Consolidated FDI Policy – 2010

Bombay Chartered Accountants' Society

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(The article was published in the journal of Bombay Chartered Accountants Society in June 2010)

1. Ministry of Commerce and Industry has issued a "**Consolidated FDI Policy**" effective from 1st April 2010. *[Circular 1 of 2010.]*

   The policy has consolidated into one document, the entire policy on foreign direct investment spread over various press notes. The past press notes are rescinded. A fresh consolidated policy will be issued every six months.

   Though it states that there are no new measures in the policy, there are a few provisions which did not exist earlier. In this article I have mainly covered those issues which were not discussed earlier, and those where there is additional or more clarity. I have covered the basic policy provisions very briefly.

2. **Basic FDI policy:**

   The basic policy for FDI is that foreign investment is freely permitted in all sectors in India – except where there is a restriction. In some sectors, FDI is totally prohibited like agriculture, retail trade, Real estate, etc. In some sectors, there are some conditions like NBFC, Construction and Development, etc. However by and large, investment is freely permissible. On investment, some compliances have to be completed.

   If the investment is not under the automatic route, an approval from FIPB or SIA is required.

   Non-residents are required to invest at a price which is at least equal to the value as per erstwhile CCI guidelines.

   Transfer of shares is also under automatic route – subject to compliance of the conditions laid down.

3. **Legal Background:**

In the past, the foreign investment policy was issued as a part of Industrial Policy. The Industrial Policy dealt with licensing, and other issues. Over a period by 2003, the Government titled the document as Foreign Investment policy, etc. In actual practice, "Industrial Policy", "Foreign Direct Investment Policy", "Foreign Investment Policy" have been used interchangeably. There has never been a "Foreign Direct Investment Policy" as such.

3.1 The Consolidated FDI policy has not been issued under any law. It is a policy issued by the Department of Industrial Policy and Promotion (DIPP) which is under the Ministry of Commerce and Industry.

DIPP issues press notes for amendments to the policy. The legal framework is the Foreign Exchange Management Act and the regulations issued under it. FEMA regulations lay down the law, and procedures. For Foreign Direct Investment, FEMA notification 20 is applicable. Generally the RBI issues notifications to amend the regulations in line with the Press Notes issued by DIPP. However where RBI has some differences or requires some clarifications, FEMA regulation does not get amended.

On a few issues, there are differences between the FDI policy and FEMA regulation.

3.2 Clause 1.1.9 of the Consolidated FDI policy states that *"the circular consolidates FDI policy framework, the legal edifice is built on notifications issued by RBI under FEMA. Therefore, any changes notified by RBI from time to time would have to be complied with and where there is a need / scope of interpretation, the relevant FEMA notification will prevail."*

This is for the first time that a document states that it is FEMA regulations which have the legal binding force. This is a clear provision which is good. Where the Press note (or Consolidated FDI policy) liberalises any provision, till the FEMA notification is amended, the liberalisation will not have any effect. In such situation, one can approach RBI with an application. Generally RBI would grant an approval, unless it has some differences with DIPP on the liberalisation measures.

3.3 Clause 1.1.4 states that *"the regulatory framework over a period of time thus consists of Acts, Regulations, Press Notes, Press Releases, Clarifications, etc."*. Thus according to DIPP, all communication from the DIPP are a part of regulatory framework! At times, there are clarifications given by Ministers, or by DIPP on its website. Would they be a part of legal framework?

It will be interesting to read the decision of Federal Association of Manufacturers referred to in paragraph 6. The Delhi High Court has said in case of policy matters, Government is free to decide the meaning it wants to adopt for various terms. In that case, the Government had adopted a modern meaning of wholesale trading compared to the traditional meaning. That time the meaning was not in the public domain. The Government gave its view by way of an affidavit to the Court. The issue is that the Government can be more upfront in providing its view.

3.4 FEMA notification no. 20, states the following in Schedule I, clause 2(1):

"An Indian company, not engaged in any activity/sector mentioned in Annex A to this schedule, may issue shares or convertible debentures to a person resident outside India, subject to the limits prescribed in Annex B to this schedule, in accordance with the Entry Routes specified therein and the provisions of Foreign Direct Investment Policy, as notified by the Ministry of Commerce and Industry, Government of India, from time to time."

As mentioned above, there has never been any Foreign Direct Investment Policy as such. There has been an "Industrial policy". Practically, the document published by the Ministry of Commerce and Industries has been referred to as the FDI policy.

3.5 The Consolidated FDI policy states that in cases of interpretation, FEMA notification will prevail. FEMA notification states that investment will be permitted as per the limits stated in the schedule and the FDI policy.

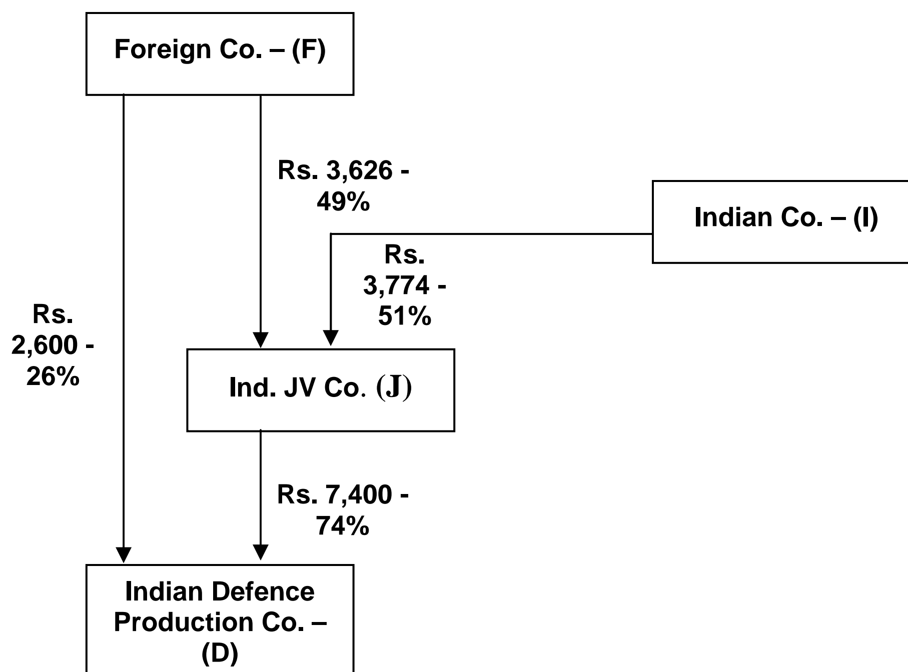
Which prevails – FEMA regulations or FDI policy?

Take an example.

Chapter 4 of the Consolidated FDI policy lays down the policy for deciding whether an Indian company is controlled and owned by Indian residents and citizens. (Earlier the policy was laid down in Press notes 2, 3 and 4 of 2009. These press notes now stand rescinded.) It states that if the Indian company in which there is foreign investment, is owned or controlled by non residents to the extent of 50% or more, it will be considered as foreign investment. Any investment by such a company in another Indian company will be considered as foreign investment. Sectoral caps will apply.

Vice-versa, if the Indian company is owned and controlled by persons who are Indian residents and citizens to the extent of more than 50%, it will be considered as Indian investment. Investment by such a company in another Indian company will not be considered for counting foreign investment.

A chart is given below to illustrate the issue:



Thus the Foreign Co. (F) owns directly and indirectly (through the JV Co. – (J)) total capital Rs. 6,226 (3,626 + 2,600) of 62.26% in Defense production company (D).

In defence sector, foreign investment cannot exceed 26%. With the above structure, the investment can exceed 26%, although the control will be with the Indian Co. – I.

Is this permitted?

A plain reading of FDI policy gives an impression that it is permitted. Investment in the above manner can take places in several sectors where there is a restriction or a sectoral cap.

However these provisions have not been enacted in FEMA regulations.

This is situation where FDI policy is more liberal that the FEMA regulation.

The Consolidated FDI policy states that if there is any interpretation issue, FEMA will prevail. As such a provision is not there in FEMA, the investment cannot be made.

Under FEMA, it states that the investment is subject to provisions of the FDI policy. Can we say that the investment can be made?

In my view, as the Consolidated FDI policy clearly states that FEMA will prevail, the investment cannot be made. (Also see paragraph 3.11.)

3.6 Take a situation where FEMA is more liberal than the FDI policy.

All sectors where there is no restriction, foreign investment can be made freely. Services sector is under automatic route under FEMA.

Under the erstwhile FDI policy before 31.3.2010 also, services sector was under automatic route.

The Consolidated FDI policy now states under clause 5.20 that FDI is allowed in specified "Business services". Does this mean that other services are now no longer under automatic route? (See paragraph 9.1 also for more discussion.)

3.7 Is it possible to take a view that only if the Consolidated FDI policy and FEMA regulations both permit, then only investment can be made?

My personal view is as under:

Where FEMA permits an investment on automatic basis, the non-resident can make the investment. Where the FDI policy permits an investment, but FEMA does not permit it, then one needs to take an approval from RBI / FIPB before making the investment.

3.8 Consider a situation where the non-resident wants to invest in "Cash and carry / Wholesale trading". It is an activity which is permitted on automatic basis.

There were however controversies on the meaning of "Cash and carry / Wholesale". One of the controversies was that whether goods sold on credit will be in line with "Cash and carry". FEMA regulations do not explain the meaning of "cash and carry". The Consolidated FDI policy now explains the meaning of this term. It states that normal credit terms can be given to the customers. Thus investment can be made in this sector and normal credit can be extended to the customers. (See paragraph 6 for more discussion.)

Thus where FEMA is "silent" on the meaning of any term, one should be able to rely on the FDI policy. In the case of Federation of Association of Manufacturers, the Delhi High Court has stated that such issue is a policy matter. The Government is within its rights to formulate policy matters. If the Government decides to adopt a particular meaning of any business phrase, it can do so. If the Government has considered that normal credit terms are permissible, then the same are permissible.

3.9 Therefore in a situation where there is a clear conflict between FDI policy and FEMA, FEMA will prevail. Where it is an issue of understanding of particular terms, the clarification given by DIPP or FEMA will prevail.

3.10 One may appreciate that Consolidated FDI policy by DIPP is a **policy level document**, whereas FEMA is the **legal document**. Both have different objectives. The Consolidated FDI policy can be considered as the intention of the Government, whereas FEMA lays down the detailed rules. Unless a policy is enacted as a statute, it does not have the force of law.

3.11 With the FDI policy, a press release has also been issued. One of the paragraphs in the press release states that – *"There are a number of issues related to FDI policy that are currently under discussion in the Government, such as foreign investment in Limited Liability Partnerships (LLPs), policy on issuance of partly paid shares/warrants, rescinding Schedule IV of FEMA, clarifications on issues related to Press Notes 2, 3 & 4 of 2009 and on Press Note 2 of 2005, as also certain definitional issues etc. When a decision on these is taken, the Government decision would be announced and thereafter incorporated into the Consolidated Press Note subsequently."*

Thus there is recognition that there are some issues on which the Government thinking has still not been finalised.

In my view, press notes 2, 3 and 4 of 2009 are not operational as far as the automatic route is concerned. One can approach FIPB for a specific approval.

Government is considering to scrap non-repatriable category of investment for NRIs. One will have to wait for the announcement.

Investment in a LLP is desirable. There will be issues of partners' investment in capital, withdrawal of the same, payment of interest, etc.

Let us consider some specific issues dealt with by the FDI policy which have not been dealt with earlier.

4. **Investee entity:**

A non-resident can invest in an Indian company (on automatic basis). An NRI can invest in an Indian company on repatriable basis and non-repatriable basis. An NRI can invest in a partnership firm or a proprietory concern on non-repatriable basis. This policy continues under the Consolidated FDI policy.

Investment in other entities was not permitted. Now the Consolidated FDI policy is more specific.

4.1 **Investment in Partnership firm on repatriable basis:**

Normally investment in partnership / proprietory concern is not permitted on repatriable basis. The only sector where there is a reference of investment in a firm is Defence sector (Press Note 2 dated 4.1.2002 and entry 5.9 of Consolidated FDI policy). RBI had issued a circular no. AP 39 dated 3.12.2003. As per the circular, **NRIs** could invest in a partnership firm or a proprietrory concern on repatriable basis after obtaining an approval from Secretariat of Industrial Approvals / RBI. The circular also provides that persons of **Non-Indian origin** can invest in a partnership firm or a proprietory concern after obtaining an approval from RBI.

In actual practice, RBI is not granting any approval for repatriable investment in a partnership firm and proprietory concern.

The Consolidated FDI policy now provides that NRIs and persons other than NRIs can apply to RBI [para 3.2.2]. The application will be decided in consultation with the Government of India. This is the first time that the FDI policy provides for a foreigner to invest in a partnership

firm / proprietory concern. The criteria however has not been specified. One will have to wait and see whether RBI / Government permits investment in a firm / proporietory concern and on what terms and conditions.

4.2 **Trusts:**

Para 3.3.3 prohibits FDI in trusts other than Venture Capital Fund (VCF). Investment in trusts was in any case not permitted. However let us consider some issues.

4.2.1 Can an NRI or an FII invest in mutual funds which are formed as trusts? So far they have been permitted to invest *[Schdeule 5 of FEMA notification 20]*.

4.2.2 An NRI wants to set up a private trust in India. The trust is for his family members. Some beneficiaries are NRIs and some are Indian residents. The NRI settlor himself can be a beneficiary.

Can such a trust be settled? Will such a settlement be considered as an "investment"?

At the outset one may observe that "settlement" cannot be considered as "investment". However there will be a transfer of assets to the Indian trust where a non-resident will have an interest. It requires an approval from RBI. Now with a specific bar under the FDI policy, will it be possible to have an Indian trust with non-residents as beneficiary? Will RBI consider an application at all? One will have to wait and watch.

The above situation is different from a situation where a non-resident wants to invest in the Indian economy through a trust. Consider a situation where an NRI settles funds in an Indian trust. The trust will have an NRI as a beneficiary. The trust will undertake portfolio investment / business activities. This is not permitted.

4.2.3 The personal status of the trust (whether it is a person), and its residential status are existing issues under FEMA. These are however beyond the scope of this article.

4.3 **Other entities:**

FDI is not permitted in other entities. Thus investment in Association of Persons is not possible.

A non-resident and an Indian resident have to jointly bid for a contract. The bidding may be done jointly. They may be even awarded the contract jointly. This is clearly permitted. Under the Income-tax Act, it may become an AOP. That is a different matter.

As long as there is no "investment" to be made in the AOP, there is no restriction. In this kind of AOP, the parties only carry out the work jointly. The finances are independently managed by the investors. This is clearly permitted. As far as the non-resident is concerned, he may have to comply with the "project office" rules.

If however the non-resident wants to "invest" in the AOP, then it is prohibited.

5. **Securities in which the non-resident can invest in:**

5.1 **Convertible debentures and preference shares:**

5.1.1 Prior to 1.5.2007, Indian companies could issue debentures and preference shares to non-residents which were partly or fully convertible into equity shares.

There were different views on how much of the face value could be converted into equity shares. Different offices of RBI had given varying views on the amount which had to be converted into equity shares (ranging from 10 to 25% of the face value). However DIPP had a different view. According to DIPP, even if 1% of the face value was converted into equity shares, it was acceptable. With such an instrument, it was possible for a non-resident to invest in Partly convertible debentures (PCDs) or Partly convertible preference shares (PCPs). By having an option to convert only 1% of the face value, the investor could participate in the debt in India. Without the PCDs, it was difficult to participate in the debt.

India received a lot of foreign exchange in the form of FDI, ECB, and portfolio investment. The economy started heating up in 2007. Hence the Government banned partly convertible debentures and partly convertible instruments.

Only fully convertible debentures (FCDs) and fully convertible preference shares (FCPs) are now permitted.

5.1.2 There is however an issue of the price at which the FCDs and FCPs can be converted.

The basic policy is that Non-residents are required to invest at a price which is at least equal to the value as per erstwhile CCI guidelines (referred to as the "minimum price"). Therefore at what price the convertible debentures / preference shares should be converted. (This was an issue even when PCDs or PCPs could be issued.)

Broadly, there can be different alternatives for the price at which the instruments can be converted. These can be as under:

i) The **price** of conversion could be the "minimum price" of equity shares at the time of issue of FCDs / FCPs. It could be at face value in case of a new company or at a "minimum price" in case of existing companies. This is the minimum price at which the non-resident has to invest.

ii) The price of conversion could be decided at the time of conversion.

iii) The third alternative is a variation of the second alternative. The **basis of the price** could be decided upfront depending on the profits which the company earns. The conversion period could also be a range of dates. It need not be a fixed date. The actual price could be worked out later. As in the second alternative, the "minimum price" of conversion would be decided at the time of conversion.

5.1.3 The RBI held a view that the price could not be determined at the time of issue. It had to be determined at the time of conversion. Their argument was that if at the time of issue the prescribed price was Rs. 10, and at the time of conversion after 3 years, the price was Rs. 20, the non-resident must get the shares at Rs. 20.

Recently at a conference, we were told that the price was to be decided upfront at the time of issue. This was the understanding from 2007 when PCDs and PCPs were banned! In my view, when PCDs and PCPs were banned, there was nothing in the press releases and circulars on the pricing issue.

5.1.4 The FDI policy states in clause 3.2.1 that the pricing of the capital instruments should be decided / determined upfront at the time of issue of the instruments. Does this have any significance?

Does the "minimum price" have to be determined at the time of issue? Or only the basis for the "minimum price" has to be determined?

Does it have to be an exact amount, or can it be determined with reference to a basis like price to earnings ratio?

The FDI policy states that the "pricing" shall be decided / determined at the time of issue. "Pricing" is a broader term. It is different from the term "price". Pricing means basis of the price and not a certain number. Therefore if the basis of the price is determined, but the actual price is determined later, the condition should be considered as complied with.

However RBI does not appear to have this view. Let us consider an example below.

5.1.5 The "minimum price" could be as under:

At the time of issue -	Rs. 10
At the time of conversion into equity	Rs. 20

From investors' point of view, there could be bonafide reasons for conversion at a "minimum price" on the date of issue of FCDs / FCPs. They would consider their appreciation from the date of investment.

If the "minimum price" is decided at the time of issue, then the investor will benefit. Consider further that the investor may receive interest on FCDs till the same are converted. In this situation, the investor will get interest, as well as the benefit of conversion at a lower price.

From issuer's (investee company's) point of view, there could be bonafide reasons for conversion at a "minimum price" on the date of conversion of FCDs / FCPs. If the "minimum price" is higher at the time of conversion, the Indian company would not like to give away the shares at a lower price.

This issue has become a grey area. It requires more clarification from RBI / Government.

In the share purchase agreements, it is advisable to provide that the price at which the FCDs / FCPs will be converted will be on a particular basis; however it will not be less than the price prescribed as per regulations under FEMA.

5.2 **Prohibitions:**

Apart from the FCDs and FCPs, no other instrument can be issued. It has been specifically stated that warrants and party paid shares cannot be issued.

6. **Trading:**

6.1 FDI in trading activities is primarily prohibited. However trading for exports, Cash and Carry trading / Wholesale trading (WT), single brand retail trading is permitted. [Press note 4 dated 10.2.2006 / clause 5.39 of Consolidated FDI policy.]

6.2 It will be interesting to note the meaning of "Cash and Carry" as understood internationally.

The business format of cash and carry includes the following characteristics:

- The seller sells on cash.
- Seller does not provide delivery services. The purchaser takes the goods himself. This is a major distinction between normal wholesale trading and cash and carry wholesale trading.
- The volume of trade is not relevant. What is relevant is type of customer – whether he uses the goods for business, or for personal consumption. The customer should use the goods for business.

6.3 This understanding was never explained by the Government in the past. Initially there were several issues on which there was no clarity. Over time however some issues were clarified on the website of DIPP, or by way of clarification from DIPP on a specific request.

The meaning of WT as understood by DIPP is:

- The sale should be to a person who had sales tax number / VAT registration.

  Say a hospital wants to buy medical sutures on wholesale basis. The hospital has registration numbers, under various government

authorities. Yet it is the ultimate consumer. Whether this was permitted or not was not clear.

- Sale should not be to an end user. i.e. The sale should be to an intermediary like distributor, etc.

- Sale should be on cash basis. Whether normal credit period as prevalent in the industry was permitted or not was not clear. On a specific request, DIPP clarified that normal credit period was permissible.

Subsequently, the Federation of Association of Manufacturers had filed a writ petition in Delhi High Court. In that case, the Government has given its understanding on the meaning of the term "Wholesale Cash and Carry trading". The writ petition was filed mainly because the Government had permitted non-resident investment in B2B e-commerce. The Delhi High Court had said that this is policy matter. If the Government in its wisdom adopts a modern meaning of "wholesale trading" against a traditional meaning, then it is right in doing so.

6.4 The Consolidated FDI policy now explains this issue elaborately in clause 5.39.1.1. The important clarifications which the policy provides are as under:

- Sale of goods can be to distributors or intermediaries, and also to institutions and other professional business users. Thus the Indian company can sell computers in bulk to a person who wants to purchase them for office use.

The sale cannot be for personal consumption of the retail buyer.

Can sale take place to an individual Chartered Accountant in practice who will purchase say one box of papers for printing in his office? Clearly this is permitted. The policy clarifies that – "*The yardstick to determine whether the sale is wholesale or not would be the <u>type of customers</u> to whom the sale is made and <u>not the size and volume of sales</u>.*"

Thus essentially sale to end user for personal consumption is not permitted. Sale for business use is permitted.

Is a sale to a charitable trust or a hospital or a educational institution permitted? Again the answer is that as these organisations will

purchase for consumption during the course of their activities, the sale can be undertaken.

- The policy provides for guidelines as under:

(a) All necessary approvals from Central / State / local government should be obtained by the wholesaler.

(b) Sale to Government is permitted. Sale to person other than the Government will be permitted only when the "buyer" fulfills any one of the following conditions:

(i) The buyer holds sales tax/ VAT registration/service tax/excise duty registration; or

(ii) The buyer holds trade licenses i.e. a license/registration certificate/membership certificate/registration under Shops and Establishment Act, reflecting that the buyer is itself engaged in a business involving commercial activity; or

(iii) The buyer holds permits/license etc. for undertaking retail trade (like tehbazari and similar license for hawkers); or

(iv) The buyer is an institution having certificate of incorporation or registration as a society or registration as public trust for its self consumption.

(c) Full records of the purchasers including their registration/license/permit etc. should be maintained on a day to day basis.

(d) WT of goods is permitted among group companies. However, there are further conditions:

- such WT to group companies taken together should not exceed 25% of the total turnover of the wholesale venture.

- the wholesale made to the group companies should be for their internal use only.

However say for example, if the wholesaler proposes to sell the goods to a group company which is a retailer. Can it be done? This is clearly a permitted transaction. It cannot be a situation that

the wholesaler can sell goods to a 3rd party retailer, but not to its own group company which is a retailer. It is only if the sale to group company is for internal consumption that there is a restriction.

However the manner in which the restriction has been provided, it seems that sale to group company is permitted only for self-consumption.

(e) WT can be done as per normal business practice. Credit facilities as per normal business practice can be given subject to applicable regulations.

(f) A Wholesale/Cash & carry trader cannot open retail shops to sell to the consumer directly.

7. **NBFC activities:**

NBFC activities are permitted under automatic route. There are capitalisation norms for such companies. For fund based activities, in case the non-resident investor wants to invest upto 100% of the equity capital, the minimum capital required to be brought in is US$ 50 mn.

For non-fund based activities the capitalisation is US$ 0.5 mn. The Consolidated FDI policy now has stated that the following activities will be considered as non-fund based activities:

a) Investment Advisory Services.
b) Financial Consultancy.
c) Forex Trading.
d) Money Changing Business.
e) Credit Rating Agencies.

8. **Transfer of shares:**

Transfer of shares from an Indian resident to a non-resident is generally under automatic basis. [AP circular 16 dated 4th October 2004 read with other circulars]. However if the Indian company is engaged in financial services, and the transfer is from an Indian resident to a non-resident, automatic route is not available.

8.1 DIPP had issued a press note no. 4 dated 10.2.2006 stating that transfer of shares of an Indian company engaged in financial services sector will be on automatic basis.

However RBI had not agreed to that issue. Therefore when RBI issued the notification no. 179 dated 22.8.2008 (with effect from 10.2.2006 - the date of DIPP press note no. 4), it still provided that automatic route is not available if the Indian company is engaged in financial sector.

Now the FDI policy again states that if the Indian company is engaged in financial services sector, automatic route will not be available.

8.2 RBI has issued the notification no. 131 dated 17.03.2005. It has defined "financial services" as "*service rendered by banking and non-banking companies regulated by the Reserve Bank, insurance, companies regulated by Insurance Regulatory and Development Authority (IRDA) and other companies regulated by any other financial regulator as the case may be.*" The notification (No. 131) was issued with effect from 16.10.2004 (the date of issue of AP circular 16 dt. 16.10.2004).

Thus if the company which is regulated by a financial regulator, automatic route will not be available.

9. **Business services:**

Clause 5.20 provides that FDI upto 100% is permitted for Business services under automatic route. However it states that FDI is allowed in "*Data processing, software development and computer consultancy services; Software supply services; Business and management consultancy services, Market Research Services, Technical testing & Analysis services.*"

Does this mean that FDI is not allowed in other business services?

This kind of a clarification was not provided in FDI policy earlier. It is also not provided in FEMA notification.

This cannot be the intention. Any sector where there is no restriction, is freely permitted (clause 5.41 of FDI policy). FDI in service sector has been permitted on automatic basis except in the areas where there is a sectoral cap (like courier services, ground handling services at airports, telecom services, etc.).

In any case, FEMA prevails in case of interpretation issue. Therefore in my view, FDI is freely permitted in "services sector".

See paragraph 2 on the basic FDI policy.

10. In nut shell it is a good attempt to provide the entire policy in one document. To refer to various press notes spread over a few years is difficult. Some issues will always remain. Over time, these should be sorted out.