

The Chamber of Tax Consultants
Indirect Foreign Investment and Downstream investments

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Executive Summary

1. Foreign Direct Investment (**FDI**) can be made directly in the Indian company, or indirectly through an intermediate Indian company. Investment by an intermediate Indian company (which is owned or controlled by foreigners) into **another Indian entity** is considered as **Indirect Foreign Investment (IFI)** or downstream investment. IFI rules apply across all levels of downstream investment. IFI rules are amongst the most complicated rules. With multiple regulators and multiple laws, it has become a complex subject.
2. The **basic policy** behind IFI rules is - **What can be done directly can be done indirectly. What cannot be done directly cannot be done indirectly.**
3. **Implications of Indirect Foreign Investment** - All IFI have to comply with all FEMA rules - **sectoral caps, conditions or restrictions** of FDI policy. This includes capitalisation norms, valuation rules, optionality clauses, etc. Where approvals are required, the same have to be obtained. **Thus even though the transactions may be between Indian entities, if one of them is Indirect foreign investor, FEMA applies.**

The responsibility for compliance of IFI rules is on the investee company at all levels. Thus even small start-up companies which receive investment from a Venture fund, will need to consider whether the VCF is domestic investment or foreign investor.

The **first level Indian company** which has received Direct Foreign Investment, is required to get a certificate from the auditor annually that downstream investment rules have been complied with (including its subsidiaries).

4. IFI can be undertaken by an Indian company, Limited Liability Partnership or an Investment Vehicle (VCF / AIF). Investment includes equity shares and fully convertible instruments.

If an Indian company or LLP is owned to the extent of 50% or more by non-residents or foreign citizens; or is controlled by non-residents or foreign citizens, it will be considered as **indirect foreign investor**. FEMA rules have to be complied with. On the other hand, only if the Indian company or LLP has Resident Indian citizen investment of more than 50% AND is controlled by Resident Indian citizen, it will be considered as **domestic investor**. The manner **The author acknowledges important contributions from Mr. Rashmin Sanghvi and Mr. Rutvik Sanghvi for this article**

in which rules are made, it is possible that the financial interest in the downstream company may be more than 50% but still it will be considered as domestic investor. It should also be noted that **residence and citizenship**, both have to be considered.

In case of investment by Investment Vehicle, if the fund's sponsor or manager is foreign owned or controlled, then the investment by Investment vehicle will not be considered as domestic investment. Foreign investment in units of IV will not be considered to determine whether IV is domestic or foreign.

If Indian entity is considered as indirect foreign investor, the entire investment will be considered as IFI. **There is no proportionality**. Thus if there is foreign investment of 60% in Indian company, investment by Indian company in downstream company will be entirely considered as IFI. IFI will not be restricted to 60%. This method has to be considered for every downstream company at every level.

It should however be noted that there are some sectors which are totally prohibited for foreign investment like agriculture, atomic energy, etc. Even if the Indian company is owned and controlled by Indian resident citizens, but has slightest foreign investment, it cannot invest in these sectors.

6. To determine the extent of foreign investment in Indian entity (whether it is 50% or more), **all categories of foreign investments have to be considered** – FDI, FII, NRI repatriable, FVCI, etc. In fact now for considering the sectoral cap in the first level company also, all categories of foreign investment have to be considered. Thus if FDI is 20%, but together with other foreign investments, total foreign investment crosses 50%, the company will be considered as foreign investor for downstream investment.

NRI Investment on Non-Repatriation basis (Schedule 4) is not counted as foreign investment for these purposes. Share issued as Sweat equity or under employee stock option plans are also not to be considered.

7. Indian companies/LLPs have to bring in requisite **funds from abroad** for making downstream investment. Downstream investments can also be made through **internal accruals** also. Internal accruals mean profits transferred to reserve account after payment of taxes.

Indian entity however cannot borrow and invest. They can raise debt for their business, but not for further downstream investments.

8. DIPP press notes for Indirect Foreign investment were issued on 13.2.2009. FEMA notification was issued effective from 21.6.2013. Transactions between 13.2.2009 and 20.6.2013 (between the dates of issue of DIPP press notes and FEMA Notification) need to be examined whether these fall within the guidelines. If they do fall within the guidelines, suitable action should be taken.

Detailed article

1. **Background:**

1.1 Foreign Direct Investment (**FDI**) has been welcomed in India since 1991. Investment by foreigner (non-resident) in an Indian entity is considered as Direct Foreign Investment. Investment by an Indian company (which is owned or controlled by foreigners) into **another Indian entity** is considered as **Indirect Foreign Investment (IFI)**. It is also known as downstream investment.

1.2 Prior to 2009, there were no clear rules on Indirect Foreign Investment. There were some rules for Telecom, broadcasting, insurance and infrastructure service sectors. DIPP issued press notes in February 2009 bringing in the concept of IFI. These guidelines were notified by RBI only in June 2013. The delay was due to differences between RBI and Government of India. There have been some amendments after June 2013. In 2015-16, several notifications under FEMA have been issued which have brought in a lot of clarity.

1.3 IFI rules are amongst the most complicated rules. Drafting of the law could be far more simple. Further there are multiple regulators dealing with foreign investment as under:

RBI - for administering, reporting, compounding and approval for some transactions.

DIPP - for issuing policy measures and approvals in some sectors like NRI investment and retail trading.

FIPB - approval for foreign investment not falling within automatic route.

Ministries - approvals / licenses for specific matters like defense, insurance, etc.

Apart from the above, other laws also may be applicable – SEBI, Company law, NBFC, Income-tax, etc.

1.4 There have been controversies. This article discusses the rules for Indirect Foreign Investment from FEMA angle considering the latest rules.

A) Abbreviations used in this article:

AIF	-	Alternative Investment Fund
FDI	-	Foreign Direct Investment
FII	-	Foreign Institutional Investor
FPI	-	Foreign Portfolio Investment
IC	-	Indian company which has foreign investment and which is making downstream investment
IFI	-	Indirect Foreign Investment / Downstream investment, or Indirect Foreign Investor (as may be relevant)
IV	-	Investment Vehicle
LLP	-	Limited Liability Partnership
QFI	-	Qualified Foreign Investor
RBI	-	Reserve Bank of India
VCF	-	Venture Capital Fund

B) Terms frequently used in this article:

Domestic investor - Indian company which does NOT have any Indirect foreign investor (i.e. foreign ownership and control is less than the prescribed threshold). It is in contrast with IFI. ("Domestic investment" means 'investment made by such Domestic investor'.)

Downstream investment - Investment made by Indian company / LLP, in another Indian company / LLP. ("Downstream company" means the 'investee company / LLP in which downstream investment is made'.)

Foreign investment - Investment in an Indian company / LLP by a non-resident person.

C) Relevant law - The relevant law for IFI is as under:

Press notes 2, 3 and 4 of 2009 (while these are now subsumed within the Consolidated FDI Policy), these form the basis. (Issued by DIPP.)

FEMA Notification No. 20 on Foreign Investment - especially Regulation 14. (Issued by RBI.)

Specific Notification nos. 278, 354, 355, 362 (including the corrigendum), and 363 which have amended FEMA Notification No. 20. (Issued by RBI.)

(Generally these are referred to as "rule/s" in this article.)

2. **Basic policy for Indirect Foreign Investment (IFI):**

The basic policy behind IFI rules is - **What can be done directly can be done indirectly. What cannot be done directly cannot be done indirectly.**

3. **Where are IFI rules relevant?**

3.1 IFI rules are most relevant where there are **sectoral caps, conditions or restrictions** for foreign investment, or where **Government approval** is required. Fortunately the list of such industries is now small.

All investment by IFI has to comply with Schedule 1 of FEMA notification No. 20 (FDI policy). Thus if investment is in NBFC activity, capitalisation norms have to be complied with.

3.2 IFI rules are also relevant for past investments which may not have been as per IFI rules and involved investment in industries where there were sectoral caps and conditions. (E.g. real estate development sector had condition of minimum area of 50,000 sq. meters of built-up area.)

3.3 For the remaining industries which are under **automatic route**, the regular compliance of conditions for foreign investment - valuation rules, allotment / refund of share application rules etc. have to be complied with for IFI. **This is an area which is missed out by many. Even though the transactions may be between Indian entities, if one of them is Indirect foreign investor, FEMA applies. (See para 16.)**

3.4 Thus IFI rules are relevant where:

- Foreign investment is not allowed – e.g. agriculture.
- There are sectoral caps for foreign investment – e.g. Scheduled air transport.
- There are conditions prescribed for foreign investment – e.g. Real Estate Development.
- There are minimum capitalisation norms prescribed for foreign investment – e.g. NBFC.
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- Transfer of capital or control from residents to non-residents.
- Compliance with regular conditions – e.g. allotment or refund of share application within 180 days, valuation rules, etc.
- Reporting.

IFI rules apply throughout **all levels in a multi-level structure.**

4. **Person responsible for compliance of IFI rules:**

- 4.1 **The responsibility for compliance of IFI rules is on the investee company.** For example if there are ten levels of companies, all companies from second to tenth level are required to see that they are eligible to receive investment from the preceding level company! If first company has invested in the second company, the second company has invested in the third company and so on, and if there is a violation of some FEMA regulation at tenth level, all the investee companies in between may have to file for Compounding. AP circular 73 dated 26.5.2016 provides for a framework as per which compounding fee will be levied.

To consider another practical example, if an Indian Venture Capital Fund or Alternative Investment Fund has invested in an Indian company, the investee company will have to consider whether the VCF or AIF is foreign controlled or not. Usually companies receiving investment from VCFs or AIFs are small companies / start-ups. They do not have the capability to examine. Yet responsibility is with them.

- 4.2 The **first level Indian company** which has received Direct Foreign Investment, is required to get a certificate from the auditor that downstream investment rules have been complied with for all its subsidiaries. (See para 12.)

5. **Key issues to be checked for IFI:**

Key issues to be checked for IFI are:

- Whether the **Indian investor entity** is Indian owned and controlled and therefore domestic investor; or it is foreign owned or foreign controlled and therefore foreign investor. (Para 7 and 8).
- What **kind of foreign investment** in IC is considered for determining whether Indian investor entity is considered as Indirect foreign investor. (Para 9).
- The guidelines for Indian investor company to invest in **downstream companies**. (Paras 11 to 15).

6. **Entities eligible to undertake IFI:**

Following Indian entities can undertake IFI:

- A company.
- A Limited Liability Partnership.

An Investment Vehicle.

Investment includes equity shares and fully convertible instruments. Investment does not include loans, Non-convertible or partly convertible debentures / preference shares.

7. Indirect Foreign Investment (IFI):

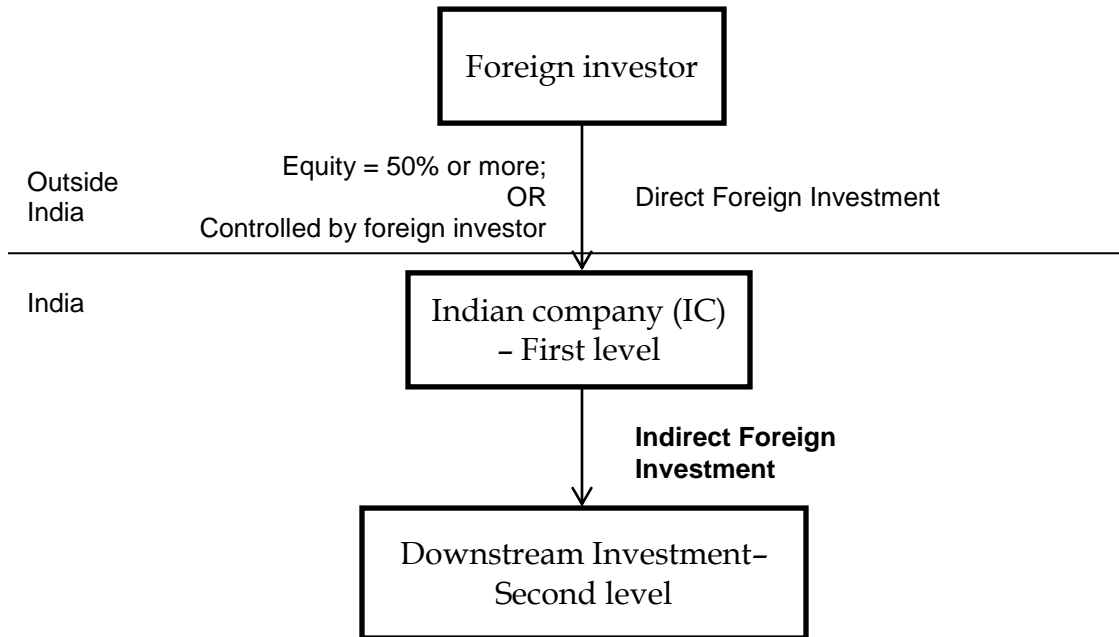
7.1 IFI has been defined in Regulation 14(1)(v) of FEMA Notification No. 20 as under:

“Indirect foreign investment’ means entire investment in other Indian companies by an Indian company (IC), having foreign investment in it provided (a) IC is not ‘owned and controlled’ by resident Indian citizens and/or Indian Companies which are owned and controlled by resident Indian citizens or (b) where the IC is owned or controlled by non-residents.

However, as an exception, the indirect foreign investment in the 100% owned subsidiaries of operating-cum-investing/investing companies will be limited to the foreign investment in the operating-cum-investing/ investing company.”

A simple chart (A) explains IFI :

Chart A



Thus if the IC has foreign investment of 50% or more; OR is controlled by non-resident through the board of directors or any other agreement; it will be considered **Indirect foreign investor**. On the other hand, only if IC has Resident Indian citizen investment of more than 50% AND is controlled by Resident Indian citizen, it will be considered as **domestic investor**.

In the First level IC, there can only be Direct foreign investment. IFI can be there in Second level companies and further downstream companies.

If IC is considered as indirect foreign investor, the entire investment by IC will be considered as IFI. **There is no proportionality**. Thus if there is foreign investment of 60% in IC, investment by IC in downstream company will be entirely considered as IFI. IFI will not be restricted to 60%. See Chart B. As a corollary, if foreign investment in IC is say 40%, entire investment by IC in downstream company will be considered as domestic investment.

This method has to be considered for every downstream company at every level.

FEMA rules apply if IC invests in Downstream companies.

7.2 The definition of Indirect Foreign Investment has two limbs as under:

Limb 1 - *“Indirect foreign investment’ means entire investment in other Indian companies by an Indian company (IC), having foreign investment in it*

Limb 2 - *provided (a) IC is not ‘owned and controlled’ by resident Indian citizens and/or Indian Companies which are owned and controlled by resident Indian citizens or (b) where the IC is owned or controlled by non-residents.*

The first limb provides that investment by “IC which has foreign investment” will be considered as IFI provided.... Thus if there is no foreign investment at all, there is no question of considering it as IFI.

The second limb provides a further condition that investment by IC will be considered as IFI where IC is either “owned” or “controlled” by non-resident.

Take case where a foreign pharma company provides APIs to Indian formulation manufacturing Indian company. The Indian company is held 100% by Indian residents and citizens. However there is an agreement between the foreign pharma company and the Indian company through which all key business decisions for manufacturing and formulations is undertaken by the foreigner. If the Indian company does not perform as per instructions of the foreign pharma company, the business of the Indian company will stop. If the Indian pharma

company wants to invest in a downstream company, does FEMA apply? Will the Indian company be considered as IFI as “control” is with the foreign company? (Such situations are rare but possible.)

In the above example, if the non-resident had just 1 share and then it would have control of Indian company, investment by IC will be IFI.

The purpose of IFI is that if non-resident owns or controls an IC, FEMA should apply for downstream investment.

However technically, if the first limb does not apply, the rest of the definition fails. Thus if there is no foreign investment at all in IC, the Indian company will not be considered as IFI even if it is controlled by foreigner.

If the Government wants control also to be a determining factor, then drafting could have been better.

7.3 If the IC has to invest abroad, IFI rules do not apply. It is not considered as “Reverse Round Tripping”.

7.4 “Total Foreign Investment” has been defined in Regulation 14(1)(x) as under:

“Total foreign investment’ in an Indian Company would be the sum total of direct and indirect foreign investment.”

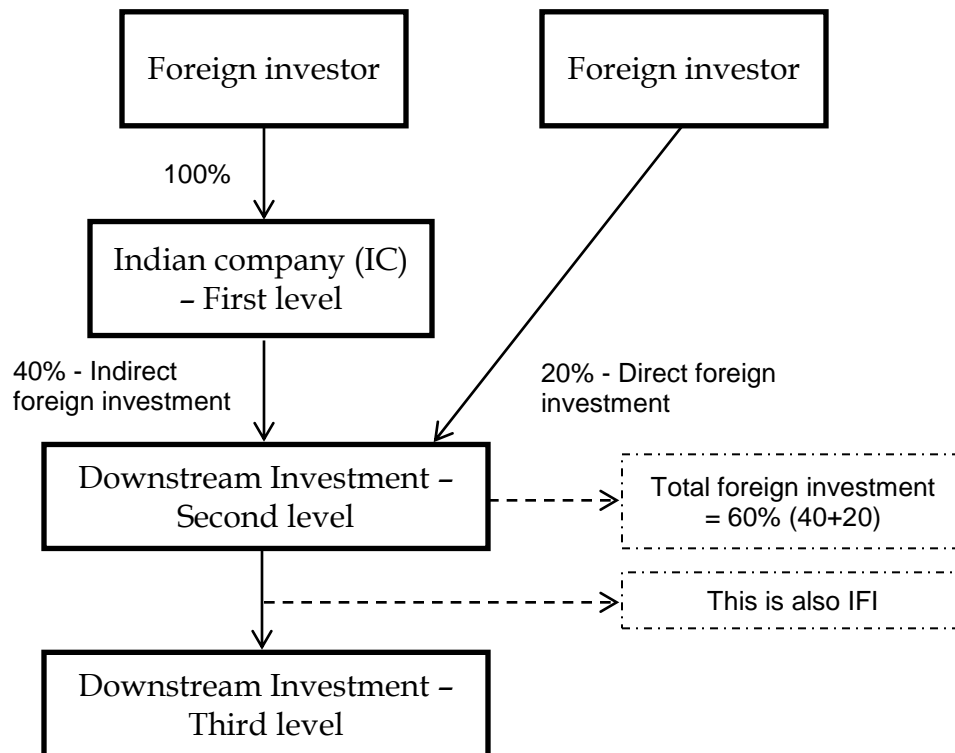
“Direct foreign investment” has been defined in Regulation 14(1)(ii) as under:

"Direct foreign investment" shall mean investment received by an Indian Company from non-resident entities regardless of whether the said investments have been made under Schedules 1, 2, 2A, 3, 6 and 8 of the Notification No. FEMA 20/2000-RB dated May 3, 2000, as amended from time to time."

IFI is added to Direct foreign investment to arrive at Total foreign investment in an Indian company. Based on the Total foreign investment, investment in further downstream companies can be considered.

Total foreign investment has to be considered in Second level companies and further downstream companies. A chart is given below:

Chart B

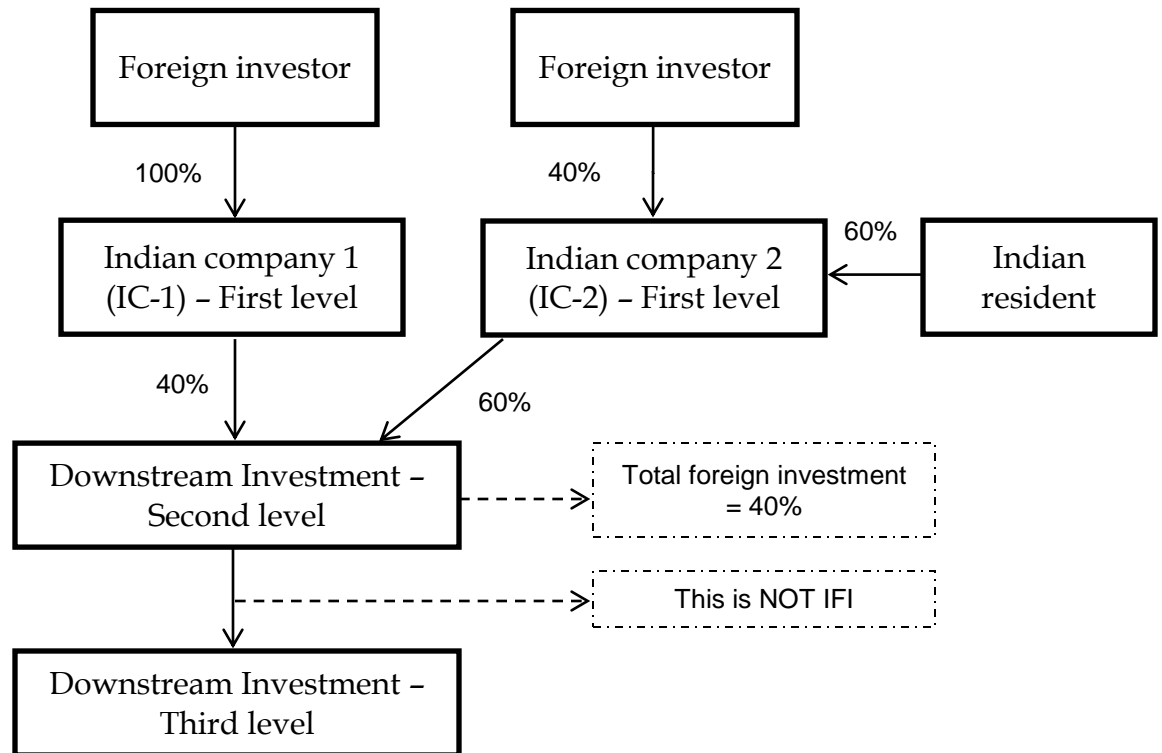


In this illustration, even if Foreign Direct Investment in IC was say 60%, while computing IC's downstream investment in the Second level company, entire 40% will be considered as Foreign investment, and not just 24%.

In case of investment by the Second level company in the Third level company, as the Third level company is a 100% subsidiary, the foreign investment in Third level will be considered as 60%. If there was however resident investment in the Third level company (however small), the entire stake of Second level company would have been considered as IFI.

Take another illustration.

Chart C



In the above chart, foreigners own 64% in second level company [40% through IC-1 and 24% through IC-2 (40x60%)]. **However IC-2 is considered as domestic investor as it is owned (and controlled) by Indian resident.** Therefore foreign investment in second level company is considered as only 40%. As a result, second level company is also domestic investor. Consequentially investment in third level will not be foreign investment.

Contrast this with the earlier Chart B. Foreigners have 60% stake and is considered as foreign investment. Whereas in Chart C, despite having 64%, it is not considered as foreign investment.

Can one say the Third level company is controlled by foreigners – otherwise than by direct shareholding? No. Such a control is not the purpose of the rules. The control has to be considered based on directorship and agreements. Financial ownership control is not to be considered. (See para 8.)

- 7.5 If IC is owned or controlled by non-residents, FEMA rules apply. The meaning of ownership and control is explained below in para 8.

8. **Owned and controlled:**

“Owned” and “Controlled” are separate terms. One has to consider the meanings separately. **This is the crux of the IFI guidelines.**

IFI can happen through a company, LLP or Investment Vehicle in India. Therefore the meaning is also different for a company, LLP and Investment Vehicle. The meanings for different entities are discussed below.

8.1 **Indian company (IC):**

8.1.1 Regulation 14(1)(i)(a) defines “owned” as under:

“a company shall be 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.”

Regulation 14(1)(i)(b) provides a converse definition – “ A company owned by non residents shall mean an Indian company that is not owned by resident Indian citizens.”

If shareholders of IC are Indian companies, those companies should also be owned and controlled by Indian resident citizens for IC to be considered as domestic investor. This applies to all levels of investments upward and downward.

8.1.2 Importance has been given to Residence and Citizenship. It is one of the very few provisions where citizenship is being considered as one of the criteria. If a person is a foreign citizen though an Indian resident, IC will be considered as foreign owned for IFI purposes.

Consider two situations:

- i) A foreign citizen resident in India owns 100% shares of IC. The IC wants to make downstream investment.
- ii) There is foreign investment in the IC. That IC also has investment by foreign citizen resident in India. Such IC wants to make downstream investment.

Can the IC make downstream investments under IFI rules?

It may be interesting to understand that FEMA does not regulate transactions based on citizenship. Then how is it that for rules for IFI, citizenship is being considered? (Rules are sub-ordinate to the law.)

FEMA regulates transactions based on whether these are Capital Account transactions or Current Account Transactions. **Foreign investment is a Capital Account Transaction.** Unless permitted by rules, it cannot be undertaken. **While permitting the IFI rules, conditions / criteria can be provided.** One of the criteria is citizenship. The citizenship criteria has been provided for “foreign investment” which can be regulated under FEMA.

Contrast this with rules for acquiring Immovable property in India by non-residents. These provide that citizens of some countries like Pakistan, etc. cannot acquire property in India. While such citizens are non-residents, restrictions are permissible under FEMA. **However if such citizens are Indian residents, FEMA does not apply at all.** If FEMA law does not apply, the rules also cannot apply. To the extent the immovable property rules put restrictions on foreign citizens who are Indian residents to acquire property, these are ultra-vires the FEMA. Can this argument be applied to a foreign citizen resident in India?

FEMA rules cannot travel beyond the law. In situation (i) where the foreign citizen is an Indian resident, FEMA does not apply. Even definition of IFI refers to IC which has foreign investment. (See para 7.2). Therefore in situation (i), IC should be able to make downstream investment without considering FEMA.

However in situation (ii), once there is foreign investment, then conditions can be applied as it comes within the FEMA purview.

This is another example where drafting can be better.

Thus a foreign citizen resident in India, can make investment in an Indian company freely. FEMA applies only if a person is a “non-resident” under FEMA (irrespective of citizenship). However for considering IFI, such a person will NOT be considered as domestic investor if there is foreign investment in the IFI.

- 8.1.3 **Shares in downstream Indian company held through LLP / other entities -** There is no mention of shares being held in downstream company by other Indian entities (like LLP). Thus if non-resident has invested 51% of capital in Indian LLP and that LLP holds shares in downstream company, will it be considered as IFI in downstream company? [The meaning of “owned” in case of downstream LLP includes shareholding by any “entity”. (See para 8.2.1 below).]

In my view, if the Indian LLP is foreign owned, downstream investment by LLP will be considered as IFI. One cannot take a view that investor is IFI, but recipient of investment is receiving domestic investment! One should consider

investment by any Indian entity in the downstream company for the purpose of IFI rules. FEMA is a Policy law. It is advisable to consider the policy and not just technical interpretation.

8.1.4 The reference here is to foreign “capital” of the IFI.(Regulation 2(ii) of FEMA Notification No. 20). However how does one consider investment in Fully Convertible Debentures if price of conversion has not been decided as yet. The guidelines do not give any answer.

8.1.5 Regulation 14(1)(ia) defines “control” as under:

“Control’ shall include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements.”

8.2 **Indian Limited Liability Partnership (LLP):**

8.2.1 Regulation 14(1)(i)(a) defines “owned” as under:

“A Limited Liability Partnership will be considered as owned by resident Indian citizens if more than 50% of the investment in such an LLP is contributed by resident Indian citizens and/ or entities which are ultimately ‘owned and controlled by resident Indian citizens’ and such resident Indian citizens and entities have majority of the profit share.”

Contribution to capital by any Indian entity also has to be considered. Further share in the profit also has to be considered.

8.2.2 Regulation 14(1)(ia) defines “control” as under:

“For the purpose of Limited Liability Partnership, ‘control’ shall mean right to appoint majority of the designated partners, where such designated partners, with specific exclusions to others, have control over all the policies of Limited Liability Partnership.”

8.3 **Indian Investment Vehicle (IV):**

8.3.1 Foreign investment has been permitted in Indian companies, or Indian LLPs. Foreign Venture Capital Investors (FVCIs) which are registered with SEBI have been permitted to invest in Venture Capital Funds (VCFs) registered with SEBI.

Venture Capital Fund Regulations of 1996 under SEBI law have been replaced with Alternative Investment Fund (AIF) regulations of 2014. Under the AIF regulations, various categories of AIFs can be registered.

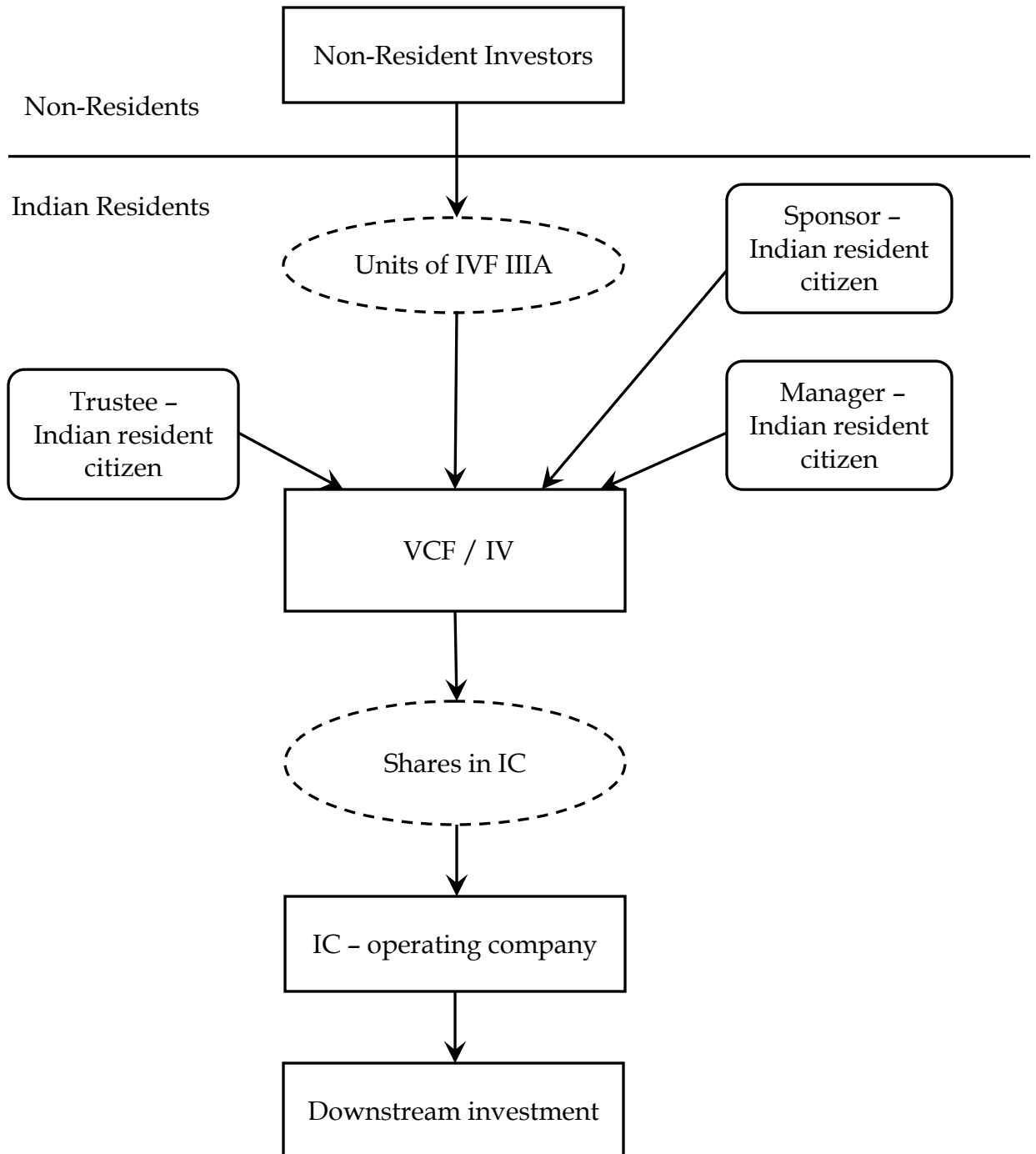
Under Regulation 5(10) of FEMA Notification No. 20 (inserted vide Notification No. 355 dated 16.11.2015), non-residents have been permitted to invest in "Investment Vehicle". Investment Vehicle is defined in Regulation 2(iif) of FEMA Notification No. 20 as under:

'Investment Vehicle' shall mean an entity registered and regulated under relevant regulations framed by SEBI or any other authority designated for the purpose and shall include Real Estate Investment Trusts (REITs) governed by the SEBI (REITs) Regulations, 2014, Infrastructure Investment Trusts (InvIts) governed by the SEBI (InvIts) Regulations, 2014 and Alternative Investment Funds (AIFs) governed by the SEBI (AIFs) Regulations, 2012.'

Schedule 11 of FEMA notification No. 20 (inserted vide Notification No. 355 dated 16.11.2015 and substituted by Notification No. 362 dated 15.2.2016) lays down guidelines for non-residents to invest in IVs.

The chart below depicts a typical Venture Capital Fund structure:

Chart D



In the above chart, the non-residents invest in units. They do not invest in “equity capital”. The VCF / IV is managed by Indian resident citizens. Investment by such a VCF will be considered as domestic investment and not IFI.

8.3.2 Hitherto, IFI rules applied to investment by ICs. IFI rules clearly did not apply to IVs. IVs are funds which are usually sponsored and managed by Indian

residents. Non-resident investors have no say in management of IVs. However in some cases, FIPB has taken a view that IFI rules apply to investment in IVs also irrespective of the fact that they are managed by Indian resident citizens / entities owned and controlled by such Indian resident citizens.

Now under clause 4 of Schedule 11, IFI rules can apply to IVs. It states as under:

“Downstream investment by an Investment Vehicle 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.

Provided 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.

Explanation 1: Ownership and control is clearly determined as per the extant FDI policy. AIF is a pooled investment vehicle. ‘Control’ of the AIF should be in the hands of ‘sponsors’ and ‘managers/investment managers’, with the general exclusion to others. In case the ‘sponsors and ‘managers/investment managers’ of the AIF are individuals, for the treatment of downstream investment by such AIF as domestic, ‘sponsors’ and ‘managers/investment managers’ should be resident Indian citizens.

Explanation 2: The extent of foreign investment in the corpus of the Investment Vehicle will not be a factor to determine as to whether downstream investment of the Investment Vehicle concerned is foreign investment or not.”

- 8.3.3 In case of companies or LLPs, “ownership” and “control” – both are considered to determine whether the company or the LLP is Indian owned and controlled. **In case of IVs, only “control” is considered. Foreign investment in IV will not be considered to determine whether the investment by IV is IFI.**

To determine “control”, the status of sponsor, manager or investment manager will be considered.

If the sponsors or managers are individuals, they should be Indian residents and citizens for the IV to be considered as domestic investor.

If the sponsor or manager is an Indian company, the meaning of control as given in Regulation 14 will apply. The company should be Indian owned and controlled for the IV to be considered as domestic investor.

If the sponsor and manager is an LLP or any other entity, SEBI will determine whether the sponsor and manager is Indian owned and controlled.

- 8.3.4 If the IV is Indian owned and controlled, then downstream investment can be made without FEMA restrictions. However if IV is considered as foreign controlled, then the downstream investment will be governed by FEMA rules (Schedule I for investment in companies and Schedule 9 for investment in LLPs).
- 8.4 Insurance, Information and Broadcasting, Defense industries have specific guidelines. Or their regulators also have ownership and control guidelines. Those will also apply.
- 8.5 **Change in rules** - What happens if the IC has not been considered as IFI hitherto; but it becomes an IFI due to change in law? Consider Chart D above. Assume that IC had received investment from IV. IV is owned by non-residents. It was not a foreign investor for IFI. FEMA conditions have not been complied with as IC was not considered as IFI.

Vide Notification No. 355 from November 2015, IV has been considered as foreign investor as it is owned by non-resident. Will the past investment made by IV in IC be considered as IFI? I believe that past investments cannot be considered as IFI. However fresh investments will be considered as IFI. Fresh investments in existing downstream company will mean a mix of domestic investment and IFI. Will sale of such investments be considered as sale by IFI? Will valuation rules have to be complied with?

In such situations, it will be advisable to inform RBI. Based on directions from RBI, further action may be taken.

9. **What kind of foreign investment in IC is considered for IFI?**

- 9.1 Foreign Direct Investment and Foreign Portfolio Investment have been treated separately. For Direct Foreign Investment, Schedule I of FEMA Notification No. 20 applies. However for computing Total foreign investment, Direct foreign investment and Indirect foreign investment have slightly different meanings. Thus there are practically 3 meanings of foreign investment:
- i) Meaning of foreign investment for FDI in the first level company. (Para 9.2)
 - ii) Meaning of Direct foreign investment in first level company for Indirect Foreign Investment in second level company. (Para 9.4)

- iii) Meaning of Indirect foreign investment in second level company for Indirect Foreign Investment in third level company (and so on for further levels). (Para 9.5)

For IFI rules, we are concerned with (ii) and (iii) above. However for the sake of completeness, item (i) also has been discussed below in brief.

9.2 **Meaning of foreign investment for FDI in the first level company:**

- 9.2.1 FDI in Indian companies is permitted under Regulation 5 subject to Schedule I of FEMA notification No. 20 and the FDI policy. For certain industries there are sectoral caps. Foreign investment can come in upto the sectoral cap under Schedule I.

Other kinds of investment - e.g. FII, FPI, FVCI have separate schedules. Investment can be made under those schedules separately. Each schedule has its own conditions / limits. (e.g. FPIs can invest upto 10% separately and 24% collectively.) Unless specified in the rules, **each schedule is separate**. Investment can come in separately. Together the foreign investment may cross the sectoral cap in Schedule I.

This is the normal meaning of foreign investment in **first level company**.

- 9.2.2 Vide Notification No. 354 dated 30.10.2015, proviso (c) has been inserted after clause 2(1) in Schedule 1 (FDI) to FEMA Notification No. 20. It states as under:

““Sectoral cap” i.e. the maximum amount which can be invested by foreign investors in an entity, unless provided otherwise, is composite and includes all types of foreign investments, direct and indirect, regardless of whether the said investments have been made under Schedule 1, 2, 2(A), 3, 6, 8, 9 and 10 of FEMA (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000. FCCBs and DRs having underlying of instruments which can be issued under Schedule 5, being in the nature of debt, shall not be treated as foreign investment. However, any equity holding by a person resident outside India resulting from conversion of any debt instrument under any arrangement shall be reckoned as foreign investment under the composite cap. Sectoral cap is as per table appended below.”

Hitherto inclusion of all kinds of foreign investment was relevant for determining whether IFI can be made. Now this applies to Direct foreign investment itself. This may not have much significance as most of the sectors where there are caps, also have other regulators which have their own foreign investment conditions - like Banking, Insurance, etc.

There are 17 sectors where there are caps. (Some other sectors are also there where automatic route has a cap and beyond that investment can be made with Government approval.) For example, if there is a sectoral cap of 49% and the company has received 49% FDI, then other investors cannot invest.

NRI investment under Schedule 4 is not to be considered. (See paras 9.4.3 and 9.8 also).

9.3 We now come to IFI. Essentially we have to see foreign investment in first level company for investment in second level company; and foreign investment in second level and subsequent levels for further downstream investments.

9.4 **Meaning of Direct foreign investment in first level company for Indirect Foreign Investment in second level company:**

9.4.1 For second level company, direct investment in first level company is defined in Regulation 14(1)(ii) as under:

"Direct foreign investment" shall mean investment received by an Indian Company from non-resident entities regardless of whether the said investments have been made under Schedules 1, 2, 2A, 3, 6 and 8 of the Notification No. FEMA 20/2000-RB dated May 3, 2000, as amended from time to time."

Thus following investments will be considered as foreign investment:

Schedule 1	-	FDI in Indian company
Schedule 2	-	FII portfolio investment
Schedule 2A	-	FPI portfolio investment
Schedule 3	-	NRI Portfolio investment (repatriation basis)
Schedule 6	-	FVCI investment in Indian company; and Investment Vehicle (subject to Schedule 11)
Schedule 8	-	QFI investment in equity shares

Schedule 11 - IV if it is controlled by non-resident or foreign citizen.

9.4.2 Category of FIIs and QFIs will be considered as FPIs after following the process under SEBI rules. The investments made as FII and QFI will be considered as foreign investment till then.

Schedule 11 has not been included as foreign investment as per the rules. However if one considers Schedule 11, investment by IV will be counted as FDI under Schedule 1 of FEMA notification No. 20 (sectoral caps) if IV is controlled by non-resident or foreign citizen. One cannot take a view that investment by

foreign owned or controlled IV will be considered as FDI but the recipient company will not be considered to have received FDI. Therefore Schedule 11 also has to be considered.

Thus even if FDI is 20%, but together with other investments it crosses 50%, the second level company will be considered as foreign investor for downstream investment.

- 9.4.3 **NRI Investment on Non-Repatriation basis (Schedule 4)** is not counted as foreign investment for these purposes. NRI can invest in an Indian firm or LLP or company. The schedule has very few restrictions compared to restrictions or conditions for FDI under Schedule 1. That Indian entity can invest in downstream companies to undertake activities where FDI is restricted. (See para 9.8 also).

Further, a **company, trust or partnership outside India which is owned and controlled by NRIs**, can invest in Indian entities under this Schedule 4. Thus foreigners can invest in India through this route in almost any sector. Earlier also, OCBs (foreign entities in which NRIs held 60% or more) were permitted to invest liberally compared to foreign investors. This route was misused in the past. The OCB as an entity was derecognised in 2003 after stock market scam by a share broker. Now this route has been brought back after 12 years. It will again lead to misuse.

- 9.4.4 For foreign investment in LLP, Schedule 9 has to be considered. Investment cannot come in the LLP under any other schedule.
- 9.5 **Meaning of Indirect foreign investment in second level company for Indirect Foreign Investment in third level company (and so on for further levels):**

- 9.5.1 For third level company, Indirect foreign investment in second level company has been defined as under:

Regulation 14(3)(i) of FEMA notification No. 20 defines Indirect foreign investment as under:

“Counting of direct foreign investment : All investments made directly by non-resident entities into the Indian company would be counted towards "Direct foreign investment".

(ii) Counting of indirect foreign investment :For the purpose of computation of indirect foreign investment, foreign investment in an Indian company shall include all types of foreign investments regardless of whether the said investments have been made

under Schedules 1, 2 (FII holding as on March 31), 2A (FPI holding as on March 31), 3, 6, 8, 9 and 10 of FEMA (Transfer or Issue of Security by Persons Resident outside India) Regulations, 2000. FCCBs and DRs having underlying of instruments which can be issued under Schedule 5, being in the nature of debt, shall not be treated as foreign investment. However, any equity holding by a person resident outside India resulting from conversion of any debt instrument under any arrangement shall be reckoned as foreign investment."

Thus it will include:

Schedule 1	-	FDI in Indian company
Schedule 2	-	FII portfolio investment
Schedule 2A	-	FPI portfolio investment
Schedule 3	-	NRI Portfolio investment
Schedule 6	-	FVCI investment in Indian company; and Investment Vehicle (subject to Schedule 11)
Schedule 8	-	QFI investment in equity shares
Schedule 9	-	FDI in LLP
Schedule 10	-	Investment in Indian Depository Receipts

Schedule 11	-	IV if it is controlled by non-resident or foreign citizen.
Regulation 14	-	Investment by first level company if it has foreign investment as mentioned in para 9.4 above.

9.5.2 Here also, Schedule 11 has not been included as foreign investment as per the rules. As explained in para 9.4.1 above, Schedule 11 also has to be considered.

Under Schedule 10 Indian company can issue Depository Receipts (DRs) for securities which can be issued to foreign investors under Schedules 1, 2, 2A, 3, 5 and 8. The securities are themselves issued to foreign depository. It is a mechanism of issue of securities to foreigners. DRs could be covered in the list of foreign investors stated in para 9.4 itself – i.e. for second level company itself.

DRs are considered as FDI for first level company (see para 9.2.2).

NRI investment under Schedule 4 is not to be considered. (See para 9.4.3 and 9.8 also).

9.6 The shares under portfolio investment acquired by FIIs and FPIs have to be considered as on 31st March of the immediately preceding year in which the Indirect foreign investment takes place. This is because portfolio investors keep fluctuating.

However investment made by NRIs and QFIs have to be considered as on the date of IFI investment transaction. Earlier even NRI and QFI investment was also to be considered as on 31st March. (See definition of “Counting of Indirect Foreign Investment in para 9.5.1).

- 9.7 Regulation 14(1)(x) of FEMA notification No. 20 defines Total foreign investment as under:

“(x) "Total foreign investment" in an Indian Company would be the sum total of direct and indirect foreign investment.

[Explanation:

- (i) Total Foreign Investment shall include all types of foreign investments, direct and indirect, regardless of whether the said investments have been made under Schedule 1, Schedule 2, Schedule 2A, Schedule 3, Schedule 6, Schedule 8, Schedule 9 and Schedule 10 of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000.*
- (ii) Foreign Currency Convertible Bonds (FCCB) and Depository Receipts (DR) having underlying of instruments which can be issued under Schedule 5, being in the nature of debt, shall not be treated as foreign investment. However, any equity holding by a person resident outside India resulting from any conversion of any debt instrument under any arrangement shall be reckoned as foreign investment.”*

- 9.8 It should be noted that Schedule 4 investment (**NRI investment on non-repatriable basis**) will not be considered for determining whether the IC is foreign owned or not. NRI investment is sought to be treated as domestic investment. The meaning of NRI has been amended vide Notification No. 361 dated 15.2.2016. **It includes Indian citizens and OCI cardholders.** Foreign citizens of Indian origin are no longer considered as NRIs unless they acquire an OCI card.

Similarly, investment by **foreign company, trust and firm which are owned and controlled by NRI** are also eligible for investment in India on non-repatriable basis under Schedule 4. Their investment also will not be counted for IFI.

- 9.9 Shares issued as **sweat equity** or under **Employee Stock Option Plan** under Regulation 8 will not be counted for determining total foreign investment. These are not issued under any of the Schedules.
- 9.10 Listed companies have serious difficulties about determining whether they are owned by residents or non-residents. Their shares are bought and sold

frequently on the stock market. Not only FIIs invest, but even other companies (which they may themselves be owned by non-residents) invest. Such companies' status may change from domestic investor to indirect foreign investor and vice-versa frequently due to trading by investors!

10. Some Ownership issues:

10.1 The objective is to consider ownership and control of Indian entities, by non-residents and foreign citizens. In other words, prima facie IFI rules apply to,

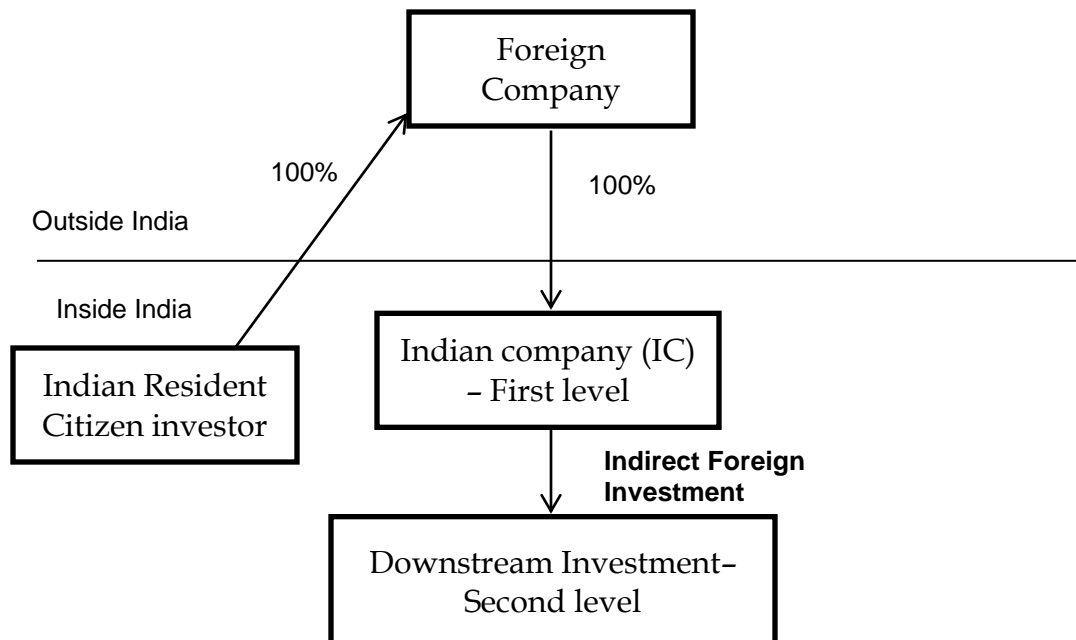
- investment in Indian entities and not investment in foreign entities.
- investment by non-residents and foreign citizens and not by Indian resident citizens.

Thus if IC invests in an overseas company, IFI rules do not apply. Overseas investment rules (FEMA Notification No. 120 will apply independently.)

Consider a situation, where the foreign company is owned by Indian resident citizens. That foreign company has invested in an Indian company. (It is round tripping. However assume that it has been considered as bonafide structure and has been specifically permitted by RBI.)

The structure is given below:

Chart D



In this situation, will IFI rules have to be considered? Prima facie, IFI rules apply, from the first level Indian company - i.e. IC. Investment in IC is Direct foreign investment. One does not have to see beyond the foreign company as far as IFI rules are concerned.

IFI rules however refer to investment through companies owned and controlled by Indian resident citizens. IC is ultimately owned and controlled by Indian residents. Can one say that IFI rules do not apply? In my view, for the sake of conservatism, one should apply the IFI rules. (Separately, under the Income-tax Act, if control is in India, it may lead to foreign company being treated as tax resident of India on account of Place of Effective Management (POEM) being in India. There are of course differences in the meaning of "POEM" under Income-tax Act and "control" under FEMA. However that is beyond the scope of this article.)

10.2 Differential Voting rights:

Assume that the Indian company has variations of following equity structures:

Variation 1:

<u>Share type (held by)</u>	<u>No. of Shares</u>	<u>FV (Rs.)</u>	<u>Total (Rs.)</u>
A shares (Non-Resident)	26,000	1	26,000
B shares (Indian Resident)	74	1000	<u>74,000</u>
		Total	<u>1,00,000</u>

Equity capital share of non-resident shareholder is only 26%. However control is with the non-resident.

Variation 2:

<u>Share type (held by)</u>	<u>No. of Shares</u>	<u>FV (Rs.)</u>	<u>Total (Rs.)</u>
A shares (Non-Resident)	26,000	10	2,60,000
B shares (Indian Resident)	74,000	1	<u>74,000</u>
			<u>3,34,000</u>

Voting rights of Resident shareholder is 74%. However equity capital share of the non-resident is 77.8%.

Under both the variations, the Indian company will be considered as foreign owned.

10.3 **Convertible debentures / instruments:**

Convertible instruments also have to be counted for considering the extent of foreign investment. FCCBs and Depository Receipts also have to be considered (except those which are issued with underlying securities referred to under Schedule 5). There can be difficulties in determining the percentage holding in case the price of conversion has not been decided upfront.

11. **Downstream investments:**

Once it is determined that IC is a foreign owned or controlled company, IFI rules apply. Regulation 14(6) provides for regulations for IC to undertake downstream investment:

11.1 **Operating Indian Company** - Downstream investment by IC, will have to comply with sectoral conditions on entry route, conditionalities and caps.

If the investment is permitted under automatic route, investment can be made without any permission.

Regulation 14(6)(ii) specifies the compliances as under:

"The IC has to notify SIA, DIPP and FIPB of its downstream investment in the form available at <http://www.fipb.gov.in> within 30 days of such investment. Even if securities have not been allotted, the form has to be filed. The modality of investment in new/existing ventures (with/without expansion programme) have to be stated.

A resolution of the Board of Directors and shareholders agreement should be provided.

Issue/transfer/pricing/valuation of shares shall be in accordance with applicable SEBI/RBI guidelines."

11.2 **Investing Company** – If the Indian company does not have business activity, but only invests in other Indian companies, it requires prior approval of FIPB for accepting Foreign investment. The amount of foreign investment is not relevant.

11.3 **NBFC** – FDI conditions will be applicable for foreign investment in NBFCs.

Core Investment Companies (CICs) will have to additionally follow RBI's Regulatory Framework for CICs.

11.4 **No operations and no investment** - Indian companies which do not have any operations and investments, can receive foreign investment under automatic route. Subsequently if the Indian company wants to invest in downstream companies, it will have to comply with the FDI norms. If activities of downstream investments require FIPB approval, the same will have to be obtained.

11.5 **Prohibited sectors:**

If an IC has foreign investment but is owned and controlled by Indian resident citizens, can it make downstream investment in prohibited sectors like agriculture? Let us consider the provisions.

FEMA (Permitted Capital Account Transactions) Regulations (Notification No. 1) is the fundamental notification. Regulation 4(b) provides that a non-resident cannot make investment in India, in any form, in any company, firm, proprietorship or any entity whether incorporated or not which is engaged in:

- i) Chit fund,
- ii) Nidhi company,
- iii) agricultural or plantation activities,
- iv) Real estate business of construction of farm houses,
- v) Trading in TDRs.

(Some real estate activities are not considered as Real estate business, Hence those are not prohibited.)

It is an all-encompassing provision.

Further Explanation after Regulation 5(7A) to FEMA Notification No. 20 also states no class of foreign investor referred to in regulations 5(1) to 5(7A) (i.e. FDI, FII etc.) can invest in sectors stated in FEMA (Permitted Capital Account Transactions) Regulations. (It does not refer to investment in LLP. However that is not necessary.)

Regulation 2(1) of Schedule 1 of FEMA notification No. 20 also states that Indian company can issue shares which is not engaged in any sector in Annex A of the Schedule 1. This is the prohibited list for FDI. It includes following 5 other sectors:

- i) Lottery business,
- ii) Gambling,
- iii) Cigarettes, etc.,
- iv) Atomic energy,
- v) Railway operations.

These ten sectors are prohibited completely for FDI.

Therefore if there is slightest foreign investment in IC, it cannot make downstream investment in these ten sectors.

One may technically argue that investment by NRIs under Schedule 4 does not have all these restrictions. Further investment by foreign entities which are owned and controlled by NRIs also do not have all these restrictions. Can foreigner invest in such entities abroad and invest? In my view in these sectors no foreign investment can be accepted in any manner.

12. **Audit:**

- 12.1 The **FDI recipient Indian company at the first level** is responsible for ensuring compliance with the FDI conditionalities for indirect foreign investment. It is also responsible for downstream investment made by its subsidiary companies at all subsequent levels.

The first level company is required to obtain a **certificate to this effect from its statutory auditor on an annual basis** regarding the status of compliance with the instructions on downstream investment and compliance with FEMA provisions.

The **Director's report** in the Annual report of the Indian company has to mention that the statutory auditor has certified that the company is in compliance with the regulations as regards downstream investment and other FEMA prescriptions.

- 12.2 If the statutory auditor has given a **qualified report**, the same has to be immediately brought to the notice of the Reserve Bank of India, Foreign Exchange Department (FED), Regional Office (RO) of the Reserve Bank in whose jurisdiction the Registered Office of the company is located and shall also **obtain acknowledgement** from the RO of having intimated it about the qualified auditor report.

The RO will direct the corrective steps to be taken. RO has to file the action taken report to the Chief General Manager-in-Charge, Foreign Exchange Department,

Reserve Bank of India, Central Office, Central Office Building, Shahid Bhagat Singh Road, Mumbai 400001.

- 12.3 Very few companies and auditors are aware of this requirement. It is in the interest of companies and auditors to comply with this provision.

13. **Indian LLP:**

Schedule 9, clause 4 of FEMA notification No. 20 provides that an LLP, having foreign investment, is permitted to make downstream investment in another company or LLP which is engaged in sectors where 100% FDI is allowed under the automatic route, and there are no FDI-linked performance conditions. Thus real estate sector where 100% FDI is allowed on automatic basis, cannot be permitted as there are conditions prescribed.

It further provides that onus is on the Indian LLP accepting downstream investment to ensure compliance with the conditions.

14. **Transfer of shares or control:**

14.1 **Industries under automatic route:**

For transfer of “shares” from an Indian resident to an Indirect Foreign Investor, one has to consider the valuation guidelines for the transfer.

For transfer of “control”, there are no restriction, guidelines and rules. As there are no rules, it does not require any FEMA compliance.

14.2 **Industries under approval route:**

Wherever the sector is under Government approval route, transfer of shares or control from an Indian resident to an Indirect Foreign investor requires an approval from FIPB (Regulation 14(5)). The transfer may happen in any manner – through mergers, demergers, restructuring, agreements, etc.

15. **Sources of funds for IFI:**

Regulation 14(6)(ii)(d) specifies how can IFI be funded.

15.1 **Permitted funding:**

Indian companies/LLPs have to bring in requisite **funds from abroad** for making downstream investment. Thus the investor company will have to bring

in foreign investment. If there are upper level companies in the chain, the first level company will have to bring in foreign investment and pass it on downstream.

Downstream investments can also be made through **internal accruals** also. Internal accruals mean profits transferred to reserve account after payment of taxes.

Thus for example, if resident investors have invested in the IC, those funds cannot be used for investment downstream.

15.2 **Funding not permitted:**

IC cannot leverage funds from the domestic market. Thus they cannot borrow and invest. Of course downstream companies/LLPs, with operations, can raise debt in the domestic market for their business, but not for further downstream investments.

In other words, acquisition of downstream companies is possible either from foreign funds or internal accruals.

15.3 With effect from 31st day of July, 2012, Downstream investment by a foreign owned / controlled **banking company**, under Corporate Debt Restructuring (CDR), or other loan restructuring mechanism, or in trading books, or for acquisition of shares due to defaults in loans, shall not count towards indirect foreign investment. However, their "strategic downstream investment" shall count towards indirect foreign investment. For this purpose, 'strategic downstream investments' means investment by these banking companies in their subsidiaries, joint ventures and associates.

15.4 Shares can be issued to foreigners against knowhow and some other permitted transactions under Direct Investment route. Normally what can be done directly, can be done indirectly. However due to the above regulation, issue of shares to IFI can only be in cash.

16. **Regular matters affected by IFI rules:**

If investment is considered as foreign investment, regular FEMA regulations apply (Regulation 14(6)(ii)(c). One has to consider the following issues and comply with the same.

16.1 Issue of shares to the investor has to consider valuation rules under FEMA (Schedule 1 of FEMA notification No. 20).

The provisions of Schedule 1 which cannot be complied with are - receipt of funds for shares in foreign exchange, filing of Advance Reporting Form, FC-GPR form, FC-TRS form.

- 16.2 IC cannot give loans to Indian residents as this will amount to loan from IFI.
- 16.3 It has to allot the shares or refund the money within 180 days. (Under companies act the allotment has to happen within 60 days.)
- 16.4 Partly paid shares have to be made into fully paid shares within 12 months.
- 16.5 In case of securities other than equity shares, investment can be made only in fully and compulsorily convertible instruments.
- 16.6 Sale of shares by the investor should be as per valuation rules of FEMA. (Thus even the buyer also has to consider whether the seller is foreign owned or Indian owned!)
- 16.7 If the investor purchases shares, it will have to be as per valuation rules of FEMA. (Thus even the seller also has to consider whether the buyer is foreign owned or Indian owned!)
- 16.8 There cannot be any guaranteed return to the indirect foreign investor. There can be optionality clauses but cannot have an assured price for exit.
- 16.9 Transfer of shares by NRI to a foreign owned Indian company will require RBI approval. (Regulation 9(2)(ii) of FEMA Notification No. 20).
- 16.10 Sale of shares by an erstwhile OCB to foreign owned Indian company will require an RBI approval.
- 16.11 Deferred payment consideration for sale of shares should be as permitted under the FEMA rules (Regulation 10A).
- 16.12 Shares cannot be issued against knowhow and certain other non-cash consideration. Alternatively, an FIPB approval may be obtained. (See para 15.)
- 16.13 FLA returns - **This is an exception.** A company which has FDI is required to file a FLA return. However downstream company which has no Direct foreign investment, is not required to file FLA return. (The first level company will capture the foreign investment in its FLA return.)

Further the VCF / IV which has issued **units** to the foreign investor also **does not have to file the FLA return** as there is no equity capital which is issued to the non-residents.

The above transactions are Indian transactions. Hence there is no question of reporting the investment or transfer in Form FC-GPR or Form FC-TRS. However conditions have to be complied with.

17. Past investment:

What is the date for considering whether IFI is valid or not? What happens to the past investments?

The Press notes by DIPP were issued on 13.2.2009 (press note nos. 2 and 3). The FEMA notification No. 278 was issued on 7.6.2013. It was notified on 21.6.2013. The related AP circular (No. 1) was issued on 4.7.2013.

DIPP press notes are not the law. These are only policy. These became law on 21.6.2013 when the same were notified.

Thus there are 3 periods during which IFI could have been made:

- Before 13.2.2009 (the date when DIPP press notes were issued).
- Between 13.2.2009 and 20.6.2013 (between the dates of issue of DIPP press notes and FEMA Notification).
- After 20.6.2013 (date of FEMA notification).

17.1 Investment made before 13.2.2009:

Investment made prior to 13.2.2009 as per guidelines existing then, do not require any modifications to confirm to IFI rules. (Para 3(ii) of AP circular No. 1 dated 4.7.2013). In other words any downstream investment is all right (provided the investment was as per the then FEMA rules).

17.2 Investment made between 13.2.2009 and 20.6.2013:

For investment made between February 13, 2009 and 20.6.2013, Indian companies had to intimate within 90 days from the date of the AP circular, the details of issue/transfer of shares or downstream investment which was not in conformity of IFI rules (Para 3(iii) of the circular). The intimation had to be sent through the bank to the concerned Regional Office of the Reserve Bank, in whose

jurisdiction the Registered Office of the company is located. Reserve Bank would have considered treating such cases as compliant with these guidelines within a period of six months or such extended time as considered appropriate by RBI in consultation with Government of India.

If the investment is not in line with the IFI rules, the companies are required to regularise it (by disinvesting or restructuring).

If the reporting did not take place within the period of 90 days, then there can be compounding.

Again this is a requirement which few people are aware.

Period of violation:

If investments are made prior to 21.6.2013 which are not in compliance with IFI rules, and they continue thereafter, the period of violation will be considered from 21.6.2013. However “reporting violation” is likely to be considered from the date of investment.

Example - An IC had made investment in Cable TV operation downstream company on 1.1.2014 beyond 49% (sectoral cap limit). It continued the investment after 21.6.2013 till 31.12.2015 and did not report within 90 days from 21.6.2013. In this case, as the IFI rules were notified on 21.6.2013, the sectoral cap violation will be considered from 21.6.2013 till 31.12.2015. However as the transaction was between 13.2.2009 and 20.6.2013, the reporting violation (as required by para 3(iii) of AP circular 1) would be considered from 1.1.2014.

Example - The IC invested in share application money on 1.1.2013. The shares were allotted on 30.9.2013 (well beyond 180 days). This is a case where the transaction became IFI from 21.6.2013. Prior to that it was not an IFI. It was Indian transaction and FEMA did not apply. From 21.6.2013, the shares were allotted within 180 days. Hence it will not be considered as FEMA violation.

The difference compared to the first example of cable TV investment is that in that case, from 21.6.2013 itself, it became a violation. Further no intimation was filed with RBI within 90 days. Whereas in case of share application money, there was time available of 180 days to refund from the date it became IFI.

There can be several permutations. Each one has to be analysed on its own merits.

17.3 Investment made after 20.6.2013:

Investment made after 20.6.2013 should be as per the IFI rules.

There could be a series of investments made in a company, some of which may be prior to 13.2.2009 and some could be after it. The compliances will apply accordingly.

18. Summary:

Indirect Foreign Investment rules have been amongst most complex rules. It has led to many unintended violations. The company receiving the investment should check from the investors whether they are foreign owned or domestic. It may be necessary to take an indemnity from them.

Auditors and management should conduct a FEMA compliance audit annually.

All this till FEMA is abolished!

Regulations in brief before IFI rules

Prior to introduction of IFI rules, any downstream investment by an Indian company which had FDI, required an approval from the Government. Even 1 share of FDI in first level company required FIPB approval for downstream investment. Earlier there were two levels of approval. The first was for foreign investment in a holding company or holding-cum-operating company. Second one was for the holding company or holding-cum-operating company, to invest in downstream company. (Press Note No. 3 of 1997 and Press Note No. 9 of 1999).

In 1999, vide Press note No. 9 dated 12.4.1999, it was decided to do away with the second approval as long as the investment was in sectors which were under automatic route. For operating companies, an approval had to be taken to convert itself from operating company to operating-cum-holding company.

With IFI rules, the ownership and control of investor company will determine whether the investor will be considered as foreign investor or not.