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Valuation under FEMA

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1. Introduction

- Foreign Direct Investments (FDI) is considered as a major source of non-debt financial resource for the economic development by bringing in long term sustainable capital.

- India is playing an increasingly more important role in global economic growth and has emerged out as one of the most beneficial and safe destinations in the whole world for FDI.
- As per quarterly fact sheet on Foreign Direct Investment published quarterly by Department for Promotion of Industry and Internal Trade (DPIT), Ministry of Commerce & Industry, Government of India, the inflows of foreign investment in India during fourth quarter of financial year 2021-22 (January, 2022 to March, 2022), India received the FDI inflow of USD 15,599 million,
- Different sectors have received different amount of FDI over the period of time also the state wise distribution of FDI is skewed towards metro cities.

FDI Inflow in Different Sectors in FY 2021-22

S.No	Sectors	% of FDI Inflow
1	Computer Software	35%
2	Service Sector	17%
3	Automobile Industry	17%
4	Trading	11%
5	Construction Development	8%
6	Metallurgic Industry	5%
7	Drugs& Pharmaceuticals	3%
8	Chemicals (Other Than Fertilizers)	2%
9	Telecommunication Sector	2%

- With effect from 15th October 2019, powers to regulate capital account transactions with regard to Non-debt Instruments have been transferred from Reserve Bank of India (RBI) to the Central Government.
- Pursuant to the transfer of powers, the Government has issued Foreign Exchange Management (Non debt Instruments) Rules, 2019 (NDI Rules) with effect from 17th October 2019.
- The foreign investment can come in India in various modes as specified in NDI Rules. The Foreign Direct Investment can come in India subject to:

❑ Entry Routes.

❑ Sectoral Caps

❑ Investment Limits

❑ Relevant Conditions and

❑ Pricing Guidelines,

- The pricing guidelines in the Rules are framed with the objective of conserving the Foreign exchange of the country.

2. Pricing Methodology

2.1 Pricing Methodology To Be Followed:

As per the NDI Rules, the allotment/transfer of shares/convertible debentures to/by non-residents can be as per the pricing guidelines prescribed by the RBI only.

2.2 Present Prescribed Pricing Methodology:

The present prescribed pricing methodology is that the share/convertible debentures can be valued by using any internationally accepted pricing methodology What is Considered as internationally accepted pricing methodology has not been described therefore, the price may be arrived at by using Market Approach, Asset Approach or Earning Approach as decided between the parties at the time of entering into agreement. if any.

It may be seen that trust has been placed on the intermediaries like chartered accountant/merchant bankers to come at the fair value of shares issued under their certificate.

2. Pricing Methodology

2.3 The RBI Guidelines Issued For Fema Purposes Only: (Case Law)

RBI guidelines issued for FEMA purposes only not relevant for computing capital gains under the Income Tax Act [Zeppelin Mobile System GmbH. v Add DIT 2013) Del Tribunal)]. The brief facts of the case are discussed below:

- Zeppelin Mobile Systems Gmbh Germany sold part of its investment in its Indian subsidiary at the rate of INR 390 per share. As per the valuation carried out under the RBI guidelines for FEMA purposes, the value per share came to INR 400 The Assessing Officer (AO) computed capital gains after making an addition of INR 10 per share, e assessing the sale consideration at INR 400 per share.
- The Tribunal held that the duly to examine the compliance or otherwise of the RBI guidelines lay within the purview of authorized dealer banks and not the Income Tax Authorities. The RBI guidelines are relevant for remittance only and are not biding under the Income Tax Act, 1961. Even if any violation was observed, the appropriate course of action for the Income Tax Authorities would be to bring it to the notice of the banks and no further.
- In the present case, no such objection of violation of the said clause was raised to the rate of INR 390 per share by the RBI and the approval was obtained from the RBI. If the RBI guidelines would have been violated, the approval would not have been given to it. Thus, the Tribunal rejected the Revenue's contention and directed the AO to compute the capital gains after taking into consideration the sale price actually agreed between the parties an approved by the RBI.

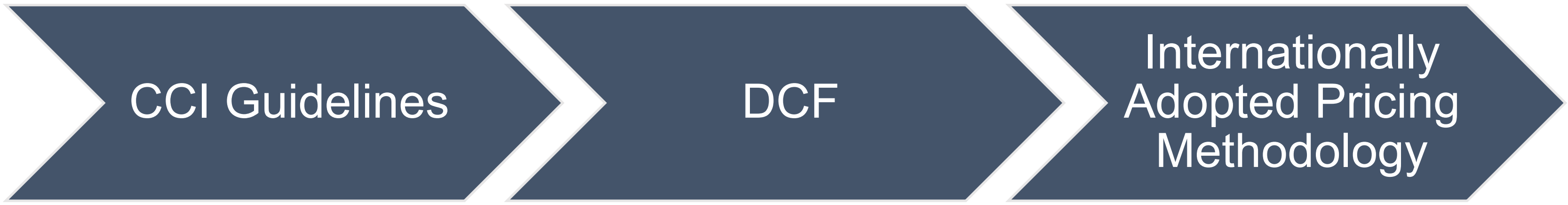
3. Evolution of pricing methodology under FEMA over a period of time

<u>3.1 The pricing guidelines under FEMA</u>

The pricing guidelines under FEMA have evolved over a period of time, From CCI to DCF to internationally accepted methodology, there have been continuous change to achieve international best practices to provide flexibility to investors.
Pricing guidelines prescribe the price at which the security can be acquired/sold/ transfer by/to non-resident shareholder in various cases:

<u>Pricing guidelines of listed companies</u>. The pricing guidelines of listed companies have always been based on the price of share on stock exchange,

<u>Pricing guidelines of unlisted companies</u>. The evolution of pricing guidelines for unlisted companies has been as follows:



3. Evolution of pricing methodology under FEMA over a period of time

a. Controller of Capital Guidelines (CCI Guidelines):

Before 4 May 2010 the price was to be arrived at using the CCI guidelines. The methods prescribed by CCI guidelines (Net Asset Value Method. Market Value Method, Profit earning capacity Value) were based on the historical data (except market value method which could only be used for listed companies and set the floor price at which the shares could be transferred, it ignored the future prospects of the Business, on the other hand.

3. Evolution of pricing methodology under FEMA over a period of time

b. Discounted cash flow methods:

Vide A. P (DIR Series) Circular No. 49 dated 4 May 2010, pricing guidelines were changed and discounted cash flow method was introduced as the pricing method for unlisted companies

It take into account the free cash flow for the company based on future projections, assumptions and forward looking calculations based on past performance of a company as well as future growth capabilities. Hence, DCF valuation is a better method and the RBI took the right step by changing the method to DCF.

However, there are various variants of DCF which can be changed and the whole valuation is dependent on the accuracy and appropriate estimates of projections and it had its inherent limitations in terms of authenticity of projections, assumptions, discount rate to be used, etc, which made it very subjective. The RBI issued lot of notices to the companies regarding the manner of arriving the share price under the DCF method.

3. Evolution of pricing methodology under FEMA over a period of time

c. Internationally Accepted Pricing Methodology:

Vide A P (DIR Series) Circular No. 4 dated 15 July 2014, the pricing guidelines were changed as follows:

In case of listed companies:

(a) The issue and transfer of shares including compulsorily convertible preference shares and compulsorily convertible debentures shall be as per the SEBI guidelines

(b) The pricing guidelines for FDI instruments with optionality clauses shall continue to be in accordance with AR (BR Series) Circular No, 86 dated 9 January 2014, i.e., the non-resident investor shall be eligible to exit at the market price prevailing on the recognised stock exchanges subject to lock-in period as stipulated without any assured return.

In case of unlisted companies:

The issue and transfer of shares including compulsorily convertible preference shares and compulsorily convertible debentures with or without optionality clauses shall be at a price worked out as per any internationally accepted pricing method ology on an arm's length basis.

3. Evolution of pricing methodology under FEMA over a period of time

Thus, the guiding principle will be that the non-resident investor is not guaranteed any assured exit price at the time et making such investment agreement and shall exit at a fair price computed as above at the time of exit subject to lock in period requirement as applicable in terms of AP [DR Series Circular No. 86 dated 9 January 2014,

W.e.f. 15 July 2014, pricing methodology was changed to 'Internationally Accepted Pricing Methodology'. What is considered as internationally accepted pricing methodology has not been described, therefore, the price may be arrived at by using market approach, asset approach or earning approach as decided between the parties at the time of entering into agreement, if any. To the extent the prices are at arm's length price, it should be fine with the RBI.

It may be seen that trust has been placed on the intermediaries like Chartered Accountant, Merchant Bankers to come at the fair value of Shares issued under their certificate.

3. Evolution of pricing methodology under FEMA over a period of time

3.2 Pricing in case of investment by way of subscription to its memorandum of association

It may be noted that where non-residents (including NRIs) are making investments in an Indian company in compliance with the provisions of the Companies Act 2013 by way of subscription on to its Memorandum of Association, such investments may be made at face value subject to their eligibility to invest under the FDI scheme and pricing guidelines need not be followed.

4. Present pricing guidelines

4.1 Where Pricing Guidelines to be complied:

Sr. No.	Particular	Provision
1	Issue of shares in case of a listed company	**Capital Instruments Issued by a company to a person resident outside India** The price worked out in accordance with the relevant SEBI guidelines in case of a listed Indian company or in case of a company going through a delisting process as per the SEBI (Delisting of Equity Shares) Regulations, 2009.
2	Where the shares of the company are not listed on any recognised stock exchange in India	**Capital Instruments Issued by a company to a person resident outside India** The valuation of capital instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI-registered Merchant Banker or a practicing Cost Accountant, in case of an unlisted Indian company.
3	Where issue of shares is on preferential allotment	The price as applicable to transfer of shares from resident to non-resident as per the pricing guidelines laid down by the RBI from time to time.
4	Transfer of shares of a company the shares of which are listed on a recognised stock exchange in India Transfer from resident to non-resident	**Transfer by resident to non-resident** The price of capital instruments of an Indian company transferred by a person resident in India to a person resident outside India should not be less than: The price worked out in accordance with the relevant SEBI guidelines in case of a listed Indian company; or the price at which a preferential allotment of shares can be made under the SEBI Guidelines, as applicable, in case of a listed Indian company or in case of a company going through a delisting process as per the SEBI (Delisting of Equity Shares) Regulations, 2009. The price should be determined for such duration as specified in the SEBI Guidelines, preceding the relevant date, which shall be the date of purchase or sale of shares. In case of a company which has completed a delisting process, the price as determined for such duration as specified in the SEBI Guidelines will apply for those shares which have not been tendered to the company during the delisting process.

4. Present pricing guidelines

4.1 Where Pricing Guidelines to be complied:

5	Transfer of shares of a company the shares of which are not listed on a recognised stock exchange in India Transfer from resident to non-resident	**Transfer by resident to non-resident** The price of capital instruments of an Indian company transferred by a person resident in India to a person resident outside India should not be less than: the valuation of capital instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI-registered Merchant Banker or a practicing Cost Accountant, in case of an unlisted Indian Company.
6	Transfer of shares in case of a listed security From non-resident to resident	**Capital instruments transferred by a person resident outside India to a person resident in India** The price of capital instruments of an Indian company transferred by a person resident outside India to a person resident in India should not exceed: a. The price worked out in accordance with the relevant SEBI guidelines in case of a listed Indian company; b. The price at which a preferential allotment of shares can be made under the SEBI Guidelines, as applicable, in case of a listed Indian company or in case of a company going through a delisting process as per the SEBI (Delisting of Equity Shares) Regulations, 2009. The price is determined for such duration as specified in the SEBI Guidelines, preceding the relevant date, which shall be the date of purchase or sale of shares.
7	Transfer of shares in case of an unlisted security From non-resident to resident	**Capital instruments transferred by a person resident outside India to a person resident in India** The price of capital instruments of an Indian company transferred by a person resident outside India to a person resident in India should not exceed: c. The valuation of capital instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI-registered Merchant Banker or a practicing Cost Accountant, in case of an unlisted Indian company.

4. Present pricing guidelines

4.1 Where Pricing Guidelines to be complied:

8	Capital instruments with optionality clause	In case of an unlisted company, the non-resident investor shall be eligible to exit from the investment in capital instruments of the investee company at a price not exceeding that arrived at as per any internationally accepted pricing methodology on arm's length basis, duly certified by a Chartered Accountant or a SEBI-registered merchant banker. The guiding principle would be that the non-resident investor is not guaranteed any assured exit price at the time of making such investment/agreements and shall exit at the fair price computed as above at the time of exit, subject to lock-in period requirement, as applicable.
9	Convertible instruments	The price/conversion formula of the instrument should be determined upfront at the time of issue of the instrument. The price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such instruments, in accordance with these Regulations.
10	Issue of right shares	The price of shares offered on rights basis by the Indian company to non-resident shareholders shall be In the case of shares of a company listed on a recognised stock exchange in India, at a price as determined by the company.
11	Swap Shares	In case of swap of capital instruments, irrespective of the amount, valuation will have to be made by a Merchant Banker registered with SEBI or an Investment Banker outside India registered with the appropriate regulatory authority in the host country.

4. Present pricing guidelines

4.1 Where Pricing Guidelines to be complied:

12	Subscription to Memorandum of Association	Where shares in an Indian company are issued to a person resident outside India in compliance with the provisions of the Companies Act, 2013, by way of subscription to Memorandum of Association, such investments shall be made at face value subject to entry route and sectoral caps.
13	Partly paid shares	The pricing of the partly paid equity shares shall be determined upfront.
14	Share warrants	In case of share warrants, their pricing and the price/ conversion formula shall be determined upfront. The price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such warrants.

4. Present pricing guidelines

4.2 Where Pricing Guidelines Are Not Mandatory:

The pricing guidelines will not apply for investment in capital by a person resident outside India on non-repatriation basis. The pricing guidelines will not be applicable for any transfer by way of sale done in accordance with SEBI Regulations where the pricing is prescribed by SEBI. A Chartered Accountant's Certificate to the effect that relevant SEBI Regulations/ Guidelines have been complied with has to be attached to the Form FC-TRS filed with the AD bank instruments.
Basically, this gives exemption to the cases where pricing guidelines could not be met because of compliance of SEBI Regulations.

Company going through delisting process	Swap of equity instruments	Shares by way of subcription to MOA	Share warrents	CCPS/ CCD's
• as per SEBI (delising of Equity Shares) Regulations, 2009.	• Valuation by SEBI registered Marchant Banker; or • Investment Banker outside India	• at face value • subject to entry route & sectoral caps.	• Pricing and price/ conversion formula shall be determined upfromt.	• Issue Price/ Formula to be specified upfront at time of issue. • Price@Conversion Date > FMC @Issue Date

5. Who can do the valuation?

- The valuation as required under the pricing guidelines can be undertaken by Chartered Accountant or a SEBI Registered Merchant Banker or a practicing Cost Accountant, in case of an unlisted Indian company, Certificate of valuation is not required to be taken from the Registered Valuer.

- As per section 247 of Chapter VXII of the Indian Companies Act 2013.
- Section 247 of the Companies Act provides that "where a valuation is required to be made in respect of any property. stocks, shares debentures securities or goodwill or any other asset or net worth of a company or its liabilities under the provisions of this Act it shall be valued by a person having such qualifications and experience and registered as a valuer in such manner and on such terms and conditions as maybe prescribed and appointed by the audit committee or in its absence by the Board of Directors of that company
- For the same Central Government have prescribed the Companies (Registered Valuers and Valuation Rules, 2017 (Rules').
- The above section mandates that all any valuation as required to be done under companies Act 2013 shall be done by Registered valuer as prescribed the Companies (Registered Valuers and Valuation) Rules, 2017 only.
- However, there is no such requirement under pricing guidelines under FEMA, 1999 that the valuation should be done by the RV, The valuation under NDI rules is mandated to be done by a Chartered Accountant or a SEBI-registered Merchant Banker or a practicing Cost Accountant.

THANK YOU

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