Foreign Direct Investment

Why consider inbound investment?

ADVANTAGES TO THE FOREIGN INVESTOR

- India emerging as a major global player – the rapid growth of its economy on a worldwide scale, particularly the services and information technology sector, provide ample opportunity for foreign investors
- Deregulation in India – Inward FDI trends have been increasing ever since the reform in FDI regime which has provided simplified procedures and policies, with foreign investors facing less restrictions.
- Incentives to promote investments e.g. government subsidies, attractive borrowing rates
- Efficiency-seeking investments i.e. lower production costs
- Market-seeking investments i.e. fast-growing population and economy

ADVANTAGES TO INDIA AS THE HOST ECONOMY

- Generates Employment
- Transfers technology, knowledge, expertise, managerial know-how
- Brings in capital – and added bonus of foreign currency
- Develops infrastructure – economic and social progress

Modes of Foreign Investment into India

ROUTES UNDER FOREIGN DIRECT INVESTMENT

- *Automatic route* - All sectors allow up to 100% FDI under the automatic route, where no prior Government approval is required. This is the case except for the following which do require prior approval from the Government:

(i) Where provisions of Press Note 1 (2005 Series) issued by the Government of India are attracted.

(ii) Where more than 24 per cent foreign equity is proposed to be inducted for manufacture of items reserved for the small scale sector.

(iii) FDI in sectors/activities to the extent permitted under automatic route does not require any prior approval either by the Government or the Reserve Bank of India.

(iv) The investors are only required to notify the Regional Office concerned of the Reserve Bank of India within 30 days of receipt of inward remittances and file the required documents along with form FC-GPR with that office within 30 days of issue of shares to the non-resident investors.

- *Government route* - FDI in activities not covered under the automatic route requires prior Government approval and is considered by the Foreign Investment Promotion Board (FIPB). Application can be made in Form FC-IL. Plain paper applications carrying all relevant details are also accepted. Decision of the FIPB is usually conveyed in 4-6 weeks. Thereafter, filings have to be made by the Indian company with the RBI.

- *General permission of RBI under FEMA* - Indian companies having foreign investment approval through FIPB route do not require any further clearance from the Reserve Bank of India for receiving inward remittance and issue of shares to the non-resident investors. The companies are required to notify the concerned Regional Office of the Reserve Bank of India of receipt of inward remittances within 30 days of such receipt and submit Form FC-GPR within 30 days of issue of shares to the non-resident investors.

FOREIGN INSTITUTIONAL INVESTMENT

Foreign Institutional Investors (FIIs) are entities established or incorporated outside India and make proposals for investments in India. Distinction can be made between FDI and FIIs, where FDI is longer-term and thus less affected by short-term liquidity problems compared with FIIs.

The FII, given its short-term nature, might have bi-directional causation with the returns of other domestic financial markets like money market, stock market, foreign exchange market, etc. These investment proposals by the FIIs are made on behalf of sub-accounts, which may include foreign corporates, individuals and funds and so on. The biggest source through which FIIs invest is the issuance of Participatory Notes (P-Notes), which are also known as offshore derivatives.

FIIs can invest in the stocks and debentures of the Indian companies. In order to invest in the primary and secondary capital markets in India, they have to venture through the Portfolio Investment Scheme (PIS). According to the RBI Regulations, the ceiling for overall investment for FIIs is 24 per cent of the paid-up capital of the Indian company. The limit is 20 per cent of the paid-up capital in the case of public sector banks. However, if the Board and the general body approve and pass a special resolution, then the ceiling of 24 per cent for FII investment can be raised up to sectoral cap for that particular segment.

There is a long list of entities that are eligible to get registered as FIIs such as pension funds, mutual funds, insurance companies, investment trusts, banks, university funds, endowments, foundations, sovereign wealth funds, hedge funds and charitable trusts. In fact, asset management companies, investment managers, advisors or institutional portfolio managers set up and/or owned by NRIs are also eligible to be registered as FIIs. The nodal point for FII registration is SEBI and, hence, all FIIs must register themselves with SEBI and should also comply with the Exchange Control Regulations of the Central Bank. Apart from being allowed to invest in securities in primary and secondary markets, FIIs can also invest in mutual funds, dated Government securities, derivatives traded on a recognised stock exchange and commercial papers.

FIIs are among the major sources of liquidity for the Indian markets. If FIIs are investing huge amounts in the Indian stock exchanges, then it reflects their high confidence in the markets, so FIIs are usually net buyers. But with the current global credit crunch and liquidity freeze in the international markets, FIIs have become net sellers.

Market regulator Security Exchange Board of India (SEBI) recently announced new rules for foreign investments through financial instruments such as participatory notes, asking FIIs to wind up P-Notes for investing in derivatives within 18 months.

The SEBI has also imposed restrictions on P-Notes for investing in spot market, where FIIs will not be allowed to issue P-Notes more than 40 per cent of their assets under custody. The reference date for calculating such assets will be September 30.

Those FIIs who have issued P-Notes of more than 40 per cent of their assets could issue such instruments only if they cancel, redeem, or close their existing PNs. Those FIIs who have issued P-Notes less than 40 per cent of their assets under custody can issue additional instruments at the rate of 5 per cent of their assets.

FOREIGN VENTURE CAPITAL INVESTMENT

- In the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 ('the Principal Regulations'),

"As per clause (iiia) of regulation 2 'Foreign Venture Capital Investor' means an investor incorporated and established outside India which proposes to make investment in Venture Capital Fund(s) or Venture Capital Undertaking(s) in India and is registered with SEBI under SEBI (Foreign Venture Capital Investors) Regulations, 2000;"

As per clause (xia) of regulation 2 "'Venture Capital Fund' means a fund established in the form of a trust, a company including a body corporate and registered under the Securities and Exchange Board of India (Venture Capital Fund) Regulations, 1996 which has a dedicated pool of capital raised in a manner specified under the said Regulations and which invests in Venture Capital Undertakings in accordance with the said Regulations."

- Investment by Foreign Venture Capital Investor - A registered Foreign Venture Capital Investor (FVCI) may, through the SEBI, apply to the Reserve Bank for permission to invest in Indian Venture Capital Undertaking (IVCU) or in a VCF or in a scheme floated by such VCFs. Permission may be granted by the Reserve Bank, subject to such terms and conditions as may be considered necessary.

The registered FVCI permitted by the Reserve Bank under sub-paragraph (1), may purchase equity/equity linked instruments/debt/debt instruments, debentures of an IVCU or of a VCF through initial public offer or private placement or in units of schemes/funds set up by a VCF.

The amount of consideration for investment in VCFs/IVCUs shall be paid out of inward remittance from abroad through normal banking channels or out of funds held in an account maintained with the designated branch of an authorised dealer in India

NON-RESIDENTIAL INVESTMENT

Non Resident Investors (NRIs) and Persons of Indian Origin (PIOs) are eligible to bring investment trough the automatic route of the RBI for all sectors excluding those falling under government approval.

Further, under the non-repatriation scheme (i.e., capital is not repatriable outside India), the NRIs are permitted to invest even in those sectors where sectoral caps are prescribed under the FDI policy. The NRIs are also permitted to purchase and sell shares/convertible debentures under the portfolio investment scheme through a branch designated by an authorised dealer for the purpose and duly approved by the RBI, subject to fulfilment of certain conditions.

The total holding by each NRI cannot exceed 5 per cent of the total paid up equity capital or 5 per cent of the paid up value of each series of convertible debentures issued by an Indian company. Further, the total holdings of all NRIs put together cannot exceed 10 per cent of paid up equity capital or paid up value of each series of convertible debentures. This limit of 10 per cent may be increased to 24 per cent by the concerned Indian company by sanction of the shareholders through a special resolution.