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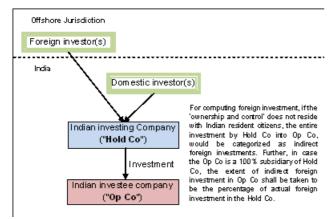
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WELCOME TO INDIA: FOREIGN INVESTMENTS FRAMEWORK OVERHAULED!

Pursuant to last week's press release¹ on manner of calculating indirect foreign investments, Ministry of Commerce & Industry has issued two new press notes i.e. Press Note 2 and Press Note 3 of 2009 ("**Press Notes**"). Press Note 2 clarifies the manner and mechanism for calculating indirect foreign investments in Indian companies and Press Note 3 provides the guidelines for transfer of ownership or control of Indian companies that are engaged in sectors that have sectoral caps prescribed for foreign investments. The Press Notes not only provide the definitions that were missing in the press release, they have in fact overhauled the foreign investments framework for calculating the indirect foreign investments in Indian investee companies ("**Op Co**") which in turn have received investments from Indian investing companies ("**Hold Co**").

New FDI Policy

The following chart broadly summarizes the intent of the Press Notes.



Press Note 2 (2009)

The key provisions of the Press Note 2 (2009) are as follows:

- Definitions of "Owned" and "Controlled": For the purpose of computing indirect foreign investments, "Owned" by resident Indian citizens would mean that the resident Indian citizens on a look through basis beneficially own more than 50% of the equity interest of the Hold Co. "Controlled" by resident Indian citizens would similarly mean that the resident Indian citizens on a look through basis have the power to appoint a majority of directors of the Hold Co.
- Principle for computing indirect foreign investment: The Op Co would not be treated as having indirect foreign investments as long as the Hold Co in which there are foreign investments, is ultimately 'owned and controlled' by Indian resident citizens. However, the foreign investments through the Hold Co would be considered for computing indirect foreign investments in the Op Co if the Hold Co is not 'owned and controlled' by Indian resident citizens on a look through basis or if the Hold Co is 'owned' or 'controlled' by 'non resident entities'. In these cases, the entire investment by the Hold Co into the Op Co would be categorized as indirect foreign investments into the Op Co. As a matter of added clarification, Press Note 2 (2009) states that in case of investment into an Op Co which is 100% owned by the Hold Co, the extent of indirect foreign investment in the Op Co, shall be taken to be the percentage of actual foreign investments in the Hold Co. It has also been clarified that the method of computation of indirect foreign investments would be made applicable at each layer of investments in Indian companies. This clearly indicates the alertness of the regulators to multi-layered structures.
- Types of foreign investments: It has been clarified that for the purpose of calculating indirect foreign investment in an Op Co, all types of foreign investments i.e. FDI, FIIs, FVCIs, NRIs, ADRs, GDRs, FCCBs, convertible preference shares and convertible debentures would be considered.
- Disclosure of details: For cases where government approval is required, full details about the foreign investment including details about ownership, control including any shareholders agreement that affect appointment of the board of directors or manner of exercise of voting rights and differential voting rights, if any, in Hold Co are required to be disclosed.
- Treatment of beneficial interest: A declaration under Section 187 C of Companies Act, 1956 provides that a person is holding the shares of a company as a nominee of the original investor (registered owner) then the beneficial interest in such shares would be vested in the original investor. Press Note 2 (2009) provides that if there is a declaration under section 187 C of Companies Act, 1956, the investment in such shares would be counted as

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foreign investment regardless of the fact that such investment was made by a resident Indian citizen.

Exempt sectors/activities: It is pertinent to note that for sectors such as insurance where methodology for calculating foreign investment is prescribed under sector specific statute or rules, the policy and methodology under the Press Notes shall not be applicable.

Press Note 3 (2009)

The key provisions of Press Note 3 (2009) are as follows:

- Exempt sectors/activities: The Press Note 3 (2009) does not apply to sectors/activities where there are no foreign investment caps.
- Transfer of 'ownership' or 'control': In cases of Indian companies that are engaged in sectors that have prescribed sectoral caps, in the following situations, prior Foreign Investment Promotion Board ("HPB") approval would be required:
 - The Indian company has received foreign investments and is owned or controlled by non-resident entity;
 - The control or ownership of the Indian company currently owned or controlled by resident Indian citizens on a look through basis, is being or will be transferred to non resident entities either through fresh foreign investment or when such transfer is effected through direct acquisition or through corporate reorganisations, i.e. amalgamations or mergers.

Implications

The following are some of the implications arising as a consequence of the Press Notes:

- The definition of the term 'control' for the purposes of computing indirect foreign investments has been kept restricted to ability to appoint majority of directors. Prior to the issuance of the Press Notes, one of the concerns was that if minority investor protection rights provided to non-residents in Hold Cos are construed as "control", then practically all investments by Hold Cos in Op Cos would have qualified as indirect foreign investments for the Op Cos as per the Press Note.
- There is an ambiguity as to whether Press Note 2 (2009) would be able to filter out the investments that are not made in compliance with the FDI policy. For e.g. a foreign investor intends to invest in an Op Co which is a credit information company where 49% foreign investment is allowed subject to FIPB approval. The question arises as to whether the foreign investor would need to obtain FIPB approval if it invests into a Hold Co (engaged in pharma sector) which is owned and controlled by Indian resident citizens and the Hold Co in turn holds 99% in the Op Co which is engaged in the credit information business. While it seems that the intention of the FDI policy to restrict investments (direct or indirect) in certain prescribed sectors still remains, the Press Note 2 (2009) does not seem to emphasize that.
- The Hold Co has been defined to mean an Indian company making investments through equity/preference/CCD in Op Co. Since optionally convertible debentures ("OCD") have not been covered in the definition of Hold Co, ambiguity remains as to whether indirect foreign investment would be considered in Op Co in a situation where the Op Co has issued OCDs to Hold Co and Hold Co in turn is either owned or controlled by foreign investors.
- For the purpose of calculating indirect foreign investment, all types of foreign investments such as FDI, FII, FVCI, etc. would be considered. However, it is pertinent to note that this in no way would dilute the applicability of the regime specific sectoral caps. For e.g. FDI and FII investment in commodity exchanges is permitted upto 26% and 23% respectively. However, the Press Note 2 (2009) does not allow the flexibility to infuse FDI in commodity exchanges beyond 26%.

Explanatory illustrations

Following are some of sector specific illustrations based on the Press Notes. For the purposes of the same, we assume that no direct foreign investments have been made in the Op Co.

Scenario 1: Foreign investors control the Hold Co which is holding 40% stake in the Op Co. Op Co is engaged in the business of gambling and lottery in which FDI is currently prohibited.

Analysis: Since the Hold Co is controlled by foreign investors, any downline investment by Hold Co in Op Co would be considered as indirect foreign investment which is currently prohibited for gambling under the extant FDI policy. In the instant case, an interesting situation would arise if the ownership and control of the Hold Co was with Indian resident citizens. In such a scenario, though against the spirit of FDI policy, it remains to be seen as to whether the downline investments by Hold Co in Op Co be ignored for calculating indirect foreign investment.

Scenario 2: Hold Co is owned to the extent of 75% by foreign investors and Op Co is owned to the extent of 60% by the Hold Co and is in the business of courier services in which FDI is allowed upto 100% subject to FIPB approval.

Analysis: The amount of indirect foreign investments into Op Co would stand at 60%. However, if Hold Co owned 100% in Op Co, then as per the Press Note 2 (2009), the indirect foreign investment in Op Co would have been 75%.

Scenario 3: Foreign investors have on cumulative basis, 49% stake in the Hold Co and do not control the Hold Co. Hold Co in turn holds 95% stake in Op Co which is a loan company.

Analysis: Since the Hold Co is neither owned nor controlled by foreign investors, indirect foreign investment should not be ascribed to Op Co which is a loan company. In this case, though against the spirit of FDI policy, question arises as to whether the Op Co would be required to be capitalized to the extent of USD 500,000 since the foreign investors indirectly through the Hold Co, own upto 49% equity in Op Co.

Scenario 4: Foreign investors own an equity stake of 45% in the Hold Co. The Hold Co in turn holds 65% stake in the Op Co which is engaged into construction and development of real estate projects. The ownership and control of the Hold Co is with Indian resident citizens.

Analysis: Since Hold Co is owned and controlled by Indian resident citizens, the investment by Hold Co in Op Co

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Vyapak Desai speaking on the danger of deepfakes | Legally Speaking with Tarun Nangia | NewsX April 01, 2025 would not be considered as indirect foreign investment. In that case, though against the spirit of FDI policy, it remains to be seen whether the Op Co would be required to meet with the requirements of minimum capitalization and minimum built up area under Press Note 2 (2005).

Conclusion

The guidelines have come as a big sigh of relief for the foreign investors by bringing in the much needed clarity on the foreign investment norms. However, it remains to be seen as to how do the regulators tackle some of the cases mentioned in this Hotline which do not seem to have been addressed by the Press Notes.

1. Foreign investments into India: Unshackled?

Sources:

- http://siadipp.nic.in/policy/changes/pn2_2009.pdf
- http://siadipp.nic.in/policy/changes/pn3_2009.pdf

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