

ERGO

Analysing developments impacting business

FOREIGN INVESTMENT – STREAMLINING THE REGULATORY STRUCTURE

23 October 2019

With effect from 15 October 2015, amendments in terms of sections 139, section 143(i) and section 144 of the Finance Act, 2015 (Finance Act) which amend the Foreign Exchange Management Act, 1999 (FEMA) have been notified.

A brief summary of the impact of these amendments and rules and regulations notified pursuant thereto is summarized below:

Distinction between powers of Central Government and Reserve Bank of India

- The amendment aims to clearly lay down the specific provisions regarding powers of the Reserve Bank of India (RBI) and Central Government in relation to transactions contemplated under the FEMA.
- By virtue of Section 6(a) of FEMA, RBI has been empowered to classify permissible capital account transactions that involve debt instruments in consultation with the Central Government. Further in terms of the amended section 47 of FEMA, RBI is authorized to frame regulations in relation to debt instruments which includes setting limits and other restrictions.
- Further, under section 46 of FEMA the Central Government, has been empowered to frame rules in relation to non-debt instruments, which includes laying down limits, and other restrictions.

FEMA (Non-debt Instruments) Rules, 2019 – Supersession of Old FEMA 20

In light of the aforesaid amendments to FEMA, the Central Government, vide notification dated 17 October 2019, notified the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (NDI Rules)¹ in supersession of the Foreign Exchange Management (Transfer and Issue of Security by a Person Resident outside India) Regulations, 2017 (Old FEMA 20) and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2018 (Immovable Property Regulations). While the Immovable Property Regulations have been included in the NDI Rules, there are no substantial amendments to these regulations. The RBI has, vide Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt

¹ In terms of clause (aa) and (bb) of subsection (2) of section 46 of the Foreign Exchange Management Act, 1999

Instruments) Regulations, 2019 laid down the mode of payment and attendant conditions.

Changes in definitions of the NDI Rules

- Equity Instruments: The term “capital instruments” has been deleted and replaced with “equity instruments” throughout the NDI Rules. The definition of equity instruments now includes convertible debentures, which formed part of capital instruments in the Old FEMA 20.
- Hybrid Instruments: A definition of “hybrid instruments” has been introduced to mean hybrid instruments such as optionally or partially convertible preference shares or debentures and other such instruments as specified by the Central Government, which can be issued by an Indian company or trust to a person resident outside India. However, this expression has not been used in the NDI Rules.
- Investment Vehicle: The term “investment vehicle” now also includes mutual funds that invest more than 50% in Equity Instruments and are governed by the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 (Mutual Funds Regulations).
- Debt and Non-Debt Instruments: The clear distinction has been made between debt and non-debt instruments by these amendments to FEMA and the rules and regulations notified pursuant to these amendments. Debt instruments mean all instruments other than non-debt instruments. The non-debt instruments mean: (i) all investments in equity instruments in incorporated entities: public, private, listed and unlisted; (ii) capital participation in LLP; (iii) all instruments of investment recognized in the extant foreign direct investment policy notified from time to time (FDI Policy); 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 50% in equity; (vi) junior-most layer (i.e. equity tranche) of securitisation structure; acquisition, sale or dealing directly in immovable property; (viii) contribution to trusts; and (ix) depository receipts issued against equity instruments.

Conditions applicable to all investors

Requirement of consultation with Central Government has been added in certain provisions of the NDI Rules, including:

- to permit a person resident outside India to make any investment in India subject to such conditions as may be considered necessary;
- to permit an Indian entity or an investment vehicle, or a venture capital fund or a firm or an association of persons or a proprietary concern to receive any investment in India from a person resident outside India or to record such investment subject to such conditions as may be considered necessary;
- specifying pricing guidelines, documentation and reporting requirements.

Sector changes

- E-commerce can now only be undertaken by a company incorporated or existing under the Companies Act, 2013 and 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.

- Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Amendment) Regulations, 2018 had amended the sectoral cap and entry route for single brand product retail trading to 100% under automatic route. These amendments had further liberalized sectoral conditions in relation to this sector. However, the NDI Rules have restored the position as was prevalent in the Old FEMA 20 prior to the amendment in 2018, with the entry route being automatic for foreign investment up to 49% and approval route beyond 49%.
- The NDI Rules have not taken into account the changes brought about in the FDI policy by press note no. 4 of 2019 released by Department for Promotion of Industry and Internal Trade on 18 September 2019 in relation to FDI in coal mining, single brand retail, contract manufacturing and digital media.

Investments by Foreign Portfolio Investors (FPI)

- Old FEMA 20 provided for an individual limit of 10% and aggregate limit of 24% of the paid-up value of each series of debentures or preference shares or share warrants issued by an Indian company. In terms of the NDI Rules with effect from 1 April 2020, the aggregate FPI limit shall be the sectoral caps applicable to the Indian company as set out in Schedule I of the NDI Rules.
- The aggregate limit as provided above, may be decreased by the Indian company (prior to 31 March 2020) or increased with the approval of its board of directors and its shareholders by a special resolution. However, once increased, the limits cannot be reduced.
- The aggregate limit with respect to an Indian company in a sector where FDI is prohibited would be 24%.
- In case FPI investment thresholds are exceeded, such FPI entity would have 5 trading days to divest excess holding, failing which, investment would be re-categorised as FDI.
- FPIs have been permitted to invest in Category III AIFs and offshore funds for which no-objection certificate has been issued under the Mutual Funds Regulations and which invest more than 50% in equity or in units of REITs and InvITs all on repatriation basis.

Other changes

- Foreign venture capital institutions (FVCIs) have been permitted to invest in equity, equity linked instruments or debt instruments of Indian start-ups (irrespective of the sector in which start-up is engaged in). If the investment is being made in an equity instrument of a start-up, then the FVCI must comply with the sectoral caps, entry routes and other specified conditions.
- Non-resident Indians and Overseas Citizens of India can now purchase or sell units of domestic funds which invest more than 50% in equity.
- The requirement to determine the price or conversion formula of a convertible instrument would no longer be applicable. As such, the price of convertible instruments may be either determined upfront or not earlier than 30 days of

the date on which the holder of convertible security becomes entitled to apply for shares.

- The power to prescribe terms and conditions for investment by an FVCI is now vested with the Central Government instead of the RBI.

Comment

The amendments to FEMA and consequential introduction of NDI Rules are welcome steps to avoid conflicts between different regulations and policies and to clearly set the rules for investment in India. However, it remains to be seen how the additional consultative powers would be exercised by the Central Government and RBI without impacting the efficiency and timelines in relation to implementation.

Further, in relation to sectoral caps, there are discrepancies between the NDI Rules and the existing position under the extant regulations. We expect further clarifications on these issues in due course.

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