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RBI permits Foreign Investors to use Put and Call Options

Reserve Bank of India (RBI) first allowed pre-emption rights such as Put and Call options vide Notification No. FEMA. 294/2013-RB dated November 12, 2013. Vide this notification RBI amended Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 to add "Further, shares or convertible debentures containing an optionality clause but without any option/right to exit at an assured price shall be reckoned as eligible instruments to be issued to a person resident outside India by an Indian company subject to the terms and conditions as specified in Schedule I" to Regulation 5 (1) (i).

A 'Call' option allows a holder to buy shares in an entity at an agreed price while a 'Put' option allows an investor to sell, thus, now even foreign investors would be able to use such options in their agreements with Indian companies.

On 9th January 2014 vide its circular [RBI/2013-2014/436 A.P. (DIR Series) Circular No. 86] titled "Foreign Direct Investment- Pricing Guidelines for FDI instruments with optionality clauses" further cleared the picture. This Circular provides that on a review, it has now been decided that optionality clauses may henceforth be allowed in equity shares and compulsorily and mandatorily convertible preference shares/debentures to be issued to a person resident outside India under the Foreign Direct Investment (FDI) Scheme. The optionality clause will oblige the buy-back of securities from the investor at the price prevailing/value determined at the time of exercise of the optionality so as to enable the investor to exit without any assured return. The provision of optionality clause shall be subject to the following conditions:

a. There is a minimum lock-in period of one year or a minimum lock-in period as prescribed under FDI Regulations, whichever is higher (e.g. defence and construction development sector where the lock-in period of three years has been prescribed). The lock-in period shall be effective from the date of allotment of such shares or convertible debentures or as prescribed for defence and construction development sectors, etc. in Annex B to Schedule 1 of Notification No. FEMA. 20 as amended from time to time;

b. After the lock-in period, as applicable above, the non-resident investor exercising option/right shall be eligible to exit without any assured return, as under:

i. In case of a listed company, the non-resident investor shall be eligible to exit at the market price prevailing at the recognised stock exchanges;

ii. In case of unlisted company, the non-resident investor shall be eligible to exit

from the investment in equity shares of the investee company at a price not exceeding that arrived at on the basis of Return on Equity (RoE) as per the latest audited balance sheet. Any agreement permitting return linked to equity as above shall not be treated as violation of FDI policy/FEMA Regulations. *Note: For the above purpose, RoE shall mean Profit After Tax / Net Worth; Net Worth would include all free reserves and paid up capital.*

iii. Investments in Compulsorily Convertible Debentures (CCDs) and Compulsorily Convertible Preference Shares (CCPS) of an investee company may be transferred at a price worked out as per any internationally accepted pricing methodology at the time of exit duly certified by a Chartered Accountant or a SEBI registered Merchant Banker. The guiding principle would be that the non-resident investor is not guaranteed any assured exit price at the time of making such investment/agreement and shall exit at the price prevailing at the time of exit, subject to lock-in period requirement, as applicable.

Moreover, all existing contracts will have to comply with the above conditions to qualify as FDI compliant.

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Indian Companies allowed to issue Non-convertible/ Redeemable bonus Preference Shares or Debentures to non-residents

RBI vide its circular [RBI/2013-2014/428 A.P. (DIR Series) Circular No.84] dated 6thJanuary 2014 allowed the Indian companies to issue Non-convertible/ Redeemable Preference Shares or Debentures as bonus. This circular provides that on a review and with a view to rationalizing and simplifying the procedures, it has been decided that an Indian company may issue non-convertible/redeemable preference shares or debentures to non-resident shareholders, including the depositories that act as trustees for the ADR/GDR holders, by way of distribution as bonus from its general reserves under a Scheme of Arrangement approved by a Court in India under the provisions of the Companies Act, as applicable, subject to no-objection from the Income Tax Authorities.

The above general permission to Indian companies is only for issue of non-convertible/ redeemable preference shares or debentures to non-resident shareholders by way of distribution as bonus from the general reserves. The issue of preference shares (excluding non-convertible/redeemable preference shares) and convertible debentures (excluding optionally convertible/partially convertible debentures) under the FDI scheme would continue to be subject to A.P. (DIR Series) Circular Nos.73 and 74 dated June 8, 2007 as hitherto.

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Government contemplating allowing FDI in e-commerce

On 7th January 2014, the Department of Industrial Policy and Promotion (DIPP) issued a Discussion Paper inviting comments on allowing Foreign Direct Investment (FDI) in e-commerce. This highlights the government's intention to liberalize the FDI in retail e-commerce.

Presently, FDI is only allowed in business-to-business or wholesale e-commerce. Industry is abuzz with much discussion with both kinds of views- opposing FDI and favoring FDI doing the rounds. The Discussion Paper is quite comprehensive and charts out both the advantages and disadvantages of allowing FDI in B2C e-commerce. The major advantages are stated as follows:

- Boost to the infrastructural development: Increased capital will help to establish supply chain, distribution system and warehousing.

- Impetus to manufacturing sector: Growth in retail sector will have cascading effect in the manufacturing sector which will positively contribute to overall growth of economy and job creation.

- More efficient supply chain management: Will reduce the need for middlemen leading to lower transaction costs, reduced overhead and reduced inventory and labour costs.

- Adopting best global business practices: Will lead to better work culture and customer service.

- Increased outreach: Will provide increased access to buyers/sellers, allow MSMEs and artisans to reach out to customers far beyond their immediate location, both locally within India and abroad.

- Traceability and transparency: Will not only empower consumers with information and data but also help in better compliance of regulatory framework.

- Reduced costs: On marketing and distribution, travel, materials and supplies will benefit businesses.

- Improved customer service: providing more responsive order taking and after-sales service to customers and competitive pricing.

Major disadvantages are stated to be as follows:

- Works against the spirit of FDI policy in MBRT. Allowing FDI in e-commerce will provide e- commerce players complete geographical reach which will be against the spirit of FDI in multi brand retail trade i.e. being restricted to

cities with a population of more than one million or any other city as per the choice of consenting states.

- Indian market is not yet ready for opening up e-retail space to foreign investors. It will seriously impair small time trading of brick and mortar stores. Small time shopkeepers are not highly qualified and will not be able to compete with sound e-retail business format.

- Because of scale of economic operations, e-commerce players in the inventory based model will have more bargaining power than standalone traders and will resort to predatory pricing.

- The infrastructure created by major e-commerce players will be captive and government will not be able to achieve its objective of creating back end infrastructure.

- Indian e-commerce market is at a nascent stage of development. With FDI in e-commerce, global players will have adverse impact on this domestic industry. It will lead to monopolies in e- commerce, manufacturing, logistics and retail sector.

- Inventory based e-commerce competes directly with MSMEs. Indian e-commerce B2C is growing in an eco- system with Indian owned/led companies offering open marketplace models which provide a technology platform to help MSME reach across India and even globally. These marketplaces do not compete with MSME or retailers and allow everyone to trade. On the other hand, allowing the entry of inventory based large foreign e-tailers may shrink Indian entrepreneurship and the MSME sector.

- MNCs may dump their cheaper products in the market causing a negative impact on the Indian manufacturing sector in general and to MSMEs in particular.

- Small time businesses/ kirana stores remain the largest source of employment in the country. Opening of B2C e-commerce on inventory based model is likely to seriously impact these shopkeepers leading to large scale unemployment.

Comments, views, etc. of the relevant stakeholders are invited on a number of issues in suggested format latest by 30th January 2014.

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