INDIA'S FDI POLICY ON E-COMMERCE: Some Observations[*]

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Introduction

India's foreign direct investment (FDI) policy went through successive relaxations since the process of economic liberalisation was initiated in 1991. The scope of FDI expanded gradually from manufacturing to services and infrastructure sectors. As of now almost all the sectors are open for FDI to varying degrees except for a very few prohibited ones.[1] The domestic trading sector was also opened in various phases. Full foreign ownership was allowed in wholesale trading as early as in 1997. Wholesale trading would include resale, processing and thereafter sale, bulk imports with ex-port/ex-bonded warehouse business sales and business to business (B2B) e-Commerce.[2] The government allowed FDI up to 51 per cent in single brand retail trading (SBRT) in the year 2000 with the stated objective of attracting foreign investment in production and marketing, improving availability of various products and encouraging competitiveness among Indian enterprises. Along with opening SBRT, India also allowed 100 per cent FDI in ecommerce with the restriction that the companies can engage only in B2B ecommerce activities.

Bookings done electronically between two trading partners for purchase or sale of goods and services are referred to as ecommerce. B2B refers to trade taking place between a manufacturer and a wholesaler or between a wholesaler and a retailer.[3] Trade between a company and the end-users who are consumers of the product or

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[1] Department of Industrial Policy and Promotion (DIPP), "Consolidated FDI Policy", April 2014.

[2] *ibid*.

[3] See the Discussion Paper issued by DIPP on ecommerce in January 2014 and available at: http://dipp.nic.in/English/Discuss_paper/Discussion_paper_ecommerce_07012014.pdf

service is referred to as B2C commerce.[4] E-commerce activities have been divided into sub-categories based on their business model. One of them is known as Marketplace model in which the ecommerce portal provides a platform for business transactions between buyers and sellers and earns commission from the sellers of goods/services. Ownership of the inventory in this model vests with the enterprises which advertise their products on the website and who are the ultimate sellers of goods or services. The Market Place, thus, works as a facilitator of e-commerce. Different from the Market Place model is the Inventory Based model. In this model, ownership of goods and services and the market place vests with the same entity (the ecommerce portal). In this model the portal does not work as a facilitator of e-commerce but is engaged in ecommerce directly.[5] India's FDI policy does not allow FDI in retail ecommerce activities. The FDI policy describes E-commerce as the activity of buying and selling by a company through the e-commerce platform. Such companies would engage only in Business to Business (B2B) e-commerce and not in retail trading, inter-alia implying that existing restrictions on FDI in domestic multi-brand retail trading would be applicable to e-commerce as well.

Relaxing the FDI policy in 2012 in trading sector, the cap on foreign equity in SBRT was removed, thereby allowing 100 per cent foreign ownership. Simultaneously, FDI up to 51 per cent was allowed in multi brand retail trading (MBRT) in 2012. But FDI was specifically excluded from the retail ecommerce sector. The Consolidated FDI Policy (Circular 1 of 2013) stipulated that "Retail trading, in any form, by means of e-commerce, would not be permissible, for companies with FDI, engaged in the activity of single brand retail trading or multi brand retail trading". As such, the extant FDI policy does not permit FDI in B2C e-commerce. The efforts of many of the foreign as well as Indian ecommerce firms like yebhi.com, fashionforyou.com to make a case for allowing FDI in this sector did not bear fruit.[6] The main focus of the present note is on B2C ecommerce which is not open to FDI yet.

[4] *ibid*.
[5] *ibid*.
[6] See:http://articles.economictimes.indiatimes.com/2014-05-25/news/50083706_1_b2c-e-commerce-cent-fdi-dipp and "Amazon steps up US lobbying in Indian FDI", *Business Standard*, April

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The e-commerce sector in India is reported be growing fast. For instance, between 2009 and 2012 it increased from US$3.8 billion to US$ 9.5 billion.[7] eBay and Amazon are the two major American e-commerce players operating in India.[8] eBay started its operations in 2004 by acquiring Baazee.com, which was promoted by two Indians. Amazon Inc. entered almost a decade later, in 2013. Both these companies are following the marketplace model. High growth of the sector, large consumer base and the development of digital infrastructure have encouraged various other foreign online sellers like Rakuten and Alibaba to focus on the Indian market. All these developments have taken place even when the online retail sector or B2C ecommerce is closed for FDI. In between many Indian start-ups like Flipkart and Snapdeal entered the sector. A few of them attracted substantial foreign investment. Companies which were operating in the online retail sector have effectively adjusted their method of operation to comply with the India's FDI policy. During this process some of them have also been accused of violating the provisions of the policy. On the other hand, there was also the tendency to take advantage of the inventory model. This is the issue, which this note seeks to address in detail taking the cases of Amazon and Flipkart, both of which have been accused of circumventing the FDI policy. [9] Incidentally, both the companies are among the largest ecommerce companies in India in terms of net revenue for the year 2013-14.[10] They are also the closest competitors of each other.

Amazon in India

Amazon Sellers Services Private Limited was incorporated in Karnataka, in 2012 as a subsidiary of Amazon Asia-Pacific Resources Private Limited, Singapore. Its other shareholder was Amazon Eurasia Holdings S.A.R.L, Luxembourg. The company

28, 2014, ISID Clipping Service.

7 KPMG-IAMAI, *E-Commerce Rhetoric, Reality and Opportunity,* 2013, (Executive Summary), available at https://www.kpmg.com/IN/en/IssuesAndInsights/ArticlesPublications/Documents/KPMG-IAMAI-ES.pdf

8 In this note Amazon and Amazon Sellers Services Private Limited are used interchangeably.

9 Flipkart refers to Flipkart Online Services Private Limited if not mentioned otherwise.

10 See: http://techcircle.vccircle.com/2014/11/06/peek-at-how-indias-top-three-e-com-marketplaces-flipkart-amazon-snapdeal-fared/

started its commercial operations through the website www.amazon.in in 2013. Within one year of its operation Amazon reached the $1 billion sales in India. Amazon indeed mentioned that India was the first country to reach $1 billion sales in such a short duration.[11]

Allegation against Amazon

In September 2014, Amazon India was accused of violating the FDI policy in retail trade by Reserve Bank of India. It was suspected that Amazon was selling directly to consumers and showing the sale as being made by the vendors registered with it. The Enforcement Directorate (ED) was directed to investigate the possible violations of FDI norms by the company. As a part of the same investigation, commercial tax authorities in Karnataka issued a notice to some of the vendors who sell their goods through Amazon India's website. The authorities asked them to stop storing their goods in Amazon's warehouse. The dispute is related to the fulfilment centres[12] of Amazon through which Amazon meets the orders placed by the customers through its website. The tax department has alleged that ownership of the product is transferred to Amazon once the product reaches the fulfilment centre. Moreover, the sellers show the fulfilment centre as their business branch. Hence, Amazon is liable to pay value added tax (VAT) instead of the service tax that it pays.[13] However, Amazon's defence was that the fulfilment centres only facilitate storage by third party sellers and it does not own any product stored in these centres. Investigations are also going on whether Amazon is controlling the prices of the products sold on its website.[14] However, as of now any further development in this case could not be traced.

[11] See: http://articles.economictimes.indiatimes.com/2014-09-29/news/54437474_1_binny-bansal-biggest-online-retailer-flipkart-team-india

[12] Fulfilment centre is a centralised unit where products are received from various sellers and processed for delivery. Amazon facilitates its third party sellers to store their inventories in these fulfilment centres. see http://services.amazon.in/services/fulfilment-by-amazon/how-it-works.html accessed on 11.12.14

[13] See: "Amazon runs into tax trouble in Karnataka", *Live Mint*, September 15, 2014, ISID Clipping Service.

[14] See: "Amazon's India retail under lens", *Financial Express*, September, 7, 2014, ISID Clipping

contd…

Amazon's Investment in Retail Venture[15]

In August 2014, Amazon and Catamaran Management Services Private Limited (CMS) jointly acquired Prione Business Services Private Limited, a private investment firm promoted by Mr. Narayana Murthy, founder of Infosys, in 2009.[16] While CMS holds 51 per cent of the shares of Prione, Amazon Asia Pacific Resources Pvt. Ltd. Singapore and Amazon Eurasia Holding Luxembourg hold 48 per cent and 1 per cent respectively. The latter two companies are subsidiaries of Amazon Inc and together they hold 100 per cent of the shares of Amazon Sellers Services Private Limited which operates www.amazon.in.

Prione acquired Cloudtail India Private Limited (Cloudtail) in September 2014. As per the filings with Ministry of Corporate Affairs (MCA), Prione holds 99.99 per cent and Mr. Arjun Narayanswamy (who is also nominated by Prione) holds the remaining portion in Cloudtail. The ownership structure of the Cloudtail is shown in the Diagram. It is obvious that Amazon contributed to the equity capital of Cloudtail indirectly through Prione. Pegging Amazon's investment in Prione at 49 per cent appears to have been aimed at taking advantage of India's FDI policy on downstream investments as can be seen in the following.

Press Note nos. 2 and 3 of 2009 series issued by DIPP, mention that if there is any Indian company which is owned and controlled by resident Indian citizens, then such a company can make downstream investments in any venture in India. Such downstream investments will not be counted as FDI.[17] Had Amazon invested the same amount directly in Cloudtail which is in retail business, it would have been seen as a violation of the FDI policy. With majority shares in Prione being held by CMS, Prione will be seen as controlled by Indians and thus its downstream investments

Service.

15 This section is based on the information compiled from the documents submitted to MCA by the respective companies.

16 Mr. Narayana Murthy holds 80% of shares of CMS and the remaining are held by his wife.

17 RBI defines downstream investment as indirect foreign investment, by one Indian company into another Indian company, by way of subscription or acquisition, while an Indian company is a company incorporated in India under the Companies Act, 1956. See: http://rbi.org.in/scripts/NotificationUser.aspx?Id=8209&Mode=0 Accessed on 10.4.15.

would not have the FDI tag. The fact, however, is that CMS is only a financial investor and the activities of Cloudtail are directly aligned with those of Amazon. Even assuming that CMS controls Prione and Amazon's representatives on Prione's Board, being in minority, cannot influence its decisions (which is quite unlikely given their importance in Amazon's operations, as can be seen in the following) the fact remains that Catamaran joined hands with Amazon for the business it generates for Cloudtail. In fact, the Shareholders' Agreement between Amazon Asia Pacific and Amazon Eurasia and CMS acting as trustee of Hober Mallow Trust gives certain rights to Amazon which also bind 'JV Subsidiary' like Cloudtail.[18]

Amazon has two of its nominees on the Board of Prione. It is important to note that the nominees hold senior positions in Amazon Sellers Services Private Limited as country head and finance director.[19] Since Amazon is operating in India as marketplace model it is expected that it will have arm's length distance from the sellers. But its indirect ownership of Cloudtail and presence of its important personnel on the board of Prione raises a serious question about such independence. It would be unthinkable that Cloudtail will have the freedom to sell through Amazon's competitors. Notwithstanding India's FDI policy, Amazon will have a claim on 49 per cent of the profits generated out of this arrangement. It is possible that foreign retailers may direct the local sellers through such intermediaries. Obviously, the foreign retailer is exploiting the flaw in India's FDI policy which ignores corporate realities.

It is a different matter that the stated aim of Cloudtail was to help India's small and medium enterprises (SMEs) to take their business online and tap the fast-growing online customer base.[20] The Memorandum of Association of Cloudtail, however, does not have any reference to the SME sector. Further, most of the products like mobile phones, electronic items, books sold by Cloudtail are hardly produced by

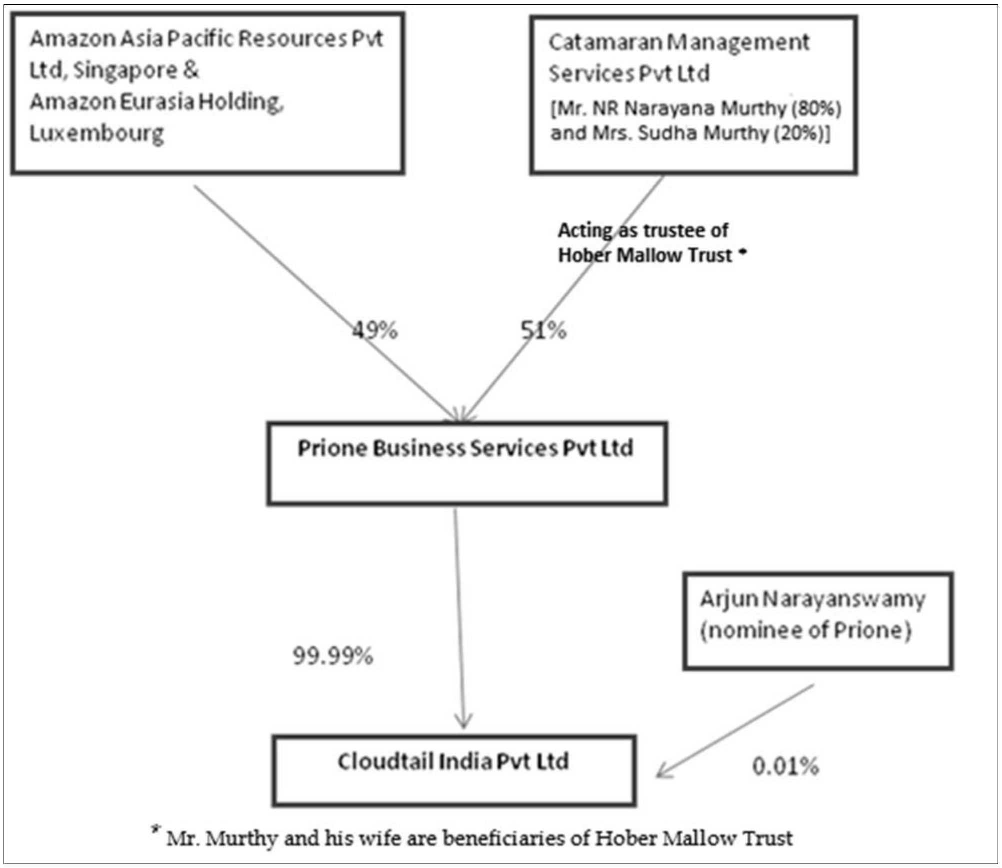
[18] As per the Articles of Association of Prione filed with the MCA on May 21, 2014.

[19] http://www.livemint.com/Companies/5rcMyyEJgbQzZUnkJ9dRjJ/Amazon-stake-in-seller-may-come-under-scrutiny.html

[20] http://www.business-standard.com/article/companies/murthy-s-catamaran-partners-amazon-for-sme-platform-114062700830_1.html

small and medium enterprises of India. Also there is no evidence to show that Cloudtail charges lower commission from SME sellers.

Diagram: Ownership Structure of Cloudtail India



The criteria for identifying indirect FDI enables foreign companies enter prohibited or restricted sectors through the backdoor. One does not find any justification in allowing such downstream investment while restricting direct investment. Amazon is not the only company taking advantage of the loopholes. Wal-Mart did it earlier to promote its retail business by using the Cedar Support Services Ltd-Bharti Retail Ltd route. Another case in point now is the relationship between Jade e-services and Xerion Retail. [21]

[21] http://www.businessworld.in/en/storypage/-/bw/fdi-escapades/r544358.37489/page/0

Restructuring of Flipkart

Flipkart Online Services Private Limited (FOSL) was incorporated in 2008 and started its commercial operations through its website flipkart.com. During April -- July 2009 it was involved in online retail distribution of goods and services. Afterwards, it started operating as a wholesale distributor. The promoters of FOSL incorporated another company called WS Retail in June 2009. WS Retail was selling various goods through the Flipkart website. In other words, Flipkart was selling goods through its retail entity WS Retail. Moreover, the remarks of the auditors of FOSL for the year 2011-12 suggest that, WS Retail was the only seller at the Flipkart website.[22] Between 2009 and 2012 FOSL raised around US $ 180 million from different foreign PE investors.[23] These fund raising activities led to the ED investigation against Flipkart in 2012 for possible violation of FDI rules which restrict FDI in online retail trade. Probably sensing trouble, the promoters of Flipkart resigned from the Board of WS Retail in February 2011. They had also transferred their shareholding to others. WS Retail continued the same business under the new ownership and management.

Changes in the corporate structure of Flipkart group did not end with divesting WS Retail. The domain name Flipkart.com which was originally owned by Flipkart Online Services Private Limited was transferred to Flipkart India Private Limited in 2011. Flipkart.com was again sold to Flipkart Internet Pvt. Ltd. in 2012. Flipkart Internet Pvt. Ltd which is a subsidiary of Singapore based Flipkart Marketplace Private Limited (holding company) with 99 per cent voting rights and Flipkart Private Limited (the ultimate holding company) with 1 per cent voting rights. MCA documents show that another company by name Flipkart Marketplace Private Limited was incorporated as a subsidiary of foreign company in India in 2012 and renamed as Flipkart Internet Pvt. Ltd later in the same year. While breaking away from WS Retail is obviously related to the compulsion of complying with India's FDI policy, one is not clear of the additional factors that could have been responsible for the broader restructuring exercise. In fact, the exercise makes Flipkart Internet Pvt Ltd subsidiary of a foreign

[22] See also: http://techcircle.vccircle.com/2014/11/06/flipkarts-in-house-vendor-ws-retail-sold-stuff-worth-rs-3135cr-last-year/
[23] http://www.dealcurry.com/20140724-Flipkart-Raises-Fresh-Round-Of-Funding.htm

company. One possible reason could be its plans to list on Nasdaq in which case it has nothing to do with the FDI policy.

From April 2013 onwards Flipkart.com started following the marketplace model of e-commerce business[24]. Thus Flipkart.com (now under the control of Flipkart Internet Private Limited) started providing a platform to several third party sellers. One of these registered sellers is WS Retail. While there does not appear to be any direct relationship between Flipkart and WS Retail either at ownership or at the board level, it is interesting to note that the products sold at flipkart.com by WS Retail are sourced from Flipkart India Private Limited which is a cash and carry entity of Flipkart group. Indeed it was reported that around 75 per cent of the business in the flipkart.com comes from WS Retail[25]. It has been noticed that some of the bestselling products on flipkart.com like Moto brand of Motorola and Xiaomi brand smart phones are exclusively sold by WS Retail. The discounts offered by WS Retail are also comparatively higher than many other registered sellers. Two of the directors who control 46 per cent of the equity of capital of WS Retail were earlier employees of Flipkart. They are reported to be close to the promoters of Flipkart.[26] Recent reports suggest that Flipkart is trying to reduce its dependence on WS Retail.[27]

A Way Forward

What emerges from the above two case studies is that while an international retailer could circumvent India's FDI policy by associating itself with an Indian financial investor, genuine Indian retailers receiving investments from financial investors, who have no direct interest in retail trade and are thus portfolio investors seeking large return on their investments, were forced to change their operating model. The intent of the first is to circumvent the law, while that of the latter is to secure finance

[24] http://www.business-standard.com/article/companies/flipkart-changes-business-model-launches-flipkart-marketplace-113040600051_1.html
[25] http://www.livemint.com/Companies/VXr8oJzNJ4daOYSO5wNETN/Inside-Flipkarts-complex-structure.html
[26] *ibid*.
[27] See: http://articles.economictimes.indiatimes.com/2015-03-19/news/60286677_1_ws-retail-binny-bansal-flipkart-spokesperson

to their operations. While the former strengthens the position of the foreign retailer, the latter constrains the growth of the Indian retailer. To put simply, the policy failed to distinguish between foreign retailers and foreign portfolio investors. In fact, there is considerable inconsistency in treating foreign portfolio investors. Had the criteria followed in case of commodity exchanges, asset reconstruction companies and the defence sector, where foreign portfolio investors were treated differently from foreign direct investors, Flipkart would have managed to continue with the B2C format. Interestingly, NRI investments are also treated differently in case of air transport services. A similar approach in case of e-commerce would not have been against the spirit of promoting Indian entrepreneurs.

India should learn to use foreign investments strategically. For all intents and purposes foreign portfolio investments and foreign direct investments are quite different from each other. Portfolio investments are basically short term, with the foreign investor not being a competitor but a collaborator in the sense of not being in the same line of activity and the sole purpose being providing much needed finance in return for handsome gains.[28] There are, however, other risks in terms of huge capital repatriations and the companies being subjected to mergers and acquisitions. The e-commerce sector is growing rapidly and it is very important for the policy makers to devise measures which do not place hurdles in the path of Indian entrepreneurs. Every effort should be made to create conditions for the emergence of Indian entrepreneurs in soft sectors at least. Prohibiting FDI in B2C e-commerce is directly related to the implementation of FDI policy with regard to MBRT which is characterised by locational restrictions.

[28] See: Thillai Rajan A. and Somaj Bandyopadhyay, *The Landscape of Institutional LPs investing in India: Venture Capital and Private Equity Report*, 2014, available at indiavca.org/pdf/2014vcpa.pdf.