Infolex NEWSALERT

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FDI REFORMS: RELAXED PRICING FOR WARRANTS AND PARTLY PAID SHARES

In an attempt to further liberalize the foreign investment regime in India, the Reserve Bank of India ("**RBI**") has amended the Foreign Exchange Management (Transfer or issue of Security by a Person Resident Outside India) Regulations, 2000 by way of a notification published on July 8, 2014 read with notifications dated May 23, 2014 and July 14, 2014.

The key changes brought about by this amendment include the following:

1. Share warrants and partly paid shares shall now be treated as instruments eligible for foreign investment (Foreign Direct Investment ("FDI") and Foreign Portfolio Investment ("FPI")), subject to sectoral caps and other conditions, provided that:

a. *For partly paid shares*

i. Foreign investment (in partly paid shares) has only been allowed in partly paid equity shares. For foreign investment to be made into preference shares and convertible debentures, these instruments shall continue to be required to be fully paid and mandatorily and fully convertible to qualify as instruments eligible for foreign investment (FDI and FPI).

ii. Pricing should be decided upfront.

iii. 25% of the total consideration (including premium if any) should be received upfront.

iv. The balance consideration should be received within 12 months. If the issue size exceeds INR 500 Crores (i.e., approximately USD 83 Million), the balance amount can be paid after 12 months subject to the company appointing a monitoring agency (applicable to both public and private companies).

v. If the equity shares are not issued within 180 days, the consideration received has to be refunded to the person concerned. This period of 180 days shall be calculated from the date of receipt of each call payment.

b. For Warrants

i. Pricing and price/ conversion formula should be decided upfront.

ii. 25% of the total consideration (including premium if any) should be received upfront.

iii. The balance consideration should be received within 18 months.

iv. Price at the time of conversion should not be lower than the fair value calculated at the time of issuance of such warrants. However, the investee company can receive consideration for an amount larger than the pre-agreed price.

The guidelines clearly specify that the deferment of payment of consideration amount or shortfall in receipt of consideration amount by the foreign investors will not be covered so as to be treated as subscription to partly paid shares and warrants.

2. Non-Resident Indians are also allowed to invest on a non-repatriation basis in partly-paid shares and warrants issued by Indian Companies, subject to applicable provisions of the Companies Act / SEBI and Income tax provisions.

3. In furtherance of its notifications dated November 12, 2013 (effective from December 30, 2013) and January 9, 2014, RBI has reiterated that shares or convertible debentures containing an optionality clause but without any option/right to exit at an assured exit price shall also be eligible instruments under FDI. RBI has further clarified that the guiding principle should be that the non-resident investor should not be guaranteed any assured exit price at the time of making such investment/agreements, and should exit at the price determined at the time of exit, such price being the market price prevailing at the floor for listed companies and the price calculated on return on equity basis for unlisted companies.

4. The discounted cash flow ("**DCF**") based method of valuation which was earlier prescribed as the mechanism to determine pricing for private companies has been done away with. Eligible securities should now be issued at a price not less than the fair price worked out as per any internationally accepted pricing methodology for valuation of shares on arm's length basis. This pricing has to be duly certified by a Chartered Accountant or a SEBI registered Merchant Banker, as applicable.

IndusLaw Quick View:

The decision with respect to allowing warrants, and partly paid shares under the FDI route had been pending with the government for a long time. The government has come a long way by allowing the use of these instruments as eligible instruments for FDI purposes, a move likely to expand the scope of FDI and attract more investors into India. The decision of relaxing the pricing requirements to internationally accepted pricing methodology instead of the DCF is a welcome relaxation. We had hoped that the government would clarify that equity shares without optionality clauses could be exempted from the restriction on guaranteeing an exit price (or IRR), but the government saw fit not to go that extra step. Further, the regulations do not appear to permit an entity registered under the FVCI / AIF Regulations from subscribing to such securities. In addition, the requirement to issue shares after every call on partly paid up shares seems to be an anomaly, as the shares will likely be issued immediately upon the first call, and the recording of the payment is all that will be done thereafter. Despite a few areas that may require more clarification, we see this as a step forward to allowing better options for structuring investments into India.

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