Recent changes in policy on foreign direct investment in e-commerce

This article aims to:

- Highlight the changes made in policy on foreign direct investment in e-commerce and the potential impact of the changes on the e-commerce entities.

The Ministry of Commerce & Industry published a press note (Press Note 2/2018) dated 26 December 2018 to provide clarity to the Consolidated Foreign Direct Investment (FDI) Policy 2017 in relation to e-commerce sector which includes, *inter alia,* entities operating as marketplace for e-commerce in India.

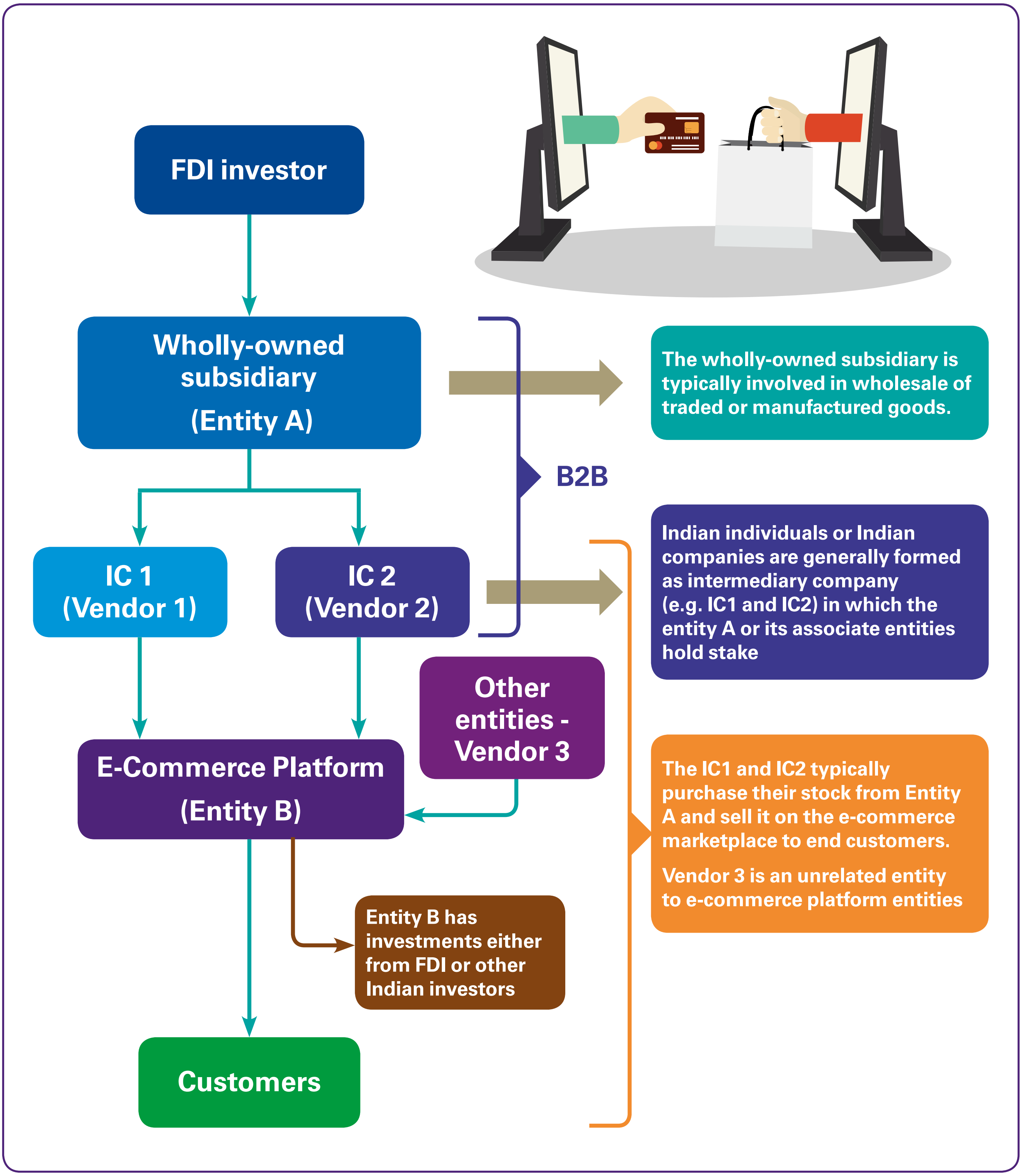
The amendments and clarifications are effective from 1 February 2019.

Changes have been made to the FDI policy to ensure that the marketplace entity is strictly operating as a facilitator between buyer and seller (marketplace-based model) and is not indirectly influencing the sale price of goods or services or controlling the inventory. The Press Note seeks to regularise the relationship between the marketplace entity and vendors who sell products through the platform of the marketplace entity, by imposing various restrictions on both the vendors and the marketplace entity.

Key changes brought by the press note are as follows:

- The Press Note reiterates that foreign direct investment is not permitted in the inventory based model of e-commerce.
- Inventory of a vendor will be deemed to be controlled by e-commerce marketplace entity if more than 25 per cent of purchase of such a vendor is from the marketplace entity or its group companies.
- An e-commerce entity can now sell products of vendors without any limit through its marketplace. However, an entity having equity participation from an e-commerce marketplace entity or its group companies, or having control on its inventory by e-commerce marketplace entity or its group companies, will not be permitted to sell its products on the platform run by such marketplace entity.
- Services to vendors such as warehousing, payments, logistics, etc. on the platform should be at an arm’s length and should be fair and non-discriminatory.
- E-commerce marketplace entity would not mandate any seller to sell any product exclusively on its platform only.

To explain the impact of the changes and clarifications brought in by the press note on the FDI policy on the e-commerce companies, we have described the existing structure of business with the help of the diagram below.



(Source: KPMG in India's analysis 2019)

Key definitions

E-commerce: E-commerce means buying and selling of goods and services including digital products over a digital and electronic network.

E-commerce entity: E-commerce entity means a company incorporated under the Companies Act, 1956 or the Companies Act, 2013 or a foreign company covered under section 2 (42) of the Companies Act, 2013 or an office, branch or agency in India as provided in section 2 (v) (iii) of FEMA 1999, owned or controlled by a person resident outside India and conducting the e-commerce business.

Inventory based model of e-commerce: Inventory based model of e-commerce means an e-commerce activity where inventory of goods and services are owned by e-commerce entity and is sold to the consumers directly.

Marketplace-based model of e-commerce: Marketplace based model of e-commerce means providing of an information technology platform by an e-commerce entity on a digital and electronic network to act as a facilitator between buyer and seller.

Group company : Group company means two or more enterprises which, directly or indirectly, are in a position to:

i. Exercise 26 per cent or more of voting rights in other enterprise; or

ii. Appoint more than 50 per cent of members of board of directors in the other enterprise.

Impact of the changes and clarifications

- **Control over inventory:** Existing vendors of e-commerce companies are not allowed to purchase more than 25 per cent of their products from the marketplace entity or its group companies. Therefore, the e-commerce entities will not be able to sell the products of few vendors (e.g. intermediary companies as given in the diagram above) who may currently purchase more than 25 per cent of their products from the e-commerce entity or its group companies. This is likely to significantly impact the availability of vendors/ products on the marketplace and thereby the business of the e-commerce entity.

  It is possible that on 1 February 2019, the intermediate companies control inventory that is in excess of the above 25 per cent threshold. Currently, the press note does not provide clarity on the time and manner of computing 25 per cent threshold.

  Additionally, the e-commerce entities need not restrict their sales of products of any particular vendor going forward (earlier there was a restriction of 25 per cent of its sales). However, e-commerce entities or their group companies are no longer allowed to have an equity interest in any of the vendors selling through their marketplace. This will significantly impact the e-commerce companies since all intermediary companies (vendors) as mentioned in the diagram above will no longer be allowed to sell their products on the platform as group company of e-commerce companies generally hold a reasonable stake. This change poses a significant challenge for e-commerce companies in disposing the significant existing inventories lying with such related entities.

- **Exclusive agreements:** E-commerce companies would not be able to require a vendor to sell their products exclusively on their marketplace.

  This will significantly impact the e-commerce companies as the customers who visit the marketplace to purchase the exclusive product are likely to reduce i.e., the customers could get split into various marketplace platforms.

- **Provide level-playing field:** E-commerce entities providing marketplace platform will not directly or indirectly influence the sale price of goods or services and would maintain level playing field. E-commerce marketplace entity or other entities in which e-commerce marketplace entity has direct or indirect equity participation or common control, would provide services to vendors on the platform at an arm's length and in a fair and non-discriminatory manner. Such services will include but not limited to fulfilment, logistics, warehousing, advertisement/marketing, payments, financing, etc. Cash back provided by group companies of marketplace entity to buyers should also be fair and non-discriminatory. For the purposes of this clause, provision of services to any vendor on such terms which are not made available to other vendors in similar circumstances would be be deemed unfair and discriminatory.

Processes to be put in place

Due to the changes and clarifications brought in by the press note, amongst many things, the following processes would need to be implemented by the e-commerce entities:

- The companies will need to design new controls to determine and monitor the percentages of purchases by vendors.
- The legal team at e-commerce companies need to review contracts with vendors to ensure compliance with the new guidelines. They would need to design new process of onboarding vendors which will include understanding the equity ownership of these vendors. For all the existing vendors a thorough one-time check will need to be completed as the control definition has been changed in the press note.
- The e-commerce companies will have to design new process and controls to demonstrate that various services given to vendors is at an arm's length and are fair and non-discriminatory. The key challenge will be to decide on a method that needs to be followed to establish the compliance with the new requirements.

Certificate

The press note mentions that an e-commerce marketplace entity should **furnish a certificate along with a report of the statutory auditor** to the Reserve Bank of India, confirming compliance with the FDI guidelines by 30 September of every year for the preceding financial year.

Subsequently, on 31 January 2019, the RBI issued a notification (FEMA. 20(R) (6)/2019-RB) regarding Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Fifth Amendment) Regulations, 2019, in which the requirement to furnish the statutory auditor's certificate is not mentioned. Hence, there is in clarity on timing and need for this certificate. If this certificate were to be issued, a number of clarifications will be required on manner of computing mandatory thresholds prescribed in the new guidelines.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