

## EDITORIAL

## Demystifying new FDI norms

The objective behind Press Note 2 of 2009, issued by the Government on February 11, is ostensibly to bring about clarity in the manner in which foreign investment in Indian companies is to be calculated. Yet, the fact is that the Press Note seems to be an attempt to indirectly liberalise the existing foreign investment regime of the country by bringing about a systemic change in the manner in which indirect foreign holding is determined.

## KEY PRINCIPLE

Prior to Press Note 2 of 2009, indirect foreign investment in Indian companies engaged in certain sectors was calculated on a proportionate basis, that is, if direct investment by a foreign company in an Indian company was 30 per cent and the Indian company, in turn, made a downstream investment of 90 per cent in a target Indian company, the indirect foreign investment in the target Indian company would be 27 per cent (90 per cent of the initial 30 per cent).

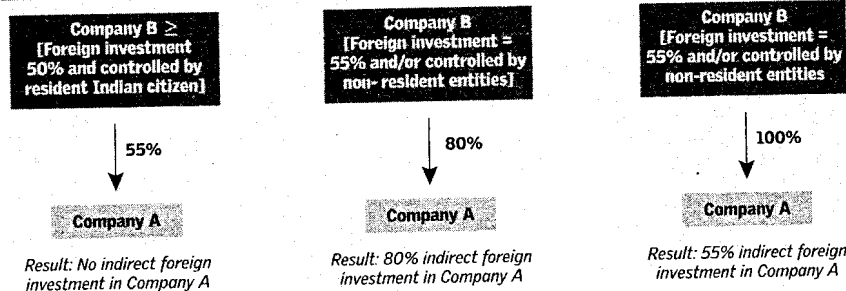
The key principle that seems to emanate from Press Note 2 is that foreign investment in an Indian company investing downstream will not be considered for calculation of indirect foreign holding in the target Indian company if the investing Indian company is "owned" and "controlled" by resident Indian citizens. In other words, only if the investing Indian company is "owned" or "controlled" by non-resident entities, its entire investment in the target Indian company would be considered as indirect foreign investment.

The Press Note deems an Indian company to be "owned" by resident Indian citizens and Indian companies, if more than 50 per cent of the equity interest in it is beneficially owned by resident Indian citizens, and Indian companies which are owned and controlled ultimately by resident Indian citizens. A company is deemed to be "controlled" by resident Indian citizens and Indian companies, if majority of the directors of the investing Indian company are appointed by resident Indian citizens, and Indian companies which are owned and controlled ultimately by resident Indian citizens.

Thus, an investing Indian company having foreign investment and being controlled and owned by Indian resident citizens can make investment in Indian company/ies engaged in sectors in which foreign

*Press Note 2 of 2009 is an attempt by the Government to bring about clarity in the manner in which foreign investment in Indian companies is to be calculated. But various issues still need to be addressed to put to rest any confusion on the subject, say AJAY SHAW and HARSH MAGGON.*

## Calculating Indirect Foreign Investment



investment is prohibited or restricted. This is a significant deviation from the existing foreign investment norms.

Applying Press Note 2 to the abovementioned illustration, the indirect foreign investment in the target Indian company would be nil, on the assumption that the investing Indian company is ultimately "controlled" by resident Indian citizen.

## BENEFITING FROM DEVIATION

The sectors that could benefit from this deviation are retail trading, real estate, telecom, defence, information and broadcasting. Press Note 4 of 2009 (clarifying the policy on downstream investment), issued last week, does not alter this position.

The indirect foreign investment in 100 per cent owned subsidiaries of investing Indian company, will be limited to the foreign investment in the investing Indian company (that is, foreign investment in the 100 per cent owned subsidiaries will be a mirror image of foreign investment in the investing Indian company).

Therefore, the calculation of indirect foreign investment in Company A in a scenario where Company A is partly owned or fully owned by Company B may be relevant while assessing the capitalisation norms that will be applicable for different percentages of shareholding in sectors such as NBFCs.

As per existing capitalisation

norms applicable to fund based NBFCs: \$5 million is required to be brought upfront if foreign investment is above 51 per cent and \$50 million (\$7.5 million is to be brought upfront and the balance in 24 months) if foreign investment is above 75 per cent.

Assuming that Company A is a fund based NBFC and if Company B having foreign investment of 55 per cent invests 80 per cent in Company A, the minimum capitalisation that will be required with respect to Company A will be \$50 million as Company A will be deemed to have 80 per cent indirect foreign investment; whereas if Company B having foreign investment of 55 per cent invests 100 per cent in Company A, then the minimum capitalisation that will be required with respect to Company A will be \$5 million as it will be deemed to have 55 per cent indirect foreign investment.

"Control" has been linked to the ability of the resident Indian citizens to appoint the majority of the directors on the Board of the investing Indian company, however, it does not address the aspect of "de facto" control which can be exercised by various *inter se* arrangements between the shareholders.

In sectors/activities where approval is required for foreign investment, the shareholders agreement with respect to *inter se* arrangement between them in relation to the investing Indian company will be re-

quired to be furnished to the Government and in this scenario the Government may go beyond the definition of "owned" and "controlled" as set out in the Press Note. Further, the concepts of "ownership" and "control" have been restricted to the investing Indian company.

Therefore, a foreign investor can invest in an Indian company, "owned and controlled" by resident Indian citizens, which, in turn, can invest in the target Indian company (engaged in the restricted or prohibited sector) and exercise control with respect to such target Indian company through contractual rights.

## ISSUES TO ADDRESS

For calculating indirect foreign investment in target Indian company, Press Note 2 of 2009 now includes all types of foreign investment — FDI, investment by FIIs, NRIs, ADRs, GDRs, Foreign Currency Convertible Bonds (FCCB), convertible preference shares and convertible debentures — in the investing Indian company. This raises a number of issues.

Including FCCB as "foreign investment" may lead to ambiguity due to the fact that till the FCCB is converted it is treated as an external commercial borrowing and further it does not take into account the fact that the holders of FCCB may decide to seek redemption of the FCCB against conversion of the same.

Second, the existing FDI norms in certain sectors differentiate between FDI and NRI investment. For instance, in the real estate sector, 100 per cent foreign investment is permitted subject to the foreign investor complying with certain minimum capitalisation and other norms.

The said minimum capitalisation and other norms do not apply where the foreign investor is an NRI, in which case 100 per cent investment in the real estate sector is permitted without any conditions.

However, going by Press Note 2, if an NRI holds more than 51 per cent in an Indian company, which, in turn, seeks to invest in a target Indian company engaged in the real estate sector, the entire NRI investment will be deemed to be "foreign investment" for the purposes of calculating the indirect foreign investment in the target company.

Further, NRIs are also permitted to invest in listed Indian companies through the Portfolio Investment Scheme and, therefore, the inclusion of NRI investments in calculating indirect foreign investment may pose a huge logistical issue. Again, FII investment will be calculated as on March 31 of a given year. This means that any increase or decrease in FII investment post March 31 will not be taken into account while calculating indirect foreign investment.

Press Note 4 of 2009 provides clarification with regards to downstream investment by investing Indian company:

**foreign investment** in operating companies and operating-cum-investing companies will be required to be in compliance with the relevant sectoral caps of the sector in which the subject companies are operating; and

**foreign investment** in investing companies and holding companies without any downstream investment and operations will require the prior Government/FIPB approval, regardless of the amount or extent of foreign investment.

Press Note 4 does not still address the various issues with regard to Press Note 2 and, therefore, any further clarification on Press Note 2 is much awaited so as put to rest any confusion on the subject.

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