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***FEMA Update***

***New pricing guidelines for FDI instruments with optionality clauses***

***RBI's clarification on Establishment of Liaison Office/Branch Office/Project Office in India by Foreign Entities***

***RBI's clarification on the rate of exchange for conversion of External Commercial Borrowing and Lumpsum Fee/Royalty into Equity***

If you have questions or would like additional information on the material covered in this Newsletter, please contact the authors:

## E-New pricing guidelines for FDI instruments with optionality clauses

In terms of the extant foreign direct investment policy ("FDI Policy") of the Government of India, only equity shares and compulsorily and mandatorily convertible preference shares/debentures are allowed to be issued by Indian companies to non-residents.

However, the Reserve Bank of India ("RBI") has vide A.P. (DIR Series) Circular No. 86 dated January 09, 2014, now also recognized and allowed certain optionality clauses with respect to issuance of the above instruments to non-residents, that oblige the buy-back of securities from the non-resident investor at the price prevailing/value determined at the time of exercise of the option, so as to enable the non-resident investor to exit without any assured return.

The above optionality clauses have been permitted subject to fulfillment of the following conditions:

(a) There should be a minimum lock-in period of 1 (one) year or a minimum lock-in period prescribed under the FDI Policy for the relevant sector (if any), whichever is higher (e.g. in regulated sectors such as defence and construction development). The lock-in period will begin from the date of allotment of the securities, unless otherwise prescribed for any specific regulated sector under the FDI Policy;

(b) After completion of the lock-in period, a non-resident investor exercising its exit option as aforesaid, will be eligible to exit without any assured return, as under:

(i) In case of a listed company, the non-resident investor will be eligible to exit at the market price prevailing on the recognized stock exchanges;

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(ii) In case of an unlisted company, the non-resident investor will be eligible to exit from the investment in:

(A) equity shares at a price not exceeding that is arrived at on the basis of 'Return on Equity' (i.e. profit after tax/net worth, where net worth would include all free reserves and paid up capital) as per the latest audited balance sheet of the Indian company. Henceforth, any agreement permitting return linked to equity as above will not be treated as violation of FDI Policy.

(B) Compulsorily convertible debentures and compulsorily convertible preference shares at a price worked out as per any internationally accepted pricing methodology at the time of exit, after being 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 will be eligible to exit at the price prevailing at the time of exit, subject to lock-in period requirements and other sectoral conditions, as applicable. The RBI has further emphasised that all existing investment contracts will now need to comply with the above conditions to qualify as FDI compliant.

## RBI's clarification on Establishment of Liaison Office/Branch Office/Project Office in India by Foreign Entities

Presently, in terms of the Foreign Exchange Management (Establishment in India of Branch or Office or other Place of Business) Regulations, 2000, no entity or person, being a citizen of Pakistan, Bangladesh, Sri Lanka, Afghanistan, Iran or China is allowed to establish in India, a branch office or a liaison office or a project office or any other place of business by whatever name called, without the prior permission of the RBI.

However, the RBI vide its A.P. (DIR Series) Circular No.93 dated January 15, 2014, has also added Hong King and Macau to the above list to control and regulate indirect entry of residents of China through Hong King and Macau.

Resultantly, applications from entities registered in/resident of Hong Kong and Macau, for establishment of liaison/branch/project offices or any other place of business by whatever name called, shall require prior approval of the RBI.

## RBI's clarification on the rate of exchange for conversion of External Commercial Borrowing and Lumpsum Fee/Royalty into Equity

In terms of the extant FDI Policy, Indian companies can convert external commercial borrowings and lump sum fee/royalty into equity, subject to compliance with certain conditions, including the pricing guidelines for issuance of equity shares.

In this regard, the RBI has vide A.P. (DIR Series) Circular No. 94 dated January 16, 2014 clarified that without prejudice to the extant conditions for conversion of external commercial borrowings or lump sum fee/royalty into equity:

(a) where the liability sought to be converted is denominated in foreign currency (as in case of external commercial borrowings, import of capital goods, etc.), the Indian companies will need to apply the exchange rate prevailing on the date of the agreement between the parties concerned for such conversion;

(b) the above principle will also apply *mutatis mutandis* to all cases where any payables/liability of an Indian company (such as lump sum fees/royalties, etc.) are permitted to be converted to equity shares or other securities to be issued to a non-resident; and

(c) the RBI will have no objection if a borrower Indian company intends to issue equity shares for a rupee amount less than that arrived at as above, by a mutual agreement with the non-resident lender. The fair value of the equity shares to be issued will, however, be worked out with reference to the date of conversion only.

**Feedback**

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