Debt Funding in India

Onshore and Offshore Debt Funding
(With Special Focus on NBFCs)

June 2014
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analyze emerging legal, regulatory and tax issues, serving as an effective forum for cross pollination of ideas.

Our trust-based, non-hierarchical, democratically managed organization that leverages research and knowledge to deliver premium services, high value, and a unique employer proposition has now been developed into a global case study and published by John Wiley & Sons, USA in a feature titled ‘Management by Trust in a Democratic Enterprise: A Law Firm Shapes Organizational Behavior to Create Competitive Advantage’ in the September 2009 issue of Global Business and Organizational Excellence (GBOE).

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## Contents

1. **OFFSHORE DEBT FUNDING – THE FDI AND THE FPI ROUTE**
   - I. The FDI Route 01
   - II. The FPI Route 01
   - III. FVCI Route 04

2. **TAXATION OF SECURITIES AND STRUCTURING THROUGH INTERMEDIATE JURISDICTIONS**
   - I. Taxation of Securities 06
   - II. Intermediate Jurisdiction 07

3. **ONSHORE DEBT FUNDING – THE NBFC ROUTE**
   - I. Advantages of the NBFC Route 10
   - II. Challenges Involved in the NBFC Route 11

**ANNEXURE I**

Foreign Investors Permitted to put: Some Cheer, Some Confusion 18

**ANNEXURE II**

Foreign Portfolio Investors Regulations Notified – Significant Departure from the Existing Foreign Institutional Investors Regime 22
1. Offshore Debt Funding – The FDI and the FPI Route

Foreign debt could be infused in one of the following ways (other than external commercial borrowing):

i. FDI Route: Through fully and compulsorily convertible debentures; and

ii. FPI Route: Through purchase of listed non-convertible debentures (“NCDs”) of an Indian company by an FPI on the floor of the stock exchange.

iii. FVCI Route: Through purchase of NCDs and/or optionally convertible debentures (“OCDs”) of an Indian venture capital undertaking or a venture capital fund.

I. The FDI Route

Under the FDI regime, investment can only be made into equity, fully and compulsorily convertible preference shares (“CCPS”) and fully and compulsorily convertible debentures (“CCDs”). Instruments which are not fully and convertible instruments are considered to be external commercial borrowing (“ECB”) and therefore, are governed by ECB regime. Also, any such instrument having a ‘put option’ in favour of a non-resident shall not be FDI compliant unless in consonance with the conditions laid down by RBI, wherein the valuation norms for such optionality clauses are prescribed which prohibit any assured returns to the non-resident.

Please refer to Annexure I for detailed analysis on put options.

Investment through subscription of CCDs subjected to the restrictions applicable to FDI, as it is essentially an equity route in as much as there is definite commitment to convert into common equity shares.

II. The FPI Route

A. Listed Compulsorily Convertible Debentures

On January 7, 2014, SEBI introduced the SEBI (Foreign Portfolio Investment) Regulations 2014 (“FPI Regulations”). FPI is the portfolio investment regime. The Foreign Institutional Investor regime and the Qualified Foreign Investor regime have now been subsumed into the FPI regime. As regards exiting FIIs or sub-accounts, they can continue to buy, sell or otherwise deal in securities, subject to payment of conversion fees of USD 1000¹ to SEBI, before the expiry of its registration as an FII or sub-account. In case of QFIs, they may continue to buy, sell or otherwise deal in securities subject to the provisions of these regulations, for a period of one year from the date of commencement of FPI Regulations, or until it obtains a certificate of registration as an FPI, whichever is earlier. Accordingly, the existing FIIs and QFIs will be rolled over into FPI or be phased out in timely manner.

Under the new regime SEBI has given the power to designated depository participant (“DDP”) who on their behalf will register the FPI.

Under the amended TISPRO Regulations, the RBI has permitted ‘Registered Foreign Portfolio Investors’ (“RFPI”) to invest on the same footing as FIIs.

A new Schedule 2A has been inserted after Schedule 2 of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (“TISPRO Regulations”) to provide for the purchase / sale of shares / convertible debentures of an Indian company by an RFPI under the Foreign Portfolio Investment Scheme (“FPI Scheme”). The newly introduced Schedule 2A largely mirrors Schedule 2 of TISPRO which provides for investments in shares / convertible debentures by FIIs under the portfolio investment scheme (“PIS”).

B. Listed NCDs

Under Schedule V of the amended TISPRO Regulations, read with the provisions of the FPI Regulations, FIIs are permitted to invest in, inter alia, listed or to be listed NCDs issued by an Indian company. FIIs are permitted to hold securities only in the dematerialized form.

Currently, there is an overall limit of USD 51 Billion on investment by FIIs in corporate debt, of which 90% is available on tap basis. Further, FIIs can also

1. Please refer to Annexure II for a detailed analysis on the FPI Regulations.
2. Specified in Part A of the Second Schedule of the FPI Regulations
invest up to USD 30 Billion in government securities.

Listing of non-convertible debentures on the wholesale debt market of the Bombay Stock Exchange is a fairly simple and straightforward process which involves the following intermediaries:

i. Debenture trustee, for protecting the interests of the debenture holders and enforcing the security, if any;

ii. Rating agency for rating the non-convertible debentures (there is no minimum rating required for listing of debentures); and

iii. Registrar and transfer agent (“R&T Agent”), and the depositories for dematerialization of the non-convertible debentures.

The entire process of listing, including the appointment of the intermediaries can be completed in about three weeks. The typical cost of intermediaries and listing for an issue size of INR One Billion is approximately INR One Million.

Herein below is a structure chart detailing the steps involved in the NCD route:

Recently, the RBI and SEBI permitted direct subscription of ‘to be listed’ NCDs by the FII (now FPIs), thus doing away with the requirement of warehousing entity. These ‘to be listed’ NCDs have to listed on a recognized stock exchange within 15 days of issuance, else, the FPI shall be required to dispose-off the NCDs to an Indian entity / person.

Under this route, any private or public company can list its privately placed NCDs on the wholesale debt market segment of any recognized stock exchange. An FPI entity can then purchase these NCDs on the floor of the stock exchange from the warehousing entity. For an exit, these debentures may be sold on the floor of the stock exchange, but most commonly these NCDs are redeemed by the issuing company. So long as the NCDs are being offered on private placement basis, the process of offering and listing is fairly simple without any onerous eligibility conditions or compliances.

3. There have been examples where offshore private equity funds have exited from such instruments on the bourses.
The NCDs are usually redeemed at a premium that is usually based on the sale proceeds received by the company, with at least 1x of the purchase price being assured to the NCD holder.

Whilst creation of security interest is not permissible with CCDs under the FDI route, listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee that acts for and in the interest of the NCD holders.

Also, since NCDs are subscribed by an FPI entity under the FPI route and not under the FDI route, the restrictions applicable to FDI investors in terms of pricing are not applicable to NCD holders. In the real estate sector, NCDs are favored by developers who do not want to share their equity interest in the project. Further, not only are there no interest caps for the NCDs (as in the case of CCDs or CCPS), the redemption premium on the NCDs can also be structured to provide equity upside to the NCD holders, in addition to the returns assured on the coupon on the NCD.

Separately, purchase of NCDs by the FPI from the Indian company on the floor of the stock exchange is excluded from the purview of ECB and hence, the criteria viz. eligible borrowers, eligible lenders, end-use requirements etc. applicable to ECBs, is not applicable in the case of NCDs.

The table below gives a brief comparative analysis for debt investment through FDI (CCDs) and FPI (NCDs) route:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>CCD – FDI</th>
<th>NCD – FPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Ownership</td>
<td>Initially debt, but equity on conversion</td>
<td>Mere lending rights; however, veto rights can ensure certain degree of control.</td>
</tr>
<tr>
<td>ECB Qualification</td>
<td>Assured returns on FDI compliant instruments, may be construed as ECB.</td>
<td>Purchase of NCDs by the FPI from the Indian company on the floor of the stock exchange is expressly permitted and shall not qualify as ECB.</td>
</tr>
<tr>
<td>Coupon Payment</td>
<td>Interest pay out may be limited to SBI PLR + 300 basis points. Interest can be required to accrue and paid only out of free cash flows.</td>
<td>Arm’s length interest pay out should be permissible resulting in better tax efficiency. Higher interest on NCDs may be disallowed. Interest can be required to accrue only out of free cash flows. Redemption premium may also be treated as business expense.</td>
</tr>
<tr>
<td>Pricing</td>
<td>DCF Valuation applicable</td>
<td>DCF Valuation not applicable</td>
</tr>
<tr>
<td>Security Interest</td>
<td>Creation of security interest is not permissible either on immovable or movable property</td>
<td>Listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee that acts for and in the interest of the NCD holders</td>
</tr>
<tr>
<td>Sectoral Conditionalities</td>
<td>Only permissible for FDI compliant activities</td>
<td>Sectoral restrictions not applicable.</td>
</tr>
<tr>
<td>Equity Upside</td>
<td>Investor entitled to equity upside upon conversion.</td>
<td>NCDs are favorable for the borrower to reduce book profits or tax burden. Additionally, redemption premium can be structured to provide equity upside which can be favourable for lender since such premium may be regarded as capital gains which may not be taxed if the investment comes from Singapore.</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>No intermediaries required</td>
<td>NCD listing (of approximately Rupees One Billion) may cost around INR 1 Million including intermediaries cost. In case of FP, additional cost will be incurred for SEBI registration and bidding for debt allocation limits.</td>
</tr>
</tbody>
</table>

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4. Security interest is created in favour of the debenture trustee that acts for and on behalf of the NCD Holders. Security interest cannot be created directly in favour of non-resident NCD holders.
III. FVCI Route

SEBI introduced the SEBI (Foreign Venture Capital Investors) Regulations, 2000 ("FVCI Regulations") to encourage foreign investment into venture capital undertaking. The FVCI Regulations make it mandatory for an offshore fund to register itself with SEBI. Unlike FDI regime where investors can only subscribe to equity / CCDs / CCPS, FVCIs can also invest into Optionally Convertible Preference Shares ("OCPS"), OCDs and even NCDs.

SEBI and the RBI have extended certain benefits to FVCIs some of which are as follows:

A. Free pricing

The entry and exit pricing applicable to FDI regime do not apply to FVCIs. To that extent, FVCIs can subscribe, purchase or sell securities at any price.

B. Lock-in

Under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("ICDR Regulations") the entire pre-issue share capital (other than certain promoter contributions which are locked in for a longer period) of a company conducting an initial public offering ("IPO") is locked for a period of 1 year from the date of allotment in the public issue. However, an exemption from this requirement has been granted to registered FVCIs, provided, the shares have been held by them for a period of at least 1 year as on the date of filing the draft prospectus with the SEBI. This exemption permits the FVCI to exit from its investments immediately post-listing.

C. Exemption under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011

Federal Court of India has also exempted promoters of a listed company from the public offer provisions in connection with any transfer of shares of a listed company, from FVCIs to the promoters, under the Takeover Code.

D. QIB Status

FVCIs registered with SEBI have been accorded qualified institutional buyer ("QIB") status and are eligible to subscribe to securities at the IPO through the book building route.

List of sectors in which FVCI can invest is not specified in any regulations or law. However, RBI while granting the permission/certificate imposes the conditions that an FVCI can only invest in the following sectors. FVCIs are permitted to invest only in the infrastructure sector and/or in Indian venture capital undertaking engaged in the following nine sectors:

i. biotechnology;
ii. IT related to hardware and software development;
iii. nanotechnology;
iv. seed research and development;
v. research and development of new chemical entities in pharmaceuticals sector;
vi. dairy industry;
vii. poultry industry;
viii. production of bio-fuels; and
ix. hotel-cum-convention centers with seating capacity of more than three thousand.

In addition, the FVCI Regulations specify that:

i. at least 66.67 percent of the investible funds of a FVCI shall be invested in unlisted equity shares or equity-linked instruments of venture capital undertaking; and

ii. not more than 33.33 percent of the investible funds of a FVCI may be invested by way of, inter alia, debt or debt instrument of a venture capital undertaking in which the FVCI has already made an investment by way of equity.

A comparison between the key features of FPIs and FVCIs is provided below:

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5. Venture capital undertaking means a domestic company: (i) whose shares are not listed in a recognised stock exchange in India; (ii) which is engaged in the business of providing services, production or manufacture of articles or things, but does not include such activities or sectors which are specified in the negative list by the Board, with approval of Central Government, by notification in the Official Gazette in this behalf.

6. Schedule VI of the TISPRO Regulations and the FVCI Regulations

7. Regulation 11 of the FVCI Regulations. These investment conditions may be achieved by the FVCI at the end of its life cycle.
<table>
<thead>
<tr>
<th>Particulars</th>
<th>FPI</th>
<th>FVCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration</td>
<td>Registration with DDP is mandatory.</td>
<td>Registration with SEBI is mandatory under the FVCI Regulations.</td>
</tr>
<tr>
<td>Permitted investment instruments</td>
<td>Listed or to-be-listed NCD of Indian companies.</td>
<td>NCD, OCD or OCRPS of Indian venture capital undertaking and/ or venture capital funds.</td>
</tr>
<tr>
<td>Listing of securities</td>
<td>Listing is mandatory. A FPI may subscribe to to-be-listed non-convertible debentures of an Indian company. However, such non-convertible debentures are required to be listed on a recognized stock exchange within 15 days from the date of allotment.</td>
<td>Listing is not required.</td>
</tr>
<tr>
<td>Maximum interest payable</td>
<td>No limits specified on interest payable.</td>
<td>No limits specified on interest payable.</td>
</tr>
<tr>
<td>Sectoral restrictions</td>
<td>No sectoral restrictions – FPIs may invest in debt securities of Indian companies engaged in any sector.</td>
<td>Sectoral restrictions are present – FVCIs may invest in the infrastructure sector or in Indian venture capital undertakings engaged in the nine sectors specified above.</td>
</tr>
</tbody>
</table>
2. Taxation of Securities and Structuring through Intermediate Jurisdictions

I. Taxation of Securities

The tax rates applicable to residents as well as non-residents in respect of the various types of income in relation to the securities are provided in the table below:

<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>STATUS</th>
<th>WITHHOLDING TAX/INTEREST</th>
<th>CAPITAL GAINS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Listed</td>
<td>Unlisted</td>
</tr>
<tr>
<td>Individual</td>
<td>Resident</td>
<td>0%</td>
<td>10%</td>
</tr>
<tr>
<td></td>
<td>Non-Resident</td>
<td>30%, 20% for FPIs (5% until June 2015)</td>
<td>30%</td>
</tr>
<tr>
<td>Corporate</td>
<td>Resident</td>
<td>0%</td>
<td>10%</td>
</tr>
<tr>
<td></td>
<td>Non-Resident</td>
<td>40%, 20% for FPIs (5% until June 2015)</td>
<td>40%</td>
</tr>
</tbody>
</table>

8. The rates mentioned above are exclusive of applicable surcharge and cess. Further, the above rates may be subject to applicable tax treaty relief.
9. Listed debentures held for a period of 12 months will be treated as long-term capital assets.
10. Unlisted debentures held for a period of 36 months will be treated as long-term capital assets.
11. Though the withholding on the interest is 0, but the receiver may still be taxed based on the applicable rates.
12. Provided that the interest is not more than State Bank of India’s PLR plus 500 Basis point.
13. For residents, capital gains are generally computed after allowing the benefit of indexation, based on the inflation index prescribed in this regard.
Redemption premium, if treated as interest, will be subject to withholding tax at the rates applicable for interest in the above table, otherwise they will be subject to taxation at the rates applicable for capital gains.

**II. Intermediate Jurisdiction**

Foreign investors may invest in India via an intermediate jurisdiction to mitigate tax leakage.

Of the various Double Taxation Avoidance Agreements ("DTAAs") which India has entered into across the globe, some of them contain beneficial provisions with regard to capital gains tax and tax withholding on interest payments. Favourable legal and regulatory environment, coupled with a lower domestic tax regime in few of these jurisdictions, including Mauritius, Singapore and Netherlands, have made them, over the years, a popular choice for an intermediate jurisdiction. The diagram below illustrates the use of intermediate jurisdiction for investment into India:

Since taxation on business income in most jurisdictions is higher, and repatriation of dividends from India is not tax effective, returns to foreign investors from India are generally structured as capital gains or interest income, which can reduce the effective tax liability of foreign investor to 0% or 10% respectively, with the use of appropriate intermediate jurisdiction. Herein below is a comparison of four key jurisdictions – Mauritius, Singapore, US and Netherland:

<table>
<thead>
<tr>
<th>INCOME STREAM</th>
<th>TAX TREATMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mauritius</td>
<td>Singapore</td>
</tr>
<tr>
<td>Sale of shares</td>
<td>Income from the sale of shares of an Indian Company by a Mauritius Company is only taxable in Mauritius under the</td>
</tr>
</tbody>
</table>

14. There is DDT of 15% (exclusive of surcharge and cess) payable by the Indian company on the dividend distributed to its shareholders; further, since DDT is a corporate level tax and not a tax in the hands of the shareholder, credit for DDT is usually not available.
India-Mauritius tax treaty. Mauritius taxes capital gains at the rate of zero percent. Hence, there will be no tax incidence.

Presently, a limitation on benefits ("LoB") clause is being negotiated in the India-Mauritius tax treaty whereby a minimum annual expenditure requirement as under the India-Singapore treaty may be prescribed for availing the exemption.

Thus, tax residents may have to pay capital gains tax in India and the US. There is an ambiguity under US laws on whether tax credit will be available for taxes paid in India.

The India-Singapore tax treaty. There is no capital gains implication in Singapore if the income is characterized as capital gains.

To avail the capital gains exemption under the treaty, the entity claiming the tax benefit must have incurred an annual expenditure of 200,000 Singapore dollars in Singapore, on operations, in the immediately preceding 24 months prior to the date the gains arise (LoB). However, Singapore tax authorities may construe capital gains to be in the nature of business income unless (a) the Singapore Company holds 20% of the ordinary shares in the Indian Co. and (b) the shares are held for a continuous period of 24 months.

However, Singapore tax authorities may construe capital gains to be in the nature of business income unless (a) the Singapore Company holds 20% of the ordinary shares in the Indian Co. and (b) the shares are held for a continuous period of 24 months.

If India exercises such taxing right, the Netherlands shall allow a credit for taxes paid in India.

Participation exemption would be available under Dutch domestic law by which capital gains derived from alienation of shares of a subsidiary where there is at least 5% holding inter alia would be fully exempt from taxation in the Netherlands.

| Taxation of Securities and Structuring through Intermediate Jurisdictions |
|-----------------------------|-----------------------------|-----------------------------|
| Buyback | Tax shall be payable by the Indian company at the rate of 20% on the total consideration paid by it which is above the amount received by the company at the time of issuing the shares. | Tax shall be payable by the Indian company at the rate of 20% on the total consideration paid by it which is above the amount received by the company at the time of issuing the shares. |
| Dividend | Dividend Distribution Tax shall be payable by the company in India prior to distribution of profits at the rate of 15%. Dividend Income received by the Mauritius Company shall be taxable as business income in Mauritius at the rate of 15%. However, the Mauritius Company may be eligible to avail deemed foreign tax credit of 80% or underlying tax credits, which may reduce the effective tax incidence to 0%-3%. | Any dividend distributed by a company in India is subject to dividend distribution tax at the rate of 15%. The dividend received by the Singapore Company should be exempt from tax in Singapore. |
| Dividend | Dividend Distribution Tax shall be payable by the company in India prior to distribution of profits at the rate of 15%. Dividend income received by the American Company shall be taxable at the rate of 10-15% (depending on the case). However, the India-US tax treaty also provides that if a US company owns at least 10% of the voting stock of its subsidiary in India, the US would grant underlying tax credit for tax paid in India for distributions made by the Indian company in the form of dividends. Thus, tax credit Dividend Distribution Tax shall be payable by the Netherlands Company at the rate of 10%. However, participation exemption would be available under Dutch domestic law by which dividends received from a subsidiary where there is at least 5% holding inter alia would be fully exempt from taxation. | Dividend Distribution Tax shall be payable by the India Company prior to distribution of profits at the rate of 15%. Dividend Income received by the Mauritius Company shall be taxable as business income in Mauritius at the rate of 15%. However, the Mauritius Company may be eligible to avail deemed foreign tax credit of 80% or underlying tax credits, which may reduce the effective tax incidence to 0%-3%. |

Buyback Tax shall be payable by the Indian company at the rate of 20% on the total consideration paid by it which is above the amount received by the company at the time of issuing the shares.

Dividend Tax is payable by the Indian Company prior to distribution of profits at the rate of 15%.* Dividend Income received by the Mauritius Company shall be taxable as business income in Mauritius at the rate of 15%. However, the Mauritius Company may be eligible to avail deemed foreign tax credit of 80% or underlying tax credits, which may reduce the effective tax incidence to 0%-3%.

Any dividend distributed by a company in India is subject to dividend distribution tax at the rate of 15%. The dividend received by the Singapore Company should be exempt from tax in Singapore.

Dividend Distribution Tax shall be payable by the company in India prior to distribution of profits at the rate of 15%. Dividend income received by the American Company shall be taxable at the rate of 10-15% (depending on the case).

However, the India-US tax treaty also provides that if a US company owns at least 10% of the voting stock of its subsidiary in India, the US would grant underlying tax credit for tax paid in India for distributions made by the Indian company in the form of dividends. Thus, tax credit Dividend Distribution Tax shall be payable by the Netherlands Company at the rate of 10%. However, participation exemption would be available under Dutch domestic law by which dividends received from a subsidiary where there is at least 5% holding inter alia would be fully exempt from taxation.

Dividend Distribution Tax shall be payable by the company in India prior to distribution of profits at the rate of 15%.

Dividend income received by the Mauritius Company shall be taxable as business income in Mauritius at the rate of 15%. However, the Mauritius Company may be eligible to avail deemed foreign tax credit of 80% or underlying tax credits, which may reduce the effective tax incidence to 0%-3%.

Dividend Distribution Tax shall be payable by the company in India prior to distribution of profits at the rate of 15%.

Dividend income received by the American Company shall be taxable at the rate of 10-15% (depending on the case).

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<table>
<thead>
<tr>
<th>Interest income earned by a Mauritian company from an Indian company</th>
<th>Interest income earned by a Singapore company from an Indian company would be subject to a 15% withholding tax in India.</th>
<th>Interest income earned by a US company from an Indian company shall be subject to a 15% withholding tax in India.</th>
<th>Interest income earned by a Dutch company from an Indian company shall be subject to a 10% withholding tax in India under the India-Netherlands tax treaty.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income earned by a Mauritian company from an Indian company would be subject to 40% withholding tax for Indian rupee.</td>
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15. Since the treaty has a most favoured nation clause in its protocol, the withholding rate would be reduced to 5%.
3. Onshore Debt Funding – The NBFC Route

In light of the challenges that the FDI and the FPI route are subjected to, there has been a keen interest in offshore funds to explore the idea of setting up their own NBFC to lend or invest in Indian companies.

An NBFC is defined in terms of Section 45I(c) of the RBI Act, 1934 (“RBI Act”) as a company engaged in granting loans/advances or in the acquisition of shares/securities, etc. or hire purchase finance or insurance business or chit fund activities or lending in any manner provided the **principal business** of such a company does not constitute any non-financial activities such as (a) agricultural operations, (b) industrial activity, (c) trading in goods (other than securities), (d) providing services, (e) purchase, construction or sale of immovable property. Every NBFC is required to be registered with the RBI, unless specifically exempted.

The Act has however remained silent on the definition of ‘principal business’ and has thereby conferred on the regulator, the discretion to determine what is the principal business of a company for the purposes of regulation. Accordingly, the test applied by RBI to determine what is the principal business of a company was articulated in the Press Release 99/1269 dated April 8, 1999 issued by RBI. As per the said press release, a company is treated as an NBFC if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from these financial assets is more than 50 per cent of its gross income. Both these tests (“50% Tests”) are required to be satisfied in order for the principal business of a company to be determined as being financial for the purpose of RBI regulation.

**Recommendation of the Working Group on the Issues and Concerns in the NBFC Sector chaired by Usha Thorat has been issued by RBI in the form of Draft Guidelines (“Draft Guidelines”). Draft Guidelines** provide that the twin criteria of assets and income for determining the principal business of a company need not be changed. However, the minimum percentage threshold of assets and income should be increased to 75 per cent. Accordingly, the financial assets of an NBFC should be 75 per cent or more (as against more than 50 per cent) of total assets and income from these financial assets should be 75 per cent or more (as against more than 50 percent) of total income.

The NBFC could be structured as follows.

![Diagram of Offshore Fund, NBFC, and Indian Company]

The Offshore Fund sets up an NBFC as a loan company, which then lends to Indian companies. The NBFC may either lend by way of loan or through structured instruments such as NCDs which have a protected downside, and pegged to the equity upside of the company by way of redemption premium or coupons.

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16. The Working Group report was published by the RBI in the form of Draft Guidelines on its website 12th December 2012
I. Advantages of the NBFC Route

A. Assured Returns

The funding provided through NBFCs is in the form of domestic loans or NCDs, without being subjected to interest rate caps as in the case of CCDs. These NCDs can be structured to provide the requisite distribution waterfall or assured investors’ rate of return ("IRR") to the offshore fund.

B. Regulatory Certainty

The greatest apprehension for funds has been the fluid regulatory approach towards foreign investment, for instance put options. The NBFC being a domestic lending entity is relatively immune from such regulatory uncertainty.

C. Security Creation

Creation of security interest in favour of non-residents on shares and immoveable property is not permitted without prior regulatory approval. However, since the NBFC is a domestic entity, security interest could be created in favour of the NBFC. Enforceability of security interests, however, remains a challenge in the Indian context. Enforcement of security interests over immovable property, in the Indian context, is usually a time consuming and court driven process. Unlike banks, NBFCs are not entitled to their security interests under the provisions of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act.

D. Repatriation Comfort

Even though repatriation of returns by the NBFC to its offshore shareholders will still be subject to the restrictions imposed by the FDI Policy (such as the pricing restrictions, limits on interest payments etc.), but since the NBFC will be owned by the foreign investor itself, the foreign investor is no longer dependent on the Indian company as would have been the case if the investment was made directly into the Indian entity.

E. Tax Benefits to the Investee Company

As against dividend payment in case of shares, any interest paid to the NBFC will reduce the taxable income of the investee company. However, an NBFC may itself be subjected to tax to the extent of interest income so received, subject of course to deductions that the NBFC may be eligible for in respect of interest pay-outs made by the NBFC to its offshore parent.

II. Challenges Involved in the NBFC Route

A. Setting up

The first challenge in opting for the NBFC route is the setting up of the NBFC. Obtaining a certificate of registration from the RBI for an NBFC is a time consuming process. This process used to take anywhere in the region of 12 – 14 months earlier, which wait period has now significantly reduced, but it may still take as much as 6 months, or in some cases, even longer.

Draft Guidelines provide that NBFCs with asset size below Rs. 1000 crore and not accessing any public funds shall be exempted from registration. NBFCs, with asset sizes of Rs. 1000 crore and above, need to be registered and regulated, even if they have no access to public funds.

Draft Guidelines also provide that small non-deposit taking NBFCs with asset of Rs. 50 crores or less should be exempt from the requirement of RBI registration. Not being deposit taking NBFCs and being small in size, no serious threat perception is perceived to emanate from them.

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17. Exchange control regulations do not prescribe for any cap on coupon in case of CCDs, but only prescribe for a cap on payment of dividends on a CCPS, which is three hundred basis points over and above the state bank of India prime lending rate, prevailing at the time of issue of the CCPS. Nevertheless, it is market practice to restrict the coupon that can be paid on CCDs to the same extent as dividends that can be paid on CCPS.

18. SARFAESI Act facilitates enforcement of security interest without intervention of the courts.
Due to the elaborate time period involved in setting up the NBFC, one of the common alternatives adopted, especially in case of non-deposit taking NBFCs was to purchase an existing NBFC. This was because earlier there was only a requirement of giving 30 thirty days’ written notice “prior to effecting a change of ‘control’ of non-deposit NBFC (the term ‘control’ has the same meaning as defined in the SEBI Takeover Code), and a separate approval was not required; and unless the RBI restricted the transfer of shares or the change of control, the change of control became effective from the expiry of thirty days from the date of publication of the public notice.

However, recently, the RBI vide its circular dated May 26, 2014 19, has prescribed that in order to ensure that the ‘fit and proper’ character of the management of NBFCs is continuously maintained for both, ‘deposit accepting’ and ‘non-deposit accepting’ NBFCs, its prior written permission has to be obtained for any takeover or acquisition of control of an NBFC, whether by acquisition of shares or otherwise. This RBI circular requires prior approval in the following situations also:

i. any merger/amalgamation of an NBFC with another entity or any merger/amalgamation of an entity with an NBFC that would give the acquirer / another entity control of the NBFC;

ii. any merger/amalgamation of an NBFC with another entity or any merger/amalgamation of an entity with an NBFC which would result in acquisition/transfer of shareholding in excess of 10 percent of the paid up capital of the NBFC;

iii. for approaching a court or tribunal under Section 391-394 of the Companies Act, 1956 or Section 230-233 of Companies Act, 2013 seeking order for mergers or amalgamations with other companies or NBFCs.

The abovementioned RBI approval is sought from the DNBS (Department of Non-Banking Supervision) division of the RBI.

Separately, earlier, any transfer of shares of a financial services company from a resident to a non-resident required prior approval of the Foreign Exchange Department of the Reserve Bank of India ("FED"), which took anywhere in the region of 2 – 4 months. In a welcome move, as per a recent RBI circular dated November 11, 2013, the requirement to procure such an approval was removed if:

i. any ‘fit and proper/ due diligence’ requirement as regards the non-resident investor as stipulated by the respective financial sector regulator shall have to be complied with; and

ii. The FDI policy and FEMA regulations in terms of sectoral caps, conditionalities (such as minimum capitalization, etc.), reporting requirements, documentation etc., are complied with.”

Since, the requirement of obtaining RBI approval in case of change in control even for non-deposit taking NBFC is relatively very new, only time will tell how forthcoming RBI is in granting such approvals and to that extent, how favourable is this option of purchasing NBFC.

**B. Capitalization**

The NBFC would be subject to minimum capitalization requirement which is pegged to the extent of foreign shareholding in the NBFC as set out in the FDI Policy.

<table>
<thead>
<tr>
<th>Percentage of Holding in the NBFC</th>
<th>Minimum Capitalisation</th>
</tr>
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<tbody>
<tr>
<td>Up to 51% FDI</td>
<td>USD 0.5 million, with entire amount to be brought upfront.</td>
</tr>
<tr>
<td>More than 51% FDI</td>
<td>USD 5 million with entire amount to be brought upfront.</td>
</tr>
<tr>
<td>More than 75% FDI</td>
<td>USD 50 million, with USD 7.5 million to be brought upfront and the balance in 24 months.</td>
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19. The public notice had be published in one English and one vernacular language newspaper, copies of which were required to be submitted to the RBI.

20. DNBS (PD) CC.No.376/03.10.001/2013-14

21. Under the Master Circular on Corporate Governance dated July 1, 2013, RBI had emphasized the importance of persons in management who fulfil the ‘fit and proper’ criteria. The Master Circular provides as follows: “...it is necessary to ensure that the general character of the management or the proposed management of the non-banking financial company shall not be prejudicial to the interest of its present and future depositors. In view of the interest evinced by various entities in this segment, it would be desirable that NBFC-D with deposit size of Rs 20 crore and above and NBFC-ND-SI may form a Nomination Committee to ensure ‘fit and proper’ status of proposed/existing Directors.”
Considering the need for capitalization, it is not uncommon to see non-residents holding less than 75% stake in the NBFC even though a significant portion of the contribution comes from non-residents. Premium on securities is considered for calculating the minimum capitalization.

In addition to the above, every NBFC is required to have net owned funds of INR 20 million (INR 2.5 million provided application for NBFC registration is filed on or before April 20, 1999).

C. The Instrument

Before we discuss the choice of an instrument for the NBFC, let’s discuss the instruments that are usually opted for investment under the FDI route.

The only available options under the FDI route are equity shares, CCPS and CCDs. Typically, and naturally depending from case to case, a combination of equity and CCDs is usually preferred to capitalize the investee company. Equity usually forms a nominal part of the investment, and a large portion of the investment is made by subscription to CCDs.

CCDs essentially offer three important benefits. Firstly, any coupon paid on CCDs is a deductible expense for the purpose of income tax. Secondly, though there is a 40% withholding tax that the non-resident recipient of the coupon may be subject to, the rate of withholding can be brought to as low as 10% if the CCDs are subscribed to by an entity that is resident of a favorable treaty jurisdiction. Thirdly, coupon can be paid by the company, irrespective of whether there are profits or not in the company. Lastly, being a loan stock (until it is converted), CCDs have a liquidation preference over shares. And just for clarity, investment in CCDs is counted towards the minimum capitalization.

CCDs clearly standout against CCPS on at least the following counts. Firstly, while any dividend paid on CCPS is subject to the same dividend entitlement restriction (300 basis points over and above the prevailing State Bank of India Prime Lending Rate at the time of the issue), dividends can only be declared out of profits. Hence, no tax deduction in respect of dividends on CCPS is available. To that extent, the company must pay 30% corporate tax before it can even declare dividends. Secondly, any dividends can be paid by the company only after the company has paid 15% dividend distribution tax. In addition, unlike conversion of CCDs into equity, which is not regarded as a ‘transfer’ under the provisions of the Income-tax Act, 1961, conversion of CCPS into equity may be considered as a taxable event and long term or short term capital gains may be applicable. Lastly, CCPS will follow CCDs in terms of liquidation preference.

However, unlike other companies, a combination of nominal equity and a large number of CCDs may not be possible in case of NBFCs. Though all non-deposit accepting NBFCs are subjected to NBFC (Non-Deposit Accepting or Holding) Companies Frudential norms (Reserve Bank) Directions (the ‘Prudential Norms’), once such NBFC has ‘total assets’ in excess of INR 1 billion (USD 20 million approximately), the NBFC is referred to as a ‘systemically important NBFC’. Unlike other NBFCs, a systemically important NBFC is required to comply with Regulation 15 (Auditor’s Certificate), Regulation 16 (Capital Adequacy Ratio) and Regulation 18 (Concentration of Credit / Investment) of the Prudential Norms. The choice of instrument is largely dependent on the capital adequacy ratio required to be maintained by the NBFC for the following reason.

Regulation 16 of the Prudential Norms restricts a systemically important NBFC from having a Tier II Capital larger than its Tier I Capital.

22. Net Owned Funds has been defined in the RBI Act 1934 as (a) the aggregate of paid up equity capital and free reserves as disclosed in the latest balance sheet of the company, after deducting there from (i) accumulated balance of loss, (ii) deferred revenue expenditure and (iii) other intangible asset; and (b) further reduced by the amounts representing (1) investment of such company in shares of (i) its subsidiaries; (ii) companies in the same group; (iii) all other NBFCs and (2) the book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to and deposits with (i) subsidiaries of such company and (ii) companies in the same group, to the extent such amounts exceed ten percent of (a) above

23. Although the requirement of net owned funds presently stands at INR 20 million, companies that were already in existence before April 21, 1999 are allowed to maintain net owned funds of INR 2.5 million and above. With effect from April 1999, the RBI has not been registering any new NBFC with net owned funds below INR 20 million.

24. Exclusive of surcharge and cess.

25. Exclusive of surcharge and cess.

26. Note that an NBFC becomes a systemically important NBFC from the moment its total assets exceed INR 100 crores. The threshold of INR 1 billion need not be reckoned from the date of last audited balance sheet as mentioned in the Prudential Norms.
“Equity Capital” = Equity Capital + CCPS + Free Reserves + Share Premium + Capital Reserves – (Accumulated losses + BV of intangible assets + investment activity.

Thus, CCDs being hybrid debt instruments which fall in Tier II cannot be more than Tier I Capital. This disability in terms of capitalization is very crucial for the NBFC and its shareholder as it not only impedes the ability of the NBFC to pay out interests to the foreign parent in case of inadequate profits, but is also tax inefficient. There is currently an ambiguity on whether NCDs are to be included in Tier II Capital as they do not qualify in any of the heads as listed above for Tier II Capital.

D. No Ability to make Investments

Having discussed the funding of the NBFC itself, let’s discuss how the NBFC could fund the investee companies. Under the FDI Policy, an NBFC with foreign investment can only engage in certain permitted activities under the automatic route, and engaging in any financial services activity other than such activities will require prior approval of the Foreign Investment Promotion Board ("FIPB"), an instrumentality of the Ministry of Finance of the Government of India.

While lending qualifies as one of the permitted categories ('leasing and finance'), 'investment' is not covered in the list above. Therefore, any FDI in an NBFC that engages in 'investments' will require prior approval of the FIPB. Such an approval though discretionary is usually granted within 3 months’ time on a case to case basis. Therefore, an NBFC with FDI can only engage in lending but not in making investments.

We are given to understand that in a few cases where the redemption premium of the NCDs was linked to the equity upside, RBI qualified such instruments to be in the nature of investments rather than just loan instruments. Once the nature of the instrument changed, then nature of the NBFC automatically changed from lending to investment, and FIPB approval was immediately required in respect of foreign investment in an NBFC engaged in investment activity.

CORE INVESTMENT COMPANIES

A core investment company ("CIC") is a company which satisfies the following conditions as on the date of the last audited balance sheet (i) it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies; (ii) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its net assets; (iii) it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment; and (iv) it does not carry on any other financial activity referred to in Section 45 I (c) and 45 I (f) of the Reserve Bank of India Act, 1934 except for granting of loans to group companies, issuing of guarantees on behalf of group companies and investments in bank deposits, money market instruments etc.

A CIC is not required to register with the RBI, unless the CIC accepts ‘public funds’ AND has total financial assets in excess of INR 1 billion.

‘Public funds’ for the purpose of CIC include funds raised either directly or indirectly through public

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27. “Owned Fund” means Equity Capital + CCPS + Free Reserves + Share Premium + Capital Reserves – (Accumulated losses + BV of intangible assets + Deferred Revenue Expenditure)


29. The FDI Policy however under paragraph 6.2.17.8.2 (v) provides that: "(iv) NBFCs (i) having foreign investment more than 75% and up to 100%, and (ii) with a minimum capitalisation of USD 50 million, can set up step down subsidiaries for specific NBFC activities, without any restriction on the number of operating subsidiaries and without bringing in additional capital. (v) Joint Venture operating NBFCs that have 75% or less than 75% foreign investment can also set up subsidiaries for undertaking other NBFC activities, subject to the subsidiaries also complying with the applicable minimum capitalisation norms."
deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue.

E. Deployment of Funds

NBFCs can issue debentures only for deployment of the funds on its own balance sheet and not to facilitate requests of group entities/parent company/associates. Core Investment Companies have been carved out from the applicability of this restriction.

F. Credit Concentration Norms

A systemically important NBFC is not permitted to lend or invest in any single company exceeding 15% of its owned fund, or single group of companies exceeding 25% of its owned fund. If however the systemically important NBFC is investing and lending, then these thresholds stand revised to 25% and 40% respectively.

Exemption from such concentration norms may be sought and has been given in the past where the NBFC qualified the following two conditions – firstly, the NBFC did not access public funds, and secondly, the NBFC did not engage in the business of giving guarantees. Interestingly, ‘public funds’ include debentures, and to that extent, if the NBFC has issued any kind of debentures (including CCDs), then such relaxation may not be available to it. In the absence of such exemption, it may be challenging for loan or investment NBFCs to use the leverage available to them for the purpose of making loans or investments.

G. Only Secure Debentures can be Issued

NBFCs can only issue fully secured debentures whether by way of private placement or public issue. The security has to be created within a month from the date of issuance. If the security cover is inadequate, the proceeds have to be placed in an escrow account, till the time such security is created.

H. Enforcing Security Interests

NBFCs, unlike banks, are not entitled to protection under the SARFAESI Act. This is a major handicap for NBFCs as they have to undergo through the elaborate court process to enforce their security interests, unlike banks which can claim their security interests under the provisions of SARFAESI Act without the intervention of the courts. Representations were made by industry associations seeking inclusion of NBFCs within the ambit of SARFAESI Act, especially in the current times when NBFCs are fairly regulated.

We understand that the then RBI Governor D. Subbarao responded to the exclusion of NBFCs on the ground that their inclusion under the SARFAESI Act would distort the environment for which Securitisation Companies (SCs)/Reconstruction Companies (RCs) were set up by allowing more players to seek enforcement of security rather than attempting reconstruction of assets.

Subbarao mentioned that SARFAESI Act was enacted to enable banks and financial institutions to realise long-term assets, manage problem of liquidity, asset liability mis-matches and improve recovery by exercising powers to take possession of securities, sell them and reduce nonperforming assets by adopting measures for recovery or reconstruction, through the specialised SCs/RCs, which would be registered with the RBI and purchase the NPAs of the banks and FIs. According to him, two methodologies were envisaged - first, the strategy for resolution of the assets by reconstructing the NPAs and converting them into performing assets, and second, to enforce the security by selling the assets and recovering the loan amounts.

Subbarao further mentioned that SARFAESI Act is not merely a facilitator of security enforcement without the intervention of Court. It is a comprehensive approach for restructuring the assets and make it work and only when it does not work, the recovery mode was envisaged.

He was apprehensive that since NBFCs have followed the leasing and hire purchase models generally for extending credit and they enjoy the right of repossession, the only benefit SARFAESI Act would extend to the NBFCs will be for enforcement of security interest without the intervention of the
court, which may distort the very purpose for which SCs/RCs were created, namely, reconstruction and the inclusion would simply add a tool for forceful recovery through the Act.

Draft Guidelines provide that NBFCs should be given the benefit under SARFAESI Act, 2002, since there is an anomaly that unlike banks and public financial institutions ("PFIs"), most NBFCs (except those registered as PFIs under Section 4A of the Companies Act) do not enjoy the benefits deriving from the SARFAESI Act even though their clients and/or borrowers may be the same.

I. Exit

Exit for the foreign investor in an NBFC is the most crucial aspect of any structuring and needs to be planned upfront. The exits could either be by way of liquidation of the NBFC, or buy-back of the shares of the foreign investor by the NBFC, or a scheme of capital reduction (where the foreign investor is selectively bought-back), or the sale of its shares in the NBFC to another resident or non-resident, or lastly, by way of listing of the NBFC.

Unlike most countries, liquidation in the Indian context is a time consuming and elaborate process in India, sometimes taking in excess of 10 years.

Buyback of securities is another alternative, however, CCDs cannot be bought back. CCDs must be converted into the underlying equity shares to be bought back. Buy-back of securities is subjected to certain conditionalities as stipulated under Section 68 of the Companies Act, 2013. A buyback of equity shares can happen only out of free reserves, or proceeds of an earlier issue or out of share premium. In addition to the limited sources that can be used for buy-back, there are certain other restrictions as well that restrict the ability to draw out the capital from the company. For instance, only up to a maximum of 25% of the total paid up capital and free reserves of the company can be bought in one financial year, the debt equity ratio post buy-back should not be more than 2:1 etc. Buy-back being a transfer of securities from a non-resident to a resident cannot be effected at a price higher than the price of the shares as determined by the discounted cash flows method. Although, buy back from the existing shareholders is supposed to be on a proportionate basis, there have been certain cases such as Century Enka where the court approved a scheme for selective buy-back of 30% of its shareholding from its non-resident shareholders.

From a tax perspective, traditionally, the income from buyback of shares has been considered as capital gains in the hands of the recipient and accordingly the investor, if from a favourable treaty jurisdiction, could avail the treaty benefits. However, in a calculated move by the Government to undo this practice of companies resorting to buying back of shares instead of making dividend payments the Budget 2013-2014 has now levied a tax of 20%\(^3\) on domestic unlisted companies, when such companies make distributions pursuant to a share repurchase or buy back.

The said tax at the rate of 20% is imposed on a domestic company on consideration paid by it which is above the amount received by the company at the time of issuing of shares. Accordingly, gains that may have arisen as a result of secondary sales that may have occurred prior to the buy-back will also be subject to tax now.

The proposed provisions would have a significant adverse impact on offshore realty funds and foreign investors who have made investments from countries such as Mauritius, Singapore, United States of America and Netherlands etc. where buy-back of shares would not have been taxable in India due to availability of tax treaty benefits. Further, being in the nature of additional income tax payable by the Indian company, foreign investors may not even be entitled to a foreign tax credit of such tax.

Additionally, in the context of the domestic investor, even the benefit of indexation would effectively be denied to such investor and issues relating to proportional disallowance of expenditure under Section 14A of the ITA (Expenditure incurred in relation to income not includible in total income) may also arise. This may therefore result in the buy-back of shares being even less tax efficient than the distribution of dividends.

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\(^3\) The forms of exit discussed here are in addition to the ability of the foreign investor to draw out interest / dividends from the NBFC up to 300 basis points over and above the State Bank of India prime lending rate.

\(^3\) As a structuring consideration, the CCDs are converted into a nominal number of equity shares at a very heavy premium so that the share premium can then be used for buy-back of the shares.

\(^3\) Exclusive of surcharge and cess.
As an alternative to buy-back, the investor could approach the courts for reduction of capital under the provisions of section 68 of the Companies Act, 2013; however, the applications for such reduction of capital need to be adequately justified to the court. From a tax perspective, the distributions by the company to its shareholders, for reduction of capital, would be regarded as a dividend to the extent to which the company possesses accumulated profits and will be taxable in the hands of the company at the rate of 15%. Any, distribution over and above the accumulated profits (after reducing the cost of shares) would be taxable as capital gains.

Sale of shares of an NBFC or listing of the NBFC could be another way of allowing an exit to the foreign investor; however, sale of shares cannot be effected at a price higher than the price of the shares determined by the discounted cash flow method. Listing of NBFCs will be subject to the fulfillment of the listing criterion and hinges on the market conditions at that point in time.

36. Exclusive of surcharge and cess
Annexure I
Foreign Investors Permitted To Put: Some Cheer, Some Confusion

- Amendment recognizes shares/debentures with a built-in option/right as eligible instruments which may be issued to foreign investors;
- Such securities cannot have an assured exit price, although the Amendment specifies methodologies to determine the exit price;
- The prescribed price determination measures may make it more beneficial to invest in compulsorily convertible securities rather than equity shares;
- A minimum lock-in period of one year has been prescribed before the option can be exercised.

'Put Options' in favour of a non-resident requiring an Indian resident to purchase the shares held by the non-resident under the foreign direct investment (“FDI”) regime were hitherto considered as violative of the FDI Policy by the Reserve Bank of India (“RBI”). The RBI has now legitimized option arrangements through its recent amendment (“Amendment”) to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 (“TISPRO”), notified through its circular dated January 09, 2013 (the “Circular”). TISPRO now recognizes that equity shares, fully and mandatorily convertible preference shares and debentures (“FDI Instruments”) containing an optionality clause can be issued as eligible instruments to foreign investors. However, the Circular specifies that such an option/right when exercised should not entitle the non-resident investor to exit at an assured return.

I. Background

The validity and enforceability of put options has always been a bone of contention from an Indian securities law and exchange control perspective.

In the past, Securities and Exchange Board of India (“SEBI”) had taken a stand, in context of public companies, that option arrangements are akin to forward contracts, hence restricted. SEBI relaxed its position through a notification in October, 2013. The SEBI notification granted validity to contracts containing clauses related to preemptive rights, right of first offer, tag-along right, drag-along right, and call and put options.

From an RBI perspective, the issue was more from an external commercial borrowings (“ECB”) perspective. RBI had issued a notification on June 8, 2007 vide Circular 73, setting out that non-residents could only subscribe to FDI Instruments, and any instrument that may be redeemable or optionally redeemable will qualify as ECB. Interpreting that Circular, the RBI regarded put options in favour of non-residents as redeemable instruments, not permitted under the FDI regime. That interpretation was even extended to situations where the put option was not on the company, but the promoters of the company.

On a separate count, taking a cue from SEBI, the RBI also took a view that a put option provision in an investment agreement would qualify as a ‘option’ or an over the counter derivative, which is not permitted under the FDI route. That view was taken despite the fact that no separate price was paid for the optionality, and the optionality could not be traded independent of the FDI Instrument.

Having said that, there was no clear written policy that restricted put options, and RBI’s approach was seen to be on a case-to-case basis, typically in cases where the promoters (not willing to honor the put) approached the RBI themselves. However, the aggressiveness with which the RBI implements such an unwritten policy was remarkable. The risk of having a put was not just limited to it being not enforceable, RBI in fact regarded the mere existence of put in a contract as a violation of the FDI Policy and initiated proceedings against the parties for having provided for such options in their investment contracts.

In fact, the Department of Industrial Policy and Promotion (DIPP) had brought in a written prohibition on options in the Consolidated FDI Policy dated October 01, 2011, but deleted that provision within 30 days of it in light of industry expectations.

wide criticism. However, notwithstanding the deletion of prohibition of options, RBI continued with its approach that put options in favour of non-residents were violative of the FDI policy. Please refer to our hotline discussing the change in regulatory policy here [http://tmp.nishithdesai.com/old/New_Hotline/CorpSec/CORPSEC%20HOTLINE_Oct0311.htm](http://tmp.nishithdesai.com/old/New_Hotline/CorpSec/CORPSEC%20HOTLINE_Oct0311.htm) and here [http://tmp.nishithdesai.com/old/New_Hotline/CorpSec/CORPSEC%20HOTLINE_Nov0311.htm](http://tmp.nishithdesai.com/old/New_Hotline/CorpSec/CORPSEC%20HOTLINE_Nov0311.htm).

II. Amendment

The Amendment, for the first time, provides for a written policy on put options, and in doing that sets out the following conditions for exercise of options by a non-resident:

i. Shares/debentures with an optionality clause can be issued to foreign investors, provided that they do not contain an option/right to exit at an assured price;

ii. Such instruments shall be subject to a minimum lock-in period of one year;

iii. The exit price should be as follows:

   - In case of listed company, at the market price determined on the floor of the recognized stock exchanges;
   - In case of unlisted equity shares, at a price not exceeding that arrived on the basis of Return on Equity ("RoE") as per latest audited balance sheet. RoE is defined as the Profit after Tax divided by the net worth (defined to include all free reserves and paid up capital);
   - In case of preference shares or debentures, at a price determined by a Chartered Accountant or a SEBI registered Merchant Banker per any internationally accepted methodology.

III. Analysis

In a market where IPOs are almost non-existent, put options give tremendous comfort to offshore private equity funds, should a trade sale not materialize within their exit horizons. Put options become even more important for certain asset classes like real estate or other stabilized yield generating assets where secondary sales and IPOs are not very common in the Indian context. The Amendment is a positive development for such players as commercial justifications behind inclusion of options into investment agreements have been recognized, and Indian companies and their founders can no longer treat such rights/options as mere paper rights.

A detailed analysis of the Amendment, its ambiguities and practical challenges are set out herein below.

A. Lock in

While a minimum lock in period of one year has been specified, it is unclear as to which date it should apply from. For example, if the date of optionality agreement and issuance of securities are different, which would be the relevant date? On a conservative basis, it may be appropriate to reckon the lock-in conditions from the later of the two dates.

There are also issues about whether the lock-in restricts only the exercise of securities or also the secondary transfer of securities, as well as whether a secondary transfer would reset the clock in the hands of the new investor. It appears that the one year lock would be required only if the option is being exercised (and not in case of all secondary transfers), and would apply afresh in the hands of each subsequent transferee.

B. Will DCF Pricing Cap Still Apply, if the Exit Price for Options is Higher than DCF

Under the current regulations, non-residents are not entitled to sell the FDI Instruments to an Indian resident at a price exceeding the price computed per the discounted free cash flows ("DCF") methodology.

However, the DCF cap applicable to FDI Instruments will not be applicable to sale of FDI Instruments with a put option. This is because the exit pricing applicable in case of exercise of the option by the non-resident has been introduced by amendment to Regulation 9 of the TISPRO regulations, whereas the DCF price cap is applicable to securities transferred under Regulation 10 B(2) (by virtue of the RBI circular dated May 4, 2010). Regulation 10B only applies to transfers by non-residents, which are not covered under Regulation 9. Therefore, the DCF cap will not be applicable when determining the exit price pursuant to exercise of put option.

The question remains on whether the option pricing norms set out in the Amendment will only apply if the option is exercised, or even if shares with options are transferred to the grantor of the option without the exercise of an option.
C. Exit Price for Equity Shares

The Amendment provides that the exit price in respect of equity shares of unlisted company should not exceed the price arrived at on the basis of Return on Equity ("RoE") as per the last audited balance sheet.

The formula is divorced from the traditional form of calculating RoE (where the denominator is average shareholder equity and not networth) and brings in several impractical situations set out below.

Plain reading of the provision suggests that the exit price would be capped at the RoE. Whilst it is not clear, it appears that the RoE formula should be interpreted to mean principal plus the RoE. That is to say, if the invested amount was INR 100, and the company generated profits of INR 20 each year for five years, leading to a hypothetical net worth of 200, the RoE would be equal to the profits of the sixth year divided by 200. If the profit after tax in the sixth year were INR 20, the RoE would be 20/200 or 10%. Accordingly, the exit price for the foreign investor would be capped at INR 110, which clearly may not be reflective of the FMV of the instrument.

The formula for determining the exit price seems to be at complete odds with the pricing suggested for convertibles (any internationally accepted valuation methodology), listed equity shares (ruling market price), or even shares and convertibles without optionality attached (discounted cash flow valuation), which are likely to be much closer to FMV than the RoE methodology.

For instance, if the formula is applied, accumulated profits only decrease the RoE. The formula also leaves the exit price contingent on the last audited balance sheet, which may have unintended and distortionary consequences. For example, if the put option is to be triggered after a fixed period of time (being five years, in the above example), and the company incurs a loss in the sixth year, on a conservative basis, the exit price may be capped at a price lower than the investment amount.

If the put option is tied to an event of default, the valuation mechanism may have unintended consequences as the default may have an impact on the profitability of the company in the year of exit.

Requiring an exit at RoE is clearly ambiguous. Ideally the RoE can only be the basis to compute the exit price. To that extent, it remains to be seen if the RBI will permit the exit price on equity shares with optionality attached to be a variable of the RoE that brings the exit price closer to FMV, just as in case of convertibles and listed shares.

D. Determination of Price of Convertibles Securities

The Amendment provides the exit price for convertibles upon exercise of put option should be a price determined based on international accepted pricing methodology, as determined by a SEBI registered merchant banker or chartered accountant.

This valuation mechanism is likely to provide more flexibility to investors at the point of exit, and hence going forward we may see investors preferring more of convertible securities as compared to equity shares for their investments in Indian companies. Having said this, it is unclear why different valuation mechanisms were believed to be required for equity shares and compulsorily convertible securities, which are in any case treated on the same footing and subject to DCF cap on an as if converted basis under the current regulatory regime.

E. Status of Existing Option Arrangements

The Circular clearly sets out that all existing contracts must comply with the conditions set out in the Amendment to qualify as being FDI compliant.

In light of this, a position could be taken that all existing contracts that are not compliant with the conditions set out in the Amendment become FDI non-compliant, especially if they provide for options with assured returns.

The terms of such put options contained in existing contracts may need to be revisited to bring them in compliance with the Amendment. However, if the existing terms of issuance already provide that the exit price should be subject to applicable law, then the terms of the security may be considered to have been amended by the law and should thus be considered valid notwithstanding the Amendment.

F. Impact on Joint Ventures and M&A Deals

Options are not just contained in private equity transactions. Even joint venture transactions and sometimes M&A transactions contain put options in favour of non-residents. These options are usually pegged to fair market value (determined per commercial negotiations) or at discount or premium to the fair market value.
There may be a need to look at such joint venture agreements, as the commercially negotiated price will now be subjected to the pricing for options as set out in the Amendment.

IV. Conclusion

The Amendment is a welcome development as it gives predictability and commercial flexibility to foreign investors, in relation to contractual provisions, which are fairly standard in the international investment context. However, pegging the exit price for equity to RoE (and not a multiple of RoE that brings the exit price closer to FMV) is likely to be a cause of major concern for investors. While preference shares may be preferred from an exit pricing perspective, Companies Act 2013, which denies the flexibility of voting on as-if-converted basis may galvanize the investors to invest in common equity. The need to amend existing contracts to bring them in line with the Amendment may be a challenging task, especially for most offshore private equity players that would be hesitant to revisit investment agreements if they are close to their exit horizons. What will also be interesting is to see how the term ‘exercise’ is interpreted and whether RBI will require exit pricing as set out for options to be applicable even when the shares are transferred to the Indian resident granting the option voluntarily, and not in exercise of the option/right.

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Shreya Rao,
Ruchir Sinha

You can direct your queries or comments to the authors.
Annexure II
Foreign Portfolio Investors Regulations Notified – Significant Departure from the Existing Foreign Institutional Investors Regime

- Foreign Portfolio Investors (FPI) Regulations notified, repeals FII Regulations.
- FPIs differentiated into categories based on risk-based KYC norms.
- Changes made to broad-based criteria and eligibility to issue and hold ODIs.
- Rules concerning taxation of FPIs yet to be formalized; anticipated to be largely in line with tax framework for FIIs.
- Designated Depositary Participants (DDPs) authorized to process applications on behalf of SEBI.

The recently notified Securities and Exchange Board of India (“SEBI”) has harmonized foreign institutional investors (“FIIs”), sub-accounts and qualified foreign investors (“QFIs”) regimes into a single investor class – foreign portfolio investors (“FPI”) and provide a single window clearance through designated depository participants (“DDPs”). With each investor registering directly as an FPI (under the respective three categories discussed later), the sponsored sub accounts structure seems to be over.

FPI Regulations seek to introduce a risk-based approach towards investor Know Your Customer (KYC) requirements, ease the entry process and reduce timelines for investor participants. However, on the key issues which foreign investors currently deal with, viz. ambiguity on the ‘broad based’ criteria, eligibility to issue/subscribe to offshore derivative instruments and clubbing of investment limit, SEBI seems to have revisited the current position which may impact the industry. Interestingly, SEBI also seems to have changed the individual investment cap that an FPI can hold in Indian companies under the FPI Regulations.

I. FPI: An Introduction

Under the FPI regime, Securities and Exchange Board of India (“SEBI”) has harmonized foreign institutional investors (“FIIs”), sub-accounts and qualified foreign investors (“QFIs”) regimes into a single investor class – foreign portfolio investors (“FPI”) and provide a single window clearance through designated depository participants (“DDPs”). With each investor registering directly as an FPI (under the respective three categories discussed later), the sponsored sub accounts structure seems to be over.

The FPI Regulations put into effect several recommendations made by the Committee on Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments chaired by Mr. K.M. Chandrasekhar in 2013.

From the point of view of KYC, the committee recommended (and the FPI Regulations provide) for following categorization of FPIs based on their perceived risk profile:

**Eligible Foreign Portfolio Investors**

<table>
<thead>
<tr>
<th>Category I FPI</th>
<th>Category II FPI</th>
<th>Category III FPI</th>
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<tbody>
<tr>
<td>Government and Government-related investors such as central banks, Governmental agencies, sovereign wealth funds or international and multilateral organizations or agencies</td>
<td>i. Appropriately regulated broad based funds[^39]; ii. Appropriately regulated persons[^40]; iii. Broad-based funds that are not appropriately regulated[^41];</td>
<td>Includes all eligible FPIs who are not eligible under Category I and II, such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.</td>
</tr>
</tbody>
</table>

[^39]: Includes mutual funds, investment trusts, insurance/reinsurance companies
[^40]: Includes banks, asset management companies, investment managers/advisors, portfolio managers
[^41]: This is subject to the fact that the investment manager of such broad based fund is regulated and undertakes that it will be responsible for the acts, omissions and other things done by the underlying broad based funds.
The FPI categorization follow the risk based KYC regime as set out in SEBI’s circular dated September 12, 2013 for foreign investors investing under portfolio investment scheme.

**II. Changes in the Broad-Based Criteria**

Under the FII Regulations, a “broad-based fund” meant a fund, established or incorporated outside India which has at least 20 investors with no investor holding more than 49% of the shares or units of the fund. It was also provided that if the broad-based fund had any institutional investor, it was not necessary for such fund to have 20 investors. Further, any institutional investor holding more than 49% of the shares or units of the fund would have to itself satisfy the broad based criteria.

The FPI Regulations continue to follow the broad-based criteria with two notable deviations. One, in order to satisfy the broad-based criteria, it would be necessary for a fund to have 20 investors even if there is an institutional investor. Two, for the purpose of computing the number of investors in a fund, both direct and underlying investors (i.e. investors of entities that are set up for the sole purpose of pooling funds and making investments) shall be counted.

**III. ‘New’ Investment Limits**

Regulation 21(7) of the FPI Regulations states that a single FPI or an investor group shall purchase below ten percent of the total issued capital of a company. The position under the FII Regulations was that such shareholding was not to exceed ten percent of the share capital. Effectively, a single FPI can now hold up to 9.99% of the share capital of an Indian company.

The FPI Regulations provide that in case the same set of ultimate beneficial owner(s) invests through multiple FPI entities, such FPI entities shall be treated as part of the same investor group and the investment limits of all such entities shall be clubbed at the investment limit as applicable to a single FPI.

**IV. New Rules for Holding ODI**

Regulation 22 of the FPI Regulations provides that Category I FPIs and Category II FPIs (which are directly regulated by an appropriate foreign regulatory authority) are permitted to issue, subscribe and otherwise deal in offshore derivative instruments (“ODIs”). However, those Category II FPIs which are not directly regulated (which are classified as Category-II FPI by virtue of their investment manager being appropriately regulated) and all Category III FPIs are not permitted to issue, subscribe or deal in ODIs. As compared to the FII regime, two differences emerge, (1) Broad based ‘unregulated’ funds are not eligible to subscribe to ODIs, even if they are managed by appropriately regulated person (which, under the FII Regulations, were eligible to hold ODIs) and, (2) Entities that qualify as regulated broad based sub accounts, may also issue ODIs under the FPI Regulations (which, under the FII Regulations, could not do so as ‘broad based sub-accounts’). These are critical set of changes for FIIs that issue ODIs. The class of eligible entities issuing ODIs has been expanded (bringing more potential players who have the requisite balance sheet to issue such instruments, in the fray). Further, the

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42. CIR/MIRSD/07/2013
43. As per the Operational Guidelines for Designated Depository Participants ("Operational Guidelines") released by SEBI, for the purpose of ascertaining investor group, the concerned DDPs shall consider all such entities having direct or indirect common shareholding / beneficial ownership / beneficial interest of more than 50% as belonging to same investor group.
44. ODIs have been defined as “any instrument, by whatever name called, which is issued overseas by a FII against securities held by it that are listed or proposed to be listed on any recognized stock exchange in India, as its underlying.”
45. Reference may be made to Explanation 1 to Regulation 5 of the FPI Regulations where it is provided that an applicant (seeking FPI registration) shall be considered to be “appropriately regulated” if it is regulated by the securities market regulator or the banking regulator of the concerned jurisdiction in the same capacity in which it proposes to make investments in India.
FPI Regulations also remove unregulated funds as potential holders of ODIs (as the regulator seems to encourage the format of direct participation for such investors). Additionally, there is still no clarity on which entities would qualify as being regulated by an “appropriate foreign regulatory authority” and to whom ODIs can be issued under the FPI Regulations.

**Whether offshore derivative instruments (ODIs) can be issued or otherwise dealt with?**

<table>
<thead>
<tr>
<th>Category I FPI</th>
<th>Category II FPI</th>
<th>Category III FPI</th>
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<tr>
<td>Yes</td>
<td>Yes. (However, unregulated broad-based funds which are classified as Category-II by virtue of their investment manager being appropriately regulated, are not permitted to issue, subscribe or otherwise deal in ODIs)</td>
<td>No.</td>
</tr>
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**V. PCC/SPC: Now Welcomed**

Prior to December, 2013, there was a blanket ban on protected cell companies ("PCCs"), segregated portfolio companies ("SPCs") or equivalent structures which used to ring-fence assets and liabilities under law) from participating under the FII route.

Based on the representations made by our firm, SEBI recently provided that entities that apply for registration under the FII Regulations shall not be regarded as having an opaque structure if they are required by their regulator or under any law to ring fence their assets and liabilities from other funds / sub-funds in the entity. This applied for structures such as open-ended investment companies (OEICs) in the UK. OEICs are typically set up in the format of umbrella companies that have several 'sub-funds'. Recent amendments to the OEIC regulations in the UK required that a PCC structure be adopted to ring fence liabilities between these sub-funds.

The position has evolved further under FPI Regulations and, as long as (a) the applicant is regulated in its home jurisdiction, (b) each fund / sub-fund in the applicant satisfies the broad-based criteria, and (c) the applicant undertakes to provide information regarding its beneficial owners upon SEBI’s request, the applicant shall not be regarded as having an 'opaque structure'.

**VI. Next Steps for the Regime Roll Over**

SEBI has to be lauded for its effort to harmonize the different foreign portfolio investment routes under the umbrella FPI regime. With the delegation of responsibilities to DDPs, the regime roll over will have to be carefully carried out with minimum disruption to the market and taking into account the views of the all participants in the market, most importantly the foreign investors.

Clarity is still lacking on certain key issues such as the rollover process from the FII regime to the FPI regime (particularly from a registration standpoint) as well as on tax implications, as the FPI Regulations in their current form do not contain any language to suggest that all categories of FPIs would be treated as FIIIs for the purpose of the Income Tax Act, 1961 ("Tax Act") and no circulars have yet been issued by Central Board of Direct taxes (CBDT).

Thus, while SEBI has notified the FPI Regulations, repealing the FII Regulations, the FPI regime would become fully operational only once suitable amendments have been made to the Tax Act and the Foreign Exchange Management Act, 1999 ("FEMA"). Consequently, the FPI Regulations provide that SEBI will continue to process applications under the old regime till March 31, 2014 since SEBI appears to be of the view that required amendments to the Tax Act and the FEMA will take place by such date.

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46. Regulation 47(3)(c) of the FPI Regulations.
The following research papers and much more are available on our Knowledge Site: [www.nishithdesai.com](http://www.nishithdesai.com)

**NDA Insights**

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<thead>
<tr>
<th>TITLE</th>
<th>TYPE</th>
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<tr>
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<td>M&amp;A Lab</td>
<td>January 2014</td>
</tr>
<tr>
<td>Apollo's Bumpy Ride in Pursuit of Cooper</td>
<td>M&amp;A Lab</td>
<td>January 2014</td>
</tr>
<tr>
<td>Diageo-USL - 'King of Good Times; Hands over Crown Jewel to Diageo</td>
<td>M&amp;A Lab</td>
<td>January 2014</td>
</tr>
<tr>
<td>File Foreign Application Prosecution History With Indian Patent Office Warburg - Future Capital - Deal Dissected</td>
<td>IP Lab</td>
<td>02 April 2013</td>
</tr>
<tr>
<td>Public M&amp;A's in India: Takeover Code Dissected</td>
<td>M&amp;A Lab</td>
<td>01 January 2013</td>
</tr>
<tr>
<td>Copyright Amendment Bill 2012 receives Indian Parliament's assent</td>
<td>Realty Check</td>
<td>September 2013</td>
</tr>
<tr>
<td>Real Financing - Onshore and Offshore Debt Funding Realty in India</td>
<td>IP Lab</td>
<td>01 May 2012</td>
</tr>
<tr>
<td>Pharma Patent Case Study</td>
<td>M&amp;A Lab</td>
<td>21 March 2012</td>
</tr>
<tr>
<td>Patni plays to iGate’s tunes</td>
<td>M&amp;A Lab</td>
<td>04 January 2012</td>
</tr>
<tr>
<td>Vedanta Acquires Control Over Cairn India</td>
<td>M&amp;A Lab</td>
<td>03 January 2012</td>
</tr>
<tr>
<td>Corporate Citizenry in the face of Corruption</td>
<td>Yes, Governance Matters!</td>
<td>15 September 2011</td>
</tr>
<tr>
<td>Funding Real Estate Projects - Exit Challenges</td>
<td>Realty Check</td>
<td>28 April 2011</td>
</tr>
<tr>
<td>Real Estate in India - A Practical Insight</td>
<td>Realty Check</td>
<td>22 March 2011</td>
</tr>
<tr>
<td>Hero to ride without its 'Pillion Rider'</td>
<td>M&amp;A Lab</td>
<td>15 March 2011</td>
</tr>
<tr>
<td>Piramal - Abbott Deal: The Great Indian Pharma Story</td>
<td>M&amp;A Lab</td>
<td>05 August 2010</td>
</tr>
<tr>
<td>Bharti connects with Zain after two missed calls with MTN</td>
<td>M&amp;A Lab</td>
<td>05 June 2009</td>
</tr>
<tr>
<td>The Battle For Fame - Part I</td>
<td>M&amp;A Lab</td>
<td>01 April 2010</td>
</tr>
</tbody>
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Research @ NDA

Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Research has offered us the way to create thought leadership in various areas of law and public policy. Through research, we discover new thinking, approaches, skills, reflections on jurisprudence, and ultimately deliver superior value to our clients.

Over the years, we have produced some outstanding research papers, reports and articles. Almost on a daily basis, we analyze and offer our perspective on latest legal developments through our "Hotlines". These Hotlines provide immediate awareness and quick reference, and have been eagerly received. We also provide expanded commentary on issues through detailed articles for publication in newspapers and periodicals for dissemination to wider audience. Our NDA Insights dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction. We regularly write extensive research papers and disseminate them through our website. Although we invest heavily in terms of associates’ time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with a much needed comparative base for rule making. Our ThinkTank discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged.

As we continue to grow through our research-based approach, we are now in the second phase of establishing a four-acre, state-of-the-art research center, just a 45-minute ferry ride from Mumbai but in the middle of verdant hills of reclusive Alibaug-Raigadh district. The center will become the hub for research activities involving our own associates as well as legal and tax researchers from world over. It will also provide the platform to internationally renowned professionals to share their expertise and experience with our associates and select clients.

We would love to hear from you about any suggestions you may have on our research reports. Please feel free to contact us at research@nishithdesai.com