Page 653 - 663 **DOI:** http://doi.one/10.1732/IJLMH.25196

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 3 | Issue 6

2020

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Legal Analysis of the FDI Policy Amendment of Opportunistic Takeovers/Acquisition of Indian Companies in Lieu of the Current Covid-19 Pandemic

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ABSTRACT

On the outset of the increase in alertness and restrictions imposed against Chinese investments in India, the Indian Council of Investors (ICI), an investor association group, suggested to the Ministry of Finance to initiate a strong approval-based regime for both FDI and Foreign Portfolio Investment (FPI) rules, where the investment crosses a certain threshold. Moreover, the recent situation, where of China's central bank showed its interest in Housing Development Finance Corporation (HDFC), raised several concerns which were critical since the plunge in HDFC's share price which was essentially caused due to the Coronavirus- led hold up in the economy.

On April 11, 2020 People's Bank of China (PBC) raised its stake of ownership in HDFC Bank to 1.01 percent from 0.8 percent. Various media reports also cited that Ministry of Finance was ruffled as market regulator; SEBI had not raised red flags when PBC was buying shares in HDFC. No law currently restricts central banks of other countries from investing in Indian commercial entities. However, this move by PBC is unusual considering that central banks typically buy bonds of companies in other countries, and not equities. Investments by Chinese companies and institutions have attracted widespread scrutiny from all over the world since the beginning of this pandemic. As COVID-19 continues to threaten lives and livelihoods across the globe, businesses and their assets are not reflecting their true value, thereby becoming attractive targets for hostile takeovers and acquisitions.

In light of this, Rule 3.1.1 of Foreign Exchange Management (Non-debt Instruments) Rules, 2019 was amended. The new amendment in question requires certain investments from countries outside India as FDI to come through the government approval route alone, and not under the direct route of investment. Wherein, with the new amendment, FDI in these cases would require an approval from the Government of India, which would mean that the government would be able to monitor the extent of these investments and give its approval, should it choose to do so. The initiative by the Government is to block direct investments from mainly China; these Chinese companies may buy assets at

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lower valuations and act for serving their personal agenda. Therefore, this paper aims to critically analyse the amendment and tries to establish whether such amendment is needful in the longevity and smooth functioning of India's national security.

Keywords: *Foreign Direct Investment (FDI), market regulator, Foreign Portfolio Investment (FPI) rules, Foreign Exchange Management (Non-debt Instruments) Rules*

I. INTRODUCTION

FDI is known to be the most significant external source of finance for developing countries. It can be inferred that funds contributed through the FDI route account for one third of these countries' GDP presently.

Foreign Direct Investment (FDI) refers to the process by which a firm takes a controlling stake in a firm based in another country. Due to FDI, foreign companies have overt and direct involvement in the daily operations in the other country. However, FDI does not refer to just bringing money into other countries, but also includes skill, advanced knowledge and technology. The most important feature of Foreign Direct Investment is that it gives foreign firms control over the company's affairs. This also means that they would have substantial control over the company's decision making. It is common knowledge that the benefits accrued from the FDI process, do not reflect automatically and equally across all sectors of the economy. Hence, there is a demand to introduce a transparent, inclusive and conducive policy for investment and to establish the necessary framework for the implementation to monitor and encourage FDI.

The Department of Industrial Policy & Promotion, Ministry of Commerce is responsible for formulation of the policy of the Government on Foreign Direct Investment (FDI). It is also responsible for maintenance and management of data on inward FDI into India, based upon the remittances reported by the Reserve Bank of India. The current FDI policy states two routes through which a foreign company can invest – Automatic Route and the Government Route. The policy also states how much ownership a company can acquire in a specific sector and also imposes restrictions on businesses that are based in specific countries such as Pakistan, Bangladesh and China.

The automatic route implies that foreign companies do not require the approval of the Central Government before investing in an Indian business. Taking into consideration, the economic significance of FDI, the Government of India has formulated a liberal, transparent and investor friendly policy. FDI up to 100 per cent investment is permitted for majority of the

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sectors and the investor does not require any prior approval from the Government of India. FDI rates are not the same for all sectors in the Indian economy. Some of them have been allowed to accept 100% FDI which means the entire capital of a business can originate from the FDI route. Some other common rates vary from 26%, 49%, 51% and 74%.

- Infrastructure Company in the Securities Market: 49%
- Insurance: up to 49%
- Medical Devices: up to 100%
- Pension: 49%
- Petroleum Refining (By PSUs): 49%
- Power Exchanges: 49%

Government approval in the sectors mentioned below is mandatory. The Company would have to apply through the Foreign Investment Facilitation Portal which provides for single window clearance. The application is then sent to the respective ministry, which will approve/reject the application while consulting with the Department for Promotion of Industry and Internal Trade (DPIIT), Ministry of Commerce. DPIIT is responsible for issuing the Standard Operating Procedure (SOP) for processing of applications under the existing FDI policy. Moreover, the following sectors listed below fall under the "Government Route" category:

- Banking & Public sector: 20%
- Broadcasting Content Services: 49%
- Core Investment Company: 100%
- Food Products Retail Trading: 100%
- Mining & Minerals separations of titanium bearing minerals and ores: 100%
- Multi-Brand Retail Trading: 51%
- Print Media (publications/ printing of scientific and technical magazines/ specialty journals/ periodicals and facsimile edition of foreign newspapers): 100%
- Print Media (publishing of newspaper, periodicals and Indian editions of foreign magazines dealing with news & current affairs): 26%

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- Satellite (Establishment and operations): 100%[3]

It should be noted that FDI from industries based in Pakistan and Bangladesh and now China, mineral separation of titanium etc requires security clearance from the Ministry of Home Affairs. It must be further clarified, that Pakistani businesses cannot invest in defence, space, atomic energy and sectors or activities prohibited by FDI through any route be it the Government route or the Automatic Route. Moreover, the security clearance documents prescribed by the Government must include details of the investor and the investee and whether the investor or its subsidiaries have presence of operations in Bangladesh, China or Pakistan. The issue of national security in the context of foreign investment from Pakistan and Bangladesh have always taken prominence. Along with FDI in specific sectors such as telecommunication, broadcasting, satellites (establishment and operation), private security agencies, defence, civil aviation, mining, etc.

While the FDI policy states that FDI in sectors that fall under the automatic route will be subject to applicable law, including security conditions, the government has not explicitly used its discretion to block FDI in such sectors on grounds of security. As Covid-19 continues to spread, regulators worldwide are expanding the scope of their FDI screening mechanisms to include healthcare and critical infrastructure and technology to protect their national and economic interest.

II. FDI POLICY AND AMENDMENT

Foreign equity investments in an Indian company are bound by the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ('Rules') and Foreign Direct Investment ('FDI') policy issued by the Ministry of Finance and Ministry of Commerce and Industry respectively (together referred as 'Government').

Earlier Position:

Para 3.1.1:

A non-resident entity can invest in India, subject to the FDI Policy except in those sectors/activities which are prohibited. However, a citizen of Bangladesh or an entity incorporated in Bangladesh can invest only under the Government route. Further, a citizen of Pakistan or an entity incorporated in Pakistan can invest, only under the Government route, in sectors/activities other than defence, space, atomic energy and sectors/activities prohibited for foreign investment.

[3] "Foreign Direct Investment Policy", (Indo France European Triangle – 2019), http://www.ifet.eu/foreign-direct-investment-policy/ (Accessed: October 19, 2020)

Revised Position:

Para 3.1.1:

a) A non-resident entity can invest in India, subject to the FDI Policy except in those sectors/activities which are prohibited. However, 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. Further, a citizen of Pakistan or an entity incorporated in Pakistan can invest, only under the Government route, in sectors/activities other than defence, space, atomic energy and sectors/activities prohibited for foreign investment.

b) 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/purview of the para 3.1.1(a), such subsequent change in beneficial ownership will also require Government approval.[4]

The above decision will take effect from the date of FEMA notification.

Further specifics given by the Indian Government are as follows:

1. Investment made by any non-resident entity of a country, which shares land border with India i.e. Pakistan, Bangladesh, China, Nepal, Myanmar, Bhutan and Afghanistan (‘Border States’) to be allowed only after obtaining Government approval.
2. Investment in India where beneficial owner of such investment is situated in or is a citizen of, any Border States to be permitted only under the Government approval route.
3. New restrictions to 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.
4. Further, a citizen of Pakistan or an entity incorporated in Pakistan can invest, only under the Government route, in sectors / activities other than defence, space, atomic energy and sectors / activities prohibited for foreign investment.

The amendment is effective from 22 April 2020. Thus all previous investments are grandfathered.

[4] Amendments made in FDI policy and the Rules vide Press Note No. 03 (2020 Series) Dated-7/04/2020 read with Foreign Exchange Management (Non-debt Instruments) Amendment Rules, 2020.

III. SHORT- COMINGS OF THE AMENDMENT

- **Definition of Beneficial owner not defined**

The term 'beneficial owner' has been defined under Prevention of Money Laundering Act, 2002 and the term 'significant beneficial owner' is defined under the Companies (Significant Beneficial Owners) Rules, 2018, however the extent of limit and scope under these definitions are different. Therefore, there is a dire need to define 'beneficial ownership' in the context of assessing potential investment for the government approval as proposed by the amendment.

While Foreign Exchange Management Act or its rules and regulations does not provide for this definition. Section 90 of the Companies Act, 2013 read with the Companies (Significant Beneficial Owners) Rules, 2018 mentions the term Significant Beneficial Owner ("SBO") as against the beneficial owner.

Section 90 of the Companies Act, 2013:

It states that SBO is "an individual who acting alone or together, or through one or more persons or trust, possesses one or more of the following rights or entitlements in such reporting company, namely: -

- holds indirectly, or together with any direct holdings, not less than ten per cent. of the shares
- holds indirectly, or together with any direct holdings, not less than ten per cent. of the voting rights in the shares;
- has right to receive or participate in not less than ten per cent. of the total distributable dividend, or any other distribution, in a financial year through indirect holdings alone, or together with any direct holdings;
- has right to exercise, or actually exercises, significant influence or control, in any manner other than through direct-holdings alone.."

Moreover, the term "Beneficial Owner" mentioned under the provisions of Prevention of Money Laundering Act, 2002 is defined as:

"An individual who ultimately owns or controls a client of a reporting 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"

However, in absence of any specific direction by the Government, it may not be appropriate

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to simply use the above definitions provided in the other Acts. Immediate clarification in this aspect should be provided by the Government.

- **Transparency required on bonus issues, right issues, warrants on existing investments, clarity required:-**

There should be some light thrown on the issue at present if government approval will also be required in case of issuance of right shares, bonus shares, warrants to their existing non-resident shareholder situated in Border States or is it required only to the entity whose beneficial owner is situated in the Border States. These issues are left very ambiguously and Government without fail, should provide an adequate clarification on this aspect.

- **Foreign investment in AIFs/REITs/In VITs ('Investment Vehicles') not covered:-**

At such a time when the economy is facing challenges and the channel of fundraising through public equity markets has almost gone dry, alternative financing vehicles like Real Estate investment Trusts (REITs), Infrastructure Investment Trusts (InvITs) and Alternative Investment Funds (AIFs) have become the preferred choice for fundraising as there has been a significant growth in funds raised and invested over the past few years and are thus synonymously called as investment vehicles too.

- **Clause (a) of Rule 6 of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019**[5] states about investment by person resident outside India in an Indian Company.
- **Clause (c) of the Rule 6 of the Foreign Exchange Management (Non-debt Instruments) Rules** states about investment by person resident outside India into Investment Vehicles.

Now, it is key to note that the amendment imposing restriction on Border States to invest in India is made in clause (a) of Rule 6 and not in clause (c). Hence, on mere reading of the amendment with Rule 6, it is very clear that the said restriction is not applicable for investment in investment vehicles in India. However, the intent of the amendment is to curb opportunistic takeover of Indian entities and such an interpretation may defeat the purpose for which amendment is made. Accordingly, Government should also clarify this aspect as this may affect many private equity funds in India.

Nevertheless, market regulators must closely monitor share transactions and investments by foreign companies and institutions, especially in unprecedented times when market

[5] Foreign Exchange Management (Non-debt Instruments) Rules, 2019 issued by the Ministry of Finance.

valuations are at historical lows such as now.

The notification under FEMA which brought the amendment into effect on April 22 has not clarified these concerns.

IV. Legal analysis of the amendment

Amidst the fear that Chinese companies may buy assets at lower valuations, several nations such as Japan, Australia and the US have taken protective positions against foreign investments. European countries such as Germany, Spain and Italy have also re-examined their investment norms with regard to possible takeover of their strategic assets by Chinese entities which may take advantage of the economic crash to raise their stakes in the global economy. Moreover, in the last few years, countries such as the United States have intervened in or blocked proposed foreign direct investment (FDI) transactions to address national security concerns, with a particular focus on China. The Covid-19 pandemic has not only brought healthcare and critical infrastructure into focus from an FDI perspective, but has also weakened companies in other sectors and made them easy targets for creditors and opportunistic buyers, where the investor is directly or indirectly controlled by a government of another country. Italy – one of the worst affected by Covid-19 – has also expanded the list of sectors in which FDI will require prior governmental review to include those mentioned above. With Europe having been declared as the epi- center of the Covid-19 pandemic in March, the above measures were perhaps expected.

However, countries in other continents have also taken severe measures – for example, Australia temporarily amended its FDI regime with effect from March 29, 2020 in national interest to deal with the economic implications arising from the spread of Covid-19, following which all proposed foreign investments subject to the Foreign Acquisitions and Takeover Act 1975, where the other conditions for the notifications are met, will now require prior regulatory approval, regardless of value or the nature of the foreign investor. Now a very interesting fact which can be taken into consideration is the fact that the Government of India is currently not concerned with possible suspected takeovers from European or US-based entities, rather its attention seems to be focused on entities backed by the People’s Republic of China. Along India’s borders, it is well-documented that China is seeking to increase its foothold in the region and the China Pakistan Economic Corridor (which has constantly been met with opposition by India) that would give China access to ports is one of a significant example of Chinese ingress in areas too close for India's comfort.

The new amendment in question requires certain investments from countries outside India as

FDI to come through the government approval route alone, and not under the direct route of investment. In other words, with the new amendment, FDI in these cases would require an approval from the Government of India, which would mean that the government would be able to monitor the extent of these investments and give its approval, should it choose to do so. Now on the Indian front, there has been a spike in the investments made by China in India as FDIs. Chinese investments in India have only risen from $1.8 billion in 2014 to an estimated $8-9 billion in 2017. As of today, with Indian Government's decision to restrict investments, the Government of India under the leadership of Prime Minister Narendra Modi has decided that it keeping in mind the best interests of India to come out of this pandemic with its industries and entities intact and still in Indian control, Chinese companies investing in Indian entities during the time of the global pandemic may not be the best plan, as found by several studies conducted and suggestion made by the economists. Moreover, the news of the People's Bank of China raising its stake in a major Indian lender (HDFC) had been met with a lot of suspicion which resulted in speculation (not completely unfounded) that Chinese companies could try and possibly takeover Indian companies during this time of the pandemic.

The initiative by the Government is to block direct investments from mainly China. But going by the definition of Beneficial Owner (and interpreting the definition of the term used in the other laws), it is open for interpretation that that the revised position would also impact investments from other jurisdictions where Beneficial Owners intended to or have invested more than 50 per cent of the capital instruments of an Indian company through special purpose vehicles ("SPV"). For instance, 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 per cent 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 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.[6]

[6] Rajat Sethi & Tanya Aggarwal, "Impact of Covid-19 On FDI Regimes", BloombergQuint, (April 14, 2020) https://www.bloombergquint.com/coronavirus-outbreak/impact-of-covid-19-on-fdi-regimes (Accessed: October

As there are several speculations and tension created among those in the industry that these entities may be backed by the Chinese government to make inroads into global jurisdictions including India to satisfy their ulterior motive as a country. Hence this issue is of utmost importance and this cannot be neglected. Therefore, Market regulators must closely monitor share transactions and investments by foreign companies and institutions, especially in unprecedented times such as this, when market valuations are at historical lows, not forgetting the situation when India's GDP dramatically collapsed during the lockdown quarter by 23.9% in April-June, 2020. Taking all these conditions and the introduction of the amendment into account, the Government of India may not be a complete shield and is definitely not in the protective mode or nature, but for sure on the contrary, this could be construed as one which will ensure that no Indian entity will be unfairly or dishonestly treated with as a result of this, during the current time of the pandemic by giving a freeway pass for Chinese FDI investments in India, like the past times.

Speaking about the time bound extent of this regulation, 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. Undoubtedly this amendment is a huge step to avoid investments and takeover of Indian listed and unlisted companies and their subsequent control, directly or indirectly, by Chinese Companies, which would help in India's economic growth and this amendment is needful in the longevity and smooth functioning of India's national security.

V. CONCLUSION

The effect of COVID 19 pandemic on the Indian economy has been catastrophic, as the valuations of Indian businesses continue to decrease. The Government of India in its response has been taking a slew of measures to overcome this roadblock. The Government of India is of the view that the change in the FDI policy serves the economic interests of India. The aim of the Government to retain its industries and businesses cannot be construed as protectionist in nature. On the contrary, it should be viewed as a move that would ensure that Indian businesses would remain in the right hands and would be immune to takeovers.

One cannot ignore the fact that FDI is indeed important for meeting India's developmental

19, 2020)

goals, the pandemic has actually put India in a relatively better position to leverage its FDI policy to suit its national interest. Moreover, India's handling of the COVID 19 crisis has yet again proved that India is a responsible and also a trustworthy nation with inclusive governance. On the other hand, India's rival China has damaged its reputation in the world arena with allegations of misinformation on COVID 19 that has further been exacerbated by Chinese predatory takeover of firms based in countries facing economic hardship. As a consequence of China's actions, countries such as Spain and Italy have announced measures too in this regard to protect domestic businesses from hostile takeovers by businesses based in countries such as China. These nations are also providing economic stimulus packages to entice firms to shift their production houses out of China, Japan is another well-known example.

While firms from other countries are busy shifting their supply chains away from China and exploring other options, this would be the perfect time for India to increase its manufacturing competitiveness so that it can serve as an integral part to the global supply chain. There cannot be a more suitable time for India to capitalize on its start-up advantage and new innovations. As long as the Government plays a role by announcing fiscal incentives and economic stimulus grants, India would have the opportunity to build on its position as an attractive country for FDI from businesses with genuine intent.

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