

Stake in local companies: RBI refuses special rights to foreign investors through FDI

Sugata Ghosh, ET Bureau Jan 9, 2012, 12 52AM IST

MUMBAI: The dilemma among policymakers over allowing special rights to foreign investors acquiring strategic stakes in local companies has once again turned up like the proverbial bad penny.

Even after the government clarified that such rights, in the form of inbuilt options in [foreign direct investment](#) (FDI), are permissible, the [Reserve Bank of India](#) is unwilling to approve the practice. In eight out of 10 FDI deals, foreign investors have a right to exercise such options to sell back shares either to the local company or its promoters if certain conditions related to listing and performance are not fulfilled.

For years, the RBI has been objecting to these conditions on the ground that such inflows are foreign currency loans masquerading as foreign equity (or, FDI).

Since the RBI has the final say on all cross-border inflows, last September the commerce ministry banned options in FDI deals. The move sparked a spate of representations from private equity investors, industry lobbies and several professional advisors who mediate such deals. Amid fears that a ban could impact FDI inflows, the ministry did a volte face.

The Flip-Flop on Options

THE TIMELINE

JAN-AUG 2011

- RBI QUESTIONS** FDI deals where investors have the option to sell back shares to local owners
- INDUSTRY MINISTRY** bans such options in FDI. Private equity funds oppose the ban

SEPT 2011

- RBI FROWNS** upon options agreement in a company. Regulator thinks inflows with inbuilt options are foreign loans and not foreign equity
- MINISTRY LIFTS** ban on options fearing slowdown in FDI inflows

OCT 2011

DEC 2011

THE BACKGROUND

IN MOST FDI deals, foreign investors have the option to sell back shares to Indian owners if certain conditions related to listing and performance are not met

FOR YEARS, RBI has been objecting to these conditions saying such inflows are foreign currency loans masked as foreign equity

THE FALLOUT

- SEVERAL COMPANIES** may have to renegotiate terms with foreign strategic investors
- IT MAY** send wrong signal to foreign investors

A month later, it issued a notification lifting the ban - a decision that all concerned felt would put an end to the dispute. But in December, the RBI put a question mark on the shareholder agreement between the promoters of a domestic company and their FDI partner which was sold a put option.

The RBI came to know of the option agreement after the company approached it to complete certain documentation. Confirming the development, Nishchal Joshipura, head of M&A at law firm [Nishith Desai Associates](#), said there have been instances where the RBI raised objections even after the clarification by the [Department of Industrial Policy &](#) on the option issue. Joshipura declined to name the company due to client confidentiality.

In this case, the company concerned - a mid-sized unlisted firm - has to buy back the shares. With the RBI sticking to its earlier view, several companies may have to rework terms with foreign strategic investors.

Since options can significantly influence the pricing and size of a deal, it may also send a wrong signal to investors. "It is not a good thing in these difficult times if what has been expressly rolled back is still sought to be enforced," said H Jayesh, founder partner at law firm [Juris Corp.](#)

According to investment banking circles, the DIPP's change of stand perhaps never went down well with the regulator. Indeed, the RBI had even said earlier that a put option (or, sell-back right) is similar to over-the-counter equity derivative deals that are not backed by local law.