India Expands the Path for Foreign Investment—But Tightens It for E-Commerce

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To further encourage foreign investment in India, the Reserve Bank of India (the "RBI") has been systematically liberalizing the External Commercial Borrowings ("ECB") Framework, which governs foreign debt. The simplified ECB restrictions expand the pool of eligible lenders and borrowers and permit funds to be used for a wider range of purposes, including working capital and refinancing. In addition, the ECB Framework may now be used for investment and not just pure lending purposes.

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At the same time, however, new restrictions have been imposed regarding foreign direct investment ("FDI") in Indian e-commerce companies. The FDI policy changes tighten the regulation of large online marketplaces and seek to create a level playing field in response to complaints from smaller Indian players in the e-commerce market. These changes came into force from 1 February 2019 after the Department of Industrial Policy and Promotion rejected requests from large foreign-invested e-commerce players in India to postpone the effective date. Foreign investors involved in India's booming e-commerce sector should take these changes into account when structuring and planning their activities and those of their portfolio companies.

New ECB Policy. Foreign participation in India's debt market is heavily regulated and must be routed through one of three main avenues: the Foreign Portfolio Investor ("FPI") route, the Foreign Venture Capital Investor ("FVCI") route or the ECB route. The FPI and FVCI regimes are subject to registration and compliance requirements established by the Securities and Exchange Board of India. The ECB route is regulated by the RBI and is subject to restrictions contained in its ECB policy.

In December of last year and January of this year, the RBI promulgated two new sets of regulations with the goal of easing ECB restrictions in India and encouraging the inflow of foreign debt: the Foreign Exchange Management (Borrowing and Lending) Regulations, 2018 and the New External Commercial Borrowings Framework (the "New ECB Policy"). The New ECB Policy marks a significant change for foreign investors who, until now, have had to rely on the FPI or FVCI routes and time-consuming registration processes to invest in Indian debt instruments. The new regulations expand the ECB route from its traditional use in pure lending transactions to being a viable channel for debt investments. While the New ECB Policy provisions are still to be tested in the market, key policy changes for foreign investors to consider are set forth below.

- **Recognised Lenders**. The expanded list of recognised lenders opens new avenues for lending and financing options. Residents of any country compliant with Financial Action Task Force or International Organization of Securities Commissions requirements now qualify as recognised lenders for Indian regulatory purposes. Accordingly, international debt funds, overseas corporate bodies, hedge funds and other pooled investment vehicles in these jurisdictions may now qualify as recognised lenders and gain direct access to India's debt market. As interest is typically taxed at a lower rate than dividends, this change may present new alternatives for foreign investors who have so far limited their investments to Indian equity instruments.

- **Eligible Borrowers**. In order to expand financing options for Indian entities, the RBI has simplified the requirements for eligible borrowers by aligning requirements with the FDI policy. All entities eligible to receive FDI may now explore financing alternatives via the ECB route. In addition, the previously narrow list of eligible borrowers has been further expanded to include units in special economic zones, microfinance entities and start-ups.

- **End-Use Restrictions**. In an attempt to simplify end-use restrictions, the New ECB Policy imposes a single set of restrictions uniformly across all ECB tracks. In addition, the RBI issued a clarification on 7 February 2019 in a welcome move for distressed asset investors who have been monitoring India's Insolvency and Bankruptcy Code (the "IBC"). Applicants under the insolvency resolution process are now permitted to raise ECB from recognised lenders (except branches/overseas subsidiaries of Indian banks) to repay Rupee-denominated term loans. This policy change provides further impetus to the resolution process which has been making headway since the enactment of the IBC in 2016. Indian companies with distressed assets and foreign investors bidding for them now have ECB financing options as a possible avenue when structuring investments.

- **Borrowing Limit**. Under the previous regulatory framework, only a limited amount of ECB could be raised in a financial year under the automatic route, with ECB proposals beyond those limits requiring government approval. However, under the New ECB Policy, existing sector limits have been removed, and every eligible borrower is permitted to raise ECB up to USD 750 million or its equivalent in any given financial year under the automatic route, without government approval. If the ECB is raised from direct foreign equity holders in a foreign currency, the ratio of ECB liability to equity must not exceed 7:1, except where the aggregate ECB amount is less than USD 5 million or its equivalent.

FDI Policy Changes. The Department of Industrial Policy and Promotion of India issued Press Note No. 2 (2018 Series) on 26 December 2018 (the "Press Note") outlining changes to the Foreign Direct Investment Policy of 2017 (the "FDI Policy") for Indian e-commerce companies.

Under the current FDI Policy, 100 percent FDI is permitted without government approval in Indian e-commerce companies that operate a marketplace model. FDI in e-commerce companies with inventory-based models continues to be prohibited. The Press Note introduces the following key changes:

- **Control of Inventory**. As noted above, the former FDI Policy prohibited FDI in e-commerce entities that operate an inventory-based model (i.e., entities that own their inventory). The Press Note expands this restriction by also prohibiting FDI in e-commerce entities that exercise *control* over their inventory. Control over a vendor's inventory is deemed to exist if more than 25 percent of the vendor's purchases are from the e-commerce entity or its group companies. This restriction replaces the former prohibition on e-commerce entities having more than 25 percent of their sales generated through a single vendor or its group companies.

- **Exclusivity**. Marketplace entities are no longer permitted to require any seller to sell their products exclusively on their e-commerce platforms.

- **Equity Ownership**. The former FDI Policy prohibited e-commerce entities from investing in the equity of sellers operating on their marketing platform. However, the Press Note goes a step further by prohibiting a seller from using a marketplace platform if the platform or its group companies have an equity stake in that seller. In the absence of further regulatory clarification, the extent to which this restriction applies to minority and indirect equity participation remains unclear.

- **Additional Services**. In order to create a level playing field, services provided to a vendor by an e-commerce entity (or any entity in which that e-commerce entity has a direct or indirect equity participation or control) must be at arm's length and on fair, non-discriminatory terms.

The Press Note is likely to have an adverse impact on foreign-invested e-commerce companies in India, which will need to re-evaluate their existing business models to ensure compliance with the more stringent regulations. Following the liberalisation of FDI in retail trade in India a few years ago, the Press Note seems tailored to placate smaller domestic retailers. Given the upcoming general elections in India, foreign investors should keep a close eye on these regulatory changes over the coming months.

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Please note that Debevoise & Plimpton does not practice Indian law and that this update is based on publicly available information.

Please do not hesitate to contact us with any questions.

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