Government of India to regulate foreign investment from neighbouring countries in Indian entities

Introduction

The Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Government of India issued a press note number 3 (2020 Series) on 17 April 2020 ("**PN 3**") to revise the Foreign Direct Investment Policy -2017 ("**FDI**") to curb opportunistic takeover/ acquisition of Indian companies due to the current COVID-19 pandemic and consequently amended the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("**Non-debt Instruments Rules**") vide notification no. S.O. 1278 (E) dated 22 April 2020 ("**Amendment**").

Key changes

1. PN 3 and the consequent Amendment seeks to regulate foreign investment in India from countries which share land borders with India ("**Neighbouring Countries**") by 'Eligible Investors' under FDI.
2. Accordingly, any investment by non-resident entities of Neighbouring Countries or where the beneficial owner of such investment is situated or is a citizen of any such Neighbouring Countries will now be permitted only under the Government approval route. This includes Nepal, Pakistan, Bhutan, Bangladesh, Myanmar, Afghanistan and most notably China.
3. Further, any transfer of ownership of any existing or future FDI in an entity in India, either directly or indirectly, resulting in the beneficial ownership of the relevant securities falling within the aforesaid restriction will also require Government approval.

Effective Date

The changes proposed by PN 3 have become effective by the Amendment i.e. from 22 April 2020.

Likely Impact on Investments and Investors

While existing investments are unlikely to be impacted by the Amendment, the ability of investors falling within the ambit of this the Amendment to acquire any further stake in companies in which they already have investments, whether by virtue of rights under existing agreements containing optionality clauses, or rights issues and/or preferential allotments becomes questionable. Further, the ability of any entities that are wholly or substantially owned (beneficially or directly) by investors from Neighbouring Countries to raise further capital from existing shareholders will now be impeded.

PN 3 as well as the Amendment is also silent on whether agreements executed before 22 April 2020

can be honoured where these involve investments by investors falling within the ambit of the Amendment or whether governmental approval will now be required for those investments as well. In our view, the latter is the likely intention.

Beneficial Owner

Another issue that will require clarity is the interpretation of the term beneficial ownership.

Whilst efforts are being made to ensure that there is no backdoor opportunistic takeover or acquisition of Indian companies by including beneficial ownership, PN 3 and the Amendment has also created some amount of confusion as neither it, nor the Foreign Exchange Management Act, 1999 ("**FEMA**"), nor the FDI Policy, nor the Non-debt Instruments Rules define or clarify what beneficial owner means.

It is pertinent to note that while the current FDI Policy as well as the Non-debt Instruments Rules require any investment made by a resident Indian would also be counted as foreign investment where a declaration is made by a person as per the provisions of the Companies Act, 2013 with the beneficial interest being held by a person resident outside India, neither of these legislations speak of deal with undeclared beneficial interest or ownership, or indeed beneficial interest or ownership in the foreign investor. These concepts have been touch upon in exchange control legislation for the first time in PN 3 and the consequent Amendment, quite evidently with the intention of ensuring that no indirect investments from Neighbouring Countries are made in Indian entities without governmental approval, irrespective of whether a declaration of beneficial interest has been made under Companies Act, 2013 or not.

As beneficial ownership has not been defined in any exchange control regulations, unless there is further clarification on what would be construed as beneficial ownership from the Government, we have to look to other statutes to understand and interpret the term "beneficial ownership".

Likely the most significant of these is Section 90 of Companies Act, 2013 read with Companies (Significant Beneficial Owners) Rules, 2018 which defines "significant beneficial owner" as an ultimate individual who, directly or indirectly, acting alone or together:

(i) holds indirectly, or together with any direct holdings, not less than 10% of the shares or 10% of the voting rights in the shares;
(ii) has right to receive or participate in not less than 10% of the total distributable dividend, or any other distribution, in a financial year through indirect holdings alone, or together with any direct holdings;
(iii) has right to exercise, or actually exercises, significant influence or control, in any manner other than through direct-holdings alone.

The relevant rules further clarify how these individuals are to be identified[1].

[1] *For the purpose of this clause, an individual shall be considered to hold a right or entitlement indirectly in the reporting company, if he satisfies any of the following criteria, in respect of a member of the reporting company, namely: -*
(i) where the member of the reporting company is a body corporate (whether incorporated or registered in India or abroad), other than a limited liability partnership, and the individual,-
(a) holds majority stake in that member; or
(b) holds majority stake in the ultimate holding company (whether incorporated or registered in India or abroad) of that member;
(ii) where the member of the reporting company is a Hindu Undivided Family (HUF) (through karta), and the individual is the karta of the HUF;
(iii) where the member of the reporting company is a partnership entity (through itself or a partner), and the individual,-
(a) is a partner; or
(b) holds majority stake in the body corporate which is a partner of the partnership entity; or
(c) holds majority stake in the ultimate holding company of the body corporate which is a partner of the partnership entity.

However, since the provisions of the Companies Act, 2013 determine "significant beneficial owner" of an Indian company to be 'individuals' while PN 3 as well as the Amendment merely refers to "beneficial owner", it may be difficult to use this definition while interpreting the Amendment.

Another statute that could be looked at is the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 ("**PMLA Rules**"), which set out criteria for identifying a "beneficial owner".

The term "beneficial owner" has been defined under PMLA Rules to *inter alia* mean a natural person who, acting alone or together, or through one or more juridical person, has, in the case of a company ownership / entitlement of shares, capital or profits of 25% or more or control has of the company, and in the case of other entities, this threshold is 15% of capital or profits, etc.[2]

Reserve Bank of India (Know Your Customer (KYC)) Directions, 2016 which are guidelines of the Reserve Bank of India as well as of the Securities and Exchange Board of India follow criteria similar to those set out in the PMLA Rules.

(iv) where the member of the reporting company is a trust (through trustee), and the individual,-

(a) is a trustee in case of a discretionary trust or a charitable trust;

(b) is a beneficiary in case of a specific trust;

(c) is the author or settlor in case of a revocable trust.

(v) where the member of the reporting company is,-(a) a pooled investment vehicle; or (b) an entity controlled by the pooled investment vehicle,

based in member State of the Financial Action Task Force on Money Laundering and the regulator of the securities market in such member State is a member of the International Organization of Securities Commissions, and the individual in relation to the pooled investment vehicle,- (i) is a general partner; or (ii) is an investment manager; or (iii) is a Chief Executive Officer where the investment manager of such pooled vehicle is a body corporate or a partnership entity.

(vi) Where the member of a reporting company is, (i) a pooled investment vehicle; or (ii) an entity controlled by the pooled investment vehicle,

based in a jurisdiction which does not fulfil the requirements referred to in clause (v) above, the provisions of clause (i) or clause (ii) or clause (iii) or clause (iv) above, as the case may be, shall apply.

[2] *The beneficial owner for the purpose of sub-rule (1) shall be determined as under -*

(a) where the client is a company, the beneficial owner is the natural person(s), who, whether acting alone or together, or through one or more juridical person, has a controlling ownership interest or who exercises control through other means.

Explanation.- For the purpose of this sub-clause-

1. *"Controlling ownership interest" means ownership of or entitlement to more than twenty-five percent of shares or capital or profits of the company;*
2. *"Control" shall include the right to appoint majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements;*

(b) where the client is a partnership firm, the beneficial owner is the natural person(s), who, whether acting alone or together, or through one or more juridical person, has ownership of/entitlement to more than fifteen percent of capital or profits of the partnership;

(c) where the client is an unincorporated association or body of individuals, the beneficial owner is the natural person(s), who, whether acting alone or together, or through one or more juridical person, has ownership of or entitlement to more than fifteen percent of the property or capital or profits of such association or body of individuals;

(d) where no natural person is identified under (a) or (b) or (c) above, the beneficial owner is the relevant natural person who holds the position of senior managing official;

(e) where the client is a trust, the identification of beneficial owner(s) shall include identification of the author of the trust, the trustee, the beneficiaries with fifteen percent or more interest in the trust and any other natural person exercising ultimate effective control over the trust through a chain of control or ownership; and

(f) where the client or the owner of the controlling interest is an entity listed on a stock exchange in India, or it is an entity resident in jurisdictions notified by the Central Government and listed on stock exchanges in such jurisdictions notified by the Central Government, or it is a subsidiary of such listed entities, it is not necessary to identify and verify the identity of any shareholder or beneficial owner of such entities.

Both these definitions are, of course, intentionally nebulous so as to facilitate (a) the government being able to understand who has ultimate control of a company, if at all, and (b) the prevention of black money laundering and therefore has a very different context from the Amendment. They are, therefore, ill suited, in our view, to use this when interpreting the Amendment.

The intention of the government may have been as conservative as, there should be absolutely no indirect holding in Indian companies from Neighbouring Countries without governmental approval, as liberal as that ownership/control of the investor should not be with persons in a Neighbouring Country, or anywhere in between.

Conclusion

While PN 3 and the consequent Amendment seeks to regulate investments from Neighbouring Countries, the investee companies are likely to suffer the biggest problems from the lack of clarity in PN 3 and the Amendment. This is primarily because the investee companies are the ones, being the resident entities involved, that are required to follow the law of the land, and will therefore be held liable for any non-compliance, however inadvertent.

This is a particularly significant concern when it comes to determination of beneficial ownership of the investors as the companies are largely dependent on clear and accurate disclosures from their investors. Interestingly enough, while the definition of "significant beneficial owner" under Companies Act, 2013 may be nebulous, the relevant rules make it much easier for a company to comply with the necessary disclosure requirements and therefore in many cases the company in question, if it shows due procedure having been followed, may not be found to be in default under that statute. However, in the case of PN 3 and the Amendment as it now stands, the investee company will likely face the consequences of beneficial ownership of its investor not having been properly declared by the investor, something that the company itself would have little to no control over. This requirement on beneficial ownership may of course, also result in a slowdown in investments in Indian companies from the Neighbouring Countries as many investors are loathe to disclose their structures and limited partners for a variety of reasons.

Now that the PN 3 has become effective from 22 April 2020 upon notification of the Amendment, replicating the language of PN 3 as is, one can only hope that the government will soon issue clarifications and that investee companies are not made to suffer penal consequences for inadequate or wrong disclosures about their investors.

DISCLAIMER

For further clarification and details on the above, you may write to the Exchange Control team comprising of among others Ms. Siddhi Ghatlia (Partner) at sghatlia@almtlegal.com , Ms. Khusbu Jasani (Senior Associate) at kjasani@almtlegal.com and Ms. Amishi Vira (Associate) at avira@almtlegal.com.