LEXCOUNSEL
LAW OFFICES

June 30, 2010 New Delhi, India

LexCounsel, Law Offices

C-10, Gulmohar Park
New Delhi 110 049, INDIA.

Tel.:+91.11.4166.2861
Fax:+91.11.4166.2862

Plugging the FDI Loopholes

The Indian Government has taken one more step to plug the loopholes in the foreign direct investment ("FDI") policy. Indian companies that have foreign shareholders, and wish to make downstream investments in sectors restricted for FDI will soon have to disclose their shareholding pattern and shareholders agreements to a specifically constituted committee ("Committee").

The Indian FDI policy classifies the industry in three major categories, namely "automatic" where foreign investment may come up to the specified limits without prior Government approval; "restricted" where foreign investments would require prior Government approval; and "prohibited" where foreign investment is not permitted at all.

The comprehensive downstream investment guidelines published in February 2009 led to a possibility where the Indian companies, which are owned and controlled by resident Indians, could invest in restricted, or even in prohibited sectors, even if they had minority foreign investments.

Earlier this year the Government clarified that the intention of the policy was not to permit indirect foreign investment in restricted or prohibited sectors even if the foreign shareholding in the investing company was less than 50%. Downstream investments by such entities in restricted sectors would require prior Government approval. Further, for downstream investments in any prohibited sector, the investing company shall not have any foreign investment.

The Government thereafter considered formation of a Committee to ensure that foreign investment does not slip into restricted and prohibited sectors undetected. The corresponding changes to the FDI policy have been cleared by the Ministry of Finance and are expected to be notified soon by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry.

The news reports on the subject however mention a difference of opinion between the different Government camps over permissibility of investment in prohibited sectors by companies that have foreign investment but are not owned or controlled by the foreign shareholders. Accordingly, the industry players are anxiously waiting to see the final revisions.

Applicability of New Valuation Norms to Insurance Companies

The Reserve Bank of India ("RBI") has insisted that its recent guidelines in pricing of shares of unlisted companies also apply to insurance companies. The statement of the RBI has come in the aftermath of Insurance Regulatory and Development Authority ("IRDA") expressing its view last week that the RBI share pricing guidelines apply to sectors other than financial sector, and consequently would not apply to insurance sector.

The RBI pricing guidelines seek to change the method of valuation of shares in unlisted entities from "fair value" to "discounted free cash flow" method. By the new valuation norms the shares of insurance companies are likely to be valued at a far higher price, as insurance companies usually have long gestation periods and loss in initial years. Resultantly, the foreign investors who intend to acquire more shares in Indian insurance companies, once the FDI policy is further relaxed, would have to shell out more money to acquire the same number of shares.

Pursuant to RBI's insistence, IRDA is expected to clarify its earlier statement soon.