

# Downstream Investments under FEMA – Regulatory and Practical Considerations

With the growth of foreign investments in India, the Government of India has framed structured foreign exchange regulations which aim to achieve the twin goals of (a) ease of doing business in India by liberalizing certain policies; and (b) ensuring promotion, and orderly development and maintenance of foreign exchange market in India.



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## INTRODUCTION

**A**ny direct or indirect foreign investments in India are regulated by the Foreign Exchange Management Act, 1999 ("FEMA") read with the rules/regulations made thereunder. Under FEMA, the Reserve Bank of India has been granted power to formulate 'regulations' whereas the Central Government is empowered to frame 'rules'<sup>1</sup>.

This article aims to provide a detailed overview of the regulatory framework for downstream investments in India with practical considerations. As per the Consolidated FDI Policy Circular of 2020 ("FDI Policy"), 'Downstream investment' means indirect foreign investment, by an eligible Indian entity, into another Indian Company/LLP, by way of subscription or acquisition<sup>2</sup>.

The regulatory framework for downstream investments in an Indian company comprises of the following:

- FEMA;
- Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("NDI Rules");
- Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 ("Foreign Investment Reporting Regulations");
- FDI Policy; and
- Master Direction – Foreign Investment in India.

## WHICH INVESTMENTS ARE COVERED UNDER 'DOWNSTREAM INVESTMENT' / 'INDIRECT FOREIGN INVESTMENTS'?

In terms of the NDI Rules, '*Downstream investment*' means the investment made by an Indian entity which has total foreign investment in it, or a specified investment vehicle, in the capital instruments or the capital, as the case may be, of another Indian entity<sup>3</sup>.

However, the term '*indirect foreign investment*' is defined to mean downstream investment received by an Indian entity from -

- another Indian entity which has received foreign investment; and (i) the Indian Entity is not owned and not controlled by resident Indian citizens; or (ii) is owned or controlled by persons resident outside India; or
- an investment vehicle whose sponsor or manager or investment manager (i) is not owned and not controlled by resident Indian citizens or (ii) is owned or controlled by persons resident outside India<sup>4</sup>.

Accordingly, the meaning of the term '*Downstream investment*' seems to be broader than the term '*indirect foreign investment*' under the NDI Rules, as downstream investment covers further investments by another Indian entity that has received foreign investment in India (without specifying any threshold or quantum), whereas, indirect foreign investment covers only those further investments which are made by Indian entities that are owned or controlled by persons resident outside India.

It is also pertinent to note that the meaning of the terms 'owned or controlled by persons resident outside India' which are explained below.

## AMBIT OF FOREIGN OWNED AND/OR CONTROLLED ("FOCC")

The following terms are relevant to be noted:

- "*company owned by persons resident outside India*" shall mean an Indian company that is owned by persons resident outside India and 'LLP owned by persons resident outside India' shall mean an LLP that is owned by persons resident outside India<sup>5</sup>.

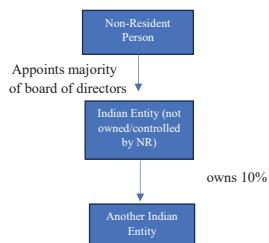
In the said regard, it is to be noted that '*ownership of an Indian company*' means the beneficial holding of more than 50% (fifty percent) of the equity instruments of such company and '*ownership of an LLP*' means the contribution of more than 50% (fifty percent) in its capital and having majority profit share<sup>6</sup>.

(ii) "*company controlled by persons resident outside India*" shall mean an Indian company that is controlled by persons resident outside India and "*LLP controlled by persons resident outside India*" shall mean an LLP that is controlled by persons resident outside India<sup>7</sup>.

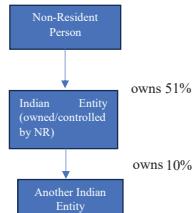
In the said regard, it is to be noted that '*control*' means the right to appoint majority of the Directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreement or voting agreement and for the purpose of LLP, "*control*" shall mean the right to appoint majority of the designated partners, where such designated partners, with specific exclusion to others, have control over all the policies of an LLP<sup>8</sup>. The said definition is akin to the definition of '*control*' as provided under the Companies Act, 2013. The Hon'ble Supreme Court of India<sup>9</sup> while interpreting the meaning of control under the Companies Act, 2013 has stated that the said definition of control envisages (a) de-jure control (*i.e., right to majority of directors*); and (b) de-facto control (*i.e., control management rights or policy decisions*) and the same has to be positive control only. It further stated that '*management decision*' is a decision to be taken as to how the corporate body is to be run in its day-to-day affairs whereas a '*policy decision*' would be a decision that would be beyond running day to day affairs, *i.e.*, long term decisions.

Identifying whether an entity can be classified as foreign owned/controlled entity becomes critical to ascertain the applicability of downstream investment norms in case such an entity is contemplating to make further investments in an Indian Entity.

**a) Indirect Foreign Investment (foreign controlled)**



**b) Indirect Foreign Investment (foreign owned)**



In the aforesaid illustrations, the entire 10% (ten percent) of investment in another Indian Entity will be considered as '*downstream investment*' and '*indirect foreign investment*'.

## KEY CONSIDERATIONS FOR DOWNSTREAM INVESTMENTS/INDIRECT FOREIGN INVESTMENTS

### 1. Applicability of foreign direct investments norms to indirect foreign investments:

It is specified that an Indian entity which has received indirect foreign investment shall comply with the entry route, sectoral caps, pricing guidelines and other attendant conditions as applicable for foreign investment<sup>10</sup>. The underlying principle of the downstream investment guidelines is that '*what cannot be done directly shall not be done indirectly*'<sup>11</sup>. Accordingly, it can be stated that all the provisions applicable to a direct foreign investment in India would apply to indirect foreign investments.

In the said regard, it can be inferred that any downstream investment will also have to comply with Press Note 3 of 2020<sup>12</sup> issued by the Reserve Bank of India. Further, it may also be contended that the norms for deferred purchase consideration under the NDI Rules<sup>13</sup> may also apply for an investment by a foreign owned/controlled entity in another entity (*the said issue is detailed below*).

### 2. Additional conditionalities for indirect foreign investment<sup>14</sup>:

- The downstream investment shall have the approval of the Board of Directors and also compliance with the shareholders' Agreement, if any, of the FOCC. Even Section 179 of the Companies Act, 2013, statutorily mandates a prior board approval for making any further investments by any Indian entity.
- The Indian entity making the downstream investment shall bring in requisite funds from abroad and not use funds borrowed in the domestic markets<sup>15</sup> and the downstream investments may be made through internal accruals<sup>16</sup>. Further raising of debt and its utilisation shall be in compliance with the FEMA, rules or regulations made thereunder.

Many of the authorized dealer banks in India require a declaration from the FOCC stating the investment complies with these sourcing norms.

- Indirect foreign investment by an LLP is allowed in an Indian company operating in sectors where foreign investment up to 100% is permitted under automatic route and there are no FDI linked performance conditions. Further, an indirect foreign investment is permitted in an LLP in sectors where foreign investment is allowed 100% under automatic route and there are no FDI linked performance conditions<sup>17</sup>. Accordingly, any downstream investment by, or in, the LLP engaged in a sector which is not under 100% automatic route would require prior approval of the Reserve Bank of India.

### 3. Responsibility for compliance:

It is prescribed that the first level Indian company making downstream investment shall be responsible for ensuring compliance with the provisions of the NDI Rules for the downstream investment made by it at second level (investee company) and so on and so forth and such first level company shall obtain a certificate to this effect from its statutory auditor on an annual basis and such compliance of the NDI Rules shall be mentioned in the Director's report in the annual report of the Indian company. In case the statutory auditor has given a qualified report, it is also mandated that the same shall be immediately brought to the notice of the regional office of the RBI in whose jurisdiction the registered office of the company is located and shall also obtain acknowledgement from the registered office.

### 4. Investments in capital instruments:

It is pertinent to note the NDI Rules specify that downstream investments can be made by way of investment in capital instruments or capital of another Indian entity. The term '*capital instrument*' has not been defined under the NDI Rules, however, the term '*equity instruments*' is defined which includes equity shares and compulsorily convertible instruments under its ambit. Accordingly, it can be interpreted that '*capital instruments*' cover those instruments as enumerated under the definition of the term '*equity instruments*'. In the event, any optionally convertible instruments are issued to FOCC, then the same would not be construed as downstream investment until such instruments are converted to equity, as optionally convertible instruments are considered as '*debt*' instruments under FEMA.

## WHETHER DISCHARGE OF CONSIDERATION BY NON-CASH CONSIDERATION IS PERMISSIBLE?

Investments in a share of a company can be made either in cash or by way of a non-cash consideration. Non-cash consideration would typically involve consideration other than cash such as intellectual property, any movable or immovable asset, goodwill, shares or other securities, services etc. However, as far as downstream investments by an FOCC under FEMA are concerned, the NDI Rules contemplate that FOCC can make further downstream investment in an Indian entity only by way of (a) funds brought from abroad (i.e., by not using funds borrowed in the domestic markets); and (b) internal accruals (i.e., amount transferred to reserve account after payment of taxes)<sup>18</sup>. Accordingly, it can be stated that the NDI Rules contemplate cash investment by way of internal accruals but non-cash consideration is not permitted. Therefore, in such a case, the no-objection/approval of Reserve Bank of India should be sought for transactions involving discharge of consideration by way non-cash consideration.

Such a restriction under FEMA would be problematic in cases involving business/asset transfer transactions wherein an FOCC is selling its business/asset and the consideration by the buyer is being discharged by way of issuance of shares or other securities rather than cash.

## WHETHER DEFERRED CONSIDERATION IS PERMITTED IN CASE OF A DOWNSTREAM INVESTMENT?

Under the NDI Rules, there are specific provisions for an investment by a non-resident person in an Indian entity wherein deferred consideration is involved. The said provisions stipulate that an amount not exceeding 25% (twenty five percent) of the total consideration may be paid by the buyer on a deferred basis within a period not exceeding 18 (eighteen) months from the date of the transfer agreement<sup>19</sup>.

In the context of downstream investment by an FOCC, the NDI Rules do not provide for any such requirements. Accordingly, it can be contended that an FOCC is an Indian entity and an investment on deferred consideration by an Indian company with another Indian company would be outside the purview of FEMA as there is no express stipulation in this regard. Therefore, it can be argued that an FOCC can make downstream investment by way of a deferred consideration.

However, before undertaking such transactions, it is relevant to obtain the views of the authorised dealer bank who will process the reporting of downstream investment, as a contrary view can be taken that what is directly not permitted under FEMA is also not indirectly permitted and therefore, one may contend that the downstream investment on a deferred consideration basis is not permitted under FEMA.

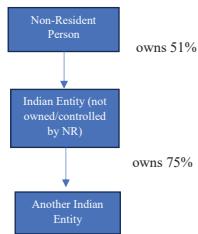
## COMPUTATION OF DOWNSTREAM INVESTMENT<sup>20</sup>

With respect to the computation of the indirect foreign investment, the FDI Policy prescribes that:

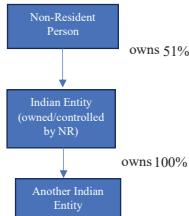
- (a) the foreign investment through the investing Indian company/LLP would not be considered for calculation of the indirect foreign investment in case of Indian companies/LLPs which are 'owned and controlled' by resident Indian citizens and/or Indian Companies/LLPs which are owned and controlled by resident Indian citizens;
- (b) downstream investment by an Investment Vehicle (*as defined under the NDI Rules*) shall be regarded as foreign investment if either the Sponsor or the Manager or the Investment Manager is not Indian 'owned and controlled' as defined in Regulation 14 of the principal Regulations as defined in RBI Notification No.362/2015-RB dated February 15, 2016<sup>21</sup>;

(c) for cases where condition (a) above is not satisfied or if the investing company is owned or controlled by 'non-resident entities', the entire investment by the investing company/LLP into the subject Indian Company would be considered as indirect foreign investment, provided that, as an exception, the indirect foreign investment in only the wholly-owned subsidiaries of operating-cum-investing/investing companies, will be limited to the foreign investment in the operating-cum-investing/ investing company. The same is explained with an illustration below:

**a) Indirect Foreign Investment (other than WOS)**



**b) Indirect Foreign Investment (WOS)**



In the aforesaid illustration under (a), the entire 75% of the further investment will be reckoned as downstream investment, whereas under (b), only 51% of the further investment will be reckoned as downstream investment.

This exception is made since the downstream investment of a 100% owned subsidiary of the holding company is akin to investment made by the holding company and the downstream investment should be a mirror image of the holding company. This exception, however, is strictly for those cases where the entire capital of the downstream subsidiary is owned by the holding company.

## REPORTING FRAMEWORK

The Foreign Investment Reporting Regulations prescribe the following reporting norms for downstream investments to be made:

**(a) Intimation of downstream investment:** An Indian entity or an investment vehicle making downstream investment in another Indian entity which is considered as indirect foreign investment for the investee Indian entity in terms of the NDI Rules, shall notify the Secretariat for Industrial Assistance, DPIIT within 30 (thirty) days of such investment, even if equity instruments have not been allotted, along with the modality of investment in new / existing ventures (with / without expansion programme).

The filing of the intimation is to be made on the Foreign Investment Facilitation Portal (FIFP) (<https://fifp.gov.in/Public/ApplicantRegister.aspx>) wherein for each downstream investment an FOCC requires a separate registration on the portal. The intimation

This exception, however, is strictly for those cases where the entire capital of the downstream subsidiary is owned by the holding company. Entities entering into transactions have to be mindful of the downstream investment compliances as any non-compliance thereof can attract penalties prescribed under FEMA.

should mention the details of the investor and investee company (*such as nature of business, automatic/ approval route, date of incorporation, registered office details etc.*), shareholding pattern of the investor and investee company, details of the investment (*such as nature of investment (rights issue, share transfer etc.), date of passing board resolutions etc.*) and the intimation should be annexed with the charter documents and shareholding pattern of the entities, diagrammatic flow of investment, copies of board resolution etc. The intimation may also be physically filed with DPIIT and the regional offices of the RBI.

**(b) Form DI filing with AD Banker:** An Indian entity or an investment Vehicle making downstream investment in another Indian entity which is considered as indirect foreign investment for the investee Indian entity in terms the NDI Rules shall file Form DI with the RBI within 30 (thirty) days from the date of allotment of equity instruments.

The filing of Form DI is required to be made on the FIRMS Portal of RBI (<https://firms.rbi.org.in/firms/faces/pages/login.xhtml>). The filing can only be made once the acknowledgement of downstream investment intimation with Secretariat for Industrial Assistance, DPIIT is generated on the FIFP as the authorised dealer banks request such intimation prior to approving the Form DI. Further, few authorised dealer bankers also request a declaration confirming compliance with the (a) Press Note 3 of 2020 (explained above); and (b) Prevention of Money Laundering Act, 2002, and Unlawful Activities (Prevention) Act, 1967 with respect to the end usage of funds.

The NDI Rules further specify the pricing and reporting norms for any transfers by FOCC<sup>22</sup>:

Transferor	Transferee	Pricing norms	Reporting norms
FOCC	Person resident outside India	No	Form FC-TRS
FOCC	Person resident in India	Yes	No
FOCC	FOCC	No	Form DI



## ROLE OF COMPANY SECRETARIES

The further investment by an FOCC requires adherence to downstream investment norms and any non-compliance thereof can attract significant penalties under FEMA which can go up to 3 (three) times of the sum involved in the contravention (in case of a quantifiable amount). Accordingly, Company Secretaries can play an important role in advising the investor companies with respect to downstream investment norms and appropriately structure the transaction to avoid any violations of FEMA. Any downstream investment also requires timely reporting with the regulators wherein the Company Secretaries can undertake such tasks for the investor companies. The same also involves interaction with the authorized dealer banks in India and accordingly, a professional like a Company Secretary having requisite knowledge can undertake such task efficiently and achieve the desired results.

## CONCLUSION

The downstream investment norms aim to ensure that the foreign investment norms are not flouted indirectly by using different entity structures. It also brings transparency by mandating disclosure of the indirect foreign investment and the applicability of pricing guidelines ensure development and maintenance of foreign exchange. Entities entering into transactions have to be mindful of the downstream investment compliances as any non-compliance thereof can attract penalties prescribed under FEMA.

## REFERENCES:

- i. Section 46 and 47 of FEMA
- ii. Para 3.8.2 of the Consolidated FDI Policy Circular of 2020
- iii. Rule 23(7)(g) of the NDI Rules
- iv. Rule 23(7)(i) of the NDI Rules.
- v. Rule 23(7)(c) of the NDI Rules.
- vi. Rule 23(7)(a) of the NDI Rules.
- vii. Rule 23(7)(f) of the NDI Rules.
- viii. Rule 23(7)(d) of the NDI Rules.
- ix. *In the matter of Arcelormittal India Private Limited v. Satish Kumar Gupta & Ors. [Civil Appeal Nos.9402-9405 OF 2018]*
- x. Rule 23(1) of the NDI Rules.
- xi. Paragraph 9 of the Master Directions - Foreign Investment in India.
- xii. Press Note 3 of 2020 specifies that, an entity of a country, which shares land border with India or where the beneficial owner of an investment into India is situated in or is a citizen of any such country, can invest only with the prior approval of the Government of India. Further, any transfer of ownership of any existing or future FDI in an entity in India, directly or indirectly, resulting in the beneficial ownership falling within the restriction/purview specified for a land border country, then such subsequent change in beneficial ownership will also require prior Government approval.
- xiii. Rule 9 (6) of the NDI Rules states that in case of transfer of equity instruments between a person resident in India and a person resident outside India, an amount not exceeding twenty five percent of the total consideration,-
  - (i) may be paid by the buyer on a deferred basis within a period not exceeding eighteen months from the date of the transfer agreement; or
  - (ii) may be settled through an escrow arrangement between the buyer and the seller for a period not exceeding eighteen months from the date of the transfer agreement; or
  - (iii) may be indemnified by the seller for a period not exceeding eighteen months from the date of the payment of the full consideration, if the total consideration has been paid by the buyer to the seller:

Provided that the total consideration finally paid for the shares shall be compliant with the applicable pricing guidelines.
- xiv. Rule 23 of the NDI Rules.
- xv. Master Directions - Foreign Investment in India have clarified that subscription by persons resident outside India to non-convertible debentures issued by an Indian company will not be construed as funds borrowed/leveraged in the domestic market.
- xvi. Internal accruals' shall mean profits transferred to reserve account after payment of taxes.
- xvii. Paragraph 9.3.3. of the Master Directions - Foreign Investment in India.
- xviii. Rule 23(4) of the NDI Rules.
- xix. Rule 9(6) of the NDI Rules.
- xx. Paragraph 1.2.(ii) of Annexure-4 of the FDI Policy. Other guidelines, other than mentioned herein, are prescribed under Annexure 4 of the FDI Policy read with Rule 23 of the NDI Rules.
- xxi. However, it is to be noted that for sponsors or managers or investment managers organized in a form other than companies or LLPs, SEBI shall determine whether the sponsor or manager or investment manager is foreign owned and controlled.
- xxii. Rule 23(5) of the NDI Rules.