

Consolidated FDI Policy: A compilation or a fresh construct

Introduction

Since the liberalization of foreign investment regime in India, the Government of India has issued various press notes on foreign investment. In addition, various circulars and guidelines were issued under the Foreign Exchange Management Act, 1999 (“**FEMA**”), Reserve Bank of India (“**RBI**”) independent of government press notes. It was a tedious exercise to harmonize the press notes and various circulars and guidelines issued by FEMA and RBI. Due to lack of single platform on Foreign Direct Investment (“**FDI**”) norms there were inconsistencies in the applicable policy and statutory framework creating frequent confusion among investors.

In an attempt to simplify the rules and regulations pertaining to **FDI** policy, the Department of Industrial Policy and Promotion (“**DIPP**”), Ministry of Commerce and Industry, Government of India, issued a consolidated FDI policy (“**Circular**”) on March 31, 2010¹ which came into effect from April 1, 2010. It subsumes all prior press notes/press releases/clarifications issued by the DIPP periodically and reflect the current policy regulatory framework on FDI. The Government has decided to update the FDI policy on a bi-annual basis, by issuing new circulars which would supersede all prior press notes and circulars. Hence, the present Circular would be superseded with a circular to be issued on September 30, 2010. It has been specifically clarified that the Circular is a mere consolidation and does not intend to change the existing legal framework. Additionally, any changes notified by the RBI from time to time would have to be complied with and in the event of any need for interpretation of the Circular; the relevant **FEMA** notification/rule/regulation would prevail.

1.0 Some specific changes under the Circular

The Circular is a convenient compendium of the FDI Policy of the Government of India. Some of the salient features highlighted reflect changes in the interpretation of FDI policy which have now been clarified. Also, clearer guidance has been provided with regard to the FDI policy. An attempt has been made to highlight some of the important developments in the following sectors that would be important for foreign investors while they plan their projects in India.

2.0 Venture Capital Funds (“**VCF**”) and Trusts

Earlier, a SEBI registered Foreign Venture Capital Investor (“**FVCI**”) ² was allowed to invest in a domestic venture capital fund registered under the SEBI (Venture Capital

¹ For details refer to http://siadipp.nic.in/policy/fdi_circular_1_2010.pdf visited on May 13, 2010.

² FVCI means an investor incorporated and established outside India, which is registered under SEBI (Foreign Venture Capital Investor) Regulations 2000 and proposes to make investment in accordance with these regulations.

Fund) Regulations, 1996 under the automatic route (i.e. without any government approval). However, there was no distinction with respect to accepting foreign investment from a FVCI for a domestic venture capital fund, structured either as “company” or “trust”. Under the Circular, the position seems to have changed and states that a FVCI can now invest in a domestic venture capital fund that is set up as a trust registered under the Indian Trust Act, 1882 after obtaining a prior government approval. The Circular also prohibits investment in a trust which is not registered with SEBI. The purpose of these changes is, presumably, to curb money laundering activities through trusts that were not regulated as companies.

2.1 Cash and Carry Wholesale Trading

Under the current FDI policy, 100% FDI is permitted in Wholesale Trading; 51% is permitted in single brand retail and FDI in multi-brand retail is not allowed. The Circular has introduced guidelines for “Wholesale Trading”. The Circular also defines the term “Wholesale Trading” which was not defined earlier. It is defined as “sale of goods/merchandise to retailers, industrial, commercial, institutional or other professional business users or to other wholesalers and related subordinated service providers”. Wholesale Trading would thus, accordingly be construed as sales for the purpose of trade, business and profession, as opposed to sales for the purpose of personal consumption.

The yardstick to determine whether the sale is wholesale or not would depend upon the type of customers to whom the sale is made and not the size and volume of sales. An additional guideline now permits group companies to engage in Wholesale Trading of goods. However, such Wholesale Trading to group companies taken together should not exceed 25% of the total turnover of the wholesale venture and the sale made to the group companies should be for their internal use only. This clause, in effect, appears to restrict joint venture wholesale companies (including with foreign retailers) from becoming a dedicated back-end supply chain provider for an Indian retail partner.

In 2007, American giant Wal-Mart had entered into a joint venture with India’s largest telecom provider Bharti, a venture for wholesale services in India. The deal involved the establishment of two separate companies: the first running a back-end supply chain - technically a wholesaling operation called Bharti Walmart - which was a 50-50 Wal-Mart/Bharti operation. A second company running the front-end retail operation is a franchise, solely-owned by Bharti. The company sources its supply from the Bharti Walmart and runs a chain of ‘Easy Day’ stores. Under the new regulations as mentioned under the Circular, Wal-Mart/Bharti’s retail operation would now have to look for additional suppliers.

It seems that an attempt is made to stop foreign traders from grabbing a huge share of retail, in the name of wholesale trading. It poses a big threat to the participation of international wholesale retailers in the country’s retail development.

2.2 Lottery, gambling and betting sector

Ministry of Commerce & Industry through Press Note 5 (2002) had prohibited foreign investment and foreign technology collaboration in any form in the business of lottery, gambling and betting. However, there was certain ambiguity as to whether foreign

licensing of franchise/trademark/brand name, management contract etc is permitted under the business of lottery, gambling and betting. This has now been clarified, and such arrangements are completely prohibited with a primary intent to eliminate back-door entries by various entities.

2.3 Construction development projects

The guidelines governing FDI prior to the Circular prescribed the obligations and restrictions on sale of undeveloped plots. The investor had the primary responsibility to secure all the statutory approvals only for the investor company. The Circular has now imposed such obligation on both the investor and the investee.

2.4 Security Agencies in Private Sector

Prior to the issue of the Circular, there were no guidelines regarding security agencies in private sector. That has now changed, and FDI upto 49% is permitted under the approval route.

3. Ambiguities

Whilst the Circular succeeds (to a large extent) in simplifying the policy framework, some degrees of transparency must be further added to completely erode ambiguities which still prevail. The following issues, for instance, demand further clarity and consistent interpretation.

a. Indian retail sector has been creating its own niche. It has become the cynosure for foreign eyes. With foreign players making investment and inroads into the Indian market, the Circular states that “Wholesale trading to group companies taken together should not exceed 25% of the total turnover of the wholesale venture and the wholesale made to the group companies should be for their internal use only.” This has triggered a lot of reactions and uncertainty in the retail industry. It poses a big threat to the participation of international wholesale retailers in the country’s retail development. There is a fear that initial enthusiasm might fade in spite of 100% FDI permission in wholesale trading.

b. The Circular does not clearly address the issue of foreign investment in Limited Liability Partnerships (“**LLP**”s), and is silent on the quantum of investment permitted in LLPs with the prior approval of the FIPB.

c. The Circular does not clearly address various implication arising out of Press Notes 2³, 3⁴ and 4⁵ (2009) (“**Press Notes**”) issued by DIPP. The guidelines as stated under the

³ Press Note 2 (2009) stipulates that if an Indian company is owned and controlled by resident Indians or companies, its investment in other Indian companies will not be considered as indirect foreign investment, even when the equity participation is sourced from a foreign company.

⁴ Press Note 3 (2009) stipulates guidelines for transfer of ownership/control from resident to non-resident entities in sectors with caps.

⁵ Press Note 4 (2009) stipulates guidelines for downstream investment by Indian companies owned or controlled by non-resident entities.

Press Notes have impacted companies where the majority ownership remains with non-residents. It also impacts the downstream investments of companies where majority ownership is with non-residents and restricts their ability to invest in sectors that have limits on foreign investments. For example, the Circular has not provided any clarification about the situation where foreign and Indian investors have equal shareholding and equal board control of an investing company which was a big lacuna of the three Press Notes. There are several other implications as well which need to be considered but these are outside the purview of the present newsletter.

Conclusion

While the simplified consolidated FDI policy framework has added a certain degree of clarity, transparency, and reduced the regulatory burden, however, there are certain issues that require serious consideration on which the Circular is silent. It is to be hoped that review of the Circular on September 30, 2010 would suitably clear most of the ambiguities which still remain, thereby maintaining its dynamicity of the Circular.

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