India's Investment Environment – December 2008

Table of Contents

I. Introduction

FDI inflows declined 26 percent this October compared to fund flows in the same month last year. The fall after seven months of robust growth can be attributed to the drying up of investments from countries hit by the global slowdown. Another reason for this decline could also be the higher base in 2008 as FDI flow during September 2008 were almost three times that in September 2007. However, the government seems confident of achieving the FDI target of $35 billion for the current fiscal year. Since India's growth story is believed to be on track and as performance of the Indian economy improves, it is expected to attract more FDI in the future.

II. Expected changes in FDI rules

Following changes in FDI rules are expected in the near future:

(i) Rules eased for entry of foreign companies
The Ministry of Corporate Affairs has removed the requirement of foreign companies/nationals to get consular verification in their country of origin for establishing a place of business or setting up a subsidiary in India. The foreign companies will now find it less cumbersome to establish business in India. The move is expected to reduce the time taken to incorporate a company in India significantly.

This benefit will be available to only those foreign companies incorporated in non-Commonwealth countries which are parties to the Hague Apostille Convention, 1961. The purpose of the Convention was to establish the requirement of diplomatic and consular legislation of public documents originating in one convention country and intended for use in another.

(ii) Enabling foreign investors to buy equity at pre-determined price and time
The government is considering permitting FDI through share options to enable purchase of equity by foreign investors at a pre-determined price and time. At present, FDI is allowed through subscription to equity shares, convertible warrants and debentures but not through share options.

The Ministry of Company Affairs is looking into the possibility of amending the Act so that share options can be treated at par with warrants. Convertible warrants are loans that are subsequently exchanged for shares on pre-agreed terms. The issuance of share options is based on a mutual agreement, subject to call-and-put option and commercial agreement between the parties.

(iii) Tough norms for FDI in sensitive sectors
An umbrella legislation to scan foreign investments in sensitive sectors is expected soon. The objective of the legislation is to boost national security by restricting foreign investment in sensitive areas such as ports, airports, telecommunication and defence equipments. The purpose of the new legislation is to strengthen the explicit authority of the government to adequately and efficiently track, analyse and respond to FDI in India that might threaten national or economic security. Two options under consideration are restrictions on the basis of sensitivity of the sector or the source of foreign investment.

Last year, the Ministry of Home affairs had proposed security screening of foreign investment through a national security exception clause but it did not materialise.

(iv) FDI cap on tobacco may be reduced
The government is expected to reduce the FDI cap for the tobacco industry from 100 to 74 percent and insert a caveat that cigarettes manufactured in new ventures or in upgraded facilities must be mainly for consumption outside India.

III. News & Views

(i) FDI in local investment companies ruled out
The government has rejected a proposal by the Tata Sons - promoted by Tata investment Corporation (TIC) - seeking permission to bring FDI into the company. The rejection came on the grounds that FDI is not permitted in investment companies and that these entities do not figure in the list of NBFC activities in which foreign investment is allowed. The rejection of the proposal makes it clear that government will not allow FDI in investment companies. TIC's argument was that FDI in investment companies should be permitted as these entities are similar to holding companies in which FDI is allowed. But the government is of the view that investment companies cannot be held at par with holding companies as the latter are well defined under FDI guidelines.

(ii) New formula for calculating indirect foreign holdings
Government is considering a new formula for calculating indirect foreign equity, which may have major consequences for foreign holdings across various sectors. The new formula proposes that foreign equity routed through an investing Indian company should not be considered for calculation of indirect foreign equity, if the Indian firm is owned and controlled by resident Indian citizens. In case, this investment company is owned and controlled by foreign equity, the entire investment made by it into an Indian company should be considered as indirect foreign equity.

It is being debated that the new method of computation of indirect foreign equity would lead to an anomaly as it would allow investment through the investment company route. Further, the foreign investment cap may also get diluted through a complex structuring of investment companies.

(iii) US asks India to allow 100percent FDI in 3G spectrum
The US has asked India to clarify whether it will amend the 74 percent cap on FDI in telecom and allow foreign companies to bid for 3G spectrum as 100 percent foreign entities.

US is of the view that the current 3G policy does not favour new foreign players. Existing norms do not allow foreign telecom companies to hold over 74 percent in their Indian ventures. Thus, a foreign player entering the Indian telecom market as a 100 percent entity needs to find an Indian partner to hold a 26 percent stake in the joint venture.

Disclaimer: This information has been collected through secondary research and CUTS C-CIER is not responsible for any errors in the same.