

# DOWNSTREAM INVESTMENTS: POLICY REGIME

ISSUANCE OF PRESS NOTES 2-4 [2009 SERIES]

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## **I. INTRODUCTION<sup>1</sup>:**

I.1 One of the most important issues, while deciding on Foreign Direct Investments in a Jurisdiction, is the Country's Policy on Down Stream Investments. The Government of India [Department of Industrial Policy and Promotion], by the issuance of Press Notes 2 to 4 of 2009, has for the first time laid down a clear and comprehensive Policy of Down-stream Investments.

I.2 Down Stream Foreign Investments<sup>2</sup>, until now not defined, generally means the Investments made by a Foreign Owned Indian Company into another Indian company by way of subscription or acquisition of shares. A Policy on Down Stream Investments should normally take into consideration and balance various conflicting interest i.e. on the one hand to avoid the cascading effect of Foreign Direct Investment and on the other hand the need to increase Foreign Direct Investments.

## **II. BACKGROUND: THE 1997 GUIDELINES**

II.1 In order to 'liberalise' and 'streamline' the procedures and mechanisms for approval of both domestic and foreign direct investment, the Government had taken various steps. However, to ensure 'greater transparency', the Government had announced the 'Guidelines for the Consideration of Foreign Direct Investment Proposals by the Foreign Investment Promotion Board' [for short 'Guidelines'] and 'formulate its recommendations'. These guidelines were issued by Press Note 3 of 1997 dated 17.01.1997<sup>3</sup>.

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<sup>1</sup> The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

<sup>2</sup> Downstream investment has been defined in Press Note 4 [2009 Series] to mean 'indirect foreign investment by one Indian company into another Indian company by way of subscription or acquisition in terms of Press Note 2 of 2009'.

<sup>3</sup> These Guidelines specifically pointed out that the Guidelines were meant to assist the FIPB to consider proposals in an objective and transparent manner. However, these guidelines would not in any way restrict the flexibility or bind the FIPB from considering the proposals in their totality or making recommendations based on other criteria or special circumstances or features it considers relevant. The Guidelines also stated that the Government can change the guidelines or the policies whenever considered necessary.

II.2 Clause 11 [a] of the said guidelines provided as under:-

“11. FIPB may consider and recommend proposals for 100 per cent foreign owned holding/subsidiary companies based on the following criteria :

[a] where only "holding" operation is involved and all subsequent/ downstream investments to be carried out would require prior approval of the Government; ...”

II.3 In terms of Guideline 11[a], the FIPB was required to recommend a proposal for 100% Foreign Owned Companies, when a Company was involved in ‘holding’ operations. All ‘*subsequent*’ or ‘*downstream investments*’ to be carried out by the ‘holding’ Company would require prior approval of the Government. Therefore, for any ‘downstream investments’ by the ‘holding’ company it has to seek approval of the Central Government [through the FIPB Route].

### III. THE TRANSITION: PRESS NOTE 9 OF 1999

III.1 Thereafter, the Government vide Press Note 9 of 1999 dated 12.04.1999 modified the Policy relating to downstream investments by Foreign Owned Indian Holding Companies. The Press Note noted that the existing Policy [i.e. existing on the date of the Press Note] had a standard condition applicable to Foreign Owned Indian Holding Companies. It required ‘prior and specific approval of FIPB/ Government for downstream investments’.

III.2 However, ‘with a view to further simplify the investing procedures for downstream investments’, the Press Note No. 9 modified the Policy relating to such downstream investments in the following manner:-

*“...it has been decided to permit foreign owned Indian holding companies to make downstream investments in Annexure III<sup>4</sup> activities, which qualify for Automatic Approval subject to the following conditions”*

III.3 Therefore, Press Note 9 modified the FDI Policy in-relation to downstream investments to the extent that if a ‘downstream investment’ is made in relation to an activity- which qualifies for Automatic approval then there is no requirement to seek further approval of the FIPB/Government. It is also important to point out that such a ‘general permission’ was qualified and subject to various conditions. They were as follows:-

- a. downstream investments may be made within foreign equity levels permitted for different activities under the automatic route ;
- b. proposed existing activities for the joint venture company being fully confined to Annexure III activities ;
- c. increase in equity level resulting out of expansion of equity base of the existing/fresh equity of the new joint venture company ;
- d. the downstream investment involving setting up of an EOU/STP/ 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 FIPB Government ;
- e. the holding company to notify SIA of its downstream investment within 30 days of such investment even if shares have not been allotted along with the modality of investment in new/existing ventures [with/ without expansion programme] ;
- f. proposals for downstream investment by way of induction of foreign equity in an existing Indian company to be duly supported by a resolution of the board of directors supporting the said induction as also a shareholder's agreement and consent letter of the foreign collaborator ;
- g. issue/transfer/pricing/valuation of shares shall be in accordance with SEBI/RBI guidelines

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<sup>4</sup> Annexure III is a reference to Annexure III of the Industrial Policy Statement dated 24.07.1991. Under the Industrial Policy Statement 1991 , the Central Government decided to provide approval for direct foreign investment up-to 51 percent Foreign Equity in High Priority Industries [Annex III]. There shall be no bottlenecks of any kind in this process. Such clearance will be available if foreign equity covers the foreign exchange requirement for imported capital goods.

- h. foreign-owned holding companies would have to bring in requisite funds from abroad and not leverage funds from the domestic market for such investments. This would, however, not preclude downstream operating companies to raise debt in the domestic market.

[Underlining supplied]

III.4 It is important to point out, that Press Note 9 stipulated that the procedure provided in the Press Note will form part of the Guidelines as paragraph 11[a] shall stand modified accordingly<sup>5</sup>.

III.5 During this period, the FERA was repealed and the Regime provided under the Foreign Exchange Management Act 1999 [for short 'FEMA'] and the Foreign Exchange Management [Transfer or Issue of Security by a Person Resident Outside India] Regulations 2000 took over.

#### IV. **THE MAZE OF CALCULATIONS:**

IV.1 During this regime, several demands were made to increase the Sectoral Cap for various Sectors. One of the Sectors, as a matter of illustration, was Telecommunication. It is important to note that in terms of Press Note 2 [2000 Series] dated 11.02.2000; the limit of FDI by way of the 'automatic route' was to the extent of 49%. This was changed by Press Note 5 [2005 Series]. Press Note 5 enhanced the FDI Ceiling from 49% to 74% in the Telecommunication Sector. However, for the purpose of calculating the ceiling limit of 74%, Press Note 5 stated as under:-

*"The total composite foreign holding including but not limited to investments by Foreign Institutional Investors [FIIs], Non-resident Indians [NRIs], Foreign Currency Convertible Bonds [FCCBs], American Depository Receipts [ADRs], Global Depository Receipts [GDRs], convertible preference shares, proportionate foreign investment in Indian promoters/investment companies including their holding companies, etc., herein after referred as FDI, will not exceed 74 per cent. Thus, 74 per cent foreign investment can be made directly or indirectly in the operating company or through a holding company."*

[Emphasis Supplied]

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<sup>5</sup> Clause 2 of Press Note 9 of 1999 dated 12.04.1999.

IV.2 Therefore, while examining the ceiling limit of FDI in the Telecommunication Sector, the method of calculation of the Foreign Direct Investment includes 'the total composite foreign holding' as well as the 'proportionate foreign investments in Indian promoters/ investment companies including their holding'. Similarly, in the case of Broad casting Sector, the Government [Press Note 1 of 2006 Series] had permitted FDI up-to the ceiling limit of 26% under the automatic route in the 'Up-Linking of TV Channels'. Press Note 1 further states:-

“...While calculating foreign equity of the applicant company, the foreign holding component, if any, in the equity of the Indian shareholder companies of the applicant company will be duly reckoned on pro-rata basis, so as to arrive at the total foreign holding in the applicant company. However, the indirect FII equity in a company as on 31<sup>st</sup> March of the year would be taken for the purpose of pro-rata reckoning of foreign holdings”

This principle is similar for other Items in the Broadcasting Sector such as FDI in Terrestrial Broadcasting FM<sup>6</sup>, FDI in Cable Network, FDI in Direct to Home Services etc.

IV.3 Therefore, the method for calculating the Foreign Direct Investment was by the 'proportionate method' whereby the foreign investment in Indian promoters/ investment companies including their holding companies, etc. will be calculated in a proportionate manner to arrive at the 'foreign holding component' of the Company seeking FDI. It would also include FII Holdings etc.

IV.4 At the same time, the Government by way of Press Note 10 [2000 Series] decided that foreign equity participation up-to 26% in the Insurance sector, as prescribed in the Insurance Act, 1999, will be allowed under the automatic route. However, Companies bringing in FDI were required to obtain necessary license from the Insurance Regulatory & Development Authority<sup>7</sup> [for short 'IRDA']. In order to obtain the

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<sup>6</sup> Press Note 6 [2005 Series] dated 15.11.2005.

<sup>7</sup> Press Note 10 [2000 Series] dated 19.10.2000.

necessary License, the Insurance Regulatory and Development Authority Act 1999 as well as the Insurance Regulatory and Development Authority [Registration of Indian Insurance Companies] Regulations, 2000 had to be followed. Regulation 11 [1] of the said Regulations states as under:-

**“11. Manner of calculation of twenty six per cent. equity capital held by a foreign company.—**

[1] For the purposes of the Act and these Regulations, the calculation of the holding of equity shares by a foreign company either by itself or through its subsidiary companies or its nominees [hereafter referred to as foreign investor] in the applicant company, shall be made as under and shall be aggregate of:-

- (i) the quantum of paid up equity share capital held by the foreign company either by itself or through its subsidiary companies or nominees in the applicant company;
- (ii) the quantum of paid up equity share capital held by other foreign investors, non-resident Indians, overseas corporate bodies and multinational agencies in the applicant company; and
- (iii) the quantum represented by that proportion of the paid up equity share capital to the total issued equity capital of an Indian promoter company mentioned in sub-clause [i] of clause [g] of regulation 2 held or controlled by the category of persons mentioned in sub-clauses [i] and [ii] of this sub regulation.

Explanation: For purposes of calculation referred to above, account need not be taken of the holdings of equity in an Indian promoter company held by foreign institutional investors, other than the foreign promoters of the applicant and their subsidiaries and nominees, and Indian mutual funds to the extent the investment of foreign institutional investors and Indian mutual funds are within the approved limits laid down by the Securities and Exchange Board of India under its rules, regulations or guidelines issued from time to time.”

IV.5 Contrary, to the above two modes of calculations, to calculate the total Foreign Direct Investment in an 'Investing Company in Infrastructure/Service Sectors'<sup>8</sup> the mode of Calculation was given in Press Note 2 [2000 Series]<sup>9</sup>:

*"In respect of the companies in infrastructure/service sector, where there is a prescribed cap for foreign investment, only the direct investment will be considered for the prescribed cap and foreign investment in an investing company will not be set off against this cap provided the foreign direct investment in such investing company does not exceed 49% and the management of the investing company is with the Indian owners. The automatic route is not available"*

[Emphasis supplied]

## V. **POLICY REGIME OF PRESS NOTES 2-4 [2009 SERIES]:**

V.1 The three different modes of calculating the level of Foreign Direct Investments arose out of a need to ensure that Indian Holding in Strategic Sectors could not be 'diluted' by the 'cascading effect' of multi layered investments. However, the methods of calculating the ceiling limits could not achieve the desired results. The methods were also frailed with pitfalls.

V.2 Therefore, the Central Government recognising 'the need to bring in clarity, uniformity, consistency and homogeneity into the exact methodology of calculation across sectors/activities for all direct and indirect foreign investment in Indian companies,'<sup>10</sup> laid down certain guidelines by issuing Press Note 2 [2009 Series]. Press Note 2 states as under:-

### **"5.1 Counting the Direct Foreign Investment:**

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<sup>8</sup> Prior to Press Note 2 [2000 Series], FDI in an 'Investing Company in Infrastructure/Service Sectors' was not within the List of Activities for which Automatic Route was available.

<sup>9</sup> Press Note 2 [2000 Series] dated 11.02.2000.

<sup>10</sup> Press Note 2 [2009 Series] dated 17.02.2009.

5.1.1. All investment directly by a non-resident entity into the Indian company would be counted towards foreign investment.

#### 5.2 Counting of indirect foreign Investment:

5.2.1 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.”

[Emphasis Supplied]

V.3 Under the Guidelines, a Company is regarded to be **'owned'** by resident Indian citizens and Indian companies, when it has been owned and controlled by resident Indian citizens, if more than 50% of the equity interest in it is beneficially owned by resident Indian citizens and Indian companies, which are owned and controlled ultimately by resident Indian citizens. Similarly, a Company is regarded to be **'controlled'** by resident Indian citizens and Indian companies, when it is owned and 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 .

V.4 To provide further clarity, the Press Note 2 provides for the following illustration:-

“If the indirect foreign investment is being calculated for Company A which has investment through an investing company B having foreign investment, the following would be the method of calculation:

- (i) Where company B has foreign investment less than 50%- company A would not be taken as having any indirect foreign investment through company B.

- (ii) Where company B has foreign investment of say 75% and:
- a. Invests 26% in company A, the entire 26% investment by company B would be treated as indirect foreign investment in company A;
  - b. Invests 80% in company A, the indirect foreign investment in company A would be taken as 80%.
  - c. Where company A is a wholly owned subsidiary of company B [i.e. Company B owns 100% shares of Company A], then only 75% would be treated as indirect foreign equity and the balance 25% would be treated as resident held equity. The indirect foreign equity in Company A would be computed in the ratio of 75:25 in the total investment of Company B in Company A.”

V.5 The Press Note 2<sup>11</sup> lays down a broad principle in calculating the Foreign Investments [both Direct as well as Indirect] in an Indian Company. This broad principle of **‘owned and controlled’** seeks to achieve a balance of various conflicting interest viz; on one hand the interest that the holding of a Company by ‘resident Indians’ are not diluted by the ‘cascading effect’ of multilayered investments and on the other the desire to further liberalise Foreign Investments in the Country.

V.6 Press Note 2 further provides for certain additional conditions<sup>12</sup>. It makes it mandatory for the Indian Company to inform the ‘details about foreign investment including ownership details etc. in Indian Company [s] and information about the control of the company[s] would be furnished by the Company [s] to the Government of India’ at the time of seeking approval.

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<sup>11</sup> Para 7 of Press Note 2 points out that based on the methodology provided in the Press Note, the policy on downstream investments would be notified separately.

<sup>12</sup> Additional conditions are provided in Para 5.5 of Press Note 2 [2009 Series]

V.7 As a consequence of the methodology laid down in Press Note 2, the Central Government issued Press Note 3 [2009 Series]<sup>13</sup> in relation to Sectors where there is a Cap on FDI<sup>14</sup>. Clause 3 lays down the guidelines for transfer of ownership or control of Indian companies in sectors with caps from resident Indian citizens to non-resident entities in sectors with caps. It states as under:-

“3.1 In sectors with caps, including inter alia defence production, air transport services, ground handling services, asset reconstruction companies, private sector banking, broadcasting, commodity exchanges, credit information companies, insurance, print media, telecommunications and satellites, Government approval/FIPB approval would be required in all cases where.

3.1.1 An Indian company is being established with foreign investment and is owned by a non-resident entity or

3.1.2 An Indian company is being established with foreign investment and is controlled by a non-resident entity or

3.1.3 The control of an existing Indian company, currently owned or controlled by resident Indian citizens and Indian companies, which are owned or controlled by resident Indian citizens, will be/is being transferred/passed on to a non-resident entity as a consequence of transfer of shares to non-resident entities through amalgamation, merger, acquisition etc. or

3.1.4 The ownership of an existing Indian company, currently owned or controlled by resident Indian citizens and Indian companies, which are owned or controlled by resident Indian citizens, will be/is being transferred/passed on to a non-resident entity as a consequence of transfer of shares to non-resident entities through amalgamation, merger, acquisition etc.”

[Emphasis supplied]

V.8 Consequently, thereafter, the Central Government issued a Press Note 4 [2009 Series] on 25.02.2009. Press Note 4<sup>15</sup> actually laid down the Policy for Downstream Investments. According, to the said Press Note, the Policy for Downstream Investment Policy constitutes:-

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<sup>13</sup> Press Note 3 [2009 Series] was issued on 13.02.2009. These guidelines were in modification of Para 2[e] of Press Note 4 of 2006.

<sup>14</sup> Clause 3.2 of Press Note 3 clarifies that these guidelines will not be applicable to 'sectors/activities where there are no foreign investment caps i.e. foreign investment is permitted under the automatic route.

<sup>15</sup> Clause 4 of Press Note 4 [2009 Series].

- A] Only Operating Companies<sup>16</sup>;
- B] Operating-cum-Investing Companies;
- C] Only Investing Companies<sup>17</sup>.

V.9 The Downstream Investment Policy in relation to an Operating Company<sup>18</sup>, would require compliance with the relevant sectoral conditions on entry route, conditionalities and caps with regard to the sectors in which such companies are operating. In relation to Operating-cum-investing Companies<sup>19</sup>, the Policy would require compliance with the relevant sectoral conditions on entry route, conditionalities and caps with regard to the sectors in which such companies are operating. Further, the subject Indian companies into which downstream investments are made by such companies would have to comply with the relevant sectoral conditions on entry route, conditionalities and caps with regard to the sectors in which such companies are operating.

V.10 The Downstream Investments in relating to Foreign Investment in Investing Companies<sup>20</sup> would require the prior government/FIPB approval regardless of the amount or extent of foreign investment. The Indian Companies into which downstream investments are made by such Investing Companies would have to comply with the relevant sectoral conditions on entry route, conditionalities and caps in regard of the sector in which the subject Indian Companies are operating.

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<sup>16</sup> 'Only Operating Companies' has been defined in Para 3.2 of Press Note 4 to mean an Indian company which is undertaking operations in various economic activities and sectors.

<sup>17</sup> An 'Investing Companies' has been defined in Para 3.4 of Press Note 4. It has been defined to mean an Indian Company holding only investments in another Indian company, directly or indirectly, other than for trading of such holdings/securities

<sup>18</sup> Para 4.2.1 of Press Note 4 [2009 Series].

<sup>19</sup> Para 4.2.2 of Press Note 4 [2009 Series].

<sup>20</sup> Para 4.2.3 of Press Note 4 [2009 Series].

V.11 Clause 5 of Press Note 4 further provided that in case of a Company which do not have any operations and also do not have any downstream investments, for infusion of foreign investments into such companies, Government/FIPB Approval would be required regardless of the amount or extent of the foreign investment. Further, as and when such companies commence business or make downstream investments, it will have to comply with the relevant sectoral conditions on entry routes, conditionalities and caps.

V.12 For Operating cum Investing Companies, Investing Companies and companies that do not have operations or downstream investments, downstream investments can be made subject to the following conditions<sup>21</sup>:

- (a) Such companies to notify SIA, DIPP and FIPB of its downstream investment within 30 days of such investment even if equity shares/CCPS/CCD have not been allotted along with the modality of investments in new/existing ventures [with or without expansion programs];
- (b) Downstream investments by way of induction by way of foreign equity in an existing Indian Company to be duly supported by a resolution of the Board of Directors supporting the said induction as also a shareholders agreement, if any;
- (c) Issue/transfer/pricing/valuation of shares shall be in accordance with applicable SEBI/RBI Guidelines;
- (d) Investing Companies would have to bring in requisite funds from abroad and not leverage funds from domestic market for such investments. This would however not preclude downstream operating companies to raise debts in the domestic market.

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<sup>21</sup> Para 6 of Press Note 4 [2009 Series].