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FDI IN E-COMMERCE ACTIVITIES | PRESS NOTE NO 2 (2018 SERIES)

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Introduction

The Department of Industrial Policy and Promotion (DIPP) of the Ministry of Commerce and Industry, Government of India has issued Press Note No 2 (2018 Series) on 26 December 2018 (PN 2 of 2018). PN 2 of 2018 amends paragraph 5.2.15.2 (e-commerce activities) of the current 'Consolidated FDI Policy' of the DIPP effective from 28 August 2017 (FDI Policy), effective from 1 February 2019. Paragraph 5.2.15.2 (e-commerce activities) incorporates the provisions of Press Note No 3 (2016 Series) dated 29 March 2016 (PN 3 of 2016), pursuant to which foreign direct investment (FDI) up to 100% was allowed under the automatic route in entities engaged in the marketplace model of e-commerce, subject to compliance with certain conditions. However, FDI in entities engaged in the inventory-based model of e-commerce was expressly prohibited, and this continues to be the case as on date. A marketplace based model of e-commerce is a model of providing an information technology platform by an e-commerce entity on a digital and electronic network to act as a facilitator between buyer and seller. An inventory-based model of e-commerce, on the other hand, is a model where inventory of goods and services is owned by an e-commerce entity and is sold to the consumers directly.

While the conditions contained in PN 3 of 2016 were introduced to bring some comfort to brick and mortar retailers and to ostensibly create a level playing field for such retailers with their e-commerce counterparts, it was felt in some quarters that the wording of PN 3 of 2016 was not stringent enough and that the intended goal of such PN 3 of 2016 was not being achieved.

With the Indian general elections being just around the corner, it appears that the Union Government has moved just in time to plug some of these alleged gaps in the FDI Policy (on e-commerce activities) by issuing PN 2 of 2018. PN 2 of 2018 primarily targets the following conditions for receiving FDI in e-commerce activities (in the marketplace model): (a) control over inventory by the provider of the marketplace platform, (b) equity participation by the provider of the marketplace platform in the sellers that are selling on such platform, (c) fair and non-discriminatory dealings by the marketplace platform with such sellers, and (d) exclusivity arrangements between such platform and sellers.

Key Highlights

- Ownership and control over inventory:

- In the present regime, entities providing a marketplace platform (Marketplace Entities) are restricted from: (a) exercising actual ownership over the inventory, and (b) permitting total sales value on its marketplace from one seller or such seller's group companies in excess of 25% of such marketplace's total sales value in a financial year. 'Group companies' means two or more enterprises which, directly or indirectly, are in a position to: (a) exercise 26% or more of voting rights in other enterprise, or (b) appoint more than 50% of members of board of directors in the other enterprise. The DIPP has, in the past, clarified that two or more companies that are owned and / or controlled by a common parent company (either directly or indirectly) are deemed to be group companies.
- Pursuant to PN 2 of 2018, 'ownership' or 'control' over inventory of the sellers by a Marketplace Entity will be the primary test for differentiating a marketplace model of e-commerce from an inventory-based model of e-commerce, as opposed to the present 'ownership' only test.
- If more than 25% of a seller's inventory is purchased from the Marketplace Entity or its group companies then such Marketplace Entity will be deemed to have control over the inventory sold by such seller.
- Owing to this change, Marketplace Entities will not be able to exercise 'control' over inventory sold on their platform by the sellers, failing which, the e-commerce activities of such Marketplace Entities will be treated as inventory-based e-commerce activities.

Comment: This change will impact Marketplace Entities that use one or more of their group entities to sell goods to sellers on a business to business basis with such sellers in turn listing the goods on the Marketplace Entity's platforms for sale to retail customers. Additionally, this restriction may also impact sellers selling on marketplace platforms even if such sellers are not FDI recipients or foreign nationals as some of them may now be forced to look at multiple sources for acquiring their inventory. This is likely to put an additional capital burden on such sellers.

➢ Equity participation and control over inventory:

- Presently, the FDI Policy does not prohibit equity participation by Marketplace Entities in any seller entities operating on its marketplace platform.
- Pursuant to PN 2 of 2018, sellers will not be permitted to sell their products on platforms run by a Marketplace Entity if such Marketplace Entity or its group companies have equity participation in the sellers or control over the inventory (as discussed above).

Comment: Unlike other provisions of PN 2 of 2018, the DIPP has not clarified whether such equity participation is direct or indirect. Therefore, structures where subsidiaries of an Indian owned and controlled company (also having minority equity participation from a Marketplace Entity or its group companies) carry out e-commerce activities on the platform of such Marketplace Entity may be workable absent any subsequent clarification from the DIPP or any other competent authority. However, such a view may not be in line with the spirit and intention of the changes sought to be made by PN 2 of 2018.

➢ Fair dealings:

- Marketplace Entities will have to ensure that any services (such as in relation to logistics, warehousing, fulfilment, etc.,) provided by them (or, any entity in which such Marketplace Entity has direct or indirect equity participation or is under common control of such Marketplace Entity) (Service Providers) to the sellers carrying out e-commerce activities on their platforms are fair and non-discriminatory and on an arms-length basis.

This is an extension of: (a) the restrictions on Marketplace Entity's influence (direct or indirect) on sale price, and (b) the Marketplace Entity's obligation to maintain a level playing field vis-à-vis the sellers on its platform.

- Additionally, cashback offers provided to buyers by group companies of the Marketplace Entities will have to be fair and non-discriminatory.
- PN 2 of 2018 specifies that service terms offered by the Services Providers to one or more sellers but that are not offered to other sellers in similar circumstances will be deemed to be unfair and discriminatory.

Comment: Compliance with these conditions will continue to be confusing on account of the vagueness of these conditions. It is unclear what sellers in 'similar circumstances' mean for purposes of determining fair and non-discriminatory terms of services provided to various sellers. Additionally, it may not be commercially viable to provide cashback offers to buyers in an unfair or a discriminatory manner, unless applicability of these conditions is also vis-à-vis the sellers, wherein any unfair or discriminatory treatment of sellers will affect the buyers buying from such sellers. It will certainly help if the DIPP further clarifies these conditions.

➢ <u>Exclusivity arrangements:</u>

- Marketplace Entities will be prohibited from requiring the sellers to sell their products exclusively on their platforms.

Comment: PN 2 of 2018 does not clarify if: (a) multiple platforms that are operated by group companies or a Marketplace Entity, or (b) specific contractual terms restricting a seller from selling on specified platforms will be considered as imposition of exclusivity. Absent any specific clarification from the DIPP, a view could be taken that only affirmative exclusive arrangements are prohibited through this condition. However, such a view may not be in line with the spirit and intention of the changes sought to be made by PN 2 of 2018.

➢ <u>Other changes:</u>

- It would be relevant to note that the restriction on capping the total sales value of a Marketplace Entity's platform from one seller or such seller's group companies to 25% of such platform's total sales value in a particular financial year has been done away with.
- Marketplace Entities will be required to submit a certificate along with report of its statutory auditor to the Reserve Bank of India. This certificate should confirm compliance with the guidelines for each financial year by 30 September of the calendar year in which such financial year ends.

Comment: While the removal of the aforementioned 25% restriction cap on total sales value is a welcome change for Marketplace Entities, it will be a practical nightmare for them to monitor the compliance of the new condition with regard to the sourcing of inventories by sellers. As PN 2 of 2018 will be effective from 1 February 2019, the aforementioned requirement will have to be complied with by the Marketplace Entities from the financial year ending 31 March 2019 onwards (i.e., the first submissions will have to be made by 30 September 2019 for the truncated period between 1 February 2019 and 31 March 2019).

Concluding Remarks:

As discussed above, many of the changes introduced by PN 2 of 2018 require some additional clarifications regarding their applicability and scope. The effects of PN 2 of 2018 will be felt through the industry and it may force a number of influential players to re-examine their respective business models going forward. Given the short time within which the changes pursuant to PN 2 of 2018 are sought to be implemented, Marketplace Entities would need to quickly take measures to comply with such provisions. In the meanwhile customers can optimistically expect an extended "sale" season to continue.

A clarification from the DIPP on grandfathering of existing structures and the forward looking applicability of PN 2 of 2018 (i.e., only to those Marketplace Entities that receive FDI on or after 1 February 2019) would be appreciated by the industry. This is also relevant keeping in mind India's push for ease and certainty of doing business in the country and its commitments under investment treaties.

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