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New FDI policy – a boon or a bane in disguise?

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Private equity investments by foreigners in Indian companies are in the form of pooled investments having a fixed life and require a minimum pre-determined return in order that the funds may be liquidated within the assured time for the benefit of the investors. This objective is achieved typically by Indian promoters providing an exit in the form of 'put options' to such private equity investors. The importance of such exit opportunities to foreign investors has been highlighted by a recent policy decision by the Department of Industrial Policy and Promotion, Government of India (DIPP) communicated on October 1, 2011.

Here, we briefly consider the law of India in relation to such exit opportunities. In 2010, the DIPP introduced the Policy Framework for Foreign Direct equity Investments (FDI) in Indian companies by consolidating all prior regulations/policies issued under the Foreign Exchange Management Act, 1999, circulars issued by the Reserve Bank of India and Press Notes/Press Releases/Clarifications issued by DIPP (Policy). While initially, the Policy intended to merely consolidate the extant provisions without making any changes thereto, the revised Policy of October 2011 supersedes all previous Press Notes/Press Releases/Clarifications/Circulars. The Policy has been given statutory force by virtue of amendments to the Foreign Exchange Management (Issue or Transfer of Security by a Person Resident Outside India) Regulations, 2000 and reflects the law relating to FDI in India.

The Policy protects the Indian Promoters providing 'put options' as aforesaid by containing provisions to the effect that a non-resident can only sell shares to a resident at a maximum price not exceeding the valuation as specified therein. Conversely the non-resident can buy shares of the Indian resident at a minimum price based on such valuation.

The Policy, was amended to provide that equity instruments with 'put options' would be disregarded as FDI, thereby taking away an exit opportunity available to such investors. Based on an ideology that where the investors are assured a pre-determined return and exit, the investment adopts the characteristics of a debt investment rather than equity, the revised Policy purported to regard such instruments with pre-defined exits as debt instruments.

This would mean that instruments subscribed to by foreign investors would lose their equity character and would have to comply with the extant guidelines for external commercial borrowing . The said guidelines stipulate the categories of persons who would qualify as "recognized lenders", and lay down restrictions on permissible end uses, interest rates and the like. Compliance with the said provisions would render the private equity market rather shallow and without large players.

While amendments to the Policy did not purport to apply retrospectively, it was unclear how existing investments with 'put' and 'call options' would be treated. Even assuming that investments would have complied with the aforesaid criteria, it is not clear as to how such instruments, which are really in the nature of equity products, be treated by tax authorities.

While, the conservative approach of Indian Regulators is argued to have insulated India from the recent global meltdown, an over conservative approach could 'spell a death knell' for foreign investment in India.

The Government appears to have consequently appreciated the adverse effects of the amendments to the Policy and has accordingly reversed the purported amendments pursuant to a press release dated October 31, 2011. However, the Indian regulators should avoid constant amendments to their policies so as to lay down a stable framework for foreign equity investment in the Country.

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