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Analysing developments impacting business

IMPACT OF THE NEW FOREIGN EXCHANGE LAWS ON INVESTMENT FUNDS: WHAT HAS CHANGED?

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The Ministry of Finance on 17 October 2019, released the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (NDI Rules) in supersession of the Foreign Exchange Management (Transfer of Issue of Security by a Person Resident outside India) Regulations, 2017 (TISPRO Regulations) and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2018. With this, the Reserve Bank of India (RBI) also notified the Foreign Exchange Management (Debt Instruments) Regulations, 2019 (DI Regulations), in supersession of TISPRO Regulations, thereby creating a dual foreign exchange regime for both non-debt instruments and debt instruments. The rationale behind such revamp is to ensure that RBI governs the debt segment, whereas the Central Government regulates non-debt segment. Pursuant to the same, while such bifurcation of foreign exchange laws into debt and non-debt instruments brings about more structured legal regimes for these instruments and facilitates ease of prospective regulatory amendments with respect to these classes of instruments, it is notable that there are some changes introduced in the NDI Rules and DI Regulations, that may have significant implications on the investment funds industry.

- *Inclusion of equity oriented mutual funds in the definition of 'investment vehicles':* Under the NDI Rules, the definition of "investment vehicle" includes an entity registered and regulated under the regulations framed by the Securities and Exchange Board of India or any other authority designated for that purpose and shall include, *inter alia*, mutual funds which invest more than 50% in equity governed by the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 (Mutual Funds Regulations).

With the inclusion of equity oriented mutual funds in the definition of investment vehicles, mutual funds investing more than 50% of their corpus in equity and are 'foreign owned or controlled' will be subject to the downstream investment restrictions under Schedule VIII of the NDI Rules. Pursuant to this, such foreign owned and controlled mutual funds will be required to comply with the filing requirements relevant for investment vehicles under NDI Rules. These reporting requirements will entail such mutual funds to duly submit Form InVI in relation to receipt of foreign investment upon issuance of units to persons resident outside India, Form DI in relation to any downstream investment made by such mutual funds in another Indian entity, and Form Foreign Liabilities and Assets (FLA) regarding foreign assets and liabilities of such mutual funds, with the relevant regulatory authorities. Further, the recently introduced requirement for foreign owned and controlled investment vehicles to notify downstream investments

made by them to the Secretariat for Industrial Assistance, Department for Promotion of Industry and Internal Trade (DPIIT) (as *discussed later*) will also be applicable to foreign owned and controlled mutual funds. It is notable that Category III alternative investment funds (AIF) that have foreign owned and controlled manager/sponsor and taking long-short positions as a part of the investment strategy were already facing the brunt of these downstream investment restrictions and consequent filing requirements.

- Aggregate holding of foreign portfolio investors (FPIs) in an Indian company: Under the erstwhile TISPRO Regulations, language that was pertinent to the aggregate holding of FPIs in Indian companies read in a manner that indicated that the total holdings of all FPIs put together shall not exceed 24% of paid-up equity capital on a fully diluted basis or paid up value of each series of debentures or preference shares or share warrants. However, under the NDI Rules, the modification that has been introduced in this language indicates that the total holdings of all FPIs put together, "including any other direct and indirect foreign investments in the Indian company permitted under these rules", shall not exceed the 24% threshold. Therefore, the extent of the word "holdings" has been clarified to include any other direct and indirect foreign investment in an Indian company, that is in accordance with the NDI Rules. This clarificatory language that has been introduced indicates that for the purposes of calculation of the applicable investment limits for an FPI investing in an Indian company, even foreign direct investment (FDI) investments made by registered FPIs will be counted towards the 24% aggregate FPI limitation.
- Levelling of the aggregate limit for FPIs with sectoral caps: With effect from 1 April 2020, the aggregate limit for FPIs with respect to Indian companies will be as per the relevant sectoral caps applicable to the Indian company, as per the NDI Rules, with respect to its paid-up equity capital on a fully diluted basis or such same sectoral cap percentage of paid up value of each series of debentures or preference shares or share warrants. This change effectively ensures that only sectoral limitations shall apply to the companies receiving foreign investment from FPIs.

Further, a window continuing till 31 March 2020 has been made available to Indian companies to decrease the aggregate limit to a lower threshold limit of 24% or 49% or 74%, with the approval of its board of directors and its general body through a resolution and a special resolution, respectively. Once an Indian company which has decreased its aggregate limit, it may only increase such aggregate limit to 49%, 74% or the sectoral cap as relevant, with the approval of its board of directors and its general body through a resolution and a special resolution, respectively.

Once the aggregate limit has been increased to a higher threshold, an Indian company cannot reduce the same to a lower threshold. Further, in case of prohibited sectors, aggregate limit with respect to an Indian company in a sector where FDI is prohibited will be 24%.

Further, provisions in relation to the divestment of excess holding of FPIs in breach of the stipulated thresholds as provided in the SEBI (FPI) Regulations 2019 (FPI Regulations) have been included in the NDI Rules. Additionally, clubbing of FPIs as a part of the same investor group based on common control exceeding 50% and the related conditions and exemptions that are relevant to the same, as have been provided under the FPI Regulations, also find a place in the NDI Rules.

- Purchase or sale of securities other than equity instruments by FPIs: The NDI Rules have expressly permitted FPIs to purchase units of domestic mutual funds, Category III AIFs, and offshore funds for which no objection is issued in

accordance with the Mutual Fund Regulations, which in turn invest more than 50% in equity instruments on repatriation basis subject to the terms and conditions specified by the Securities and Exchange Board of India (SEBI) and RBI. Further, FPIs are permitted to purchase units of real estate investment trusts (REITs) and infrastructure investment trusts (InvITs) on repatriation basis subject to the terms and conditions specified by SEBI. Further, FPI investment in liquid and money market mutual fund schemes continues to be prohibited.

Additionally, there is a need for clarification regarding the participation of FPIs in hybrid mutual funds, i.e. such mutual funds that allocate their investment in both debt and equity instruments. Whether investment in such fluid hybrid mutual funds will be governed by the NDI Rules or the DI Regulations is a grey area that will need some elucidation.

- "Sector-free" eligibility for foreign venture capital investors (FVCIs) to invest in start-ups: Under the erstwhile TISPRO_Regulations, FVCIs were permitted to invest in securities of start-ups. However, the NDI Rules narrow down the earlier language in this regard to specify that FVCIs are permitted to invest in equity, equity linked instrument or debt instrument issued by an Indian 'start-up' irrespective of the sector in which the start-up is engaged. Further, for the purposes of investment by FVCI in start-ups, the definition of a start-up is as per Department for Promotion of Industry and Internal Trade's (DPIIT) Notification No. G.S.R. 364(E), dated the 11 April 2018, which now defines start-ups to include start-ups existing for up to a period of 7 years from the date of incorporation/registration (as compared to start-ups up to 5 years from the date of its incorporation/registration previously). Further, for start-ups in the biotechnology sector, the period for existence is up to 10 years from the date of its incorporation/ registration. Additionally, start-ups now also include such eligible entities that have a scalable business model with a high potential of employment generation or wealth creation, which was not the case as per the definition of start-ups referred to in the erstwhile TISPRO Regulations. However, an important point to note in this regard is that the said DPIIT notification dated 11 April 2018 has been superseded by a subsequent DPIIT notification dated 19 February 2019, wherein the definition of start-ups has been made more inclusive in terms of the number of years of operation, turnover cap, etc. However, for the purposes of FVCI investment in start-ups, the definition of start-ups will be as per the 2018 notification, thereby limiting FVCI investment in start-ups.
- Reporting for investment vehicles making downstream investment: With respect to the reporting requirements for investment vehicles under the NDI Rules, while the reporting obligation for AIFs issuing units to a person resident outside India to file Form InVI for receipt of foreign investment and Form DI in relation to an AIF making downstream investment in another Indian entity still subsist, an additional reporting obligation for such downstream investments made by AIFs is introduced under Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations 2019. The NDI Rules now mandate AIFs making downstream investment in another Indian entity to notify the Secretariat for Industrial Assistance, DPIIT within 30 days of such investment, even if equity instruments have not been allotted, along with the modality of investment in new/existing ventures (with/without expansion programme). This is in addition to the Form FLA (Foreign Liabilities and Assets) that is required to be submitted by AIFs in relation to the foreign investment received by them.

In addition to introduction of parallel regulatory regimes for both debt and non-debt instruments, the new foreign exchange regime has effectively collated and harmonised the regulatory positions for investment funds, mutual funds and FPIs, that were earlier present under multiple circulars and notifications released SEBI and RBI. While the key changes under the new regime are largely mirroring the FPI Regulations for FPIs, the

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position for other investment products remains largely aligned with the erstwhile TISPRO Regulations. Considering that segregation of regulation of non-debt and debt instruments will establish delineated boundaries in terms of regulation and enforcement, treatment of such investment instruments and products that still lie in the nebulous frontier between debt and non-debt instruments like hybrid mutual funds is yet to be seen.

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