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GREY MATTERS

Foreign Direct Investment

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In light of the ongoing COVID-19 pandemic and with a view to "curbing opportunistic takeovers / acquisitions of Indian companies due to the current COVID-19 pandemic", the Government has recently announced that investments from an entity based in a country which shares a land border with India, or where the beneficial owner of the investment in India is situated in a country which shares a land border with India, will require prior Government approval.

The restriction would also apply to secondary transfers of existing foreign investment in an Indian entity to an acquirer which meets this condition. The restrictions appear to be directed primarily at investments coming from China and seems to be a reaction to recent press reports that the People's Bank of China has been steadily raising its stake in India's largest non-banking mortgage provider HDFC to over 1%.

Unfortunately, the notification introducing the restriction makes no reference to a sunset clause so until it is amended by a further decision by the Government, this restriction will continue to apply.

Just by way of background, as you may know, for several years, the Foreign Investment Promotion Board (the ***FIPB***) acted as the single window clearance for applications under the foreign investment regime. There was also a mechanism for investors or their counsel to have informal discussions on the interpretation and the application of the policy.

However, the FIPB was abolished in mid-2017 in favour of an online portal for filing applications for foreign investment approvals. The power to review and approve such applications has now been vested in individual administrative departments or ministries in charge of the sector in which the proposed investment is being made. For example, an investment in a pharmaceuticals company will be reviewed and approved by the Department of Pharmaceuticals. As a result, the process of seeking foreign investment approvals is not as streamlined as it used to be with the FIPB.

In its current form, the announcement raises a number of questions:

1. So far the review process around a foreign investment approval focussed on the ultimate source of funds and the overall legitimacy of the investor. Authorities rarely, if ever, went into commercial aspects of the proposed investment such as valuation. Comfort was taken from the fact that there was a regulated regime in place for cross-border investments which required investments (both primary as well as secondary) by non-residents to be made subject to the pricing guidelines

prescribed by the Reserve Bank of India. However, with one of the objectives of the announcement being "curbing opportunistic takeovers", is the intent now that the Government (through the relevant administrative ministry or department) will second guess the valuation arrived at by the parties? Do these ministries or departments even have the expertise to perform this role?

2. The threshold question of who constitutes the "beneficial owner of an investment into India" is not without doubt or uncertainty. What if there is an entity that is incorporated and listed in a non-regulated territory such as Cayman Islands but is headquartered in, or controlled by residents of, a country sharing a land border with India (regulated territory)? Will foreign direct investments made by such an entity (or its subsidiaries) be considered as having a beneficial owner in a regulated territory only if say more than 50% of the shares or voting rights in such an entity are held by persons situated in a regulated territory?

3. Whilst the notification is clear in that it will apply to a structure where say an entity from a regulated territory sets up or uses an SPV in say Singapore or Cayman Islands to invest in an Indian entity, it is not clear whether the notification will apply to a structure where an entity from a regulated territory makes a minority investment say in a Singapore hold co of a largely Indian operation. The issue is that this primary leg will be entirely offshore but the Singapore hold co will ultimately fund the Indian operation and therefore query whether an effort will be made at that stage to establish a connection between this subsequent leg and the initial investment by an entity from a regulated territory? Even if such an attempt were to be made, we believe it will be difficult to successfully argue that the entity from a regulated territory is the "beneficial owner" of the Singapore hold co if indeed it has made only a minority investment in the Singapore hold co.

4. The existing rules to determine significant beneficial owners of Indian companies and ultimate beneficial owners of foreign portfolio investors (FPIs) making on-market investments are in a different context in that they seek to identify the natural persons who are behind corporate structures. Having said that, if the Government were to apply similar principles to identify the beneficial owners for FDI purposes, they would seek to look through the holding structure, possibly using a shareholding and/or control type threshold. In the case of a fund / pooled investment vehicle which is structured as a partnership firm, rather than seeking to identify the general partner or investment manager, the Government would likely want to understand the economic / voting interest in such entities. Whilst a majority / controlling interest seems like an obvious threshold, we have seen lower thresholds being used in other contexts. It also remains to be seen as to how far up the chain the Government will want to go in determining the beneficial owner.

5. It is unclear if the requirement will also apply to investments coming from Hong Kong and possibly even Taiwan. We know that in an analogous context the securities market regulator is keeping an eye on on-market investments by portfolio investors whose ultimate beneficial owners are based in Hong Kong and Taiwan as well.

It may well be that the Government may have deliberately left the language rather broad and vague, with the expectation that investors will approach the Government in cases where there is any uncertainty. However, given the "flurry" that has been caused, one is hopeful that they will clarify (at least some of!) the questions above in the coming weeks but until then the firmament of

Indian companies particularly in sectors such as technology and startups may well have to face significant delays when it comes to their capital raising plans.

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For further information, please contact:

Karam Daulet-Singh
Partner
karam.dauletsingh@platinumpartners.co.in

Gaurav Desai
Partner
gaurav.desai@platinumpartners.co.in

Sameeksha Chowla
Associate
sameeksha.chowla@platinumpartners.co.in

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