Suresh Surana & Associates LLP

WIRC - FEMA CONFERENCE

FDI AND INDIRECT FOREIGN INVESTMENTS

CA Amit Amlani

25 July 2015

Agenda

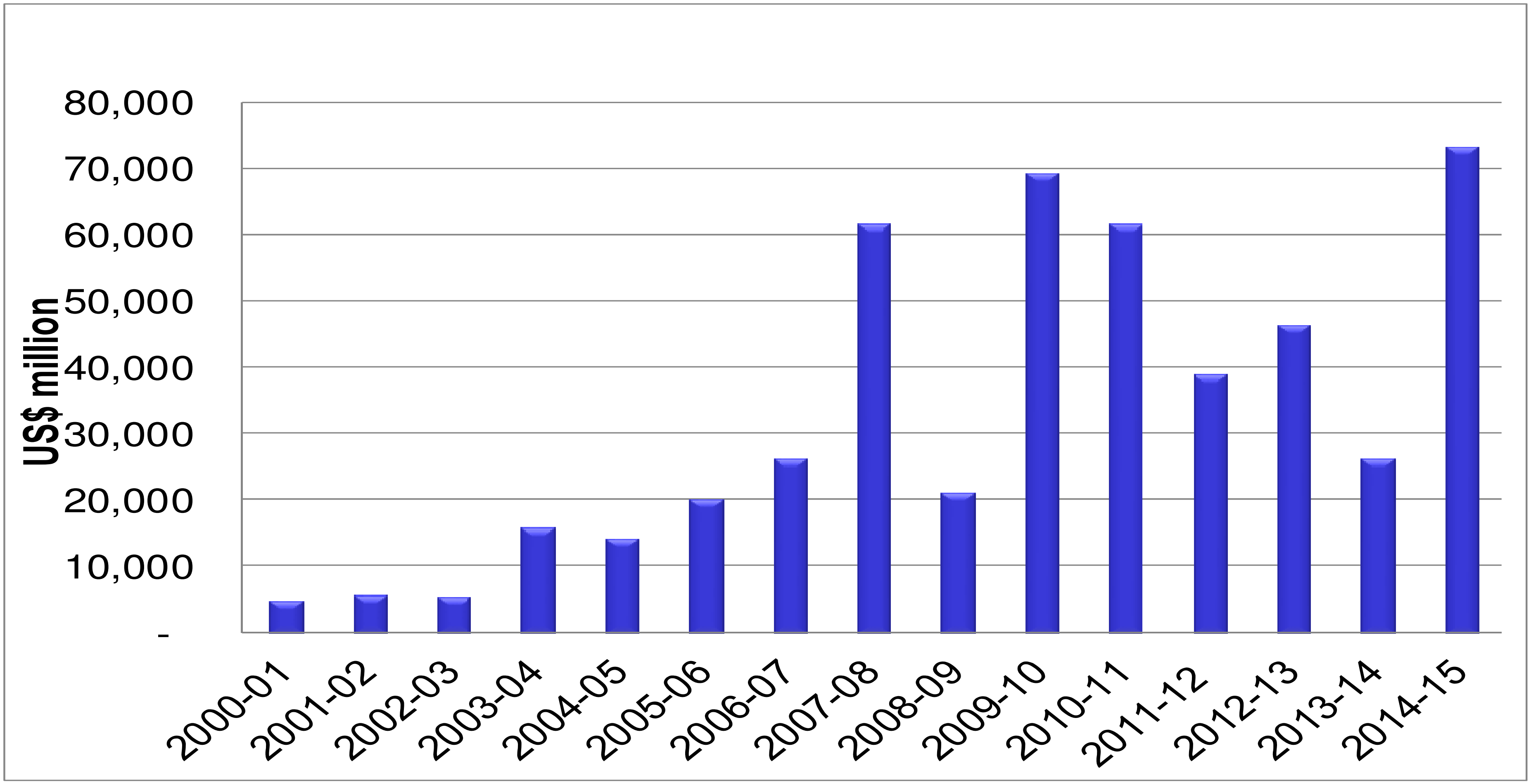
- India - Global Investment Destination
- Foreign Direct Investment in India
- Indirect Foreign Investment

INDIA - GLOBAL INVESTMENT DESTINATION

India - at a Glance

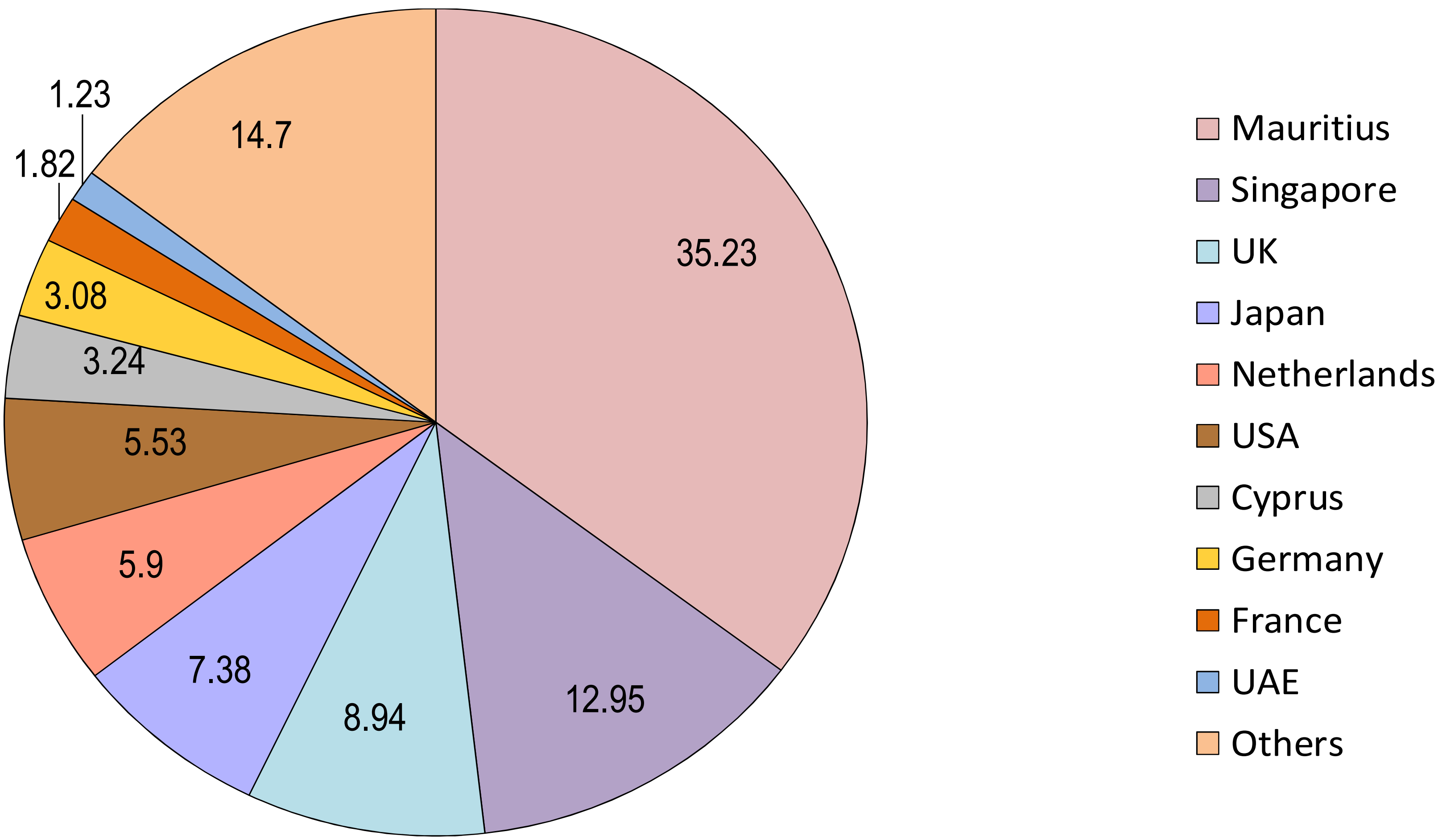
Factors	Index / Particulars
Gross Domestic Product (GDP)	US$ 8 trillion (PPP, April 2015)
GDP Growth rate	7.3% (2014-15)
Global Ranking	3rd largest economy in the world
Population	1.2 billion (more than 50% of the population below the age of 25 years)
Political System	Federal Constitutional republic with Parliamentary democracy
Currency	Indian Rupee
Business Languages	English, Hindi
Foreign Investment Inflow	US$ 74 Billion (2014-15)

Foreign Investment Inflows - Statistics



Source: RBI Bulletin - June 2015

Country-Wise FDI inflow From April 2000 to March 2015 - Statistics



Source - DIPP, Ministry of Commerce

Pre-liberalization Background (before 1990)

Protectionist Policy	Strong emphasis on import substitution, industrialization under state monitoring, state intervention at micro level in all businesses especially in labour and financial markets, a large public sector, business regulation, central planning
Nationalization of Industries	Steel, mining, machine tools, water, telecommunications, insurance, electrical plants, among other industries, were effectively nationalized in the mid-1950s.
Elaborate Licenses	Elaborate licenses, regulations and the accompanying red tape, commonly referred to as License Raj, were required to set up business in India between 1947 and 1990
Rupee Non-convertibility	Rupee was inconvertible and high tariffs and import licensing prevented foreign goods reaching the market.

Post Liberalization Background (1991 onwards)

- Exemption of Industries from Licensing
- Expansion of Industries
- Inviting Direct Foreign Investment
- Going away with the Concept of MRTP
- Extending Investment Limit of Small Industries
- Freedom of Production

Make in India - Foreign Investment initiatives

- Launched in September 2014, 'Make in India' is a new and macro level national program designed to facilitate investment, foster innovation, enhance skill development, protect intellectual property and build best-in-class manufacturing infrastructure.
- With motto of 'Zero Defect Zero Effect", the major objective behind the initiative is to focus on 25 sectors of the economy that includes automobiles, textiles, railways and tourism for job creation and skill enhancement.
- India ranked the No.1 investment destination in the world as per the 2015 Baseline Profitability Index (BPI). It has been ranked among the top 3 attractive destinations for inbound investments.
- Recently, Union Cabinet has issued the press release on composite caps for foreign investment in India to uniform and simplify foreign investment opportunities among wide spread investors including FII, FPI, NRI, etc. subject to sectors caps and conditions.

Ease of Doing business in India-Initiatives

- Series of measures are under review to improve Ease of Doing Business. The emphasis has been on simplification and rationalization of existing rules and introduction of information technology to make governance more efficient and effective.
- C&I Ministry is expecting a significant improvement in India's ranking in the **World Bank's Ease of Doing Business report** in the range of 95 to 105 as compared to the present ranking of 142 out of 189 countries in 2014

Major initiatives includes the following:

- E-biz services (single online window for integration of multiple Central Government Services including industrial license, incorporation of company, Filing of FEMA forms, PAN, TAN, etc.)
- Checklist with specific time-lines being developed
- Investor Facilitation Cell
- Automation of EPFO and ESIC Services
- VAT and Professional tax registration merged by Govt. of Maharashtra.
- Central Government to rank states on 'ease of doing business‘ with the help of questionnaire circulated amongst several states by DIPP.


FDI IN INDIA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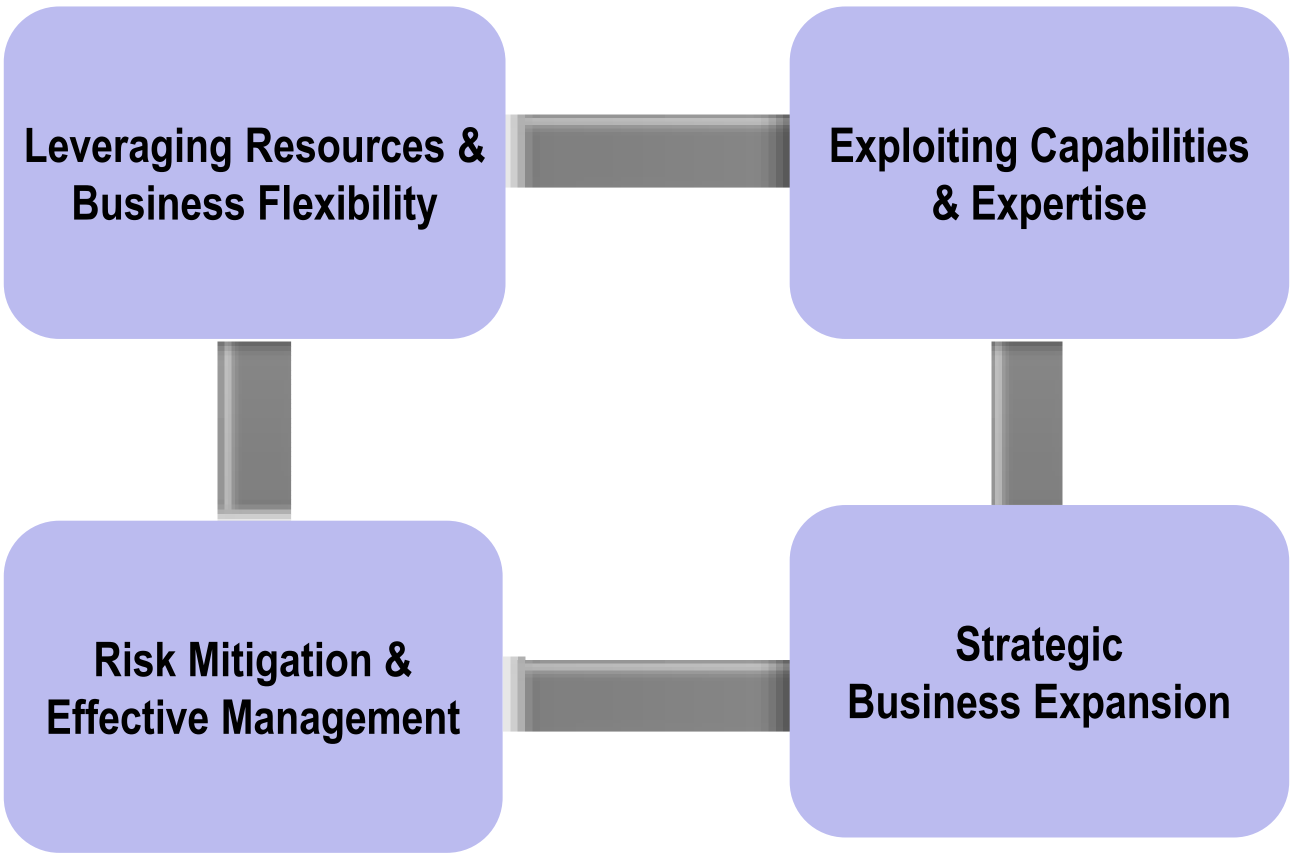
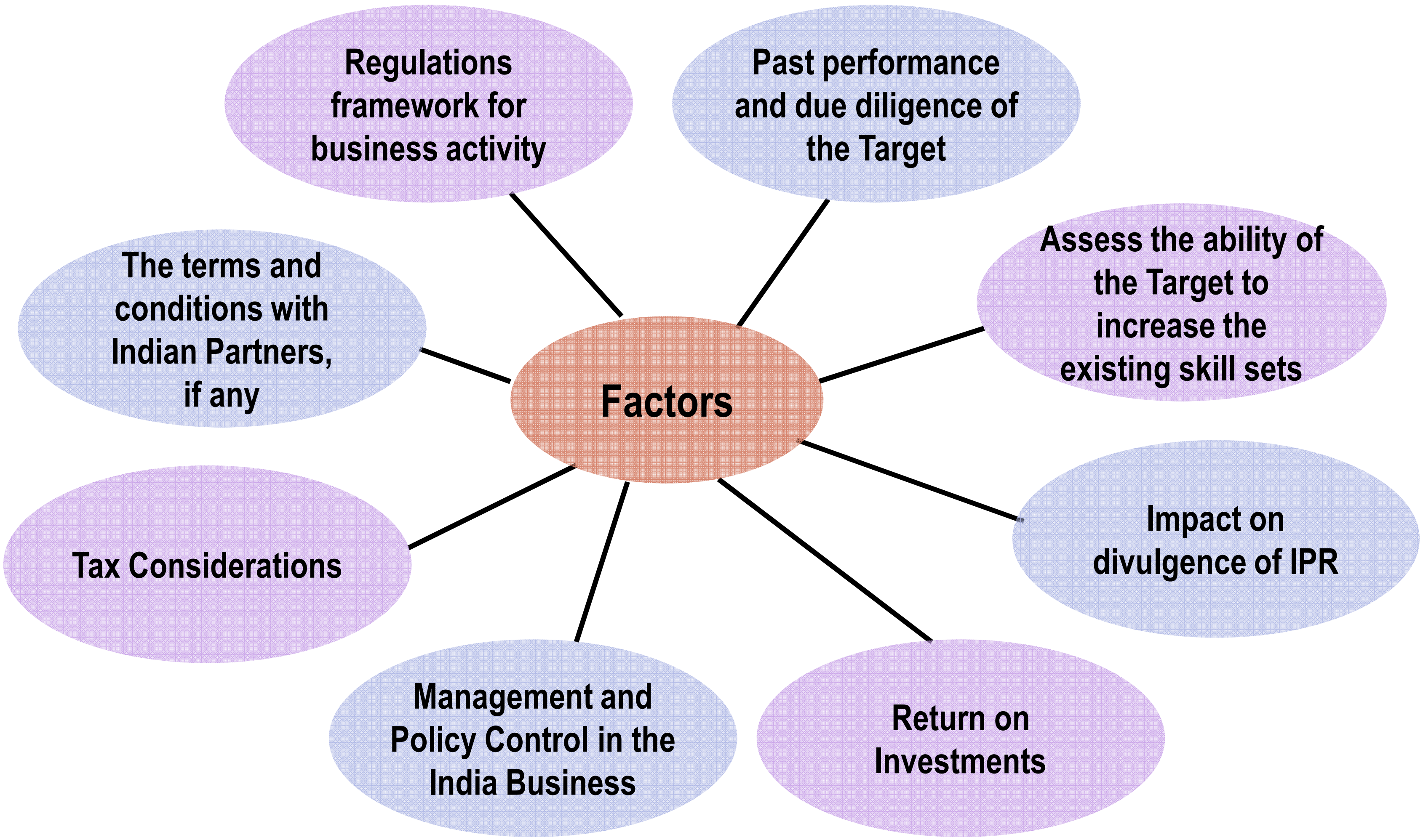
Purpose of Setting-up of Operations in India



Process for Setting-up of operations in India

- Foreign investors' determining the need for setting-up the operations in India
- Understanding regulatory framework in India for the proposed venture
- Commercial feasibility & Due Diligence (legal, financial, tax, valuation, etc.)
- Need for Intermediary Jurisdiction to bring in legal / tax efficiency
- In case of JV, it need to understand the nature of JV entity, Capital Contribution by each JV partner, Roles and Responsibilities of each party to JV, Dispute Resolution Mechanism, etc.
- Legal Documents such as SHA, MoA/AoA, LLP agreements, Business Co-op. Agreement etc., as applicable
- Incorporation and capital contribution (cash / no-cash)
- Resource mobilization (human / capital / infrastructure / funding / assets)
- Obtaining various business registration.

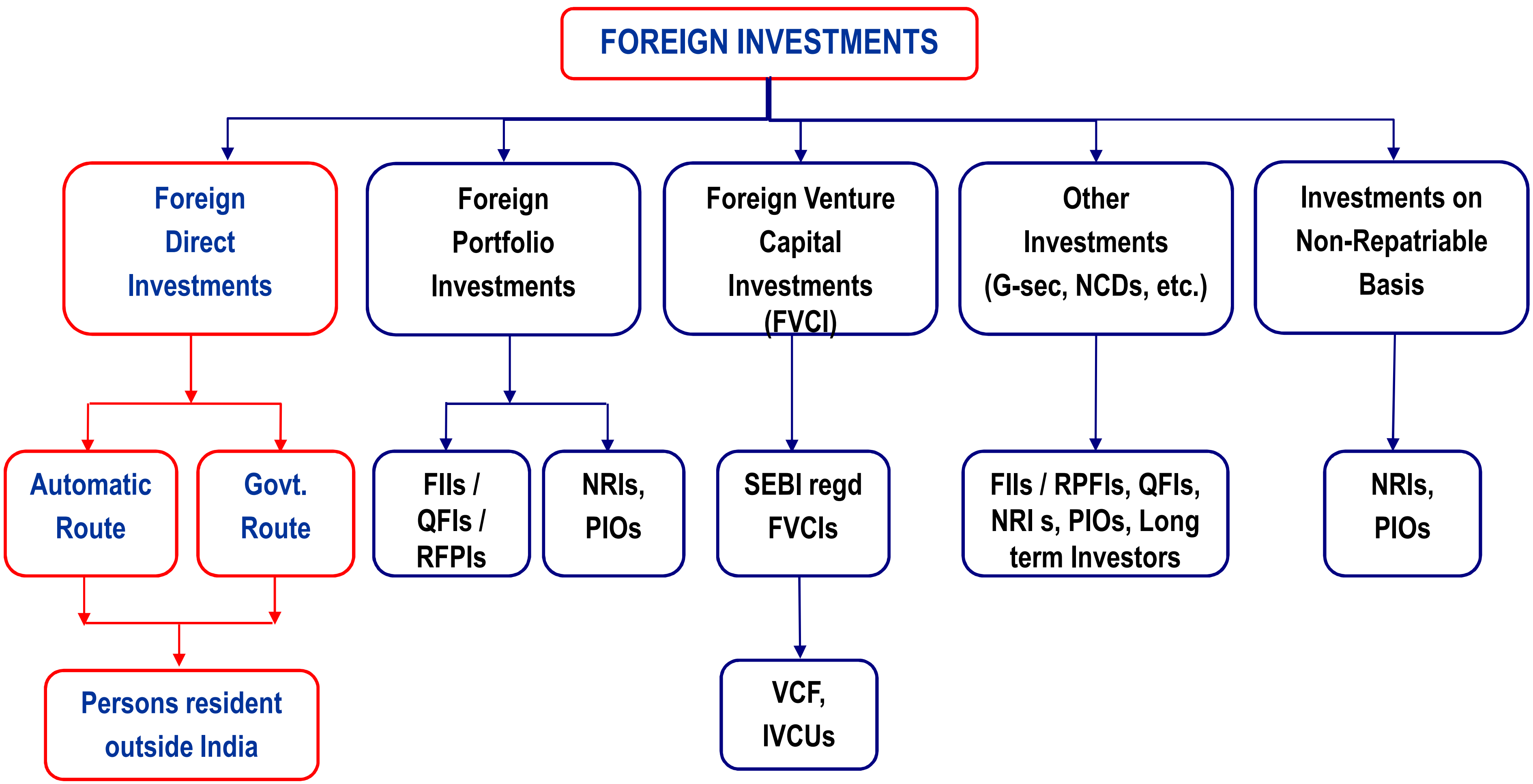
Factors Influencing Set-up of operations in India



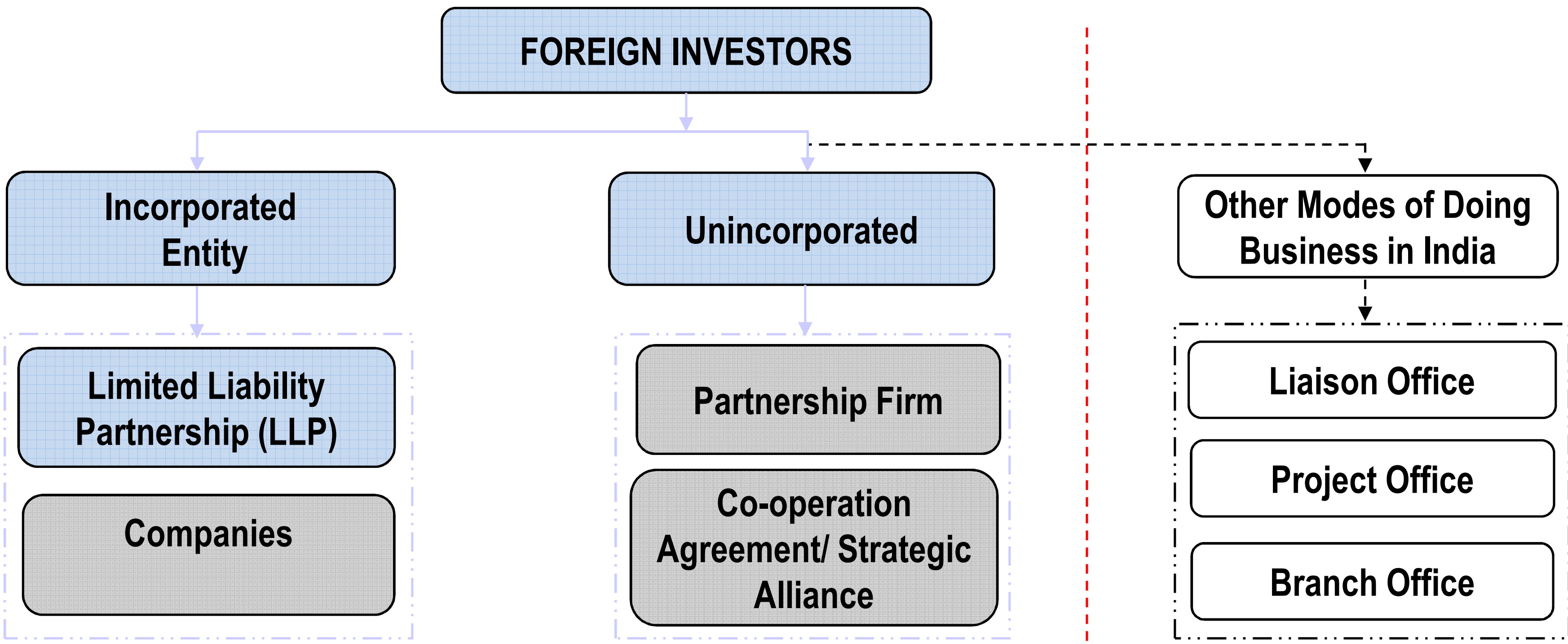
Indicative Documentation

MoU / Letter of Intent	Memorandum & Articles of Association	Joint Venture Agreement (JVA) / Share Holders Agreement (SHA)
<u>Issues to be addressed</u> ▪ Intentions / Aspirations of the parties ▪ Future roadmap of the venture ▪ Commercial Terms / Capital Contribution ▪ Clarity on the management & control ▪ Cost Distribution / Profit sharing ▪ Extent of Legality of the MoU	▪ Binding Incorporation Documents ▪ Anything outside the MoA would be ultra-virus ▪ Documents not consistent with Companies Act or MoA & AoA not valid ▪ Any agreement between shareholders not valid, if company not a party ▪ MoA & AoA to be consistent with the JVA / SHA ▪ **AoA supersedes the JVA / SHA in case of any dispute**	▪ Objects & Products ▪ Contribution by JV partners ▪ Management structure ▪ Right of first refusal / Drag Along Rights / Tag Along Rights ▪ Dispute resolution & Arbitration ▪ Representations / Warranties or indemnities ▪ Transfer of shares, Put & Call Options, Exit Options / Termination Terms ▪ Non-Compete clause ▪ Technical Assistance / License agreement ▪ Dilution clause in case of non fulfillment by one JV partner ▪ Transfer price of inter-group transactions ▪ Valuation for non-cash contributions

Permissible Avenues for Investment in India



Forms of Entities



Note: 1) FDI in LLP allowed through Government route only in sectors/ activities where 100% FDI is allowed, through automatic route and there are no FDI-linked performance conditions.
2) Investment in Partnership Firms by way of capital is allowed in case of non-resident Indians or person of Indian origin resident outside India. A person resident outside India other than NRI or PIO may make investment with prior approval of RBI.

Permitted Sectors / Activities for FDI

AUTOMATIC ROUTE	APPROVAL ROUTE (FIPB Approval)
▪ Allowed for most sectors / activities ▪ Subscription as well as acquisitions allowed ▪ Limits - Sectoral caps / stipulated sector specific guidelines ▪ Inward remittances through proper banking channels** ▪ Pricing guidelines prescribed** ▪ Post facto filing of FDI report within 30 days of receipt of funds ** ▪ Allotment of shares within 180 days from receipt of funds** ▪ Filings of form FC-GPR within 30 days of share allotment ** ▪ Includes Technical Collaboration / Royalty** ▪ Filing of Annual Return of Foreign Liabilities & Assets**	▪ Specified activities / sectors which requires approval ▪ An application to be made to the FIPB in the Ministry of Commerce & Industry. ▪ FIPB is empowered to approve the projects having FDI up to Rs. 3000 crores ▪ Proposals exceeding Rs. 3000 crores shall be approved by Cabinet Committee of Economic Affairs (CCEA) **** To be complied in Approval route, as well**

Prohibited Sectors / Activities For FDI

- Lottery Business including Government /private lottery, online lotteries, etc.
- Gambling and Betting including casinos etc.
- Chit Funds (Note 1)
- Nidhi company
- Trading in Transferable Development Rights (TDRs)
- Real Estate Business or Construction of Farm Houses (Note 2)
- Manufacturing of Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes
- Activities / sectors not opened to private sector investment including Atomic Energy and Railway operations (other than permitted activities)

Notes:

1. NRIs are eligible to subscribe to chit funds on non-repatriation basis subject to specified conditions
2. "Real estate business" means dealing in land and immovable property with a view to earning profit or earning income therefrom and does not include development of townships, construction of residential / commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships.

Sectoral Caps for FDI

- The FDI policy incorporates equity caps at broadly four levels - 26%, 49%, 51% and 74%. These caps reflect the ownership / control levels in a company, under the Companies Act, 2013

Caps	Purpose
> 26%	Equity holding greater than 25% gives a right to block a ‘special resolution’.
49%	A level just short of ownership
51%	Ownership and a right to pass all ordinary resolution
74%	The Indian equity holders, acting in unison, can block a special resolution

Recent FDI Policy Measures

Sector/Industry/Activity	FDI Cap	Remarks
Construction/ Development Projects	100%	Subject to specified conditions. Liberalization in certain conditions for Construction Development including reduction in minimum built-up area and minimum capitalization
Defence (Subject to industrial licence under the IDRA)	49%	Government route up to 49%. Above 49%, permission from Cabinet Committee on Security on case to case basis, wherever it is likely to result in access to modern and 'state-of-art' technology in the country
Insurance	49%	Government route beyond 26% and up to 49%. Subject to sectoral requirements. Subject to licensing by the IRDA and other specified conditions
Rail infrastructure	100%	Subject to specified conditions and areas of investment
Single Brand Retail Trading	100%	Automatic upto 49% and government route beyond 49%. Subject to approval and specified conditions

Recent FDI Policy Measures (Contd..)

Sector/Industry/Activity	FDI Cap	Remarks
Multi Brand Retail Trading	51%	Government route up to 51%. Subject to approval and specified conditions
Investment by NRIs under Schedule 4 on non-repatriation basis		Union Cabinet has given its approval for review of FDI Policy on investments by NRIs, PIOs and OCIs which includes following: ✓ NRI means an individual resident outside India who is citizen of India or is an OCI cardholder. Further, registered PIO cardholders shall be deemed to be OCI cardholders ✓ 'Investment by NRIs under Schedule 4 will be deemed to be domestic investment at par with investment made by residents Note - DIPP is yet to notify the same
Banking - Private Sector	74%	Government route beyond 49%. Subject to guidelines for setting up branches / subsidiaries of foreign banks issued by RBI and other specified conditions

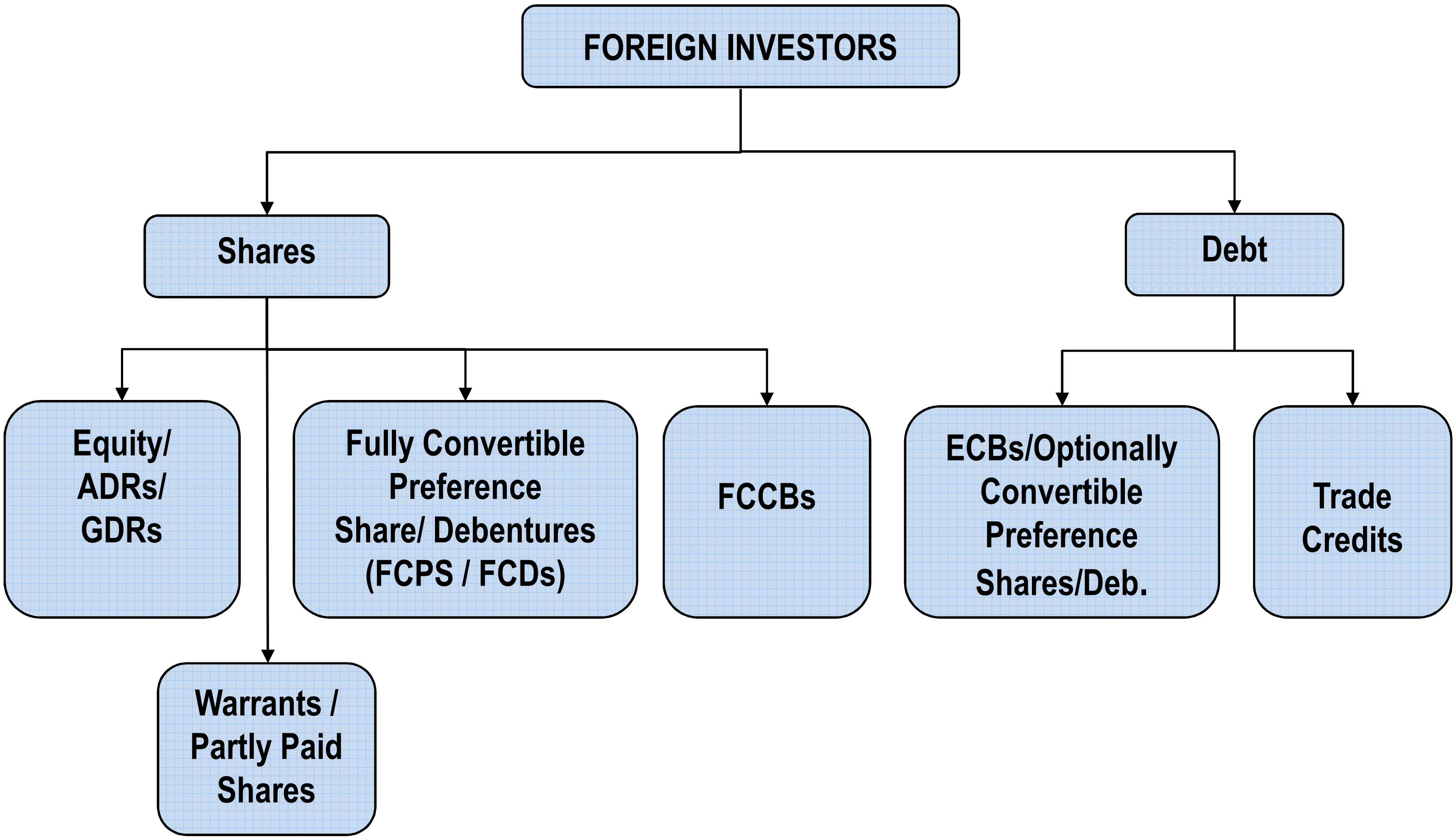
Recent FDI Policy Measures (Contd..)

Sector/Industry/Activity	FDI Cap	Remarks
Telecom Services	100%	Government route beyond 49%. Subject to sectoral requirements. This will include services provided by Telecom Infrastructure Providers Category-I).
Power Exchanges	49%	Up to 49% under automatic route. Subject to specified conditions
Credit Information Companies	74%	Up to 74% under automatic route. Subject to specified conditions
E-commerce activities	100%	Permissible to be engaged only in B2B e-commerce and not in retail trading
Pharmaceuticals (including manufacturing of medical devices)	100%	Greenfield-100% (Automatic) Brownfield-100% (Government) Subject to specified conditions
Asset Reconstruction Companies	100%	Up to 49% under automatic route. Subject to specified conditions

Recent FDI Policy Measures (Contd..)

- The Union Cabinet has given its approval to introduce composite caps to bring uniformity and simplicity across the sectors in FDI policy for attracting foreign investments.
- Amendments approved are as under:
  - ✓ Aggregate FII/FPI/QFI investment, individually or in conjunction with other kinds of foreign investment will not exceed sectoral / statutory cap
  - ✓ Foreign investments include both direct and indirect and will not exceed sectoral / statutory cap
  - ✓ FCCBs and DRs having underlying instruments-to be considered as debt until converted into equity.

Funding - Permissible Modes



Valuation Guidelines - Certain Relevant Aspects

When Required

- At the time of issue of shares to non-resident
- At the time of transfer of shares from resident to non resident
- At the time of transfer of shares from non resident to resident
- Downstream Investment

Governing Regulations

Notification No. FEMA 20/2000-RB dated May 3, 2000, as amended from time to time deals with Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000

Certificate

- From Chartered Accountant
- SEBI registered Merchant Banker

At What Value

- Before 21 April 2010, valuation based on CCI Guidelines.
- After 21 April 2010, DCF valuation to be followed
- W.e.f. 15 July 2014, internationally accepted method to be followed

Pricing Guidelines for Issue / Transfer of Shares

Indian Company	**Issue of Shares to non-residents**	**Transfer of shares from resident to non-resident**	**Transfer of shares from non-resident to resident**
(a)	**(b)**	**(c)**	**(d)**
Listed Companies	The price shall not be less than the price worked out in accordance with the SEBI guidelines.	Price shall not be less than the price at which a preferential allotment can be made under SEBI guidelines	Price of shares transferred by way of sale, by non-resident to resident shall **not be more than the minimum price** at which the transfer of shares can be made from a resident to non-resident as per column (c)
Unlisted Companies	Price shall not be less than the valuation of shares done as per any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by a CA or SEBI registered Merchant Banker	Price shall not less than the fair value worked out as per any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by a CA or a SEBI registered Merchant Banker.	

Issue of Convertible / Optionally Convertible Instruments

Pricing for issue of Convertible Instruments

- The Price / conversion formula of convertible capital instruments should be determined upfront at the time of issue of the instruments.
- The price at the time of conversion should not be in any case be lower than the fair value worked out, at the time of issuance of such instruments.

Pricing of Optionally Convertible Instruments

- Optionality clauses are allowed in equity shares, FCPS and FCDs subject to following conditions:
  - ✓ There is minimum lock-in period of 1 year which shall be effective from the date of allotment of such capital instruments.
  - ✓ After the lock-in-period and subject to FDI Policy provisions, if any, the non-resident investor exercising option / right shall be eligible to exit without any assured return, **as per pricing / valuation guidelines issued by RBI from time to time.**

Pricing not relevant in following cases

- FDI by way of subscription to Memorandum of Association to be made at Face Value subject to non-resident (including NRIs) eligibility to invest under the FDI scheme.
- For transfer of shares between two Non-Residents for both legs under FDI scheme.

Issue of Shares for consideration other than cash

An Indian company can issue shares to a person resident outside India against consideration other than inward remittance for the following categories:

- **Automatic Route**
  - ✓ Shares issued on conversion of ECB / Royalty / Lump sum technical know-how fee due for payment
  - ✓ Shares issued against import of capital goods by units in Special Economic Zones
  - ✓ Shares issued under the scheme of ESOP to its employees of its JV / WOS abroad who are resident outside India subject to specified conditions.

- **Government Route**
  - ✓ Shares issued against shares swap i.e. in lieu of consideration to be paid for shares acquired in the overseas company
  - ✓ Shares issued against import of capital goods / machinery / equipment (excluding second-hand machinery) subject to conditions specified by Government and RBI
  - ✓ Shares issued against pre-operative/ pre-incorporation expenses (including payments of rent etc.) subject to conditions specified by Government and RBI.

Issue of shares under ESOPs

For Listed Indian Companies - They are allowed to issue shares under the Scheme of ESOPs, to its employees or employees of its JV or WOS abroad, who are resident outside India.

- ESOPs can be issued directly or through a Trust subject to the condition that:
  - ✓ The scheme has been drawn in terms of relevant regulations issued by the SEBI, and
  - ✓ **Total allotment does not exceed 5% of the paid-up capital of the issuing company**

For Unlisted Indian Companies - They have to follow the applicable provisions of Companies Act.

- *Conditions for issue of shares under ESOP-A.P. (DIR Series) Circular No.4 dated 16 July 2015:*
  - ✓ *Scheme drawn either in terms of SEBI Act or rules made under the Companies Act, 2013*
  - ✓ *Shares issued should be in compliance with the applicable sectoral cap*
  - ✓ *Prior approval of FIPB required where foreign investment is under the approval route*

Reporting requirements:

- Issuing company to furnish return (**Form-ESOP**) for granting of stock options under the scheme within 30 days from the date of issue of such scheme
- Form FC-GPR after exercise of stock options **within 30 days** from date of issue of shares

Other Miscellaneous Aspects

Issue of shares under Scheme of Merger/ demerger

- Transferee company or new company is allowed under automatic route to issue shares pursuant to the approved scheme of arrangement subject to specified conditions
- Issue of shares subject to compliance with Sectoral Cap under FDI policy
- Form FC-GPR Reporting obligation prescribed within 30 days of issue.

Pledge of Shares

- Residents Promoters of Indian company or its associate resident companies can pledge shares to non-residents in the course of raising ECB subject to no objection from AD bank
- Non-Residents can pledge shares of an Indian Company in favor of AD-Bank to secure credit facilities for the resident Indian Investee Company for its business purposes
- Non-Residents can pledge shares of an Indian Company in favor of an Overseas Bank to secure credit facilities for non-resident investor / overseas group company subject to certain conditions.

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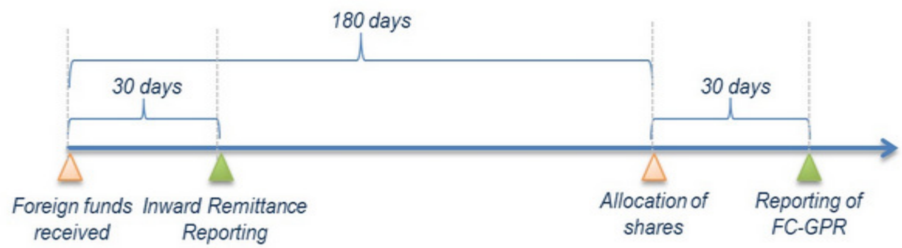
Reporting Requirements

Reporting of FDI

- Advance Reporting Form - Details of inward remittances is to be reported within 30 days from the date of such receipt or date of receipt of each call payment, in case of partly paid equity shares.
- Form FC-GPR – Details of issue of shares is to be reported within 30 days from the date of such issue. The same should be accompanied by share valuation certificate, compliance certificate from a CS and other specified documents.



Government has recently introduced an innovative digital platform viz. eBiz - India's G2B Portal under which Indian Companies can complete FDI compliances online, thereby eliminating physical interface. Presently, FDI reports in 'Advance Report Form' and form FC-GPR can be filed through e-Biz Platform (https://www.ebiz.gov.in/home).

- RBI allots UIN No. for initial intimation and Registration No. for allotment / issues
- FLA return - To be filed by an Indian Company (receiving FDI or making overseas investment) directly with the RBI (fla@rbi.or.in) on or before 15 July every year.

Reporting Requirements (contd..)

Reporting of transfer of Shares

- Form FC-TRS - Details of transfer of shares from R to NR and *vice versa* is to be reported within 60 days from the date of receipt / payment of the amount of consideration.
  AD Bank may ask to an Indian entity to submit the said form even in case of redemption of redeemable preference shares issued prior to 1 May 2007.
- No reporting requirement in case of transfer of shares from non-resident to another non-resident.

Reporting on conversion of ECB into shares

- Form FC-GPR (specifying the shares issued) within 30 days from the date of conversion and Form ECB-2 within 7 working days from the end of the month in which conversion takes place.

Reporting of FCCB/DR Issues

- The domestic custodian shall report the issue / transfer of DR in Form DRR as per DR Scheme 2014 within 30 days of close of the issue / program.

Non-compliance with the reporting requirements

- Non-compliance with the reporting requirements will be treated as a contravention under Section 13 of FEMA. Penalty on such contravention may be upto thrice the sum involved.

Repatriation - Certain Options

- Payment of Brand License Fees
- Payment of Dividend
- Buyback of Shares
- Reduction in Share Capital
- Cost allocation arrangement / Service fees
- <u>Other Options</u>
  - Acquiring office premises
  - Downstream JVs / investments – strategic / investment
  - Business Expansion
- Combination of aforesaid options may also be explored

FDI in Partnership Firm / Proprietory Concern

- NRI or PIO can invest in the capital of a firm or a proprietary concern in India on **non-repatriation basis** provided:
  - ✓ Amount is invested by inward remittance or out of NRE/FCNR(B)/NRO account
  - ✓ Firm or proprietary concern is not engaged in any agricultural/plantation or real estate business or print media sector
  - ✓ Amount invested cannot be repatriated outside India
- NRIs/PIO may seek prior permission of Reserve Bank for investment in sole proprietorship concerns/partnership firms with **repatriation option**.
- A PROI other than NRIs/PIO must seek prior approval of Reserve Bank for making investment in the capital of a firm or a proprietorship concern or any association of persons in India. The application will be decided in consultation with the Government of India.

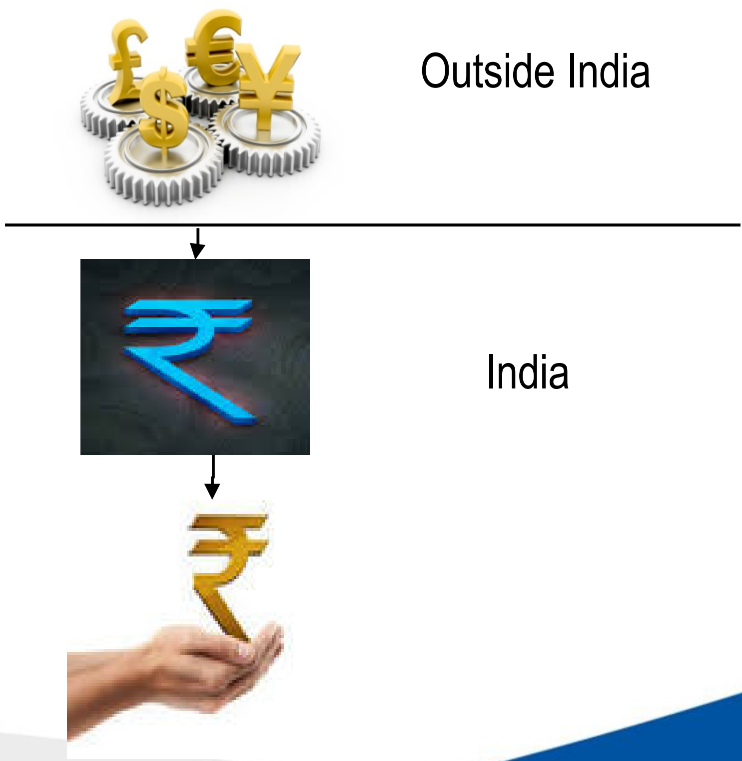
FDI in LLPs

- LLP combines limited liability of the company model & flexibility of partnerships
- FDI in LLPs is allowed, through Government / Approval route, only in LLPs:
  - ✓ Operating in sectors/activities where 100% FDI is allowed through automatic route and
  - ✓ There are no FDI-linked performance related conditions (such as NBFCs / Development of Townships, Housing, Built-up infrastructure and construction-development projects' etc.)
- LLPs with FDI not allowed in agricultural/plantation activities, print media or real estate business
- An Indian company, having FDI, will be permitted to make downstream investment in an LLP only if both (the company as well as LLP) are operating in sectors where 100% FDI is allowed through Automatic route and there are no FDI-linked performance conditions
- LLPs with FDI will not be eligible to make any downstream investments
- Capital contribution by partners in Cash consideration
- LLPs are not allowed to raise funds through ECBs
- The Designated Partner should be Indian company or person resident in India
- Conversion of a company with FDI, into an LLP, will be allowed only if the above stipulations are met and with the prior approval of FIPB / Government.

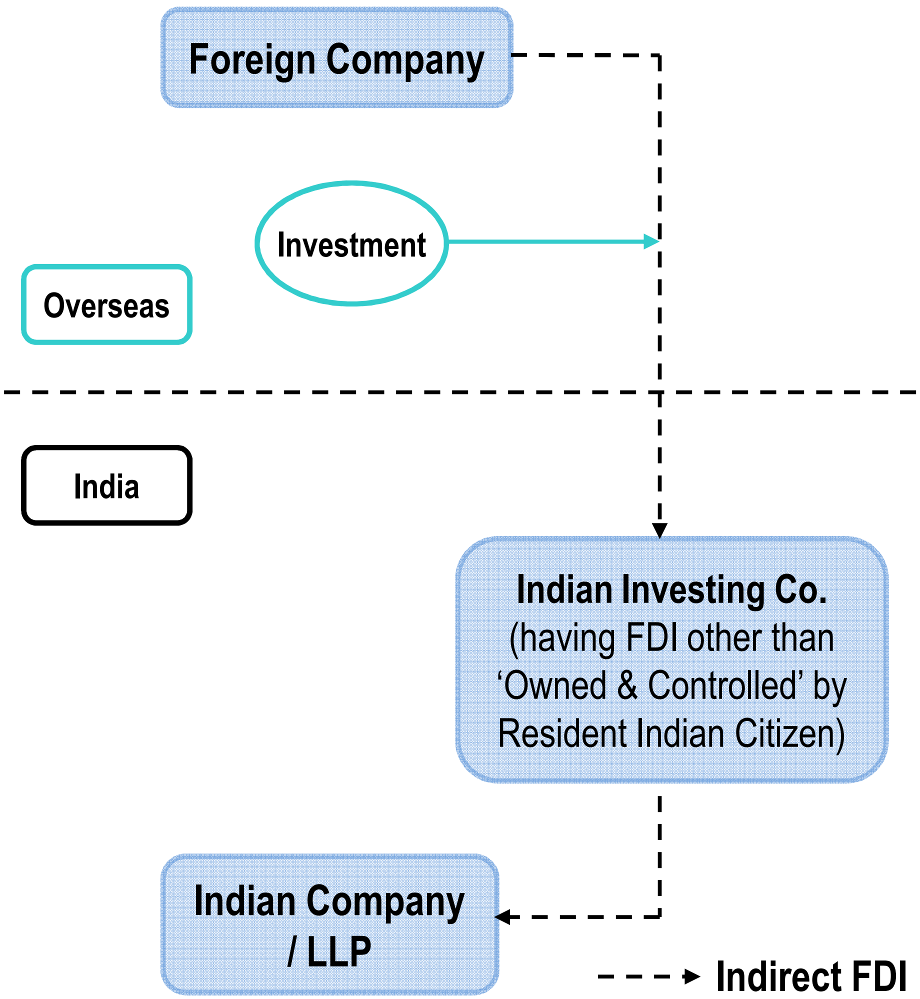
FDI in REIT / InvIT

- REITs are vehicles where the Trust would be holding Real Estate assets or SPVs which hold Real Estate assets in order to earn rent.
- SEBI has introduced REIT and InvIT providing that the non-resident shall subscribe to the Units of a REIT / InvIT in accordance with the SEBI (REITs) Regulations 2014. However, no similar provisions available under the extant FEMA regulations.
- Under the extant FEMA regulations, FDI is not permitted in real estate business. As such, appropriate modifications would be required in order to permit FDI in REIT / InvIT.
- On 6 May 2015, the Union Cabinet has given its approval to allow the REITs as an eligible financial instrument / structure under the FEMA which would enable foreign investment inflows into the completed rent yielding real estate projects, which is currently prohibited under FEMA
- This would reduce pressure on the banking system to which the real estate sector looks for funds, free up existing funds of Banks and to encourage construction activities
- Concessional withholding tax rates provided for REIT / InvIT borrowing from non-resident lenders. However, REIT / InvIT may not qualify as eligible borrowers under the ECB Regulations

INDIRECT FDI (DOWNSTREAM INVESTMENT)

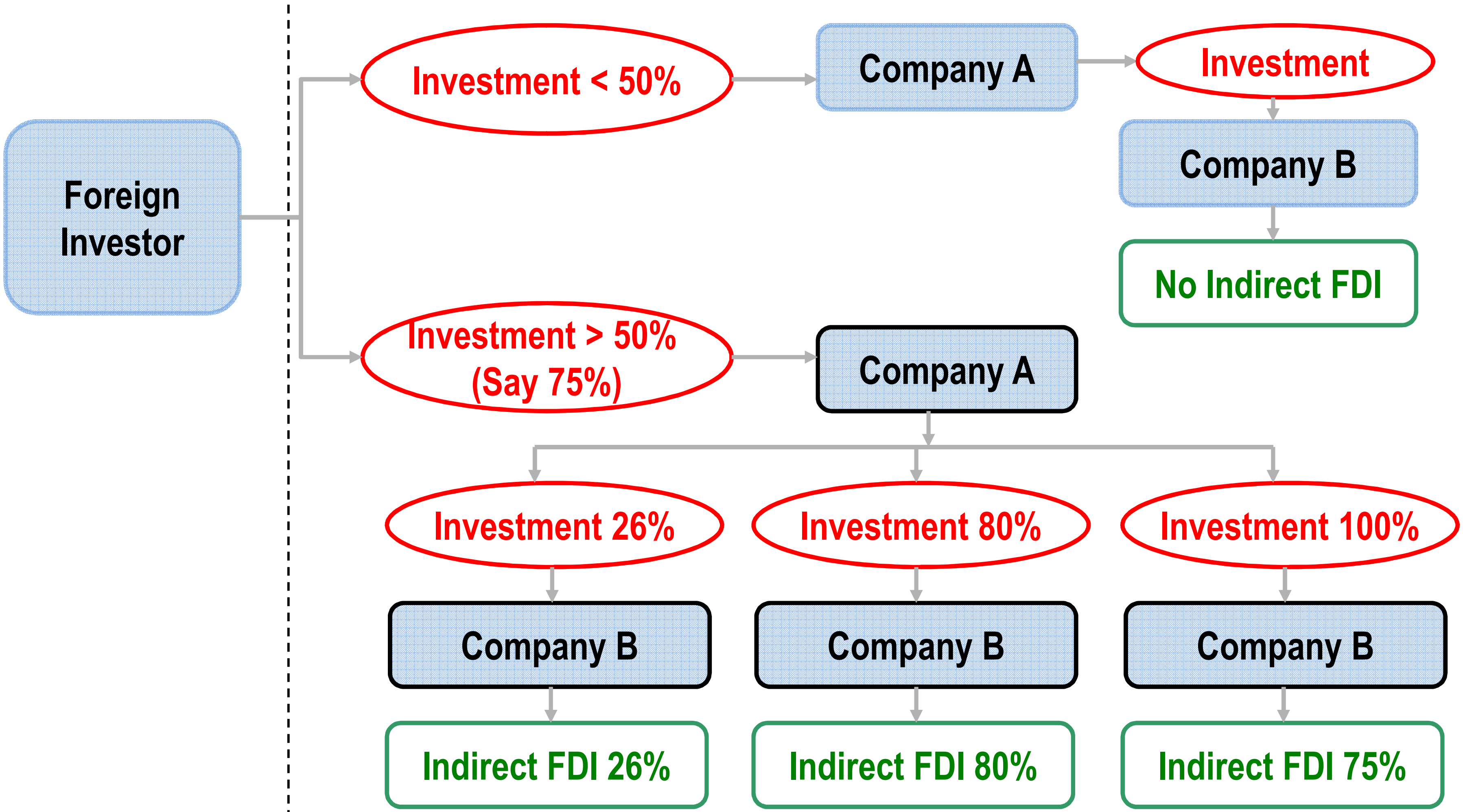


What is Downstream Investment?



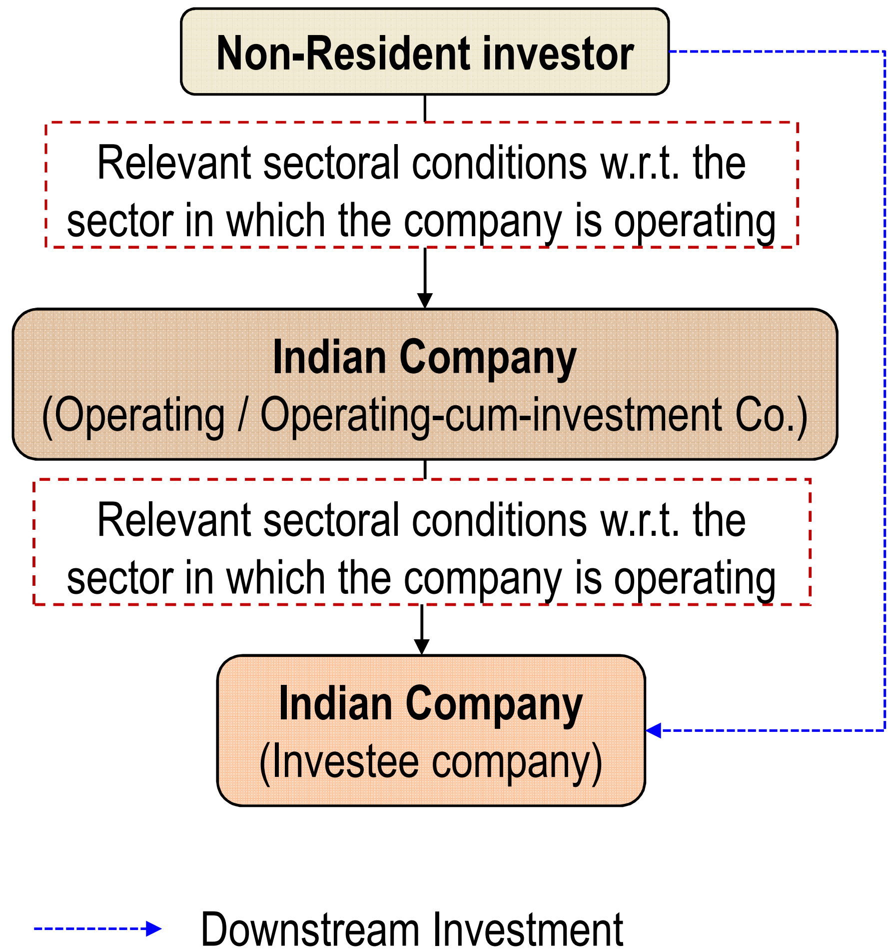
- 'Downstream investment' means indirect foreign investment, by one Indian Co having foreign investment, into another Indian Co, by way of subscription or acquisition, subject to certain conditions.
- If the investing company is owned **or** controlled by 'non-resident entities', the entire investment by the Investing Co into subject Indian Co would be considered as indirect foreign investment.
- Foreign investment through investing Indian Co would not be considered for calculation of indirect foreign investment in case of Indian Cos which are '**owned and controlled**' by resident Indian citizens.
- The total foreign investment is the sum of direct and indirect foreign investment.

Calculation of Indirect / Downstream FDI



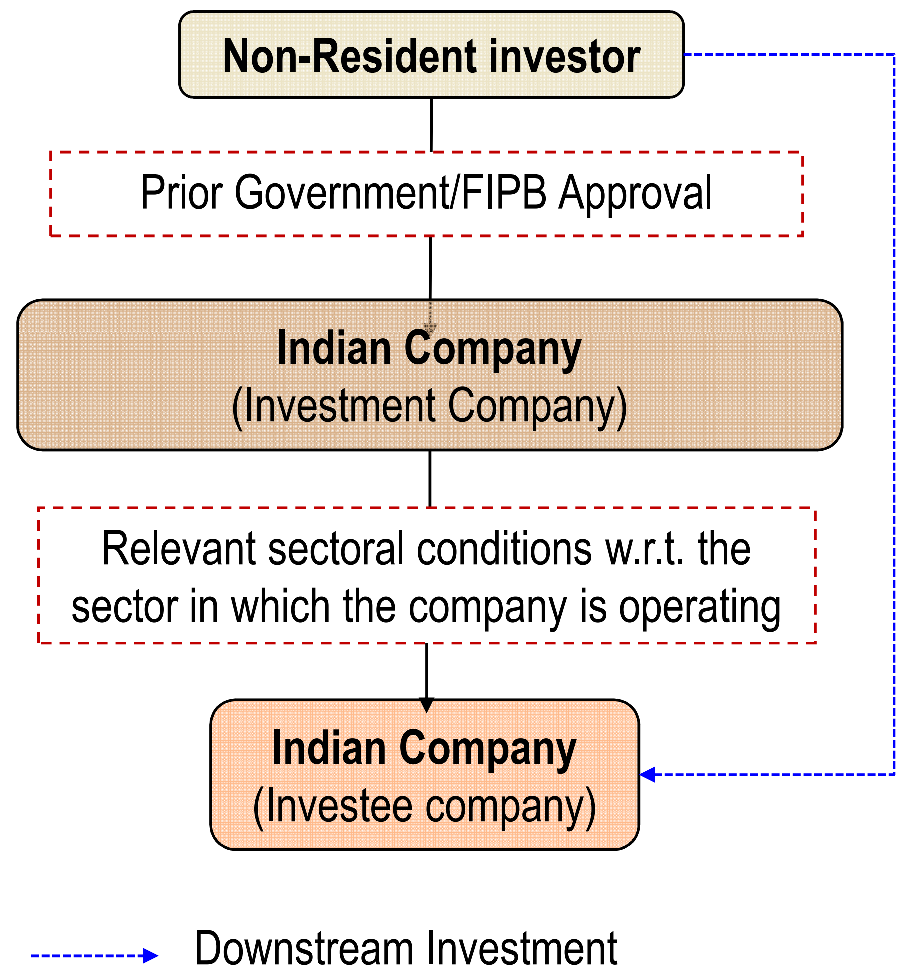
Operating / Operating-cum-Investment Companies

- Foreign investment to comply with the relevant sectoral conditions with regard to the sectors in which such companies are operating.
- The subject Indian companies into which downstream investments are made by such companies would have to comply with the relevant sectoral conditions on entry route, conditions and caps in regard of the sector in which the subject Indian companies are operating.



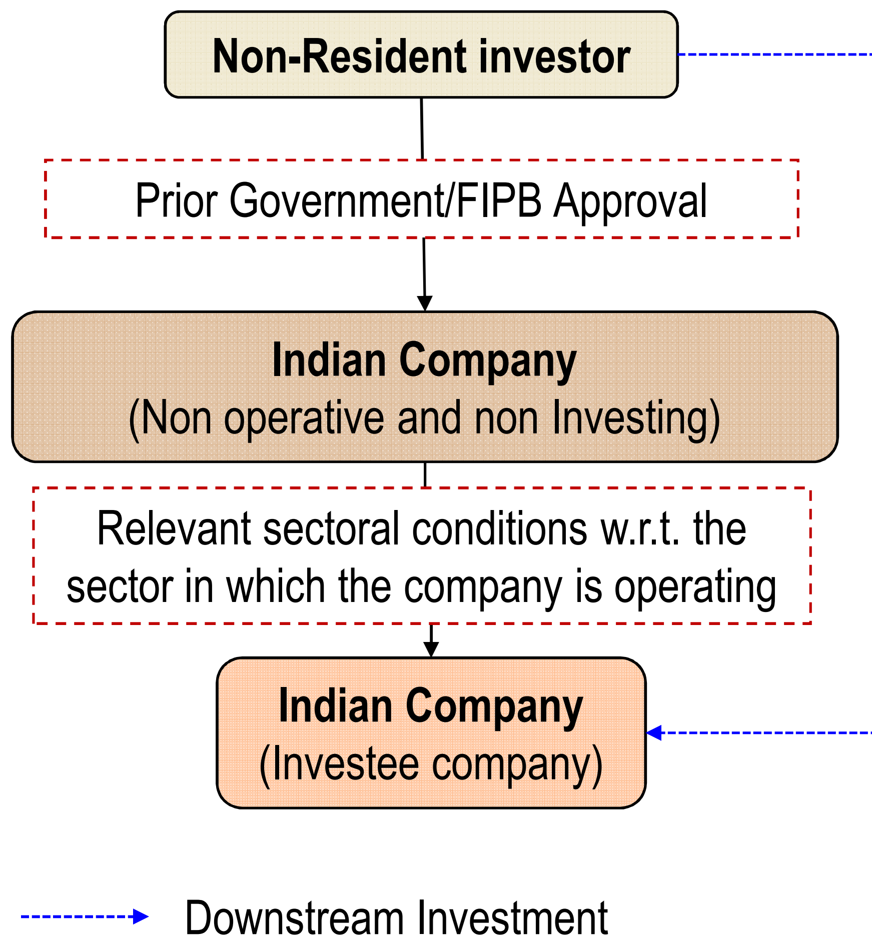
Investment Companies

- Foreign Investment in Investing Companies – prior Government/FIPB approval, regardless of the amount or extent of foreign investment
- The Indian companies into which downstream investments are made by such investing companies would have to comply with the relevant sectoral conditions on entry route, conditions and caps in regard of the sector in which the subject Indian companies are operating



Non operative and non Investing Companies

- Government/FIPB approval be required
- As and when such company commences business(s) or makes downstream investment it will have to comply with the relevant sectoral conditions on entry route, conditions and caps

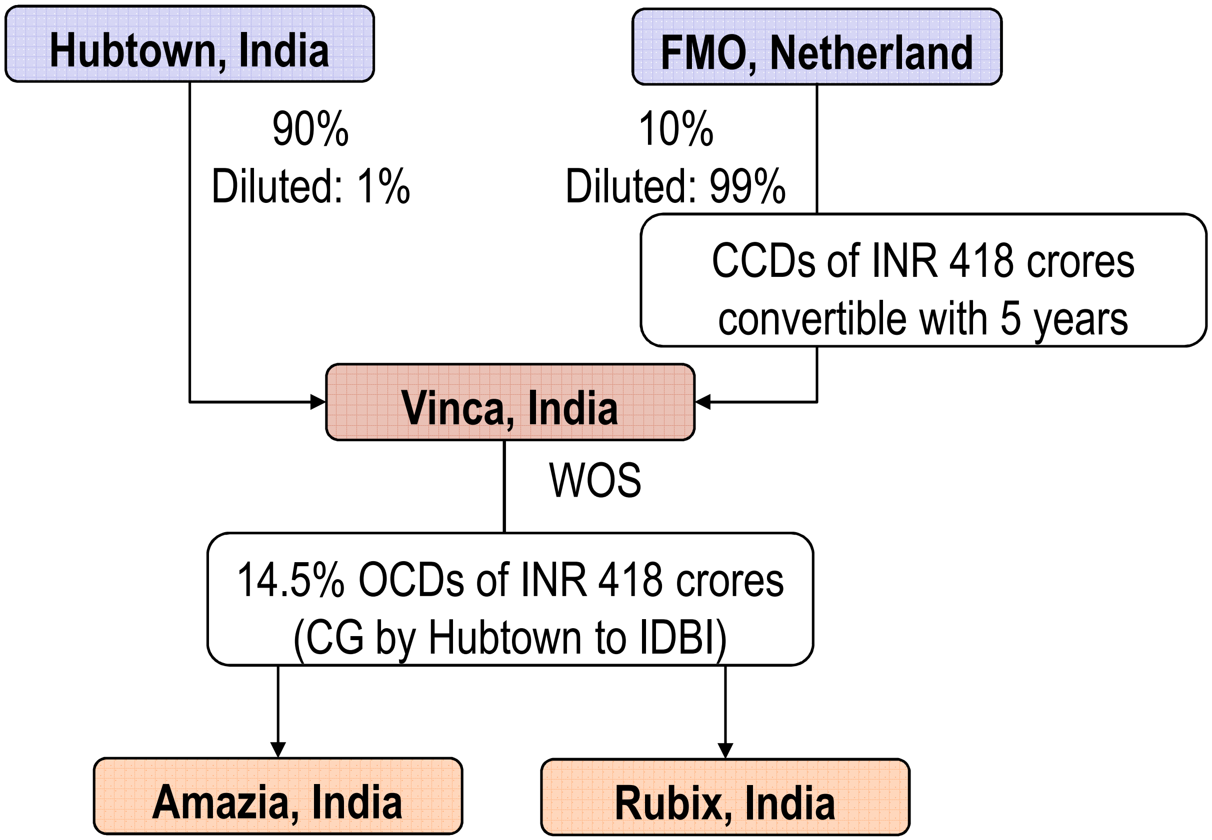


Downstream Investment - Other Conditions

- Downstream investments guidelines / parameters:
  - ✓ Investment subject to entry route conditions as direct FDI and Company's Board approval
  - ✓ The computation of Indirect FDI as per mechanism prescribed and applies at each level in multi-tier structure. The Companies Act, 2013 restricts corporates from making investments through more than two tiers of such subsidiaries (investment companies)
  - ✓ Indian Investor Company to notify SIA/ DIPP/ FIPB within 30 days of such investment
  - ✓ Issue / transfer / pricing / valuation of shares to be in accordance with SEBI / RBI guidelines
  - ✓ For downstream investments requisite funds to be brought from abroad and no leveraging of funds from domestic market permitted
  - ✓ Downstream investments permissible from internal accruals

CASE STUDY

Diagrammatic Depiction



IDBI Trusteeship Services Limited Vs. Hubtown Limited (Summon for Judgment No. 39 of 2013 / Summary Suit No. 520 of 2013)

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Partner - Suresh Surana & Associates LLP