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INTRODUCTION

The current issue of Legal Eye gives an update on the recent material developments in the area of securities laws in India. Three important developments in recent times have been analyzed. The first article pertains to Multi Class Fund Structures which fall under the FII regulatory framework. This is followed by an analysis of the implications of a recent case concerning restrictive covenants in Shareholders' arrangements. The last article in this edition gives a gist of the AAR's ruling in the E*Trade case.

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» CORE INVESTMENT COMPANIES

Introduction

Ordinarily, in order to identify a particular company as a non-banking financial company (" NBFC"), Reserve Bank of India (" RBI") considers both, the assets and the income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. 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 financial assets are more than 50 per cent of the gross income. Both these tests are required to be satisfied as the determinant factor for principal business of a company.

Whilst the parameters for determining whether a company is a NBFC or not is defined above, however, in the past, there has always been a lack of clarity whether investment holding companies (i.e. companies which hold shares of group companies) are considered as NBFCs and whether the laws, rules and regulations applicable to NBFCs are applicable to such investment holding companies. There have been instances where when approached for clarification, RBI granted exempted to companies from seeking registration and in some cases such companies were directed to seek certificate of registration from RBI.

In view of systemic implications of access to public funds, directly or indirectly, by such investment holding companies, RBI has decided to bring such companies under RBI's regulatory framework as well. Therefore, RBI has recently on April 21, 2010 proposed a regulatory framework for such investment holding companies

which have been categorized as ' Core Investment Companies' (" CICs").

Regulatory Framework
All CICs having an asset size of Rs.100 crore or more will be considered as Systemically Important CIC and would be required to obtain registration from the RBI, even if they have been advised to the contrary in the past. Additionally, such CICs would also need to ensure that:

- 90% of their total assets should be in investments in equity, debt, or loans in group companies, provided investments in equity shares of group companies is not less than 60% of total assets;
- they should not trade in shares except for block sale to dilute or divest their holding and should not accept or hold public deposits;
- they should not carry on any other financial activities except investments in bank deposits, government securities, loans to and investments in debt issuances of group companies, or guarantees issued on behalf of group companies;

The guidelines also prescribe a minimum capital ratio of 30% and also restrict the ability of Systemically Important CICs to leverage its balance sheet beyond 2.5 times its adjusted networth. However, Systemically Important CICs may be exempted from statutory minimum net owned fund requirement as applicable to NBFCs and adhering to "NBFCs Prudential Norms Directions, 2007" including requirements of capital adequacy and exposure norms.

CICs not regulated
CICs with asset size of less than Rs 100 crore are exempted from registration provided 90% of their total assets are in investments in shares of investee companies for the purpose of holding stake in the said investee companies.

Issues
Since now Systemically Important CICs will come under the purview of RBI, the guidelines have resolved the prevalent confusion of whether CICs are governed by the RBI or not. However, following provisions of the guidelines have attracted the criticism of experts:

(i) CICs meeting the prescribed conditions may be exempted from net owned fund requirement and the prudential norms. This means such CICs would have to apply to RBI in order to avail exemptions. There do not seem to be a reason in having this additional requirement, when a detailed regulatory framework has already been provided for.
(ii) The regulations provide that investment in equity shares of Group companies for the purpose of holding stake in these companies should not be less than 60% of total assets. The terminology ' equity shares' used here is too narrow and it should be widened to include all other equity instruments which come under the basket of equity like convertible preference shares, convertible debentures, warrants etc. and not only equity shares.
(iii) CICs are restricted from trading except by way of block trade. If the intention is to ensure that there should be no trading, then it could be accomplished even without restricting it only to block trade. It should also include trades such as bulk trade, negotiated deals, private arrangements etc.
(iv) The restriction on debt:equity ratio of 2.5 is too low for industries like infrastructure where typically there is a holding company structure.
(v) It is not clarified if these guidelines would apply to CICs whose do not meet both the test for NBFCs, i.e. financial assets to be 50% of total assets and income from financial assets to be more than 50% of total income.

It is expected that RBI will take into account these issues whilst coming up with formal laws regulating the CICs.

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» INFRASTRUCTURE FINANCE COMPANIES

Introduction

Till recently, non-banking finance companies ("NBFCs") were categorized in 3 categories, i.e. Asset Finance Companies, Investment Companies and Loan Companies. In view of the critical role played by certain NBFCs in providing credit to the infrastructure sector, Reserve Bank of India ("RBI") has vide its notification dated February 12, 2010 introduced a fourth category of NBFC called Infrastructure Finance Companies ("IFC").

Criterion

IFC has been defined as a non deposit taking NBFC that fulfills the following criteria:

- Minimum of 75 per cent of its total assets should be deployed in infrastructure loans as defined in Para 2(viii) of the Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 ("Directions");
- Net owned funds of Rs. 300 crore or above;
- Minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA or equivalent rating by any other accrediting rating agencies; and
- CRAR of 15 percent (with a minimum Tier I capital of 10 percent).

The Companies satisfying the above conditions are required to get their certificate of registration amended by the RBI, by incorporating a reference to 'infrastructure finance company' therein.

Relaxation for IFCs

Whilst IFCs are required to adhere to the Directions, IFC's can exceed the concentration of credit norms as provided in paragraph 18 of the said Directions by 10% of its owned fund in lending to a single borrower, or by 15% in lending to a single group of borrowers; and in lending to and investing in (loans/investments taken together) a single party by 5% of its owned fund and in a single group of parties by 10% of its owned fund.

RBI has also stated that the banks' exposures to IFCs will henceforth be risk weighted as per the ratings assigned to an IFC by the rating agencies registered with the Securities and Exchange Board of India and accredited by the RBI. Further with a view to encouraging larger flow of funds to infrastructure sector, the exposure of a bank to IFCs has been enhanced up to 20 per cent of its capital funds.

RBI has permitted the IFCs to avail of ECBs, upto 50% of their owned funds under the automatic route, subject to their compliance with the prudential guidelines already in place. However, ECBs above 50% would require the approval of the Reserve Bank and will, therefore, be considered under the approval route.

As per the extant policy, domestic Rupee denominated structured obligations have been permitted to be credit enhanced by non-resident entities under the approval route. In view of the growing needs of funds in the infrastructure sector, the existing norms have been reviewed and RBI has vide A.P. (DIR Series) Circular No. 40 dated March 2, 2010 decided to put in place a comprehensive policy framework on credit enhancement to domestic debt raised through capital market instruments such as bonds and debentures, by Indian companies engaged exclusively in the development of infrastructure and by IFCs. Such credit enhancement is subject to following conditions:

- Credit enhancement will be permitted to be provided by multilateral / regional financial institutions and Government owned development financial institutions;
- The underlying debt instrument (i.e. bonds or debentures) should have a minimum average maturity of seven years;
- Prepayment and call / put options would not be permissible for such debt instruments up to an average maturity period of 7 years;
- Guarantee fees and other costs in connection with the credit enhancement arrangement not to exceed 2 percent of the principal amount involved;

- Where the guarantor is required to meet the liability, a new loan will effectively come into existence between the Indian issuer and the guarantor.
- On invocation of the credit enhancement, if the guarantor meets the liability and if the same is permitted to be repaid in foreign currency, the all-in-cost ceilings specified under the ECB Policy would apply to such novated loans. On the other hand, if such a loan will be serviced in Indian Rupees, the applicable rate of interest would be the higher of (i) the coupon of the bonds or (ii) 250 basis points over the prevailing secondary market yield of 5 year Government of India security, as on the date of novation;
- As with any foreign currency borrowings contracted by an IFC, IFCs will be required to fully hedge their foreign currency exposures under such novated loans; and
- Reporting requirements under the ECB Policy would apply to such novated loans.

Conclusion

Amendments to the Directions vis-à-vis IFCs would enable IFCs to provide a higher credit facility to a borrower in the infrastructure sector and relaxation would ensure that the need to fund large capital requirements entails in development, operations and maintenance of an infrastructure project.

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» CONSOLIDATED FDI POLICY

Introduction

Foreign direct investment (“ FDI”) laws in India have been the most complex laws with the policies being framed by the Department of Industrial Policy and Promotions (“ DIPP”) through Press Notes, Press Releases and Circulars. In turn, the Reserve Bank of India (“ RBI”) has the responsibility of implementing the policy by framing regulations in that regard under the umbrella of Foreign Exchange Management Act, 1999. The DIPP has now issued Circular No. 1 of 2010 with effect from April 1, 2010 (“ Circular”) with the objective of consolidating all the prior policies / regulations on foreign direct investment (“ FDI”) in India. The Circular reflects the current policy framework on FDI prevailing as on March 31, 2010.

Intent and Objective

All earlier press notes / press releases / circulars / clarifications on FDI issued by DIPP which were in force and effective as on March 31, 2010 stand rescinded as on March 31, 2010. The Circular has subsumed all press notes / press releases / circulars / clarifications on FDI as on March 31, 2010. The Circular has consolidated/compiled a comprehensive list of most matters on FDI, but has made any policy changes in the present FDI policy. The Circular consolidating FDI policy has been issued as an investor friendly measure with a 6 months sunset clause. An updated consolidated FDI policy will be issued by DIPP every six months and such updated circular to be next issued on September 30, 2010 will supersede the Circular.

Clarifications by the Circular

1. *‘ Capital’ Defined*. The Circular has categorically stated that the term ‘ Capital’ for the purpose of FDI shall mean equity shares; fully, compulsorily and mandatorily convertible preference shares; and fully, compulsorily and mandatorily convertible debentures. Any other instrument including warrants, partly paid shares are not considered as ‘ capital’ and cannot be issued to a person resident outside India. The DIPP seem to have now banned the issuance of partly-paid shares and warrants. However, recently, there have been instances

where Foreign Investment Promotion Board has considered and approved the issuance of partly-paid shares to persons resident outside India.

2. *Dominance of RBI Regulations*. Whilst the Circular consolidates the FDI policy framework, the DIPP has clarified that in case there is a need or scope of interpretation on FDI policy, the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("RBI Regulations") issued by Reserve Bank of India shall prevail. Having said that, we expect RBI to come up with amendments to the RBI Regulations to bring it in sync with the FDI policy particularly to introduce the manner of computation of indirect foreign investment, downstream investment by operating companies, operating-cum-investing companies and investing companies, requirement for FIPB approval for establishing an Indian company to be owned and controlled by a person resident outside India or transfer of ownership and control from a resident to a person resident outside India in sectors having sectoral caps etc.

3. *FII investment under FDI Scheme*. Earlier there was a general perception that FIIs can invest in an Indian company under the FDI Scheme subject to applicable sectoral caps/regulations. However, the Circular now clarifies that the limits on FII investments in a company under the portfolio investment scheme as specified under Schedule 2 of RBI Regulations, that is 10% by an individual FII and 24% for all FIIs put together, shall also apply to investment by an FII under the FDI Scheme. Whilst Schedule 2 of RBI Regulations provides that the ceiling of 24% may be increased upto the sectoral cap/statutory ceiling by passing a special resolution of the shareholders of a company, the Circular is silent on this aspect for the purpose of FDI investments by FIIs.

4. *Pricing of instruments to be determined upfront*. The Circular provides that the pricing of the capital instrument should be decided / determined upfront at the time of issue of the instruments. Whilst pricing of equity shares is determined upfront at the time of issue of such shares by an Indian company to a person resident outside India, it has been a common practice to defer the determination of conversion ratio of compulsorily convertible instruments to a later date based on future PAT / EBIDTA of the company. However, the Circular seems to indicate that the conversion price/ratio for convertible instruments will have to be determined upfront at the time of issuance, thus ceasing the ability of investors in venture capital undertakings to determine their stake in such undertakings based on performance thereof.

5. *FDI in Trusts*. The Circular categorically states that FDI in Trusts other than venture capital funds is not permitted. Thus, subject to RBI Regulations and the FDI policy, a SEBI registered FVCI can invest in domestic venture capital fund registered under the SEBI (Venture Capital Fund) Regulations, 1996. It has been clarified that where the SEBI registered FVCI invests in an entity undertaking venture capital fund activity which is registered as a Trust under the Indian Trust Act, 1882, such investment will be subject to prior FIPB approval.

6. *Investment in 'Same Field'*. Fresh foreign direct investments / technology transfer / trademark agreement would be subject to 'existing venture / tie-up condition' and will

require prior FIPB/Project Approval Board approval only where the foreign investor has an existing joint venture / technology transfer / trademark agreement in the ‘ same field’ which had materialized prior to January 12, 2005. The Circular clarifies that the FDI policy is expected to protect the interest of the joint venture partner where such agreements have been entered prior to January 12, 2005. Thus, future investments / tie-ups in India in the ‘ same field’ by foreign investors who have entered into ventures / tie-ups with Indian partners post January 12, 2005 will be subject to commercial understanding / agreements between the parties and will no longer require intervention by the Government.

7. *Cash & Carry Wholesale Trading*. Whilst Circular has defined cash & carry wholesale trading / wholesale trading, it has clarified that the yardstick to determine whether the sale is wholesale or not would be the type of customers to whom the sale is made and not the size and volume of sales. The FDI policy requires that a sale to be classified as ‘ wholesale’ should be made only to entities having either business registrations or trade licenses or being a company, registered society or registered trust. It has been clarified that wholesale trade to group companies should not exceed 25% of the total turnover and such sale to group companies should be for internal use only. However, there is no clarity as to what would constitute a ‘ group’ company. It is expected that DIPP will soon come up with clear definition of what constitutes ‘ group’ under the FDI policy.

8. *Construction development activities*. The guidelines governing FDI in townships, housing, built-up infrastructure and construction-development projects as prescribed in Press Note 2 of 2005 imposed obligations upon the investor to obtain all necessary approvals. Now the Circular has imposed these obligations on the investor/investee company. It means approval may be obtained by any of them. The powers given to investee company to obtain the necessary approvals may give more flexibility in the investments in construction development activities

Conclusion

The Circular compiles all the statutory provisions governing FDI in one document giving more transparency and less regulatory burden to the investors. Also the clarification of several issues which were never addressed before removes ambiguity regarding those issues. However there are still couple of issues which awaits clarity, such as:

- foreign investment in Limited Liability Partnerships;
- policy on issuance of partly paid shares / warrants; and
- clarifications on issues arising out of policy on downstream investments.

It is understood that when a decision is taken by the Government on these issues, such decisions would be announced and thereafter incorporated into the Consolidated Press Note subsequently.

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» PROPOSED CHANGES IN ARBITRATION AND CONCILLIATION ACT ’ 96

Introduction & Objective

On recommendations of the Law Commission, Chairman Justice B.P. Reddy through the 176th Law Commission Report, Law Ministry (" Ministry") released a consultation paper on the amendments to the Arbitration and Conciliation Act, 1996 (" Act") detailing recommendations to overhaul the Act. The idea behind these proposed changes is " to resolve disputes at the earliest" .

Proposed Important Amendments in the Act

Whilst there are number of amendments proposed to the Act, important amendments proposed by the Ministry are discussed below:

- Section 2(2) – Scope of application of Part I of the Act. The Supreme Court in the case of Bhatia International v. Bulk Trading, (2002) 4 SCC 105, categorically held that " the provisions of Part I would apply to all arbitrations and to all proceedings relating thereto. Where such arbitration is held in India the provisions of Part I would compulsorily apply and parties are free to deviate only to the extent permitted by the derogable provisions of Part I. In cases of international commercial arbitrations held out of India provisions of Part I would apply unless the parties by agreement express or implied, exclude all or any of its provisions. In that case, the laws or rules chosen by the parties would prevail. Any provision, in Part I, which is contrary to or excluded by that law or rules will not apply."

  Existing Section 2(2) in Part I of the Act reads as follows: " This part shall apply where the place of arbitration is in India" . There are conflicting views of the Courts about the applicability of Part I in respect of international commercial arbitration, where the seat of arbitration is not in India. In the case of Shreejee Traco (I) Pvt. Ltd. v. Paper Line International Inc (2003) 9 SCC 79, it was held that Sec 2(2) is clear and unambiguous and excludes the application of Part I to any arbitration outside India. However, In Venture Global Engineering v. Satyam Computer Services Limited, (2008) 4 SCC 190,the Supreme Court, following the Bhatia International decision, held that Part I of the Act does apply to foreign awards and parties may make an application under Section 34 of the Act to set aside such awards.

  In order to curtail interference from the Courts and to remove the conflict of opinions of the courts, the Paper proposes to amend Section 2(2) of the Act as" (2) This part shall apply only where the place of arbitration is in India. Provided that provisions of section 9 and 27 shall also apply to international commercial arbitration where the place of arbitration is not in India, if an award made in such place is enforceable and recognized under Part II of this Act."

  Thus, the proposed amendment seeks to exclude the applicability of all the provisions of Part I of the Act except for Section 9 (Application for interim reliefs) and Section 27 (Court Assistance in taking evidence) for arbitrations held outside India. Further, from the reading of the provision, it appears that Parties cannot contract out of Section 9 and Section 27 of the Act.

- Amendment in Section 11 (Appointment of Arbitrators). Under the current Act, the power to appoint an arbitrator is vested in the Chief Justice of the Supreme Court (for international arbitration), or the Chief Justice of the High Court (for domestic arbitration). A Constitution Bench consisting of five Judges in Konkan Railway Corp. Ltd. v. Rani Construction (P) Ltd. (2002) 2 SCC 388 held inter-alia that the order of the Chief Justice or his designate under section 11 nominating an arbitrator is not a adjudicatory order and that neither the Chief Justice nor his designate acts as a Tribunal and hence any order passed by them cannot be a subject matter of appeal by Special Leave under Article 136.

  In case of SBP Co. v. Patel Engineering Ltd, (2005) 8 SCC 618, Supreme Court held if an order passed by the Chief Justice of the High Court or by the designated Judge of that Court is a judicial order, an appeal will lie against that order only under Article 136 of the Constitution to the Supreme Court. However, there can be no appeal against an order of the Chief Justice of India or a Judge of the Supreme Court designated by him while entertaining an application under Section 11(6) of the Act. To remove these contradictions, it is proposed in the consultation paper to vest these powers in the Supreme Court and High Court itself, rather than to the

Chief Justices of these institutions.

Further the Paper proposes to introduce two sub-sections describing as under:

1. Sub-section 13 – The consultation paper has tried to shift to institutional arbitration instead of ad hoc arbitration.
2. Sub-section 14 – Speedy disposal of the matter within 60 days from the date of service of notice on the opposite party should be done.

· Amendment of Section 28 (Rules applicable to substance of dispute). In the case of ONGC v. Saw Pipe Limited, AIR 2003 SC 2629, the Supreme Court held that if the award is contrary to the substantive provisions of law or the provisions of the Act or against the terms of the contract, it would be patently illegal, which could be interfered under Section 34. To establish this position, the paper proposes to amend Section 28(3) to " In all cases, the arbitration tribunal shall take into account the terms of the contract and trade usage applicable to the transaction."

- Amendment of Section 34 (Application for setting aside arbitral award). Under Section 34 (2)(b)(ii) of the Act, the term ' public policy' should be given a broader meaning, was held in the ONCG case by the Supreme Court. In the matter of Renusagar Power Plant Co. Ltd. v. General Electric Co., AIR 1994 SC 860, the court accedes that " it is for the Parliament to provide for limited or wider jurisdiction of the court in case where award is challenged" , it still holds that, in its view, a wider meaning is required to be given to the phrase " public policy of India" so as to " prevent frustration of legislation and justice" . To nullify the effect of this case, the Paper proposes to insert Explanation II to Section 34 and narrow the scope of public policy as a ground for setting aside an award. Accordingly, an award will be considered to be in conflict with public policy only when it conflicts with the following:

  1. the fundamental policy of India; or
  2. an interest of India; or
  3. justice / morality.

  The proposed amendment also seeks to harmonize Section 34 with that of Sections 13 (Challenge procedure) and 16 (Competence of arbitral tribunal to rule on its jurisdiction) of the Act by proposing insertion of an additional sub-clause under Section 34, one that provides a ground of challenge to an award on the basis of rejection of a plea of bias under Section 13 of the Act as well on the ground of lack of jurisdiction under Section 16.

  Further a new section 34 A, is proposed to be inserted reiterating the court' s order as an additional ground to challenge a domestic award on patent and serious illegality.

- Substitution of Section 36 (Enforcement of the Award). The Act provides for automatic stay of enforcement of the award, once an application is made to set aside the award under section 36 of the Act. This has resulted in the misuse and frustration of the provision whereby the party filing an application does so only for the purpose of delaying the execution of the award. To have this practice discontinued, the consultation paper proposes to substitute Section 36. The substituted section will provide that while granting stay of the operation of the award, the Court may also grant interim measures to protect the interests of the party in whose favour the award is passed.

- Insertion of new Chapter IXA for arbitration related to commercial disputes of high value. This new chapter provides for establishment of Commercial Division which will also entertain applications under Section 34 (Application for setting aside arbitral award) and Section 36 (Enforcement) and appeals under section 37 (Appealable Orders) of the Act where the arbitration relates to " Commercial Disputes" of specified value, for speedy disposal. For this purpose, consequential amendment to the definition of ' Court' in Section 2 of the Act is also being proposed. For this purpose, the Lok Sabha has passed the Commercial Division of High

Courts Bill, 2009.

Conclusion

Ministry has invited comments on the aforementioned clauses which are proposed to be introduced in the Act. The objective of these changes is ' speedy disposal of commercial disputes' for growth and development in the Indian economy. The proposed amendments will also minimize court intervention and will also promote the institutional arbitration.

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