

Foreign Direct Investment in India: Impact of Press Note 3 of 2020

The Government of India has changed its foreign direct investment policy (“**FDI Policy**”) pursuant to a Press Note No. 3 (2020 Series) dated April 17, 2020, (the “**Press Note**”). The Press Note seeks to curb “*opportunistic takeovers/acquisitions of Indian companies*” due to the current COVID-19 pandemic.

In terms of the Press Note, (i) all investments by entities incorporated in 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*” (“**Restricted Investor**”) will require prior approval of the Government of India; and (ii) in the event of any transfer of ownership of any existing or future foreign direct investment (“**FDI**”) in an entity in India, directly or indirectly, resulting in the beneficial ownership falling within the restriction/purview of (i) above, such change in beneficial ownership will also require prior government approval. The countries which share a land border with India are Afghanistan, Bangladesh, Bhutan, China, Myanmar, Nepal and Pakistan (“**Bordering Countries**”).

The Press Note changes the FDI Policy in two fundamental respects: *First*, it expands the list of countries whose investors are no longer eligible to invest in India under the automatic route. *Second*, an investment in India – that would otherwise fall under the automatic route – now falls under the government route if it is from an entity whose “*beneficial owner*” is from such Bordering Country. These changes have far-reaching implications on the overall FDI regime. Set out below are some key considerations arising from these changes.

BENEFICIAL OWNERSHIP

While the Press Note covers investments in India where the “*beneficial owner*” of such investment is situated in or is a citizen of any Bordering Country, it does not elaborate the manner in which the beneficial ownership test is to be calculated and applied. The term “*beneficial owner*” has different meanings under different laws in India. Depending on how it is defined it could mean (i) an entity with a prescribed shareholding level in the investing entity (as is the case under the Companies Act of 2013) or (ii) the owner or holder of

ultimate control over the investing entity (as defined under the Prevention of Money-laundering Act, 2002). A somewhat similar concept is also used by the Securities and Exchange Board of India to identify the ultimate beneficial owner for the purposes of certain securities laws.

If the term “*beneficial owner*” is not linked to control or a prescribed shareholding threshold, the requirement for prior government approval could arguably be triggered even if a single share of an investing entity is beneficially held by an investor from one of the Bordering Countries. This ambiguity could significantly impact foreign investments into India from across the globe as Chinese investors have stakes in hundreds of companies around the world.

Clarity will also be required on how the beneficial ownership test is to be applied in cases where the entity looking to invest in India under the FDI route is a private equity fund. Several private equity funds have Chinese limited partners. In the absence of clear guidance, investments by such funds could hit a regulatory roadblock.

INDIRECT FOREIGN INVESTMENT

Investment by an Indian entity which is not owned or controlled by Indian residents (“**FOCC Entity**”) into another Indian entity (“**Downstream Investment**”) is required to be made in compliance with the applicable foreign investments conditions as if the target entity was directly receiving foreign investment.

Pursuant to the Press Note, government approval will also be required for any Downstream Investment made by an FOCC Entity that has received FDI from a Restricted Investor. This will apply even if the Indian entity receiving the Downstream Investment operates in a sector covered under the automatic route.

ONGOING TRANSACTIONS

Partly paid-up shares and warrants

The FDI Policy allows foreign investors to acquire partly paid-up shares and warrants in sectors that are under the automatic route without any approval. In case of warrants, a foreign investor is required to pay at least 25% of the consideration up-front and the balance within 18 months. As an example, a Chinese investor could have acquired such warrants of an Indian company last year by paying 25% of the purchase consideration at the time of acquiring the warrants. However, if the Chinese investor were to convert its warrants and pay the balance 75% consideration, it is not clear if such conversion will require prior government approval.

Mergers

Restricted Investors in Indian companies that are currently undergoing a merger and awaiting final clearance would likely face a similar situation. Given the rationale for the

Press Note and the ensuing uncertainty of mandating government approval for such ongoing transactions, an exemption for such transactions can be considered by the government.

Options

Investors from the Bordering Countries may have entered into binding call or put option arrangements with other shareholders of their Indian portfolio companies at the time of their original investments. In situations where the exercise of such options involves the transfer of shares to investors from the Bordering Countries, such exercise will now require government approval.

BONUS AND RIGHTS ISSUE

Ordinarily, further issuance of shares to existing shareholders by an Indian company covered under the automatic route would not require government approval. However, based on a plain reading of the Press Note, the acquisition of shares by an investor from the Bordering Countries that is an existing shareholder of an Indian company pursuant to a rights issue or bonus issue will, henceforth, require government approval.

Since the objective of the Press Note is to regulate acquisitions by Restricted Investors, an exemption could be considered for such share issuances to Restricted Investors who are existing shareholders to the extent required to maintain their shareholding.

CONCLUSION

Given the unprecedented situation the world is faced with today, countries are re-evaluating foreign participation from a public welfare and national security perspective. It is important to note that, in line with global trends, the Press Note is intended to increase regulatory oversight on investments from Bordering Countries. However, it would be helpful for the government to clarify the matters discussed above in the Indian foreign exchange regulations.

*This insight has been authored by **Viral Mehta** (Partner), **Sudip Mahapatra** (Partner), **Pratichi Mishra** (Associate) and **Vidhi Sharma** (Associate). They can be reached on vmehta@snrlaw.in, smahapatra@snrlaw.in, pmishra@snrlaw.in and vsharma@snrlaw.in for any questions. This insight is intended only as a general discussion of issues and is not intended for any solicitation of work. It should not be regarded as legal advice and no legal or business decision should be based on its content.*

S&R
ASSOCIATES
ADVOCATES



NEW DELHI

64 Okhla Industrial Estate
Phase III
New Delhi 110 020
Tel: +91 11 4069 8000

MUMBAI

One Indiabulls Centre, 1403 Tower 2 B
841 Senapati Bapat Marg, Lower Parel
Mumbai 400 013
Tel: +91 22 4302 8000