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## FDI POLICY

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### 19.1 Introduction

Foreign investment is one of the main sources of investments in several growing nations and India is no different from the rest. Foreign Direct Investment or FDI has been the stimulus of growth in several sectors in India. The advent of globalisation and liberalisation since 1991 has seen a sea change of reforms in India. Leading the charge has been the FDI Policy of the Government which has undergone a massive liberalisation since 1991. The Foreign Exchange Management Act, 1999 ("FEMA") along with the Foreign Investment Promotion Board's Policy ("FIPB Policy") are the twin tenets on which the Government's FDI Policy hinges. The Ministry of Finance is the key Ministry which takes all the decisions regarding the FDI Policy in consultation with the relevant ministry for the concerned sector, e.g., a change regarding the hike of the FDI allowed in oil and gas companies would be jointly taken by the Finance Ministry and the Petroleum Ministry. The concerned department under the Finance Ministry which implements the FIPB Policy is the Secretariat of Industrial Assistance ("SIA"), Department of Industrial Policy & Promotion ("DIPP"), Government of India or the Foreign Investment Promotion Board. The FEMA is administered and implemented by the Reserve Bank of India ("RBI").

### 19.2 Foreign Direct Investment

19.2.1 FDI refers to the direct investment by foreign investors in the capital of an Indian company. FDI under the FEMA is permitted in the equity, preference shares, convertible preference shares or convertible debentures of a company. Schedule 1 to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 deal with FDI. FDI is permitted from all types of foreign investors, i.e., foreign companies, NRIs, foreigners, etc. It could be either on an Automatic Route or with the prior permission of the FIPB and the RBI. From the viewpoint of the investee company in India, the FDI policy can be divided into the following 4 categories:

- (1) Part A of Annexure-A of Schedule 1 contains a list of industry sectors in which FDI is prohibited on an Automatic Route basis of the RBI, i.e., the prior permission of the FIPB is required.
- (2) Part B of Annexure-A of Schedule 1 contains a list of industry sectors in which FDI is prohibited altogether, i.e., even with the prior permission of the FIPB and the RBI, FDI is not permitted in these sectors. This list currently includes the following:
  - (i) Retail trading (except Single Brand Product retailing)
  - (ii) Atomic energy
  - (iii) Lottery business
  - (iv) Gambling and Betting
- (3) Annexure-B of Schedule I contains a list of industry sectors in which FDI is restricted up to a certain level, i.e., there are sectoral caps on the level of foreign direct investment permitted in these industries.
- (4) Where no sectoral caps are prescribed and automatic route investment is permitted.

The list of sectors where there is a sectoral cap or restriction is attached and marked as APPENDIX-I. The FDI under Schedule 1 is on a repatriation basis, i.e., the income, principal as well as the sale proceeds can be freely repatriated abroad by the investor.

19.2.2 The Automatic Route for FDI is available up to the sectoral caps specified in Annexure-B provided that:

- (i) the activity of the issuer company does not require an industrial licence under the provisions of the Industries (Development & Regulation) Act, 1951 or under the locational policy notified by Government of India under the Industrial Policy of 1991;
- (ii) the shares or convertible debentures are not being issued by the Indian company with a view to acquiring existing shares of any Indian company.

Automatic Route for FDI is also available in case of a trading company to the extent of 51% of its capital, subject to the condition that remittance of dividend to the shareholders outside India is made only after the company has secured registration as an Export/Trading/Star Trading/ Super Trading House from the Directorate General of Foreign Trade, Ministry of Commerce, Government of India, New Delhi. Certain small scale industrial units may also issue shares on an automatic route.

A company can also issue equity shares on an automatic route against conversion of Lump sum Fee/ Royalty and External Commercial Borrowings (ECBs) which are already due. The conditions for the same are that:

- (a) the company is eligible for FDI on an automatic route;
- (b) the post-conversion foreign equity does not exceed the sectoral caps;
- (c) the pricing of the shares must be as per the SEBI Guidelines for listed companies or as per the erstwhile CCI Guidelines for unlisted companies;
- (d) the requirements prescribed by any other statute and regulation in force must be complied with; and
- (e) the reporting requirements specified by the RBI must be followed.

In case the automatic route is not open, then the prior permission of the FIPB is required. The following information should form part of the proposals submitted to FIPB:

- (i) Whether the applicant has any existing financial/technical collaboration or trade mark agreement in India in the same field for which approval has been sought; and
- (ii) If so, details thereof and the justification for proposing the new venture/ technical collaboration (including trade marks).

19.2.3 The pricing of FDI shares issued under Schedule 1, must not be less than:

- (a) the SEBI Guidelines on preferential issue pricing if the company is a listed company, and
- (b) the fair valuation of shares done by a chartered accountant as per the guidelines issued by the erstwhile Controller of Capital Issues.

19.2.4 The amount of consideration for issue of shares must be received:

- (i) by inward remittance through normal banking channels, or
- (ii) by debit to the NRE/FCNR account of the person concerned maintained with an authorised dealer/ bank.

19.2.5 The Indian company must comply with the reporting requirements of the RBI.

### 19.3 Portfolio Investment Scheme for FIIs

19.3.1 Portfolio Investment Scheme or PIS refers to foreign investment in a company but on the secondary market, i.e., there is no direct investment in the company. The shares of the company are bought on the secondary market / stock exchange. A Foreign Institutional Investor ("FII") registered with the SEBI may purchase the shares and convertible debentures of an Indian company under the PIS. Along with an FII its SEBI registered sub-accounts can also acquire shares under the PIS. Once an FII is registered with the SEBI it does not need any registration with the RBI.

19.3.2 The total holding by each FII/SEBI approved sub-account of FII must not exceed 10% of the total paid-up equity capital or of each series of convertible debentures issued by an Indian company and the total holdings of all FIIs/ sub-

accounts of FIIs put together must not exceed 24% of the paid-up equity capital or paid up value of each series of convertible debentures.

The Company may by a special resolution increase the limit of 24% to the applicable sectoral cap. For arriving at the ceiling on holdings of FIIs, shares/ convertible debentures acquired both through primary as well as secondary market is included. However, the ceiling does not include investment made by FII through off-shore Funds, GDRs, FCCBs.

Provided Further that the total holding by each sub-account being a foreign corporate / individual shall not exceed more than 5% of the total issued capital.

19.3.3 An FII may purchase shares/ convertible debentures of an Indian company through offer/ private placement, within the above ceilings provided that:

- (a) in case of a Public Offer, the price of the shares to be issued is not less than the price at which shares are issued to residents, and
- (b) in case of issue by private placement, the price is not less than the price arrived in terms of SEBI guidelines on preferential issue in case of listed companies or the guidelines issued by erstwhile Controller of Capital Issues in case of unlisted companies.

19.3.4 In addition to the above FEMA guidelines, the SEBI Guidelines also place certain investment restrictions, important among them being:

- (a) FIIs can invest in listed as well as unlisted companies;
- (b) FIIs must transact business only on the basis of taking and giving deliveries of securities bought and sold and must not engage in short selling of securities;
- (c) Transactions on the stock exchange cannot be carried forward;
- (d) FIIs must transact only through a SEBI registered broker;
- (e) If the FII is investing on behalf of its sub-accounts, then the investment on behalf of each sub-account must not exceed 10% of the total capital of the company. In case the sub-account is a foreign corporate or individual, then each of such sub-account cannot invest more than 5% of the total issue capital of the investee company.
- (f) The FII may also participate in a stock lending scheme approved by the SEBI.

19.3.5 The investments made by the FIIs are freely repatriable. The authorised dealer may allow remittance of net of tax sale proceeds or credit the net amount of sale proceeds of shares/ convertible debentures to the foreign currency account or a Non-resident Rupee Account of the FII.

#### 19.4 Portfolio Investment Scheme for NRIs

19.4.1 A Non Resident Indian ("NRI") may purchase the shares and convertible debentures of an Indian company under the Portfolio Investment Scheme. An NRI for this purpose is a person resident outside India who is a citizen of India or is a person of Indian origin ("PIO"). A PIO is a citizen of any country other than Bangladesh or Pakistan, if he/ his spouse at any time held an Indian passport or if he, his or his spouse's parents, grand parents were at any time an Indian citizen.

19.4.2 The total holding by each NRI must not exceed 5% of the total paid-up equity capital or of each series of convertible debentures issued by an Indian company and the total holdings of all NRIs put together must not exceed 10% of the paid-up equity capital or paid up value of each series of convertible debentures. The Company may by a special resolution increase the limit of 24% to the applicable sectoral cap. Earlier, Overseas Corporate Bodies or OCBs were allowed to invest under the Portfolio Investment Scheme at par with NRIs. However, OCBs as a class of investors are now derecognised.

19.4.3 The investments are freely repatriable. The authorised dealer may allow net of tax sale/ maturity proceeds of shares and/ or debentures of an Indian company purchased by the NRI under this scheme:

- (a) to be credited to NRO account of the NRI investor where the payment for purchase of shares and/ or debentures sold was made out of funds held in NRO account or where the shares and/ or debentures were purchased on non-repatriation basis, or
- (b) at the NRI's option, to be remitted abroad or credited to his/ its NRE/FCNR/NRO account of the NRI, where the shares and/ or debentures were purchased on repatriation basis.

#### 19.5 Non Repatriable Investments

19.5.1 Schedule 1 permits FDI on an repatriable basis. Schedule 4 allows FDI by an NRI on a non repatriable basis either through a public issue or private placement or rights issue. However, the investment is not allowed if the company is a Chit Fund or a Nidhi company or is engaged in agricultural/ plantation activities or real estate business or construction of farm houses or dealing in Transfer of Development Rights. Real estate business does not include development of township, construction of residential/ commercial premises, roads, bridges, etc.

The investor must obtain the prior permission of the Central Government to acquire the shares if he has a previous venture or tie up in India through investment in shares or debentures or a technical collaboration or a trade mark agreement or investment by whatever name called in the same field as the Indian company.

19.5.2 The amount invested under this Scheme and the capital appreciation thereon are not allowed to be repatriated abroad. The dividend income may be freely repatriated.

## 19.6 Foreign Venture Capital Investor

19.6.1 A Foreign Venture Capital Investor (FVCI) is an investor incorporated and established outside India which is registered with the SEBI. It can with the RBI permission, invest in an Indian Venture Capital Undertaking (IVCU) or in a Venture Capital Fund or in a scheme floated by such VCFs. The investment can be through an Initial Public Offer or a Private Placement or in the units of schemes/ funds set up by a VCF.

19.6.2 The SEBI Guidelines in this respect must be complied with. Some of the key requirements under the SEBI Guidelines are as under:

- (a) it can invest its total funds committed in one venture capital fund;
- (b) at least 67% of the investible funds must be invested in unlisted equity shares or equity linked instruments of a venture capital undertaking.
- (c) not more than 33% of the investible funds may be invested by way of:
  - (i) subscription to an IPO of a venture capital undertaking;
  - (ii) debt instruments of a venture capital undertaking in which the FVCI has made an equity investment;
  - (iii) preferential allotment of equity shares of a listed company;
  - (iv) equity shares of a financially weak company or a sick company whose shares are listed; and
  - (v) special purpose vehicles created for facilitating investments.
- (d) An FVCI cannot invest in the following sectors:
  - (i) NBFCs other than RBI registered Equipment Leasing and Hire Purchase Companies;
  - (ii) Gold financing
  - (iii) Activities not permitted under the Industrial Policy of Government of India.

The negative list of sectors earlier also included real estate which has since been removed.

## 19.7 Others

### 19.7.1 Rights Shares

A person resident outside India may purchase equity or preference shares or convertible debentures on a right basis if:

- (i) The offer on right basis does not result in an increase in the percentage of foreign equity already approved, or permissible under the FDI Scheme.
- (ii) The existing shares or debentures, against which rights are offered, are held in accordance with the FEMA Regulations;

- (iii) The existing non-resident shareholders may apply for issue of additional shares, provided the overall issue of shares to non-residents in the total paid-up capital does not exceed the sectoral cap;
- (iv) The offer on right basis to the persons resident outside India is at a price which is not lower than that at which the offer is made to resident shareholders;

The right shares or debentures purchased by the person resident outside India are subject to the same conditions including restrictions in regard to repatriability as are applicable to the original shares against which right shares or debentures are issued.

#### 19.7.2 Bonus Shares

An Indian company may issue bonus shares to its non-resident shareholders, subject to the following conditions:

- (a) the original shares against which bonus shares are issued were acquired or held by the non-resident shareholder in accordance with the applicable Regulations;
- (b) the bonus shares acquired by the non-resident shareholder are subject to the same conditions including restrictions in regard to repatriability as are applicable to the original shares.

#### 19.7.3 Merger/ Demerger

In case of a court approved merger, amalgamation, reconstruction by way of demerger or otherwise, the transferee company/ the new company is allowed to issue shares to the shareholders of the transferor company resident outside India , subject to the following key conditions, namely:

- (a) the percentage of shareholding of persons resident outside India in the transferee/ new company does not exceed the percentage specified in the approval granted by the Central Government or the Reserve Bank, or specified in these Regulations. If it is likely to exceed the percentage specified in the approval or the Regulations, then after obtaining an approval from the Central Government, an application may be made to the RBI.
- (b) the transferor company or the transferee or new company shall not engage in agriculture, plantation or real estate business or trading in TDRs; and

#### 19.7.4 ESOP

An Indian company may issue shares under an ESOP to its employees or employees of its joint venture or wholly owned subsidiary abroad who are resident outside India, directly or through a Trust. The key conditions in this respect are that:

- (a) the scheme has been drawn in terms of regulations issued under the SEBI; and

- (b) the face value of the shares to be allotted under the scheme to the non-resident employees does not exceed 5% of the paid-up capital of the issuing company.

19.7.5 Now let us discuss how a Non Resident investor can dispose off his investment in Indian companies. These are divided into the following heads:

- (a) Sale/ Gift by a person resident outside India
- (b) Gift by a person resident in India
- (c) Sale by a person resident in India
- Sale/ Gift by a person resident outside India
- (A) RBI has given general permission for the following transfers by persons resident outside India:
  - (a) A person resident outside India holding the shares or debentures of an Indian company, may transfer the shares or debentures so held by him, in compliance with the conditions specified in the relevant Schedule relating to the foreign investment.
  - (b) A person resident outside India, not being a non- resident Indian may transfer by way of sale or gift, the shares or convertible debentures held by him or it to any person resident outside India.
  - (c) A non-resident Indian may transfer by way of sale or gift, the shares or convertible debentures held by him or it to another non-resident Indian only.

The person to whom the shares are being transferred, must obtain the prior permission of the Central Government to acquire the shares if he has a previous venture or tie up in India through investment in shares or debentures or a technical collaboration or a trade mark agreement or investment by whatever name called in the same field or allied field in which the Indian company whose shares are being transferred is engaged.

  - (d) A person resident outside India holding the shares or convertible debentures of an Indian company may transfer the same to a person resident in India by way of gift or he may sell the same on a recognized Stock Exchange in India through a registered broker.
- (B) In case of a sale not covered by (b) or (c) above, a person resident outside India, may transfer share or convertible debenture of an Indian company, without the prior permission of the RBI, to a person resident in India subject to the specified pricing guidelines, documentation and reporting requirements. The important pricing guidelines in this respect are as under:
  - (l) Listed Company
    - (i) The sale is at the prevailing market price on stock exchange and is effected through a merchant banker or a stock broker;



- (ii) If the transfer is other than that referred to above, the price shall be arrived at by taking the average quotations (average of daily high and low) for one week preceding the date of application with 5% variation.

Where, however, the shares are being sold by the foreign collaborator or the foreign promoter of the Indian company to the existing promoters in India with the objective of passing management control in favour of the resident promoters the proposal for sale will be considered at a price which may be higher by up to a ceiling of 25% over the price arrived at as above,

(II) Unlisted/ Thinly Traded Company

- (i) If the consideration for the transfer does not exceed Rs.20 lakh per seller per company, then the price may be mutually agreed to between the seller and the buyer. It may be based on any valuation methodology currently in vogue, on submission of a valuation certificate from the statutory auditors of the company whose shares are proposed to be transferred; and

- (ii) If the consideration for the transfer exceeds Rs.20 lakh per seller per company, the price may be arrived at, at the seller's option, in any of the following manner, namely:

- Earning Per Share (EPS) linked to the Price Earning (P/E) Multiple, or a price based on the Net Asset Value (NAV) linked to book value multiple, whichever is higher
- The prevailing market price in small lots as may be laid down by the Reserve Bank so that the entire shareholding is sold in not less than five trading days through screen based trading system
- For unlisted companies, at a price which is lower of the two independent valuations of share, one by the statutory auditors of the company and the other by a Chartered Accountant or by a Merchant Banker.

Explanation:

- (i) A share is considered as thinly traded if the annualized trading turnover in that share, on main stock exchanges in India, during the 6 calendar months preceding the month in which application is made, is less than 2% (by number of shares) of the listed stock.
- (ii) Net Asset Value = Total Assets (-) the miscellaneous expenses carried forward, accumulated losses, total outside liabilities, revaluation reserves and capital reserves (except subsidy received in cash) number of equity shares

issued and paid up. Alternatively, Net Asset Value = Equity capital + reserves (excluding revaluation reserves) (-) intangible assets

The NAV so calculated shall be used in conjunction with the average BV multiple of Bombay Stock Exchange National Index during the calendar month immediately preceding the month in which application is made and BV multiple shall be discounted by 40 per cent.

- (iii) Earning Per Share = EPS as per the latest balance sheet of the company used in conjunction with the average Price Earning Multiple of the Bombay Stock Exchange National Index for the calendar month preceding the month in which application is made and Price Earning shall be discounted by 40 per cent.

#### 19.7.6 Gift by a person resident in India

A person resident in India who wants to transfer any security, by way of a gift to a person resident outside India, must first apply to the Reserve Bank for its approval. The Reserve Bank may grant such approval on being satisfied of the following key conditions:

- (a) The donee is eligible to hold such a security under the FEMA Regulations.
- (b) The gift does not exceed 5% of the paid up capital of the Indian company/ each series of debentures/each mutual fund scheme.
- (c) The applicable sectoral cap/foreign direct investment limit in the Indian company is not breached.
- (d) The donor and the donee are relatives as defined in section 6 of the Companies Act, 1956.
- (e) The value of security to be transferred by the donor together with any security transferred to any person residing outside India as gift in the calendar year does not exceed the rupee equivalent of USD 25,000.
- (f) The application for approval must be accompanied by:
  - In case of Government dated securities and treasury bills and bonds, a certificate issued by a Chartered Accountant on the market value of such securities.
  - In case of units of domestic mutual funds and units of Money Market Mutual Funds, a certificate from the issuer on the Net Asset Value of such security.
  - In case of shares and debentures, a certificate from a Chartered Accountant on the value of such securities according to the guidelines issued by the SEBI in case of listed companies or the CCI guidelines in case of unlisted companies.

#### 19.7.7 Sale by a person resident in India

The transfer of shares/ convertible debentures, by way of sale, from residents to non-residents of an Indian company is put on the automatic route of the FIPB and

the RBI, i.e., prior approval of the FIPB and RBI is not required. Earlier, this automatic route transfer was not available in the financial service sector (i.e. Banks, NBFCs and Insurance). However, recently even this has been put on the automatic route. The authorised dealer is empowered to process such applications. The onus of complying with the sectoral cap/limits prescribed under FDI policy as well as other guidelines/regulations would rest with the buyer and seller/issuer. The following key conditions must be complied with:

- (a) The activities of the investee company are under the automatic route under FDI policy
- (b) Earlier, the automatic route was not available if the transfer attracted the provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. Press Note 4 of 2006 has recently clarified that the automatic route would be available even in cases where approval for such transfer is required from SEBI, RBI, IRDA, etc. Even cases attracting the provisions of the Takeover Regulations which require SEBI's approval would be eligible for automatic route transfer. However, it is respectfully submitted that the Press Note is not very happily worded and leaves a lot to be desired. Although the spirit of the Press Note appears to be to put all transfers on an auto route, its form suggests that only those transfers which require the prior approval of the SEBI or the RBI would be covered. It may be noted that SEBI does not approve any open offers under the Takeover Regulations.
- (c) The non-resident shareholding after the transfer, complies with sectoral limits under FDI policy.
- (d) The price at which the transfer takes place is in accordance with the pricing guidelines prescribed by SEBI/ RBI. It should not be less than:
  - the ruling market price, in case the shares are listed on stock exchange,
  - a fair valuation of shares done by a Chartered Accountant as per the guidelines issued by the erstwhile Controller of Capital Issues, in case of unlisted shares.The price per share arrived at should be certified by a Chartered Accountant.
- (e) Form FC-TRS along with the necessary supportings must be filed with the authorised dealer.