Significant changes in Foreign Investment Policy

Making sense out of Press note 2 and 4 of 2009

-Vinod Kothari & Company
March, 2009

Two recent press notes by Govt. of India, Ministry of Commerce & Industry, Department of Industrial Policy & Promotion (FC Section), viz., Press note 2 and Press Note 4 have rationalized and tightened the policy of the Govt. of India for foreign investment in Indian companies.

Press Note 2 is a significant step towards rationalizing and harmonizing the requirements regarding 'indirect' foreign ownership or control over Indian companies. Indirect ownership refers to Indian companies, which have substantial foreign ownership or control, making investments in Indian companies, as opposed to "direct" ownership or control where a foreign entity or non-resident directly holds shares or control of an Indian entity. Hitherto, the norms on indirect ownership/control were scattered – for instance

- Proportionate method is used in Telecom/ Broadcasting sectors through Press Note 5 of 2005 (modifying Press Note 2 of 2000), Press Note 1(2006) and Press Note 3(2007)
- Insurance: outlined in IRDA regulations, and
- In all other sectors, for an investing company in the infrastructure / service sector attracting equity caps, indirect equity is calculated as was given in Press Note 2 of 2000 (entry no. 10). This policy was reiterated by Press Note 4 of 2006(Entry no.18) which was modified by a Press release dated November 13, 2006 and Press Note 7(2008) (entry 24).

Press Note 2 now provides that where an Indian entity is **either** majority-owned by non-residents, or majority-controlled by non-residents, any investments made by such Indian entity will be counted as foreign investment for the purpose of reckoning the caps and conditionalities applicable on foreign ownership or control.

An Indian entity is majority-owned by non-residents, if majority of its equity capital is held by non-residents. The word used in the Press Note is "equity interest", which is usually understood in the light of legal equity of the entity. In accounting standards on consolidation, the word "equity" has a wider meaning, in the sense of residual economic interest. In our understanding, preference shares, even though they might have acquired voting rights due non-payment of dividends, would not be taken as equity, though such a situation may fall in the next definition of majority-control.

Majority-control by non-residents would exist where non-residents have the power to appoint a majority of directors. The power may be either implied by voting rights, or may be conferred by contract, or provision in the constitutional documents.

In case of an investment made by an Indian entity A, which is wholly-owned subsidiary of an Indian operating-cum-investing company B, the investment made by A into an Indian entity C will be treated as non-resident, to the same extent as foreign interest in entity B. For instance, if B has 75% non-resident stake, and A is B's wholly owned subsidiary, then, if B takes 60% stake in C, such 60% investment put in by B into C will be taken as non-resident interest only to the extent of (75% * 60% = 45%). This is on the simple principle that a wholly owned subsidiary is the mirror image of its holding company.

Press Note 4 applies to downstream investment. The significant point here is that any foreign investment in "investment" companies will require approval. Investments by majority-foreign-owned or majority-foreign-controlled "operating companies" or "operating and investing" companies will be subject to the same sectoral caps, conditionalities and approvals as in case of investment in the target entity itself.