INFOLEX
NEWSALERT

NOVEMBER 2019

NEW FOREIGN INVESTMENT RULES AND REGULATIONS: THE BANK SURRENDERS THE BATON?

1. INTRODUCTION

On October 17, 2019, the Central Government issued the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (the "**Rules**"), and the RBI notified the Foreign Exchange Management (Debt Instrument) Regulations, 2019 (the "**Debt Regulations**"), and the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019.

The Rules and both the regulations supersede the Foreign Exchange Management (Transfer of Issue of Security by a Person Resident outside India) Regulations, 2017 (the "**TISPRO**"). The Rules also supersede the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2018.

2. KEY ASPECTS

The major changes brought in by the Rules and the Debt Regulations have been discussed below.

2.1. Dilution of Authority of the RBI

Earlier, the RBI was entrusted with powers to approve transactions which were not covered under general permission. The Rules have introduced additional language which mandates that the applications for the approval of the transactions which are not under the purview of general permission, will need to be decided after consultation with Central Government.

The RBI has been the final authority for approving such transactions in the past. The new provisions are a deviation which will result in a greater involvement of the Central Government into the non-general permission matters.

Central Government consultation has now also been prescribed for several other items including approving transfers not covered through general permission, divestment of investments by non-resident Indians ("**NRIs**") or overseas citizens of Indians ("**OCIs**") in case of a breach of the relevant limits or sectoral caps, and issuance of shares in case of swap of equity instruments.

2.2. Replacement of the definition of 'capital instruments' with 'equity instruments', 'debt instruments' and 'non-debt instruments'

The definition of 'equity instruments' is similar to the definition of 'capital instruments' as defined in the earlier regime. The following paragraph in the definition of 'capital instruments' under the erstwhile TISPRO has been deleted:

"Capital instruments shall include non-convertible/ optionally convertible/ partially convertible preference shares issued as on and up to April 30, 2007 and optionally convertible/ partially convertible debentures issued up to June 7, 2007 till their original maturity. Non-convertible/ optionally convertible/ partially convertible preference shares issued after April 30, 2007 shall be treated as debt and shall conform to External Commercial Borrowings guidelines regulated under Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2000."

Since the above portion is deleted, it creates confusion on how such non-convertible, optionally convertible or partially convertible preference shares shall be treated. Irrespective of such deletion, we believe that these instruments should continue to be covered under the external commercial borrowing ("**ECB**") framework.

Further, "non-debt instruments' are defined to include what was originally covered as capital instruments under TISPRO and additionally, to also include:

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

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

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

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

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

(viii) contribution to trusts;…"

Now, these instruments will be under the purview of the Rules and it will have to be seen how some of these items will be treated as instruments.

2.3. **Changes in definitions**

The following definitions have been changed:

(a) *"listed Indian company" means an Indian company which has any of its equity instruments or debt instruments listed on a recognized stock exchange in India and the expression "unlisted Indian company" shall be construed accordingly*.

(b) *"sectoral cap" means the maximum investment including both foreign investment on a repatriation basis by persons resident outside India in equity and debt instruments of a company or the capital of an LLP, as* *the case may be, and indirect foreign investment, unless provided otherwise. This shall be the composite limit for the Indian investee entity.*

The term 'debt instruments' has been defined to mean any instruments other than non-debt instruments. Thus, the inclusion of debt instruments in the definition of listed Indian company and sectoral cap creates confusion and deviates from the principles of the foreign direct investment ("**FDI**") policy and TISPRO. It is premature to comment on the impact of these changes and it is better to wait for the government to provide further clarification in this regard.

2.4. **Introduction of 'hybrid securities'**

A definition of 'hybrid securities' has been introduced by the Rules. However, the term does not find place anywhere else in the Rules or in the Debt Regulations.

The Rules define 'hybrid securities' as 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.

This raises concern on how such hybrid securities will be treated and under which conditions can they be issued to non-residents, among others. As mentioned above, instruments such as optionally convertible or partially convertible preference shares should continue to be governed by the ECB regime.

2.5. **Start-ups**

The definition of a start-up company under the Rules still refers to the old definition as per the notification issued by the department of industrial policy and promotion in 2016, while in the Schedule VII in relation to foreign venture capital investors ("**FVCIs**"), a start-up company is defined as per the notification issued by the department of industrial policy and promotion in 2018.

This begs the question whether this discrepancy is willful and whether the revised thresholds under the notification of 2018 for start-ups are not to be made applicable while considering the relaxation for issuance of convertible notes among others.

Since the notification of 2018 supersedes the notification of 2016 and the start-up notification of 2019 is in supersession of the notification of 2018, the references to notifications of 2016 and 2018 in the Rules can be read as the start-up notification as amended from time to time.

2.6. **Non-incorporation of Press Note 4 of 2019 ("PN4")**

The Rules appear to ignore the following changes to the FDI policy introduced through press note 4 of 2019 issued by the department for promotion of industry and internal trade ("**DIPP**"):

(a) *Manufacturing*: The definition and description of manufacturing as a sector does not take into account that manufacturing can be done through 'contract manufacturing'.

(b) *Single Brand Retail Trading ("**SBRT**")*: The sectoral cap is still reflected as 49% versus 100% under the automatic route, as permitted through PN4. Further, the relaxed conditions for operating an SBRT business from PN4 have not being accounted for either.

(c) *Digital Media*: The restriction in relation to uploading or streaming of news and current affairs through digital media does not find place in these Rules.

(d) *Coal and mining*: The changes such as any sale of coal (not just sale of coal post processing of such coal), coal mining (not just for captive consumption) and other associated coal mining activities being permitted, have not been accounted for.

Considering the approach of the current government and all the measures being implemented to enhance the ease of doing business in India, it seems unlikely that the intention of the government was to revert from a liberalized regime to a stricter one. In this regard, it appears when the PN4 changes were notified, the ministry was already in the advanced stages of publishing the Rules (which included consultation with the RBI and the ministry of law and justice). Hence these Rules were published without incorporating the PN4 changes. We expect that the Rules will be amended subsequently to incorporate such changes. This will be in line with the process which was earlier followed for revising TISPRO to account for changes notified by DIPP through the press notes issued by them.

That said, since the Rules are superior law and supersede the TISPRO, the current position in law should be as provided by the Rules and one should not rely on the relaxations provided by PN4 till the Rules are amended to incorporate such changes.

2.7. **Pricing guidelines**

The provisions on pricing guidelines no longer contain the following explanation:

"…in case of convertible capital instruments, the price/ conversion formula of the instrument should be determined upfront at the time of issue of the instrument. The price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such instruments, in accordance with these Regulations."

In relation to a convertible equity instrument, this deletion raises uncertainty as to the relevant time for complying with the requirements with regard to the fair market value ("**FMV**"). It is unclear whether the pricing guidelines shall have to be met at time of conversion, at the FMV prevalent then or at the FMV prevalent at the date of issuance. Thus, in some cases defeating the purpose of having pricing guidelines applicable to a convertible instrument or a formula for converting it.

Further, convertible notes ("**CNs**") are not covered within the definition of an equity instrument and hence not part a of the non-debt instruments. Similar to the previous regime, CNs can be converted into equity shares, only upon meeting the conditions for conversion and the relevant sectoral caps, and pricing guidelines, among others. Given that the language on conversion price being higher than the FMV at time of issuance is not included in the Rules, it is uncertain whether the FMV at time of issuance of the CN can be used as a reference point for conversion of the CN or whether the holder needs to meet the FMV for such CN as at the time of conversion.

However, until further clarity is provided, it is prudent to comply with the pricing guidelines at the time of conversion basis the FMV at the time of issuance of a convertible equity instrument, as was the requirement under TISPRO.

2.8. **Foreign Portfolio Investment ("FPI")**

As per the Rules, the FPI limits will stand revised to the relevant sectoral caps, with effect from April 1, 2020. Unlike TISPRO which required the companies to pass resolutions to increase the cap for FPI, now the deemed limit for FPI is the relevant sectoral cap. If a company is desirous of decreasing the limit (to a lower threshold limit of 24% or 49% or 74% as deemed fit), it will require its board of directors and the members to pass resolutions to that effect, before March 31, 2020.

Further, the Rules provide that the Indian company which has decreased its aggregate limit to 24% or 49% or 74%, may increase such aggregate limit to 49% or 74% or the sectoral cap or statutory ceiling respectively as deemed fit, with the approval of its board of directors and its members, through a resolution and a special resolution, respectively. However, once the limits are increased as aforesaid, the same cannot be decreased again.

However, if FDI is prohibited in a company, the cap for FPI for such company remains at 24%, in aggregate. In case FPI thresholds are exceeded, such FPI entity will have 5 trading days to divest such excess holding, failing which, the investment will be deemed to be FDI.

The FPIs have now also been permitted to invest in Category III AIFs and offshore funds for which no-objection certificate has been issued under the SEBI (Mutual Funds) Regulations, 1996 and which invest more than 50% in equity or in units of REITS and InvITs, on a repatriation basis.

Earlier, an FPI could have acquired more than 24% of the total shareholding in a company, only if the shareholders agreed to increase the limit for FPI. However, now that the limit is deemed to be the sectoral cap, if the shareholders do not resolve to decrease the limit before March 31, 2020, an FPI can acquire more than 24% stake (up to the sectoral cap) without any specific consent of the board of directors and the shareholders, but subject to the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (the "**Takeover Code**"). Interestingly, this deemed increase in the limit for FPI may make listed companies susceptible to a creeping acquisition or a hostile takeover under the Takeover Code by an FPI, even without the board of directors and the shareholders agreeing to increase the limit to allow for such acquisitions.

2.9. **Transfers**

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, a 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.*

2.10. **Investment Vehicle**

Apart from REIT, InvIts. AIF, even Mutual Funds (governed by SEBI (Mutual Funds) Regulations, 1996) which invest more than 50% in equity, have now been included under the definition of an "investment vehicle"

2.11. **Requirements with respect to capitalisation of pre-incorporation expenses**

A resident wholly owned subsidiary of a foreign entity is permitted to issue shares to the holding company against any amount invested as pre-incorporation expenses by such holding company. In this regard, the following language included in TISPRO, with regard to the requirement of procuring a statutory auditor certificate is missing in the Rules:

"A certificate issued by the statutory auditor of the Indian company that the amount of pre-incorporation/ pre-operative expenses against which capital instruments have been issued has been utilized for the purpose for which it was received should be submitted with the Form FC-GPR. Explanation: Pre-incorporation/ pre-operative expenses shall include amounts remitted to Investee Company's account, to the investor's account in India if it exists, to any consultant, attorney or to any other material/ service provider for expenditure relating to incorporation or necessary for commencement of operations."

It is unlikely that the intention was to remove such a requirement completely, particularly the explanation as to what can be termed as pre-incorporation or pre-operative expenses and a clarification is required in this regard.

2.12. **Provisions for Non-Resident Indians** ("**NRIs**") **and Overseas Citizen of India** ("**OCI**")

OCI's can now enroll for the national pension scheme governed and administered by Pension Fund Regulatory and Development Authority of India, which was not allowed earlier. Further, NRIs and OCIs can now invest in units of domestic funds which invest more than 50% in equity.

2.13. **E-commerce**

E-commerce business can now only be undertaken by a company incorporated or existing under the Companies Act, 2013 or the Companies Act 1956. The definition of an 'e-commerce entity' no longer includes a foreign company covered under section 2(42) of the Companies Act, 2013 or an office, branch or agency in India owned or controlled by a person resident outside India and conducting the e-commerce business.

This does not really change the position in relation to FDI, since a foreign company was never governed through the FDI regime. However, there has been some back and forth on the inclusion and removal of foreign companies from this definition. This is a welcome change and reduces a lot of confusion.

2.14. **The Debt Regulations**

The provisions on investments by FPI, NRI, OCI, foreign central banks, and multilateral development banks, in government securities, debt, non-convertible debentures, and security receipts, among others (which were earlier part of TISPRO), have been moved to the Debt Regulations. These should not be confused as regulations governing pure debt and borrowing obligations. An external commercial borrowing continues to be governed by the ECB Regulations.

Earlier, it was clear that the non-convertible or optionally convertible instruments issued to non-residents will be covered under the ECB regulations. Now the language which clarified this position has not been included in the Rules, and the 'debt instruments' are defined as instruments which are not 'non-debt instruments'.

Thus, there seems to be a confusion as to what will govern the issuance of non-convertible instruments or optionally convertible instruments to any person which is not governed as issuance of specified securities to FPIs, NRIs, OCIs, and foreign banks under the Debt Regulations.

It appears that all other types of investors in respect of instruments such as non-convertible debentures, optionally convertible debentures, optionally convertible preference shares, redeemable preference shares, and optionally convertible redeemable preference shares, among others, will continue to be governed by the ECB regulations.

INDUSLAW VIEW

The Rules have been issued under section 46 of Foreign Exchange Management Act, 1999 ("**FEMA**") unlike TISPRO which were regulations issued by RBI though the powers delegated to it by the Central Government under FEMA.

As mentioned above, the provisions stipulating consultation of the Central Government are a deviation from the TISPRO regime. Given that for several years, the RBI has been dealing with applications for seeking permissions for FDI under FEMA, among other matters, it remains to be seen how this change will affect the overall process and timelines. On the other hand, it may provide RBI an opportunity to efficiently utilize its resources towards lender supervision and implementation of the monetary policy.

It also remains to be seen how certain non-debt instruments are treated as FDI instruments or how the issuance of non-convertible or optionally convertible instruments to non-residents will be governed. The Rules and the Debt Regulations definitely require further changes and clarification.

Authors: Avimukt Dar | Akhoury Winnie Shekhar | Jaidrath Zaveri | Nabarun Chandra Ray

Practice Areas: Corporate & Commercial | Government & Regulatory | Private Equity, Venture Capital & Fund Investment | Capital Markets & International Offerings

Date: November 08, 2019

DISCLAIMER

This alert is for information purposes only. Nothing contained herein is, purports to be, or is intended as legal advice and you should seek legal advice before you act on any information or view expressed herein.

Although we have endeavored to accurately reflect the subject matter of this alert, we make no representation or warranty, express or implied, in any manner whatsoever in connection with the contents of this alert.

No recipient of this alert should construe this alert as an attempt to solicit business in any manner whatsoever.