd.* - 2014 (9) SCALE 567]

Electricity tariff – Private hospitals and Government run hospitals are different: Electricity Appellate Tribunal has held that private hospitals/clinics/dispensaries cannot be placed in the category of domestic users along with the hospitals run by the Government of NCT of Delhi or Municipal Corporation, for the purpose of fixing electricity tariff. It was held that though private hospitals are run for the need of the society, rendering essential services to the public at large, the purpose and motive of government run hospitals and private hospitals are different. The Tribunal in this regard noted that it was dealing with private hospitals and dispensaries/clinics run by private bodies having no charitable or social purpose. It was further held that such hospitals have been reasonably placed under the Non-Domestic Low Tension (NDLT) category for the purpose of tariff imposition based on the principle of intelligible intelligentsia. No concession was further granted to private hospitals from the time of day tariff aimed to optimize cost of power purchase. [*Delhi Voluntary Hospital Forum* v. *Delhi Electricity Regulatory Commission* – Appeal No. 300 of 2013, decided on 12-8-2014]

Service of SCN by SEBI – Service by speed post not relevant: Securities Appellate Tribunal has held that service of show cause notice under the SEBI (Procedure for Holding Inquiry and Imposing Penalties by Adjudicating Officer) Rules, 1995 has to be by registered post and not by speed post. The Tribunal in this regard held that reliance on SEBI (Manner of Service of Summons and Notices issued by Board) Amendment Regulations, 2007 would be irrelevant. It was contended that the Rules of 1996 were applicable as the enquiry was being conducted by an adjudicating officer who is an independent and quasi-judicial authority. Holding that though service by speed post may be an equally efficient mode, since such mode is not specifically mentioned in the rules, such mode should be discarded by SEBI, the Tribunal went on to state that if SEBI feels that speed post is also an important and efficient mode of service, it is free to amend the rules. [*Vilas Valunji* v. *SEBI* – Appeal Nos. 68 and 70, decided on 5-9-2014, SAT]

Annulment of trade when 'material mistake in the trade': Trades executed by mistake cannot be termed as 'material mistake in the trade' merely because every mistake contains element of negligence in executing such trade. Annulment of the trade related to punching of erroneous order to sell 17 lakh NIFTY 50 units instead of punching order to sell Rs. 17 lakh worth NIFTY 50 units, was declined by the Securities Appellate Tribunal on the ground of inviolability of trades being the rule and annulment being an exception as per the Regulations [bye-law 5(a) framed by NSE], and where a dealer fails to exercise due care, caution or diligence while entering into the dealings on the Exchange, then consequences of such failure have to be borne. The Tribunal, in its majority order, while holding so noticed absence of suitable validation mechanism within the risk management system due to negligence on part of appellant-dealer not only at dealer's computer level but also at higher levels, as prescribed by SEBI in its circulars. Holding that a mistake does not become 'material mistake' merely because that mistake has led to huge financial losses, the Tribunal also observed that the said expression would be attributable to unforeseen circumstances which vitiate sanctity of the trades executed on the Stock Exchange and that breach of duty/negligence cannot be an unforeseen circumstance.

However, though contention that erroneous sale order was transferred into trades because of unrealistic purchase orders executed in violation of margin money requirements and hence there was violation of Section 16(2) of Securities Contracts (Regulations) Act, 1956, was rejected by the Tribunal, it set aside the NSE order rejecting annulment of trade in respect of two buyers. The matter on the issue was remanded observing that violations of margin money norms by the two buyers should be considered before rejecting plea of annulment of trade in respect of these buyers. [*Emkay Global Financial Services Limited* v. *National Stock Exchange of India Limited* – Order dated 26-8-2014, SAT]