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Analysing developments impacting business

KEY CHANGE: PRIOR APPROVAL FOR ALL CHINESE FDI INVESTMENTS

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India today announced a new policy for foreign direct investment (FDI) from China by way of Press Note 3 of 2020. All such investment from China will now require prior approval of the Indian Government, and this approval requirement also applies to transactions, where the beneficial owner of the investment, (whether directly or indirectly) is from China.

In short, India has taken a leaf from the Committee on Foreign Investment in the United States' (CFIUS) playbook, and gone a bit further by:

- applying it across all sectors, and not just those historically deemed "sensitive" in India (eg telecom, banking, insurance, pharma)

- not distinguishing between majority / control investments or minority / passive investments from China

Implications on transaction timelines and the like

Chinese investments into India, particularly in (a) technology / internet businesses; (b) manufacturing; (c) renewable energy and (d) auto, has seen large year on year increases. India has fairly liberal FDI rules, and accordingly, none of these sectors required any prior government approval for infusion of new capital or purchase of existing shares except for sensitive sectors like telecom, defence manufacturing etc. Over the last few years, a buzzing eco-system of quick Chinese investment transactions (especially in early stage tech companies) was turning into a norm.

At present, the time period for processing of FDI applications for government approvals ranges between 8-10 weeks, and is dependent on the relevant ministry processing the application. Further, investments from China are subject to security clearance from the Ministry of Home Affairs (MHA) in case of sensitive sectors, which generally takes an additional 1-2 weeks. With the advent of these new developments, the volume of applications from Chinese investors seeking the government's approval is expected to rise exponentially, which could increase timelines for transactions in this corridor, apart from adding the obvious new layer of regulatory uncertainty (especially in terms of which economic sectors the Government perceives as "benefitting" from Chinese participation).

While investments from China are subject to the requirements of the new Press Note, it does not fully clarify the status of investments from Hong Kong, which is a special administrative region. Although DPIIT tracks investments data from Hong Kong and China separately, by virtue of this new policy, whether prior approval of the government will be required for any investments from Hong Kong (or where the beneficial owners are from Hong Kong) remains to be seen.

Implications on Global Transactions and India Legs

All global transactions by Chinese investors with an India leg e.g. a German target company which has an India subsidiary, proposed to be acquired by a Chinese investor, will now require prior approval in India (in addition to applicable German approvals) – as the beneficial ownership of the Indian entity will be deemed to have been transferred to the Chinese investor.

This will need to be factored, and if such approval is delayed, transacting parties need to be prepared for an India hive-off / value adjustment strategy.

Ambit of 'Beneficial Ownership'

The government notification does not delve into the ambit of 'beneficial ownership' and the method of computation of the same. It would be interesting to see as to how the government determines the ambit of beneficial ownership, considering that investors often have multi-layered structures, spread across various jurisdictions.

Accordingly, Indian banks may potentially increase their KYC requirements and seek additional information (which by itself may be a time-consuming exercise) while implementing a transaction with a Chinese investor nexus.

Implications on investment funds with Chinese LPs

There is concern that the new policy is broadly worded ("*direct or indirect beneficial ownership with a Chinese entity*"), and could result in global funds and collective investment vehicles with Chinese LPs / beneficiaries, being subjected to an unequal playing field ie being required to take approvals for their India transactions.

We do not believe this to be intent of the policy, and while we await the fine print of the implementing exchange control regulations (expected to be notified shortly), our initial assessment is that investments by (a) broad based funds domiciled in Cayman, Mauritius, Singapore or Luxembourg (amongst others); and (b) managed by regulated third party fund managers -- which have Chinese LP contributions -- should not be subject to the compliance norms now associated with Chinese FDI in India.

Treatment of Existing Investments / Intra-Group Reorganizations / Future Divestments

The policy doesn't require existing FDI made by Chinese investors to go through the gamut of a new approval process; and only applies on a going forward basis. Notwithstanding this "limited grandfathering", one consequence could be that further capital infusion by a Chinese parent into its Indian subsidiary (whether by a rights issuance or otherwise), would also require prior government approval. As such, where circumstances warrant, these subsidiaries would be well advised to tap into other local sources of bridge financing for their short terms needs, pending government approval.

Our interpretation of the policy does not suggest that any future transfer of Indian assets by Chinese investors will require government approval; except in the case where the transferee is also another Chinese investor. Accordingly, this new prior approval requirement could become of significance even in the case of intra-group reorganizations.

Way forward

Much will depend on how the Indian Government weaves the new policy into the existing statutory framework (Foreign Exchange Management Act or FEMA) – and this policy will go into law only when the corresponding FEMA amendments are notified.

That said, it is clear that by subjecting Chinese investments to case by case approval, the Indian Government is looking to:

- Closely monitor capital flows from China into India; and

- Exercise discretion on where such capital will be welcome. For instance, approvals may not be necessarily forthcoming for media businesses, sensitive manufacturing (eg pharmaceuticals), but may be open for large scale manufacturing with job creation potential (eg electric vehicles).

Given that the fund-raising attempts presently underway by various Indian companies may also be potentially impacted, it is hoped that the government will come out with clarifications, and hopefully exclude "non-sensitive" sectors as well as sectors having employment / large cap-ex potential from the ambit of this new policy. While we will update on the developments relating to the above (especially on the fund management industry), feel free to reach out to us or any of your regular contacts at the firm for any questions / queries you may have on the above.

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