

Regulatory Hotline

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PN3 – HERE FOR THE LONG HAUL? INVESTMENT FROM NEIGHBOURING COUNTRIES

The Ministry of Corporate Affairs (“MCA”) recently introduced a slew of amendments which endeavors to implement additional measures to ensure more robust compliance by investors and companies alike with the Press Note No. 3 (2020 Series) dated April 17, 2020.

The recently notified Company (Share Capital & Debentures) Amendment Rules, 2022 is just the latest in a string of measures implemented by the MCA to tighten and further regulate investment from any person or entity situated in a country sharing land border with India (“Neighbouring Countries”).

BACKGROUND

In an attempt to curb opportunistic takeovers/acquisitions of Indian companies, the Government of India (“Government”) issued Press Note No. 3 (2020 Series) dated April 17, 2020¹ (“PN3”) restricting foreign direct investment from Neighbouring Countries. Subsequently, the Foreign Exchange Management (Non-Debt Instruments Rules), 2019 (“NDI Rules”) was also suitably amended to give effect to PN3 on April 22, 2020.

Prior to the implementation of PN3, any non-resident investor/entity could invest in India subject to the Foreign Direct Investment Policy and only citizens/entities incorporated in either Bangladesh or Pakistan required the prior approval of the Government before undertaking any investment.

However, by way of introduction of PN3, this restriction to procure the prior approval of the Government was broadened to include investments (whether by way of primary or secondary) made by (i) any entity incorporated in a Neighbouring Country; (ii) a citizen of a Neighbouring Country; or (iii) a beneficial owner (who is a citizen of or situated in a Neighbouring Country).

In the backdrop of PN3, the Ministry of Corporate Affairs (“MCA”) has recently introduced certain pivotal amendments to the Companies Act, 2013 (“CA 2013”) and the rules made thereunder, with the primary objective of enforcing additional measures for strict implementation of PN3.

We highlight below the recent additional measures introduced by the MCA which are likely to impede investments made by any person or entity situated in a Neighbouring Country.

KEY AMENDMENTS & ANALYSIS

- 1. Restriction on Directorship in Indian Companies** – The MCA introduced the Companies (Appointment and Qualification of Directors) Amendment Rules, 2022 (“Appointment Rules”)² on June 01, 2022 which mandates that any person (being a national of a Neighbouring Country) who seeks appointment as a director in an Indian company will now require prior security clearance from the Ministry of Home Affairs (“MHA”) at (i) the time of filing Form DIR -2 (which is the consent procured from an individual to act a director of a company); and (ii) at the time of filing Form DIR-3 (which is the application for allotment of a Director Identification Number (“DIN”).

However, though it may *prima facie* seem that the Appointment Rules are silent on the treatment of existing directors of Indian companies who are nationals of Neighbouring Countries (“Existing Directors”), even Existing Directors will require prior security clearance from the MHA at the time of their re-appointment on the board of the company. Thereby, the Appointment Rules will have extensive implications not only on the nationals of Neighbouring Countries who seek directorship in Indian Companies but also on Existing Directors.

While PN3 was initially introduced under the guise of hindering strategic takeovers of Indian companies, the enforcement of the Appointment Rules strives to take this objective one step further by limiting the access or ability of nationals of Neighbouring Countries to control/ take strategic business decisions in relation to Indian companies.

- 2. Mandatory Declaration** – Through various amendments listed below, the MCA has introduced additional declarations required to be made by individuals/entities at different stages:

- The Company (Share Capital & Debentures) Amendment Rules, 2022³ introduced on May 4, 2022 requires a transferee to make an express declaration in the securities transfer form (Form SH-4) if such transferee is required to obtain the approval of the Government under the NDI Rules and where, the transferee is required to obtain approval, the transferee has to first obtain such approval and thereafter file Form SH-4 along with a copy of such approval. While share transfers were covered under the purview of PN3 from its inception, this

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additional declaration intends to cast direct responsibility of compliance with PN3 on the acquirer/transferee.

- In a similar vein, the Companies (Incorporation) Second Amendment Rules, 2022⁴ which was introduced on May 20, 2022 has revised the format for declaration by the subscribers and first directors of a company in Form INC-9. With effect from June 1, 2022, an explicit declaration is required to be given by the first subscribers to the Memorandum of Association as well as the first directors on whether or not, they are required to obtain the prior approval of the Government under NDI Rules. If yes, such approval needs to be obtained and a copy of same should be enclosed with Form INC-9. This measure ensures that requisite PN3 approval is in place, prior to incorporation of an Indian company.
- Moreover, the Companies (Compromises, Arrangements and Amalgamation) Amendment Rules, 2022⁵ was introduced on May 30, 2022 pursuant to which, in case of a compromise, arrangement, merger or demerger between an Indian company and a company incorporated in a Neighbouring Country, an additional declaration will need to be submitted at the stage of making the application with the National Companies Law Tribunal in Form CAA-16 stipulating whether such company or body corporate is required to obtain the prior approval of the Government under the NDI Rules for consummating the transaction and if yes, such approval needs to be obtained and a copy of the same should be enclosed with the Form CAA-16. With this measure, it appears that any cross-border restructuring which may result into issue of shares of an Indian company to a person resident in a Neighbouring Country may not be approved under the provisions of the Companies Act, 2013, until PN3 approval is in place.

While all the aforesaid declarations stem from the basic tenet of PN3, they appear to lend more clarity to certain processes and steps involved in a transaction which attracts PN3. Besides, the increased level of compliance tends to put responsibility of seeking approval on the individual/ company filing the declarations.

3. **Restriction on Allotment** – In addition to the self-declarations specified above, the Companies (Prospectus and Allotment of Securities) Amendment Rules, 2022⁶ was notified by the MCA on May 05, 2022 (“**Allotment Rules**”), pursuant to which, an Indian investee company is not allowed to make an offer or invitation of securities to a body corporate incorporated in or a national of a Neighbouring Country, unless such body corporate or the national has obtained the prior approval of the Government under the NDI Rules, to the extent applicable.

While the Allotment Rules *prima facie* appear to be aligned with the PN3, on a deeper analysis, it appears that they are more restrictive in approach than its predecessor for the following reasons:

- Under the PN3, the restriction was imposed not only on the immediate investor but also on any ultimate beneficial owner of the immediate investor. However, the Allotment Rules stay silent on the applicability of such restrictions on the ultimate beneficial owners.
- While the PN3 applied to all investments made into India (irrespective of the mode of issuance adopted by the Indian investee company in question) by either (i) individuals who are nationals or residents of Neighbouring Countries; or (ii) companies situated in Neighbouring Countries, the restriction imposed by the Allotment Rules only extends to investment made through a private placement by an Indian company. It is not clear on why the other modes of issuance of securities under CA 2013 viz rights issue, bonus issue, sweat equity, ESOPs etc. have been left out by the MCA.

While the Allotment Rules seem to be much narrower in scope and applicability in terms of restricting only immediate investors investing through a private placement route, it is not clear on why the MCA would introduce amendments which are not fully in line with the PN3.

CONCLUSION

When initially introduced, the adoption of PN3 was presumed to be a temporary measure adopted by the Government to hinder strategic takeover of Indian companies due to the global pandemic, however, with the wave of recent amendments brought into force by the MCA, not only do investors and companies alike need to pay great heed to compliance with PN3 but it also seems that PN3 is here to stay.

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You can direct your queries or comments to the authors

¹ https://dpiit.gov.in/sites/default/files/pn3_2020.pdf.

² <https://www.mca.gov.in/bin/dms/getdocument?mds=U4Pl6Cz4l3T9YHrD1ZOq2g%253D%253D&type=open>.

³ <https://www.mca.gov.in/bin/dms/getdocument?mds=z0TPPB0xhsbnobHAN7dyxw%253D%253D&type=open>.

⁴ <https://www.mca.gov.in/bin/dms/getdocument?mds=QJAZ8U7ilBs%252FRWVx91HwmQ%253D%253D&type=open>.

⁵ <https://www.mca.gov.in/bin/ebook/dms/getdocument?doc=MTEwNjc1OTYz&docCategory=Notifications&type=open>.

⁶ <https://www.mca.gov.in/bin/dms/getdocument?mds=Dso1KsGQ4j1STD%252FfO%252BDCVw%253D%253D&type=open>.

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