SBS AND COMPANY LLP
CHARTERED ACCOUNTANTS

DOWNSTREAM INVESTMENT UNDER FEMA

Introduction:

Foreign Investment in to India comprises of both direct foreign investment from non-residents and indirect investments through resident Indian entities having such direct foreign investment. Indirect Foreign Investment is often referred to as **"Downstream Investment (DI)" under FEMA**.

Background and Regulatory Framework:

Department of Industrial Policy and Promotion ("DIPP"), Ministry of Commerce and Industry, Government of India issues Press Notes ("PN") from time to time to pronounce the FDI Policy of the Central Government. Prior to 2009, there were no clear and concise rules on Downstream Investment. There were only some rules for Telecom, broadcasting, insurance and infrastructure service sectors prior to 2009. DIPP issued press notes in February 2009 bringing in the concept of DI for the first time. Thereafter DIPP has issued Press notes 2 (2009 Series), 3 (2009 Series), both dated 13th February 2009, and 4 (2009 Series), dated 25th February, 2009 bringing more clarity on DI and also provided guidelines on calculation of Indirect Foreign Investment. These are now subsumed within the Consolidated FDI Policy. RBI incorporated DIPP's DI related guidelines in its Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017, commonly known as "FDI Regulations". In short, DI is governed by DIPP PNs and RBI FDI Regulations.

Definitions:

Downstream Investment:

As per Regulation 14(g) of FDI Regulations, Downstream Investment shall mean investment made by an Indian entity or an Investment Vehicle in the capital instruments or the capital, as the case may be, of another Indian entity.

Indirect Foreign Investment:

As per Regulation-14(i) of FDI Regulations, Indirect Foreign Investment means downstream investment received by an Indian Entity (IE) from:

i. another Indian entity (IE) which has received foreign investment and
    a. the IE is not owned and not controlled by resident Indian citizens or
    b. is owned or controlled by persons resident outside India; or

ii. an investment vehicle whose sponsor or manager or investment manager
    a. is not owned and not controlled by resident Indian citizens or
    b. is owned or controlled by persons resident outside India

Provided no person resident in India other than an Indian entity can receive Indirect Foreign Investment.

Foreign Investment can be made directly in an Indian entity or indirectly through an intermediate Indian entity. Investment by an intermediate Indian entity, which is owned or controlled by Person Resident Outside India into another Indian entity is considered as Downstream Investment (DI). DI rules apply across all levels of downstream investment. DI rules are amongst the most complicated rules. With multiple regulators and multiple laws, it has become a complex subject.

Foreign Entity → **Indian Entity** → **Downstream Indian Entity**

The main principle behind DI is – ***"What can be done directly can be done indirectly. What cannot be done directly cannot be done indirectly."***

Accordingly, any DI has 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 has to be obtained. Thus, even though the transactions may be between Indian entities, if one of them is Indirect foreign investor, FEMA applies.

<u>Important Points:</u>

(a) ***"Ownership of an Indian company"*** shall mean beneficial holding of more than 50 % of the capital instruments of such company.

(b) ***"Control"*** shall mean
- 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.

(c) ***"Company owned by resident Indian citizens"*** shall mean an Indian company where ownership is vested in resident Indian citizens and/ or Indian companies which are ultimately owned and controlled by resident Indian citizens.

(d) ***"Company controlled by resident Indian citizens"*** means an Indian company, the control of which is vested in resident Indian citizens and/ or Indian companies which are ultimately owned and controlled by resident Indian citizens.

(e) ***"Company owned by persons resident outside India"*** shall mean an Indian company that is owned by persons resident outside India.

(f) ***"Company controlled by persons resident outside India"*** shall mean an Indian company that is controlled by persons resident outside India.

(g) ***"Indian Entity"*** shall mean an Indian Company or an LLP.

<u>Downstream Investment by an LLP:</u>

Downstream investment by an LLP not owned and not controlled by resident Indian citizens, or owned or controlled by persons resident outside India, 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. Indian entity however cannot borrow and invest such borrowed funds. They can raise debt for their business, but not for further downstream investments.

<u>Conditions for Downstream Investment:</u>

1. The Downstream Investments should have the approval of the Board of Directors as also a Shareholders' Agreement, if any.
2. Downstream investments may be made within foreign equity levels permitted for different activities under the automatic route.
3. The Downstream Investment involving setting up of an Export Oriented Units (EOU)/Software Technology Parks (STP) /Electronic Hardware Technology Parks (EHTP) project or items involving compulsory licensing, SSI reserved items, acquisition of existing stake in an Indian company by way of

transfer/ as also buyback shall not be eligible for automatic approval and shall require prior approval of Foreign Investment Promotion Board (FIPB)/Government.

4. Issue/transfer/pricing/valuation of shares shall be in accordance with SEBI/RBI guidelines
5. For the purpose of downstream investment, the Indian entity making the downstream investment shall bring in requisite funds from abroad and not use funds borrowed in the domestic markets. These guidelines were first issued by DIPP in 2009 vide their Press Note 4 and was thereafter incorporated by RBI in FDI Regulations.
6. Downstream investments can be made through internal accruals. Internal accruals mean profits transferred to reserve account after payment of taxes. DIPP issued these guidelines vide Press Note 12 of 2009 and was thereafter incorporated by RBI in FDI Regulations.
7. Further, raising of debt and its utilisation shall be in compliance with FEMA Act, rules or regulations made thereunder.
8. Capital instrument of an Indian company held by another Indian company which has received foreign investment and is not owned and not controlled by resident Indian citizens, or is owned or controlled by persons resident outside India may be transferred to:
   - A person resident outside India, subject to reporting requirements in Form FC-TRS
   - A person resident in India subject to adherence to pricing guidelines
   - An Indian company which has received foreign investment and is not owned and not controlled by resident Indian citizens or owned or controlled by persons resident outside India
9. The first level Indian company making downstream investment shall be responsible for ensuring compliance with the provisions of these regulations for the downstream investment made by it at second level and so on and so forth.
10. The first level company shall obtain a Certificate to this effect from its Statutory Auditor on an annual basis and compliance of these regulations shall be mentioned in the Director's Report in the Annual Report of the Indian company. In case statutory auditor has given a qualified report, the same shall be immediately brought to the notice of the 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.

Reporting requirements:

As per Regulation-13.1.11 of FEMA FDI Regulations, 2017 , an Indian company making downstream investment in another Indian company which is considered as indirect foreign investment for the investee company in terms of FDI Regulations, shall intimate the Secretariat for Industrial Assistance, DIPP and file ***"Form DI"*** within 30 days of such investment and, even if capital instruments have not been allotted along with the modality of investment in new/existing ventures (with/without expansion programme).

With effect from 1st September,2018, an Indian entity or an Investment Vehicle making downstream investment in another Indian entity which is considered as indirect foreign investment for the Indian entity in terms of Regulation 14 of FEMA FDI Regulations,2017 shall file ***"Form DI with the Reserve Bank of India (RBI) within 30 days from the date of allotment of capital instruments."***

Consequences of non-reporting:

In case of non-reporting of Foreign Investment received, it shall be treated as a contravention of the provisions made under FEMA. It may be required to compound the contraventions made under FEMA regulations either by suo moto or by notice from RBI. For compounding the contraventions, an application has to be filed with RBI RO as per the prescribed procedure. In some cases of non-reporting, we may be required to submit compounding application to Central Office of RBI.

In case, the company has contravened the provisions, Late Service Fee (LSF) at the rates prescribed can be paid, without opting for compounding.