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April 20, 2020

<u>ANALYSIS OF PRESS NOTE 3 (2020)</u>

On April 17, 2020, the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Government of India ("**DPIIT**"), amended paragraph 3.1.1 of the Consolidated FDI Policy, 2017 ("**FDI Policy**"). Pursuant to this amendment, all investments 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 invest only under the Government route.

Previously, such restrictions applied only to citizens of Bangladesh or an entity incorporated in Bangladesh. Further, the existing additional restrictions applicable to investments by citizens of Pakistan or an entity incorporate in Pakistan remain unchanged. The amendments have also brought any transfer of ownership of any existing or future FDI in an entity in India, directly or indirectly, which results in the beneficial ownership falling within the restriction stipulated above, under the Government approval route. The Press Note provides that it will come into force from the date of FEMA notification.

It is pertinent to mention here that "beneficial owner" is not a term defined under the FDI Policy. It is as yet unclear whether the term will be interpreted as per its meaning provided under Companies Act, 2013[1] or any other definition will be provided.

This amendment restricts investment in India, directly or indirectly, from an entity incorporated in any of the seven countries that share land border with India without prior government approval. Such approval will be mandatory for all sectors irrespective of the quantum of FDI. Given that existing FDI Policy, already required investments from Bangladesh and Pakistan to come via government approval route (on account of security concerns), the amendment brought about by Press Note 3 (2020) will primarily impact inbound investments from Chinese companies or companies with beneficial owners located in China. This is where the concept of "beneficial owner" becomes significant as many entities operate through multi-layered structures and the investment itself may not take place from any of the countries sharing land border with India. It would be useful if the pending FEMA notification clarifies this point further. Apart from China, now these restrictions requiring prior government approval for bringing in FDI, would also apply to inbound investments from Nepal, Myanmar, Bhutan and Afghanistan.

The introductory paragraph of the Press Note states that the review of the FDI Policy has been undertaken to curb opportunistic

[1] It is likely that the Companies Act understanding of beneficial ownership may be taken, as the Explanation to the definition of "foreign investment" under Rule 2(s) of the Foreign Exchange Management (Non-Debt Instrument) Rules, 2019 which states that if a declaration is made by a person as per the provisions of Companies Act, 2013 about a beneficial interest being held by a person resident outside India, then even though the investment may be made by a resident Indian citizen, the same shall be counted as foreign investment.

takeovers or acquisitions of Indian companies due to the current COVID-19 pandemic. This measure appears to be short sighted as COVID-19 pandemic has slowed down an already slowing Indian economy, and Indian companies are, today more than ever before, in need of funds from investors. Any takeovers / acquisitions in critical sectors such as banking, defence, telecom services etc. are already controlled in terms of quantum of FDI permitted and/or government approvals. Therefore, what this Press Note essentially does is restrict flow of funds from interested investors in hitherto "open" sectors. This amendment will impact a large number of investments which are in the pipeline as well as future funding rounds of many Indian companies with existing investors from these neighbouring countries, especially China. In the financial year 2019-20, deals involving Chinese investors totalled a record $1.4bn.[2] Two thirds of India's unicorns have at least one Chinese venture capital investor.[3] It is a well-known fact in the industry that Chinese investors, particularly those operating in the early – to – mid stage segment, not only bring in capital but also connect their portfolio companies to other investors from China and make introductions across the board – manufacturers, design firms, supply chain experts – and explore go-to-market strategies across geographies.[4] The nature of amendment brought about by Press Note 3 (2020) may act as a deterrent for existing Chinese investors with Indian portfolio companies.

Over the years, the Indian government has largely liberalized the FDI Policy and other than certain key sectors which remain under government approval route for reasons of security, most sectors are under the automatic route. The amendment brought about by Press Note 3 (2020), would require inbound investments from the countries sharing land border with India to seek prior approval of the government thereby lending each and every such investment subject to unnecessary scrutiny and delays. Such scrutiny, when viewed in the context of listed entities which have public investments, may be justified in the prevailing circumstances. However, in private limited companies, such scrutiny appears to be an over reach and will impact flow of funds and consequently operations.

The government of India has, from time to time, come up with restrictive conditions on investments in India, either in general or in a specific sector, for reasons ranging from security concerns to national interests. The amendments introduced by Press Note 3 (2020), appear to be in the same vein with the stated intent being to curb opportunistic takeovers and acquisitions of Indian companies during the pandemic, however, a measured and balanced approach would have been to limit the applicability to certain critical sectors while exempting others such as manufacturing, technology, construction development, infrastructure etc., which would have also served in preserving past efforts in attracting FDI in these sectors such as the efforts undertaken to promote India as preferred option for manufacturing and a technology hub.

While the intent may be understandable, even in line with efforts made by governments of other jurisdictions, in the short run, there may be collateral damage particularly to sectors or investment routes which are in need of urgent funding and are already impacted by the existing slowdown in the Indian economy and further aggravated by the COVID-19 pandemic. In the long run, it may impact future funding rounds of Indian

[2] China provides record funding for Indian tech start-ups, Financial Times, February 17, 2020 available at https://www.ft.com/content/4899354a-4f13-11ea-95a0-43d18ec715f5

[3] *Ibid.*

[4] Chinese VCs being what money can't buy for startups, Economic Times, November 21, 2019 availableat-https://economictimes.indiatimes.com/small-biz/startups/newsbuzz/chinese-vcs-bring-what-money-cant-buy-for-startups/articleshow/72152314.cms?from=mdr

companies with existing investors from these neighbouring countries. While it remains unclear how long this policy of bringing investments from neighbouring countries under the government approval route will last, one would assume that India's timely policies and its handling of the pandemic crisis will serve towards leading the economy in the right direction thereby restoring business valuations sooner rather than later and obviate the need for recently introduced restrictive and excessive safeguards.