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Analysing developments impacting business

FOREIGN INVESTMENT BY BORDERING COUNTRIES – BRINGING CLARITY TO PRESS NOTE 3

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Introduction

On 18 April 2020, the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, by way of Press Note No.3 (2020 Series) (PN3), announced a critical change to the Consolidated Foreign Direct Investment Policy to curb opportunistic takeover of stressed and strategic assets, or Indian entities in light of the impact of COVID 19 pandemic. The change called for prior approval of the government for Foreign Direct Investment (FDI) made by (i) any entity based in any bordering country of India; or (ii) any beneficial owner of the investment situated in or citizen of any bordering country of India. The PN3 also applied to any direct or indirect transfer of ownership of any existing or future FDI and any such subsequent change in beneficial ownership. Further, on 8 December 2020, the Ministry of Finance, Government of India notified the Foreign Exchange Management (Non-debt Instruments) (Fourth Amendment) Rules, 2020 (NDI Amendment Rules) inter alia issuing certain clarifications on the present policy on investments from countries sharing land borders with India.

Impact

The PN3 had introduced certain protectionist measures against investments from countries sharing land borders with India. In view of the PN 3 restrictions, approval of the Government is required for both primary and secondary acquisitions by non-resident entities from or entities whose beneficial owners belong to countries sharing land borders with India. Our previous updates on this development can be read [here](#) and [here](#). The aforesaid requirements were also incorporated in the NDI Rules with effect from 22 April 2020.

Neither the PN3 nor the NDI Rules have specified the threshold for identifying 'beneficial ownership'. Considering that investors often have multi-layered structures, spread across various jurisdictions, this ambiguity has led to a conundrum on the ambit and method of computation of beneficial ownership.

The ambiguity in the implications of 'beneficial ownership' under PN3 has ensued an increase in the volume of FDI applications from foreign investors seeking the government's approval thereby causing delays and extension of deal timelines.

Debate on 'Beneficial Ownership'

At present, the ambiguity on the scope of 'beneficial ownership' under PN3 has struck a debate on the thresholds for identifying a beneficial owner. Different views seem to exist at present with regard to the threshold levels of investments to decide whether an FDI proposal requires the approval of the government. The first view being any individual or entity holding not less than 10% shareholding in an entity would be considered a beneficial owner. This view is based on the definition of 'significant beneficial owner' derived from the provisions under the Companies (Significant Beneficial Owners) Rules 2018 read with the Companies Act 2013.

The other view on beneficial ownership is derived from the standards encompassed in the anti-money laundering regime in India. This view is based on the provision under the Prevention of Money Laundering (Maintenance of Records) Rules 2005, which defines a 'beneficial owner' as an individual who either has a controlling ownership interest i.e., more than 25% ownership of the entity or can exercise control on the policy decisions or management of the entity.

Statement by the Ministry of Commerce and Industry

Nearly two years after the PN3 was enacted, the Minister of State in the Ministry of Commerce and Industry issued a press release in the Lok Sabha on 23 March 2022 stating that a beneficial owner of an investment based in any country sharing land border with India, can invest only under the government route. Further, 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 PN3, such subsequent change in beneficial ownership will also require government approval. The press release also refers to the provisions of the FDI Policy which clearly lays down that the onus of ensuring compliance of provisions of the FDI policy is on the Indian investee company and any violations of the FDI regulations would result in investigation and enforcement action in terms of penal provisions under FEMA.

In view of the above, investee companies should exercise caution while receiving any investment or in respect of transactions involving investors from bordering nations.

Way forward

While the industry continues to evaluate different positions on what the threshold for 'beneficial ownership' under the PN3 would be, the response from the Ministry of Commerce and Industry hasn't provided any clarification on this aspect. Further given that the onus of compliance is that of the investee companies, it must be ensured that any investment/transaction directly or indirectly involving beneficial owners from bordering nations needs to be carefully examined to ensure compliance with the FDI policy.

Formal clarifications and possibly, relaxations, are long awaited from the government. It is hoped that going forward, the process will be streamlined to reduce the waiting period on FDI applications, which creates uncertainty in deal timelines.

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