Changes in foreign direct investment ('FDI') policy to curb opportunistic takeovers and acquisitions due to COVID-19

FDI having beneficial ownership from countries which share land borders with India are now permitted only under the Government Approval Route

As a significant change to the FDI policy, on April 17, 2020, the Department for Promotion of Industry and Internal Trade ('DPIIT') issued Press Note No. 3 (2020 Series) ['PN'] imposing restrictions for receiving FDI from countries which share land borders with India[1] ('specified countries'). Subsequently, the Department of Economic Affairs ('DEA') also notified the new norms through amendment in the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ('NDI Rules') by way of Notification No. S.O. 1278 (E) dated April 22, 2020.

The objective for the move, as stated in the PN, is to curb opportunistic takeovers and acquisitions of Indian companies, presumably owing to the significant drop in valuations of many companies on account of the current COVID-19 pandemic. In specific, the restrictions introduced in the FDI policy and the NDI rules are as follows:

(1) Any entity or citizen of a country which shares land borders with India can invest in equity instruments[2] of an Indian company ***only*** under the Government route. This also includes investments where the ***beneficial owner*** is situated in or is a citizen of such a country.

(2) Transfer of ownership of an existing FDI in India to any person will also require Government approval if it, ***directly or indirectly***, results in the beneficial ownership of the investment falling within the restrictions mentioned in (1) above.

[1] Afghanistan, Bangladesh, Bhutan, China, Myanmar, Nepal, and Pakistan share land borders with India.

[2] Equity instruments have been defined under the NDI Rules to mean equity shares, compulsorily convertible preference shares, compulsorily convertible debentures and share warrants issued by an Indian Company.

Dhruva Comments

The objective of curbing opportunistic takeovers and acquisitions in view of the COVID 19 pandemic is understandable and one which has been followed by many countries. At the outset, it may be noted that investments from specified countries are not barred but can only be made with Government approval[3], unlike investments from Pakistan and Bangladesh that are barred in certain investment routes. While the amendments are made to give effect to the stated objective, there are various interpretational issues arising from the amendments to the NDI Rules which necessitate clarification on part of the Government. Some of these issues are highlighted below:

Beneficial Ownership

The Government has introduced the concept of 'beneficial ownership' but the term is not defined either under the PN or under the NDI Rules. The NDI Rules do have passing references to the terms 'beneficial interest' and 'beneficial holding'; however, these terms are also not defined both under the NDI Rules and the Foreign Exchange Management Act, 1999 ('FEMA'). The term 'beneficial ownership' has been defined or interpreted in different contexts, each having different definitions or thresholds; for instance:

- Beneficial interest in shares under section 89 of the Companies Act, 2013 refers to holder of any right or entitlement attached to a share, under contract or other arrangements (does not have any objective thresholds);
- Significant beneficial owner ('SBO') under section 90 of the Companies Act, 2013 (threshold for SBO is 10%);
- Ultimate beneficial owner ('UBO') under the Prevention of Money Laundering Act, 2002 (25% threshold for companies);
- Beneficial ownership definition under the Reserve bank of India ('RBI') KYC directions (25% ownership threshold in case of company);
- Beneficial owner of property under the Benami Law[4] (real owner for whose benefit property is held);
- Beneficial ownership of passive income such as dividends and interest under various tax laws (a test of dominion and control over income).

In the absence of clear guidance on beneficial ownership, offshore vehicles that pool money from passive investors not exercising any control, would also have to seek prior Government approval for all their FDI investments in India should they have investors from the specified countries.

Global funds with India allocation will also be severely impacted and any investment by investors from specified countries, either through primary or secondary acquisition, into such global funds, may also require prior Government approval on account of transfer of beneficial ownership of FDI to such investors.

[3] With certain additional sector restrictions for investments from Pakistan
[4] Prohibition of Benami Property Transactions Act, 1988 [as amended in 2016]

Further, any multinational group with India investments will be equally impacted should they have investors from the specified countries.

It is therefore important that the Government appropriately defines the term 'beneficial ownership' by prescribing conditions and thresholds (such as exclusions for *de minimis* investments) for its applicability, in line with the objectives of the PN.

Investment in Indian LLP

Presently, while the definition of 'foreign investment' under the NDI Rules includes investment in capital of an Indian LLP, such investment is not regarded as FDI. Further, the PN deals with the subject of "curbing opportunistic takeovers and acquisitions of Indian companies" without any reference to LLPs. As the amendment is made qua equity instruments only, LLPs where restrictions presently apply to citizens of / entities incorporated in Bangladesh and Pakistan, do not seem to be covered by the expanded list of specified countries.

However, foreign investment in LLPs is allowed only in sectors or activities where foreign investment up to 100 per cent is permitted under the automatic route and there are no FDI-linked performance conditions. Given the fact that any FDI from the specified countries itself is now brought under the approval route, this may lead to the conclusion that investments from the specified countries in a LLPs may not be permissible at all. Accordingly, Government may consider appropriately clarifying as to whether investment in LLPs will require Government approval or there is an expansion to the restrictions presently applicable only to Bangladesh and Pakistan.

Downstream Investment

Downstream investment under the NDI Rules has been defined to mean any investment made by an Indian entity[5] (which has received foreign investment) or an investment vehicle[6] into another Indian entity. Further, such downstream investment is regarded as 'indirect foreign investment' where (a) the Indian entity making downstream investment is either not an IOCC entity i.e. an entity that is owned or controlled by resident Indian citizens ('IOCC') or is an FOCC entity i.e. an entity that is owned and controlled by non-residents ('FOCC') or (b) the sponsor or investment manager of the Investment Vehicle is not IOCC or is FOCC. Such indirect foreign investment needs to comply with the same entry route restrictions and other conditionalities as applicable for foreign investment. Where the downstream investment is not an indirect foreign investment (i.e., downstream investment in case of an IOCC entity), the amendment to the NDI rules should not have any impact. However, where the downstream investment is an indirect foreign investment, it would be pertinent to evaluate the impact of the amendments to the NDI Rules where the foreign ownership (including minority ownership of FOCC) is from specified countries i.e. whether such investment requires prior Government approval. This aspect should be clarified to remove ambiguity.

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[5] Defined as Indian Company or an LLP under NDI Rules.
[6] Investment Vehicles being SEBI registered alternative investment funds, real estate investment trusts and infrastructure investment trusts.

Investments through Foreign Portfolio Investor ('FPI'), Foreign Venture Capital Investor ('FVCI'), etc.

The language of the PN and the notification amending the NDI Rules suggests that the requirement of prior government approval only applies to investments under the FDI Route (Schedule I of the NDI Rules).

Accordingly, foreign investment under the FPI Route (Schedule II of the NDI Rules), FVCI Route (Schedule VII of the NDI Rules), Investment Vehicles (Schedule VIII of the NDI Rules), should not require prior government approval.

However, investment in equity instruments under the FVCI Route is subject to the same entry route restrictions and other conditionalities as applicable for foreign investment and accordingly could be subject to the requirement for prior Government approval.

Impact on investments from Hong Kong

The PN and the Notification under the NDI Rules covers investments from countries which share a land border with India. Hong Kong is a special administrative region of China and does not share a land border with India. Hong Kong and China are treated as distinct entities under many situations such as:

- Hong Kong is treated as a separate customs territory by the World Trade Organisation;
- Independent of China, India has entered into a separate tax treaty (including treaty for information exchange) with Hong Kong;
- DPIIT tracks foreign investment data separately for Hong Kong and China.

Accordingly, FDI investments from Hong Kong (or where the beneficial owners are from Hong Kong) should not require the prior approval of the Government; however, an appropriate clarification would be welcomed from the Government on the subject.

Other impact areas

The language of amendment is wide enough and could trigger requirement of prior Government approval on various modes of acquisitions such as bonus and rights issue (in investments already made), honouring capital calls on partly-paid shares, conversion of warrants into shares, conversion of debt into equity etc. The amendment will also have an impact on acquisitions in terms of exercising existing contractual rights/ obligations such as call or put option, pre-emptive rights etc. Further, even secondary transfer of FDI amongst investors from specified countries (even where there is no change in beneficial ownership) is also covered within the restriction and will require prior Government approval for such secondary transfers.

As the objective of the PN is to restrict any opportunistic acquisitions by investors from specified countries, a clarificatory FAQ may need to be issued by the Government to appropriately deal with the abovementioned situations.

The COVID-19 pandemic has resulted into an unprecedented situation requiring countries to take necessary measures with regard to public welfare and national security. This amendment is an outcome of such measures pursuant to which the Government will have an increased regulatory oversight on investments from specified countries. While this is welcome, now more than ever there is a need for FDI inflows to help boost the Indian economy to which such move will act as impediment. Thus, the Government should issue suitable clarifications such as prescribing threshold for beneficial ownership, applicability for Hong Kong investors, clarity on committed situations etc.

The Government needs to quickly bring forth a framework of the approval process including specification of criteria for approval, defined timelines for granting approvals, etc. to help boost FDI inflows and alleviate investor concerns.

ADDRESSES

Mumbai
11th Floor, One IndiaBulls Centre,
Tower 2B, 841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai 400 013
Tel: +91 22 6108 1000 / 1900

Ahmedabad
B3, 3rd Floor, Safal Profitaire,
Near Auda Garden,
Prahladnagar, Corporate Road,
Ahmedabad - 380 015
Tel: +91-79-6134 3434

Bengaluru
Prestige Terraces, 2nd Floor
Union Street, Infantry Road,
Bengaluru 560 001
Tel: +91-80-4660 2500

Delhi / NCR
101 & 102, 1st Floor, Tower 4B
DLF Corporate Park
M G Road, Gurgaon
Haryana - 122 002
Tel: +91-124-668 7000

Pune
305, Pride Gateway, Near D-Mart, Baner,
Pune - 411 045
Tel: +91-20-6730 1000

Kolkata
4th Floor, Unit No 403, Camac Square,
24 Camac Street, Kolkata
West Bengal – 700016
Tel: +91-33-66371000

Singapore
Dhruva Advisors (Singapore) Pte. Ltd.
20 Collyer Quay, #11-05
Singapore 049319
Tel: +65 9105 3645

Dubai
WTS Dhruva Consultants
U-Bora Tower 2, 11th Floor, Office 1101
Business Bay P.O. Box 127165
Dubai, UAE
Tel: + 971 56 900 5849

KEY CONTACTS

Dinesh Kanabar (Mumbai)
Chief Executive Officer
dinesh.kanabar@dhruvaadvisors.com

Vishal Gada (Mumbai/Ahmedabad)
vishal.gada@dhruvaadvisors.com

Ajay Rotti (Bengaluru/U.S.)
ajay.rotti@dhruvaadvisors.com

Vaibhav Gupta (Delhi/NCR)
vaibhav.gupta@dhruvaadvisors.com

K. Venkatachalam (Pune)
k.venkatachalam@dhruvaadvisors.com

Aditya Hans (Kolkata)
aditya.hans@dhruvaadvisors.com

Mahip Gupta (Singapore)
mahip.gupta@dhruvaadvisors.com

Nimish Goel (Dubai)
nimish.goel@dhruvaadvisors.com

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