

Research Articles

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RE-EVALUATING PRESS NOTE 3 OF 2020: SHOULD INDIA'S LAND BORDERS STILL DEFINE FOREIGN INVESTMENT BOUNDARIES?

The Government of India released the Press Note No. 3 (2020 Series) ("PN3") on April 17, 2020, introducing the requirement of prior government approval in case of any foreign direct investment ("FDI") from entities of countries that share land-borders with India, or where the beneficial owner of an investment into India is situated in or is a citizen of such land-bordering countries. Originally introduced as a safeguard for "curbing opportunistic takeovers / acquisitions due to the current COVID-19 pandemic", over the last half a decade, the PN3 has become an important part of India's FDI policy and assumes centre-stage when negotiating and structuring foreign investments into India.

As of April 2024, media publicly reported that out of the 526 FDI proposals submitted to the government for approval, 124 investment proposals have been accepted and 201 were rejected. While these figures may seem modest, they highlight how the PN3 has solidified its role in shaping India's foreign investment framework.

This prompts a critical question: after several years of implementation, should PN3 be revisited to better align with India's commitment to enhancing ease of doing business? To streamline the approval process, the Department for Promotion of Industry and Internal Trade ("DPIIT") issued Standard Operating Procedures ("SOP") on November 9, 2020, and August 17, 2023. Currently, the DPIIT is actively seeking stakeholder feedback on improving FDI policies, including PN3, signalling the government's openness to revising the framework to attract more foreign investment while addressing emerging challenges.

Drawing from our experience, we offer key recommendations to align the PN3 framework with India's objectives of fostering growth, safeguarding national interests, and enhancing ease of doing business.

Firstly, in order to ensure clarity and consistency in the PN3 framework, it is essential to establish a uniform threshold for determining "beneficial ownership of an investment". Currently, the SOP dated August 17, 2023, ties 'significant beneficial ownership' to the 10% shareholding threshold under the Companies Act, 2013. However, for FDI applications not attracting PN3, foreign investors must declare that neither they nor their beneficial owners are from countries sharing land borders with India, with no defined threshold for "beneficial owners". This ambiguity leads to varied interpretations and inconsistent declarations, often dictated by the preferences of authorized dealer banks.

To resolve this, the government should prescribe a clear threshold, allowing beneficial ownership to be assessed on a look-through basis at the foreign investor level. For listed entities within the ownership structure, in our view, the assessment should stop at the listed company, given the practical challenges in identifying individual beneficial owners of such entities. Aligning the PN3 framework with the processes under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 and the Prevention of Money Laundering Rules, 2005 would streamline compliance and reduce uncertainty for investors.

Secondly, drawing inspiration from the framework of the Committee on Foreign Investment in the United States (CFIUS), which evaluates all foreign investments that impact U.S. national security – especially in critical sectors like technology, defense and infrastructure, the Indian government could consider an exemption for FDI in the form of acquisition of non-controlling stakes (i.e., investments below 25% on a fully diluted basis) in sectors where 100% FDI is allowed under the automatic route. This would incentivize increased foreign investment, particularly in startups and early-stage companies, where minority stakes are more prevalent.

Thirdly, follow-on investments by investors from land bordering countries who held shares in Indian companies prior to PN3 could be exempted from prior government approval if made solely to maintain their pre-PN3 shareholding – whether through exercise of investor protection rights available to them or through participation in a rights / bonus issue). Such exemptions would protect the existing foreign investors from dilution while preserving the legislative intent.

In case a blanket exemption in such instances is not amenable to the government, then as an alternative, for Indian subsidiaries with parent entities incorporated / beneficial owners situated in land-bordering countries, a "fast track approval" mechanism for follow-on investments by the parent could be considered to ensure timely capital infusion without forcing reliance on external funding that might dilute the group's stake.

Lastly, akin to the past practices of the Foreign Investment Promotion Board, the government could periodically release key statistics on PN3, including the number of applications, approvals, rejections, and associated sectors. Additionally, non-confidential reasons for rejections and the average approval timeline could be shared. This will help stakeholders gain insight into the long-term legislative intent of the PN3, shape precedent, and provide increased certainty to potential foreign investors.

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As we step into 2025, brimming with optimism for India's growing deal-making activity, revisiting PN3 is a crucial move towards striking a balance between the intent of safeguarding national interests and the need to boost foreign investment. By making targeted amendments, the government can foster a more transparent, predictable, and investor-friendly environment, which will pave the way for a more robust and dynamic investment landscape in India.

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