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FDI IN E-COMMERCE

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Background

Retail sector in India is considered to be a sensitive sector especially due to factors, such as (i) the employment it generates; (ii) unorganised clusters of traders (iii) inability to compete with large players (iv) concentration of vote bank. Accordingly, Government over the years has traded consciously and opened up FDI in retail sector in truncated manner.

The Department of Industrial Policy and Promotion (DIPP) of the Ministry of Commerce and Industry, Government of India has issued Press Note No 2 (2018 Series) on 26th December, 2018 (PN 2 of 2018). PN 2 of 2018 amends paragraph 5.2.15.2 (e-commerce activities) of the current 'Consolidated FDI Policy' of the DIPP effective from 28th August, 2017 (FDI Policy), effective from 1st February, 2019. Paragraph 5.2.15.2 (e-commerce activities) incorporates the provisions of Press Note No 3 (2016 Series) dated 29th March, 2016 (PN 3 of 2016), pursuant to which foreign direct investment (FDI) up to 100% was allowed under the automatic route in entities engaged in the marketplace model of e-commerce, subject to compliance with certain conditions. However, FDI in entities engaged in the inventory-based model of e-commerce was expressly prohibited, and this continues to be the case as on date. A marketplace-based model of e-commerce is a model of providing an information technology platform by an e-commerce entity on a digital and electronic network to act as a facilitator between buyer and seller. An inventory-based model of e-commerce, on the other hand, is a model where inventory of goods and services is owned by an e-commerce entity and is sold to the consumers directly.

It has been a bone of contention of trade association that FDI component is creating an uneven playing field to the disadvantage of millions of small business enterprises. It is alleged that the e-retailers are engaged in predatory pricing policy and subsidizing the prices with a view to oust brick and mortar shops from retail trade.

While the conditions contained in PN 3 of 2016 were introduced to bring some comfort to brick and mortar retailers (small traders) and to ostensibly create a level playing field for such retailers with their e-commerce counterparts, it was felt in some quarters that the wording of PN 3 of 2016 was not stringent enough and that the intended goal of such PN 3 of 2016 was not being achieved. Complaints were made to regulator that certain marketplace platforms were violating policy by influencing the price of products and indirectly engaging in inventory-based model. In order to ensure that rules are not circumvented DIPP came up with PN 2 of 2018[1].

Some of the important changes made by PN 2 of 2018 are highlighted in this article.

Scope and applicability

PN 2 of 2018 proposes to amend para 5.2.15.2 dealing with e-commerce activities. Accordingly, PN 2 of 2018 has no impact on following:

- Wholesale cash and carry trading;
- Single brand retail trading operating through brick and mortar stores;
- Multi brand retail trading;
- Indian entity with no FDI engaged in online e-commerce business;
- Indian entity with FDI engaged in manufacturing selling products in India through e-commerce.

Restrictions of PN 2 of 2018 are applicable to Indian e-commerce company having FDI. It does not apply to home grown retail majors like Vijay Sales, Big Bazaar, Reliance Retail etc. Thus, PN 2 of 2018 may assure level playing field against foreign capital but does little to prevent small traders from predatory pricing and market penetration policy adopted by Indian conglomerates.

PN 2 of 2018 is applicable from 1st February, 2019. There is no express grandfathering of existing structures. Moreover, since amendments seek to clarify legislative intent, it is advisable that e-commerce companies comply with new regulations. Some of the stringent conditions will require e-commerce companies to rejig their business model.

Ownership and control over inventory

Policy

E-commerce entity providing a marketplace will not exercise ownership or control over the inventory i.e. goods purported to be sold. Such an ownership or control over the inventory will render the business into inventory based model. Inventory of a vendor will be deemed to be controlled by e-commerce marketplace entity if more than 25% of purchases of such vendor are from the marketplace entity or its group companies.

Comments

Existing regulation i.e. PN 3 of 2016 provides that e-commerce entity providing a market place will not exercise ownership over the inventory i.e. goods purported to be sold. Such an ownership over inventory will render the business into inventory-based model.

PN 2 of 2018 imposes an additional condition and deems inventory of vendor to be controlled by e-commerce marketplace entity if more than 25% of purchases of such vendor are from market place entity or its group companies.

Said condition seems to plug in loophole in existing regulatory framework. Under existing regulatory framework e-commerce entity can undertake B2B trading. Marketplace Entities used one or more of their group entities to sell goods to sellers on a B2B basis with such sellers in turn listing the goods on the Marketplace Entity's platforms for sale to retail customers.

Going forward, e-commerce entity will have to develop mechanism to track purchases of vendor listed on its portal. If 25% limit is breached by vendor it will tantamount to violation of FDI conditions for e-commerce entity. This is likely to be cumbersome compliance as vendors may be reluctant to share their financial details.

Regulation is not clear on period for computing '25%' threshold limit. Arguably, 25% of purchases should be calculated for each financial year and reference to 25% should be in value terms based on financial statement of vendor. Further, 25% of overall threshold can be computed only after closure of financial year. This poses challenge on e-commerce companies to test compliance before closure of financial year. Further, regulation is not clear in case of computation of 25% threshold in case of vendor engaged in trading of multiple goods. It is not clear whether 25% threshold should be computed for that segment of goods traded on e-commerce website or purchase on overall basis needs to be seen.

Regulation stresses on purchase aspect of vendor from e-commerce companies or its group companies and has nothing to do with the aspect of vendor selling goods on market platform of e-commerce companies. Accordingly, on plain reading - say Vendor A purchasing goods in bulk^[2] from group companies of Flipkart and selling on Amazon and offline in large quantities and on Flipkart in small quantities, will render Flipkart to violation of FDI norms.

Restriction may put limitation on Indian vendors who are not recipient of FDI to look out for alternatives sources to procure goods. Thus, PN 2 of 2018 indirectly regulates procurement pattern of non FDI companies trading on e-commerce platform.

Sellers may require to broad base their procurement function and approach directly distributors or manufacturer of products. This is likely to impact margins and supply chain efficiency.

Interestingly, PN 2 of 2018 permits e-commerce companies to provide support services in respect of warehousing, logistics, order fulfilment, call centre, payment collection and other services. Accordingly, it may be open for e-commerce company or group company to provide indenting services to sellers and facilitate them to purchase goods from distributor or manufacturers. Said services can be validly provided as long as it is provided in fair and non-discriminatory manner.

Regulation 2 of FEMA 20(R) defines group company as follows:

"Group Company means two or more enterprises which, directly or indirectly, are in a position to

- (a) Exercise 26 percent, or more of voting rights in other enterprise; or
- (b) Appoint more than 50 percent, of members of board of directors in the other enterprise.”

Definition of Group Company is based on 26% shareholder threshold and power to appoint more than 50% members of Board. This definition is in contradiction to definition of control under Ind AS 110[3]. Ind AS definition of control is expansive and requires Company to give consideration to shareholders agreement and right flowing to investor to determine control. As against that, definition of group company in FEMA 20(R) is more legalistic. Further, analyst believes that stringent condition is likely to pave way to franchisee models[4].

Restriction on group company sellers to participate on e-commerce platform

Policy

An entity having equity participation by 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.

Comments

Existing regulation i.e. PN 3 of 2016 provides that e-commerce entity will not permit more than 25% of the sales value on financial year basis affected through its marketplace from one vendor or group company.

PN 2 of 2018 prohibits i) entity having equity participation by e-commerce marketplace entity or its group companies or ii) vendor on which e-commerce marketplace entity or its group companies has control over inventory.

On comparison of existing and new regulation following are notable changes:

- Ban on entity in which e-commerce marketplace entity or its group companies has equity participation to sell on e-commerce platform.
- Ban on entity on which e-commerce marketplace entity or its group companies has control over inventory to sell on e-commerce platform.
- Other vendors (other than mentioned above) can sell on e-commerce platform even if its sales amount to more than 25% of sales value.

PN 2 of 2018 has used ambiguous term ‘equity participation’. Extant FDI Policy defines ‘capital instrument’ as referring to equity shares, CCPS, CCDs and warrants. It is therefore unclear whether the term “equity participation” refers solely to equity investments or whether it includes investments using other instruments (such as CCPS, CCDs or warrants) as well and its impact on conversion. Further no threshold for equity participation is prescribed. Accordingly, holding of 1% by specified entities will debar investee entity from trading in e-commerce platform.

At times investing in companies providing support services are driven by business and commercial consideration. Since services are so interlinked, it may be a commercial necessity to hold stake in service company to ensure quality of service and safeguard reputation of e-commerce companies. Revised policy seems to give a total go-by to business consideration and

looks involvement of service company (with equity participation of e-commerce company) as a sole driver.

- Many e-commerce entities operating in India have made (or entities controlled by them have made) investments in entities (First Level JV Entity) that are owned and controlled by an Indian resident. The First Level JV Entities establish further subsidiaries (Second Level JV Entity). In light of the current guidelines on downstream investments, these Second Level JV Entities or group entities are not subjected to similar obligations as applicable to foreign direct investment in First Level JV Entity. Use of term 'equity participation' raises issue whether restriction will apply to First Level JV entity or even Second Level JV Entity. In contrast to other clauses in PN 2 of 2018, this clause does not use the words equity participation 'directly or indirectly'.
- Policy is likely to put a break on Amazon from selling products from subsidiaries like Cloudtail and Appario, Flipkart from selling products through its investee company WS Retail unless e-commerce major restructures their business model.

No exclusivity

Policy

E-commerce marketplace entity will not mandate any seller to sell any product exclusively on its platform only.

Comments

Condition seems to be one way in terms of requiring e-commerce entity to sell product exclusively on its platform. Condition does not restrict seller to approach e-commerce company to sell its product exclusively on its platform.

This condition will put check on practices of selling mobile phones and white goods on exclusive basis. Accordingly, it will no longer be open for Flipkart to have exclusive partnership of selling smartphones like Xiaomi and Oppo. Exclusive sale was perceived to be concentration of power in hands of few and detrimental to the interest of small traders.

Said condition puts practice of selling private label products say Amazon kindle, Amazon Echo, MarQ range of electronic goods in doubt. Private label products are in-house brands of e-commerce company. Reason for promoting private label products is to earn high margin and seek repetitive customers as private label products are exclusively sold by e-commerce companies. E-commerce entities seek to sell private label products at discounted price vis-à-vis compete and try to lure customers.

On plain reading, there is no bar on sellers to sell products exclusively on e-commerce platform. DIPP in its press release has clarified that present policy does not impose any restriction on the nature of products which can be sold on the marketplace.

Level playing field

Policy

E-commerce entities providing marketplace will not directly or indirectly influence the sale price of goods or services and shall maintain level playing field. Services should be provided by e-commerce marketplace entity or other entities in which e-commerce marketplace entity has direct or indirect equity participation or common control, to vendors on the platform at arm's length and in a fair and non-discriminatory manner. Such services will include but are not limited to fulfilment, logistics, warehousing, advertisement/marketing, payments, financing etc. Cash back provided by group companies of marketplace entity to buyers shall 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 will be deemed unfair and discriminatory.

Comments

PN 3 of 2016 merely stipulates that e-commerce entities providing marketplace will not directly or indirectly influence the sale price of goods or services and shall maintain level playing field. PN 2 of 2018 imposes additional conditions on e-commerce companies and its investee company to provide services to vendors on platform at arm's length on fair and non-discriminatory manner. Policy deems that provision of services to any vendor on such terms which are not made available to other vendors in similar circumstances will be deemed unfair and discriminatory.

Policy seems to plug practices of predatory pricing policy and subsidising the prices. Going forward it will be difficult to provide cash back, fast delivery, etc., to select set of sellers. All the service providers will have to open up such services for all the sellers on its platform.

Use of terms 'arm's length', 'fair and non-discriminatory' and 'similar circumstance' are subjective and is likely to give rise to further frictions. It is equally true in a market place; all sellers can't be treated similarly. It is natural for business to give preferential treatment to set of customers who are top customers. Person selling miniscule quantity cannot be compared with customer selling substantial quantity. Use of the word 'similar circumstances' should be construed in right perspective.

Policy requires cash back to be provided to buyers and services to be provided to sellers to be fair and non-discriminatory. Policy does not seem to restrict buyer/seller to be provided better services if they are paying a premium/price to avail preferential service. Accordingly, services like prime membership are unlikely to be affected by new regulation.

Report to RBI

Policy

E-commerce marketplace entity will be required to furnish a certificate along with a report of statutory auditor to Reserve Bank of India, confirming compliance of above guidelines, by 30th of September of every year for the preceding financial year.

Comments

Regulation places additional obligation on statutory auditor to certify compliance with new guidelines. This will be an onerous task given subjectivity involved in guidelines.

Concluding Remarks

Revised regulation seeks to provide level playing field to small traders and protect them from foreign capital. Changes come at a time when investments in e-commerce are at record high. Acquisition of controlling stake by Walmart in Flipkart at whopping USD 16 billion raised bar of e-commerce industry in India. Research firm Crisil has estimated that nearly 35-40% of e-retail industry sales, amounting to Rs 35,000-40,000 crore, could be impacted due to the tightened policy. It is further estimated that Brick and Mortar business will gain 150-200 bps topline boost. Media⁵ has reported that new regulations are draconian and a bigger retrograde move than even Vodafone tax issues. It will not only impact e-commerce sector but also FDI inflow in other sectors because regulations can change overnight. One believes that DIPP will come out with clarification and allay all fears.

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