

## **“UNVEILING THE FACADE BEHIND DOWNSTREAM INVESTMENT”**

### **CHAPTER 1 – INTRODUCTION**

With the increasing influence of globalization on economies around the world, the demand of development of free/open market economies is also gaining a significant momentum. India being, one of the most fast growing economies is also feeling the heat for becoming a free market economy. Forced by the same, the Government of India has also taken few steps by initiating the reform process in its Foreign Direct Regime, the first step being the introduction of consolidated policy on Foreign Direct Investment and dispensing with the long drawn list of Press Notes and Circulars. Among others, the recent step of issuing discussion paper on introducing the next level of reform in FDI policy for public comments is also a very significant step. This step emphasizes the commitment of government of India towards bringing a more simplified and transparent policy on Foreign Direct Investment.

### **CHAPTER 2 - POLICY INITIATIVES**

FDI policy is primarily governed by the Foreign Exchange Management Act, 1999 (FEMA) which lays down the broad framework under which Government of India through various regulatory bodies create, review and regulate the detailed provisions, the Policy is reviewed and modified on continuous basis and measures for its further liberalization are taken from time to time. Till 31<sup>st</sup> March 2010, the basic Sector Specific Policy/ Equity Cap under the policy is decided from time to time through Press Notes issued by the Secretariat for Industrial Assistance (SIA), Department of Industrial Policy & Promotion (DIPP) which are subsequently adopted by Reserve Bank of India (RBI) through Regulations. Since the pronouncement of liberalized Industrial Policy in 1991, DIPP has issued various Press Notes/ Press Releases/ Clarification from time to time, to notify/modify the FDI Policy for different business sectors and to remove the ambiguities as observed from time to time by the regulators or the industry. However, after so much of hard slog, for consolidation and simplification for the Policy, the objective of simplification could not be achieved. Thereafter, the Government of India in a major step, with the beginning of 2010 decided to come out with a consolidated FDI Policy which combines into one document effects of all the prior policies/regulations relating to FDI in India. The Government has also promised to bring out an updated FDI policy (which will substitute the existing policy) every six months as stated in a comprehensive circular consolidating the entire regime for foreign investments in one place for easy reference. Till date, Government of India through DIPP has released two comprehensive FDI policy vide Circular 1 of 2010 and Circular 2 of 2010, effective from April 1, 2010 and October 1, 2010 respectively.

FDI Policy permits FDI in Indian business entities under two routes – (a) Automatic Route and (b) Approval Route. At present in most of the sectors FDI is permitted up to 100 % without prior approval in including the services sector under automatic route. In these cases, the investee companies are required to notify the Regional Office concerned of RBI of receipt of inward remittances within 30 days and have to file the required return with that office within 30 days of issue of shares to foreign investors. All activities which are not covered under the automatic route of FDI prior approval of Government of India through Foreign Investment Promotion Board (FIPB) would be required.

### **CHAPTER 3 - DIRECT & INDIRECT FOREIGN INVESTMENT**

FDI Policy takes into account only two factors of foreign investment in Indian Company; Direct foreign Investment and Indirect foreign Investment (i.e. downstream investment). All investment directly by a non-resident entity into the Indian company would be counted towards direct foreign investment.

For indirect foreign investment, the foreign investment through the investing Indian company owned and controlled by Foreign Investor is reckoned. In a bid to streamline, rationalize and liberalize the method of calculation of indirect foreign investment across sectors and make the foreign investment regime in India more transparent from the perspective of downstream investment, the Government of India amended the FDI Policy through Press Note 2 of 2009 (Guidelines for Calculation of total Foreign Investment i.e. Direct and Indirect Foreign Investment in Indian Companies) and Press Note 4 of 2009 (Clarificatory guidelines on Downstream Investment by Indian Companies) Series. FDI Policy before the introduction of above said Press Notes, provided for three regimes for calculation of indirect foreign equity:

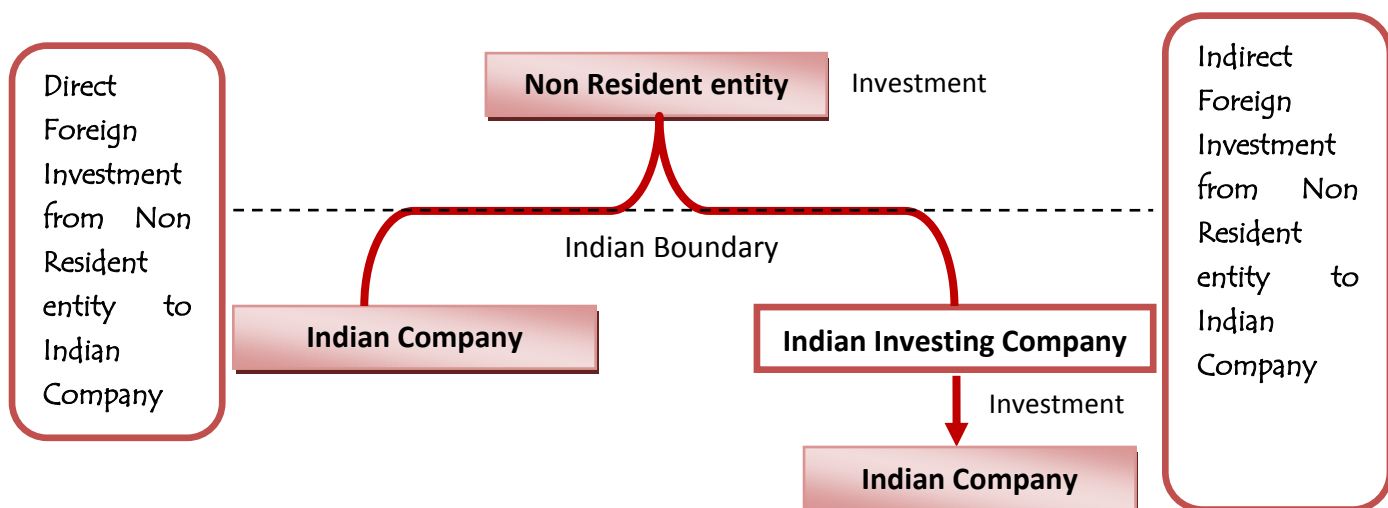
1. For telecom/ broadcasting sectors proportionate methods being used through press note 5 of 2005 (modifying press note 2 of 2000), press note 1 (2006) and press note 3(2007)
2. For Insurance sector necessary observance being outlined in IRDA regulations (IRDA (Registration of Indian Insurance Companies) Regulations, 2000) and,
3. In all other sectors and 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; Investing companies in infrastructure/ service sectors (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).

Recently, with the release of Comprehensive FDI policy vide Circular 1 of 2010 and Circular 2 of 2010, by Government of India, emphasis was made more on clarifying the aspects relating to what Indirect Foreign Investment is all about and how the same shall be calculated by bringing all the previous issued press notes/ releases at one place.

**To have more clarity about the relevance of term DOWNSTREAM INVESTMENT being referred under clause 4.1.3 sub clause (i) & (ii) of consolidated FDI Policy Circular 2 effective as on date which explicate about “Guidelines for calculation of total foreign investment i.e. direct and indirect foreign investment in an Indian company”, details are mentioned herein under for reference:**

### 3.1. RECKONING TOTAL FOREIGN INVESTMENT

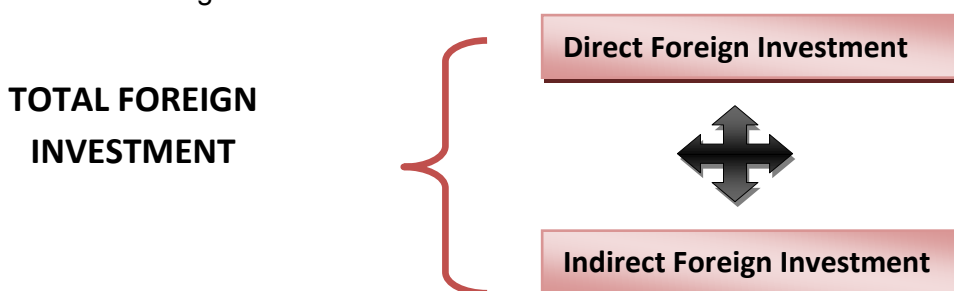
Investment in Indian Companies can be made by Non-Resident entity as well as resident Indian entities. Investment directly made by Non-Resident entity in an Indian Company is termed as Direct Foreign Investment and Investment indirectly made by Non Resident entity in an Indian Company through an Indian Investing company is termed as Indirect Foreign



**Figure 1**

Investment or Downstream Investment. Indirect Investment can be made through multi layered structure i.e. Investment by Indian Investing company in an Indian company through one or more Indian Company.

Total foreign Investment should be reckoned as a combination of Direct Foreign Investment and Indirect Foreign Investment.



**Figure 2**

## DIFFERENT SITUATIONS UNDER DIRECT & INDIRECT FOREIGN INVESTMENT

### 3.2 DIRECT FOREIGN INVESTMENT

### 3.3 INDIRECT FOREIGN INVESTMENT

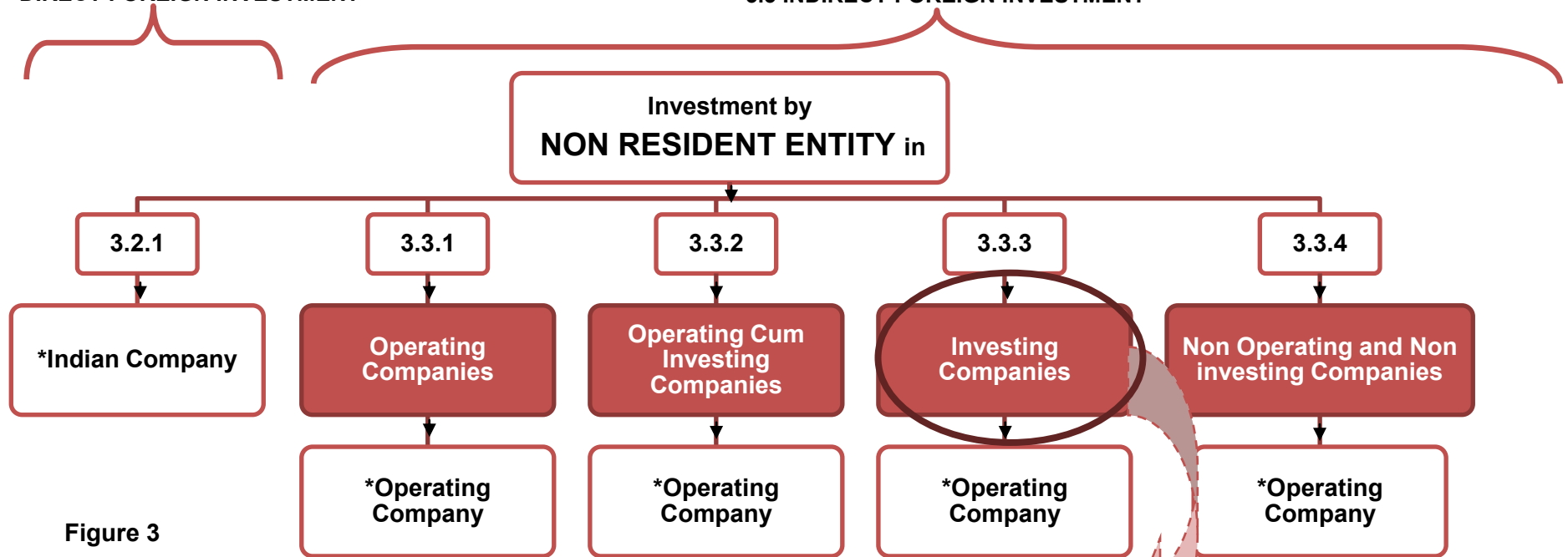
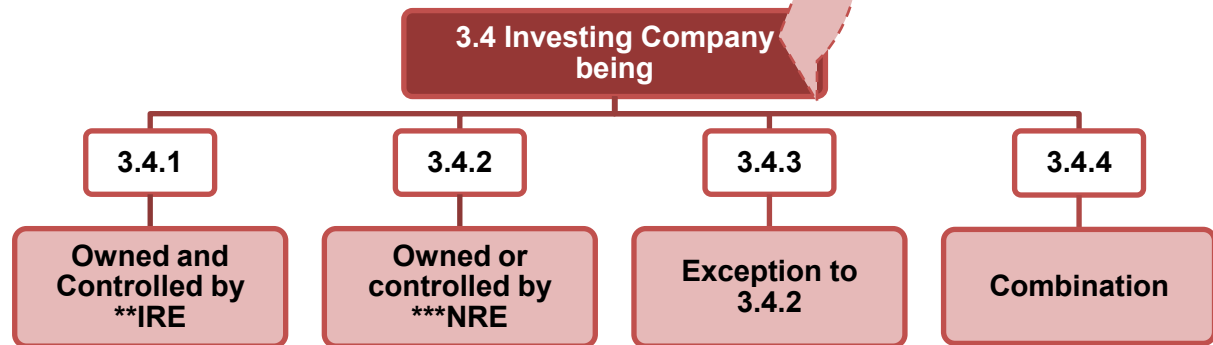


Figure 3

Figure 4



\*End User of Foreign Investment

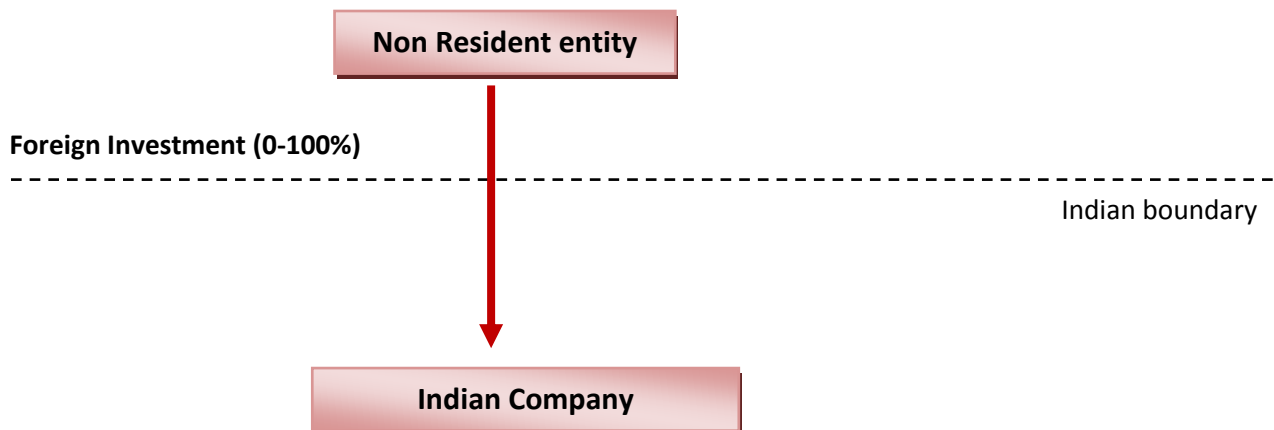
\*\* IRE: Indian Resident Entity

\*\*\*NRE: Non Resident Entity

### 3.2. DIRECT FOREIGN INVESTMENT

*In terms of clause 4.1.3 sub clause (i) of Consolidated FDI Policy, it is defined that Investment directly made by Non Resident entity in an Indian Company is counted as Direct Foreign Investment.*

#### 3.2.1 Simplified calculation of Direct Foreign Investment:



**Figure 5**

In the figure as mentioned above any percentage of investment as made by a Non Resident entity in an Indian Company would be treated as Direct Foreign Investment.

### 3.3. GUIDELINES FOR INDIRECT FOREIGN INVESTMENT I.E. DOWNSTREAM INVESTMENT BY INDIAN COMPANIES

The guiding principle on downstream investment comprises policy for:

- 3.3.1 Investment in Operating Companies
- 3.3.2 Investment by Operating Cum Investing Companies
- 3.3.3 Investment by Investing Companies
- 3.3.4 Companies having no operations and no downstream Investments

### 3.3.1 Operating Companies

Operating Company' as defined under the FDI Policy means an Indian company which is undertaking operations in various economic activities and sectors.

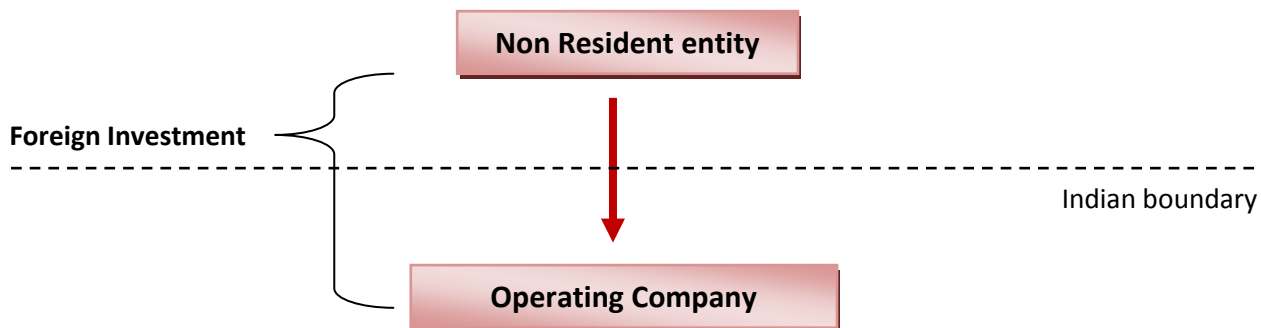


Figure 6

Foreign Investment in Operating Companies would have to comply with the relevant sectoral conditions on entry route, conditionality and caps with regard to the sectors in which such companies are operating.

### 3.3.2 Operating cum Investing Companies

Operating cum investing Companies are those, which apart from carrying their own business also make investment in other companies for carrying business therein

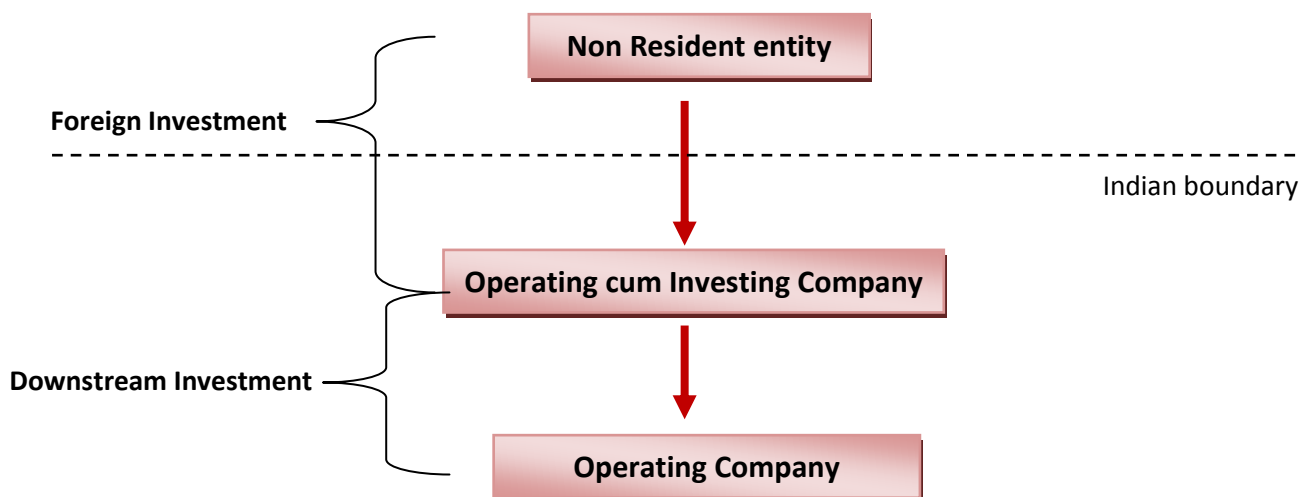


Figure 7

Foreign Investment in Operating cum Investing Companies would have to comply with the relevant sectoral conditions on entry route, conditionality and caps with regard to the sectors in which such companies are operating.

Downstream Investment in Operating Company by operating cum investing company would have to comply with the relevant sectoral conditions on entry route, conditionality and caps in regard of sector in which such Indian Companies are operating.

### 3.3.3 Investing Companies

Investing Companies as defined in FDI policy means those companies, which are formed only for the purpose of making investment in other companies for carrying business therein

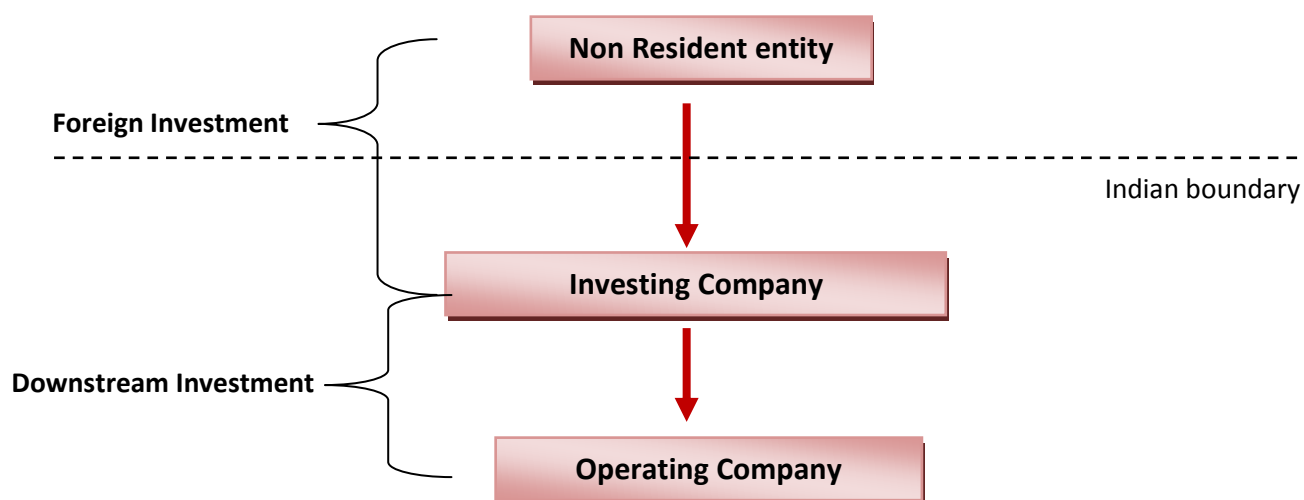


Figure 8

Foreign Investment in Investing Companies would require prior Government/ FIPB approval, regardless of the amount or extent of foreign investment.

Downstream Investment in Operating Company by investing company would have to comply with the relevant sectoral conditions on entry route, conditionality and caps in regard of sector in which such Indian Companies are operating.

### 3.3.4 Companies having no operations and no downstream Investments

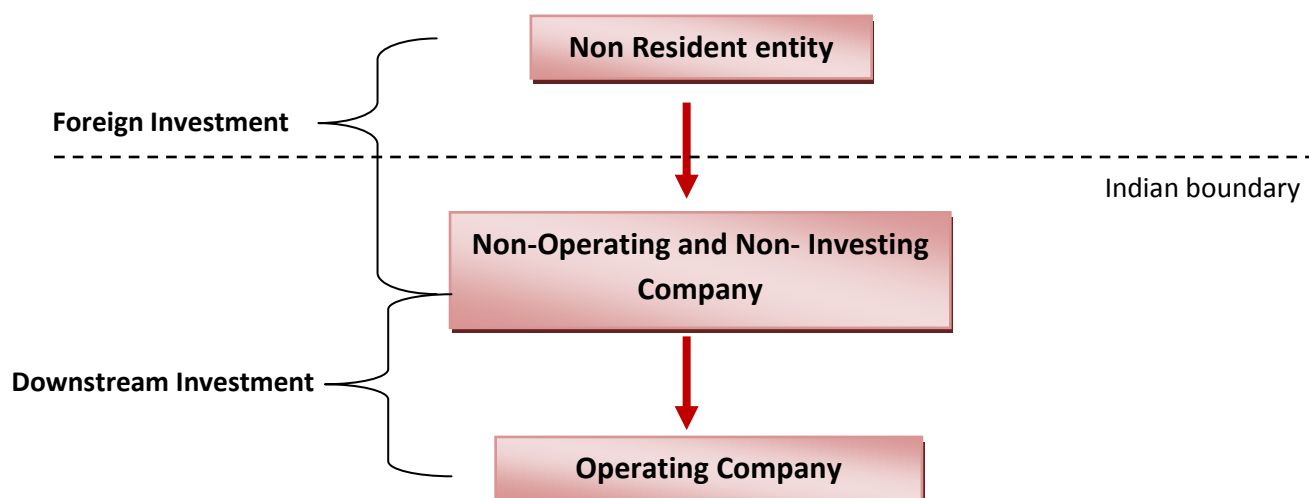


Figure 9

Foreign Investment in Non-Operating and Non-Investing Companies would require prior Government/ FIPB approval, regardless of the amount or extent of foreign investment.

When such company commences business(s) or makes downstream investment it will have to comply with the relevant sectoral conditions on entry route, conditionality and caps.

### 3.4 CALCULATION OF INDIRECT FOREIGN INVESTMENT I.E. DOWNSTREAM INVESTMENT

*In terms of clause 4.1.3 sub clause (ii) of Consolidated FDI Policy, it is defined that for counting of indirect foreign Investment, following points to be kept in mind:*

*(a) The foreign investment through the investing Indian company would not be considered for calculation of the indirect foreign investment in case of Indian companies which are 'owned and controlled' by resident Indian citizens and/or Indian Companies which are owned and controlled by resident Indian citizens.*

*(b) For cases where condition (a) above is not satisfied or if the investing company is owned or controlled by 'nonresident entities', the entire investment by the investing company into the subject Indian Company would be considered as indirect foreign investment,*

*Provided that, as an exception, the indirect foreign investment in only the 100% owned subsidiaries of operating-cum-investing/investing companies, will be limited to the foreign*

*investment in the operating-cum-investing/ investing company. 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 subsidy is owned by the holding company.*

In terms of FDI policy, Downstream Investment is an Indirect Foreign Investment by one Indian Investing Company to another Indian Company. For arriving at Indirect Foreign Investment two check points have been prescribed:

***Whether Indian Investing Company is owned by Non Resident entities OR;***

***Whether Indian Investing Company is controlled by Non Resident entities.***

For the aforesaid purpose, the FDI policy has explained the following:

- **'Indian Company'** means a company registered or incorporated in India as per the Indian Companies Act, 1956.
- An entity is considered as **Owned by Resident Indian Citizens** if more than 50% of the capital in it is beneficially owned by resident Indian citizens and/ or Indian companies, which are ultimately owned and controlled by resident Indian citizens;
- An entity is considered as **Owned by Non Resident Entities**, if more than 50% of the capital in it is beneficially owned by non- residents;
- An entity is considered as **Controlled by Resident Indian Citizens** if the resident Indian citizens and Indian companies, which are owned and controlled by resident Indian citizens, have the power to appoint a majority of its directors in that company.
- An entity is considered as **Controlled by Non Resident Entities**, if non residents have the power to appoint a majority of its directors.

### 3.4.1 INVESTING COMPANY OWNED AND CONTROLLED BY INDIAN RESIDENT ENTITY

Indian Investing Company Owned **AND** Controlled by Resident Indian Citizens i.e. more than 50% of the capital in it is beneficially owned by resident Indian companies, which are ultimately owned and controlled by resident Indian citizens and further they have the power to appoint a majority of its directors in that company.

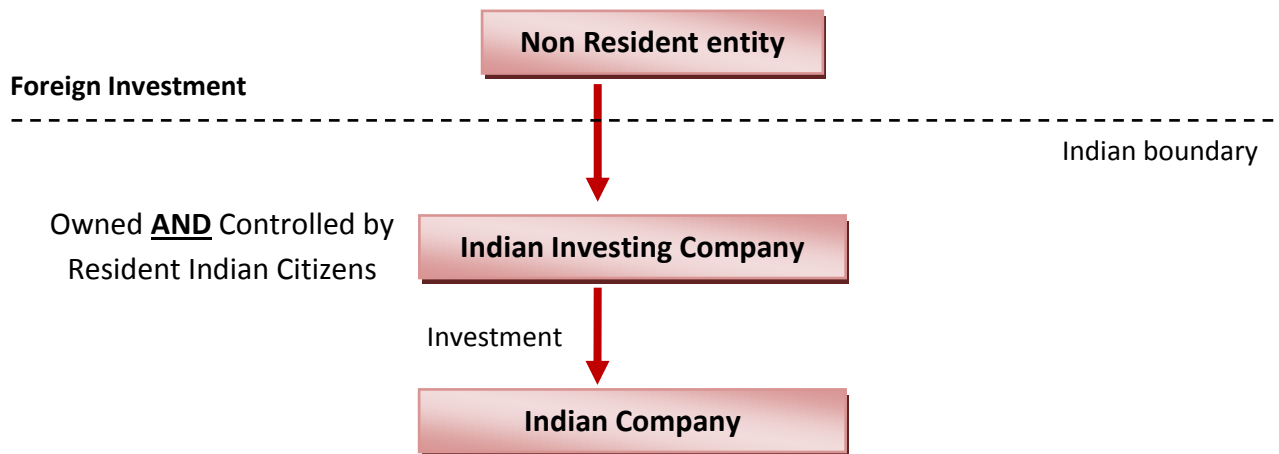


Figure 10

Here, Investment into Indian Company by Indian investing Company would not be considered as Indirect Foreign Investment.

**Example 1 to Situation 3.4.1:** Foreign Investment by a Non Resident Entity (NRE) in an Indian Investing Company (IIC) which is Owned **And** Controlled by Resident Indian Citizen, does not counts for Indirect foreign invetsment, where that IIC further make investment in an Indian Company(IC).

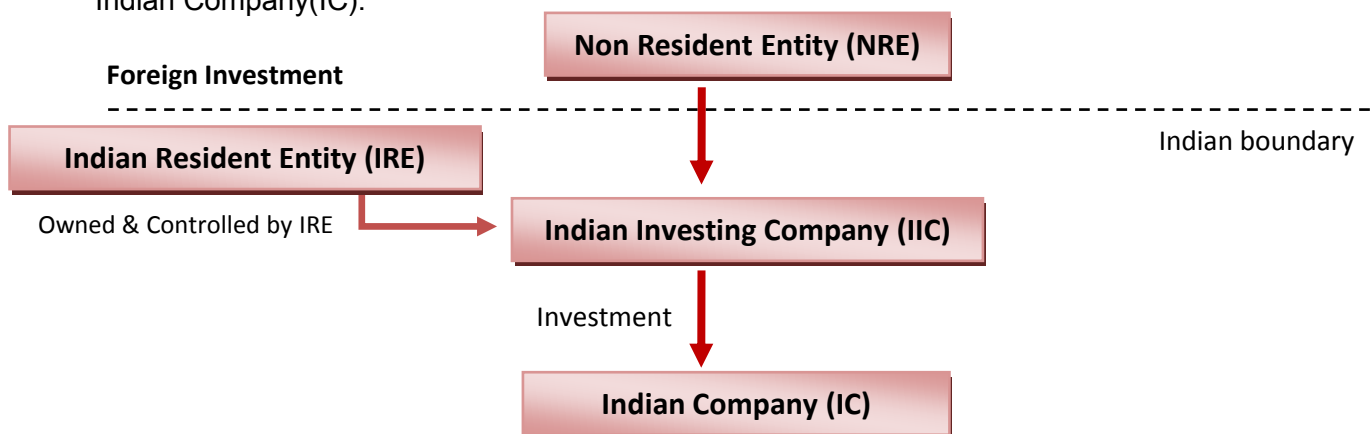


Figure 11

In above said example, Investment by Indian Investing Company (IIC), in which foreign investment is made by a Non Resident entity (NRE), is made in an Indian Company (IC), but

since that IIC is owned AND controlled by Resident Indian citizens therefore no indirect foreign investment is said to be made by NRE in IC.

### 3.4.2 INVESTING COMPANY OWNED OR CONTROLLED BY NON RESIDENT ENTITY

Indian Investing Company Owned **OR** Controlled By Non Resident Entities i.e. either more than 50% of the capital in it is beneficially owned by non-residents, or non residents have the power to appoint a majority of its directors.

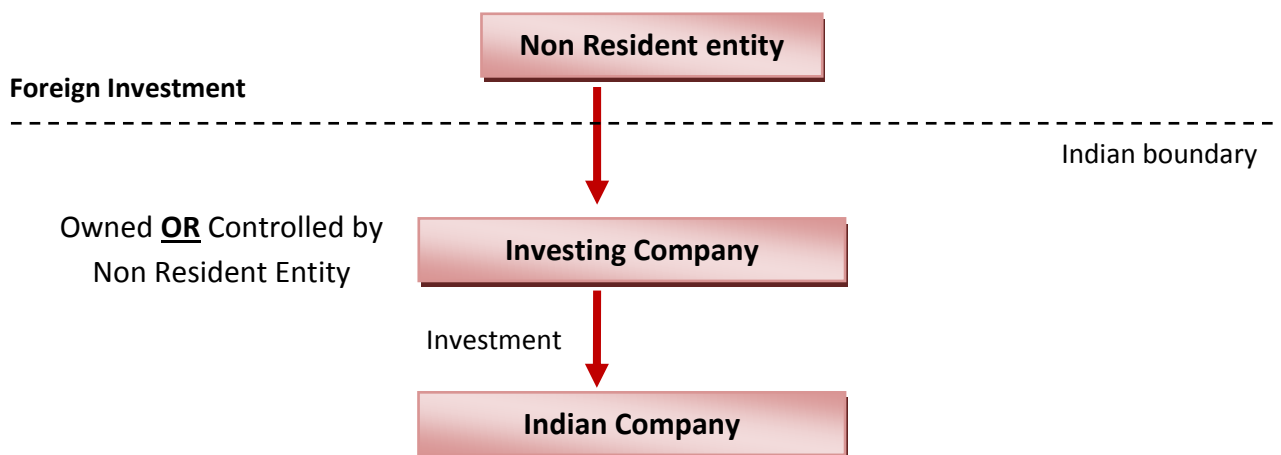


Figure 12

Here, entire Investment into Indian Company by Investing Company, which is owned or controlled by Non Resident Entity, would be considered as Indirect Foreign Investment.

**Example 1 to Situation 3.4.2:** Indian Investing Company (IIC) Owned by Non Resident Entity (NRE) but Controlled by Indian Resident Entity (IRE).

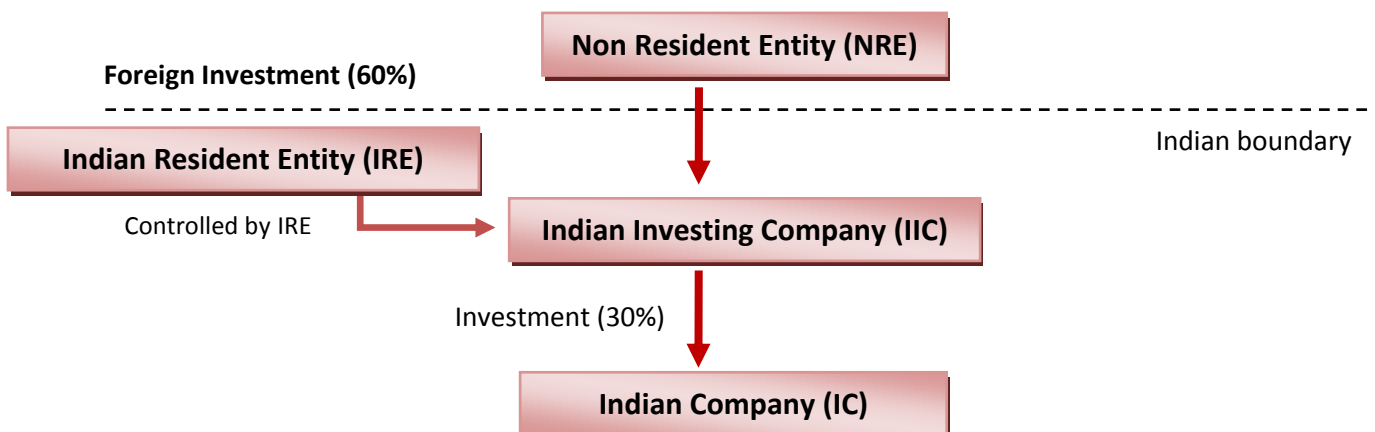
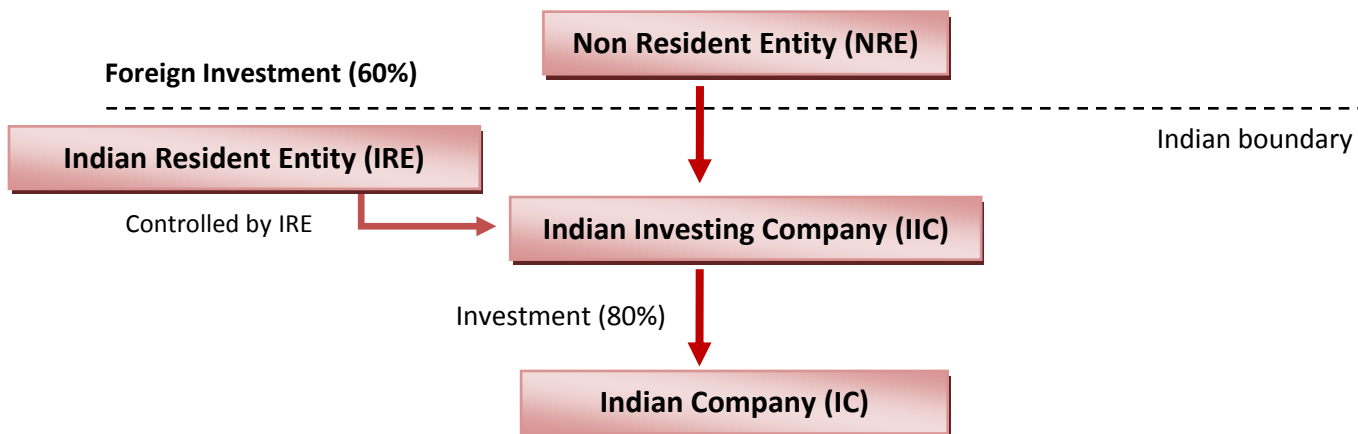


Figure 13

The entire Investment by Indian Investing Company (IIC), which is owned by Non Resident entity (NRE) to the extent of 60% but controlled by Indian resident Entity (IRE), in an Indian Company (IC), shall be considered as Indirect Foreign Investment.

Here the investment by IIC in IC is 30%, therefore entire 30% of investment by IIC would be treated as Indirect Foreign Investment.

**Example 2 to Situation 3.4.2:** Indian Investing Company (IIC) Owned by Non Resident Entity (NRE) but Controlled by Indian Resident Entity (IRE).

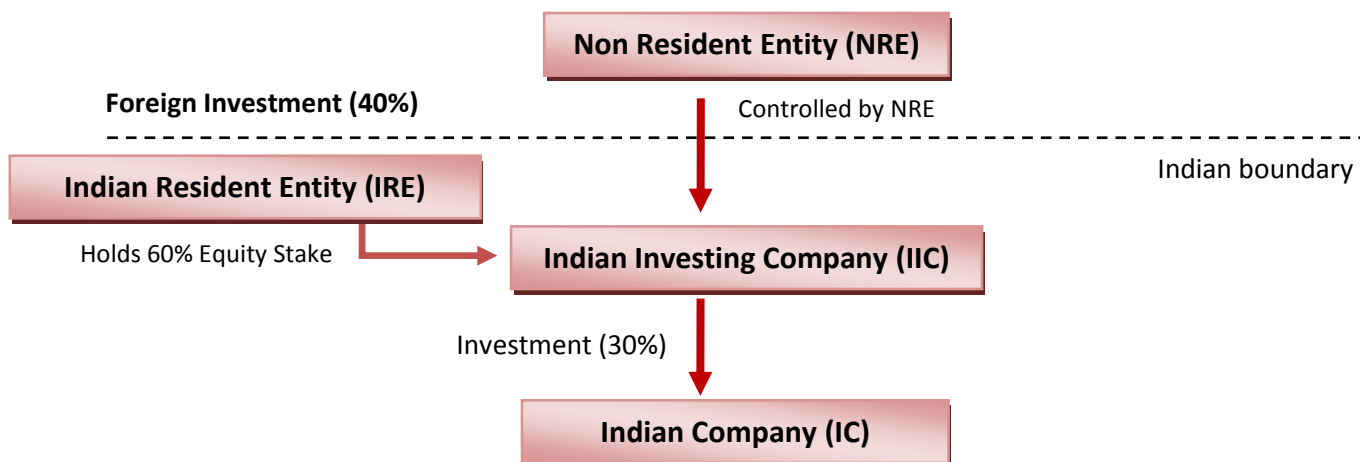


**Figure 14**

The entire Investment by Indian Investing Company (IIC), which is owned by Non Resident entity (NRE) to the extent of 60% but controlled by Indian resident Entity (IRE), in an Indian Company (IC), shall be considered as Indirect Foreign Investment.

Here the investment by IIC in IC is 80%, therefore entire 80% of investment by IIC would be treated as Indirect Foreign Investment.

**Example 3 to Situation 3.4.2:** Indian Investing Company (IIC) Controlled by Non Resident Entity (NRE) but Owned by Indian Resident Entity (IRE).

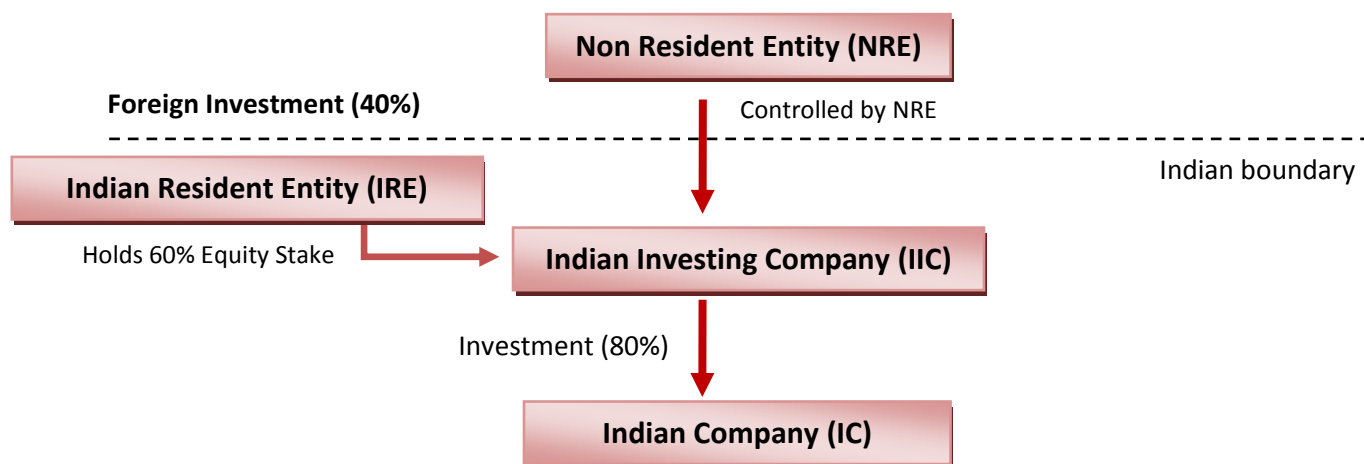


**Figure 15**

The entire Investment by Indian Investing Company (IIC), which is controlled by Non Resident entity (NRE) but owned by Indian resident Entity (IRE), in an Indian Company (IC), shall be considered as Indirect Foreign Investment.

Here the investment by IIC in IC is 30%, therefore entire 30% of investment by IIC would be treated as Indirect Foreign Investment.

**Example 4 to Situation 3.4.2:** Indian Investing Company (IIC) Controlled by Non Resident Entity (NRE) but Owned by Indian Resident Entity (IRE).



**Figure 16**

The entire Investment by Indian Investing Company (IIC), which is controlled by Non Resident entity (NRE) but owned by Indian resident Entity (IRE), in an Indian Company (IC), shall be considered as Indirect Foreign Investment.

Here the investment by IIC in IC is 80%, therefore entire 80% of investment by IIC would be treated as Indirect Foreign Investment.

### 3.4.3 Exception to 3.4.2

Indirect foreign investment in only 100% owned subsidiaries of operating cum Investing/ investing companies shall be limited to the foreign investment in operating cum investing/ investing company.

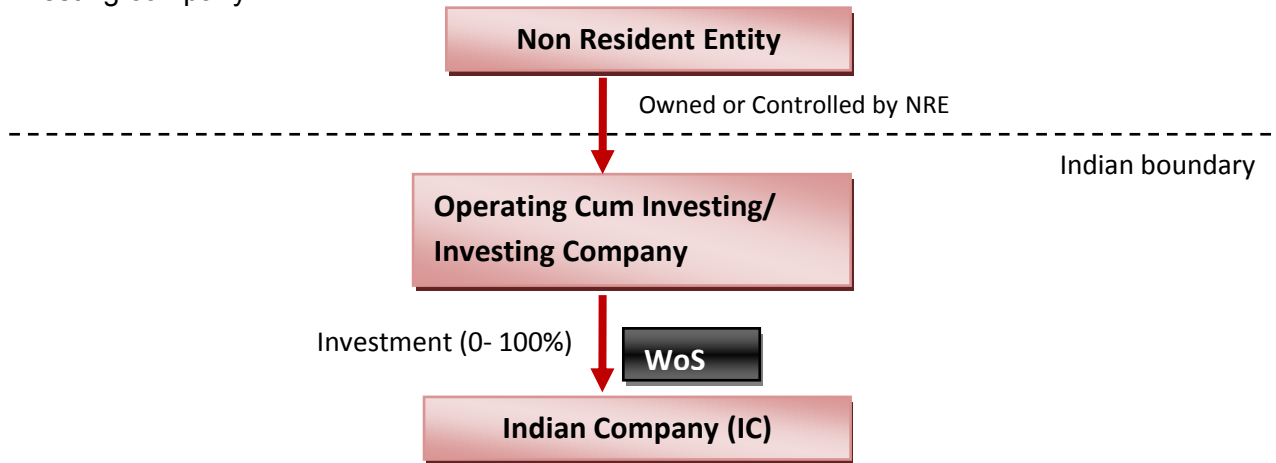


Figure 17

Here, Indirect Foreign Investment in Indian Company will be limited to the foreign Investment in the Indian operating cum investing/ investing company.

**Example 1 to Situation 3.4.3:** Indian Company (IC) is a Wholly Owned Subsidiary of an Operating cum Investing Company (OIC) which is owned by Non Resident Entity (NRE) but Controlled by Indian Resident Entity (IRE)

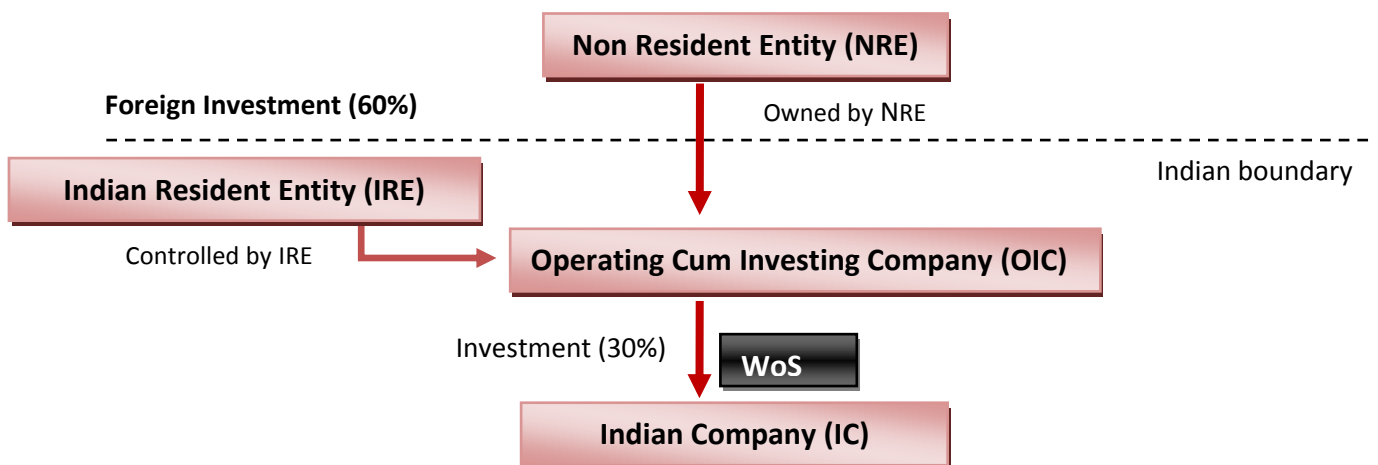
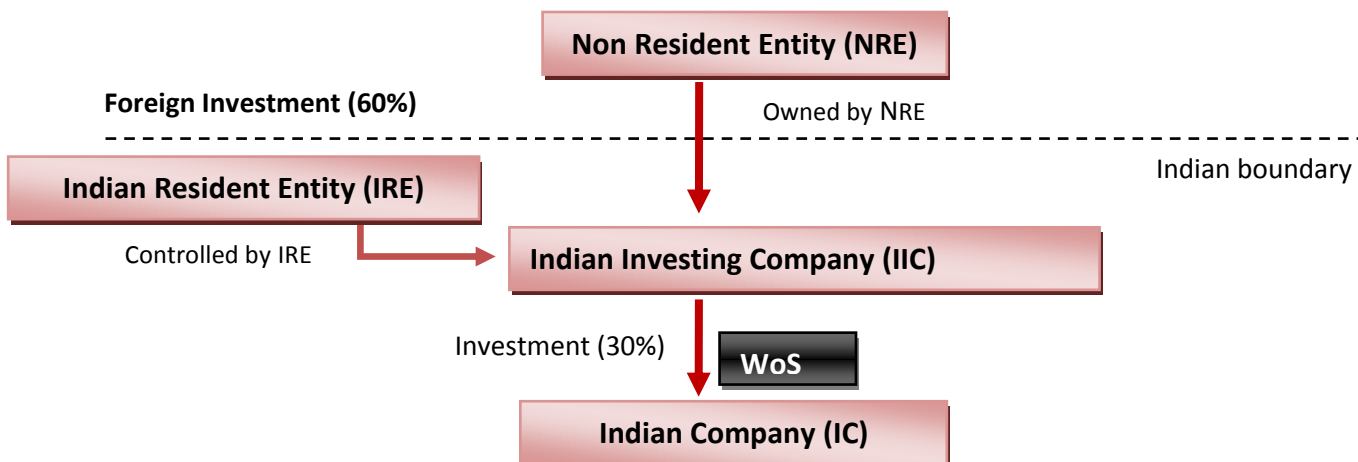


Figure 18

The entire Investment of 60% by Non Resident entity (NRE) in Operating Cum Investing Company (OIC), which is further owned by NRE but controlled by Indian resident Entity (IRE), in an Indian Company (IC), shall be considered as Indirect Foreign Investment.

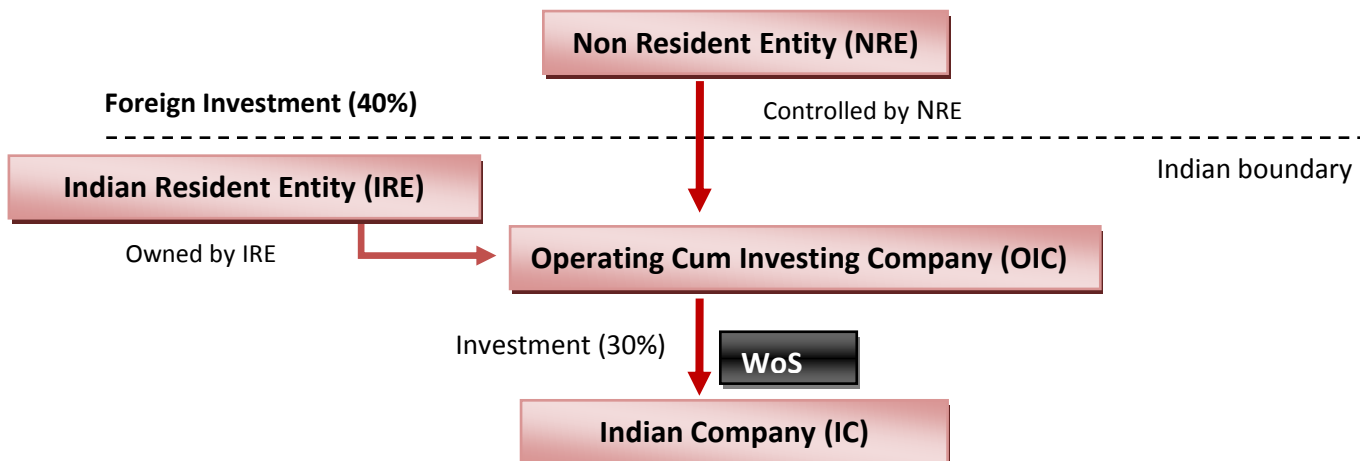
**Example 2 to Situation 3.4.3:** Indian Company (IC) is a Wholly Owned Subsidiary of an Indian Investing Company (IIC) which is owned by Non Resident Entity (NRE) but Controlled by Indian Resident Entity (IRE)



**Figure 19**

The entire Investment of 60% by Non Resident entity (NRE) in Indian Investing Company (IIC), which is further owned by NRE but controlled by Indian resident Entity (IRE), in an Indian Company (IC), shall be considered as Indirect Foreign Investment.

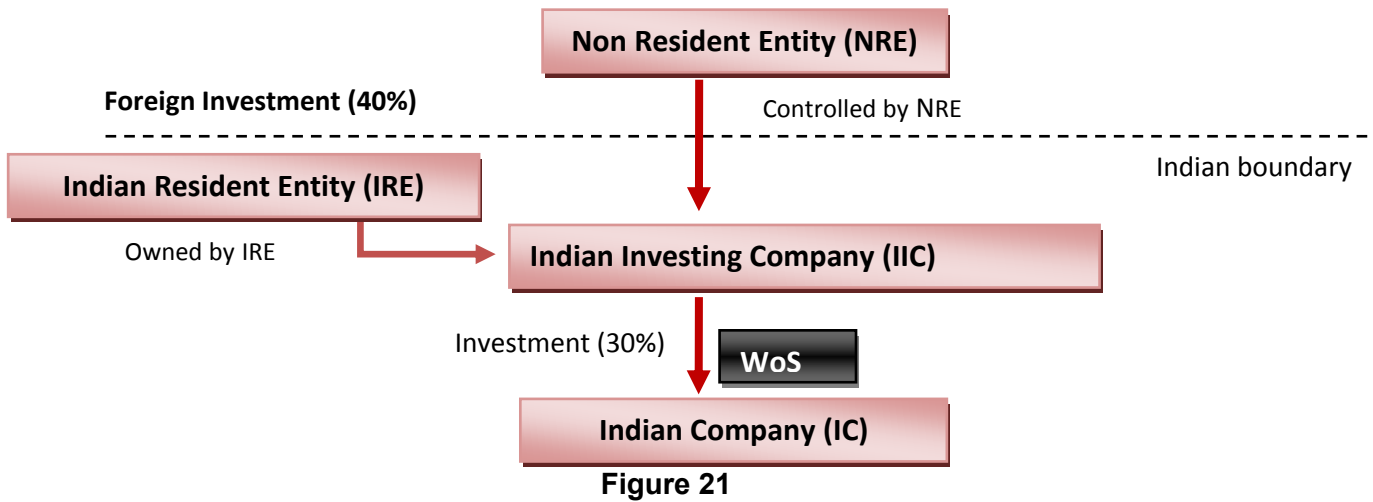
**Example 3 to Situation 3.4.3:** Indian Company (IC) is a Wholly Owned Subsidiary of an Operating cum Investing Company (OIC) which is Controlled by Non Resident Entity (NRE) but Owned by Indian Resident Entity (IRE)



**Figure 20**

The entire Investment of 40% by Non Resident entity (NRE) in Operating Cum Investing Company (OIC), which is further Controlled by NRE but Owned by Indian resident Entity (IRE), in an Indian Company (IC), shall be considered as Indirect Foreign Investment.

**Example 4 to Situation 3.4.3:** Indian Company (IC) is a Wholly Owned Subsidiary of an Indian Investing Company (IIC) which is owned by Non Resident Entity (NRE) but Controlled by Indian Resident Entity (IRE)



The entire investment of 40% by Non Resident entity (NRE) in Indian Investing Company (IIC), which is further Controlled by NRE but Owned by Indian resident Entity (IRE), in an Indian Company (IC), shall be considered as Indirect Foreign Investment.

### 3.4.4 Combination of Cases

**Example 1 to Situation 3.4.4:** Indian Investing Company (IIC) is Owned by Non Resident Entity (NRE) but Controlled by Indian Resident Entity (IRE). IIC makes investment in two Companies, 60% in Indian Company 1 (IC1) (it's Wholly Owned Subsidiary) and 40% in Indian Company 2 (IC2).

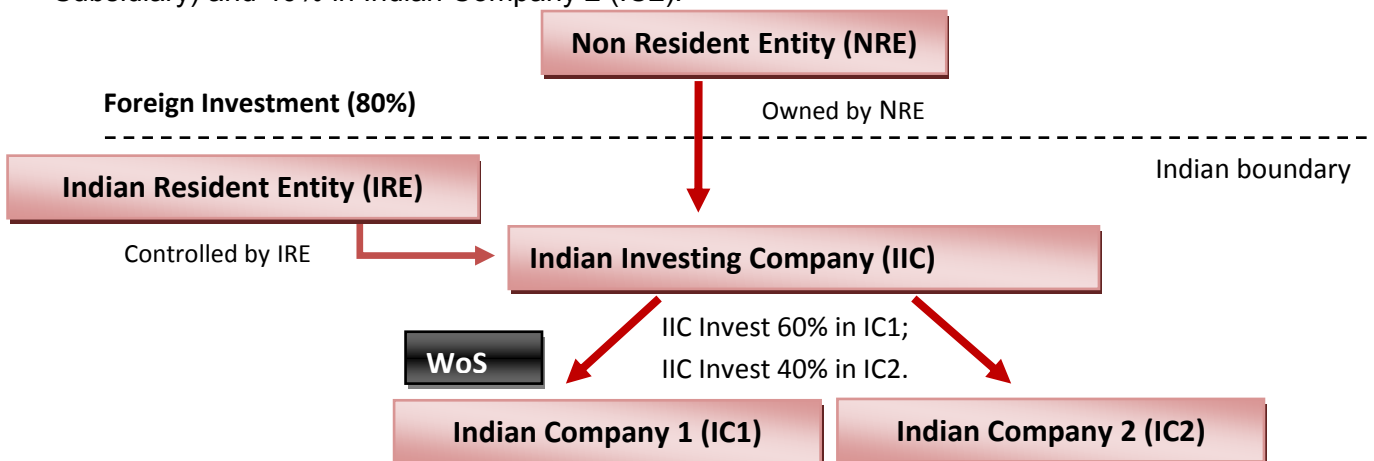
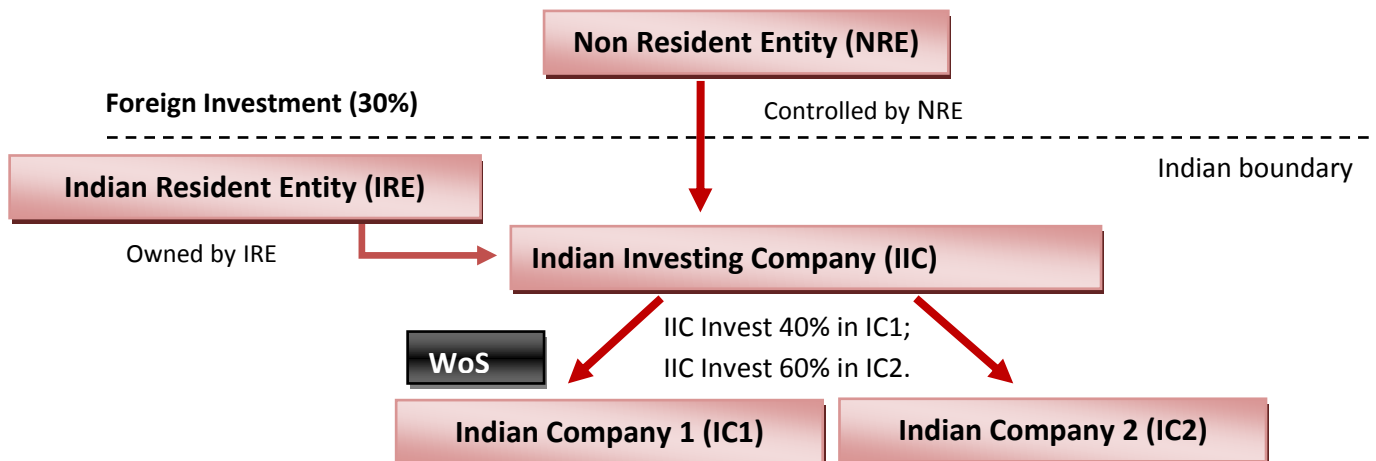


Figure 22

- The entire investment of 80% by Non Resident Entity (NRE) would be treated as Indirect Foreign Investment in Indian Company 1 (IC1), and

- The entire investment of 40% by Indian Investing Company would be treated as Indirect Foreign Investment in Indian Company 2 (IC2).

**Example 2 to Situation 3.4.4:** Indian Investing Company (IIC) is Controlled by Non Resident Entity (NRE) but Owned by Indian Resident Entity (IRE). IIC makes investment in two Companies, 40% in Indian Company 1 (IC1) (it's Wholly Owned Subsidiary) and 60% in Indian Company 2 (IC2).



**Figure 23**

- The entire investment of 30% by Non Resident Entity (NRE) would be treated as Indirect Foreign Investment in Indian Company 1 (IC1), and
- The entire investment of 60% by Indian Investing Company would be treated as Indirect Foreign Investment in Indian Company 2 (IC2).

## **CHAPTER 4 - CONCLUSION:**

The basic intent behind the guidelines is to provide clarity on what would be treated as direct and indirect foreign investment in India, so as to bring in more consistency and uniformity in the manner of calculating foreign investment across sectors/activities in Indian companies.

Despite of consolidated FDI policy issued by the Department of Industrial Policy and Promotion, ambiguity still rest under foreign investment rules and there are some issues which still requires more clarity.

Like, Private Indian Banks like HDFC & ICICI, which have foreign holding of around 74%, including that of foreign banks and overseas institutional investors will be termed as Foreign Banks or Banks owned and controlled by Foreign Nationals, as per the new FDI policy. Moreover the question further arises , whether the investment made by such banks in other sectors like insurance , mutual fund etc , will be treated as downstream investment and whether have to comply with FDI norms or not.

Though the efforts taken by government of India in simplifying and rationalizing FDI policy including downstream investment are highly commendable but lot of questions are still unresolved and we can hope that government will take the necessary steps in time to bring more clarity and to resolve important unresolved issues.