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UPDATES

India introduces stricter FDI rules for foreign investment from China and other border countries

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1 Introduction

In the wake of the economic and financial crisis caused by the COVID-19 pandemic, India has revised its foreign direct investment (**FDI**) policy through Press Note 3 of 2020 (**Press Note**) imposing stricter norms on foreign investments in Indian companies from an investor based out of bordering countries. The primary objective of the revised FDI policy is to curb any opportunistic takeovers or acquisitions of Indian companies during the COVID-19 pandemic.

To curb opportunistic takeovers or acquisitions of Indian companies during the COVID-19 pandemic, India has revised its foreign direct investment policy. Investors from bordering countries will now need prior government approval for making such investments in an Indian company.

Under the amended FDI policy, a mandatory prior government approval will now be required for any foreign investment in or acquisition/transfer of an Indian company (directly or indirectly), where the acquirer or beneficial owner of such investment is based out of a country which shares land borders with India. It may be helpful to note that the newly introduced restrictions do not prohibit foreign investment from bordering countries into India but only seek to regulate future foreign investments into India or transfer of existing Indian investments to beneficial owners located in bordering countries. Among the border countries, China is the only land neighbouring country of India who makes substantial foreign investments into India. The legal amendments and details on operational modalities are yet to be notified by the Indian government. In this update, we discuss some key takeaways and potential implications from this revised FDI policy.

2 What is the change?

Under the Indian FDI framework, a non-resident entity is allowed to invest in all sectors except certain prohibited sectors (such as tobacco, lottery and atomic energy). The FDI policy generally allows foreign investors (except for investors based out of Pakistan and Bangladesh who need to obtain prior government approval) to make foreign investment in most sectors under the automatic route (i.e. without government approval) subject to sectoral conditions.

The amended FDI Policy seeks to narrow the scope of eligible investors who are allowed to invest under the automatic route. Under the new rules, any foreign investment by a non-resident based out of a country that shares a land border with India will require the prior approval of the government irrespective of the sector into which the investment is being made. India shares a land border with China, Pakistan, Bangladesh, Nepal, Myanmar, Bhutan and Afghanistan (**Restricted Country**). This investment approval requirement also extends to: (i) those investments, where the beneficial owner (corporate or individual) is situated in the jurisdiction of a Restricted Country; or (ii) a direct or indirect transfer of ownership of any existing or future investment, which results in the beneficial owner being from a Restricted Country.

3 Key Takeaways

At present, the government has not notified the underlying amendments and in the absence of finer details, there are certain key issues which the government needs to clarify soon.

a. **Impact on signed transactions or committed deals** – Existing transactions which are finalised, definitive agreements that have been signed but completion has not taken place or transactions which have multiple closings would all be impacted. It is unclear if this prior government approval will be required for (a) completing transactions that were finalised prior to COVID-19 crisis; (b) future investments to be done by existing Restricted Country shareholders in Indian companies in a rights issue; or (c) investments made by a Restricted Country parent company in its Indian subsidiary or how this would play out in the context of downstream investments by Indian companies which have substantial Restricted Country investments. In previous instances of imposition of new regulations, the government has allowed executed transactions to proceed.

b. **Guidance on beneficial interest** – The Press Note does not clarify how the term '*beneficial interest*' will be determined and construed for approval purposes in the present context. Investors would need clarity on the manner of computation of beneficial interest and applicable thresholds. Further, many private equity firms have major Chinese financial institutions and investors as limited partners. It is unclear how this condition would affect such private equity firms.

c. **Broad Approval Review** – While the stated objective is to curb opportunistic takeovers or acquisitions of Indian companies, the approach adopted by the government to go for an '*overall*' prior review appears to be all encompassing. A more balanced approach of regulating investments in identified '*sensitive*' sectors such as telecom, banking, insurance or financial and health critical infrastructure would have been prudent. Further the revised FDI policy does not distinguish between (a) majority investment or acquisition of control transactions; and (b) minority or passive investment transactions from a Restricted Country. We anticipate some of these to be exempted or be under a faster approval route.

d. **Prior government approval an interim measure?** While the revised FDI policy is on account of factors arising from COVID-19, the Press Note does not mention if this modification is an interim measure. We would have

to examine the legal amendments to see if they provide for sunset conditions to determine till when this prior approval requirement will remain.

e. **Operational modalities/guidelines** – We expect that the legal amendments or the government would issue operating guidelines on the approval procedure, expected timelines for granting such an approval or to respond to a potential investor and set out indicative evaluation parameters it would consider in granting such an approval.

The changes under the Press Note are in the context of foreign direct investment and would not apply to foreign investments in the public securities market (i.e. foreign portfolio investment (**FPI**)). At present, it is unclear if a similar change would be introduced in the FPI regime, but SEBI has recently issued directions to custodian banks to disclose details of ultimate beneficial owners of foreign portfolio investors based in China and Hong Kong. This is also relevant for non-mainland China and Hong Kong funds where limited partners may be based in China.

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