**India growth story has a ‘beneficial ownership’ hurdle**

Foreign investments will play a crucial role in aiding the government’s goal of a $5 trillion economy by the end of the financial year 2025-26. But, in order to attract foreign investment, it is essential to remove all the bottlenecks for the Indian companies receiving this investment, and also foreign investors who are willing to bet on the India growth story.

Amendment conundrum

The amendment to the Indian Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (“FEMA NDI”) through the press note number 3 of 2020, has posed a significant challenge for Indian companies, especially start-ups and smaller enterprises seeking foreign investments. This amendment stipulates that any investments in Indian companies, whether direct or indirect, originating from entities located in countries that share land borders with India (“Neighbouring Countries”), or where the “beneficial owner” of the said Indian investment is situated in, or is a citizen of any of these Neighbouring Countries would necessitate prior government approval (“PN3 Requirement”).

While the aim of the amendment which was promulgated during the COVID-19 pandemic was salutatory — i.e., to curb opportunistic takeovers or acquisitions of Indian companies by Neighbouring Countries during difficult times created by a black swan event — it created vast incertitude as the term ‘beneficial owner’ has not been explained or defined, and other laws that have a definition of the term are context-specific. When the PN3 requirement was first introduced, the industry in general was comfortable taking a lenient view, relying on the beneficial ownership thresholds that were legislated in other laws. But since the latter half of 2023, the Reserve Bank of India (RBI) has begun taking a more conservative view concerning issues on which the law was silent, especially under FEMA NDI.

For example, last year, numerous Foreign Owned or Controlled Companies (“FOCCs”) began receiving notices from the RBI regarding their downstream investments. The industry has since taken the view that FOCCs will be placed under the same restrictions as non-residents on the aspects on which the law is silent. However, when this notion was challenged by the RBI recently, investors began to question other industry practices on which the FEMA NDI was silent. Even law firms that were once fine with adopting a lenient view in cases of beneficial ownership thresholds, are now advising clients that they cannot offer assurance by relying on the beneficial ownership thresholds legislated under other laws.

Further, the obstacle of navigating the prior government approval route is exacerbated by its time-consuming nature and high rejection rate. Although consolidated official data on pending or rejected applications is not published by the Government of India, some government officials have stated that proposals worth ₹50,000 crore from the Neighbouring Countries are either pending, withdrawn or rejected; and a staggering 201 applications have been rejected in the past three years.

With the PN3 Requirement, the onus of compliance is on the Indian company that receives foreign investment, with the regulatory authorities having the discretion to impose fines of up to three times the investment received. The inherent vagueness within the legislation, along with severe penalties, can cast doubts on the survivability of these companies.

Many of these start-ups receive investments far beyond their revenue or assets. So, such fines could leave them insolvent, even if they liquidate. Non-compliance would likely trigger legal battles, adding to India’s already significant backlog of court cases.

Issues and solutions

First, the indemnity challenge. Indian companies could consider having foreign investors to furnish representations backed by indemnities regarding their compliance with the PN3 Requirement. However, this may discourage foreign investment due to potential liabilities.

Therefore, there is a pressing need to amend the PN3 Requirement to define “beneficial owners” comprehensively, including ownership thresholds and control tests.

Second, defining ‘Beneficial Owners’. The definition of ‘beneficial owner’ should specify a precise threshold for ascertaining beneficial ownership, potentially ranging from 10% (as provided under the Indian company law) to 25% (as recommended by the Financial Action Task Force). The selection of the specific threshold can be customised to align with the government’s objective of scrutinising varying levels of foreign investment across different sectors. For example, sectors such as telecom and defence, which are sensitive in nature, may warrant heightened scrutiny when compared to sectors such as manufacturing and construction, where India requires additional capital.

The definition should also specify control-conferring rights, beyond ownership thresholds, to capture entities with significant influence. For example, rights regarding board meeting quorums or veto powers over operational matters such as incurring any capital expenditure or availing any loan may confer control and should be outlined. However, investor value protection rights, such as veto powers over mergers or right of first offer, should be excluded from the definition, as they do not constitute control.

Third, consultation mechanism. Even with the clarification of control-conferring rights in the definition, some ambiguity may persist due to the skilful drafting of peculiar clauses in the charter documents. To mitigate this issue, FEMA NDI, akin to Indian competition law, could be amended to incorporate a time-bound consultation mechanism with regulatory authorities, to determine whether specific clauses are control-conferring.