

# Regulatory Hotline

April 20, 2020

## FDI POLICY REVISED: NEIGHBOURING COUNTRIES RESTRICTED FROM OPPORTUNISTIC INVESTMENTS

### INTRODUCTION

In a step what could be best described as India echoing the words of other sovereign nations, the Government of India through Press Note 3 (2020 Series) dated April 17, 2020 ("**Press Note**")<sup>1</sup> amended its Foreign Direct Investment Policy to curb the opportunistic takeovers / acquisitions of Indian companies due to the current Covid-19 pandemic.

In this regard, Para 3.1.1 of the extant Consolidated Foreign Direct Investment Policy, 2017 ("**FDI Policy**") has been revised to state that any investment by an entity of a country, which shares land border with India, or where the beneficial owner of an investment into India is situated in or is a citizen of any such country, can be made only upon seeking prior approval of the Government.

Accordingly, any investment being made from Bangladesh, China, Pakistan, Nepal, Myanmar, Bhutan and Afghanistan ("**Neighbouring Countries**")<sup>2</sup> or where the beneficial owner of an investment into India is situated in or is a citizen of any of the aforementioned countries ("**Neighbouring Country Investments**"), shall require prior approval of the Government regardless of the sector/activities in which investment is being made.

### HOW WOULD IT BE ENFORCED?

Unlike several other temporary measures that have been announced by the Government to deal with the challenges arising due to the current Covid-19 pandemic, this change seems to be one that will have a long lasting impact. As per the Press Note, this abovesaid decision of the Government will take effect from the date of release of the gazette notification under Foreign Exchange Management Act, 1999 ("**FEMA**").

As per Section 6 (2A) of FEMA, the Central Government, in consultation with the Reserve Bank ("**RBI**") has the power to prescribe any conditions which may be placed on transactions involving any permissible class or classes of capital account transactions, not involving debt instruments. Accordingly, the Central Government had introduced the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("**NDI Rules**"), which enforces the conditions laid down in the FDI Policy. Therefore, for the above said decision to come into effect, corresponding amendments would have to be made in the provisions of the NDI Rules and accordingly be notified through a gazette notification ("**FEMA Notification**").

### CHALLENGES AHEAD DUE TO THE PRESS NOTE

While the intent of Government is clear from the Press Note that it wants to curb any opportunistic takeovers / acquisitions of Indian companies due to the current Covid-19 pandemic or may be after, however the success of the same would depend a lot on how carefully the amendments are incorporated in the NDI Rules. Due to the FDI Policy not having been fully in sync with the NDI Rules till date, there is enough room for it to be reasonably interpreted in more than one possible way.

In the article below, we have analysed some of the regulatory and practical challenges that may arise in light of the above decision of the Government.

### WHO IS A BENEFICIAL OWNER?

The Press Note not only restricts investment by a citizen or an entity from the Neighbouring Countries, but it goes on to restrict investments by any such entity that may have its beneficial owner, either situated in or a citizen, of the Neighbouring Countries. This leaves the fate of the investment hanging solely on how would the authorities interpret the term 'Beneficial Owner' in the context of foreign investments.

It is to be noted that term 'Beneficial Owner' has not been defined under FEMA or NDI rules. Therefore, it is possible the concept defined under the Companies (Significant Beneficial Owners) Rules 2018 ("**Companies Rules**") and/or the Prevention of Money-laundering (Maintenance of Records) Rules, 2005 ("**PMLA Rules**"), may be referred to for determination of the beneficial owners. However, both Companies Rules and PMLA Rules, have different thresholds for determination of beneficial owners in case of companies.

The thresholds for identifying a significant beneficial owner of a company under the Companies Rules is 10% ownership / voting rights or control / significant influence. Whereas the thresholds under the PMLA Rules for identifying the beneficial owner of a company is 25% controlling ownership / profit share of the company or the person who holds the position of senior managing official. Given the difference between the two, in a case where both rules are applicable to an entity, it would likely create an anomaly and put the interpreters of the law in the state of uncertainty, unless otherwise clarified in the fine prints of the FEMA Notification. Further, it may also need to clarify whether having beneficial ownership amounting to control or significant influence should be the criteria for applicability of the restrictions under the Press Note, or even having beneficial ownership may bring the investing entities under the Government route.

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## IMPACT ON OVERSEAS POOLING STRUCTURES

Funds setup overseas investing in India raise capital from multiple investors (which would include large institutional investors) spread across different parts of the world, including from Neighbouring Countries. Therefore, many such structures and its non-Neighbouring Countries investors are likely to be impacted by the decision of the Government to bring Neighbouring Country Investments under the Government route.

India focused funds set up overseas can make investments into India either under the FDI route, where it is not required to be registered with any regulator in India, or under the FPI or FVCI route, which would require the fund to be registered with Securities and Exchange Board of India ("SEBI") under the applicable regulations. Depending upon the route of investment that the fund chooses to make investments into India, it may be subject to different standards of 'Beneficial Ownership',

Investments made under the FDI route are likely to be judged basis the 'Beneficial Ownership' standards prescribed under the Companies Rules, whereas investments made under the FPI and FVCI route are likely to be judged basis the 'Beneficial Ownership' standards prescribed under the PMLA Rules. Therefore, depending upon the investment strategies of such funds, they may have to make some structural changes overseas to fit into standards of 'Beneficial Ownership' that may be applicable to them, specifically to identify investors from these Neighbouring Countries as part of their KYC process.

### WHICH ROUTES OF FOREIGN INVESTMENT IS COVERED?

It appears that the intent of the Government is to restrict all foreign investments from Neighbouring Countries, subject to Government approval, regardless of the route under which the investment is being made. However, if it was to be true, then the FEMA Notification may also have to clarify whether such restrictions would also apply to investments being made under the Foreign Portfolio Investment ("FPI") route in accordance with Schedule II of the NDI Rules, which is currently agnostic to entry restrictions other than the limits prescribed under the aforesaid schedule.

Further, as per Rule 6 (c) of the NDI Rules, a person resident outside India, other than a citizen of Bangladesh or Pakistan or an entity incorporated in Bangladesh or Pakistan, may invest in units of an Investment Vehicle (such as AIFs, REITs, InvITs etc.), in the manner and subject to the terms and conditions specified in Schedule VIII of the NDI Rules. However, in light of the changes introduced through the Press Note, it may be possible to interpret that a citizen of Bangladesh or Pakistan or an entity incorporated in Bangladesh or Pakistan may also now be able to invest in Investment Vehicles subject to the approval of the Government, which may not have been the intent of the Government behind the Press Note.

### WHAT HAPPENS TO THE EXISTING INVESTMENTS?

Government approvals granted for foreign investment under Government route typically contain standard conditions which, *inter alia*, allow for any further investment in the investee company to be made without any subsequent approval requirement, provided there is no change in the shareholding percentage of the investor from the time of original investment.

In that light, it is likely that the Indian companies with existing Neighbouring Country Investments (excluding from Pakistan and Bangladesh which may have already obtained approval), either under the automatic route or under the Government route but, without the above-stated standard condition, would require prior approval of the Government before investing any further capital in such companies, even if there is no change in the shareholding percentage of their investment.

Having said that, the business community in India is currently under distress due to the Covid-19 pandemic. In times like this, where businesses are finding it difficult to make ends meet, pushing the existing Neighbouring Country investors to seek prior approval of the Government in order to receive any additional rescue funding, may not be a healthy policy decision and may end up killing those businesses. Therefore, the Government should consider grandfathering the existing investments made so far and require all new Neighbouring Country Investments to be made under the Government route.

### INVESTMENTS INTO LIMITED LIABILITY PARTNERSHIPS (LLPS)

Foreign investment in LLPs are permitted upto 100% under automatic route provided that the LLPs are engaged in activities / sectors in which FDI is allowed upto 100% under the automatic route and there are no FDI-linked performance conditions. In that case, the fact that Neighbouring Country Investments itself have been brought under the approval route, leads to a possible conclusion that going forward LLPs may no longer be open to investments from Neighbouring Countries.

If so, it leads to another question of what then happens to the existing LLPs and whether or not they will be able to receive any further capital from their parent entities for their survival.

### ADDITIONAL DUE-DILIGENCE REQUIREMENTS

So far the country wise restrictions under the FDI Policy was on any investment by a citizen or an entity from a particular country, which in effect meant money coming directly from the country of concern. Hence, the due-diligence process was simple. However, going forward, the risk of legal violation is not just restricted to money coming from a country of concern, but it could also be extended to funding being routed through other non-concerning nations. Therefore, it is likely that additional due-diligence measures may have to be adopted by the Company seeking investments, Authorised Dealer Banks confirming the investment, the professionals issuing certificates and any other relevant authorities.

### WHETHER NEIGHBOURING COUNTRIES INCLUDE HONG KONG?

Hong Kong is a home to several global funds for routing their investments to the Asia-Pacific market including India. As per the fact sheet on FDI from April, 2000 to December, 2019 published by Department for Promotion of Industry and Internal Trade ("DPIIT") on its website<sup>3</sup>, total FDI inflow from Hong Kong over the past two decades has been around USD 4.2 billion.

In light of that, considering that China is one of the Neighbouring Countries, it is unclear if the investment coming from Hong Kong, which officially is the Hong Kong Special Administrative Region of the People's Republic of China, may also get impacted.

### CONCLUSION

India has taken bold step towards blocking any potential investment threats that may come from its Neighbouring

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Countries. However, unless its implementation is carefully thought through and exercised judiciously, this new policy may create some unintended hurdles for investors from other parts of the world who may have received a part of their funding from the Neighbouring Countries. Further, the Government approval process is also likely to impact the timelines of such investments.

It is imperative that changes to the regulations are clear and do not have unintended consequences of restricting FPI investments in listed securities or undue burden on funds that are broad based, without any ultimate beneficial owner in Neighbouring Countries, as Indian companies will greatly rely on foreign capital in the coming days.

With that said, we hope that the Government would take into consideration some of the foreseeable regulatory and practical challenges that may arise due to the change introduced through Press Note and accordingly try to address those in the FEMA Notification.

– **Pratibha Jain, Kishore Joshi & Prashant Prakhar**

You can direct your queries or comments to the authors

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<sup>1</sup> Press Note 3 (2020 Series) Available at [https://dipp.gov.in/sites/default/files/pn3\\_2020.pdf](https://dipp.gov.in/sites/default/files/pn3_2020.pdf)

<sup>2</sup> As per a publication of Ministry of Home Affairs on its website, India shares its international land borders with Bangladesh, China, Pakistan, Nepal, Myanmar, Bhutan and Afghanistan. Available at <https://www.mha.gov.in/sites/default/files/BMIntro-1011.pdf> (last accessed on April 19, 2020)

<sup>3</sup> Available at [https://dipp.gov.in/sites/default/files/FDI\\_Factsheet\\_December-19\\_5March2020.pdf](https://dipp.gov.in/sites/default/files/FDI_Factsheet_December-19_5March2020.pdf)

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