

Corpsec Hotline

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BLOCKING THE PREFERRED ROUTE: RESTRICTION ON USE OF PREFERENCE SHARES FOR FOREIGN INVESTMENTS

In a move that could significantly alter the manner in which foreign investments ("FI") into India are structured, the Ministry of Finance, Government of India, through its press release dated April 30, 2007 ("**Press Release**"), directed that all preference shares, other than compulsorily convertible preference shares, viz. non-convertible, partially convertible or optionally convertible preference shares, issued on or after May 1, 2007 ("**Effective Date**"), would be regarded as **debt** and not share capital for the purposes of investment into India and therefore issuance or transfer of the same would be subject to the terms and conditions of the **external commercial borrowing ("ECB")** guidelines. It further stipulates that all compulsorily convertible preference shares issued or transferred to foreign investors would now be aggregated with equity shareholding for determining the sectoral caps as provided in the extant FI policy of India, with effect from the Effective Date.

Further, in terms of the Press Release, any foreign investment, prior to the Effective Date, in non-convertible, partially convertible or optionally convertible preference shares would not be calculated along with equity shares for determining the sectoral caps **until** such preference shares reach their maturity.

Background

Prior to the Press Release, for the purposes of the regulations related to foreign exchange and FI, all types of preference shares were considered a part of the share capital of a company, pursuant to the Companies Act, 1956, and were not considered to be under the purview of the ECB guidelines and the caps, eligibility and end use restrictions as provided therein.

Though a great amount of FI in India happens by way of investment into the equity capital of a company, because of the treatment of preference shares as share capital and the flexibility afforded by the same, optionally convertible preference shares became a popular instrument for the purpose of FI into India. This was especially so since preference shares have priority over equity shareholders upon winding up, earn a fix rate of dividend and constitute a part of the share capital of a company and were also not equated with ECBs (which is essentially debt), promoters and foreign investors alike, have been amenable to the use of preference shares to structure investments into India resulting in a win-win situation. This was particularly true about investments made by private equity and venture capital investors, who have been regularly using preference shares in order to achieve the complex structures.

Implications of the Press Release

- Due to optionally convertible, non-convertible or partially convertible preference shares, issued or transferred on or after the Effective Date, being regarded as ECBs, the ECB guidelines shall be applicable to such an issuance or transfer and compliance with its provisions, including provisions such as borrower and lender eligibility, end-use restrictions, all-in-cost restrictions and minimum average maturity, limits on the maximum amounts being payable as dividends (which would now be lower than the ones earlier payable on preference shares) would become mandatory.

Moreover, ECB guidelines also permit pre-payment of ECBs only to the extent of USD 400 million for this financial year (i.e. April 1, 2007 to March 31, 2008) without the prior approval of the Reserve Bank of India.

- This move may affect the investment structures for FI, especially ones that are devised for private equity and venture capital investors and although remote, there may be a possibility of a reduction in the amount of FI into India in the short to medium term due to the new regulations.

In view of the above, we await the formal press note and any rules and regulations attendant thereto and indications of the manner in which this policy could evolve in the future.

Sources: **Press Note - Guidelines for Foreign Investment in Preference Shares**

- **Diptee Deshpande & Ruetvej Pandya**
You can direct your queries or comments to the authors

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based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

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