

Press Note 3 of 2020: FDI policy and the expanding sphere of national security



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7 MINUTE READ



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India recently joined the list of countries that have placed restrictions on foreign investment to fend off predatory investments during the ongoing Covid-19 crisis. It announced that investors from countries sharing a land border with it would henceforth have to invest only through the government approval route. India's decision follows on the heels of similar curbs on foreign investment by **Australia** and a **guidance** note issued by the EU cautioning vigilance to its members to avoid a "sell-off Europe's business and industrial actors, including SMEs." Following this, Germany, France, and Spain are **reportedly** taking steps to safeguard theirs and their companies' interests.

Para 3.1.1(a) of **Press Note 3 of 2020** dated April 17, 2020, requires that all investment from Afghanistan, Bangladesh, Bhutan, Myanmar, Nepal, Pakistan, and most importantly, China, as countries that share a land border with India, to go through the government approval route, irrespective of the sector. To ensure that indirect investments from these countries that are routed through different jurisdictions such as Mauritius are covered as well – the press note specifies that it applies to beneficial ownership of such investment in the specified countries. Further, Para 3.1.1(b) of the press note specifies that any change in the existing ownership of FDI in Indian entities resulting in the beneficial ownership falling within the purview of Para 3.1.1(a) will also require government approval.



This latest amendment to the FDI policy is indicative of the Government not wanting to leave weakened companies in strategically significant sectors vulnerable to takeover by companies looking for a greater foothold in India. The amendment to the FDI policy came into **effect** from the midnight of April 23.

The immediate aftermath of the release of the press note saw the Chinese Embassy in India allege that the amended policy violated the WTO principle of non-discrimination and express a hope that India would "revise relevant discriminatory practices, treat investments from different countries equally, and foster an open,

fair and equitable business environment”. India’s view, however, **reportedly** is that there is no violation of WTO principles since the press note only specifies a different approval process for foreign investment from the concerned countries, as opposed to a bar on such investment.

Shift in policy

Usually, foreign direct investment (FDI), which is when foreign entities invest in a company in another country, can be routed into India through two routes. The first is the automatic and the second the approval route. The automatic route allows FDI without any prior approval from the RBI or the Government and applicable for sectors such as e-commerce activities, electronic systems, and ports & shipping, among others. A formal notification is required, but no approval.

FDI through the approval route requires the prior approval of the Government. The entity proposing to invest has to apply through the Foreign Investment Facilitation Portal, which provides a single-window clearance system, after which it is sent to the concerned Ministry. The Ministry, in consultation with the Department of Promotion of Industry and Internal Trade (DPIIT) under the Ministry of Commerce, will then approve or reject the application. This route is reserved for sectors such as the banking and public sector, multi-brand retail, print media, and satellites. Foreign investment in some sectors, such as defence can be routed through the automatic route up to 49% with any additional investment requiring government approval. There are also some sectors in which no foreign investment is allowed under either route. These include sectors such as atomic energy generation.

Even earlier, all investment from Bangladesh was required to go through the approval route, while all investment from Pakistan, besides being allowed only through the approval route, was also restricted to sectors/activities other than defence, space, atomic energy and sectors/activities prohibited for foreign investment.

But Press Note 3 is a marked shift in this policy since it mandates that all investment from India's bordering countries requires government approval. There is also no sunset clause, i.e., it is not known whether this is a temporary measure for the duration of the current crisis or if it will continue to apply for all future foreign investments from these regions even post the crisis.

The China factor

Quite apparently, the policy aims to prevent a stronger Chinese foothold in significant sectors in India. Chinese investment in India **has crossed** at least 26 billion US dollars.

In India, alarm bells began ringing after HDFC informed stock exchanges that the People's Bank of China had **increased** its stake in HDFC from 0.8% to 1.01% in mid-April. The Securities and Exchange Board of India (SEBI) then turned its focus on the amount of Chinese investments in Indian companies, vigorously seeking **details** on foreign portfolio investments from Asian countries. These details include whether Chinese investors control the funds and whether any controlling interest is vested in the investors from these countries.

There is concern that Chinese state-owned enterprises having access to vast reserves and deep-pockets are capable of buying out strategically significant companies whose valuations have been hit in their home countries. Amid a global crisis caused by the Covid-19 virus, that has brought most economies to a standstill, the Chinese economy has **reportedly** shown strong resilience. Even before the crisis, governments were already becoming increasingly concerned about the over-reliance of major global supply chains on China. Various governments' concerns about the over-reliance of major global supply chains on China have been laid bare by the Covid-19 crisis, and India is not insulated from such exposure to the Chinese economy. Facing shortages of test kits for Covid-19, several countries, including India, imported rapid test kits from China, only for reports to emerge that they were **faulty and could not be relied upon**. India has also reportedly **cancelled** its order for these kits.

China's reach into India's tech sector

Chinese investment funds a significant portion of India's tech start-ups. **Of the 30 Indian unicorns, at least 18 have a Chinese investor.**

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According to a **recent report** by Gateway House, over 75 start-ups in India have Chinese investors concentrated in e-commerce, fintech, media/social media, aggregation services, and logistics. Another recent **report by the Brookings** Institution reveals that since 2016, Alibaba, Tencent, and Xiaomi have invested over 3.5 billion dollars in the Indian tech space.

BigBasket, Byju's, Flipkart, Hike, MakeMyTrip, Ola, Paytm, PolicyBazaar, Quickr, Snapdeal, ShareChat, Swiggy, and Zomato are only a few of the start-ups that have Chinese investments.

Chinese investment in these Indian start-ups consists of both venture capital funds as well as funds from Chinese tech companies such as Tencent and Alibaba. As of 2019, Chinese company BBK Electronics Corporation, which owns brands such as OnePlus, Oppo, and Vivo, has climbed to the **top** of the **Indian market** for smartphones. It is telling that its second-in-line is also another Chinese company, Xiaomi.

This level of entrenchment in the Indian economy can have significant consequences. Chinese stakeholders that have invested heavily can lean on Indian companies to adopt and use Chinese technology. Fears the world over of malicious code in Huawei's technology that allows snooping by the Chinese Government certainly warrants greater scrutiny of this technology. Also, this concern over data privacy is not limited to Huawei. According to a **ranking** for maintaining online privacy by Amnesty, Tencent was the only company that "has not stated publicly that it will not grant government requests to access encrypted messages by building a backdoor". Amnesty's assessment also gave Tencent a score of 0 out of 100. Even within India, Chinese investments have raised data-sharing concerns

with the Chinese Government. Prominent parliamentarians have questioned whether Indian users' data privacy is maintained in light of **Paytm's investments from Alibaba** and **Tiktok's growing influence** in India, given its close connection to the Chinese Government. The Huawei controversy is also indicative of the **close links** between China's private sector and the People's Liberation Army, creating a legitimate concern that Indian companies can be made to toe the Chinese line for fear of losing investment. Tencent's 150 million dollar investment into Reddit also invited heavy **criticism** on account of censorship fears.

Given these fears, China's massive reach in India's technology sector calls for a more watchful eye.

An Indian-CFIUS in the reckoning?

national security concerns have begun pervading almost every sphere, more in recent times than ever before. Some jurisdictions have a specialized screening process for all foreign investment that reviews such investment through the lens of national security. The Committee on Foreign Investments in the United States (CFIUS) is one such interagency group that reviews foreign investments in the United States to assess whether they are a threat to US national security. It includes members from Homeland Security, Defence, Energy, Commerce, Labor, National Intelligence Trade and Science & Technology Departments, as well as the Attorney General. The scope of its review includes "any merger, acquisition or takeover....which could result in foreign control of any person engaged in interstate commerce in the United States" and its role is to determine whether and the extent to which the transaction could impact US national security. Should it determine that it does, the President has powers to suspend or prohibit the transaction, or to allow it with conditions. The **CFIUS review process**, divided into various stages, is to be completed in a fixed number of days, but can be automatically extended. However, CFIUS has **traditionally been** opaque and secretive. The decisions are not made public and the companies do not have a lot of scope to present their case or challenge the decisions.

Notable action by the CFIUS includes a review of TikTok's owner ByteDance Technology's 1 billion US dollars acquisition of Musical.ly, a US social media app, as well as forcing Beijing Kunlun Tech to sell its holding in Grindr. Concerns had been raised about the collection of user data by TikTok, a video sharing platform, and Chinese **censorship** of content relating to Tiananmen Square or Tibet (among others), on TikTok even in the US. The CFIUS is **reportedly** in talks with TikTok on measures that it can take to avoid these concerns. Similarly, Kunlun's Grindr transaction was not permitted because of concerns over the personal data stored on the app, including its users' geolocations.

Other jurisdictions also similarly perceiving threats to national security posed by China's long arm are adopting a CFIUS-ish screening policy. In March 2019, the European Union adopted a regulation for a framework to screen foreign investments on the grounds of security or public order, and such investments include those "regarding critical infrastructure, critical technologies, or critical inputs which are essential for security or public order." Other member states can seek information on investments that they consider a risk to their security or public order as well as address comments on said investment. Similarly, the Union also has the right to address comments. But the ultimate decision concerning the investment is up to the individual member state.

It is perhaps time for India to consider similar mechanisms as well. Currently, each Ministry reviews foreign investment in its sector and approves it. It may be beneficial for India to consider an inter-ministerial body to similarly screen investments through the lens of national security, with due consideration given to the time taken for approvals. This will enable and reinforce a uniform and holistic approach to national security. Given the influx of investment in India's burgeoning tech sector, such a mechanism may be needed sooner rather than later.

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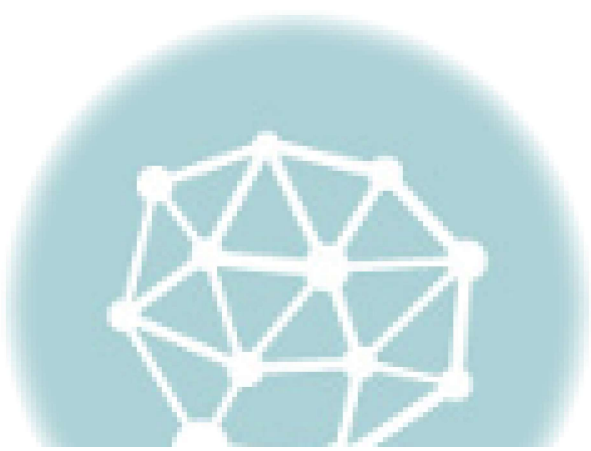
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