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Exchange Control Regulations

FDI Policy Changes

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Background

In order to curb opportunistic takeovers/ acquisitions of Indian companies due to current COVID-19 pandemic, on April 17, 2020, the Department for Promotion of Industry and Internal Trade (DPIIT) came up with a Press Note (Press Note 3 of 2020) whereby new restrictions were brought in the Foreign Direct Investment (FDI) Policy. This change saw a paradigm shift in the manner in which the government looks at foreign investments from neighbouring countries.

The Press Note brought changes to the Para 3.1.1 of the extant FDI policy (Consolidated FDI Policy 2017) whereby investments from an entity from *a country that shares land border with India* ("neighbouring country") or investments, where a beneficial owner is situated in or is a citizen of a neighbouring country, are now been brought in the Government Route. Further, even cases of transfer of ownership of any existing or future FDI in an entity in India resulting in change in beneficial ownership and falling within the restrictions of investment from neighbouring country, such subsequent change in beneficial ownership will also require Government Approval.

A corresponding amendment was brought in the Foreign Exchange Management (Non-Debt Instruments) Rules,

2019 ("FEM (NDI) Rules"), wherein the provisos to Rule 6(a) have been replaced with the following provisos:

- ***Provided that an entity of a country, which shares land border with India or the beneficial owner of an investment into India who is situated in or is a citizen of any such country, shall invest only with the Government approval: ("First Proviso")***
- ***Provided further that, a citizen of Pakistan or an entity incorporated in Pakistan shall invest only under the Government route, in sectors or activities other than defence, space, atomic energy and such other sectors or activities prohibited for foreign investment:***
- ***Provided also that 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 or purview of the above provisos, such subsequent change in beneficial ownership shall also require government approval". ("Third Proviso")***

Coverage

On a broad reading of the First Proviso and Third Proviso, it appears that the new regulations cover situations of both, fresh investments (directly or indirectly) from a neighbouring country or where the beneficial owner is situated in or is a citizen of a neighbouring country and also cases of transfer of shares involving similar conditions whereby the ownership is directly or indirectly transferred to a beneficial owner of a neighbouring country.

Concept of Beneficial Owner

As can be seen from the amended provisions, one of the key parameters for evaluating applicability of the new provisions is the concept of “beneficial owner” and hence, a check on the **Beneficial Ownership** becomes quite relevant. Surprisingly, the Government has not provided for a definition of what would constitute “Beneficial Owner” or “Beneficial Ownership” for the purpose of the amended provisos. The terms have not been defined under the extant exchange control regulations.

It is relevant to note that in the context of definition of “foreign investment”, FEM (NDI)

Rules provide for an explanation stating that if a declaration is made by a person as per *Companies Act 2013* about a *beneficial interest*, being held by a person resident outside India, then even though the investment may be made by a resident Indian citizen, the same shall be counted as foreign investment.

Provisions of Companies Act 2013

In absence of any clarification in this regard, if one were to similarly place reliance upon the provisions of Companies Act, 2013, reference can be had to provisions of section 89 and 90 thereof and Rules referred to thereunder.

As per section 89(2) and Rule 9 of Companies (Management and Administration) Rules, 2014, every person holding or acquiring a *beneficial interest* in shares of a company not registered in his name shall file a declaration disclosing such interest. Such a person who holds a beneficial interest has been referred to as a “beneficial owner”. Section 89(10) of Companies Act, 2013 provides for an inclusive meaning to the term “beneficial interest” so as to include 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
- (ii) Receive or participate in any dividend or other distribution in respect of such share

A perusal of the relevant form shows that such a beneficial owner could either be an individual or be a company. It is well accepted that “beneficial owner” for the purpose of section 89 is to be seen in the context of “nominee / registered shareholder - beneficial shareholder” relationship and thereby in most cases, the registered owner would be the beneficial owner unless shares are held by a nominee shareholder in which case provisions of section 89 would kick in.

Section 90 of Companies Act 2013 refers to “significant beneficial owner” who has been explained to mean an individual, who acting alone or together, or through one or more persons or trust, including a trust and persons residents outside India, holds beneficial

interests, of not less than twenty-five per cent, or such other percentage as may be prescribed, in shares of a company or the right to exercise, or the actual exercising of significant influence or control over the company.

As per Companies (Significant Beneficial Owners) Amendment Rules, 2019 the term "significant beneficial owner" in relation to an Indian company means an individual referred to in section 90(1), 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 company, namely:-

- i. holds **indirectly**, or together with any direct holdings, not less than ten per cent. of the shares;
- ii. holds **indirectly**, or together with any direct holdings, not less than ten per cent. of the voting rights in the shares;
- iii. 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;
- iv. has right to exercise, or actually exercises, **significant influence or control**, in any

manner other than through direct-holdings alone:

Thus, while section 89 ideally deals with the registered / direct owner being the beneficial owner except for nominee cases (as discussed above), section 90 adopts a "look-through" approach in the sense that it requires identification of the individual who fulfils the parameters and is applicable only on initial satisfaction of the requirement of *indirect* holding of any right or entitlement. It is also interesting to note that for the purpose of section 90, a beneficial owner who has already made a declaration under section 89 (under a nominee-beneficial shareholder relationship) is considered as directly (and not indirectly) holding any right or entitlement, as is required under section 90. An individual shall be considered to be holding indirect right or entitlement in the company if the individual holds a majority stake in either a member of the company or holds a majority stake in the ultimate holding company of that member.

Accordingly, one may be able to conclude that both sections 89 and 90 operate in different spheres. While section 89 does not necessitate

a "look-through" approach, section 90 adopts the same. Accordingly, for the amended FDI regulations, even if one were to refer to the provisions of Companies Act, the question would be which provisions to refer to, section 89 or section 90? Considering that the Government would want to apply a "look-through" approach while evaluating the FDI proposals for investment / transfer, a possible view is that it should ideally be more akin to the provisions of section 90. A suitable clarification in this regard is awaited.

Provisions of Prevention of Money Laundering Act (PMLA)

Apart from Companies Act, one could also take recourse to the provisions of PMLA that also provides for definition of "beneficial owner" to mean a natural person natural person who ultimately owns or controls a client and or the person on whose behalf a transaction is being conducted, and includes a person who exercise ultimate effective control over a juridical person. In the context of KYC norms, Government had further advised to check threshold of 25% ownership and had also suggested that when no natural person is

identified, the senior managing official would be considered as “beneficial owner”. It is interesting to note that initially, section 90 of Companies Act read with relevant Rules also provided for a similar criteria of senior managing official which was subsequently amended.

Thus, the meaning of “Beneficial Owner” and “Beneficial Ownership” for the purpose of the new regulations is far from clear and the Government should immediately come up with suitable clarifications to settle the dust.

Situations covered

Having considered the main feature of the new provisions i.e. Beneficial Ownership, we once again try and understand the situations that shall be covered by the new provisions.

Two situations (**First Proviso and Third Proviso**) are envisaged by the amendments:

Situation 1 – Fresh Investment Cases [First Proviso]

Investment in an Indian entity that has the following parameters:

- a. Investment is made by an Entity of a neighbouring country; or

- b. Beneficial owner of investment (irrespective of country of the Investing Entity) is situated in or is a citizen of a neighbouring country

Accordingly, once the investment falls under *either* of the two cases ‘a’ or ‘b’ above, Government Route kicks in. In case ‘a’, it becomes irrelevant as to who the Beneficial Owner is. Cases not falling under ‘a’ will have to be analysed for Beneficial Ownership and in case the Beneficial Owner is a citizen of or is situated in a neighbouring country, Government Route is applicable.

If one was to take the definition of “beneficial ownership” as per understanding of section 89 of Companies Act 2013, it may not go with the language of first proviso because the first proviso talks about two cases independently whereby the direct investor is different from beneficial owner as against section 89 which considers the owners as same unless there is a “nominee – beneficial owner” relationship. However, if we apply the meaning as provided in section 90 of Companies Act 2013, it seems to be in sync with the first proviso as section 90 also treats “significant beneficial owner” as

different from direct investor / owner which is the way the first proviso is drafted.

Situation 2 – Transfer Cases [Third Proviso]

As mentioned in the beginning, while broadly the Third Proviso deals with cases dealing with share transfer, a minute reading of the proviso could lead to different interpretations.

View 1

A literal reading of the Third Proviso implies that it covers transfer of ownership of any existing or future FDI with the following parameters:

- a. There is an event of direct or Indirect transfer of ownership of FDI in an entity in India
- b. Such a transfer could be of either an existing FDI or a future FDI
- c. As a result of the event, the beneficial ownership falls within the restriction or purview of the above proviso i.e. beneficial owner of investment is situated in or is a citizen of a neighbouring country a change in beneficial ownership

- d. Such a *change in beneficial ownership* (pursuant to the event) requires Government approval

Thus, if one was to consider this View, it leads to an interesting proposition that while Situation 1 covers cases of both direct investment from, and also when the Beneficial Owner is from, a neighbouring country, Situation 2 covers cases of change in "Beneficial Ownership" and not cases of direct share transfer (to a party of a neighbouring country) which does not result in a change in Beneficial Ownership. A possible reason behind this could be the fact that in cases of share transfer, government wishes to verify the transaction only in cases where there is a change in beneficial owner and not in all cases.

Ideally, a similar approach should also be adopted for First Proviso wherein importance should be given to "beneficial ownership". If this View was to be coupled with the meaning of "Beneficial Ownership" as per provisions of section 90, it could mean that cases that involve transfer to an entity from a neighbouring country may still go out of the purview of the Government Route if the Beneficial Owner as per section 90 of Companies Act does not belong to a neighbouring country.

View 2

Another possible view is that notwithstanding the different language used in the Third Proviso, a reference should be had to the First Proviso even while interpreting the Third Proviso and accordingly, both types of cases should require Government approval viz. cases where either the transfer is directly to a party from a neighbouring country or transfer is to any other party, but there is a change in beneficial ownership, thereby a party in a neighbouring country becoming the beneficial owner.

While it appears that View 1 should be the ideal interpretation, a suitable clarification in this regard from the Government shall help. If no clarification is provided, an approval may have to be sought as per View 2. It is also important to note that the meaning of "beneficial owner" will also have an impact on either of the Views. Interplay of section 89 and 90 of Companies Act with this View also needs consideration.

It is also important to note that Rule 9 of FEM (NDI) Rules specifically dealing with Transfer Cases has not been amended.

Taking China as an example, we have evaluated applicability of the new regulations to various

illustrative scenarios depending upon the nature of transaction, location of direct investor / transferor / transferee, location of beneficial owner and also considering both Views, 1 and 2. The illustrative scenarios are provided in a tabulated form in **Appendix A**. It is important to note that these are only illustrations pending further clarity on various aspects and should not be taken as conclusive at this stage, especially in absence of what would constitute "beneficial owner" and "beneficial ownership".

Intent and applicability of amended provisions

As mentioned in the Press Note, the main objective of the amendment is to curb opportunistic takeovers/ acquisitions of Indian companies. If one was to consider the amendments in light of the objective, there could be possible questions regarding applicability of the Government Route to the following illustrative transactions:

- a. A Group setting up a new company in India
- b. Investments pursuant to Rights Issue whereby the proportion of shareholding does not change (such Rights issue are

otherwise governed by Rule 7 of FEM (NDI) Rules)

- c. Additional investment in an existing Indian subsidiary

On a literal reading of the amended regulations, the same seem applicable to the transactions described above. However, when one looks at the intent behind the amendment, applicability of the same to these types of transactions seem completely unintended.

There could be multiple other transactions for which the Government Route may apply unintendedly. A clarification in this regard should be provided by the Government.

Foreign Investment (FI) in LLP – whether covered?

Investment in an LLP is governed by Rule 6(b) of FEM (NDI) Rules. The amendment discussed above has been brought to Rule 6(a) of FEM (NDI) Rules and pertain to FDI in an Indian Company. They do not apply to FI in LLP. As a consequence, there is a possibility that FI from neighbouring countries in LLP in India would be prohibited because FI in LLP is allowed only in

sectors where 100% FDI is allowed under Automatic Route (and not Government Route). If the same is not the intent of the Government, appropriate amendments should be brought in the Law.

Process for Approval

Government faced a lot of backlash after the amendments were brought in in a haste without appropriate clarifications regarding the new process or changes to the existing process. Currently, cases falling under Government Route have to apply online vide the Foreign Investment Facilitation Portal (FIFP) along with an application to the relevant Ministry. It is believed that cases pertaining to China will also be evaluated by Ministry of Home Affairs (MHA).

It has been observed that few changes have already been carried out to the online FIFP portal, for example, a Tab to factor applicability of Press Note 3, a Tab for details of beneficial ownership as also covering China for the Security Clearance application. However, this seems to be a Work in progress and a lot more needs to be done in order to make the portal in sync with the amended regulations, for example, in the "Reason of Proposal" Tab, the

drop down menu does not provide for cases falling with the amended regulations and one may have to select "Others" in absence of a specific option.

Apart from the nitty-gritty, many representations have already been made to DPIIT in order to streamline the Approval process, especially in cases which do not fall within the intent of the amendments. Further, representations have also been made to provide various clarifications, for example, applicability to different scenarios, applicability of the amended regulations to investments from Hong Kong, Macau and Taiwan¹, defining the concept of "beneficial ownership", etc. There were news reports that Government would come up with a Fast Track Mechanism¹ in order to speed up the process for cases pertaining to non-sensitive sectors and falling within a particular threshold of investments whereby the approval time line could come down to a month or so. Also, recently, there are news reports¹ that DPIIT shall come up with responses to various representations in consultation with Finance Ministry and Reserve Bank of India (RBI). However, official clarifications are still awaited.

Conclusion

In the current scenario, it is important for Government to come up as "investor friendly". China from among the neighbouring countries has been amongst the top in terms of bringing FDI into India in the recent years. A balanced approach from the Government is the need of the hour, whereby it ensures that there are no opportunistic takeovers or acquisitions and at the same time, genuine investments (either greenfield or brownfield) do not have to face processes that could delay potentially sound investments into India. We have discussed at length above, the areas that require immediate clarifications from the Government, especially considering that a lot of investment proposals are currently *in limbo*. As per Sources, Government is likely to come up with clarifications / mechanisms to track investments from Chinese investments in the

coming weeks. A constructive step in this regard is highly anticipated, considering that it has already been a month since the day the new regulations have become applicable.

¹ As per news reports, the new regulations should not apply to investments from Taiwan-

<https://economictimes.indiatimes.com/news/economy/policy/new-fdi-rules-not-for-taiwan-inflows/articleshow/75479443.cms?from=mdr>

² <https://timesofindia.indiatimes.com/business/india-business/government-plans-to-fast-track-chinese-investments-after-policy-change-report/articleshow/75398573.cms>

³ <https://www.thehindubusinessline.com/economy/policy/dpiit-examining-suggestions-on-fdi-restrictions-from-bordering-nations/article31565413.ece>

Should you need detailed understanding or more information, kindly reach out to



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Change in Foreign Direct Investment Policy

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Appendix A – Illustration on possible scenarios and likely impact

Sr. No.	Nature of Transaction and Direct ownership / Situation	Beneficial Ownership of Transferor	Beneficial Ownership of Investor/ Transferee	Whether Government Approval Required? – Possible Views and Interpretations (see note below the Table)
1	Fresh Investment [First Proviso] Investment by a Chinese Company	NA	Outside China	Yes (once investment is made by a Chinese entity; beneficial ownership is irrelevant)
		NA	China	Yes (both the Direct as well as beneficial owner is in China)
2	Fresh Investment [First Proviso] Investment by a non-Chinese company	NA	Outside China	No (Investment is neither directly from China, nor Beneficial Owner is from China)
		NA	China	Yes (While the Direct investor is from outside China, Beneficial Owner is in China)
3	Transfer of existing or future FDI [Third Proviso] a. From a non-Chinese Company to a non-Chinese Company b. From a Chinese Company to a non-Chinese Company c. From a Chinese Company to a Chinese Company d. From a non-Chinese Company to a Chinese Company	China / Outside China	Outside China	For situations a and b: No under both Views, 1 and 2 (transferee is non-Chinese and beneficial owner is outside China) For situations c and d: View 1: No – Beneficial Ownership is transferred to a non-Chinese company and hence, Third Proviso should not apply. Direct transferee being from China is irrelevant View 2: Yes – Once the direct transferee is a Chinese Company, it should require approval irrespective of beneficial ownership being outside China
				China (Beneficial Ownership remains the same)
		China / Outside China (Beneficial Owner changes)	China (Beneficial Ownership changes)	

Note: These are only possible views and interpretations and should not be taken as a formal advice. Exact impact shall be determined only once there is more clarity from the Government.

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