INFOLEX
NEWSALERT

JANUARY 2018

FOREIGN INVESTMENT REGULATIONS AMENDED: ATTEMPT TO EASE FOREIGN INVESTORS' TROUBLES

1. INTRODUCTION

In an attempt to simplify, consolidate and clarify the regulations relating to foreign direct investment ("**FDI**") in Indian entities by foreign investors, the Reserve Bank of India (the "**RBI**") notified the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 (the "**New Regulations**")[1] replacing the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (the "**Former Regulations**").

2. KEY CHANGES

The key aspects of the New Regulations are summarized below.

2.1. Issue of share warrants to listed companies

'Share warrants' have been defined under the New Regulations to mean share warrants as issued in accordance with SEBI regulations.[2] The definition is a deviation from the Former Regulations, which defined a 'warrant' to include a share warrant issued by an Indian company in accordance with the applicable provisions of the Companies Act, 2013 (the "**Companies Act**").

It is unclear from the definition of 'share warrants' under the New Regulations, if the intention of the RBI is to prevent private limited companies from issuance of share warrants by linking the issuance to SEBI Regulations (which apply only to listed Indian companies).

The dichotomy becomes more prominent, especially in light of the Former Regulations, which subjected issuance of a share warrant only in accordance with the provisions of the Companies Act. The intent may have been only to specify certain conditions (such as upfront receipt of minimum price for the warrants) for issue of share warrants, and not to limit issue of share warrants to listed Indian companies only. However, to avoid any ambiguity, a clarification by the RBI in this regard will be most welcome.

2.2. Definition of FDI

While the Consolidated FDI Policy Circular, 2017 (the "**2017 FDI Policy**") defined FDI as "*investment by non-resident entity/person resident outside India in the capital of an Indian company under Schedule 1 of [the Former Regulations]*", the definition of the term under the New Regulations, indicates that any investment by a person resident outside India in

[1] Notification no. FEMA 20(R)/2017-RB, dated November 07, 2017, accessible at: https://rbi.org.in/Scripts/NotificationUser.aspx?Id=11161&Mode=0

[2] Regulation 2(v) of the New Regulations.

an unlisted Indian company, or more than 10 per cent in a listed Indian company on a '*fully diluted basis*', will be treated as FDI.[3]

"**Fully diluted basis**" has been defined to mean the total number of shares that would be outstanding, if all possible sources of conversion are exercised.

From the above definition, it is unclear whether the limit of 10 per cent for a listed Indian company applies on an individual basis or is an aggregate limit. Under the Former Regulations, the aggregate paid-up value of shares of any company purchased by all NRIs (which included OCIs[4]) on repatriation basis under the portfolio investment scheme ("**PIS**"), was not to exceed 5 per cent of the paid-up value of shares of the listed Indian company on an individual basis, and 10 per cent on an aggregate basis by all NRIs.

Previously, the aggregate limit of 10 per cent could be raised to 24 per cent if a special resolution of the listed Indian company was passed. Further, registered foreign portfolio investors ("**FPIs**") and registered foreign institutional investors ("**FIIs**"), were allowed to invest in up to 10 per cent of the total paid-up equity capital of a listed Indian company on an individual basis and in aggregate, up to 24 per cent of the paid-up capital of the listed Indian company.

The aggregate limit of 24 per cent, could be further extended up to the sectoral cap (as applicable), by the listed Indian company by way of a further special resolution. In addition to the NRI/OCI and FII/FPI limits which applied under the PIS (as mentioned above), Qualified Foreign Investors ("**QFIs**") were also permitted to invest in listed Indian companies, subject to specific conditions and limits.

However, now, the PIS has been done away with, under the New Regulations, any non-resident (not just FIIs, QFIs, NRIs, OCIs or FPIs) can hold up to 10 per cent in a listed Indian company without being subject to the caps, conditions, restrictions, filings or other requirements applicable in relation to FDI.

2.3. Foreign Portfolio Investment

A new term "**Foreign Portfolio Investment**" has been defined, which paves the way for *any* person, and not just an FPI, to invest in the securities of a listed Indian company, where the investment is: (i) less than 10 per cent of the post-issue paid-up share capital on a fully-diluted basis; or (ii) less than 10 per cent of the paid-up value of each series of securities, of a listed Indian company.

In case of FPIs, it has been clarified that the 10 per cent limit for FPIs, is applicable to each FPI or investor group as defined under the SEBI (Foreign Portfolio Investors) Regulations, 2014 (the "**SEBI FPI Regulations**").[5]

Further, FIIs holding a valid certificate of registration from SEBI, are deemed to be 'FPIs' for the purposes of the New Regulations, till the expiry of the block of 3 (three) years from the enactment of the SEBI FPI Regulations.[6] This is in line with the definition of 'FPI' under the SEBI FPI Regulations, and the transition of FIIs into the FPI regime.

2.4. Change of status of residence and further issues of shares

[3] Regulation 2(xvii) of the New Regulations.

[4] "**OCI**" refers to an overseas citizen of India.

[5] Regulation 2(xix) of the New Regulations.

[6] Regulation 2(xx) of the New Regulations.

The New Regulations provide that, in case of a *rights issue* or a *bonus issue* by an Indian company, where an individual who is a person resident outside India, exercises a right which was issued when he or she was a person resident in India, such person shall hold the capital instruments (other than share warrants) so acquired, on exercising the option on a *non-repatriation basis*.[7]

Similarly, in case of *employee stock options* or *sweat equity shares* issued by an Indian company, to a person resident outside India, in exercise of an option which was issued to such person when he or she was a person resident in India, it is provided that such person will hold the shares so acquired on exercising the option, on a *non-repatriation basis*.[8]

It appears that the intent is to ensure that any future issuances in the form of a rights or bonus issue will retain the characteristic of *non-repatriation*, from the conditions applicable to the underlying security on the basis of which such rights issue have been offered or bonus issue have been made. Essentially, irrespective of new securities being acquired post the change in status of that person's residence, they shall remain subject to the same conditions that applied to the original/underlying securities in furtherance of which such new securities have been acquired.

2.5. Transfer of securities upon liquidation, demerger or amalgamation of a foreign entity

Under the New Regulations, a person resident outside India (except an NRI or OCI, or erstwhile overseas corporate body) may now also transfer by way of sale or gift, to a person resident outside India, the capital instruments of an Indian company pursuant to liquidation, merger, demerger or amalgamation of entities incorporated outside India, subject to Government approvals as applicable to the specific sector.[9]

Further, a proviso to this regulation (which has not yet been notified), clarifies that where the person resident outside India is an FPI, and the acquisition of capital instruments results in a breach of the applicable aggregate FPI limits or sectoral limits, the FPI will be required to sell such capital instruments to a person resident in India who is eligible to hold such instruments, within the time period stipulated by the RBI in consultation with the Central Government.

Such breach, if within the prescribed time limit, will not be regarded as a contravention under the New Regulations and SEBI's guidelines will be applicable in this context.[10]

2.6. RBI approval for transfers from NRI or an OCI to non-resident person not required

The Former Regulations permitted an NRI holding securities of an Indian company to transfer the same by way of sale or gift to another NRI only; and a prior approval of the RBI was required for transfer of shares from an NRI to non-resident.

The New Regulations, however, provide that an NRI or OCI holding capital instruments of an Indian company or units *on repatriation basis* can transfer the same by way of sale or gift to *any person resident outside India.* Such transfer is granted under general permission, and is no longer subject to RBI approval.[11]

[7] Regulation 6 of the New Regulations.

[8] Regulation 7(3) of the New Regulations.

[9] Regulation 10(1) of the New Regulations.

[10] Please refer to Regulation 10(1), proviso (ii) of the New Regulations.
[11] Regulation 10(2) of the New Regulations.

The New Regulations further provide, that an NRI or OCI holding capital instruments of an Indian company or units on a *non-repatriation basis*, can transfer the same to a person resident outside India by way of *sale*, without RBI approval, subject to the adherence to applicable sectoral conditions, pricing guidelines and reporting requirements.

Further, an NRI or OCI holding capital instruments of an Indian company or units on a *non-repatriation basis*, can transfer the same to a person resident outside India by way of *gift* only with RBI approval, and subject to conditions (such as, eligibility of the *donee* to hold securities in the company, the gift not exceeding 5 per cent of paid-up capital of the company, the *donor* and *donee* being relatives and the gift (and any other transfers as gift by the *donor* in the same financial year) does not exceed a value of USD 50,000).

However, the RBI has not clarified its position with respect to whether approval will be required for transfers from NRIs to *Indian residents* as well. Based on the above commentary, it can be assumed and argued, that NRIs can freely transfer capital instruments of an Indian company or units, on a *repatriation basis* to a resident as well.

Further, the New Regulations do not clarify the position on transfer of capital instruments of an Indian company by an NRI to a resident on a *non-repatriation basis*. Since such transfer of capital instruments on a *non-repatriation basis* was anyway permitted under automatic route, the same has not been specifically set out in the New Regulations.

Furthermore, a proviso to this regulation (which has not yet been notified), clarifies that where the acquisition of capital instruments by an NRI or OCI results in a breach of the applicable aggregate NRI or OCI limits or sectoral limits, the NRI or OCI will be required to sell such capital instruments to a person resident in India who is eligible to hold such instruments within the time period stipulated by the RBI in consultation with the Central Government. Such breach, if within the prescribed time limit, will not be construed to be a contravention under the New Regulations.[12]

2.7. Pledge of securities by any Indian company

While the Former Regulations provided that a non-resident investor of an Indian listed company, could pledge its *listed shares* in favour of a non-banking financial company ("**NBFC**"),[13] the New Regulations now provide that the capital instruments of *any Indian company* may be pledged with an NBFC to secure credit facilities.[14] Thus, under the new regime, a non-resident investor may also pledge its shares in an unlisted company, in favour of an NBFC, to secure credit facilities.

2.8. New reporting requirements

In addition to gathering all reporting requirements for foreign investments under one regulation, certain new forms have also been introduced by the New Regulations.[15] However, the formats of these new forms, have not yet been prescribed.

(a) *Form LLP (I), Form LLP (II)*

These forms have been prescribed for limited liability partnerships ("**LLPs**") receiving foreign investment, disinvestment, transfer of capital contribution and profit shares, respectively;

[12] Please refer to Regulation 10(2), proviso (ii) of the New Regulations.

[13] Regulation 12(v) of the Former Regulations.

[14] Regulation 10(12)(b)(iii) of the New Regulations.

[15] Regulation 13 of the New Regulations.

(b) *Form DI*

While earlier, the Indian company making downstream investment in another Indian company, was required to notify the erstwhile Foreign Investment Promotion Board, such an Indian company is now required to file Form DI;

(c) *Form CN*

This is to be filed by any Indian 'startup company' issuing convertible notes to persons resident outside India.

Further, it has been clarified that the transfer of capital instruments in accordance with the New Regulations by way of sale between a person resident outside India holding capital instruments on a *non-repatriation basis* and a person resident in India, does not need to be reported in Form FC-TRS.

2.9. Fee for late filing of forms

As a welcome measure, the New Regulations provide that in case of any delays in fulfilling the prescribed reporting requirements, a late fee will be levied on the entity responsible. Earlier, such contraventions were liable to the residuary penalty provision under the Foreign Exchange Management Act, 1999 (which provided for a penalty up to 3 (three) times the amount involved where quantifiable, or INR 200,000 (approximately USD 3,100) where the amount was not quantifiable).[16] However, such late fees have not yet been prescribed.

2.10. Period for issue of capital instruments to foreign investors

The Former Regulations were at odds with the Companies Act, in stating that the securities with respect to foreign remittances could be issued within 180 (one hundred and eighty) days of receipt of consideration, whereas the Companies Act provided for issuance within 60 (sixty) days'. This disparity has been resolved, as the New Regulations are now aligned with the Companies Act, 2013.

2.11. Reclassification of FDI by an FPI

The New Regulations provide that the total investment made by the FPI shall be re-classified as FDI (subject to the conditions as specified by SEBI and the RBI), in case the total holding of an FPI increases to: (i) 10 per cent or more of the total paid-up equity capital on a fully diluted basis; or (ii) 10 per cent or more of the paid-up value of each series of debentures or preference shares or share warrants issued by an Indian listed company. Further, the Indian investee company and the foreign investor will have to comply with the reporting requirements prescribed in the New Regulations.[17]

2.12. No cap on dividend on preference shares

The New Regulations have done away with the cap of 300 (three hundred) basis points over the SBI Prime Lending Rate applicable to the dividend on compulsorily convertible preference shares ("CCPS").

[16] Section 13(1), Foreign Exchange Management Act, 1999.

[17] Schedule 2, paragraph 1(2) of the New Regulations.

This is a very welcome move, since due to this restriction earlier, foreign investors opted for other instruments (such as convertible debentures), instead of CCPS, while looking for certain fixed returns. Now that there is no cap on the dividend on CCPS, foreign investors can enjoy the benefit of higher dividend on CCPS issued by Indian companies.

2.13. Consolidation of FEMA 24

The stipulations under the Foreign Exchange Management (Investment in Firm or Proprietary Concern in India) Regulations, 2000 ("**FEMA 24**"), have been merged and consolidated in the New Regulations, without change.

3. POSITION REGARDING DOWNSTREAM INVESTMENT

3.1 With respect to downstream investment by an Indian entity having foreign investment, it has been clarified that "**total foreign investment**" (which is the total of foreign investment and '*indirect foreign investment*') into the downstream entity, must be calculated on a *fully diluted basis*.[18]

However, no specific definition of a '*fully diluted basis*' has been provided for in this clarification. Here, it is noteworthy that the only definition of a '*fully diluted basis*' in the New Regulations, is set out under the definition of "**FDI**" (as set out in paragraph 2.2 above).

This term has been defined in an explanation to the definition of FDI, and used only in light of a listed Indian company under the said definition. Hence, it is unclear if the definition of a '*fully diluted basis*' appearing under the definition of FDI, may be imported for the purpose of Regulation 14 of the New Regulations, with respect to downstream investments, and thereby applicable to *unlisted* companies as well. Until there is clarification from the RBI, it is our understanding that such definition of '*fully diluted basis'* cannot be read to be applicable to *unlisted* companies as well.

However, for calculation of total foreign investment into a downstream entity, the fully diluted capital has to be used for the basis of the calculation. This could lead to lack of coherence and ambiguity in the manner foreign investment must be calculated for an unlisted company for purposes of direct investment versus that to be calculated in case of downstream investment.

3.2 Downstream transfers

The New Regulations have introduced new provisions for downstream transfers, that is, transfers of capital instruments of an Indian company, held by an Indian company having foreign investment and which is owned and controlled by persons resident outside India, or which is not owned and controlled by resident Indian citizens ("**FOCC**"):[19]

Transferor	Transferee	Pricing guidelines[20]	Form FC-TRS Requirement
FOCC	Person resident outside India	Not applicable	Applicable
Person resident in India	FOCC	Applicable	Not applicable. However, Form DI to be filed
FOCC	Person resident in India	Applicable	Not applicable
FOCC	FOCC	Not applicable	Not applicable

[18] Regulation 14(1)(a) of the New Regulations.
[19] Regulation 14(5)(c) of the New Regulations.

[20] Please refer to Regulation 11 of the New Regulations.

The clarifications relating to pricing guidelines and reporting requirements, set out in the table above with respect to FOCCs, are again a welcome move, as there existed a fair bit of ambiguity with respect to transfers of capital instruments involving FOCCs.

4. SECTOR-SPECIFIC CHANGES

4.1. The key changes in the New Regulations from the 2017 FDI Policy are summarized below.

Sector	Earlier Position	New Position
Broadcasting	Provided for conditions (such as security clearance, infrastructure and software-related requirements, the monitoring of information, etc.)	The list of conditions applicable to such foreign investment has been significantly limited, with the key point being that in the 'Broadcasting' sector where the sectoral cap is up to 49 per cent, the *investee* company should be owned and controlled by resident Indian citizens or Indian companies which are owned and controlled by resident Indian citizens. The above-mentioned condition appears to clarify that FOCCs are not entitled to own or control *investee* companies in the broadcasting sector.
Single-brand retail trading	Provided for a committee to determine exemptions from sourcing norms for entities engaged in single-brand retail trading, on the basis that the products are 'state-of-the-art' and of 'cutting-edge' technology.	No such committee is provided for. Hence, the determination of which products will constitute 'state-of-art' and 'cutting-edge' technology has been left open.
White-label ATM operations	Provided for 100 per cent FDI in this sector.	This sector has been removed. However, since authorization from the RBI was required under the Payment and Settlement Systems Act, 2007 to set up white-label ATM operations, it can be argued that white-label ATM operations would be covered within the ambit of 'Other Financial Services' regulated by financial sector regulators (the RBI, in the instant case) and hence, 100 per cent FDI would be permitted in white-label

		ATM operations under the automatic route.[21]
Private security agencies	Foreign investment up to 49 per cent under the automatic route and beyond 49 per cent and up to 74 per cent under the approval route, was permitted for this sector.	Now, the sector is allowed foreign investment only up to 49 per cent under the approval route.
Commodity spot exchanges	No sector such as 'commodity spot exchanges'.	A new sector, 'commodities spot exchange', has been introduced, with a cap of 49 per cent FDI under automatic route. Investment under this sector is subject to guidelines prescribed by the Central or State Government.

5. INDUSLAW VIEW

The New Regulations go some way to providing much needed clarity and compartmentalization of various provisions, consolidating and simplifying the Former Regulations with a view to providing a comprehensive code applicable to a variety of foreign investment in India.

However, as highlighted above, certain inconsistencies still persist and require further clarity. The interpretation of certain language introduced by the New Regulations will require further refinement and we expect further clarifications from the RBI in the near future in this regard.

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[21] Item F10 under Regulation 16B of the New Regulations