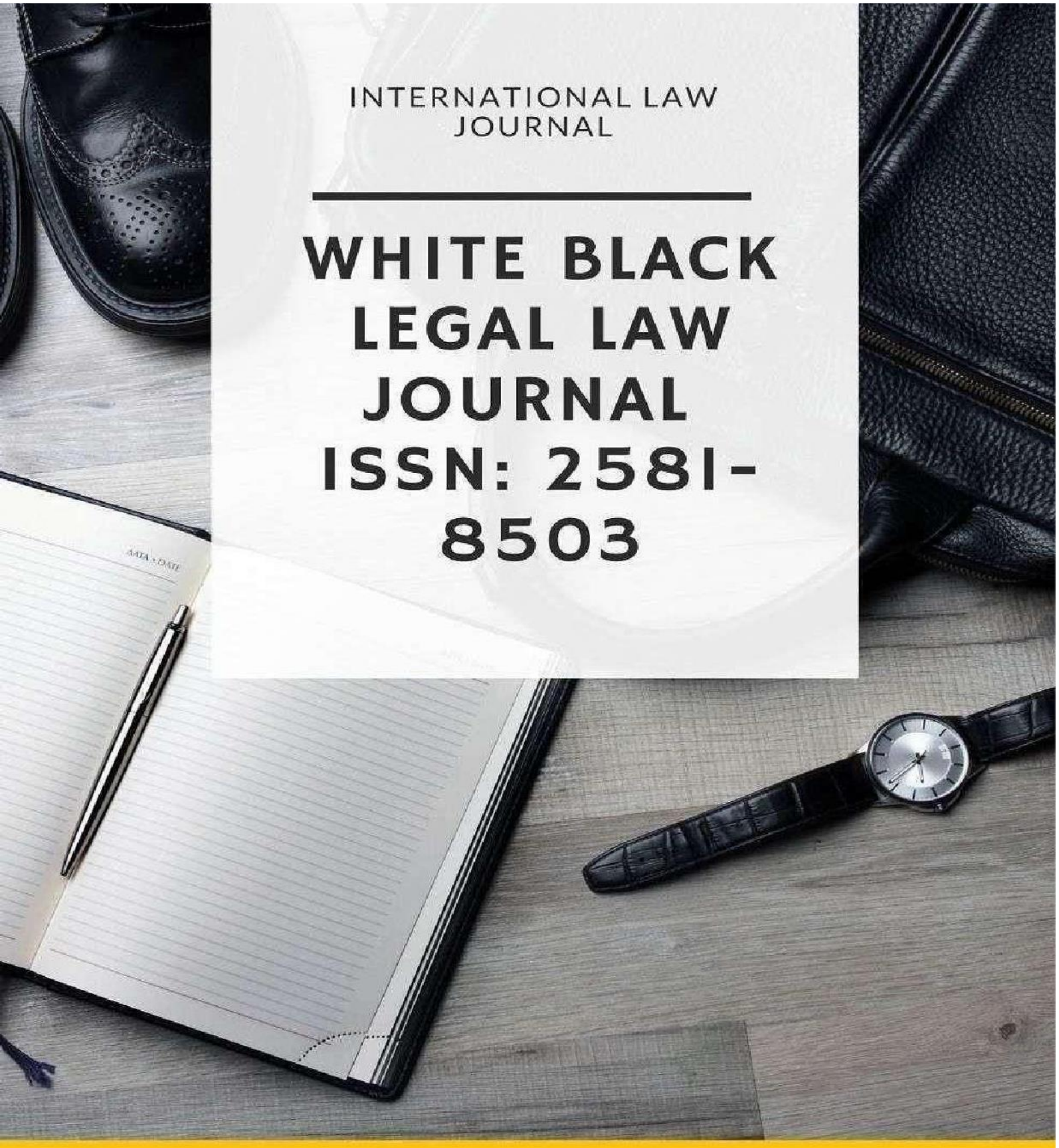

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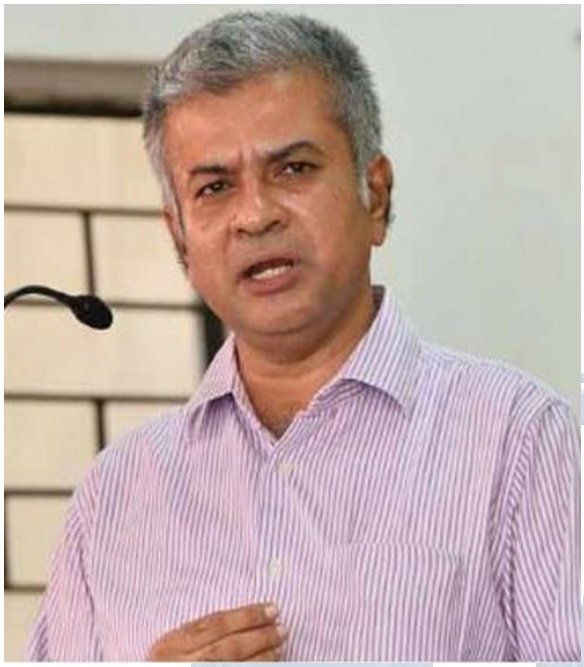

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DECODING INDIA'S CROSS-BORDER M&A LANDSCAPE: ESSENTIAL REGULATORY INSIGHTS FOR FOREIGN DIRECT INVESTMENT (FDI) TRANSACTIONS

AUTHORED BY - SARA CHARAN

Abstract:

This article highlights the main regulatory considerations typically encountered in cross-border mergers and acquisitions (M&A) transactions, with a focus on foreign direct investment (FDI) in Indian companies. FDI has become one of the most common forms of cross-border investment in India and is expected to grow significantly over the coming decade. India's regulatory landscape is complex, with multiple authorities overseeing various aspects of foreign investment. Understanding these frameworks is essential for navigating M&A transactions effectively. The article explores key areas such as the regulatory structure for FDI, sectors open to foreign investment, and permissible investment structures. It also discusses critical deal elements like pricing, deferred payments, and indemnity clauses. These aspects are crucial for structuring deals that comply with Indian regulations while meeting the interests of all stakeholders. Furthermore, the article examines the role of other regulatory bodies, such as antitrust authorities, which may impose conditions or require approvals depending on the transaction's size and nature. Awareness of these bodies' jurisdiction and compliance requirements is necessary to prevent regulatory delays. By addressing these vital issues, the article aims to help businesses and investors understand India's legal and regulatory environment and approach cross-border M&A transactions with greater clarity and confidence. Through this understanding, stakeholders can ensure compliance, manage risks, and successfully close deals in the Indian market. This overview is intended as a practical guide to assist in navigating the challenges and opportunities in India's evolving FDI and M&A landscape.

Introduction

Mergers and acquisitions across various industries are flourishing in India due to an assortment of economic and political reasons. Ever since the economy was neutralized back in 1990, the country has played a significant role to invite both local and international investments through the facilitation of better policies. However, certain regulations are still present especially in relation to foreign investment laws and provisions of foreign exchange. As the volume and speed of cross border deals continues to increase, there is an essential need to shift the attention to the regulatory frameworks governing these transactions as they seem to impact the successful completion of a deal. This overview aims to outline the key regulatory controls that generally apply to cross border merger and acquisition of transactions in India. Reassessing such transactions will enable businesses and investors to approach cross border M&A with a better understanding and sense of confidence.

Regulatory Framework for Foreign Direct Investments

Foreign Exchange in India is not freely transferable, and all transactions involving foreign exchange, including investments in securities in India or the acquisition of securities in India, are subject to the Foreign Exchange Management Act of 1999[1], which is commonly referred to as FEMA. FEMA is the primary legislation governing all foreign exchange transactions in India. Over time, the regulators have introduced a series of rules and regulations covering each specific aspect of foreign exchange. For example, there are rules and regulations governing equity investments, which are different from those for debt investments, and further distinct rules for guarantees, both onshore and offshore. Additionally, there are escrow-related regulations, and even current account transactions, which are day-to-day transactions between companies, have a separate set of regulations that apply. For the purpose of this discussion, however, the focus will be more on the simpler aspect of equity investment under FEMA. One more important factor to note here is that even within equity investments, there could be complications and further options available. For example, SEBI-registered funds like FPIs[2] or FVCIs[3] have the ability to invest in equity instruments in India, and they are not treated as FDI. They follow a parallel track, and those regulations apply.

[1] *The Foreign Exchange Management Act, 1999.*
[2] *Foreign Portfolio Investors (FPIs).*
[3] *Foreign Venture Capital Investor (FVCI).*

Permitted Sectors, Investment Structures and Securities

The most common question that comes to mind is where should investments be made. Historically, the answer has always been to invest in a company. However, there are a plethora of unique entities in India, such as Hindu Undivided Families, partnership firms, sole proprietors, etc. Investment has historically been limited only to private limited companies and public limited companies. When it comes to FDI, a few years ago, this was opened up further to also permit LLPs[4] to receive FDI, and the market is slowly evolving, increasingly seeing more and more FDI into LLPs as well. The better tax structure is obviously something that investors are happy about. However, investments in LLPs, especially FDI, are only permitted if the LLP is operating in a 100% automatic sector. There is a differentiation between a company and an LLP: for a company, any FDI is permitted in India if it's permitted anywhere in the world, but for LLPs, there is an additional level of checks and balances.

Now, when it comes to companies, what are the instruments that one can subscribe to or sell to a non-resident? The Companies Act is very liberal in the types of securities that an Indian company can issue to its shareholders. These range from simple equity shares to preference shares that have preference over equity shares when it comes to dividends. There are convertible instruments, which are compulsorily convertible into equity shares or preference shares, or even optionally convertible, meaning shareholders have the right to convert the shares or take their money back. With this plethora of investment instruments available, they can be broken into four basic parts. First, there is pure equity, which includes equity shares and preference shares, which are permitted for FDI. Second, there are compulsory convertible instruments, which are compulsorily convertible into preference shares or equity shares. They are also treated as equity shares for the purposes of FEMA. Third, there are hybrid instruments, which include optionally convertible instruments or renewable instruments, which for the purpose of FEMA, are deemed to be debt. Finally, there is pure debt structure, which consists of pure debt or loans coming in from offshore shareholders. For this, there are separate rules and regulations that apply, including restrictions on the eligibility of certain borrowers and lenders, restrictions on the end use of the debt, the period of the loan, and the interest rates that can be charged.

So the question that is left to be answered is what kinds of businesses can companies or LLPs

[4] *Limited Liability Partnership (LLP).*

engage in that can attract FDI. This is a very complicated structure and regulation, but it can be understood by breaking it into three broad buckets. The first are the absolutely prohibited sectors. These sectors do not permit any FDI to come in at all. There are nine broad buckets here, most of them being fairly small businesses, for example, gambling, lottery, etc. Something that is known is the wise manufacturing of tobacco products, investments into Nidhi companies, etc. The one important prohibited sector is the business of real estate. It is seen that many developers have received foreign investments that engaged in township development. The reason behind this is that the real estate business that is being prohibited only talks about dealing in land and immovable property. Now, the way dealing has been interpreted is to just buy and sell the land and immovable property for the sake of owning and profiting from it. There is a distinction made between such dealing in land and actual development of townships, hospitals, residential or commercial premises, or bridges, roads, etc. These construction and development activities are expressly permitted, and the acquisition of land in connection with these constructions and developments is also permitted.

The next bucket that needs to be talked about is the approval of the governmental route. These sectors are not absolutely restricted, but there are certain permissions available. Now, the permissions range in different types. For example, there could be something called the governmental route, wherein it is important to seek the government's permission and receive approvals. Now, this governmental approval requirement could vary. In certain sectors, even the first investment requires governmental approval, while in certain sectors, up to a particular threshold, it's permitted on the automatic route, and above that threshold, governmental approvals are required. The third bucket is the automatic route, where no approval is required for the FDI. There is a need to sign the SPI and its close, but the only thing required to be done is a post-facto intimation, wherein you have to inform the regulator about making the transaction. There are no approvals per se for this particular transaction. One important aspect when talking about the automatic versus governmental route is the new Press Note 3[5] that the government of India released in April 2020. It's new as there are still a few open-ended questions around the regulation. This regulation, called Press Note 3 or PN3, states that if there's an investment coming in from a resident or a company domiciled in a neighboring country, then such investment, irrespective of what sector it falls under, requires government approval. The PN3 stems from a language that states that a person which is beneficially owned

[5] *The Press Note 3 of 2020.*

by persons residing in these bordering countries is also triggered as a PN3.

The government has not mandated a beneficial ownership percentage or threshold, so there is a little bit of confusion on where the government is thinking on what is considered to be beneficial ownership. Is it 1%, 10%, or 26%? The market practice over the last three years, and this regulation is now three years old, is coalescing around the 10% mark. So, beneficial ownership of such residents of neighboring countries below 10% is typically not deemed to be triggering PN3. However, this is not a set position in law, and this is something that needs to be discussed with the authorized dealer bank prior to the transaction. There is a need to share the entire investor's details, making it clear that it is a requirement, and one can proceed by making an application to get the approval from the relevant ministry.

Pricing, Deferred Consideration and Escrow Arrangements

The next regulatory hurdle is on pricing, as it applies to all FDIs, irrespective of whether it's a governmental route or an automatic route, irrespective of whether it's coming in through an LLP or a private company, and irrespective of its CCPS[6] or otherwise. The construct is that any transaction between non-residents and residents can only happen relative to a fair market value. If an Indian resident is selling to a non-resident, the fair market value is the floor price at which the deal can be conducted. If the non-resident is selling to an Indian resident, the fair market value is the ceiling or the cap at which the deal can be done. So, please be mindful that the fair market value oscillates based on who's selling and who's buying. The question that gets asked immediately after this is: what is a fair market value? Now, FEMA does not stipulate what a fair market value is on a business-by-business or sector-by-sector basis. It has left that determination to an independent accountant. So, to determine fair market value, parties are required to appoint an independent accountant, and such an accountant is required to identify the fair market value by using any internationally acceptable valuation methodology on an arm's-length basis. The independent accountant will come in, check what the company is, check what the sector is, and identify what is the most appropriate valuation methodology. The most common is a discounted cash flow (DCF) methodology, but there are book value valuations as well and comparable valuations as well. Whatever the independent accountant deems fit, based on that, a fair market value is to be identified.

[6] *Compulsorily Convertible Preference Shares (CCPS).*

Another aspect when talking about pricing is on the timelines of the payment of the pricing or the consideration. Consideration needs to be paid within 18 months of the execution of the transaction documents, and the quantum of the deferred consideration cannot exceed 25% of the total consideration. Irrespective of the deferred consideration, the pricing fair market value still applies. So, the 75% that is being received or given needs to still comply with the fair market value requirement. So, those are the complications associated with the deferred consideration. For example, there is a working capital adjustment which is closed within a month of closing, and there are long-term indemnity escrows or deferred consideration based on certain transactions, certain additional limbs coming in, or certain thresholds being met. For the purpose of FEMA, all of them are lumped together in one big bucket, and that's deferred consideration, and all of them have to meet this 25% and 18 months requirement.

Other Sectoral Regulators

M&A deals are not the sole remit of the primary regulators, as evidenced in India. Therein lies the scope of IRDAI[7], beyond normal financial regulation. It addresses issues around foreign direct investment caps and certain regulations that apply to both insurance companies and intermediaries. IRDAI also creates another layer of compliance especially when thresholds are crossed in the process. This holds true as well for RBI[8], especially when it comes to transactions with banks or NBFCs[9]. The RBI has a low tolerance for control changes, particularly if it involves a single shareholder acquiring 26% or more of the company's shares or or more of the company's ownership, or those that lead to a change in management. This requirement goes beyond meeting basic criteria—it is fundamentally aimed at preserving stability within the financial system.

SEBI[10] is also an important stakeholder in situations where a business is connected with financial advisory services. If the business under consideration is approved or registered by SEBI, this reading of the regulatory framework will be highly applicable. No one can guarantee compliance with just one set of regulatory guidelines. Each agency is within its own jurisdiction. nor can it be guaranteed that all requirements of all regulatory authorities will be met. Especially in FDI transactions Although many recognize that there is a core regulatory

[7] *The Insurance Regulatory and Development Authority of India(IRDAI).*
[8] *The Reserve Bank of India (RBI).*
[9] *Non-Banking Financial Company (NBFC).*
[10] *Securities and Exchange Board of India (SEBI).*

framework for M&A deals, specific regulators are also in a position to have their own set of rules that can largely determine the success or failure of a transaction. Criteria These things serve as general protection. Seeing someone in the right way can jeopardize the whole deal.

Conclusion

Regulatory controls in India are an important consideration that should be carefully considered in most M&A transactions. Foreign direct investment (FDI) transactions fall under the automatic route. This means that prior government approval is not required. However, it is important to note that not all transactions will automatically qualify for the automatic route. and therefore It is important to reconfirm specific regulatory requirements before any agreement is made. It will come into effect Another important thing to consider is price compliance. In particular, ensuring that transactions are carried out at fair market value. This isn't just good practice. But it is a regulatory requirement that must be met. This is because it helps maintain transparency and ensures that transactions are carried out. In addition to these considerations All relevant regulatory approvals are also required before concluding an M&A transaction, including subsequent information that must be filed regardless of the fields involved in the transaction. Although approval is not required immediately. But it is important to ensure that all required filings and information are complete to guarantee that the securities in question have a clean title. Although the need for approval is not a restriction, it is highly recommended to proactively request and obtain all required approvals in a timely manner. This is because approvals sometimes take a lot of time to process. And delays can affect the overall timeline of the transaction. It is therefore important to keep these approval periods in mind when planning and executing large M&A transactions, as they can be an important component of the deal's overall plan.