Regulatory Digest

October 06, 2022

DOWNSTREAM INVESTMENTS – A REGULATORY CONUNDRUM

INTRODUCTION

Conceptually, a foreign investor has an option to make investment in India either directly or indirectly through an Indian entity (i.e. a company or LLP) owned or controlled by it. Direct investment by foreign investor in India is known as foreign direct investment ('**FDI**'), and where the investments are routed through an entity set up in India, it becomes an indirect foreign investment (popularly known as - downstream investment). For the foreign investors already having presence in India and intend to diversify investments or expand operations through acquisitions, downstream investment could be a better proposition considering that investment and acquisitions undertaken through the Indian subsidiary(ies) attracts relatively lesser compliances, as compared to the FDI. Downstream investment can also be used as an efficient tool for deploying surplus funds of Indian subsidiary to achieve investment goals of foreign investor in India.

The Foreign Exchange Management Act, 1999 and rules and regulations made thereunder ("**FEMA**"), particularly Rule 23 of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019[1] (the "**Rules**") provides a regulatory framework for downstream investments. Under this framework, the Indian subsidiaries of foreign investors are treated differently in terms of their further investment activities in India, as compared to other Indian entities, solely for the purpose of regulating downstream investments. An Indian entity which has received foreign investment and is not owned and controlled by resident Indian citizens or owned or controlled by persons resident outside India ("**PROI**"), is considered as "**FOCC**" (i.e., foreign owned and/or controlled company). The Rules prescribe what determines the '*control*' and '*ownership*' in the context of a company or LLP.

When FOCC acquires equity instruments of another Indian company or contributes towards the capital of LLP, it becomes a downstream investment. All the FDI conditions viz. entry routes, sectoral caps, pricing norms and other attendant conditions would be equally applicable for downstream investment also. While differential treatment for FOCC from the other Indian entities is welcomed in view of broader regulatory intent, due to lack of clear guidance from the regulators on certain key aspects, historically, implementation of such downstream investment transactions has suffered practical and regulatory challenges. This article delves into some of the key issues, which may require immediate clarifications from the regulators.

A) PRICING RELATED ISSUES

Rule 23(5) of the Rules stipulates pricing and reporting requirements for the transactions involving transfer of equity instruments held by FOCC in an Indian company, in following 3 (three) scenarios:

- Transfer by FOCC to PROI - *Only reporting applies i.e. no pricing;*
- Transfer by FOCC to Indian resident - *Only pricing applies i.e. no reporting*;
- Transfer by FOCC to FOCC – *Neither pricing, nor reporting applies.*

While the pricing and reporting requirements are expressly provided in the Rules for 'sale of investments by FOCC', there is no clarity about such requirements in case of 'purchase of equity instruments by FOCC' in the aforesaid scenarios. Owing to this, it remained a matter of subjectivity and, at times, different views were taken by different Authorised Dealer ("**AD**") banks, who are authorised to process and approve such transactions. Based on the plain reading of the aforesaid 3 (three) scenarios, it can be interpreted that the FOCC is treated as a '*PROI'* from pricing perspective and an '*Indian Resident'* from reporting perspective.

Applying the same principle, pricing norms should not be applicable in case of purchase of equity instruments of an Indian company by FOCC from a PROI ("**PROI to FOCC**") and should trigger only reporting requirements. However, this issue still remained unsettled and AD banks continued to take different view. While a few AD banks did not apply pricing norms for PROI to FOCC transaction, other AD banks strictly applied pricing norms for such transactions, which posed practical difficulty for the parties in deciding the transaction value. Although there is no official clarification on this till date, we understand that in recent such transactions, the RBI has specifically applied pricing norms by treating FOCC as an Indian resident from pricing perspective, and PROI to FOCC share transfer as a cross-border transaction. We infer from this that the RBI's intention may be to curb the flow of domestic funds outside India without any limit. While that being the intent, considering that FOCC is allowed to use only FDI amount or internal accruals for making downstream investment, it may not seem justifiable applying pricing norms for PROI to FOCC transaction. Further, in a transaction involving simultaneous acquisition of shares by FOCC from both Indian resident and PROI shareholders of an Indian company, applying pricing norms to both the legs of the transaction seems absurdity and this would also leave the acquiring FOCC with no other option than purchasing the shares exactly at a

Research Papers

Unmasking Deepfakes
October 25, 2024

Are we ready for Designer Babies
October 24, 2024

Opportunities in GIFT City
October 18, 2024

Research Articles

Acquirers Beware: Indian Merger Control Regime Revamped!
September 15, 2024

Navigating the Boom: Rise of M&A in Healthcare
August 23, 2024

Navigating The Change in Shareholding and Management Rule for Non-Banking Financial Companies in India: A Practical Perspective
August 22, 2024

Audio

Renewable Roadmap: Budget 2024 and Beyond - Part I
August 26, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part II
August 26, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part III
August 26, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

"Investment return is not enough" Nishith Desai with Nikunj Dalmia (ET Now) at FII8 event in Riyadh
October 31, 2024

Analysing SEBI's Consultation Paper

fair market value (FMV), thus jeopardizing the deal commercials.

B) REPORTING RELATED ISSUES

With respect to reporting of downstream investments, the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019[2] ("**Reporting Regulations**") prescribe filing of Form DI as well as notifying the Secretariat for Industrial Assistance (SIA), Department for Promotion of Industry and Internal Trade ("**DPIIT**"). Reporting Regulations are silent on consequential reporting to be undertaken in case of PROI to FOCC transaction. Considering FOCC is an Indian resident from reporting perspective, practically, Form FC-TRS also needs to be filed for such transaction. Reporting Regulations are also silent in case of transfer of shares between 2 (two) FOCCs, although in practice, a few AD banks insist the acquiring FOCC to file Form DI afresh.

Pricing and reporting requirements in different scenarios involving FOCC may be understood in below manner:

Seller	Buyer	Pricing	Reporting
FOCC	Indian resident	Yes	No reporting
Indian resident	FOCC	Yes	DI form filing + DPIIT Intimation
FOCC	PROI	No	Form FC-TRS
PROI	FOCC	Yes	FC-TRS & DI forms filing + DPIIT Intimation
FOCC	FOCC	No	No reporting

C) INVESTMENT IN NON-CAPITAL INSTRUMENTS

Rule 23 of the Rules defines downstream investment as an investment by FOCC in "*capital instruments*" of an Indian company. However, the Rules do not define the term "*capital instruments*". This was defined under the erstwhile Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 ("**TISPRO 2017**") which was replaced with "*equity instruments*" under the Rules. While it seems to be a drafting oversight, from the downstream investment definition standpoint, "*capital instruments*" may be considered to having same meaning as ascribed to "*equity instruments*" under the Rules.

The term '*equity instruments'* does not include optionally convertible securities like OCPS (Optionally Convertible Preference Shares) or OCDs (Optionally Convertible Debentures). Commercially, such securities offer more flexibility in terms of conversion and redemption as compared to compulsorily convertible securities. Now a question would arise on whether FOCC can invest in optionally convertible securities of an Indian company? While the Rules do not specifically restrict this, the RBI has clarified in its frequently asked questions (**FAQs**) that investment by FOCC in non-capital instrument (i.e. non-equity instrument) would not be treated as downstream investment. Hence, it can be argued that FOCC is permitted to invest also in non-equity instruments of an Indian company without complying with FDI conditions. Also, such investments are generally permissible under the Companies Act, 2013 being a primary legislation for issuance of securities. However, upon conversion of such securities into equity instruments, it becomes downstream investment and FDI conditions need to be complied with. Going by this approach, pricing guidelines should apply only on conversion and not at the time of original investment in non-capital instruments. By this, FOCC would not know the number of equity shares it will receive at the time of subscribing to such non-equity instruments and hence, may reduce the attractiveness of such securities as an instrument.

Having said that, number of AD Banks also take a view that pricing at the time of investment in non-capital instruments should be considered for the purpose of determining floor price for conversion which seems counter intuitive since pricing restrictions only apply to equity instruments and, at the time of investment, the security subscribed is a non-equity instrument.

Another issue which may arise is whether investment by FOCC in such securities takes a colour of External Commercial Borrowing ("**ECB**")? Answer for this should be in negative since only a foreign entity is qualified to extend ECB as per ECB regulations and FOCC being an Indian entity, should ideally be out of the purview of the ECB regulations.

Also, in case of investment by FOCC in redeemable preference shares or debentures of an Indian company, the RBI had clarified that ECB conditions may trigger only if FOCC invests in those securities using borrowed funds. It was also clarified that if the terms of such redeemable securities are subsequently modified for their conversion into equity shares, that would be a contravention of downstream investment conditions from the date of original investment in such securities.

D) APPLICABILITY OF DEFERRED PAYMENT CONDITIONS

Another aspect which needs clarification is whether the deferred payment (including post-closing escrow, indemnity payment and price adjustment) arrangements would be applicable to (or permitted for) downstream investment as well. Rule 9(6) of the Rules expressly permits such arrangements in case of cross-border share purchase transactions (i.e. transactions between Indian residents and PROI) subject to certain conditions. Generally, FOCC is treated as an Indian resident and only in specific cases as discussed above, it is treated at par with PROI.

While there has been no official clarification so far, we understand that the RBI had informally taken a view in a few recent cases that since Rule 9(6) permits such arrangements only for cross-border transactions and that, FOCC is essentially an Indian resident, having such arrangements in share purchase transactions between FOCC and an Indian resident may not be allowed under automatic route and requires approval of the RBI. However, considering that Rule 23 (5) treats FOCC at par with PROI from the pricing perspective, it may be argued that such arrangements should be possible in a transaction between the FOCC and an Indian resident without any approval.

on Simplification of registration for FPIs
September 26, 2024

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996
September 22, 2024

E) OTHER IMPLICATIONS OF FDI CONDITIONS ON DOWNSTREAM INVESTMENTS

i. **Other attendant conditions:** As per Rule 23(1), downstream investment has to adhere to entry route, sectoral caps, pricing guidelines and other attendant conditions as applicable for foreign investment. The expression "*other attendant conditions"* is too generic, broad and has not been defined. Unless clarified the scope of this expression, it may have wider ramifications. In strict sense, all those generic conditions which are not specifically called out in Rule 23 and are applicable to foreign investment will be equally applicable to downstream investment. For instance, the restriction imposed on FDI from neighboring countries by the Government would apply here as well and therefore, FOCC which is owned or controlled by the foreign investor belonging to such countries would also require prior approval for making any downstream investment.

ii. **Downstream investment for consideration other than cash:** Rule 23(4)(b) permits to use only funds received from abroad or internal accruals for making downstream investment. Considering this specific requirement about source of funding downstream investment, a question which is likely to arise is whether FOCC can make downstream investment for consideration other than cash under automatic route? Since FDI conditions (including other attendant conditions stated above) applies equally to downstream investment and that, FDI by PROI is permitted for non-cash consideration only in a few specific cases (like swap of shares, against import of capital goods etc.) under automatic route, a view may be taken that downstream investment for non-cash consideration is allowed only in such specific cases, under the automatic route.

CONCLUSION

The regulatory framework of downstream investment is largely based on the manner of treatment of investment from FOCC in different scenarios. FOCC is treated as a PROI under few circumstances, and generally as an Indian resident for all other purposes under the Rules, and this key differential approach makes transactions involving FOCC relatively more complex. Lack of clear regulatory framework addressing key issues or ambiguities associated with such transactions will not only affect the foreign investors sentiments, but also become a roadblock in achieving the greater objective of ease of doing business in India. Hence, it is of paramount importance that the regulators issue necessary clarifications on the issues in hand on priority basis and instil confidence in the foreign investors in terms of their existing as well as future investments.

– Chandrashekar K, Nishchal Joshipura & Kishore Joshi

You can direct your queries or comments to the authors

---

[1] https://rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=12099

[2] https://rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=11723
