NEWSLETTER

START-UP FIRMS FUNDED BY CHINESE INVESTORS MAY LOOK FOR OTHER SOURCE OF CAPITAL, SAYS MR. JINDEL

On April 17, 2020 Government of India amended FDI rules by requiring government approval for investment in Indian firms by legal entities or individuals from neighbouring countries. The government's move was aimed at preventing distressed sale of Indian businesses to Chinese companies during the COVID-19 crisis, although this has not been explicitly stated.

Legal experts feel that the move gives rise to many ambiguities and may cause subjective interpretation of the amended provisions. In an interview to MVIRDC World Trade Center Mumbai, Mr. Shantanu Jindel, Partner at India's leading law firm J. Sagar Associatespoints out that the government's move may hurt fresh investment in India's start-up enterprises. Mr. Jindel also suggests that the government should waive agreements which have already been executed between Indian companies and foreign companies before the rule came into force but flow of investment is yet to materialise.

Excerpts of the interview:

Q1. The government has made changes to the FDI policy by disallowing FDI from neighbouring countries through the automatic route through a press note. Does the move require Parliament approval for coming into force?

The Ministry of Commerce and Industry, Department for Promotion of Industry and Internal Trade has released Press Note 3 of the 2020 series (PN3) on April 17, 2020. Further, on April 22, 2020, the Central Government notified (in the official gazette) the amendment to the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (NDI Rules) to give effect to PN3. Given that the NDI Rules come under the framework of the Foreign Exchange Management Act, 1999 (FEMA), and Section 46 of the FEMA specifically provides that the Central Government may, by notification, make rules to carry out the provisions of FEMA, there is no requirement for a separate approval from the Parliament. Having said that, the place of a Press Note under the powers bestowed to the legislature and the executive under the Constitution of India is a separate discussion altogether.

Q2. Give us an overview of the scope of application of this amendment. Does the amended rule apply to only unlisted companies or even to listed companies? Are VCs, PEs based out of Mauritius, Singapore but having Chinese firms as ultimate beneficiaries affected by this law? Can an Indian firm with existing investors from China be barred from further capital raising from these investors?

The amendment is in the context of Rule 6(a) which specifically deals with subscription, purchase and sale of equity instruments of an Indian company. The term "equity instruments" has been defined to mean equity shares, convertible debentures, preference shares and share warrants issued by an Indian company. Debt instruments (such as bonds) which are not regulated by the NDI

Rules will not get impacted by the amendment. However, Put and Call options over equity instruments will get impacted by the restrictions imposed by the amendment given that there is no carve-out.

NDI Rules apply to listed companies as well. Given that the amendment has not carved out any exception for listed companies, they will need to comply with the amended provision as well.

The amendment to the NDI Rules has been phrased in a fairly broad language without any guidance for interpretation. It provides as follows:

(a) approval from the Government will be required: (i) for investment by an entity of a country, which shares land border with India; or (ii) where the beneficial owner of an investment into India is situated in or is a citizen of any such country; and

(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 purview of the para (a) above, such subsequent change in beneficial ownership will also require Government approval.

Para (a) lays down the basic change in the policy where any investment from a neighbouring country will require a prior approval from the Government of India. It covers investment by both – individuals as well as legal entities, and uses the phrase 'beneficial ownership' to cover potential investments through layered structures. Para (b) widens the scope and clarifies that even a transfer of ownership of investment which directly or indirectly results into the beneficial ownership falling into the hands of persons and entities included in para (a) would require Government approval. The terms 'beneficial interest' and 'directly or indirectly' lend a lot of subjectivity to the interpretation given that the amendment does not provide any aid to interpretation.

Till there is greater clarity from the Government or the RBI on the interpretation of the term 'beneficial ownership', the definition of 'beneficial interest' in Section 89(10) of the Companies Act, 2013 may be worth considering.

Section 89 (10) of the Companies Act, 2013 defines 'beneficial interest' as under:

(10) For the purposes of this section and section 90, beneficial interest in a share includes, directly or indirectly, through any contract, arrangement or otherwise, the right or entitlement of a person alone or together with any other person to—

(i) exercise or cause to be exercised any or all of the rights attached to such share; or
(ii) receive or participate in any dividend or other distribution in respect of such share.
The term 'beneficial interest' has wide scope even under the Companies Act, 2013 and is linked to the right/entitlement of a person to participate in dividend and other rights linked to the shareholding in a company.

Given the above, subject to any further clarification provided by the Government, the amendment will cover fresh investments as well as any follow-on investment by investors from neighbouring countries in the Indian companies. Even a rights issue and investments in wholly owned subsidiaries would get covered. As the phrase 'directly or indirectly' has been included in the language of the amendment, overseas acquisition of an entity by an investor from China which results in an indirect acquisition resulting in acquisition of beneficial interest of an Indian company, would also be covered. Similarly, downstream investment by Indian companies will also fall within the scope of the amendment.

For investment by companies which are listed in an overseas jurisdiction, one will have to examine on a case to case basis. An investor (in the overseas listed company) who does not have any special rights cannot be said to be in a position of holding the beneficial ownership of the Indian company through that listed company. However, if such an investor is in control of that listed company (by virtue of shareholding or management rights) or if such an investor has certain special rights in the listed company, then PN3 and the amended NDI Rules would apply to its investment.

As far as the VC/PE funds are concerned, if such funds are sponsored or beneficially owned by investors resident of China, then any investment by them will require approval from the Government of India. This will again need to be examined on a case to case basis.

Q3. How do you see this move impacting flow of FDI into India? What are the sectors that may face maximum impact from this move?

Historically, India has not received significant amounts of FDI from its neighbouring countries. Even China, which has made considerable investments in some of the other countries has treaded cautiously. Therefore, PN3 by itself may leave the regime more ambiguous, but given that it only applies to FDI from neighbouring countries – its impact should not be significant purely in terms of quantum of FDI received.

Having said that, Chinese behemoths such as Tencent and Alibaba have invested extensively in the tech-based start-ups in India. In fact, according to one study, majority of the unicorns in India have received investments from China. These unicorns are market leaders in fields of hospitality, education, logistics, food delivery etc. Therefore, start-up industry across sectors may need to examine its reliance on Chinese investments for the next phase of growth, and maybe explore alternatives – given that even if approvals for Chinese investments are forthcoming, it may be a time-consuming process.

Apart from the above, some of the Chinese brands such as MG Motors, Xiomi and Oppo have significant market penetration. The amendment does not distinguish between greenfield and brownfield investment. The amended provision will apply to any FDI by Chinese entities in India.Therefore, while their India operations may face certain challenges, this should not impact the respective sectors as substitutable products from the other brands are available easily.

Q4. Countries such as USA and Australia have also reportedly made legislation prohibiting investment from China. How are the moves of these counties different from our policy change?

Countries across the world have realised the vulnerability that the COVID19 induced market meltdown creates, and have taken measures to install checks and balances. There are two major differences between the actions taken by the Government of India and the governments of other countries, while dealing with opportunistic takeovers in light of COVID19:

(a) the restrictions imposed by the other countries apply irrespective of the country of origin of the foreign investment, unlike India- where the restrictions only apply to investments (directly or indirectly) originating from or having a nexus with the countries with which India shares a land border;

(b) the other countries have provided a slightly more detailed framework on how the policy decision will be implemented setting out processes and thresholds, as required. As a result of this, there is clarity on who all will get affected by the change in law, and what is the way forward.

Policy decisions which remain open to interpretation and contemplation sometimes prove to be bigger hurdles simply because of lack of clarity, and not as much because of the restrictions they impose. Further, the sudden change in policy puts into jeopardy the deals for which the agreements have been executed but the funding is yet to take place. Some leeway for FDI in India from neighbouring countries for which agreements have already been executed would have been a more balanced approach, as has been done in some other jurisdictions.

Notifications

Press Information Bureau, Government of India

- Prime Minister discusses ways to boost aerospace sector
- Prime Minister holds meeting to boost investment
- DPIIT Control Room addresses concerns of industry amidst lockdown
- G20 Digital Ministers Summit
- Free movement of trucks and empty carriers
- Minister launches new portal for MSME schemes, ideas, research and innovation
- Ministry of Shipping launches new website

CBIC

- Notification of amendment in tariff value

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