MAKING FDI INFLOWS, AND M&A MORE “SECURE”

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According to a press report of August 19, 2009, joining a gamut of nations, the Indian government is considering a sweeping review of its FDI guidelines “following increasing risk of terror funds being parked in the country and other investments being fraught with security implications.” Justifying its stance in the name of a fear of terrorism is a new twist. Many countries, including the United States, have protectionist legislation favoring their nationals. As a consequence, the result is often decreased trade flows and an eventual increase in tariff barriers in total contrast to the spirit of the World Trade Organization.

The media reports that the eleven-year old National Security Council (**“NSC”)** has, in a secret report, suggested enactment of the National Security Exception Act. The purpose of the Act is to authorize the government to “*suspend or prohibit any foreign acquisition, merger or takeover of Indian companies that could be considered damaging to national interest*.” Subjecting foreign investment to scrutiny in sensitive industries is not uncommon. The Indian regulators already monitor and screen applications for investment from certain countries very closely, and, in some situations, necessitating an additional approval/endorsement from the Ministry of Finance.

If NSC’s suggestions are implemented, it will mean that:

- The Ministry of Finance will be the principal agency responsible for implementation as well as monitoring of the security guidelines;
- Foreign participation from designated “countries and origins of concern” will be screened very closely not merely at the time of entry, but for the duration of the operation regardless of the fact whether the investment was routed under the automatic route or upon seeking prior approval of the Foreign Investment Promotion Board;
- M&A, allotment of shares, and a host of activity in the context of infrastructure shall also possibly undergo a stringent scrutiny;
- For foreign institutional investors, full disclosure of the sub-accounts and participatory notes holders may be required;
- The expectation is that key management positions (including CEO, CFO) are held by Indian citizens and foreigners undergo security clearance;

The Mumbai attacks of 26/11 have possibly accelerated this report, and the suggested changes. According to the report, the all-important FEMA Notification 20/2000 prohibiting FDI from countries like Pakistan and

Bangladesh is inadequate. As a matter of fact, in PSA's experience, the regulators have been taking far longer in granting approvals or rejecting outright investments from other Asian countries like People's Republic of China, and Hong Kong.

The media report supports NSC's stance with factual examples in the real-estate and aviation business. Additionally other "perceived threatened locations" are Taiwan, Afghanistan and North Korea as well as the funds emanating from tax havens like Mauritius, Cyprus and Cayman Islands. The government fears about the source of funds emanating from tax-havens where transacting parties often create special purpose vehicles in order to optimize tax benefits. The worry stems from the fear that the funds could be controlled by terrorist groups. While the concern may not be misplaced, the outcome will definitely impact the genuine transactions.

While not stated expressly, but the presumption is that the scrutiny shall be enforced prospectively and not retrospectively. However, that remains to be seen. Needless to say, national security cannot be compromised under any circumstance, but it will do well for the regulators to remember that xenophobia has been one of the greatest threats to national security in all countries!

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