FDI in B2C e-retail

Introduction

The last decade in India has seen a steady rise in e-commerce (e-retail, e-travel and e-classifieds) due to significant increase in the number of internet users, proliferation of internet-enabled devices, rising disposable incomes, and growing acceptability of online payments.[1] Goods or services can be ordered electronically but their payment does not necessarily have to be conducted online. The cash-on-delivery system is one of the biggest reasons for the growth of e-commerce in India. More than 50 per cent of all online transactions in India are believed to be based on the cash-on-delivery payment system.[2]

The remarkable growth of the e-commerce industry confirms that Indians are increasingly willing to buy goods and services online, and this has given a strong fillip to foreign investment. Foreign venture capitalists and private equity firms have demonstrated their faith in the Indian e-commerce industry and this is evident from the momentous increase in the total investments (US $800 million in 2011 as against US $110 million in 2010).[3] The size of India's e-commerce market in 2013 was around $13 billion, according to a joint report of KPMG and Internet and Mobile Association of India (**"IAMAI"**).[4]

Despite its burgeoning growth, the e-commerce market is not without hurdles. Apart from the problems of logistics, bottlenecks in transport, drop-outs on payment gateways and an intensely competitive environment, an added recent concern is the alleged violation of foreign investment laws by e-retail companies in India. This newsletter provides a brief overview of the current government policy on foreign direct investment (**"FDI"**) in business-to-business (**"B2B"**) and business-to-consumer (**"B2C"**) e-retail, the alleged violation of FDI norms by online retail companies and the pros and cons of FDI in B2C e-retail.

1. Extant FDI policy on B2B and B2C e-retail in India

India's FDI policy permits FDI up to 100% in e-commerce activities, but this is dependent on a very crucial stipulation– the policy applies only to companies engaged in B2B e-commerce, and not to those in retail trading.[5] It is at this point that classification of online retail businesses into B2B and B2C e-retail becomes significant.

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[1] India, with 205 million internet users, has the third largest internet user-base in the world, behind China with 300 million and the US with 207 million, according to a report released by the Internet and Mobile Association of India (IAMAI) and IMRB International in November 2013.

[2] For details please see the IBEF report of January 2013 available at http://www.ibef.org/download/The-Rise-and-Rise-of-E-commerce-in-India.pdf.

[3] *Supra.*

[4] As per information available at http://www.iamai.in/PRelease_detail.aspx?nid=3161&NMonth=9&NYear=2013 (last visited on June 6, 2014).

[5] Under paragraph 6.2.16.2 of the consolidated FDI policy circular of 2014 (effective from 17 April, 2014), FDI up to 100% is permitted in e-commerce activities, subject to the provisions of Paragraph 6.2.16.2.1, which are set out as- *"E-commerce activities refer to 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 trading would be applicable to e-commerce as well."*

In B2B e-retail, trading is between business entities such as manufacturers and wholesalers or between wholesalers and retailers. India permits 100% FDI in B2B e-commerce under the automatic route.[6] In B2C e-retail, online businesses sell directly to the consumers. The FDI policy provides that retail trading, in any form, by means of e-commerce, would not be permissible for companies with FDI and engaged in the activity of single brand retail trading or multi-brand retail trading. Therefore, it is clear that the extant FDI policy does not permit FDI in B2C e-commerce.[7]

This restriction on foreign investment in B2C e-retail has forced many online business entities with foreign investment to adopt the marketplace model. In this model, the online company runs a website which provides the marketplace— a platform for business transactions between buyers and sellers. In return for the services provided, the online company earns commission from the sellers.[8] In this model, ownership of inventory vests with the enterprises (also the ultimate sellers) which advertise their products on the online company's website.[9] Thus, the marketplace model is compliant with the FDI policy of India as the online business entity providing the marketplace does not involve itself in any retail transaction or any direct sale to the consumer.

The marketplace model translates into smaller margins, and less control over quality of service, product description, and speed of delivery. Amazon.com, Inc. has been forced to adopt a marketplace model in India to comply with FDI regulations, whereas in the United States it follows a hybrid marketplace model. An inability to adopt inventory models, or to experiment with mixes of inventory and marketplace models makes it difficult for retailers to make innovations and expand their range of offerings.

2. Flipkart's alleged violation of the FDI policy

Since November 2013, Flipkart, one of India's largest online retail businesses, has been under investigation by the Enforcement Directorate (**"ED"**)[10] for alleged violation of FDI regulations. Violation of FDI regulations is covered by the penal provisions of the Foreign Exchange Management Act, 1999. Tracing the events of the past couple of years will clarify why Flipkart is under the scanner of the ED.

Flipkart was incorporated in 2008, and was operating on an inventory-based B2C model. In August 2012, Flipkart raised $150 million in its fourth round of funding from MIH (part of Naspers Group) and Iconiq Capital. Flipkart's global investors include Accel Partners, Tiger Global, Naspers and Iconiq Capital. The foreign investment policy meant that an online retailer

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[6] FDI in B2B e-commerce was first permitted vide entry at serial number 4 of Press Note 2 (2000) dated 11.02.2000. The provisions on e-commerce, under Press Notes 4 and 5 of 2012 reiterate the existing provisions.
[7] See Paragraphs 6.2.16.3 (2)(f) and 6.2.16.5 (1)(ix) of the consolidated FDI policy circular of 2014.
[8] For instance, Flipkart only provides a platform for communication and any contract for sale of goods or services is a bipartite contract between the seller and the buyer. For details please visit http://www.flipkart.com/s/terms (as visited on June 21, 2014).
[9] In the inventory based model, ownership of goods and services as well as the marketplace vests with the same entity— the company that runs the website.
[10] The ED is a part of Ministry of Finance and is responsible for enforcement of the Foreign Exchange Management Act, 1999 and certain provisions under the Prevention of Money Laundering Act, 2002.

like Flipkart could not have FDI in its B2C entity, unless it shifted to a B2B marketplace model. Flipkart shifted to a B2B marketplace model only in April 2013 to ensure compliance with the FDI norms in e-retail. The investigation by the ED pertains to the capital that Flipkart raised *before* converting into a marketplace model. It appears that Flipkart was operating on a B2C e-commerce model where they owned the complete inventory even while having received FDI worth nearly $180 million till September 2012. Some other online retailers such as Myntra, Snapdeal, Yebhi, Jabong, and Fashionandyou are also being investigated by the ED on similar grounds. The ED has the power to impose a fine up to three times the actual investment allegedly made in violation of FDI laws.

Flipkart's marketplace model has also come under the ED probe for not complying with the spirit of FDI regulations. Flipkart has created a complex business structure by integrating its B2B operations with the marketplace model. A company called WS Retail was incorporated in 2009, which transacts with the customers and allegedly acts as a 'front' for the B2B firm (Flipkart Online Services) which receives foreign investment. This structure has been allegedly adopted to keep the foreign-funded Flipkart Online Services at an 'arm's length' from selling directly to the consumer. While this structure seems to comply with the FDI policy in letter, for this structure to comply with the FDI regulations in spirit, Flipkart must establish that it has no influence over WS Retail, and that WS Retail maintains an arm's length relationship with Flipkart Online Services.

3. Evolving government policy towards foreign investment in B2C e-retail

In September 2012, the Indian government allowed 51% FDI in multi-brand retail, subject to certain conditions. This announcement was commended by e-commerce companies, since it was hoped that it would also draw in foreign investments in B2C e-commerce. However the Department of Industrial Policy and Promotion (**"DIPP"**) of the Ministry of Commerce and Industry later clarified that this mandate did not apply to B2C e-retail and would apply only to retailers with brick-and-mortar operations. One of the reasons alluded to for this was the difficulty in monitoring inter-state transactions in e-commerce activities. Further, the new policy is merely an enabling policy and is dependent on the policies adopted by the respective governments of the States and Union Territories.

In January 2014, the DIPP floated a discussion paper[11] detailing the merits and demerits of allowing FDI in the e-retail sector, urging stakeholders to give their comments.

Opponents of FDI in B2C e-retail argue there will be loss of jobs and creation of a monopoly by multinational companies. Allowing the entry of inventory-based large foreign e-retailers like Amazon and e-Bay may shrink Indian entrepreneurship and the Micro, Small and Medium Enterprises (**"MSMEs"**) sector. It is apprehended that organized retailers would source their goods from cheaper markets abroad, which will adversely affect the Indian

[11]For details please visit: http://dipp.nic.in/English/Discuss_paper/Discussion_paper_ecommerce_07012014.pdf (as visited on June 21, 2014).

manufacturing sector. The discussion paper also noted that introducing FDI in B2C e-retail would work against the spirit of FDI policy in multi-brand retail trading.[12]

The proponents of the pro-FDI view cite benefits like creation of infrastructure, more jobs and better consumer service. The move will reduce the need for middlemen, lower transaction costs, reduce overhead charges, and reduce inventory and labour costs. FDI in B2C e-retail will allow MSMEs and artisans to reach out to customers far beyond their immediate location. Further, the spread of e-commerce in the rural and suburban India will provide choices to the growing number of customers there who have disposable income and are willing to spend for their choices. It will also help the rural economies integrate faster with the national economy. The government's discussion paper observes that e-commerce has the potential to contribute more than 4% to India's GDP by 2020.

A joint report of KPMG and IAMAI titled "e-Commerce: Rhetoric, Reality and Opportunity" has established a direct co-relation between the size of the consumer e-commerce industry and openness to FDI in inventory based e-commerce. The report found that unlike countries such as US, China, Australia, Sri Lanka and Pakistan, India was the only one among a list of developed and developing economies that did not allow FDI in inventory based e-commerce.

A decision by the newly-elected government on the entry of foreign investment in B2C e-retail is expected. As e-retail by its very nature is unlike physical retail, there are several issues which remain unclear for want of government decision on this subject. Would introduction of FDI in B2C e-retail grant back door entry to foreign investors in multi-brand retail? While the State governments were given the choice to consent to establishment of front end multi-brand retail stores within their respective areas, the same treatment is unworkable for e-retail as it is not subject to any geography or territory limitations. Furthermore, will the e-retail companies partner with local manufacturers to source products or will they source their goods from cheaper markets abroad? Will the government permit sale of agricultural produce or processed food by e-retail companies receiving foreign investment? Will the government incorporate necessary safeguards in the policy to protect the interests of various stakeholders such as the brick and mortar shopkeepers and domestic e-retail companies?

It remains to be seen whether India-based e-commerce companies like Flipkart, Snapdeal, Fashionandyou, DealsandYou and HomeShop18 will be able to fight the battle against big international business entities such as Amazon and e-Bay, once the government approves FDI in B2C e-retail and they are permitted to have their own warehouses or retail operations. The recent merger of Flipkart with lifestyle e-commerce portal Myntra, is indicative of how e-retail companies are consolidating themselves to prepare for a competitive future.

[12] The DIPP discussion paper noted that *"allowing FDI in e-commerce will provide e-commerce players complete geographical reach which will be against the spirit of FDI in MBRT i.e. being restricted to cities with a population of more than one million or any other city as per the choice of consenting states"*.

Conclusion

At present, e-commerce, as a proportion of total retail sales in India, is a small figure.[13] However, the *rate* of growth in e-commerce from year to year and the impact of such growth on the economy have forced the Indian government to study the FDI policy framework with respect to e-retail. If and when the new government introduces FDI in B2C e-retail, it will be interesting to see the entry routes, FDI caps and limits on the percentage of sourcing from domestic manufacturers. Supportive foreign investment regulations will help in easing capital constraint and building a constructive growth environment for the e-retail industry. The onus is, therefore, on the government to formulate clear e-retail policy so that these issues can be addressed.

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[13] According to the India Brand Equity Foundation (IBEF) report of January 2013 e-commerce in India accounts for just 0.1 per cent of total retail sales vis-à-vis more than 2.9 per cent in China. The online retail penetration enjoyed by the US is 7.0 per cent.