The foreign direct investment fuddle

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April is normally a time when transactional lawyers look forward to breathing easy and recovering from year-end closings and attendant hectic times of March. But this new financial year, the government has kept us all busy with ample food for thought in the form of a new circular intended to be a definitive one-stop foreign direct investment (FDI) manual.

Circular 1 of 2010 heralds a new mechanism for the notification of all FDI policy, which will be available for the convenience of investors in one comprehensive document, to be reviewed and revised every six months. Such a mechanism will lend certainty, clarity and much needed predictability to a policy framework that has thus far been subject to frequent changes by policymakers. Although a commendable initiative, the new document is not free from ambiguities and leaves unresolved some concerns. We discuss a few of these.

The circular disallows the issue of warrants to non-residents. The earlier policy contained no explicit instruction on warrants and foreign investors invested in them with prior approval from the Foreign Investment Promotion Board (FIPB). It is unclear whether the FIPB will continue to entertain these applications. If not, the embargo will close the door for all non-residents seeking to evaluate the performance of Indian targets before becoming stakeholders.

The government's disapproval of warrants is surprising, given that warrants are, in essence, options to invest at a later date, and not actual investment instruments. One wonders whether there is even a need to regulate them.

The circular mandates that "the pricing of the capital instruments should be decided/determined upfront at the time of issue of the instruments". In case of convertible instruments, it is unclear whether an agreed conversion formula would satisfy the requirement to decide and determine pricing upfront. If this is not the case and pricing must be agreed upfront, then the stipulation fails to take into account the nuances of convertible instruments, which, by their very nature, are chosen by parties in order to allow them flexibility to convert based on the performance of the target and its impact on pricing.

It also seems to be at variance with the logic of pricing restrictions. The idea behind price thresholds in the FDI regime is that foreign investments in Indian companies should be made at no less than the fair market value calculated at the time when it is made. However, by requiring convertible instruments to be priced upfront, the conversion price may not be a reflection of fair market value at the time of conversion.

The new policy reiterates that if a company which is foreign owned or controlled seeks to make downstream investments, the pricing of such investments should be in accordance with applicable Reserve Bank of India (RBI) guidelines. The implication of this could be that a purely onshore rupee transaction between two resident Indian entities will also be subject to pricing restrictions.

Given that pricing restrictions are a method of exchange control regulation, the merit to continue with such a prescription is unclear. The policy on downstream investments by foreign owned and controlled Indian companies should perhaps be to regulate indirect investment in sectors with FDI caps or prohibitions and not pricing between two resident entities. In any event the new budget seeks to tax share acquisitions of unlisted companies at less than the "fair market value" and this would address revenue loss on account of transactions contemplated at less than this value.

In addition, the method of calculating the fair market value of shares of unlisted companies has been recently amended to prescribe valuations on a discounted free cash flow method.

Based on the nature of the investment, the government regulates foreign exchange inflows into the country broadly under two regimes. Equity and equity-like investments are governed by the FDI framework while debt investments have to comply with regulations on external commercial borrowings (ECB).

Foreign currency convertible bonds (FCCBs), which have a peculiar hybrid nature, were subject to ECB policy upon issue and to FDI policy upon conversion. The circular obfuscates the nature of FCCBs by declaring that inflows from FCCB issues would be treated as, and counted towards FDI at the time of such receipt. Since it is not possible to determine upfront the number of shares into which such bonds will convert, compliance with sector specific FDI caps at the time of an FCCB issue cannot be ensured.

Although the circular is a self-confessed attempt to merely consolidate existing FDI regulations, it actually takes a step further and introduces some new restrictions. While the document states that it "is not intended to make changes in the extant regulations" it does effect some changes. Whether these changes should be ignored in light of the stated compilatory intent is a question that remains to be answered.

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