

A REGULATORY ROADMAP TO ESTABLISHING YOUR BUSINESS PRESENCE IN INDIA

Development, support and other back office or systemic operations of many organizations worldwide are being relocated to India, whether for cost saving or other reasons. Initial arrangements may be entered into with third party providers in India, while many organizations (Parent) establish their operations in India by incorporating a subsidiary, a Private Limited Company under the Indian Companies Act of 1956 (“Companies Act”).

Where a wholly owned entity is not the preferred option for an investor, a business may be undertaken as a joint venture. From the perspective of a foreign entity, in certain sectors where there are foreign equity ceilings, a joint venture with an Indian entity often becomes necessary so as to satisfy the conditions of balances shareholding over and above the foreign investment ceiling. In other sectors, from a new entrant’s perspective, factors such as the local partner’s pre-established marketing and distribution chain, human resource availability, etc play an important role in opting for a joint venture.

Previously, if a foreign investor who had a presence in India as a Joint Venture (JV) (joint venture, technical collaboration or a trademark licensing) with an Indian counterpart and wanted to set up an independent entity in India in the same or allied field, restrictions were imposed upon by Government on the creation of such new entities. The law provided that once a foreign entity entered into a joint venture, technical collaboration or a trademark licensing with an Indian party, then any subsequent venture (wholly owned / joint venture or collaboration) by the foreign entity in the same or allied field required a no-objection from such Indian party. Such a subsequent venture also required prior consent from the Government of India, through the Foreign Investment Promotion Board (“FIPB”), even if foreign investment were otherwise permitted in the sector in question under the “Automatic Route”.

This was seen as a major deterrent to the existing and potential foreign investors as it imposed a deadlock. As a result, this restriction was removed by the passing of Press Note 1 of 2005, though a more liberalized regime is still required in this respect. Press Note 1 of 2005 merely removes this restriction from the allied fields, however, the restriction continues in the “same” field in which the Indian partner was involved, except in cases where the Indian shareholding is less than 3% or where the Indian company is now defunct. If the Indian shareholding is more than 3%, the onus of proving that the foreign partner shall not jeopardize the interest of the Indian partner continues. Thus, to this extent the press note 1 of 2005 also needs to be further liberalized and amended.

A joint venture company may be incorporated as a private or public company; however, setting up a private limited company is usually a better option as private companies in India enjoy a more relaxed regime vis-à-vis public company.

It is important note that, generally, under section 3 (1) (iv) (c) of the Companies Act, a private company that is a subsidiary of a public company will be treated as a public company.

However, under section 4(7) of the Act, a private company which is a subsidiary of a body corporate incorporated outside India (and whose entire share capital is held by bodies corporate incorporated outside India, either one or more bodies corporate), such a private company can retain its private status for the purposes of the Act.

Although, if part of the share capital of the concerned private company is held by any other shareholder other than a body corporate incorporated outside India, then in order to ascertain whether such private company can retain its ‘private’ status, it must be identified whether the holding company (being the body corporate incorporated outside India) if incorporated in India, would be a public company.

If incorporated in India, such holding company has the characteristics of a private company, as discussed, above, then the concerned private company can retain its status as a 'private' company (for the purposes of the Act) irrespective of its shareholding pattern. On the contrary, if incorporated in India, such holding company has the characteristics of a public company, then the concerned private company would be deemed to be a public company for the purposes of the Act.

Therefore, in sectors where 100 % FDI is permitted - a 100% subsidiary incorporated as a private company is treated as a private company irrespective of the fact that the foreign holding company is a public company or not. List of the sectors where 100 % FDI is permitted and the routes through which it is allowed is mentioned later in this document.

The common procedure adopted for incorporating a Wholly Owned Subsidiary (WOS) is that 2 individuals promote the company and register it as a private company holding nominal shares. The Parent makes an investment and takes up the balance of the entire equity shares capital and finally; the Indian promoters transfer their nominal holdings to the foreign company.

The issues to be considered while establishing a wholly owned subsidiary are addressed hereunder briefly:

The need for Local professionals in the incorporation process is on an ongoing basis in order to address the setting up, organization and management of the business. Typically the required service providers are Accountants, Lawyers, Real Estate professionals and other ancillary professional service providers. Lawyers and accountants in India have an overlapping role in the incorporation of a company, wherein several filings need to be made before the concerned authorities. The Lawyer's role extends thereafter to identifying the licenses, clearances, registrations, permissions etc required by the business as well as advising on employment, contract and other legal issues that arise.

Location search is of vital importance for setting up business operations. Several reputed law firms specializing in project establishment and foreign investments in

India take a step further and also provide necessary support to the investor in terms of apprising him of the strategic locations in terms of the clients budget, workforce requirement and other requirements. The primary factor to be considered is the availability of a reliable employee pool with required skill sets for the services. The present locations of choice are Gurgaon (a satellite township of Delhi in the state of Haryana) and Bangalore (Karnataka). Emerging locations are Chandigarh (a Union Territory close to Delhi and Punjab) and Pune (close to Bombay in the state of Maharashtra) because of the availability of a young and educated work force, communications infrastructure and business friendly environment. For the life sciences business, Hyderabad (Andhra Pradesh) is an active destination. Another important factor impacting location is the place of residence of the key/strategic employees.

The process of incorporation of a Company in India typically involves the following steps:

1. Name Availability Filing with the Registrar and Name Reservation: Apply to the registrar of companies with a list of names in the prescribed form with the prescribed fee. The name availability process generally takes 7 days from the date of submission of the application; however, it is important to note that if a name is not available, the same process will have to be undergone once again. Therefore it is important that the primary list of names is made carefully keeping all legal restrictions and prohibitions in mind.
2. Preparation of the Memorandum and Articles of Association: The MOA /AOA should be drafted keeping in mind all legal and procedural intricacies and filed after being signed by the subscribers.
3. Payment of applicable registration fee and stamp duty: The MOA / AOA should be properly stamped under the relevant act, signed and then dated.
4. Identification and appointment of initial directors.

5. Various forms, declarations and compliance certificates to be filed together with the MOA /AOA.
6. Subscription to and Issuance of shares to shareholders
7. Printing and issuance of share certificates

Professional expenses involved in this process would vary based on the quality of the representation and complexity of the transactions envisaged or the specific needs of the Client. Stamp duty would also vary with the capitalization required.

INITIAL DIRECTORS AND SHAREHOLDERS

A Private Limited Company must have a minimum of two directors and two shareholders. Operationally, it is advisable that the directors and shareholders be residents of India to begin with, so as to efficiently complete the incorporation process. In the event that the initial directors chosen are not Indian residents, it is likely that administrative time-delays may be caused.

While the appointment of local directors and shareholders may be a necessity to avoid delays in the incorporation process, it presents corporate control issues for the Parent. It becomes important to ensure that the local director and shareholders do not incur expenditures or bind the subsidiary to any commitments inconsistent with the expectations of the Parent.

The shares held by the local directors/shareholders should be acquired by the Parent as soon as practicable.

For retention of control and to ensure that the local directors and shareholders act in the interests of the Parent separate written agreements inter se the Parent and these individuals are usually entered into governing:

Initial Board of Directors Structure

Appointment of one local director for a specified period, or, until certain events are completed and serves at the discretion of the Parent

Appointment of two or more other directors who are representatives of the Parent and usually executive officers of the Parent.

Note: The directors need not subscribe to equity of the Company.

Requirement that the local director adhere to budgetary guidelines and other instructions of the Parent and not incur any inconsistent expenditures or create obligations without the prior written approval of the Parent.

Initial Shareholders

Usually two local Indian nominal shareholders are introduced for ease in incorporation and hold shares for a certain period and at all times subject to the Parent's right to purchase the shares held by them.

Once appropriate clearances are obtained, the Parent will also be issued shares in the Subsidiary. The restrictions imposed on the aforesaid local directors may also be imposed on the shareholders.

Managing Director

The Managing Director is the Indian Equivalent of the CEO of a Company. One of the directors of the Subsidiary may be appointed as the Managing Director of the subsidiary. The Managing Director is a full-time director and is the operational head of the subsidiary and in charge of managing its day-to-day affairs. As in the case of choosing a CEO of a corporation, due care needs to be exercised and ideally a person resident or willing to reside in India should be chosen.

Funding and Budgets

Financial control / responsibility may be brought by introducing periodic funding based guidelines established by the Parent. Periodic funding of the subsidiary will ensure the subsidiary acts within the Parent's expectations when building out its infrastructure and otherwise, however due provisions should be made for variables

which in India are unpredictable at times but may be imperative at the time of incidence.

Limit of Delegation of Authority

The authority delegated to the local Managing Director of the India subsidiary may be limited, with due regard being given to the need for operational flexibility. It may be advisable to reserve certain extraordinary matters for the approval of a full board of directors, such as any material expenditures or agreements with third parties that bind the subsidiary.

The operational relationship between the Parent and the subsidiary must be carefully documented and monitored in order to maintain the separate legal status of each entity. Inter-company and other agreements must be strategically executed between the companies in order to have the intended effect for tax, isolation of liability and other business purposes. An arms length relationship must be maintained to avoid potential transfer pricing issues under the Revenue Service of the country of the parent and the Indian Income Tax. To be arms length, such agreements must contain provisions normally found in such agreements such as how the scope of services will be specified, not just tax provisions.

The Parent may face the issue of currency exchange restrictions. The government of India regulates the movement of funds out of India and approval may be required before cash may be transferred out of India. Although exchange control regulations have been fairly liberalized, it is important that the issue be identified and addressed in the initial stages with a future perspective.

EMPLOYMENT ISSUES

Since employment laws in India are complex and labyrinthine, it is important that the Parent make employment strategies before establishing the company.

Category of workforce – Workmen or Non workmen is an important issue. The Industrial Disputes Act 1947 (“ID Act”), defines the term “workman” and the terms and the ID Act would govern conditions of employment of any employee covered

under the term. All other employees are governed by the Service Rules of the company and as such no Law applies to them.

As a matter of policy it is better to keep the terms of appointment of employees in an “Industry” (as defined in the ID Act) such that they do not fall under the category of workman as it may entail the provisions of the ID Act, which are not only complex and elaborate, but also make it extremely difficult for the company to terminate / alter the terms of services of the employee or close the company as whole or even a part of it.

Contract Labour (Regulation) Act is another issues which needs to be looked into by the company as the law prohibits employees to be kept on contract basis when the work is of “perennial nature”.

Further, workmen have the option of approaching the fast and efficient Labour Courts or Tribunals as against non-workmen who have no other option but to approach the ordinary Civil Courts. Besides, the labor courts in India also depict an overt bent towards the workmen, in which circumstances it becomes extremely important to handle employment related issues with great caution. The company must ensure that the employment policies of the company are charted out properly to safeguard the company and ensure an efficient and disciplined work environment.

Benefits for the employees should be competitive but not excessive. This needs to be carefully considered when the subsidiary is established or an employee benefits infrastructure can be implemented that may not be easily changed. Compensation for employees is divided into five parts:

(1) Base Compensation; (2) Flexible Expense Plan (FEP) (3) Variable Pay (incentive and performance based pay); (4) Pension Plan Contribution; (5) Corporate Paid Expenses such as providing a corporate car and mortgage interest subsidies.

Employees are usually on probation status for at least 3 months after being hired. The probation period may be extended in the company's discretion. During the probationary period, the employee may be terminated at the sole discretion of the company, often without severance. Employees may be terminated following the probationary period but with a notice or severance period of 30 to 90 days, depending on the seniority of the employee and the length of service.

Non-compete and Non disclosure/confidentiality clauses or individual agreements need to be in place wherever relevant, though the Indian Courts do not take a very positive view of the same. However, there are instances where the employees in breach have been enjoined based on the individual circumstances of the case.

As an incentive to attract and retain employees, the Parent may want to grant stock options to key employees of the subsidiary to purchase common stock of the Parent. At senior levels, Indian employees are familiar with this type of compensation. Lower level employees may prefer cash. Generally, these stock options are granted to the Indian employees from the equity incentive plan of the Parent. The Parent sometimes has an India supplement to its plan for India grants. The Parent needs to review its equity incentive plan to ensure it conforms to the Indian government guidelines and file the plan in India. India's currency exchange controls applicable to stock option exercises by employees have been liberalized and there is presently no limit on the amount that employees are allowed to remit for this purpose.

PRELIMINARY FORMS OF A FOREIGN COMPANY CONDUCTING BUSINESS IN INDIA

Before venturing into the Indian markets in a full fledged way , it may be a better option to explore the Indian scenario by opening a branch office or a liaison office, or maybe even a project office, as the need be.

A liaison office does not transact any business but merely explores the markets and develops strategy and contacts for the foreign potential investor. Such an office is owned and controlled by the foreign entity. However the liaison office is not allowed to earn any income and is primarily opened by the foreign entity to liaise

with its customers in India and for promoting export & import. No manufacturing, trading or any other commercial activity is allowed in liaison offices.

A second available option is the establishment of a Branch Office. A Branch Office is treated just like an industrial establishment of the foreign entity and carries out the work of the foreign entity.

Foreign entities engaged in manufacturing and trading activities abroad are permitted by the Reserve Bank of India to open branch offices in India for the purpose of carrying on the following activities in India:

- to represent the parent or other foreign entities in various matters in India, for example, acting as buying/selling agents in India, etc.
- to conduct the research work in which the parent is engaged provided the results of the research work are made available to Indian companies;
- to undertake export and import trading activities;
- to promote possible technical and financial collaboration between Indian companies and overseas entities.

These branches are treated as foreign company in India and are liable for higher Income tax (48% against 35.7% for companies set up in India). The foreign parent company is liable for all activities of the Indian branch. Due to restrictions in day-to-day operations and higher taxation, it is not a popular route.

A third option is the opening of a project office for a foreign entity engaged in the execution or conduct of a project in India. The functionality of such an office is limited to matters relating to the project for which such an office is opened. A project office, for the sake of differentiation from the earlier options is an office, which is for limited time duration or until the completion of the project for which it is established.

Application for permission to open a branch, a project office or liaison office is made to the Reserve Bank of India by submitting form FNC-5 to the Controller, Foreign Investment and Technology Transfer Section of the Reserve Bank of India. For opening a project or site office, application may be made on Form FNC-10 to the regional offices of the Reserve Bank of India.

ENGAGEMENT OF FOREIGN TECHNICIANS:

No permission is necessary for hiring of foreign technicians and no application need be made to RBI for this purpose irrespective of whether the hiring of foreign technicians is under an approved collaboration agreement or not.

As regards release of foreign exchange, full powers have been delegated to RBI to authorize payments either against blanket permits or in free foreign exchange. RBI in turn has delegated these powers to the authorized dealers to release payments in free foreign exchange and against blanket permits. However, there are applicable clearances required to be obtained from the Ministry of Home Affairs relating to the ability of such foreigners to render services in India and be remunerated for the same.

FOREIGN TECHNOLOGY & KNOW HOW

Indian businesses are allowed to acquire technical know-how and expertise from foreign enterprises for their businesses. Under the present guidelines, technology tie-ups involving payment of up to US\$ 2 million and royalty up to 5% on domestic sales and 8% on exports for a period of 7 years from the date of commercial production are cleared by the Reserve Bank under automatic scheme. Tie-ups involving higher amounts are subject to approval from SIA (Secretariat for Industrial Assistance) on case-to-case basis.

Products covered under compulsory licensing, products reserved for SSI sector, renewal of technology agreements, or cases where technology was earlier sold to an Indian party also require prior approval from SIA.

Remittance of technical know how fee & royalty are allowed by Banks based on RBI approvals and filing of other requisite documents including a CA Certificate.

EOU/EPZ/EHTP/STP

Government provided for certain specific trade promotion zones classified under different categories as mentioned. Units undertaking to export the whole of their production of goods and services may be set up under the export oriented unit scheme, export processing zone, Electronic hardware Technology Park scheme or the software technology park scheme. Restrictions are however placed on trading units and prohibited items of export in ITC (HS). 100% EOUs and units set up in EPZ provide benefits such as duty free imports of all types of capital goods, raw material and consumables in addition to tax holidays against export. Automatic approvals are also available for a catena of projects located in EPZ / Free Trade Zones (FTZs)

With a view to augmenting infrastructure facilities for export production, the SEZ (min. 1000 hectares) were proposed to be set up in the public, joint sector or by the State Governments. This is primarily to promote self-contained area supported by world-class infrastructure oriented towards export production. Any private / public / joint sector of the state Govt. or its agencies can set up the SEZ's. The SEZ's besides having a large list of exemptions, benefits and concessions from the Govt. will be a specially delineated duty free enclave and deemed to be a foreign territory for the purpose of trade operations and duties / tariffs so as to usher in export led growth of the economy.

COMPLIANCES AND LICENSES

Under the Companies Act, the registrar of companies needs to be informed under the provisions of section 592. Several activity licenses need to be taken from various authorities such as the Labour Department, the IT department and other departments besides other statutory compliances and notifications. A list of such compliances and licenses may also be obtained from the department of Industrial Policy and Promotion.

ACQUISITION OF IMMOVABLE PROPERTY BY A PERSON RESIDENT OUTSIDE INDIA AND RELATED REPATRIATION ISSUES:

A person resident outside India who has established a place of business (not a liaison office) in India in accordance with the relevant FEMA provisions, may acquire any immovable property in India, which is necessary for or incidental to carrying on such activity. Provided that all applicable laws, rules and regulations or directions for the time being in force are duly complied with and the person files with the RBI a declaration in the form IPI not later than 90 days from the date of such acquisition. He can also transfer by way of mortgage to an authorized dealer as security for any borrowing, the immovable property acquired in pursuance of point stated above.

Repatriation Issues: A person resident outside India or his successor, holding, owning or transferring any immovable property situated in India in accordance with FEMA cannot repatriate outside India the sale proceeds of such immovable property, without the permission of the RBI. Further, the previous lock in period of 3 years holding before repatriation has now been removed by the RBI in case of NRI / OCB's.

BODIES INVOLVED IN FOREIGN INVESTMENT

Foreign entities can invest through 100% subsidiaries or Joint Ventures in India (known as direct investments) subject to sector-wise investment limits. Investment in certain sectors up to specified percentage is allowed under the automatic scheme. In this case requisite documents are filed with RBI after the receipt of funds and issue of shares to foreign investors.

Foreign investment is now permitted in virtually every sector, except those of strategic concern such as defense (opened up recently to a limited extent) and rail transport. Foreign companies are permitted to set up 100 per cent subsidiaries in India. No prior approval from the exchange control authorities (RBI) is required, except for certain specified activities. The investment should be in accordance with the prescribed guidelines and the details of the investment should be filed

with the authorities within the prescribed time limit. This procedure is applicable only for fresh investments directly in Indian companies and not for purchase of shares from the existing shareholders. This investment procedure is commonly known as the "automatic approval route".

Foreign Investment Promotion Board (FIPB) of the Government of India is constituted mainly to promote inflows of FDI into the country, as also to provide appropriate institutional arrangements, transparent procedures and guidelines for investment promotion and to consider and approve/recommend proposals for foreign investment.

Secretariat for Industrial Assistance (SIA) has been set up by the Government of India in the Department of Industrial Policy and Promotion in the Ministry of Commerce & Industry to provide a single window service for entrepreneurial assistance, investor facilitation, receiving and processing all applications which require Government approval, conveying Government decisions on applications filed, assisting entrepreneurs and investors in setting up projects (including liaison with other organizations and State Governments) and in monitoring implementation of projects. It also notifies all Government Policy decisions relating to investment and technology, and collects and publishes monthly production data for select industry groups. The SIA website (<http://siadipp.nic.in>) provides for chat time during fixed hours when all questions are answered. During other times, investors are encouraged to write e-mails and the Secretariat assures a reply within 24 hours.

In order to give further impetus to facilitation and monitoring of investment, as well as for better coordination of infrastructure requirements for industry, a new cell called the "Investment Promotion and Infrastructure Development Cell" has been created.

Prior approval from FIPB/SIA is required for investments in sectors not covered under automatic scheme or for investments beyond specified limits for sectors covered under automatic scheme, which is granted on case-to-case basis. After the

receipt of SIA/FIPB approval similar documents are filed with RBI as applicable under the automatic scheme.

Direct Investment only covers cases of issue of shares by Indian Companies and not purchase of shares for existing shareholders. Purchase of shares of existing shareholders requires prior SIA/FIPB approval in all cases.

Foreign Investment in India is subject to policy guidelines framed by the Government of India from time to time in accordance with its Industrial Policy. In terms of the Industrial Policy and Procedure announced by the Government of India foreign equity, with or without sectoral caps, is permitted by Reserve Bank under the Automatic Route in specified industries/services sector. Applications that do not conform to the parameters of the Automatic Route, are required to be made to the Secretariat for Industrial Assistance (SIA), Ministry of Commerce and Industry, Government of India, New Delhi. Foreign Institutional Investors are permitted to invest in securities in primary and secondary markets in India as per guidelines issued by Reserve Bank in this regard.
