

## 'OVERLAND' FDI UNDER APPROVAL ROUTE: INDIA IS NOW AN ISLAND

### 1. INTRODUCTION

The world is witnessing unprecedented times in light of the COVID-19 outbreak, which has led to countries across the globe adopting legal, political and economic measures which are equally unprecedented. In one such move, the Indian Government has, on April 17, 2020, released Press Note No. 3 (2020 Series)<sup>1</sup> ("**Press Note 3**") to amend the Consolidated Foreign Direct Investment Policy of 2017 (the "**FDI Policy**") with a stated view of curbing opportunistic take-overs/acquisitions of Indian companies.

Press Note 3 comes across as a protectionist measure to save Indian industry from predatory capital, while they struggle to survive the COVID-19 hit economy. It provides that all foreign direct investment ("**FDI**") from countries which share a land border with India (the "**Border Countries**") shall be subject to prior approval from the Government ("**Approval Route**"). Press Note 3 is scheduled to come into effect from the date of its notification under the Foreign Exchange Management Act, 1999 (the "**FEMA**"). While Press Note 3 does not list the Border Countries, India recognises land borders with Nepal, Pakistan, China, Bangladesh, Myanmar, Bhutan and Afghanistan.

### 2. THE AMENDMENT

Press Note 3 has amended the FDI Policy which currently provides that save for investments from Pakistan and Bangladesh, a non-resident is permitted to invest into India in accordance with the terms of the FDI Policy without any prior approval under automatic route, except in limited sectors.

Pursuant to Press Note 3, all FDI from the Border Countries and investments where a beneficial owner of the investment is situated in or is a citizen of a Border Country (collectively the "**Border Investors**"), will only be allowed under Approval Route.

Press Note 3 goes a step further and provides that an approval from the Government will also be required for direct or indirect transfers of ownership of any existing or future FDI in an Indian entity resulting in a change in the beneficial ownership falling within the abovementioned geographic restrictions.

### 3. KEY IMPLICATIONS AND CONCERNS

#### 3.1. Geography

Unfortunately, while mainstream media has been reporting Press Note 3 as a measure aimed at curtailing Chinese investment in India, the application of Press Note 3 to other Border Countries seems to be collateral damage.

<sup>1</sup> Available at [https://dipp.gov.in/sites/default/files/pn3\\_2020.pdf](https://dipp.gov.in/sites/default/files/pn3_2020.pdf).



While it is unfortunate that FDI from countries like Afghanistan, Bhutan and Nepal with whom India enjoys excellent relations and strong bilateral trade and investment ties will now be under Approval Route, it is unclear whether Taiwan (a major world economy and significant investor in India) will also be considered as a Border Country and whether investments from Hong Kong will also be under Approval Route. Notably, while India does not officially recognise the Republic of China as a 'country' and has unofficial diplomatic ties with the regime in Tai Pei, it does track FDI from Taiwan separately from those received from China. However, India also distinguishes and tracks FDI from Hong Kong SAR of China separately and such tracking, in and of itself, may not be sufficient to consider investments emanating directly or indirectly from Taiwan as outside the Approval Route.

### 3.2. Determination of Beneficial Owner

Press Note 3 does not define the term 'beneficial owner'. In absence of such definition, one may have to rely on the manner such term is understood under *pari materia* statutes. From a FEMA perspective, the Reserve Bank of India (the "RBI") does not rely on the definitions of 'significant beneficial ownership' and 'beneficial interest' as prescribed under the Companies Act, 2013 and as such that may prove to be a conceptual red herring for investees and investors in interpreting Press Note 3. The RBI's emphasis is on the Prevention of Money Laundering Act, 2002 (the "PMLA") and the RBI (Know Your Customer) Directions, 2016 (the "KYC Directions"). These prescribe certain criterion for determining a beneficial owner. Notably, the KYC Directions which are issued pursuant to the PMLA, define 'beneficial owner' in further detail as one or more persons/entities who hold a certain threshold of stake in the relevant entity and not just *any* stake in the entity.<sup>2</sup> Further, the SEBI (Foreign Portfolio Investors) Regulations, 2019 also prescribe the standards set out under the PMLA read with the KYC Directions for determining the beneficial owner of foreign portfolio investors ("FPIs").

The reporting requirements in relation to foreign investments in India entail a KYC check to be conducted by the authorised dealer banks for the remittances received from non-resident investors. It remains to be seen if the same basis and methodology for determining a beneficial owner shall be adopted for purpose of Press Note 3 or a new definition in this regard gets prescribed in the notification under FEMA which shall follow Press Note 3.

### 3.3. No Minimum Threshold

Despite its stated objective of restricting takeovers, Press Note 3 has not prescribed any minimum threshold of investment by Border Investors in order for these to be covered under Approval Route. Therefore, as the

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<sup>2</sup> The thresholds to qualify as a 'beneficial owner' under the KYC Guidelines are as provided below:

- (i) In case of a company – the natural person(s) who, whether acting alone or together, or through one or more juridical persons has/have ownership of/entitlement to more than 25% of the shares or capital or profits of the company, or who exercises control (which includes right to appoint majority of the directors or to control the management or policy decisions) through other means;
- (ii) In case of a partnership firm – the natural person(s) who, whether acting alone or together, or through one or more juridical persons, has/have ownership of/entitlement to more than 15% of capital or profits of the partnership;
- (iii) In case of a unincorporated association or a body of individuals – the natural person(s) who, whether acting alone or together, or through one or more juridical persons, has/have ownership of/entitlement to more than 15% of the property or capital or profits of the unincorporated association or body of individuals; and
- (iv) In case of a trust – the author of the trust, the trustee, the beneficiaries with 15% or more interest in the trust and any other natural person(s) exercising ultimate effective control over the trust through a chain of control or ownership,



position stands now, even a miniscule or passive investment by a Border Investor, as well as any investment by investment funds/ vehicles with beneficial ownership in Border Countries would be under Approval Route.

There is rampant fear in the industry that such restrictions shall adversely impact investment funds and vehicles with significant limited partners or beneficiaries from Border Countries (even when they constitute minority in their internal constitution), as compared to other investors.

If emphasis was to be placed on the objective set out in Press Note 3, only majority investments or investments which grant direct or indirect ownership or control over the affairs of the Indian entity in hands of a Border Investor, or a beneficial owner from a Border Country, should have been under the Approval Route, and passive financial investments should have been excluded from its purview. While the Government's intent could have very well be on similar lines, a clarification to this extent needs to be provided by the Government under the FEMA notification.

### 3.4. Applicability to Foreign Portfolio Investments

Given that Press Note 3 only amends Para 3.1.1 of the FDI Policy which primarily deals with FDI under Schedule I of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (the "**Non-Debt Rules**"), investments by FPIs under Annexure 9 of the FDI Policy and Schedule II of the Non-Debt Rules have not been expressly brought under the ambit of Press Note 3. FPIs are eligible to invest under Annexure 9 of the FDI Policy and Schedule II of the Non-Debt Rules in listed or to be listed Indian companies. As per the provisions therein, foreign portfolio investment by individual FPIs and their respective investor groups is limited to 10% of the total paid-up equity capital of the Indian company on a fully diluted basis and 10% of the paid-up value on each series of debentures, preference shares or warrants of the Indian company. Further, aggregate foreign portfolio investments by all the FPIs in a company as a whole is limited to the relevant sectoral cap, unless a company has decreased the limit (to a lower threshold limit of 24% or 49% or 74% as deemed fit) pursuant to a resolution by such company's board of directors and the members before March 31, 2020. Additionally, the aggregate limit for portfolio investments by FPIs with respect to an Indian company in a prohibited sector is limited to 24%.

However, as reported in mainstream media, the Securities Exchange Board of India (the "**SEBI**") in its communication dated April 13, 2020, had directed all designated depository participants/custodian banks to grant any fresh FPI registrations for applicants from neighbouring countries, or from applicants whose beneficiaries are from neighbouring countries, only after SEBI's prior approval, i.e. post an additional layer of scrutiny. However, this action from SEBI was put on hold by it, citing requirement of further clarity from the Government.<sup>3</sup> Therefore, it appears that SEBI will take similar measures in this regard for FPIs from or having beneficial owners from Border Countries. One will have to keep a close watch on any notification by SEBI in this regard.

<sup>3</sup> News Reports available at <https://www.livemint.com/market/stock-market-news/sebi-awaits-clarity-from-centre-on-fpi-flows-from-neighbours-including-china-11586869128349.html> and <https://economictimes.indiatimes.com/markets/stocks/news/sebi-seeks-details-of-beneficiaries-of-fpis-from-china-hk/articleshow/75148086.cms>



### 3.5. Impact on transactions outside India

Press Note 3 imposes the requirement of government approval for share transfers by non-residents to Border Investors. Since such transfer of shareholding between non-resident investors will otherwise not attract any reporting requirement under foreign exchange laws, Indian companies will have to exercise caution before registering any such transfer in favour of a Border Investor. However, nothing restricts transfer of existing investments by Border Investors to investors other than Border Investors. Additionally, any indirect investment into Indian companies (say for example, an investment or acquisition of/ in a foreign holding company or a special purpose vehicle established by a fund situated outside India) by a Border Investor, may also trigger Approval Route under the FDI Policy on satisfaction of the 'beneficial owner' test.

### 3.6. Impact on External Commercial Borrowings ("ECB")

ECBs from Border Investors have not expressly been brought under the ambit of Press Note 3. Accordingly, Border Investors may explore (with some caution) the ECB route in sectors where they qualify as eligible lenders within the ECB framework prescribed by the Reserve Bank of India. It can be expected that the Government will analyse the ECB route and a clarification or perhaps an amendment to the ECB framework may be brought about.

A grey area relates to equity conversion options linked to ECB availed from lenders in the Border Countries. While at time of conversion, such conversion does not involve fresh flow of funds, it results in a reclassification of ECB as FDI and as such may not be permitted and (unless clarified) Indian companies may not be able to honour their conversion obligations under such loans, thus resulting in an event of default.

### 3.7. Competent Authority for Government Approvals

The competent authorities for the grant of government approvals under the FDI Policy are spread across several ministries of the Government of India. Press Note 3 does not state the relevant competent authority from which the government approvals will be obtained for investments to be made by Border Investors.

Under the pre-Press Note 3 regime, applications for government approval involving investments from 'Countries of Concern' (which currently means Pakistan and Bangladesh) are processed by the Ministry of Home Affairs (the "MHA").

Since the newly introduced limitation for investments from Border Investors is similar to restrictions placed on the investments from Bangladesh and Pakistan under the pre-Press Note 3 regime, it is likely that the MHA shall process the applications made pursuant to Press Note 3. This processing of government approval by the MHA shall be in addition to the processing of sector-specific government approvals by the concerned competent authorities, and is likely to consume 8-12 weeks of time in aggregate. Given the likely increase in the volume of applications for government approvals, the Government may consider granting a single window clearance for applications from Border Investors.

### 3.8. Ongoing Transactions

Indian companies which are in the middle of transactions involving Border Investors, are clearly in a muddle due to the abrupt promulgation of Press Note 3 and no precise date when it will come into effect.



The investors in such transactions may be rethinking their investment strategy, as increase in any future stake shall involve a government approval. Some investors may be looking at delaying their investment and even the Indian entities and authorised dealers may not permit such investments until the notification under FEMA capturing the details of the limitations imposed by Press Note 3 is released. However, any delay in the funding cycle is likely to reduce the valuation of the Indian entity if the economy further slows down in the coming months, which shall be counterproductive for the investees that the Government is currently seeking to protect.

Going forward and in the event that the restrictions imposed by Press Note 3 continue for a longer period, the Border Investors who are looking to invest in tranches in an Indian entity, may consider seeking an all-encompassing government approval for such tranchised investment (within the sectoral cap) so that each tranche of investment does not have to go through the process of seeking a separate government approval.

#### 4. **INDUSLAW VIEW**

Press Note 3 has brought with itself, an enormous due diligence exercise for Indian investees. In the absence of any minimum threshold of beneficial ownership in investors to qualify as Border Investors, the Indian entities looking for investment will have to dive into the constitutional structure of potential investors. Further, Indian companies will be posed with a daunting task to ensure none of their shareholders have a passport belonging to Border Countries or have their beneficial ownership in Border Countries (including by way of a transfer of shares between non-residents).

Investments funds/ investee companies may have to come up with new holding structures or reorganise their own internal partnerships if they intend to expand their investment portfolio in India. Nevertheless, a clarification to introduce a minimum threshold in relation to ownership will be a relief for both Indian companies and the investor community. Absent a threshold, the effect of Press Note 3 will be that of a 'slow hand' (or worse) on all capital raise and exit transactions where existing shareholders from a Border Country have rights of pre-emption regardless of whether they may be the lead investors in the proposed transaction.

The future of Press Note 3 brings with it the uncertainty surrounding the view of the competent authorities for granting government approvals, and on treatment of ECBs reaching maturity. A list of Border Countries or a specific exemption for Taiwan will be of further help for all stakeholders.

Worryingly, the period for which the limitations imposed by Press Note 3 are likely to survive has been left unspecified. Given the purpose of Press Note 3 is to *curb opportunistic takeovers/ acquisitions of Indian companies due to the current COVID-19 pandemic*, it appears that Press Note 3 is an exceptional measure created only until effects of the COVID-19 pandemic subsist, and is not likely to continue as a norm for the future.

In fact, it appears from the lack of the detailing in Press Note 3, that the press note was a hastened measure aimed to completely restrict acquisition of all stakes in Indian companies under the FDI route by entities from Border Countries at low valuations in these troubled times. Nevertheless, in the near future, we expect the Government to come up (including through the awaited FEMA notification) with more nuanced, streamlined and detailed guidelines in relation to investments from Border Countries. Meanwhile, we also await a notification from SEBI placing restrictions on investments by FPIs, similar to those contained in Press Note 3.



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