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Analysing developments impacting business

RECENT CHANGES TO INDIA'S FDI LAWS

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Introduction

India's policy on foreign direct investment (FDI) is embodied in the Consolidated FDI Policy dated 15 October 2020 (as amended from time to time) (FDI Policy). The policy pronouncements made under the FDI Policy are notified in the Foreign Exchange Management (Non-Debt Instruments) Rules 2019 (NDI Rules), under the Foreign Exchange Management Act 1999.

On 14 March 2022, the Department for Promotion of Industry and Internal Trade, Ministry of Commerce & Industry, Government of India had issued Press Note 1 (2022 series) (PN 1) to amend the FDI Policy. The focus of PN 1 was on the review of the FDI Policy for permitting foreign investment in Life Insurance Corporation of India (LIC) and other modifications for further clarity of the existing FDI Policy. This pronouncement of PN 1 was recently notified in the NDI Rules, vide a gazette notification dated 12 April 2022 issued by the Department of Economic Affairs, Ministry of Finance, Government of India titled 'Foreign Exchange Management (Non-Debt Instruments) (Amendment) Rules 2022' (Amendment Rules). The Amendment Rules (and consequently PN 1) have become effective from 12 April 2022.

Key Highlights of PN 1 and Amendment Rules

- **FDI in LIC:** As India's largest insurance company and a crown jewel of the Government of India, LIC is set to be listed on the Indian stock exchanges in the next couple of months. The Government of India (presently the sole shareholder of LIC) plans to offload a minority stake in this listing. LIC has conducted several roadshows to invite foreign funds for purchasing a part of the Government's stake in the initial public offering (IPO).

Unlike most government business undertakings which are constituted as 'government companies' under the Companies Act 2013 (Companies Act), LIC has been constituted as a 'corporation' under the Life Insurance Corporation Act 1956 (LIC Act). FDI into LIC in this IPO was meeting a procedural roadblock - as FDI under the NDI Rules / FDI Policy can only be made in an Indian company (being a "company incorporated in India") or a limited liability partnership, and LIC was not meeting the test of an 'Indian company'.

PN 1 and the Amendment Rules aim to rectify this procedural issue. The definition of 'Indian company' under the FDI Policy and NDI Rules has been

modified to include "a body corporate established or constituted by or under any Central or State Act". The definition of 'equity shares' has also been modified on similar lines.

To avoid any confusion, it has been clarified that 'Indian company' does not include a society, trust or any entity, which is excluded as an eligible investee entity under the FDI Policy.

PN 1 and the Amendment Rules also specify the following conditions in order to facilitate foreign investment in LIC:

- foreign investment shall be upto 20% of LIC's total paid-up capital, under the 'automatic' route;
 - foreign investment shall be subject to the provisions of the LIC Act and such provisions of the Insurance Act 1938 as are applicable to LIC;
 - foreign portfolio investment shall be governed by the relevant provisions of the SEBI (Foreign Portfolio Investors) Regulations 2019; and
 - any increase in foreign investment shall be in accordance with the pricing guidelines specified in the NDI Rules.
- *Convertible Notes:* Convertible note is a hybrid instrument that uniquely combine features of debt and equity. Per the NDI Rules / FDI Policy, these instruments can only be issued by a startup company. Convertible notes are typically opted by seed investors intending to invest in an early-stage startup whose valuation is not evident. These notes acknowledge receipt of money initially as debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of the startup company, within a specified period from the date of issue of the convertible note (Specified Period), upon the occurrence of specified events as set out in the instrument's terms and conditions. PN 1 and Amendment Rules have amended the Specified Period from 'five years' to 'ten years'.

The Government vide its notification dated 19 February 2019 had extended special tax benefits to 'startup companies'. A 'startup company' could avail of such benefits for a period of ten years from its incorporation/registration. As the benefits of convertible instruments are also available only to start-ups, the Government appears to have aligned the Specified Period in the definition of convertible instruments with that of a 'startup company'.

- *Share Based Employee Benefits:* Prior to the recent amendment, the NDI Rules / FDI Policy recognized ESOPs and sweat equity shares as the two forms of employee-incentive instruments that an Indian company could issue to its employees or directors or employees or directors of its holding company or joint venture or wholly owned overseas subsidiary or subsidiaries who are resident outside India. PN 1 and Amendment Rules have added a third form of incentive scheme to this list - a 'share based employee benefits' scheme (Share Based Benefits).

The Amendment Rules define Share Based Benefits as "issue of equity instruments to employees or directors or employees or directors of the holding company or joint venture or wholly owned overseas subsidiary or subsidiaries who are resident outside India, pursuant to Share Based Employee Benefits schemes formulated by an Indian Company".

The updated Rule 8(a) of the NDI Rules clarifies that the scheme (ESOPs / sweat equity shares / Share Based Benefits) should have been drawn either in

terms of regulations issued under the Securities and Exchange Board of India Act 1992 or the Companies (Share Capital and Debentures) Rules 2014 or as per other applicable law, as the case may be. Accordingly, while Share Based Benefits as a new form of employee-incentive mechanism has been introduced for employees resident outside India, companies will have to satisfy the test of the scheme of such Share Based Benefits being drawn in terms of applicable law.

Interestingly, the Amendment Rules and PN 1 carry different definitions of Share Based Benefits (with PN 1's definition being restricted to schemes formulated by a 'body corporate' established or constituted by or under any central or state legislation).

- *Merger or demerger or amalgamation of Indian companies:* Rule 19 of the NDI Rules permits issuance of shares to a non-resident as a consideration for 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, which has been approved by the National Company Law Tribunal. PN 1 and Amendment Rules have been amended to expand the ambit of this Rule to include:
 - schemes of 'compromise and arrangement';
 - schemes involving transfer of undertaking of one or more Indian company to another Indian company, or involving division of one or more Indian company; and
 - schemes approved by any 'other authority' competent to do so under law.

In addition, the NDI Rules also now clarify that the Government approval shall not be required in case of mergers and acquisitions taking place in sectors under automatic route. This clarification was already present in the pre-amended version of the FDI Policy.

- *Real Estate Business:* FDI in 'real estate business' is prohibited under the NDI Rules / FDI Policy. Prior to the recent amendment, each of the NDI Rules and the FDI Policy contained two separate definitions of 'real estate business'. To avoid ambiguity, these definitions have been aligned in the respective documents.
- *Clarificatory changes:* The existing provisions under paragraphs 3.4.2 (vi) and 3.4.2 (vii) of the FDI Policy have been re-numbered as new paragraphs 3.4.3 and Para 3.4.4.

Earlier, the placement of paragraphs 3.4.2 (vi) and 3.4.2 (vii) gave the impression that investments by NRIs (directly or through overseas entities) shall be subject to government approval. The re-numbering proposed in PN 1 has done away with the possibility of any such misinterpretation.

Comments

Changes to the FDI Policy and NDI Rules were *sine qua non* for the LIC IPO, however, it is good to see that this opportunity of amendment of laws has been used to make changes over and above the LIC related changes. As the relaxation in the definition of 'Indian company' is not limited only to LIC, this amendment may benefit other body corporates, like the National Highways Authority of India, in inviting FDI. The Government has also taken due caution while drafting these changes, as is evident from

the exclusion of 'society, trust or any other excluded entity' from the definition of 'Indian company'.

The changes to Rule 19 of the NDI Rules are procedural, yet important. *For instance*, given the varied nature of restructurings that are permissible under the Companies Act, particularly those which could be sanctioned by the Regional Director (for fast track mergers) and the Ministry of Corporate Affairs (for government companies), such clarity is now a welcome move. In addition, clarifications to the definition of real estate business as well as liberalization of the Specified Period, being repeatedly sought after, would be welcomed by the investor community.

As for the numeric ceiling of 20% FDI in LIC, the Government appears to have borrowed the concept from the public sector banking sector, which are allowed to have FDI of upto 20% of their total paid-up capital under the government approval route.

Overall, market participants (especially the foreign investors waiting on the sidelines to grab a pie of the bumper LIC IPO) will welcome PN 1 and Amendment Rules with open arms.

- *Atul Pandey (Partner), Arjun Bhagi (Principal Associate) and Hirak Mukhopadhyay (Principal Associate)*

For any queries please contact: editors@khaitanco.com

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