Review of Foreign Direct Investment (FDI) Policy of India For Curbing Opportunistic Takeovers/ Acquisitions of Indian Companies Due to The Current COVID-19 Pandemic

written by Prithiviraj Senthil Nathan | April 18, 2020

Points Covered: Chinese direct FDI Investments and indirect investments from other jurisdictions, Investments by Venture Capital Funds and Private Equity Funds with Chinese LPs, Retrospective Effect, and Exemptions.

FDI Policy To Save Indian Companies From Takeover Amid COVID

Foreign investments into India are bound by the Foreign Direct Investment (“FDI”) Policy issued by the Ministry of Commerce and Industry, Government of India (“Government”) from time to time. The changes to the said policy are reported in the form of a press note and suitable amendments will be made to the Foreign Exchange Management Act, 2000 (“Forex Laws”). Per FDI Policy, non-resident entities are allowed to invest in India, subject to the FDI Policy except in those sectors/activities which are prohibited for foreign investment.

The Government has, vide a press note dated April 18, 2020, revised this position and stated that investment in India by non-resident entities of countries, which share a land border with India i.e., Pakistan, Bangladesh, China, Nepal, Myanmar, Bhutan and Afghanistan (“Border States”) or where the beneficial owner (“Beneficial Owner”) of investment into India is situated or is a citizen of any such Border States, such investments will be permitted only under the Government approval route. Please note that the restrictions apply even in the event of the transfer of ownership of any existing or future FDI in an entity in India, directly or indirectly, resulting in the beneficial ownership falling within the restriction.

Our comments are interspersed below:

Investments into India from the Border States including China from now on require approval from the Government. The approval will also be required in cases where a transfer of ownership in an Indian company results in the Beneficial Owner falling within the Border States. It is pertinent to note that the term ownership is not defined but reference in this regard may be drawn to the definition prescribed in the Master Direction – Foreign Investment in India which states Ownership of an Indian company as the beneficial holding of more than 50 percent of the capital instruments of such company.

The aforementioned restrictions shall notably apply to the beneficial owners of the investments made in India. It is pertinent to note that the term Beneficial Owner is not defined in the Press Note. Section 90 of the Companies Act, 2013 read with the Companies (Significant Beneficial Owners) Rules, 2018 ("Companies Act") mentions the term Significant Beneficial Owner ("SBO") as against the beneficial owner.

It states SBO is an individual who either alone or together with other individuals or trust, exercises rights or entitlements in a company by way of holding 10% shares or 10% voting rights or the right to receive 10% or more dividend, both indirect and direct holdings or right was taken together or such individual exercise significant influence or control, indirectly or along with direct holding in the Company.

Reporting and Guidelines to identify Beneficial Owner have also been prescribed under the Securities and Exchange Board of India regulations. Further per provisions of the Prevention of Money Laundering Act, 2002 ("PMLA") "Beneficial Owner" is defined as an individual who ultimately owns or controls an entity or the person on whose behalf a transaction is being conducted and includes a person who exercises ultimate effective control over a juridical person.

The provisions of the PMLA mandate the financial institutions to conduct diligence on the customers to identify the Beneficial Owner and prescribe reporting requirements. Since the purpose of the policy is meant to curb "opportunistic takeovers/acquisitions of Indian companies" due to the current COVID-19 pandemic, there is a strong possibility of the government taking the view that the Beneficial Owner will have the same meaning as Significant Beneficial Owner.

Chinese FDI Investments from other jurisdictions

The initiative by the Government is to block direct investments from China. But going by the definition of Beneficial Owner (and interpreting the definition of the term used in the other laws), one can infer that the revised position would also impact investments from other jurisdictions where Beneficial Owners intended to or have invested more than 50 percent of the capital instruments of an Indian company through special purpose vehicles ("SPV").

If a Chinese citizen, living or corporate person, has an interest in such an SPV in a foreign jurisdiction, the same will be deemed as an indirect investment. "Ownership of an India Company" has been defined as the beneficial holding of more than 50 percent of the capital instruments of the Indian Company. Usually, investments in India from the Border States will be structured by creating SPV in Hong Kong, Singapore, Mauritius, Netherlands, or other jurisdictions to avail of tax treaty benefits under the respective double taxation avoidance agreements (executed by India with these countries).

With the revised position, it appears that Government approval will be required for - a) all the future investments through SPV, if there is a Chinese element, which results in a situation of Beneficial Ownership; and/or b) transfer of more than 50% of capital instruments of the Indian Company by the SPVs where the Beneficial Owner is from the Border States.

Investments by Venture Capital Funds and Private Equity Funds with Chinese LPs

If a VC or PE fund has a Chinese LP that falls within the definition of Beneficial Owner, they will have to seek government approval for investments into Indian companies.

Retrospective Effect

This regulation has a retrospective effect, meaning that all previous transactions before the date of the current press note and involving existing investments from land bordering countries, including China, will need to seek government approval for buying/ selling and/or transacting in shares/ debt instruments if it results in a transfer of beneficial ownership. This also renders several Chinese investments locked up, until further clarification/ instruction by the government.

Exemptions

This order of the government does not provide for any restriction on investments in India by Chinese companies under the Foreign Institutional Investor (FII) or Foreign Portfolio Investor (FPI) route.

Conclusion

This is a step to avoid investments and takeover of Indian listed and unlisted companies and their subsequent control, directly or indirectly, by Chinese Companies.

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