RBI makes dual changes in FDI Norms

The Reserve Bank of India (RBI) has recently brought about two sets of related reforms that introduce much greater flexibility to foreign investors in investing in Indian companies that gets rid of some of the rigidity that hitherto existed. The two relaxations are:

I. Investment in partly paid shares and warrants.
II. Relaxation in the pricing requirements for entry and exit for foreign investors.

INVESTMENT IN PARTLY PAID SHARES AND WARRANTS

Under the pre-existing regime, foreign investment was permitted under the usual route only for investment in fully paid shares and convertible instruments (such as debentures and preference shares) that were fully and mandatorily convertible. These could contain optionality clauses but without any right to exit at an assured price. This was to ensure that the investments under the foreign direct investment (FDI) policy came as close to equity shares as possible. Party-paid shares were virtually shunned, and warrants were permissible only under the Government approval route with not much clarity on what type of instruments or terms would be viewed favourably. This substantially limited the structuring options for investment instruments as far as foreign investors are concerned.

Minimum amount to be brought upfront

RBI Vide its notification dated July 14, 2014, has brought both partly paid shares as well as warrants within the scope of the FDI policy thereby offering these instruments for investment by foreign residents. These instruments are now available for investment under the foreign portfolio investment (FPI) scheme as well. For both partly paid shares as well as warrants, a minimum of 25% of the total consideration amount is required to be brought in up front. For partly paid shares, the remaining amount must be paid within 12 months (except where the issue size exceeds Rs. 500 crores (Rs. 5 billion) in which case the period can be longer. In case of warrants, the remaining consideration must be brought within 18 months.

Determination of Pricing

As regards pricing, for partly paid shares it must be determined up front. The usual pricing guidelines for equity shares would apply. For warrants, there is some additional flexibility. The notification states that the "price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such warrants, in accordance with extant FEMA Regulations and pricing guidelines stipulated by RBI from time to time". Other requirements under the foreign investment policy such as sectoral caps must be complied with on the assumption that the partly paid shares or warrants are converted into fully paid shares.

PRICING NORMS

For several years now, the RBI, as India's foreign exchange regulator, has been controlling the price at which foreign investors may enter and exit India. RBI's primary concern relates to the flow of foreign exchange that accompanies such entry and exit. Consistent with this rationale, it has been imposing minimum price (floor) at which foreign investors may invest in Indian companies and a maximum price (cap) at which they may exit from their investments.

This philosophy continues to operate. However, what has been the subject of change in the method to determine the floor and the cap. Until 2010, the primary determinant was a formula set out by the erstwhile Controller of Capital Issues (CCI), which formula had outlived its utility. This was then replaced by the discounted cash flow (DCF) method. There has been a lot of debate about the relevance of each of these methods and how they fare against each other. In the latest round of reforms, the RBI has done away with the prescription of any specific method altogether, and has decided to set forth some general principles for determination of the price. In an amendment to the FEMA Regulations, the floor and the cap are now set at a price which is arrived at as per any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by a Chartered Accountant or a SEBI registered Merchant Banker.

The point of essence is that the guiding principle would be that the non-resident investor is not guaranteed any assured exit price at the time of making such investment/agreements and shall exit at the price prevailing at the time of exit, subject to lock-in period requirement. This represents an important shift wherein RBI has ceases to prescribe the specific method, and has instead decided to defer to the expertise of intermediaries such as chartered accountants and investment banks. It has prescribed general principles such as "internationally accepted pricing methodology" and "arm's length basis". It places the onus on the intermediary to devise the most appropriate methodology in a given set of facts and circumstances. This is somewhat similar to the approach followed by courts in the case of share exchange ratio and valuation to be arrived at in the case of mergers, demergers and restructuring where they are generally willing to defer to the expertise of the valuers. Courts tend to interfere only when there is a fundamental flaw in the process or a patent error.

CONCLUSION

It's very pertinent to understand that these reforms are beneficial to the investors as well as Indian companies who wish to raise foreign capital on attractive terms. While it confers investors with some flexibility to make deferred payments, the stringent terms and conditions such as the maximum conversion period and pricing would ensure that the mechanism is not subject to abuse. Hence, the approach appears quite balanced. The change in pricing mechanism is a welcome move from a foreign investment perspective as it provides the necessary flexibility to investors who are no longer bound by a rigid rule that may not uniformly apply to every single case. At the same time, it imposes the onus on the companies and intermediaries to comply with internationally accepted methodologies and value on an arm's length basis. The regulator seems to have left some room to interfere in case there has been an aberration from these guidelines. In that sense, while the broad philosophy of maintaining a pricing floor for investments and a cap for exits continues abated, there is liberalization on the actual methodology for determining those prices.

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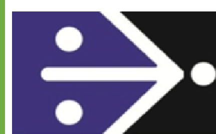

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