

Curbs on foreign investment by China: An analysis of Press Note 3

The article analyses the possible implications of the changes introduced by the Department for Promotion of Industry and Internal Trade, in the foreign investment policy.

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On April 18, 2020, the Department for Promotion of Industry and Internal Trade (DPIIT), by way of press note 3 of 2020 (PN 3 of 2020), announced a critical change to the Consolidated Foreign Direct Investment Policy (FDI Policy).

The change called for prior approval of the government for FDI by any entity based in any country sharing a border with India, or if the beneficial interest lies with any such entity.

Prior to PN 3 of 2020, FDI from entities based out of Pakistan or Bangladesh were subject to government approval.

While the intention of the government behind the introduction of PN 3 of 2020 has been to “*curb the opportunistic takeovers/acquisitions of Indian companies due to the current pandemic*”, the primary intent is to stem any attempts by Chinese firms to take control of Indian firms which have been affected by COVID-19 related lockdowns.

This follows the directive issued by the Securities and Exchange Board of India (SEBI) by which had sought, on an urgent basis, details of FPI investments from China as well as Hong Kong from custodians. Prior to PN 3 of 2020, Chinese investment was under the automatic route, except for in sensitive areas like telecom, defence and national security etc.

Post 2014, Chinese investors have invested amounts approximating USD 4 billion in Indian start ups. Chinese companies have made substantial investments in a wide range of sectors such as renewable energy, automotive, real estate, electronics, textiles, e-commerce, financial investments in start-ups. They have also secured government contracts in sectors like telecom equipment, electric vehicles, power equipment, infrastructure, construction equipment, etc.

In this background, the introduction of PN 3 of 2020 is expected to have large-scale ramifications.

Some of the potential implications are enumerated below.

1. Impact of PN 3 of 2020

a. While any existing investments by Chinese entities will not be impacted, any fresh infusion of funds by Chinese entities would now require government approval. Further, any transfer of shareholding by existing shareholders (including existing Chinese investors) to Chinese shareholders or to entities whose beneficial holding may be held by entities based in China, will also require approval of the government.

b. It remains to be seen as to how existing contractual rights such as put and call options will be exercised, given that any further acquisition/divestment by Chinese entities are not under the approval route.

c. PN 3 of 2020 does not provide any concessions to investors who want to acquire/divest minority stake/non-controlling stake in an Indian company, and if such investor is based out of China or if the beneficial interest can be determined to vest with a Chinese entity.

d. The FDI Policy clarifies that prior approval of the government will not be required for additional foreign investments in the same entity within an approved foreign equity percentage/or into a wholly owned subsidiary. However, PN 3 of 2020 seems to be an exception to this rule. Now, fresh infusion of funds by Chinese entities even in existing investments would require government approval.

e. Indian companies having existing Chinese investors, and which are in immediate requirement of funds, will not be required to explore alternate bridge funding opportunities to meet their operational requirements.

2. Ambit of ‘Beneficial Ownership’

a. In terms of PN 3 of 2020, prior government approval will be required for any FDI wherein the ultimate beneficiary is a Chinese entity. However, PN 3 of 2020 does not delve into the ambit of 'beneficial ownership' and the method of computation of the same. While the Ministry of Corporate Affairs had issued guidelines for determination of ultimate beneficial ownership of companies, the same was restricted to identification of 'individuals' who may be treated as ultimate beneficial owners, and the same determination will clearly not apply in the present case.

Accordingly, it would be interesting to see as to how the government determines the ambit of beneficial ownership, considering that investors often have multi-layered structures, spread across various jurisdictions.

b. In absence of a clear indicator of 'beneficial ownership', private equity (PE) funds which have investments from China (either by insurance companies/funds or sovereign funds) may now be required to seek prior government approval for any investments, even if such investors in PE funds are passive investors not exercising any control.

c. In addition, even minority investments/non-control investments by any foreign investor in a joint venture in India may require government approval, if the beneficial ownership of such foreign investors is determined to be held by Chinese entities.

3. Enforcement

a. Presently, FDI applications seeking prior approval of the government may take anywhere between 6-10 months for approval, depending on the relevant ministry/department processing the application. Additionally, in case of sensitive sectors like defence, telecom, private security, information and broadcasting etc, investments from China are subject to security clearance from the Ministry of Home Affairs (MHA), and the same generally takes an additional 1-2 months.

Considering that all future investments from China will now be subject to government approval, the volume of applications from Chinese investors seeking the government's approval is expected to amplify.

b. Since the definition of 'beneficial ownership' has been left open, it will be interesting to see how the government enforces the directive set out in PN 3 of 2020, in relation to companies/funds wherein Chinese investors may not be direct investors but may indirectly be beneficial owners through layers of investments.

A potential impact of the same may be the increased KYC requirements of authorised dealer banks who may seek additional information from non-Chinese investors to ensure that Chinese firms/entities do not have any beneficial interest in such investors.

4. PN 3 of 2020 covers investments from such countries which share a land border with India. This however, does not fully clarify the status of investments from Hong Kong, which is a special administrative region of China. Considering that DPIIT tracks investment data separately for Hong Kong and China, it remains to be seen whether any investments from Hong Kong (or where the beneficial owners are from Hong Kong) will also require prior approval of the government.

Comments

The introduction of PN 3 of 2020 follows similar announcements by other jurisdictions like the European Union, Australia etc in order to prevent a predatory takeover of companies which have been weakened by the COVID-19 pandemic by Chinese firms.

The government, in terms of PN 3 of 2020, has enacted a one-size-fits-all approach wherein all future Chinese investments will now be evaluated on a case-to-case basis. However, given that the fund-raising attempts presently underway by various Indian companies may also be potentially impacted, it is hoped that the government will come out with clarifications and relaxations including the following:

a. Exclusion of non-sensitive sectors as well as sectors having job creation potential from the ambit of PN 3 of 2020.

b. Exclusion of companies which are already wholly owned subsidiaries or 100% held by Chinese entities, since in such a case, the question of a 'predatory' takeover does not arise.

c. Given that a hostile takeover of private companies is not possible, exclusion of companies which have already executed definitive documents in relation to fund raising as also transactions involving investment in multiple tranches, wherein the Indian companies may have received a portion of the investment amounts through one or more tranches.

d. Exclusion of investments by pooled investment entities wherein Chinese entities do not have any controlling stake.

e. A possible relaxation may accordingly be for funds not domiciled in China and managed by regulated third party fund managers (even if they have certain Chinese beneficiaries).

Importantly, these changes introduced by the DPIIT are at present policy announcements, and will have the force of law only after amendments to the provisions of the *Foreign Exchange Management (Non-debt Instruments) Rules, 2019*.

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