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ADVOCATES AND LEGAL CONSULTANTS

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❖ **FDI norms shoot holes in caps**

**To Allow Foreign Investment in Sensitive Sectors via Circuitous Route**

The new foreign direct investment (FDI) norms announced by the UPA government have opened a can of worms. They allow foreign investment to enter restricted sensitive sectors through a circuitous route and to beat sectoral caps in sectors such as telecom, aviation and media, say experts. Unless, of course, the detailed guidelines yet to be issued by the government address some of these concerns.

The cornerstone of the new FDI norms is the notion of control by resident Indians. If company A, in which foreigners have a stake, is controlled by resident Indians, the new norms hold that any investment by A in other companies will have no element of foreign investment. Till now, the norm was that foreigners would be deemed to have a stake indirectly in the companies in which Company A has invested, proportionate to the foreign holding in Company A. According to the revised norms, there is no concept of any indirect holding—if the investing company is controlled by resident Indians, its foreign investors are deemed to have no stake in other corporate entities in which this company invests. (In the case of a 100% subsidiary of a majority foreign owned company, foreign investors are deemed to have the same stake holding as in the parent company).

According to investment bankers, even the existing sectoral foreign investment caps are insufficient to restrict foreign control.

**Revised FDI norms undermine caps**

Even with a minority stake, foreign investors are able to exercise effective control through a variety of shareholder agreement clauses, preferential shares, 'economic interest', etc. The revised FDI norms undermine the caps even further, making it easier for foreign investors to own, directly and indirectly, a larger share of the company they want to run, and to control it.

"The government is playing a trick, trying to demonstrate that we have FDI restrictions in sensitive sectors," said BMR & Co partner Mukesh Butani. But given the current economic reality, we want to allow this leeway, he added.

"(There is a) paradigm shift in the way FDI concept will be understood, i.e. now FDI will be linked to "control" and "legal ownership", completely divorced from economic ownership," said PricewaterhouseCoopers executive director Akash Gupta.

The corporate reality is that ownership and control are not related to formal stakes held, said another merchant banker, who did not wish to be named. Control can be maintained through other forms of funding like preferential shares (convertible or not); which is why RBI took into account preferential shares while regulating FDI inflows into real estate companies. Then there are those who hold equity on behalf of foreigners – both high net worth individuals and companies whose only concern is that they are adequately remunerated for such warehousing of shares.

Shareholder agreements can vest in the minority foreign shareholder executive authority, super-minority provisions to vote against a resolution even with a minority shareholding, right to demand consultation before decisions are made, right of first refusal, etc. Sectoral FDI caps in telecom, insurance and media have given birth to creative holding structures. Lenders have better rights than equity shareholders. In these days, commercial loans to companies are attracting management rights. As a result, it is possible to manage companies with lender nominees on company boards, in the garb of protecting lenders' interests. As regards the provision that government/Foreign Investment Promotion Board permission is required for transfer of ownership from residents to non-residents, this is meaningless on two counts. In the first place, ownership is not necessary for a foreign entity to control an Indian company, as explained above.

Then, enforceability of the provision is suspect. In public listed companies, SEBI, the stock exchanges and RBI get access to data on shareholding much before the government. Whether the guidelines yet to be issued will empower these agencies to send out intelligent questions to ensure that FDI caps are not being breached through either of the creative routes mentioned above (preferential equity and warehousing) remains to be seen.

In fact, this was one of the key contentious issues that had been flagged by various sections within the government like the finance, information and broadcasting and corporate affairs ministries that were opposed to the move initiated by the Department of Industrial Policy and Promotion. It may be recalled that the Foreign Investment Promotion Board after approving Vodafone's acquisition of Hutchison Essar had recommended a review of the FDI norms to plug policy loopholes to prevent companies from flouting sectoral caps.

Incidentally, a presentation was made on the Vodafone issue before the group of ministers looking into the guidelines, to highlight how the new norms would legitimise the use of policy loopholes. Sections within the government were of the view that instead of encouraging backdoor entry of FDI, sectoral caps should be removed. Since the new guidelines are meant for sensitive sectors, a non-transparent route for induction of FDI will pose further challenge to the government in keeping a watch on creative corporate structures.

RSP Rajya Sabha member Abani Roy had also written a letter to Prime Minister Manmohan Singh asking the UPA government to frame guidelines in such a manner that the 26% Indian shareholding in the telecom sector was protected, according to reports. He had said loopholes must not be left for foreign companies to exploit.

## ❖ **Interim Budget: Tax Sieve likely for all Venture Capital Funds**

**Govt. is considering allowing tax pass through for domestic Venture Capital Funds (VCFs) across sectors as well as automatic approval for foreign funds**

The government is considering a proposal under which investors in venture capital funds (VCFs) will have to pay the requisite taxes, instead of the funds themselves, as is the current practice in certain sectors. If this proposal is implemented, it would reverse a policy change introduced in the 2007 budget, which had stipulated that VCFs in all but nine industries would have to pay taxes. The change now being considered would restore what is known in tax jargon as the pass-through benefit to all VCFs, the majority of which are incorporated as trusts. In a further liberalisation, the government may put the registration of foreign VCFs under the automatic approval route, which would put them on a par with foreign institutional investors (FII).

A team of 6-7 officials from leading domestic private equity funds, law firms and the industry body met senior finance ministry officials recently, said an industry official who was part of the meeting. The team made a presentation to the government on key issues, including tax pass through for domestic VCFs and putting foreign VCFs on the automatic approval route, definition of the term promoter to specifically exclude PE players, and simplifying the taxation rules for capital gains arising out of sale of listed and unlisted company shares.

To attract VC/PE investments into certain sectors, the 2007 budget had restricted the tax pass-through status to funds investing in infrastructure, biotechnology, IT related to hardware and software development,

nanotechnology, seed research and development, R&D of new chemical entities in the pharma sector, dairy and poultry industries, production of bio-fuels and hotel-cum-convention centres with seating capacity of more than 3,000.

“Taxing an investor his distributive share in the income of the VCF is more equitable than taxing the VCF at the trust level. This ensures that investors subject to special tax regime – such as life insurers or foreign investors in VCFs whose taxation in India are subject to the Double Tax Avoidance Treaty – are not discriminated against for having invested into the underlying portfolio companies through the VCF instead of investing directly,” said MP Chitale & Associates managing partner Rajendra Chitale.

ANOTHER issue under consideration by the government is easing of investment norms for various types of private equity funds. According to an official, the registration of foreign VCFs may require only a single blanket approval. Lack of clarity over foreign venture capital investments (FVCI) in India has led to several applications from foreign VCFs piling up with RBI for approval under the Foreign Exchange Management Act (FEMA). Currently, SEBI first approves the proposal, after which RBI needs to separately clear the FVCI application, which is not applicable in the case of FII registrations.

However, in the recent past, RBI has been slowly opening the doors to foreign venture capital investors, but with riders such as restricting their investments to select sectors. At present, there are more than 100 registered foreign VCFs in the country and more than 120 SEBI-registered domestic VCFs.

In the current environment, marked by large outflows, a change in policy stance may help boost inflows. According to industry estimates, private equity and venture capital investment stood at \$13 billion in 2008, versus \$17.5 billion in 2007.

### ❖ **RBI allows foreign investors to purchase shares of SBI**

The Reserve Bank from this month allowed foreign investors to purchase shares of India's largest lender State Bank of India (SBI) as the threshold limit for the FIIs has fallen below the required limit of 18 per cent.

Foreign institutional investors (FIIs), non-resident Indians and people of Indian origin can now purchase equity shares of State Bank of India under portfolio investment scheme through secondary market, the RBI said in a release.

RBI has allowed the purchase of shares of SBI by these entities as their holdings in the bank have gone down below the prescribed threshold limit of 18 per cent of SBI's total equity.

### ❖ **Defence to get \$3.1 b from 3G auction money**

Over \$3.1 billion (Rs 15,700 crore) of the proceeds from the upcoming 3G spectrum auctions is likely to be given to the defence forces for building an alternate communications network. But, it is the state-owned BSNL, which is likely to be the biggest beneficiary since the entire sum will be given to the telco to build and maintain this network for the armed forces, said a senior DoT official.

The math doing the rounds in the communications ministry runs along these lines. BSNL will get Rs 1,077 crore

for setting up the alternative Air Force network, Rs 8,893 crore for building similar facilities for the Army and the Navy and Rs 5,730 crore for maintaining this infrastructure for the next 10 years. The Group of Ministers (GoM) that is looking into this is set to finalise the Rs 15,700 crore funding for the project and also seek Cabinet approval for this once it debates the 3G spectrum auctions roadmap.

In the interim budget, the government had said it expects to raise Rs 20,000 crore from 3G auctions. But, the

exchequer will get a mere Rs 4,000 as the remaining will be spent on the defence network. So far, the government has disbursed only a mere Rs 328.6 crore to BSNL for this project.

Spectrum is crucial for all telecom companies as it is the lifeline on which they offer their service. But, currently a bulk of these airwaves is occupied by defence forces. BSNL is slated to complete this defence network, which will involve 50,000 kms of fibre in core network, 10,000 kms of fibre in access network and will interconnect 270

locations by 2011. The armed forces will release spectrum, the airwaves on which communication signals travel, in a phased manner, depending on the progress of this alternate network.

Currently, all telecom services in India are provided using 2G spectrum, but the government does not more of these to meet the demands of existing players and well as new entrants who were given licenses last year.

### **❖ BSNL launches 3G services in 11 cities**

Bharat Sanchar Nigam Ltd (BSNL) said on Friday it had launched third-generation (3G) services in 11 cities and planned to expand services to other areas in the country.

BSNL said in a statement it had invested Rs 2,700 crore (\$530 million) on rolling out 3G infrastructure and would cover all district headquarters and important commercial towns. BSNL provides telecoms services across the country except in the major cities of New Delhi and Mumbai, which are covered by another state-run firm, Mahanagar Telephone Nigam.

India will hold an auction of 3G spectrum later this year, but state-run firms have already been given one slot in each service area, and will have to match the highest bid from private operators.

Third-generation services give users a chance to enjoy fast Internet access, games and a host of multimedia content from maps to music on their cell phones.

### **❖ IT Amendment Bill soft on cyber criminals: Assocham**

Claiming the Information Technology Amendment Bill 2008 to be lenient on cyber criminals, industry body Assocham (Associated Chambers of Commerce and Industry of India) said certain issues needed to be re-addressed before the Bill is enacted into legislation.

"The Information Technology Amendment Bill 2008 in Parliament got passed with unprecedented hurry, without any discussion in both the Houses. The most startling aspect of the new amendments is that they seek to make the Indian cyber law a cyber crime friendly legislation -- a legislation that goes extremely soft on cyber criminals," Assocham said in a release. It sought certain issues needed to be re-addressed before the Bill is enacted into legislation.

Given the apparent rise in technology adoption, it is increasingly being found that despite all precautions been taken, employees are still taking away confidential data from companies, the chamber said. The bill lacks in measures to provide security to data. The inability of the law to provide confidentiality to corporate and individual data and information in the electronic form are likely to complicate matters further for Indian companies and citizens, it said.

Another major failure of the bill is that it has not dealt with the issue pertaining to spam, it said.

The chamber said the bill does not address jurisdictional issues.

According to it, the amendments make it mandatory for corporates possessing, dealing or handling any sensitive personal data or information in a computer resource to maintain reasonable security practices, and procedures.

### ❖ **SEBI amends norms on preferential allotment**

The Securities and Exchange Board of India (SEBI) has amended the Disclosure and Investor Protection (DIP) Guidelines.

The market regulator has altered preferential issue norms, allowing companies to list warrants along with non-convertible debentures through qualified institution placements.

At present, DIP guidelines provide that warrants can be allotted on preferential basis, subject to the allottees paying upfront, an amount equivalent to at least 10 per cent of the price fixed, at the time of allotment of warrants. It has now been decided to enhance the upfront amount payable from 10 per cent to 25 per cent.

SEBI has also reduced the timelines for completing bonus issues to 15 days from six months where no shareholder approval is required and 60 days where the company requires shareholders' nod.

### ❖ **Specific law to protect tourists from touts sought**

Taking note of several cases of tourists being fleeced and harassed by touts, a parliamentary committee has recommended enactment of a specific law to ensure their safety.

At present, action is taken against touts under Section 151 of Criminal Procedure Code of India and Section 97 of the Delhi Police Act for creating nuisance that entails a very minor punishment.

Expressing surprise at the absence of any specific law to deal with the tout menace, the parliamentary committee on tourism said safety and security of tourists is paramount and should be looked into seriously. The committee sought to know from the Tourism Ministry about the steps taken to protect the foreign tourist from being fleeced by the touts and the kind of harassment they suffer and other such problems.

"Security and safety of tourist is our top priority and we have undertaken a series of measures to ensure the security for tourists. Recently we have launched an awareness campaign against fleecing of foreign tourists by unscrupulous elements involving noted film star Aamir Khan," said a senior tourism ministry official.

In order to curb cases of cheating and fleecing of tourists, Tourism Ministry has advised state governments to deploy tourist police at all important destinations.

The ministry has framed guidelines with the help of Home Ministry and Directorate General of Resettlement of Defence Ministry regarding formation of Tourist Security Force. Ten state governments including Andhra Pradesh, Rajasthan, Goa, UP, Himachal and Delhi have deployed tourist police in one form or other.

The committee however, feels the need for strengthening tourist police at all tourist destinations and recommends to equip tourist police with vehicles and mobile telephones. Besides tourist police must be given training in English language for providing information or guidance to tourists.

Since a lot of complaints emanate from tourists being harassed at the airport, the committee has also sought the cooperation from Civil Aviation Ministry and Airport Authority of India in dealing with the menace.

Tourism Ministry has also set up a tourist complaint cell for redressal of complaints from tourists.

## ❖ No separate licenses needed for VAS: TRAI

Telecom Regulatory Authority of India (TRAI) said no separate category of licence or registration is required for the value added services (VAS), a move that will boost the growth of mobile value-added services industry in the country.

In its 'Recommendations on Growth of Value Added Services and Regulatory Issues', TRAI said there is need for uniformity in various licences and amendment of various access service licence agreements to pave way for the growth of VAS, particularly in mobile 2G/3G and Next Generation Network environment.

"The authority has not recommended any separate category of licence or registration for value added services," it added.

The VAS market in India is expected to cross Rs 25,000 crore by the year 2009-10 and contribute over 30 per cent of the revenue of the telecom access service providers in the next five to seven years.

TRAI suggested that the definition of VAS be redefined as "value-added services are enhanced services, in the nature of non-core services, which add value to the basic tele-services and bearer services, the core services being standard voice calls, voice/non-voice messages, fax transmission and data transmission".

## ❖ SEBI relaxes takeover norms

Capital market regulator SEBI Eased takeover norms for companies whose board has been superseded by the government, under which suitors such as those for Satyam Computer need not make an open offer.

The amended rules also do disallow open offers from rival bidders if an acquirer has already made an open offer.

The regulator said the amendment to the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, provides for "relaxation from the strict compliance of provisions of Chapter-III in certain cases".

Chapter-III deals with mandatory open offer if an entity acquires 15 per cent stake in a company, as also for acquisition or change of control of the company, among others.

SEBI, on an application made by a target company, said it can relax any or more provisions of this chapter if certain conditions are met. It was referring to cases where central, state government or any other regulator having superseded the board of a company.

The regulator had earlier this month said it would relax the takeover norms to deal with cases like Satyam Computer, whose government-appointed board had sought relaxation in the acquisition rules.

The government had superseded the IT company's board after the company founder Ramalinga Raju disclosed on January 7 that he had fudged accounts for years.

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