INDIA'S DILEMMA WITH CHINESE INVESTMENTS

- Pranav Bafna[1]

I. INTRODUCTION

The word 'capital' is a unique homonym in the present day context. Both a business and a country cannot function without it, and ironically, both have been ravaged by the same pathogen, the Coronavirus. Not only has the virus destabilized the healthcare systems, it has also wreaked havoc on the capital markets. The Government of India imposed a nationwide lockdown to contain its spread, thereby restricting the movement of individuals into, out of and within the country. However, the economic consequences of the pandemic have led to the realization that India has to restrict the inflow of capital as well. The pandemic kicked off a huge sell off in the financial markets. The excess supply triggered the lower prices and the lower prices attracted the attention of India's much maligned neighbour, China.

When the People's Bank of China decided to go fishing, it caught a significant quantum of shares belonging to India's largest mortgage lender, Housing Development Finance Corporation Limited ('**HDFC**').[2]

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[2] Rajesh Mascarenhas, *China's central bank buys 1% stake in HDFC,* THE ECONOMIC TIMES (Apr. 13, 2020),

Undoubtedly, this purchase created apprehensions across the board. The Government of India was compelled to react. The Department for Promotion of Industry and Internal Trade (DPIIT) responded *vide* a Press Note.[3] The Press Note is high on emotions but low on coherence. It seeks to send a message to India's neighbours, particularly China, that being opportunistic in India's capital markets will not be perceived as a virtuous act.

With the paucity of capital infusion from domestic as well as western investors, China's financial involvement in Indian industries has been generating significant traction. If left unchecked, it could have dire consequences for the Indian economy. While this emotive message rings loud and clear in the Press Note, its impact on the economy is debatable, particularly if this Press Note is to be succeeded by an elaborate Foreign Direct Investment ('**FDI**') policy with regards to investments having Chinese linkages. This article seeks to address this dilemma brought forth by the prevailing COVID-19 situation.

II. GROWING DEPENDENCE ON CHINA

The period between the year 2000 and the year 2014 witnessed a meteoric rise in trade relations between India and China. The trade between the two countries has grown from less than Two Billion US Dollars in the year 2000 to 38 Billion US Dollars in the year 2008 and

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https://economictimes.indiatimes.com/markets/stocks/news/chinas-central-bank-holds-1-stake-in-hdfc/articleshow/75104998.cms

[3] Dept. for Promotion of Indus. & Internal Trade, Govt. of India, Press Note 3, 2020 Series, DPIIT File No.: No. 5(5)/2020-FDI Policy (Apr. 17, 2020).

95.5 Billion US Dollars in the year 2018.[4] However, neither was China deeply invested in India nor was it dependent on Indian companies for technology. India's burgeoning trade deficit with China indicates that this trade relationship has been a one way street.

The year 2014 is perceived as an inflexion point in the economic ties between the two nations. Approximately one-third of the 800 Chinese companies entered the Indian market during that year.[5] Further, approximately 42% of these were in the manufacturing sector and 25% in the infrastructure-related sector. The rest were in telecom (9%), petrochemicals (8%), and software and IT (4%).[6] Although official records are unavailable, China's cumulative investment in India can be pegged in excess of 8 Billion Dollars. A substantial rise from the 1.6 Billion Dollar cumulative investment figure in the year 2014[7].

While investors have been bullish about India's future, not many have been able to back their words with their wallets. Other than Chinese investors, the risk tolerance threshold of investors has been low. This has been observed in the start-up space wherein eighteen out of India's twenty three multibillion dollar start-ups have received equity infusion from Chinese companies.[8] Failure to keep this in check might result in Indian

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[4] *India-China Trade and Economic Relations*, EMBASSY OF INDIA, BEIJING, https://www.eoibeijing.gov.in/economic-and-trade-relation.php# (last visited May 2, 2020).

[5] Ananth Krishnan, *Following The Money: China Inc's Growing stake in India-China relations*, Brookings India Impact Series March 2020, at 12, *at* https://www.brookings.edu/research/following-the-money-china-incs-growing-stake-in-india-china-relations/ (last visited May 2, 2020).

[6] *Id.*

[7] *Id.*, at 11.

[8] Swaminathan S Anklesaria Aiyar, *Erecting a firewall against China will only hurt India*, THE ECONOMIC TIMES (Apr. 23, 2020),

promoters becoming salaried employees of their Mandarin speaking owners. Alas, the ethos of "Make in India" needs to be backed by the ethos of "Fund from India".

It is imperative that India avoids this financial overdependence on other countries by maintaining a balance between domestic and foreign capital infusion, in the post pandemic world.

III. CHINESE MODEL OF CORPORATE GOVERNANCE

While India proactively seeks investments from institutions abroad, its uneasiness, particularly with Chinese investments, is palpable. This trepidation over Chinese dependence primarily stems from the Chinese Corporate Governance Framework. "It's important to remember that Chinese company relationships with the Chinese government aren't like private sector company relationships with governments in the West."[9] The Communist Party of China ('Party') wants economic growth, but not at the expense of tolerating any organized alternative centres of power.[10] Having seen business threaten to take over the state in Russia, Beijing has been determined to make sure that the same disaster does not befall China.[11] Thus, unlike in Western Companies, the demarcation lines between the Party and private enterprises have increasingly blurred.

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https://m.economictimes.com/news/economy/policy/view-ere…-against-china-will-only-hurt-india/articleshow/75280011.cms

[9] Interview with William Avenina, David E. Sanger, *In 5G Race With China, U.S. Pushes Allies to Fight Huawei*, THE NEW YORK TIMES (Jan. 26, 2019), https://www.google.co.in/amp/s/www.nytimes.com/2019/01/26/us/politics/huawei-china-us-5g-technology.amp.html.

[10] Richard McGregor, *How the State Runs Business in China*, THE GUARDIAN (Jul. 25, 2019), https://www.theguardian.com/world/2019/jul/25/china-busine…-xi-jinping-communist-party-state-private-enterprise-huawei.

[11] *Id.*

Unlike the erstwhile State-owned enterprises, the private enterprises function at the behest of the Party. In 2018, the Chinese securities regulator issued a new corporate governance code wherein listed companies were mandated to incorporate an expansive role for the Party in their internal guidelines[12]. In 2017, Party committees existed in around 70 percent of 1.86 million privately owned companies in China, with a presence that is destined to grow.[13] With the Chinese Government catering solely to the Party's ideology, one can infer that private enterprises are serving as instruments for wielding their soft power across the globe.

Jack Ma, founder of the Chinese conglomerate 'Alibaba' had famously said at the World Economic Forum 2007, "My philosophy is to be in love with the government, but never marry them"[14]. This quote speaks volumes about the influential position the Party holds with respect to the domestic affairs. While Indian corporations' 'notional interest' dictate their love for Chinese backers, it must not come at the price of India's 'national interests'. A coherent economic policy shall go a long way in avoiding unwanted influence.

IV. FOREIGN DIRECT INVESTMENT AND INVESTMENT ROUTES

Before its amendment vide Press Note 3, Para 3.1.1 of the Consolidated Foreign Direct Investment Policy, 2017 mandated that

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[12] Daniel Rosen et al., *Missing Link: Corporate Governance in China's State Sector,* Asia Society Special Report, 7, *at* https://asiasociety.org/sites/default/files/inline-files/ASNC_Rhodium_SOEReport.pdf (last visited May 25, 2020)

[13] Federica Russo, *Politics in the Boardroom: The Role of Chinese Communist Party Committees*, THE DIPLOMAT (Dec. 24, 2019), https://thediplomat.com/2019/12/politics-in-the-boardroom-the-role-of-chinese-communist-party-committees/.

[14] Press Trust of India, *Jack Ma, China's richest man, is a Communist Party member,* OUTLOOK (Nov. 27, 2018), https://www.outlookindia.com/newsscroll/jack-ma-chinas-richest-man-is-a-communist-party-member/1429157.

investments by a Bangladeshi or Pakistani, corporation or citizen, ought to come from the "Government Route"[15]. In this regard, there were no restrictions for investments originating from China. The two key terms in this paragraph, "Foreign Direct Investment" and "Government Route" have been discussed hereunder.

"Foreign Direct Investment" reflects the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter.[16] In other words, Foreign Direct Investment entails the transfer of controlling rights over the business to its prospective investor. Foreign Direct Investment is an important source of financing for transition economies as it helps to cover the current account deficit, fiscal deficit and supplements inadequate domestic resources to finance both ownership change and capital formation.[17] It also facilitates the transfer of technology, know-how and skills, and helps local enterprises to expand into foreign markets.[18]

In India, Foreign Direct Investment can come via two routes, namely, "Automatic Route" and "Government Route". Under the "Automatic Route", the non-resident investor or the Indian company does not require any approval from the Government of India for investment.[19] To add

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[15] Rule 6, Foreign Exchange Management (Non-debt Instruments) Rules, 2019, Gazette of India, pt. II sec 3(ii) (Oct. 17, 2019).
[16] Maitena Duce, *Definitions of Foreign Direct Investment (FDI): a methodological note* (Banco De Espana) Jul. 31, 2003, at 2, https://www.bis.org/publ/cgfs22bde3.pdf.
[17] SUDHIR KOCHHAR, FOREIGN EXCHANGE OPERATIONS UNDER FEMA 14.3 (2019).
[18] *Id.*
[19] Dept. of Indus. Pol'y & Promotion, Govt. of India, Consolidated FDI Policy Circular of 2017, *at* https://dipp.gov.in/sites/default/files/CFPC_2017_FINAL_RELEASED_28.8.17_1.pdf. (last visited May 25, 2020)

perspective, 100% FDI under the Approval Route is permitted in the manufacturing, infrastructure, petrochemicals and technology sector.[20] As highlighted earlier, these are the sectors wherein China primarily invests.

The "Government Route", requires consideration of investment proposals by respective Administrative Ministry/ Departments.[21] The said route is infamous for an unreasonably long screening process which can take six to twelve months.[22] If capital infusion is important, its timely infusion cannot be emphasized enough. The author believes, the higher transaction costs coupled with the opportunity cost due to the delay has diluted the desirability for investments through this route.

V. A STITCH IN TIME SAVES NINE

Not so long ago, the Government of India was frantically chasing Chinese investments. It was in awe of the economic metamorphosis its Chinese counterpart had undergone. In spite of the ongoing border conflicts, it has been a widely accepted perception that partnering with China could be of tremendous value. The Government tried to tread a thin line between balancing its economic interests while preserving the security of our borders. Our neighbours have leveraged on the "Automatic Route" and squeezed in to its fullest, pumping in billions of dollars nonchalantly.

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[20] *Id.*
[21] *Id.*
[22] Ashwin Mohan, *New FDI Law covering Chinese Investments sends dealmakers into a tizzy,* MONEY CONTROL (Apr. 23, 2020), https://www.moneycontrol.com/news/business/new-fdi-law-covering-chinese-investments-sends-dealmakers-into-a-tizzy-5183921.html

Investing in a growing India serves as a useful hedge to the Chinese economy which has been suffering with a flattening growth curve.[23] Further, investing in India, China's competitor market, augments the soft power that the latter could exercise over the former. Undoubtedly, the Chinese could not go wrong when it comes to investing in India.

India's less than desirable growth rate coupled with the COVID-19 induced market crash has devalued Indian companies tremendously.[24] The pandemic could be a once in a lifetime opportunity for China to go bounty hunting in the Indian markets and gain a substantial control in India's 'abandoned, yet beloved' assets. Alas - India would not only lose a huge chunk of its family silver to this pandemic, but also lose some vital soft power in its struggle for supremacy. In a lighter vein, Indian equities could be more addictive for the Chinese than their much-loved opium.

The Housing Development Finance Corporation has been the only ray of hope during India's banking crisis. When the People's Bank of China tried to take a piece from it, alarm bells went ringing across the nation. This minor purchase served as a timely reminder that India cannot lose its strategic assets to an erratic neighbour whose goodwill has been massively eroded by the Coronavirus. In fear of potential consequences, a change in policy was hastily introduced.

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[23] *China GDP Annual Growth Rate,* TRADING ECONOMICS, https://tradingeconomics.com/china/gdp-growth-annual (last visited on 25 May, 2020).
[24] Abhishek Raja, *COVID-19 and stock market crash,* OUTLOOK MONEY (Apr. 21, 2020), https://www.outlookindia.com/outlookmoney/equity/covid-19-impact-on-stock-market-4666

VI. INTERPRETING THE NEW POLICY

The Department for Promotion of Industry and Internal Trade is responsible, *inter alia*, for formulation of FDI Policy and promotion, approval and facilitation of FDI. A key concern for the Department has been the threat of opportunistic takeovers/acquisitions of Indian companies[25]. Consequently, it decided to tinker with the extant FDI Policy vide a press note on 17th April, 2020.Relevant extract of the revised FDI Policy has been reproduced hereunder:

> *3.1.1(a) A non-resident entity can invest in India, subject to the FDI Policy except in those sectors/activities which are prohibited. However, an entity of a country, which shares land border with India or where the beneficial owner of an investment into India is situated in or is a citizen of any such country, can invest only under the Government route.*[26]

Further, the Press Note also mandated that "3.1.1(b) In the event of the transfer of ownership of any existing or future FDI in an entity in India, directly or indirectly, resulting in the beneficial ownership falling within the restriction/purview of the para 3.1.1(a), such subsequent change in beneficial ownership will also require Government approval"[27].

While these directions were given merely in the form of a policy change, legal sanction was only given vide an amendment in the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019[28]. The said amendment ought to take effect from the date of its notification, 22 April, 2020. The notification was reproduced verbatim and the contents of the

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[25] *supra* note 3.
[26] *supra* note 3.
[27] *supra* note 3.
[28] *supra* note 15.

aforementioned Press Note substituted the erstwhile contents of Rule 6, Clause (a).[29]

On breaking down the notification, one can infer that any entity of a country which "shares a land border with India", or an entity whose beneficial owner is situated in or is a citizen of such country is instructed to obtain 'Government Approval' for making an investment in India. According to the author, the expression "shares a land border with India" would include the following countries, namely, China, Bangladesh, Pakistan, Bhutan, Nepal, Myanmar, and Afghanistan. Having reviewed the structure of FDI inflows into India, it is no secret that this phrase primarily targets investments originating from China. Consequently, questions have been raised on whether direct investments originating from Taiwan and Hong Kong shall also fall under the 'Government Route'.[30]

The scope of this notification has been confined to having a "beneficial ownership" in India-bound investments. The expression "beneficial ownership" has not been defined in the Press Note or in the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019. P. M. Devaiah, Vice Chairman & Group General Counsel for Everstone Capital has aptly remarked:

> *The PN3's stoic silence on the meaning of beneficial ownership that would trigger the approval process has caused a lot of anxiety. Cautiously, experts have even opined that pre-approval might be obligatory even where the beneficial ownership is de-minimis. While one could speculate that might not be intent of PN3, in times we are faced with, such intention cannot be ruled out. It's no*

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[29] *supra* note 3.

[30] P. M. Devaiah, *Social Distancing the Dragon*, BAR AND BENCH (Apr. 27, 2020), https://www.barandbench.com/columns/social-distancing-the-dragon.

> *accident, that PN3 has been notified as is under FEMA with no amendments establishing clearly a point of harmony between the two institutions to lay bare the unequivocal regulatory intent.*[31]

"Beneficial Ownership" in an organization can be assessed through various divergent tests like a percentage threshold test or through a test of control. The former being used under the Companies Act, 2013 while the latter is under the Prevention of Money Laundering Act, 2002 ('PMLA'). "Beneficial Owner" under PMLA "means an individual who ultimately owns or controls a client of a reporting entity or the person on whose behalf a transaction is being conducted and includes a person who exercises ultimate effective control over a juridical person"[32]. The definition of "significant beneficial owner"[33] provided under the Companies (Significant Beneficial Owners) Rules, 2018 is in connection with certain disclosure requirements for shares held in trust. In this regard, the rule stipulates that any person having ten percent or more interest - directly or indirectly - in shares, voting rights or dividend of the concerned entity could constitute a Significant Beneficial Owner. A threshold based definition brings tremendous levels of clarity. However, it fails to bring all the concerned companies under its radar. Particularly those who possess a beneficial ownership in substance, not necessarily as per the nomenclature. Thus, the test of control prescribed under Section 2(fa) of the PMLA would be an effective aid to vetting investments originating from India's neighbours.

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[31] *Id.*
[32] Prevention of Money-Laundering Act, 2002, No. 15, Acts of Parliament, 2003, § 2(fa).
[33] Companies (Significant Beneficial Owners) Rules, 2018, G.S.R. 100(E) Gazette of India, r. 2(h) (Jun. 13, 2018).

The stoic silence on the meaning of "beneficial ownership" will give a lot of sleepless nights to anxious investors. Particularly if the government's intention is to scrutinize investments at a *de-minimis* level.

VII. IMPLICATIONS OF THE POLICY CHANGE

Beneath the unspoken candour of the notification lies hidden, prolific foreign policy, national interest, economic security and an unwavering message of sovereignty.[34] The government may argue that the amendment was out of sheer urgency to protect India, however, investor sentiment has been hurt in the process. The government needs to assuage their pain for ensuring a faster economic recovery. Therefore, in the process of creating a friendly, open and predictable investment environment, the government will also need to more proactively safeguard longer-term considerations of security and privacy as it opens the door to new sources of investment.[35]

Akin to India's policy change, other major economies have also taken measures to curb the inward movement of foreign investments. For instance, Spain *vide* Royal Decree-Law 8/2020 ('RDL') defines "Foreign Direct Investments" as those investments by Foreign Investors to the extent they entail (a) reaching or exceeding the 10% threshold of the share capital of a Spanish company, or (b) obtaining an effective participation in the management or taking control of a Spanish Company.[36]

Further, the government needs to clarify its position on holders of warrants, right shares and holders of call and put options. There are a huge quantum of investment funds which have investments as well as

[34] *supra* note 17.
[35] *supra* note 4, at 6.
[36] R.D.L. 8/2020, art. 7 (Spain).

shareholders in China and India. The government must clarify if the instant notification will apply to them. Basic rules of business suggests that nothing scares off an investor more than uncertainty.

The world's disenchantment with China will make India a potential destination for future supply chain routes. To win over its suitors, India needs to rise to the occasion and prove its mettle during times of crisis. With a consistent and litigation free investment climate, India can turn this crisis into its greatest ever opportunity. India's future FDI regime will go a long way in ensuring the same.

VIII. CONCLUSION

The pandemic has taught the world some critical lessons on survival - striving for a balance is better than striving for excess; overdependence on any entity can compound the devastation caused; and Chinese private entities are 'private' only in nomenclature. India's history with the East India Company must serve as a timely reminder to the higher echelons in the government that there is a stark difference between 'foreign influence' and 'foreign investment'. The future FDI Policy must send a loud and clear message that India is open to the latter, not the former. In other words, Chinese investments will be welcome, provided India's sovereignty is untouched.

Alas, just like the Coronavirus, there is no straight jacket cure to this dilemma. 'Social Distancing' ourselves has been a successful stop gap arrangement. However, the moment we decide to venture out, we will need a sustainable solution.