Operation of FDI caps in India and corporate control mechanisms

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Abstract

While India has generally been following an open door FDI policy, a few areas are still subject to caps on FDI and/or specific government approval. One of the justifications for the same is the need to retain a degree of control over the operations of the investee companies in Indian hands. Earlier this year, the government specified the methodology for calculating direct and indirect foreign equity in Indian companies in order to remove ambiguities in calculating the extent of FDI in a company. Based on empirical evidence this paper argues that percentage of shares or proportion of directors do not necessarily represent the extent of control and more direct intervention would be required if the objectives of imposing the caps are to be achieved.

Over the past several years, India has progressively liberalised its foreign direct investment (FDI) policy. As a result, in most sectors, foreign investors can hold 100% of the equity in firms registered in India. Restrictions that remain on foreign ownership are imposed in two ways: one, foreign investors are not allowed to invest in 11 sectors[2], while some others, most of which are in the services sectors, are subjected to ceilings on FDI and/or specific government approval. The justification for the same could vary depending upon the sector but includes inter alia the desire to retain a certain degree of control over the operations of the investee companies in Indian hands and possibly to give time to the domestic entrepreneurs to gain strength so as to withstand competition from foreign companies[4].

The Steering Group on Foreign Direct Investment set up by the Planning Commission addressed the possible considerations for imposing caps and bans on FDI such as national security, culture and media, natural monopolies, monopoly power, natural resources and transition costs and recommended removal of many of the restrictions.[5] Notable among the areas subject to caps are: defence industries, insurance, civil aviation, print media, broadcasting, telecom, banking and single brand product retail trade.[6] The caps are generally placed at 26%, 49% and 74%. In order to prevent breach of the ceilings by foreign investors by investing through other companies incorporated in India which they either "own" or "control" , the government has spelt out the methodology for calculating direct and indirect foreign equity in Indian companies.[7] This methodology has been elaborated in the Consolidated FDI Policy, 2010 (CFP) that became effective from April 1 2010.

Of late, however, the government has indicated its intent to relax the caps in a number of sectors, including defence and retail trade.[8] Earlier, discussion has also taken place in case of the broadcasting sector. Also, the proposal to increase the FDI limit from 26% to 49% in the insurance sector is pending. Given that the increase in foreign participation is now being proposed in sensitive sectors, and in reversal of the policies wherein the government was reluctant to cede control to foreign entities for fear of marginalisation of the Indian entities, it is imperative to understand the implications of imposing the caps on FDI. In our view, corporate control is a phenomenon that seems easy to perceive, but can manifest in several different ways in its actualisation, which can easily cause a gap between expectations and experiences. This paper is an attempt to contribute to the ongoing discussion on FDI policy with the help of India's recent experience with implementing the caps on FDI.

Does Right to Appoint Majority Directors Always Imply Control?

According to the CFP, further investments in other Indian companies by all those Indian companies which are owned and controlled by Indians will be treated as fully Indian. For this purpose, the main criteria adopted are that (i) the Indian company should be majority owned by Indians[10] (who should also act in concert)[11] and (ii) Indians should have the right to appoint majority of the directors. This is irrespective of the fact that the investing company might be having foreign equity up to 49.99%. On the face of it, this may appear to be the correct approach because a majority in equity means that nominees of majority equity shareholders get elected to the board who in turn would manage the company's affairs according to the wishes of those who had elected them. This has two dimensions: at the level of shareholders and at the board level.

First of all, ownership of majority equity shares need not necessarily ensure automatic ability to get through decisions at the annual general meetings. Special resolutions require a much larger percentage than a simple majority. Secondly, directors are not always elected at the general meetings of shareholders. It is only in the absence of special provisions majority owners can elect their nominees to all board positions on offer at general meetings. Special provisions can enable certain shareholders, notwithstanding their share in equity, to have a minimum number of directors nominated to the boards. The second is the possibility of companies issuing different categories of shares with differential voting rights – some even having no voting rights at all.[12] A majority ownership of equity capital may thus not always automatically translate into majority voting rights and majority in the Board.[13] The CFP does recognise this possibility of differential voting rights and special rights enjoyed by certain shareholders affecting decision-making (which includes election of directors) at annual general meetings when it states:

> In any sector/activity, *where Government approval is required for foreign investment* and in cases where there are any *inter-se* agreements between/amongst share-holders which have an effect on the appointment of the Board of Directors or on the exercise of voting rights or of creating voting rights disproportionate to shareholding or any incidental matter thereof, such agreements will have to be informed to the approving authority. The approving authority will consider such *inter-se* agreements for determining ownership and control when considering the case for granting approval for foreign investment. (emphasis added)

The major limitation of this approach, though it is better than looking at a simple majority in equity shares, is that it *still relies on majority in the board*. It does not address the second and more critical question of how a company's board, which is the main operational body, functions. Boards determine the policy, strategy and operational matters. Hence in more ways than one, the board's role is more decisive than that of the general body of shareholders.

Special Provisions Could Nullify Majority in the Board

It has been recognised for long that corporate "control is not an easy thing to define, and the dividing line between some control and no control is arbitrary".[14] Legal provisions can only provide some broad parameters. As noted above, ownership of majority equity is taken as a sufficient condition for unambiguous control because under company law most decisions taken in general meetings and election of directors are based on simple majority of the shares represented by those participating in the meeting. However, special provisions can also bestow control of varying degrees even to those owning minority shares. (See Table 1 for the significance of different shareholding levels) For example, a minimum of 26% would not only give the foreign investor greater bargaining power but under the Indian Company Law it would also enable the foreign shareholder to effectively oppose special resolutions thus limiting the freedom of the majority to carry out *all* their plans. Further, the investors can insist on special rights which give them disproportionate control over another company – disproportionate both in terms of voting rights and board representation. This phenomenon was often seen in case of former FERA companies at the time of their compliance with the Act.[15] For a sample of 56 companies, of which the prospectuses were available, it was found that

> ... in 32 companies foreign partners kept control over the board of directors with a 26 per cent or less share. In one instance, involving the cosmetics manufacturing company, Ponds India (...an affiliate of Cheseborough Ponds Inc of USA), the foreign partners could control the board by being only a member of the company, i.e., *even by owning a solitary share of the company*. (emphasis added)[16]

If such agreements, coupled with dependence on the foreign investor for technology, brand names and market development (including buybacks which could be a very important consideration in case of the defence sector) are entered into, then the control implied in the majority equity and majority in the board may have little relevance in practice.

Table 1. Significance of Various Levels of Equity Shareholding

Share in Equity (%)	Significance/Implications
10	Usually taken as the minimum share required to exercise control/influence. Identification of FDI relationship is based on this perception. Under Sections 397 and 398 of the Indian *Companies Act, 1956* those holding a minimum of 10% share capital can approach the Company Law Board against suppression of minority shareholders and mismanagement.
15	SEBI Takeover Code applies when this share is reached by the acquirer.
20	International Accounting Standard 28 assumes that the investor exerts significant influence if it holds, directly or indirectly, 20 percent or more of the voting power at stake.
25	Proposed by a SEBI Committee (Chairman: C. Achutan) for application of the Takeover Code. Based on the shareholding pattern of listed Indian companies, the Committee felt that 25% is the level at which promoters would be capable of exercising de facto control. Earlier, RBI classified an Indian company in which 25% shareholding was held by a foreign company as a Foreign Controlled Rupee Company (FCRC).
26	A major FDI cap. 75% being the minimum shareholding required to get special resolutions passed at company general meetings, those controlling 26% shareholding can block any special resolution, if they so desire. According to companies Bill 2009, this percentage reflects "significant influence".
$33_{1/3}$	The Industrial Licensing Policy Inquiry Committee (ILPIC) defined it as 'effective equity' for classifying a company into a business group (calculated after excluding the shares held by public financial institutions from the total)
40	Under FERA foreign branches and subsidiaries were asked to reduce the level of foreign equity to 40% thereby implying companies with up to 40% foreign equity would be treated as domestic companies.
49	Another important cap on FDI in certain restricted sectors. The objective is to have majority shares (51%) in Indian hands.
50.01	Simple majority. Sufficient to get through all ordinary resolutions as also in the absence of proportional/cumulative voting, can elect all the directors open for election.
51	Minimum government shareholding required under the *Companies Act, 1956* to be classified as a government company
74	This is the upper limit allowed where 100% FDI is not permitted. This is the counterpart of 26%. Indian shareholders with 26% shareholding will be in a position, if they so desire, to block special resolutions.
100	Wholly-owned.
Some Distorting Factors	(i) Special rights can change the relationship in favour of minority shareholders irrespective of the extent of their voting rights. (ii) Another manner in which the percentages can lose their significance is the deployment of differential voting rights. (iii) The situation would also be dependent upon the distribution of remaining shareholding. This is more so in case of listed companies.

The following cases help understand this possibility better. Under the existing provisions, foreign equity is restricted to 26% in the insurance sector. In the equity share capital of Max New York Life Insurance Co Ltd (MaxLife) Max India Ltd has 74% share and New York Life International of US (NYLI) has the remaining 26% stake thus conforming to the FDI cap applicable to the insurance sector. The Articles of Association (AoA) of Max Life stipulate that out of the total 10 directors of the company, Max India is entitled to appoint 7 directors to the Max Life's Board, NYLI two (non-retiring) directors and the remaining one will be filled up by the Max Life's CEO. On the face of it, Max India has far larger number of directors on MaxLife's board who also constitute majority. But when it comes to forming quorum at board meetings of MaxLife at least one director each nominated by Max India and NYLI should be present. And for taking certain decisions by the company and any of its subsidiaries (each a Relevant Company),

> "... shall require prior approval by a majority of the board of directors of the Relevant company, *which majority must include* at least one (1) director appointed by Max India and one (1) appointed by NYLI ... (emphasis added)[18]

These conditions thus nullify the majority enjoyed by Max India in the board of MaxLife and make NYLI an 'equal partner' in decision-making. The 26% cap on foreign equity has thus little relevance and MaxLife effectively operates as a 50:50 joint venture. Acquisition of additional equity by NYLI through indirect means by itself is not going to change the position as far as control of MaxLife is concerned.

Similar and even more interesting case is that of Bharti Axa Life Insurance Co Ltd (Bharti AXA) in which AXA India Holdings, Mauritius (AXA) has 22.222% stake and Bharti entities 40% and Bharti SPV (First American Securities Pvt Ltd)[19] 37.778%. In this case "(T)he quorum for the transaction of business at a General Meeting shall be five Members present, of whom one shall be AXA (duly represented) and, for so long as Bharti holds not less than 12.5% of the Shares, one shall be Bharti (duly represented)."[20] There are similar clauses in respect of representation on the board as also how the shareholding of Bharti SPV should be transferred whenever official FDI policy is modified to allow higher foreign share. The AoA of the Bharti SPV states that

> ... no obligation of the Company shall be entered into and no decision or determination shall be made and no action shall be taken by the Board with respect to the Company or JVCo (...) in respect of any of the matters listed in Article 172(3) hereof ("AXA Reserved Matters"), unless approved by a majority of the Directors, *including the affirmative vote of the AXA Director*.

The forty six "AXA Reserved Matters" *inter alia* include:

> (pp) Any appointment, nomination and removal of any SPV Co Nominee Director on the board of directors of JVCo.
> (qq) Utilisation of any proceeds received by the Company from the sale / transfer of its shareholding in the JVCo."[21]

The JVCo under reference here is Bharti Axa Life Insurance Co Ltd. Since AXA will decide whom to nominate to Bharti AXA's board, it means that the representatives of the SPV Co on Bharti AXA will in effect be AXA representatives. The 90% shares held by the Bharti entities in the SPV are thus of no consequence. It is relevant to note that AXA seems to have paid heavy premium for acquiring the shares of the SPV while the Bharti entities obtained the shares at the face value of Rs. 10. Between July 5, 2006 and February 26, 2010, AXA paid Rs. 406.38 crore for acquiring 43,48,973 shares of Rs. 10 each at an average premium of Rs. 924.44. On the other hand, Bharti entities were allotted 4,79,80,848 shares at par for Rs. 47.98 crore. (Table 2)

Table 2. Allotment of Shares by the First American Securities Pvt Ltd during July 2006 to February 2010

Date of Issue	Shares issued to AXA			Shares issued to Bharti entities at par value of Rs. 10 per share	
	No.	At Premium per share of Rs.	Value (Rs.)	No.	Value (Rs.)
(1)	(2)	(3)	(4)	(5)	(6)
Jul 05 2006	20,67,778	8.812	3,88,99,040	1,86,00,000	18,60,00,000
Aug 31 2006			0	88,50,000	8,85,00,000
May 07 2007	1,13,334	0	11,33,340	10,20,006	1,02,00,060
Jun 11 2007	6,12,631	0	61,26,310	55,13,690	5,51,36,900
Sep 11 2007	5,55,240	42.63021396	2,92,22,400	49,97,152	4,99,71,520
Nov 26 2007	66,666	5063.829958	33,82,51,948	6,00,000	60,00,000
Feb 19 2008	66,666	3440.036450	23,00,00,130	6,00,000	60,00,000
Mar 24 2008	66,666	3476.259667	23,24,14,987	6,00,000	60,00,000
May 14 2008	66,666	1740.018450	11,66,66,730	6,00,000	60,00,000
Jun 18 2008	66,666	4849.690636	32,39,76,136	6,00,000	60,00,000
Oct 24 2008	66,666	4855.830843	32,43,85,479	6,00,000	60,00,000
Dec 02 2008	66,666	3639.592865	24,33,03,758	6,00,000	60,00,000
Jan 23 2009	66,666	3723.272783	24,88,82,363	6,00,000	60,00,000
Apr 09 2009	66,666	5451.360378	36,40,87,051	6,00,000	60,00,000
May 20 2009	66,666	1421.565160	9,54,36,723	6,00,000	60,00,000
May 28 2009	66,666	5623.393033	37,55,55,780	6,00,000	60,00,000
Aug 06 2009	66,666	4206.711367	28,11,11,280	6,00,000	60,00,000
Sep 30 2009	66,666	3356.702367	22,44,44,580	6,00,000	60,00,000
Dec 21 2009	66,666	3772.928779	25,21,92,730	6,00,000	60,00,000
Feb 26 2010	66,666	5056.720367	33,77,77,980	6,00,000	60,00,000
Total	43,48,973		4,06,38,68,745	4,79,80,848	47,98,08,480

Source: Filings of the company downloaded from the Ministry of Corporate Affairs website.
Note: Details of shares allotted by the company prior to July 05, 2006 are not available on the MCA website.

These figures suggest that the 10% share of AXA had cost it far more than what the 90% acquired by Bharti in the SPV. While on paper the combined direct and indirect share of AXA in the JV Co works out to 25.9998% (22.222 directly and 37.778 x 0.10=3.7778 indirectly through the SPV) and thus conforms to the official FDI policy in respect of the insurance sector, the effective share of AXA works out to 60% (22.222 directly and 37.778 through the SPV Co), far in excess of the limit envisaged by the policy makers. The emphasis on acquiring a higher share formally in the JV Co by AXA is further evident from the following:

> Notwithstanding anything to the contrary contained in these Articles*, if and on each occasion that the laws or regulations of India are changed so that AXA is permitted to hold, directly or indirectly, more than 26% of the Shares, AXA shall have the right to increase its holding of Shares either by acquiring any or all of the Non-Disposal Shares from Bharti SPV or by subscribing for new Shares* .... (emphasis added)

An inescapable conclusion, therefore, is that the SPV has been created to get around the existing regulations and AXA was not prepared to settle for the 26% share.

In the case of Tata-AIG General Insurance Co. Ltd also we found that the 26% FDI limit has no operational significance as the articles give the foreign investor special rights. We did access the AoAs of Birla Sun Life Insurance Co Ltd and Bajaj Allianz General Insurance Co Ltd also. However, these not being the latest, we are not in a position to express any opinion as far as the control mechanism written into the AoAs by the collaborating parties.

It is evident that the CFP does not address the issue of functioning of the corporate boards in joint ventures. As the experience of dilution of foreign equity under FERA suggests, use of special rights and veto powers has been a very old practice. Interestingly, subsequent a news report on the special rights enjoyed by foreign investors in insurance joint ventures, based on our ongoing study of FDI[22], in the context of formulating guidelines for insurance IPOs it was reported that "... no joint venture will be able to go public without the foreign partner losing its veto power in the joint venture".[23] One is not, however, clear of how such rights be treated in case of unlisted JVs. Secondly, will the Indian partner be allowed to sell his entire stake in the open market after the company is listed and the lock-in-period, if any, is over leaving the foreign investor as the single largest investor in the company? In any case, it is surprising why the CFP missed this important and well known aspect of corporate control.

Do Veto Rights of Minority Shareholders Amount to Control?

That the interpretation of veto rights in board meetings has become a contentious issue is evident from the fact that the issue is currently engaging the attention of the highest judicial body of the country. The case concerns the veto powers held by minority shareholders namely Subhkam Ventures (I) Pvt Ltd (Subhkam) in MSK Project (India) Ltd. The Securities and Exchange Board of India (SEBI) had earlier held that since Subhkam has the right to appoint a nominee on the Board of MSKP and that the affirmative vote of the Subhkam's nominee shall be required in dealing with a large number and variety of matters as long as Subhkam holds at least 10% of the share capital of MSKP, it amounts to control of Subhkam over MSKP. When Subhkam went for appeal against this, the Securities Appellate Tribunal (SAT) observed that:

> Since the appellant (Subhkam) has the power to nominate only one director, that nominee can, by no stretch of reasoning, exercise control over the affairs of the target company or control its board of directors. That single nominee would be in a microscopic minority and he has no veto powers. It is the admitted case of the parties that the target company is a Board managed company and the overall control of that company vests with the board of directors.
>
> ...
>
> Having carefully gone through each and every sub-clause of clause 9 (which lists the matters to be decided with the nominee director's consent), we are of the view that it means what it says. The various sub-clauses are meant only to protect the interest of the acquirer (appellant) and the investment made by it. ... The list of matters provided in clauses 9(a) to 9(o) are not in the nature of day to day operational control over the business of the target company. So also, they are not in the nature of control over either the management or policy decisions of the target company. These provisions merely enable the acquirer to oppose a proposal and not carry any proposal on its bidding.[24]

Notwithstanding SAT's position it is evident that in all strategic matters, the investee company's promoters' hands are tied. They cannot decide on a business plan nor can they appoint even key officials of the company. One interpretation could be that the investee company's board has only to endorse what the investing company wishes. Otherwise there will be a stalemate. While the SAT did not deem the powers to be veto powers, there is every possibility of the veto powers being interpreted as amounting to some sort of control in this regard. It is relevant to refer in this context to the European Commission's competition policy which states that:

> Joint control exists where two or more undertakings or persons have the possibility of exercising decisive influence over another undertaking. Decisive influence in this sense normally means *the power to block actions which determine the strategic commercial behaviour of an undertaking*. Unlike sole control, which confers the power upon a specific shareholder to determine the strategic decisions in an undertaking, joint control is characterized by the *possibility of a deadlock situation* resulting from the power of two or more parent companies to reject proposed strategic decisions. It follows, therefore, that *these shareholders must reach a common understanding* in determining the commercial policy of the joint venture (emphasis added).[25]

Van Bael & Bellis, a Brussels-based leading law firm concurs by saying that

> Generally, where the support of the minority shareholder is needed to make decisions concerning the *undertaking's business plan and annual budget* and to appoint management, such a minority shareholder will be considered to jointly control the undertaking, regardless of the fact that it may be significantly less represented on the board than the majority shareholder and may have no ability to influence other less important decisions of the undertaking.[26]

It would also be relevant to refer to the SEBI Takeover Regulations Advisory Committee which noted that

> ... given the case-specific nature of "control" as a concept, the Committee decided to refrain from stipulating whether the power to say "no" would constitute "control" for purposes of the Takeover Regulations. Whether a person has

acquired control by virtue of affirmative rights would therefore have to be discerned from the facts and circumstances surrounding each case.

The Committee's recommendation that

> ... the definition of "control" be modified to include "ability" in addition to "right" to appoint majority of the directors or to control the management or policy decisions would constitute control (sic).[27]

expands the ambit of control from mere majority in the board. There is thus not only going to be a high degree of subjective element in determining control and the objectivity of the authorities is going to be crucial in ascertaining the same but one can expect considerable litigation by the interested parties.

From the foregoing it becomes obvious that the CFP's emphasis on the right to appoint majority directors as the final indicator of control is based on inadequate appreciation of corporate law and practices and is bound to help foreign investors in exercising greater control than what is intended to be permitted to them. This indeed raises doubts about the efficacy of the sectoral caps, especially high stakes like 74% in case of telecommunications, themselves. Interestingly, some of the Indian partners of the large telecom companies are multinational in nature and it would be difficult to visualise where their interests lie and where does control lie.

Need for Clarity in Objectives

This brings us to the fundamental question. What is the objective of allowing FDI in 'sensitive' areas? Is it to attract foreign capital and technology so that the sectors would grow fast and efficiently? If this is the case, then sectoral limits on FDI could obviously act as major deterrent for foreign investors. The second is about the imposition of sectoral caps. Is it to help retain control in the hands of *Indians* so that national interests and sensitivities could be well protected*?* Is it to enable domestic entrepreneurs gain strength? Or, is it to prevent higher degree of foreign ownership *per se* and thus prevent large outflows in the form of dividends? If the latter alone is the issue, there is no logic in allowing FDI in these areas in the first place. Attracting larger volumes of FDI cannot at all be a consideration for opening up such sectors.[28] Since retaining some control in Indian hands appears to be the main objective, the following points may be in order. Given the fact that there is no explicit restriction on the extent of foreign control at the entry point whenever entry through the automatic route is allowed, as complete reliance is placed on percentage shares, the subsequent effort at limiting control through monitoring indirect foreign equity would be of no use. Even in the case of defence sector, for which the government's approval is mandatory, the CFP, while elaborating on the indirect foreign equity, only says that the present limit of 26% is subject to the condition *inter alia* that, "(T)he management of the applicant company/partnership should be in Indian hands with majority representation on the Board as well as the Chief Executives of the company/partnership firm being resident Indians", thus relying on the nationality of the directors and their majority in the board. Obviously, simply looking at the nationality of the directors one is likely to misjudge the character of a company's board of directors and oblivious to the constraints under which they would be working.

It should also be underlined that in cases where the foreign contribution to the risk capital is low at 26% and the remaining has to be mobilised by the Indian partner himself, he would opt for foreign collaboration mainly to derive substantial advantages in terms of technology, goodwill, etc. This places him at a disadvantage in negotiating with the foreign partner and thus he is more likely to accede control over operations and strategy to the foreign investor. The disproportionate control of the boards conceded to the foreign partners in the insurance JVS clearly points out to this. On the other hand, a serious foreign investor would try to keep control by all means as the joint venture came into being mainly because of the restrictive FDI regime in the absence of which he would most probably have opted for a wholly owned venture. The takeover by the foreign partner of many JVs over the years is a clearly points to this possibility. His other main reason for entering into JV could be to take advantage of the partner's knowledge of local market conditions, network and political connections which are important but not always critical to the venture. An additional point that needs to be kept in mind is that the Indian partner need not always act in national interest or believe in sectoral sensitivities. Commercial interests may prevail over national and social obligations. It is always going to be difficult to achieve the twin objectives of attracting FDI along with the attendant benefits of technology while simultaneously retaining control in Indian hands. It should be underlined that the DIPP discussion paper "Foreign Direct Investment (FDI) in Defence Sector" argues for increasing the foreign stake in equity to 74% from 26% as "higher FDI limit would also provide a significant incentive for transfer of know-how/technology to the country".[29] Obviously, in such a situation only a stringent obligation, if at all, can protect national interest, especially because the Indian party cannot have majority on the board, he would also not have the capacity to prevent most decisions at the annual meetings. Alternatively, the government should think of holding 'golden shares' in such ventures.

Summing Up

The issue of indirect control came into focus because of the restriction on the extent of foreign equity imposed for certain sectors. The Consolidated FDI Policy of 2010 places emphasis on majority ownership and right to appoint majority directors for defining a domestic company. There is evidence to show that the sectoral caps, if these are aimed at restricting the extent of control yielded by foreign investors as a means of protecting national interest/objectives, can be defeated in practice through shareholder agreements/rights written into AoA as has been seen in case of the insurance sector. It is an acknowledged fact that relative strengths of the partners determines the extent of control in joint ventures and the dominant partner has many avenues to impose his will.

> Even if a foreign entity cannot own a majority of a joint venture, it may be able to legally obtain operational control through other means. One may surround the joint venture with contractual obligations to the foreign venturer. For example, if the joint venture is to assemble components manufactured in the United States, the U.S. *investor retains significant control over the joint venture regardless of how many shares the investor owns or how many directors it can name to the board* because it controls the supply of components. Similarly, a U.S. investor can exercise control through supply contracts, marketing agreements, management contracts, *and veto power in the joint venture agreements.* (emphasis added)[30]

In policy-induced JVs, the foreign partner is more likely to deploy all possible means to run the enterprise as if it was a wholly-owned one by reducing the local one to a sleeping partner. Even going by the European Commission's interpretation of the rights secured by minority shareholders through AoA or shareholder agreements the situation can at best be joint control and at worst be sole control by the foreign minority shareholders given the dependence of domestic partners. Given such a scenario, the monitoring of indirect FDI envisaged by the CFP, would hardly make a difference to the extent of control enjoyed by the foreign investor.

At the other extreme, when foreign equity up to 74% is allowed considerable control has already been yielded. Given the dependence of local partner on the foreign partner for critical inputs, it is a moot point to what extent the former will be able to influence the venture's operation by taking advantage of the 26% shareholding. In the absence of express conditions that the 26% should be held by a single Indian entity or entities having binding common interests even this expected protection would prove illusory. [31] This is irrespective of the fact whether the local partner, especially if he has substantial international businesses, would give priority to national interests. Given the manner in which funds are being raised and group operations are (proposed to be) being organised by some Indian business groups, but for their original nationality, there is nothing to suggest that national interest could be more important for them than their own personal business interests.

It is evident that India has not learnt much from her own FERA dilution experience as also from the overwhelming international evidence. As long as foreign investment up to a certain level is allowed under the *automatic route*, the foreign investor can opt for binding clauses which can give him absolute control. It does not matter whether the indirect investment route which he wishes to exploit to increase control/shareholding and which the government aims to monitor has similar clauses or not. Any scrutiny at the second level thus becomes redundant as far as control by the foreign investor is concerned. Control is the crux of the matter and it cannot be measured by percentages like 26 or 49 and proportion of directors in the board. The minimum that should be done is to disallow veto powers, withdraw automatic route facility for such sectors and follow a case-by-case approach. The government should also consider holding golden shares in all companies operating in sectors considered highly sensitive from national security and public health point of view. Before proceeding further with the regulation of indirect foreign equity, there is obviously a need for the government to specify the objectives in placing caps in each sector and also to study how the present caps are working *in practice* at all stages. The CFP should elaborate on this in its next revision.

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[2] Agriculture (except floriculture, horticulture, development of seeds, animal husbandry, pisciculture, aquaculture and cultivation of vegetables and mushrooms) retail trading (except single brand product retailing), lottery, gambling and betting, chit fund, mutual benefit financial companies, trading in transferable development rights, real estate, manufacturing of cigars, cigarettes, tobacco or tobacco substitutes, atomic energy, and railway transport (other than mass rapid transport systems). See Consolidated FDI Policy (Effective From October 1, 2010) of the Department of Industrial Policy and Promotion, Govt. of India, available at http://www.dipp.nic.in/FDI_Circular/FDI_Circular_02of2010.pdf.

[4] For example, restrictions are imposed on the entry of foreign firms in defence with a view to strengthening self-reliance in defence preparedness. For details see Department of Industrial Policy and Promotion, Ministry of Commerce & Industry (2010), paragraph 3.1.

[5] For a discussion on the FDI caps See: Planning Commission, *Report of the Steering Group on Foreign Direct Investment*, August 2002.

[6] See Annex-1 to the RBI Master Circular on Foreign Investment in India for FDI Caps and entry routes.

[7] The methodology was unveiled in Press Note No 2 (2009 Series), available at http://siadipp.nic.in/policy/changes/pn2_2009.pdf.

[8] There has been external demand also to raise the caps. See for instance, "US to ask India to raise FDI limit in Insurance, Defence: Assistant Secretary of State wants Sectoral Cap to Move Up to 49%", *Economic Times*, 20 November 2009. "UK team to push for easy FDI", *The Telegraph*, July 27 2010. Insurance, banking and defence were reported to be their focus. See: http://www.telegraphindia.com/1100727/jsp/business/story_12730405.jsp

[10] Excluding the shares held by public sector banks and public financial institutions.

[11] This is to avoid the possibility of splitting of Indian owned votes which could give the foreign shareholder the upper hand in spite of being in minority.

[12] Interestingly, Section 6A(2) of the Insurance Act, 1938 expressly states that the "the voting right of every shareholder of any public company as aforesaid shall in all cases be strictly proportionate to the paid-up amount of the shares held by him" thus prohibiting shares with differential voting rights.

[13] Hindustan Coca-Cola Beverages Pvt Ltd is reported to have issued non-voting rights to Indian shareholders and company Employee Trusts, to meet the obligation of issuing 49% shares to domestic entities while retaining 100% control. See for instance: Sridhar (2003) and Guha Thakurtha (2005). Though our understanding of the nature of shares issued to Indian shareholders by Hindustan Coca-Cola Beverages Pvt Ltd is somewhat different, we are not referring to the same here due to the Non-disclosure Agreement specified in the Company's AoA downloaded from the Ministry of Corporate Affairs as a 'Public Document'.

[14] Hymer (1993).

[15] See for instance, Goyal (1979) and Goyal (1982).

[16] Dhar (1988), p. 28.

[18] Articles of Association of Max New York Life Insurance Co Ltd (downloaded from the website of Ministry of Corporate Affairs).

[19] It is reported that the SPV, First American Securities Pvt Ltd, is 90% owned by Bharti and 10% by AXA. See: "Bharti-AXA finalize equity holding in insurance venture" at http://www.siliconindia.com/shownews/BhartiAXA_finalize_equity_holding_in_insurance_venture-nid-30617.html

[20] See the Articles of Association of Bharti Axa Life Insurance Co Ltd (downloaded from the website of Ministry of Corporate Affairs).

[21] See the Articles of Association of First American Securities Pvt Ltd (downloaded from the Ministry of Corporate Affairs website)

[22] Joe C Mathew, "Foreign firms call the shots in several insurance JVs", *Business Standard*, 28 September 2010.

[23] http://www.lifeinscouncil.org/media-centre/latest-news/521-stakeholders-of-ipo-bound-cos-must-sell-stake-equally.

[24] Before the Securities Appellate Tribunal, Appeal No. 8 of 2009. Date of Decision: 15. 01.2010 available at http://www.sebi.gov.in/satorders/subhkamventures.pdf.

[25] Point 19 of the Europen Commission Notice on the Concept of Concentration under Council Regulation (EEC) No 4064/89 on the control of concentrations between undertakings available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31998Y0302(01):EN:NOT.

[26] van Bael (2005), pp. 749-50.

[27] Securities and Exchange Board of India (2010), p. 30.

[28] For arguments against relaxation of FDI limits in the broadcasting sector by Times Now News Channel, a subsidiary of Bennett Coleman & Co. Ltd, see the channel's response to the Telecom Regulatory Authority of India at http://www.trai.gov.in/trai/upload/ConsultationPapers/138/TimesNow.pdf

[29] DIPP (2010), p. 7.

[30] Schaffer, et. al (1999), p. 581.

[31] The now-disbanded Tata Timken joint venture demonstrates how TNCs guard their technologies and how even a large house like the Tatas had to accede to the terms set by Timken. For the main clauses of the agreement, see Chandra Shekhar(1992), p. 55-57.