Regulatory Hotline

July 25, 2014

THE CURIOUS CASE OF PRICING GUIDELINES

- All pricing guidelines rationalized from DCF / RoE to “internationally accepted pricing methodologies”; and
- Partly paid shares and warrants can now be issued under automatic route subject to certain terms and conditions.

The Reserve Bank of India (“**RBI**”) this week introduced specific reforms with regard to foreign direct investments (“**FDI**”) in India. Specifically, these reforms are:

- Revision of pricing guidelines in respect of transfer / issue of shares (with and without options) to provide for greater freedom and flexibility for investors; and
- Recognition of partly paid equity shares and warrants as “eligible instruments” for the purpose of FDI and foreign portfolio investment (““**FPII**”) under the automatic route.

The reforms have been introduced through relevant amendments to the Foreign Exchange Management (Transfer or Issue of Securities to Persons Resident Outside India) Regulations, 2000 (“**TISPRO Regulations**”) and the issuance of various circulars. [1] The amendment to TISPRO Regulations for the revision of pricing guidelines can be found here and relevant RBI Circular No. 4 can be found here. The amendment to TISPRO Regulations with regards to partly paid shares and warrants can be found here and the relevant RBI Circular No. 3 can be found here.

BACKGROUND

Reflecting the evolution of pricing guidelines in line with the change in the business environment, the RBI Governor first indicated the RBI’s intention to revise the pricing guidelines with respect to FDI in his First Bi-Monthly Monetary Policy Statement where he stated that it had been decided to withdraw “*all existing guidelines relating to valuation in case of any acquisition/sale of shares and accordingly, such transactions will henceforth be based on acceptable market practices.*”[2]

The reforms relating to partly paid equity shares and warrants (under review since 2011) come as a pleasant surprise to the market, and once again will provide greater flexibility for facilitating and structuring investments in Indian companies.

POLICY EVOLUTION

Partly paid shares and warrants

Until October 1, 2010, partly paid shares and warrants under the FDI policy were not considered to be “capital” for the purpose of foreign investment. However, Consolidated FDI Circular No. 2 of 2010 (effective from October 1, 2010) stated that partly paid shares and warrants could be issued subsequent to approval by the Foreign Investment Promotion Board (“**FIPB**”). This policy underwent further change through the Consolidated FDI Circular No. 1 of 2011 (effective from April 1, 2011), which noted that the policy relating to partly paid shares and warrants was under review. This position has been maintained in consequent FDI policies as well.

Pricing Guidelines

The pricing guidelines in case of listed shares have always been based on the price of the share as on the stock exchange[3] and this continues under this present set of regulations. However, the policy on pricing guidelines with respect to unlisted shares has been amended over a period of time.

The erstwhile pricing guidelines were first introduced on May 4, 2010 via A. P. (DIR Series) Circular No.49 (“**2010 Circular**”) when the RBI did away with valuation requirements as per the Controller of Capital Issues (“**CCI**”) based guidelines and instead introduced valuation requirements based on the “Discounted Free Cash Flow” (“**DCF**”) method of valuation.

Further, earlier this year, a separate set of pricing restrictions was introduced only with regards to “FDI instruments having optionality clauses”.[4] The main clarification issued under the Options Circular stated that shares issued to non-residents with options attached thereto would be allowed to be transferred if there were no assured returns.

Specifically:

- Unlisted equity shares could not be sold at a price greater than the price arrived at on the basis of Return on Equity (“**RoE**”) as per the latest audited balance sheet;
- Unlisted compulsorily convertible debentures (“**CCD**”) or compulsorily convertible preference shares (“**CCPS**”) could be sold at a price worked out as per “any internationally accepted pricing methodology at the time of exit”.

It is not entirely clear why equity shares and convertible securities (with optionality clauses) were provided different treatment, but general market sentiment leaned towards issuance of convertible securities given the greater freedom provided to such instruments. Please see our hotline on the Options Circular and its impact, titled "Foreign Investors Permitted to Put: Some Cheer, Some Confusion" here.

Since, the Options Circular, the RBI has clarified that it would rationalize all pricing guidelines, more formally reflected in the Bi-Monthly Monetary Policy referred to above. The current set of reforms is in furtherance of this intention.

FURTHER REFORMS

Partly paid shares and warrants noted as eligible instruments

Post review by the government and the RBI, and via Circular No. 3 as well as amendments to the TISPRO Regulations, partly paid shares and warrants can now be issued to non-residents (under the FDI and the FPI route) subject to compliance with the other provisions of the FDI and FPI schemes.

With regard to partly paid shares, certain conditions need to be specifically complied with:

- Pricing of partly paid shares must be determined up front and at least 25% of the total consideration amount is required to be paid up front; and
- The remaining amount is required to be brought in within a period of 12 months of issuance.

Note: This 12 months period is not required where the issue size exceeds INR 5 billion. Further, a monitoring agency is required to be appointed (in the manner envisaged under applicable SEBI Guidelines) irrespective of whether the company is listed or unlisted, who will monitor the repatriation of monies into India within stipulated time.

For warrants, in line with the requirements of the ICDR Regulations, following are the conditions that need to be specifically complied with:

- Pricing and conversion formula / price is required to be determined up front and 25% of the total consideration is required to be paid up front; and
- The remaining amount is required to be brought in within a period of 18 months.

The price at the time of conversion should not be less than the fair value of the shares as calculated at the time of issuance of such warrants. It must further be noted that only companies in which investment can be made under the automatic route, can issue partly paid shares or warrants under this circular. For companies under the approval route, prior FIPB approval will be required to issue partly paid shares or warrants.

All partly paid shares and warrants issued under Circular No. 3 are required to be in full compliance with the Companies Act, 2013 and the Income Tax Act, 1961.

Circular No. 3 also clarifies that non-resident Indians will also be eligible to invest on a non-repatriation basis in partly paid shares and warrants in accordance with the Companies Act, 2013, applicable SEBI Guidelines, the Income Tax Act, 1961 and Schedule 4 to the TISPRO Regulations (which deals with investment by NRIs on a non-repatriation basis).

Circular No. 3 does not specify the consequence of not bringing in the remaining monies (with regard to partly paid shares / warrants) within the above mentioned period. However, as specified under the SEBI regulations, it would likely result in "forfeiture" of the partly paid shares or warrants, although operational details in this regard will need to be specified.

Revised Pricing Guidelines

The DCF based pricing guidelines till date were set out in the 2010 Circular. The pricing guidelines with respect to securities having options, based on RoE, were set out in Regulation 9 of the TISPRO Regulations read with the Options Circular.

Circular No. 3 and Circular No. 4 and the amendments to the TISPRO Regulations have revised the pricing guidelines to be as follows:

DESCRIPTION	PREVIOUS PRICING GUIDELINES	CURRENT PRICING GUIDELINES
Issue of shares	*For listed securities:* Price worked out in accordance with the ICDR Regulations issued by the Securities and Exchange Board of India ("**SEBI Guidelines**") *For unlisted securities:* Issue price to be **not less than** the fair value of shares determined as per DCF method.	*No amendment to this provision.* *For unlisted securities*: Issue price to be **not less than** fair value of shares as per any internationally accepted pricing methodology for valuation of shares on arm's length basis.
Transfer of shares from resident to non-resident **(R to NR)**	*For listed securities:* Transfer price to be **not less than** price at which a preferential allotment of shares can be made under the SEBI Guidelines; *For unlisted securities:* Transfer price to be **not less than** fair value of shares determined as per DCF method.	*For listed securities:* *No amendment to this provision.* *For unlisted securities:* Transfer price to be **not less than** fair value worked out as per any

on Simplification of registration for FPIs

September 26, 2024

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996

September 22, 2024

		internationally accepted pricing methodology for valuation of shares on arm's length basis.
Transfer of shares from non-resident to resident (**NR to R**)	*For listed securities:* Transfer price to be **not more than** price at which a preferential allotment of shares can be made under the SEBI Guidelines;	*For listed securities:* *No amendment to this provision.*
	For unlisted securities: Transfer price to be **not more than** fair value of shares determined as per DCF method.	*For unlisted securities:* Transfer price to be **not more than** fair value worked out as per any internationally accepted pricing methodology for valuation of shares on arm's length basis.
Transfer of equity shares **having optionality clause*** **Kindly refer to our analysis on scope of optionality clauses below.*	*For listed securities:* Transfer price to be the market price prevailing at recognized stock exchange where shares are listed.	*For listed securities:* *No amendment to this provision.*
	For unlisted securities: Transfer price to not exceed price arrived at on the basis of RoE as per latest audited balance sheet.	*For unlisted securities:* Transfer price to not exceed price arrived at as per any internationally accepted pricing methodology on arm's length basis.
Transfer of convertible securities **having optionality clause*** **Kindly refer to our analysis on scope of optionality clauses below.*	Transfer price to be price as worked out as per any internationally accepted pricing methodology on arm's length basis at the time of exit.	Transfer price to not exceed price arrived at as per any internationally accepted pricing methodology on arm's length basis.

As we have noted above, the pricing guidelines for listed securities have been mostly left unchanged. Although a case could be made for a more liberal pricing regime when listed securities are traded off the floor / or through off market transactions where value may be a product of negotiation. It is however, equally arguable that off market transactions also have an impact on the market and therefore should be subject to the same pricing regime.

GUIDING PRINCIPLES

As required before, all pricing must be duly certified by a chartered accountant or a SEBI registered merchant banker, and should be adequately disclosed in the financial statements of the company.

The fundamental principle to the newly issued pricing guidelines is that a non-resident investor should not be guaranteed any assured exit price at the time of making of such investment or entering into the investment agreement.

It must further be noted that for optionality based instruments the conditions relating to lock-in for one year or minimum lock-in period relating to the activity (if applicable) shall continue to apply.

WHAT DOES "OPTIONALITY CLAUSE" MEAN?

Although the above mentioned reforms go a long way in rationalizing the pricing guidelines applicable to FDI investments / disinvestments, there is still some ambiguity with regard to certain transfer permutations.

First, it is not clear if this "optionality" reference applies only to 'put options' or if it also applies to other forms of exits as well. Second, a plain reading suggests that even holding securities which have an option / right to exit at an assured return irrespective of the counter party for such rights, is not allowed under exchange control law since such instruments have been classified as "ineligible instruments".

Given that quite a few foreign investors in India currently hold multiple avenues for exit, this clarity will help provide certainty to not just investors but also to investee entities and promoters.

DOING AWAY WITH DCF

In a move that will only boost foreign investor sentiments, the revised pricing guidelines will definitely provide investors (and Indian companies) more freedom and flexibility to negotiate investment / disinvestment transactions based on commercials agreed between parties.

One of the issues with the DCF based pricing guidelines was the dependency on the company for arriving at an accurate valuation. Inputs relating to cash flow projections, current and potential working capital amounts, capital expenditure and other items to determine an appropriate discount factor to cash flows needed extensive company inputs. This left a shareholder in a company relying on the company cooperation to arrive at an accurate amount which was not always available. Under the revised pricing guidelines, fair value can be arrived at without necessarily having to rely on extensive company inputs. This allows investors to determine the fair value and exit even where the company is not cooperating.

Another disadvantage of the DCF based pricing guidelines, (highlighted in our then hotline titled "RBI revises pricing norms for foreign investments" which can be found here) was that the DCF based methodology for fair valuation restricted the valuer from basing his valuations on the assets approach or the market comparables approach. This was particularly problematic in industries with long gestation periods, or for distressed companies which had huge assets in their books but did not anticipate any future cash flows. This is no longer an issue.

UNDERSTANDING "INTERNATIONALLY ACCEPTED PRICING METHODOLOGY AT ARM'S LENGTH"

An important item for consideration is potential disputes regarding pricing methodologies for agreements which refer to exits, purchase or sale at "fair market value". If an agreement does not specifically state which methodology is to be considered, under the revised pricing guidelines it would be possible for parties with conflicting interests to obtain valuations under different pricing methodologies and arrive at completely different (and yet completely justifiable) "fair market values" for the same asset.

A view can, however, be taken that for existing agreements entered into till May 2010 (the date of the 2010 Circular) that CCI based pricing methodology would be applicable, and for agreements entered into after 2010 but before July 15, 2014 (i.e. the date of Circular No. 4) that DCF based pricing methodology would be applicable. But going forward, it would be advisable to ensure that both parties agree to a pricing methodology up front in order to avoid potential disputes at the time of exit.

IFRS 13 "Fair Value Measurement" which sets out the IFRS standards for measuring fair value identifies two broad approaches to fair valuation: (a) market based approach; and (b) income based approach.

Under market based approach, IFRS outlines two techniques, identical / similar instrument technique and comparable company valuation multiples technique. Whereas under income based approach, the DCF technique figures along-side dividend discount model, constant-growth dividend discount model and capitalization model.

In all cases, both IFRS and generally, it must be noted that the choice of a valuation technique is a decision based on the peculiar facts and circumstances of a given transaction, sector and nature of the investee entity. It is likely that now onwards, most investment documents will clearly lay out the methodology which the parties agree to be the "internationally accepted pricing method" for arriving at fair valuation instead of leaving it ambiguous given the potential connotations under the new pricing regime.

Previously, in transactions between related parties, since transfer pricing guidelines (under tax law) were also applicable, share transfers/subscriptions between related parties resulted in the requirement for pricing studies to determine 'arm's length price' that were different from the DCF valuation which was undertaken for exchange control purposes. The liberalization may also mean that a singular study analyzing and concluding the fair valuation at arm's length could be used for both tax and exchange control purposes.

CONCLUSION

The biggest uncertainty for partly paid shares and warrants has always been as to when the balance amount will need to be brought in. By requiring that the full pricing for the partly paid shares and warrants be fixed up front and brought in within 12 and18 months, respectively, the RBI has ensured some comfort is afforded to both the company issuing the securities and the subscriber. This flexibility also enables structuring of earn-outs, post buy-out incentive payments to management and in structuring re-ups.

This full scale revision of pricing guidelines continues the RBI's evolution with regards to how it seeks to regulate transfer / issuance of securities of Indian companies by / to FDI investors. Where previously, cross border transactions were heavily regulated and monitored by the RBI, we are looking at a shift which provides greater freedom and respects party autonomy.

By entrusting valuation intermediaries like chartered accountant and merchant bankers with the right to guide parties to fair valuation based on facts and circumstances of each transfer, the RBI also follows through on the general trend in modern Indian commercial laws where regulatory bodies' are looking to delegate more and more operational regulation to intermediaries.

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You can direct your queries or comments to the authors

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[1] Specifically, relevant circulars are A.P.(DIR Series) Circular No.3 dated July 14, 2014 ("**Circular No. 3**") and A. P. (DIR Series) Circular No. 4 dated July 15, 2014 ("**Circular No. 4**").

[2] Para 24, Reserve Bank of India, Dr. Raghuram G. Rajan, Governor, First Bi-monthly Monetary Policy Statement, 2014-15, April 1, 2014 available at http://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=30911 (last visited on July 17, 2014)

[3] Pricing guidelines are as prescribed by the Securities and Exchange Board of India ("**SEBI**") (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR Regulations**") in case of preferential allotment

[4] Reserve Bank of India, Foreign Direct Investment- Pricing Guidelines for FDI instruments with optionality clauses, A.P. (DIR Series) Circular No. 86 dated January 9, 2014 ("**Options Circular**"). Please note that TISPRO Regulations were also amended in furtherance of the Options Circular.
