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OVERHAUL OF REGULATIONS GOVERNING FOREIGN DIRECT INVESTMENT IN INDIA

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(A) Background

Section 6 of the Foreign Exchange Management Act, 1999 ('FEMA') deals with regulating capital account transactions. The Finance Act, 2015 amended section 6 of FEMA to provide that the Central Government will have the power to regulate non-debt instruments, whereas RBI will have the power to regulate debt instruments. However, this provision of FEMA was to be given effect from a date to be notified by the Central Government.

On 15th October, 2019, the Ministry of Finance notified the above provisions of the Finance Act, 2015 (the 'Notified Sections') which amended section 6 of FEMA. Accordingly, the Central Government assumed the power to regulate non-debt capital account transactions and RBI assumed the power to regulate debt capital account transactions from 15th October, 2019.

Subsequently, on 16th October 2019, the Central Government notified the following list of instruments which would qualify as debt instruments and non-debt instruments.

(1) List of instruments notified as Debt Instruments

(i) Government bonds;

(ii) Corporate bonds;

(iii) All tranches of securitisation structure which are not equity tranches;

(iv) Borrowings by Indian firms through loans;

(v) Depository securities where underlying securities are debt securities.

(2) List of instruments notified as Non-Debt Instruments

(a) all investments in equity instruments in incorporated entities: public, private, listed and unlisted;

(b) capital participation in LLP;

(c) all instruments of investment recognised in the FDI policy notified from time to time;

(d) investment in units of Alternative Investment Funds (AIFs), Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvIts);

(e) investment in units of mutual funds or Exchange-Traded Funds (ETFs) which invest more than fifty per cent in equity;

(f) junior-most layer (i.e., equity tranche) of securitisation structure;

(g) acquisition, sale or dealing directly in immovable property;

(h) contribution to trusts; and

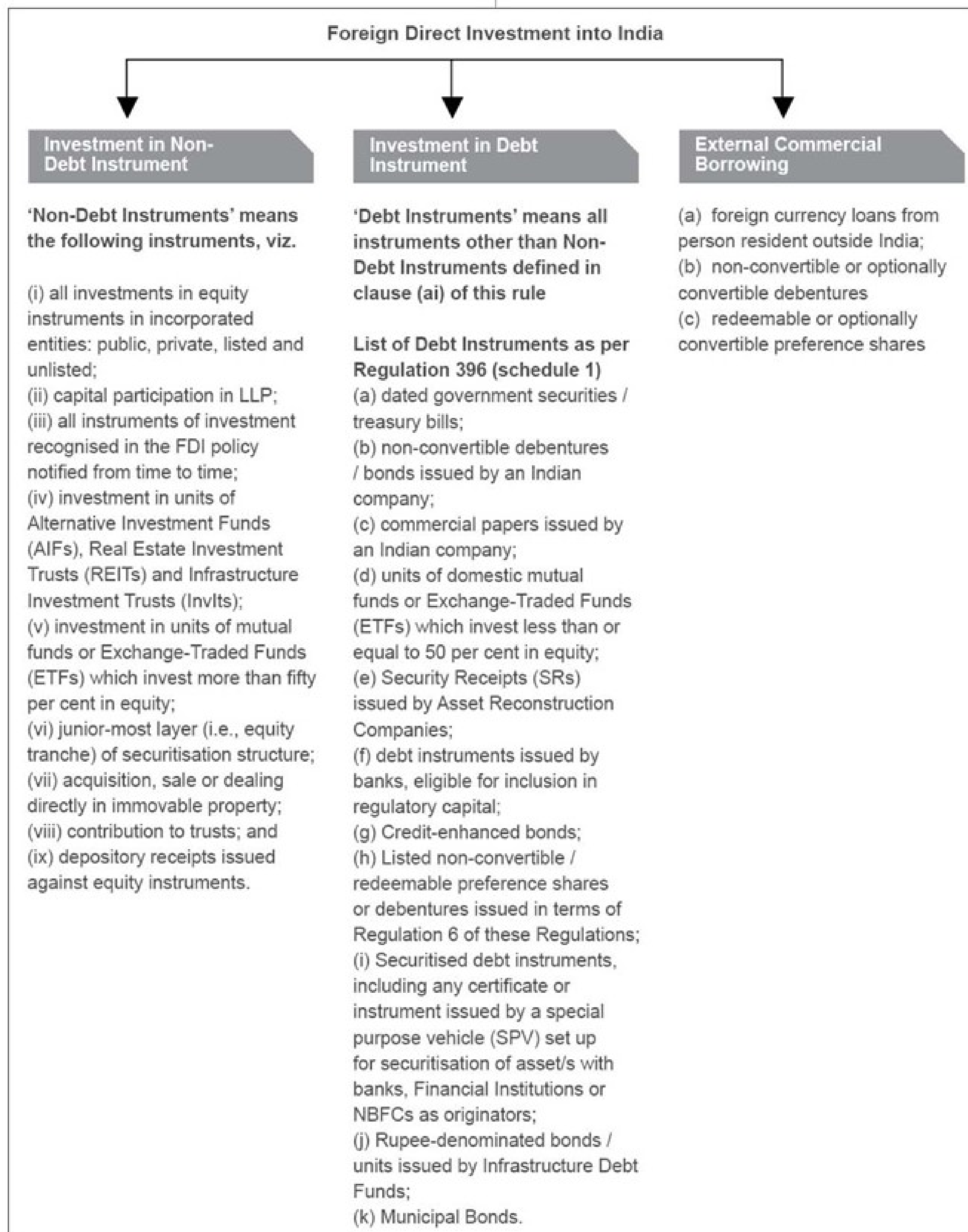
(i) depository receipts issued against equity instruments.

Further, it has also been specified that all other instruments which have not been included in the above lists of Debt or Non-Debt Instruments will be deemed to be Debt Instruments.

Thereafter, on 17th October, 2019 the Central Government issued the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ('Non-Debt Rules') for governing Non-Debt transactions and RBI notified the Foreign Exchange Management (Debt Instrument) Regulations, 2019 ('Debt Regulations') for governing Debt Instruments. Additionally, on the above date RBI also notified the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 ('Payment Regulations').

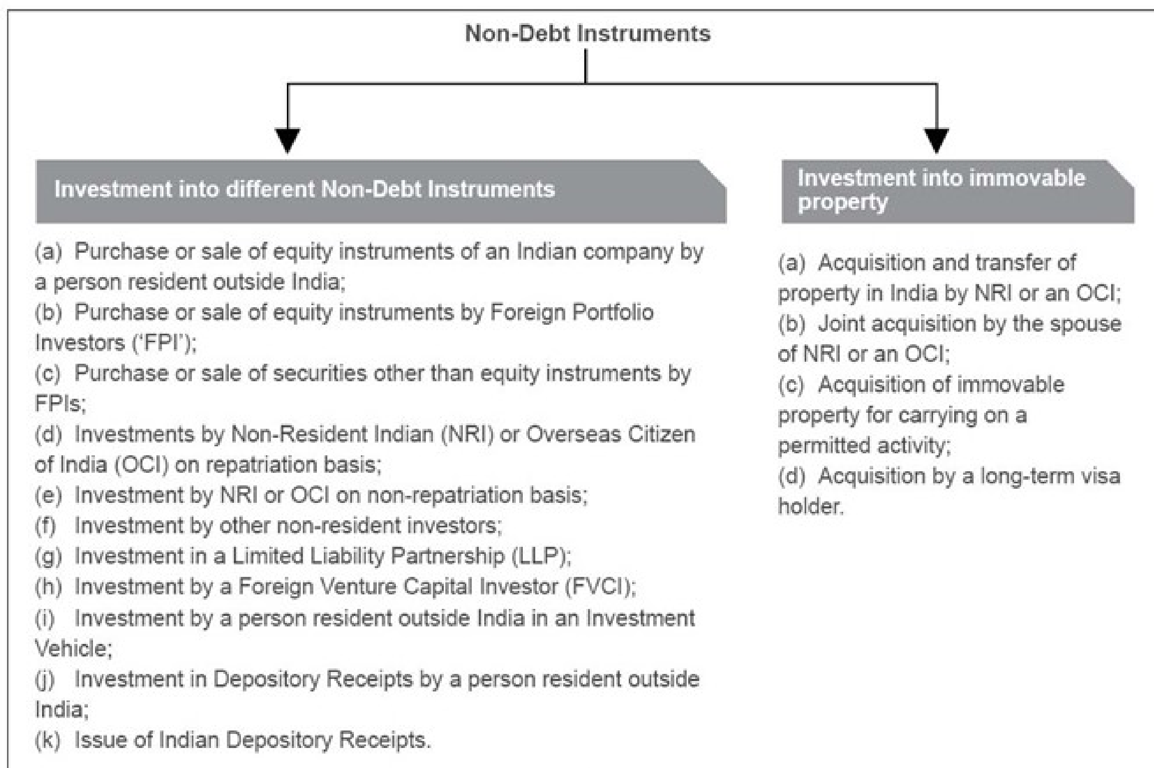
Issuance of the above Non-Debt Rules and Debt Regulations superseded FEMA regulations governing Foreign Direct Investment into India ('FDI'), i.e., FEM 20(R), Foreign Exchange Management (Transfer of Issue of Security by a Person Resident outside India) Regulations, 2017 ('TISPRO') and FEM 21(R), Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2018 ('Immovable Property Regulations').

Accordingly, after 17th October, 2019 the erstwhile FDI provisions governed by TISPRO regulations have now been divided into Non-Debt Rules and Debt Regulations. Subsequently, on 5th December, 2019 the Central Government has further amended the Non-Debt Rules. A snapshot of the revised FDI regime is as under:



(B) Overview of Non-Debt Instrument Rules, 2019

These can be further divided as under:



(C) Key changes in revised FDI regulations governing Non-Debt Instruments are summarised below:

(1) New definition of hybrid securities

Hybrid securities have been defined as under:

'Hybrid securities' means hybrid instruments such as optionally or partially convertible preference shares or debentures and other such instruments as specified by the Central Government from time to time, which can be issued by an Indian company or trust to a person resident outside India;

The expression 'hybrid instruments' has not been used in the Non-Debt Instruments Rules. Therefore, the intention of introducing these definitions is not clear and one would have to wait for some clarification from the Government on the same.

(2) Power to Central Government

The erstwhile FDI regime governed by TISPRO provided powers to RBI for regulating investment in India by persons resident outside India. Under the new regime of Non-Debt Rules, RBI in consultation with the Central Government will regulate Non-Debt investments in India by a person resident outside India.

(3) Mode of payment, remittance and reporting requirements

The mode of payment for Non-Debt Instruments along with remittance of sales proceeds will now be governed by the Payment Regulations, 2019. These regulations are broadly similar to those contained in TISPRO. The Payment Regulations, 2019 now specifically provide that transfer of

capital contribution or profit share in an LLP between a resident and a non-resident shall be reported by resident transferor / transferee in Form LLP (II).

(4) Liberalisation for Foreign Portfolio Investors

Investment by FPIs into unlisted Indian companies

Schedule 2 of the erstwhile TISPRO provided that Foreign Portfolio Investors (FPI) could purchase or sell capital instruments of an Indian company listed on a recognised stock exchange in India.

Chapter IV of the Non-Debt Rules now provide that FPI can purchase or sell equity instruments of an Indian company which is listed **or to be listed** on a recognised stock exchange in India.

Thus, earlier where FPIs were eligible to invest in capital instruments of only listed Indian companies, under the new framework FPIs are also allowed to invest in equity instruments which are to be listed on any recognised stock exchange in India.

Investment limit of FPIs

Schedule 2 of the erstwhile TISPRO provided that the individual limit of a single FPI holding in an Indian company shall be less than 10% of the total paid-up equity capital on fully-diluted basis. Additionally, on an aggregate basis, total shareholding of all FPIs in an Indian company should not exceed 24%. However, this aggregate limit of 24% could be increased by the Indian company up to the sectoral cap with specific approval of the board of directors and a special resolution being passed at the general meeting.

The Non-Debt Rules now provide that with effect from 1st April, 2020, the default aggregate FPI limits in an Indian company is the applicable sectoral cap, as laid out in Schedule I of the Non-Debt Instruments Rules and is not capped at 24% as applicable in the erstwhile TISPRO. Additionally, it has also been provided that before 31st March, 2020, the above aggregate limit of sectoral caps can be reduced to 24%, 49% or 74% as deemed fit by the company with the approval of its Board and passing of a special resolution. Further, once the Indian company has decreased its aggregate limit from sectoral cap to a lower threshold of 24%, 49% or 74%, as the case may be, the same can also be increased by the company in future. However, if an Indian company increases FPIs' aggregate investment limit to higher limit, the same cannot be decreased in future. Thus, if any Indian company wants to reduce the aggregate FPI limits from sectoral cap to lower threshold of 24%, 49% or 74%, the same should be undertaken before 31st March, 2020.

Additionally, it is also specifically clarified that in sectors where FDI is prohibited, aggregate FPI limit is capped at 24%.

Further, in case the applicable FPI ceiling limit is breached, FPI would need to divest its holdings within a period of five trading days. Failure to do so would result in the entire FPI limits being classified as FDI and the relevant FPI investor will no longer be allowed to make further investments under the FPI route.

Additionally, FPIs have now been specifically allowed to purchase units of domestic mutual funds or Category III alternative investment fund or offshore fund for which no-objection is issued in accordance with the SEBI (Mutual Fund) Regulations, 1996 and which, in turn, invests more than 50% in equity instruments on repatriation basis subject to the terms and conditions specified by SEBI and RBI.

Investment by FPIs into interest rate derivatives

FPIs were earlier permitted to invest in interest rate derivatives under the erstwhile TISPRO. However, under the new Non-Debt Rules, FPIs are not permitted to invest in interest rate derivatives.

(5) Liberalisation for Non-Resident Indians ('NRIs') and Overseas Citizen of India ('OCI')

OCIs can now enrol for the National Pension Scheme governed and administered by the Pension Fund Regulatory and Development Authority of India.

Further, NRIs and OCIs can now also invest in units of domestic mutual funds which invest more than 50% in equity on non-repatriation basis.

(6) Investments by other non-resident investors

Eligible Foreign Entities as defined in SEBI Circular dated 9th October, 2018 and having actual exposure to the Indian physical commodity market have now been allowed to participate in the domestic commodity derivative market as per the framework specified by SEBI. Eligible Foreign Entities have been defined to mean persons resident outside India as per provisions of FEMA and who are having actual exposure to Indian physical commodity markets.

(7) General provisions

A clarification has been introduced to provide that in case of transfer of equity instruments held on a non-repatriation basis to someone who wants to hold it on a repatriation basis, the transferee will have to comply with the other requirements of pricing and sectoral caps, among others, similar to any other non-resident investor holding shares on a non-repatriation basis. Further, under TISPRO, for transfers which were not under the general permission, permission was to be sought only from RBI. However, the Rules now require the permission to be sought from RBI in consultation with the Central Government.

In the case of issuance of shares to non-residents pursuant to a scheme of merger or amalgamation of two or more Indian companies, or a reconstruction by way of demerger or otherwise of an Indian company, where any of the companies involved is listed on a recognised

stock exchange in India, then the scheme of arrangement shall need to be in compliance with the SEBI (Listing Obligation and Disclosure Requirement) Regulations, 2015.

In case of Downstream Investments, the meaning of ‘Ownership of an Indian Company’ has been changed; it now states:

*‘ownership of an Indian company’ shall mean beneficial holding of more than fifty percent of the **equity instruments** of such company; and ‘ownership of an LLP’ shall mean contribution of more than fifty percent in its capital and having majority profit share;*

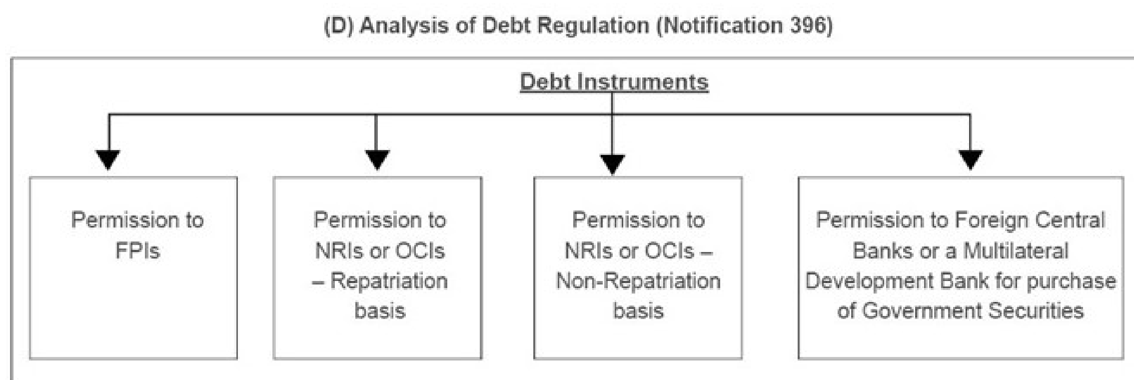
The TISPRO regulations provided 50% of capital instruments for determining ownership of an Indian company and not equity instruments as defined above.

(8) Sectoral limits

The sectoral limits for investment in different sectors under the Non-Debt Rules are similar to the erstwhile TISPRO as amended by Press Note 4 (2019 series) dated 18th September, 2019.

(9) Remaining provisions relating to investment, transfer of securities, eligibility etc.

All remaining provisions of Non-Debt Rules relating to investment, transfer, eligibility are broadly similar to those under the erstwhile TISPRO.



Key changes in revised FDI regulations governing debt instruments are summarised below:

Earlier, TISPRO allowed only FPIs, NRIs and OCIs to trade in exchange-traded derivatives. However, the revised Debt Regulations now permit all persons resident outside India to trade in exchange-traded derivatives subject to limits prescribed by SEBI and other conditions specified in Schedule 1.

Additionally, FPIs are now allowed to invest in non-convertible debentures / bonds issued by an unlisted Indian company. Earlier TISPRO allowed FPIs to invest in non-convertible debentures / bonds of following companies:

(a) listed Indian companies; or

(b) companies engaged in infrastructure sector; or

(c) NBFCs categorised as infrastructure finance companies; or

(d) Primary issue of non-convertible debentures / bonds provided they are listed within 15 days of issuance.

Further, any person resident outside India can enter into any derivative transaction subject to conditions laid down by RBI.

Additionally, it is now clarified that AD Bank can allow inward as well as outward remittances for permitted derivatives transaction.

(10) Remaining provisions relating to investment, transfer of securities, eligibility, etc.

All remaining provisions of Debt Regulations relating to investment, transfer, eligibility, taxes, repatriation are broadly similar to the erstwhile TISPRO.

Applicability of ECB provisions

Earlier TISPRO only governed investment by FPIs, NRIs, OCIs, foreign central banks and multilateral development banks in government securities, debt, non-convertible debentures and security receipts. The same are now covered under Debt Regulations.

In respect of debt instruments, other than the above, the same will be governed by ECB Regulations. Hence, non-convertible or optionally convertible debentures or preference shares would continue to be governed by ECB Regulations.

Debt Regulations only allow FPIs to invest in non-convertible debentures / bonds of an Indian company. Hence, NRIs, OCIs or any other person resident outside India if he / she wants to invest in non-convertible or optionally convertible instruments which are qualified as debt, the same would need to be in compliance with ECB Regulations.

CONCLUSION

With the onset of the above amendments, the FDI regime has now been divided into two categories, viz., Non-Debt and Debt. Further, Non-Debt would henceforth be governed by the Central Government in association with the RBI and Debt would be governed by RBI.

Going forward, it needs to be seen how this arrangement of the RBI and the Central Government works in tandem to ensure that relevant approvals under FEMA are received at the earliest.

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