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FDI Policy on downstream investment - A 'blessing in disguise' for foreign investors?

By **Rahul Dhawan**

Foreign investment in India is regulated by the Foreign Direct Investment Policy ("FDI Policy") as amended from time to time by the Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce and Industry. Barring a few prohibited sectors such as real estate, retail trading (except single brand product retailing), gambling and betting, lottery business, manufacturing of cigars & cigarettes, atomic energy and railway transport and the like, FDI is permitted in almost all industrial sectors, and it has been the constant endeavour of the Government of India to further relax the FDI Policy as a consequence of which an increasing number of industrial sectors continue to be liberalized from the regulated / prohibited category.

Entry routes: The FDI Policy envisages the foreign investments in India to be made directly as well as indirectly, under two entry routes, viz, the automatic route, in terms of which, there is no requirement of seeking a prior approval from the Government, and the only obligation is to notify the Reserve Bank of India (RBI) in the prescribed manner about the receipt of inward remittances of funds and subsequent issuance of securities to foreign investors; and the approval route, which is subject to prior Government approval. Proposals for FDI under the approval route are considered by the Government on a case-to-case basis.

Sectoral Caps: In accordance with the FDI Policy, foreign investment in an Indian company is subject to certain equity caps varying at the levels of 26% in sectors such as defence and insurance; 49% in asset reconstruction companies and credit information companies; 74% in telecom service, ground handling service and scheduled air transport service in the aviation sector; and 100% in sectors including manufacturing, agriculture, mining, power, oil & gas, construction, non-banking finance companies, wholesale trading, single brand retail trading, etc. The sectoral caps signify the extent of 'ownership' and 'control' that a foreign investor is permitted to have, or exercise, in an Indian company.

Downstream Investment : Downstream investment is an indirect mechanism of FDI, whereby an Indian company having FDI ('investing company'), which is owned or controlled by 'foreign persons/ entities', invests in the shares of another Indian company ('subject company'). It has been further provided under the FDI Policy that the investment through the investing company would not be considered for calculation of foreign investment (as downstream investment), in the event, such investment is made by an Indian company which is *'owned'* and *'controlled'* by resident Indian citizens and/or Indian companies (which in turn are owned and controlled by resident Indian citizens).

A company is said to be owned by Indian citi-

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zens / Indian companies if more than 50% of the capital in it is beneficially owned by resident Indian citizens and/or Indian companies; and a company is considered as *'controlled'* by resident Indian citizens and/or Indian companies if the resident Indian citizens / Indian companies have the power to appoint a majority of directors in that company. In case of proposals falling under the approval route, any *inter-se* agreement between/amongst shareholders which has an effect on the appointment of the directors or on the exercise of voting rights or of creating voting rights disproportionate to shareholding or any incidental matter thereof, will have to be informed to the Government.

Downstream investment was first allowed without the Government approval by Press Notes 2 and 4 of 2009 Series issued by the DIPP. Under the prevailing FDI Policy, downstream investment by an investing company which is *'owned and controlled'* by 'foreign persons / entities' has to be in compliance with the sectoral caps and the conditions attached to it, if any. However what raises a question mark on the applicability of the sectoral caps to downstream investment is the removal of a provision contained in Paragraph 4.6.1 of the earlier consolidated FDI Policy, effective from 1st October, 2010. The said paragraph stated that *"the 'guiding principle' is that downstream investment by companies 'owned' or 'controlled' by non-resident entities would require to follow the same norms as a direct foreign investment i.e. only as much can be done by way of indirect foreign investment through downstream investment..... as can be done through direct foreign investment and what can be done directly can be done indirectly under same norms".* This requirement of having to do indirectly, only what could have been done directly, was omitted from the Consolidated FDI Policy, effective from 1st April, 2011, and continues to be omitted in the Consolidated FDI Policy, effective from 1st October, 2011.

Consequently, downstream investment by entities owned and controlled by resident Indian citizens may not be counted for ascertaining indirect foreign investments which are subject to the restrictions imposed under the FDI Policy. In other words, the downstream investment of an Indian investing company, in which more than 50% of the beneficial equity, as well as the right to appoint majority of the Board of Directors, are with resident Indian citizens, may be treated as domestic investment. This may eventually lead to the contention that investing companies with no foreign ownership or control are permitted to further invest in any sector, notwithstanding the sectoral caps. This arrangement of combining the direct and indirect foreign investments to overcome the sectoral restrictions, has been taken note of by the DIPP in its discussion paper, although no formal step has been initiated by the Government to either recognise it or explicitly invalidate it, thus giving way to a bigger question as to whether 'what cannot be done directly, can be done indirectly?'

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CIRCULARS

Foreign exchange remittances for imports liberalized

Reporting requirements in Form A-1 for foreign exchange remittance towards imports into India for making payments exceeding USD 500 or its equivalent has been enhanced to USD 5000 or its equivalent. A simple letter has been prescribed in such cases where remittance does not exceed USD 5000. A.P. (DIR Series) Circular No.82 dated 21-2-2012 issued in this regard also specifies certain conditions like purchase of foreign exchange has to be for a current account transaction.

National Manufacturing Investment Zones (NMIZ) permitted to avail ECBs

Developers of the proposed National Manufacturing Investment Zones (NMIZs) have been allowed to avail of External Commercial Borrowings (ECBs) under the "approval route" for providing infrastructure facilities within the NMIZ. This change in the ECB Policy is effective from 29th February, 2012 as per A.P. (DIR Series) Circular No.85, dated 29-2-2012.

Liberalised Remittance Scheme for Resident Individuals clarified

Liberalised Remittance Scheme (LRS) is available to all resident individuals including minors in whose case, the LRS declaration form should be counter-signed by the minor's natural guardian. Remittances under the facility can be consolidated in respect of family members subject to individual family members complying with the terms and conditions of the scheme. RBI Circular No. 90, dated 6-3-2012 issued in this regard also clarifies that such remittances can be used for purchasing objects of art subject to the provisions of other applicable laws such as the Foreign Trade Policy of the Government of India. Modified application-cum-declaration form has also been annexed to the circular.

Registration of bodies intending to carry on certain professions – NOC from professional institute / regulator required

As per Circular No. 2 of 2012 issued by Ministry of Corporate Affairs on 1st March, 2012, for incorporation of companies having one of the objects as carrying on the business of banking, insurance or to practice the profession of Chartered Accountancy, Cost Accountancy, Company Secretary or Architecture, the Registrar of Companies shall take action only on production of in-principle approval/NOC from the regulator/professional institutes concerned.

RATIO DECIDENDI

Negative covenants and enforcement of determinable contracts

In one of the latest judgments delivered on 20-3-2012, the Delhi High Court has affirmatively re-emphasized the law on negative covenants and on specific enforcement of determinable contracts. A deadlock had arisen between the Indian Partner and Japanese Partner of a Joint Venture Company (JVC) in relation to undertaking a separate legal and financial audit of the JVC. The Japanese Partner

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issued a notice to Indian Partner to allow them to undertake the said diligence and rectify the breach of not allowing the said audit. The Indian Partner had counter claimed that the Japanese Partner was in breach of the JV Agreement by doing business with other competitors.

The court held that there was no clause or understanding between the parties that the Japanese Partner could not carry on business with other Indian Companies and there was nothing in the JV Agreement that the Japanese Partner cannot carry on business on its own. It noted that the parties themselves had been operating on this understanding as the Indian Partner never objected to the Japanese Partner undertaking business with other Indian companies. The court held that there was no negative covenant in the agreement restraining the Japanese Partner to deal with other companies. The court also observed that even assuming that negative covenants were existing, the same could not be enforced after expiry of the JV Agreement.

The High Court also held that in the present case, since the JV Agreement was by nature determinable and could be terminated, the remedy for the Indian Partner was only a claim for damages. It held that the bar under Section 14 of the Specific Relief Act, 1963 would be attracted and a contract, which by its nature is determinable, cannot be enforced [OMP 947 of 2011 - *Pahuja Seeds Pvt. Ltd.* v. *Takii & Co. Ltd.*].

Power of Petroleum & Natural Gas Board to adjudicate disputes

The Appellate Tribunal for Electricity, in its recent decision dated 9th March 2012, while dealing with issues relating to refund of excess gas transportation charges to consumers, has inter-alia held that the Petroleum & Natural Gas Board ("Board") has overriding power under Sections 11(a) and 12 of the Petroleum and Natural Gas Board Act, 2006, to adjudicate disputes which fall within the bounds of the aforesaid sections so as to protect the interests of consumers by fostering free trade and competition, among entities.

Accordingly in the instant decision, the Appellate Tribunal after citing various judicial pronouncements of the Supreme Court on the subject, *inter-alia,* held that any arbitrary or excessive levy of gas transportation charges being contrary to the provisions of the said Act shall have to be adjudicated upon by the Board under the aforesaid provisions and an arbitration agreement entered into by the parties for transportation and supply of gas will not automatically restrict the jurisdiction of the Board to decide the dispute under the provisions of the said Act. Therefore the Appellate Tribunal has held that the provisions of the Act would prevail and override the general law of arbitration [*GAIL* v. *Shyam Industries* – Appellate Tribunal for Electricity order dated 9-3-2012 in Appeal Nos. 86 and 87 of 2011].

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NEWS NUGGETS

Competition Commission imposes huge penalty for bid-rigging

The Competition Commission of India, in its order dated 24-2-2012, has imposed huge penalties on the LPG cylinder manufacturers for forming a cartel and rigging the process of tender and bidding by providing similar quotations for manufacture of cylinders in spite of varied costs. The Commission noted that all the factors for cartelization namely, market conditions, small number of suppliers, few new entrants, active trade associations, repetitive bidding, identical products, few or no substitutes and no significant technological changes were conspicuously present in the case in dispute. The Commission while also noting that the bidders knew each other well and had in fact met at a conference before submitting the bids, imposed penalty on 47 companies at the rate of 7% of the average turnover of the company and on one at the rate of 2.1 times of the profit. The order came after the CCI took suo-motu cognizance of the issue consequent to submission of investigation report by the Director General in another case.

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