India: Foreign Investment: Non-Debt Instruments Rules

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On 15th October 2019, the Ministry of Finance, Government of India, notified the provisions of Sections 139, 143 and 144 of the Finance Act, 2015 (the "**Notified Sections**"). The Notified Sections amends certain provisions of the Foreign Exchange Management Act, 1999.

The Notified Sections clarifies the powers of the Central Government *vis-à-vis* that of the Reserve Bank of India ("**RBI**") with respect to regulating foreign exchange transactions. The Notified Sections provides that the Central Government may, in consultation with the RBI, frame rules for regulating transactions not involving debt instruments. Similarly, the Notified Sections also provides that the RBI may, in consultation with the Central Government, frame rules for regulating transactions involving debt instruments. However, the caveat here is that it is the Central Government who is empowered to notify the classes of debt instruments.

In our view, the changes have been brought about to ensure an aligned and consistent foreign investment policy and avoid some of the pitfalls of the old regime, including any regulatory overlap or turf war between the RBI and the Central Government.

IMPACT OF THE CHANGES

1. The key impact of the Notified Sections is that the Foreign Exchange Management (Transfer or 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and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2018, stands repealed (together, the "**Repealed Regulations**") with effect from 17th October 2019. In place of the Repealed Regulations, the

Central Government has notified the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("**Non-Debt Instruments Rules**"). The Central Government has also separately issued a notification on 15th October 2019 setting out the instruments that are "debt instruments" and "non-debt instruments" (the "**Relevant Notification**").

2. **Introduction of certain new definitions**.
3.
    a. **Non-Debt Instruments and Debt Instruments**: The Non-Debt Instruments Rules has introduced a couple of key definitions. The expression "non-debt instruments" means:
    b.
        i. all investments in equity in incorporated entities (public, private, listed, and unlisted).
        ii. capital participation in Limited Liability Partnerships ("**LLP**").
        iii. all instruments of investment as recognized in the foreign direct investment ("**FDI**") policy as notified from time to time.
        iv. investment in units of Alternative Investment Funds, Real Estate Investment Trust, and Infrastructure Investment Trusts.
        v. investment in units of mutual funds and Exchange-Traded Fund which invest more than fifty per cent in equity.
        vi. the junior-most layer (i.e., equity tranche) of securitization structure.
        vii. acquisition, sale or dealing directly in immovable property.
        viii. contribution to trusts.
        ix. depository receipts issued against equity instruments.
    c. The expression "debt instruments" means the following:
    d.
        i. Government bonds.
        ii. corporate bonds.
        iii. all tranches of securitization structure which are not equity tranche.
        iv. borrowings by Indian firms through loans.
        v. depository receipts whose underlying securities are debt securities.
    e. The Relevant Notification contains a catch all provision which provides that any instrument that does not fall under any of the above definitions would be deemed to be "debt instruments".

    b. **Equity Instruments**: The expressions "equity instruments" means equity shares, convertible debentures, preference shares and share warrants issued by an Indian company.

    c. **Hybrid Securities:** The term "hybrid securities" means hybrid instruments such as optionally or partially convertible preference shares or debentures and other such instruments as may be specified by the Central Government from time to time, which can be issued by an Indian company or a trust to a person resident outside India.
    d. *The expression "hybrid instruments" has not been used in the Non-Debt Instruments Rules. Therefore, the intention of introducing these definitions*

is not clear and one would have to wait for some clarification from the Government on this issue. One could also speculate that it could be a case of the Government wanting to retain some flexibility and regulatory power over the choice of instruments going forward. The Government could potentially provide more options to foreign investors when it comes to the choice of instruments.

d. **Investment Vehicle:** The Non-Debt Instruments Rules has expanded the ambit of the term "investment vehicle". It now includes mutual funds that invest more than 50% of its corpus in equity instruments of an Indian company and is regulated by the SEBI (Mutual Funds Regulations), 1996.

3. **Convertible instruments**
4. The TISPRO Regulations required that the price / conversion formula of the convertible instrument should be determined upfront at the time of issue of the instrument. It further provided that 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 as per the TISPRO Regulations. This necessitated carrying out a valuation even at the time of conversion. The Non-Debt Instruments Rules has dropped this requirement. Going forward, convertible instruments would need to be valued at the time of their issuance.
5. *The requirement to undertake a valuation at the time of conversion was limiting the upside available to foreign investors. It resulted in lesser number of shares to them at the time of conversion as the pricing norms restricted an Indian company from issuing shares at lesser than fair value. These changes ensure foreign investors get the full benefit of an upside in case of convertible instruments. Therefore, these changes would be welcomed by the investor community.*

4. **Foreign Portfolio Investors ("FPI")**
5.

a. **Caps on aggregate FPI investment**
b. The Non-Debt Instruments Rules makes a couple of key changes governing FPI investments into Indian companies.
c. With effect from 1st April 2020, the default aggregate FPI limits in an Indian company is the applicable sectoral cap, as laid out in Schedule I of the Non-Debt Instruments Rules. The TISPRO Regulations had capped aggregate FPI limits to 24%, with the company being provided the option of enhancing the limits to the applicable sectoral cap. While this is not a big change as there is no change in the caps, it is useful that the limits are linked to the sectoral caps as a default rule. In case an Indian company wants to reduce the FPI limits to a lower threshold of 24%, 49% or 74%, they would need to do so before 31st March 2020. Further, once the limits are enhanced, the Indian company cannot reduce the limits.
d. The above changes would apply to sectors where FDI is not prohibited. In sectors where FDI is prohibited, the aggregate FPI limits is capped at 24% of the company's 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.

e. An FPI has been provided five trading days from the date of settlement of the trades to divest its holdings in case the applicable FPI ceiling limit is breached. Failure to do so would result in the entire FPI limits being classified as FDI, and the relevant FPI investor is no longer allowed to make further investments under the FPI route.

f. *These are welcome changes and provides much needed clarity on the FPI regime. The window of five days provided to FPI investors to divest their stakes to permissible levels of FPI holding is a much-needed breather for FPI investors who inadvertently breach the investment thresholds.*

b. **Investments in Mutual Funds & Investment Vehicles**

c. An FPI may purchase units of domestic mutual funds or Category III Alternative Investment Fund or offshore fund for which no objection is issued in accordance with the SEBI (Mutual Fund) Regulations, 1996, which in turn invest more than 50 percent in equity instruments on repatriation basis subject to the terms and conditions specified by the Securities and Exchange Board of India ("**SEBI**") and the RBI. An FPI may purchase units of real estate investment trusts and infrastructure investment trusts on repatriation basis subject to the terms and conditions specified by SEBI.

d. *These changes have considerably expanded the universe of investment opportunities available to an FPI investor, thereby making India a more attractive destination for foreign investors.*

5. **Sectoral Caps**
6. Press Note 4 of 2019 (the "**Relevant Press Note**") had introduced many changes to the foreign investment norms governing single-brand retail trading, contract manufacturing, coal mining and digital media. The Relevant Press Note clearly provides that policy pronouncements contained therein would take effect from the date of notification of amendments to the TISPRO Regulations. The expectation was that the Government would use this opportunity and notify the changes by way of incorporating the changes in the Non-Debt Instruments Rules. However, the Government has not fulfilled this expectation.
7. *The changes announced in Press Note 4 of 2019 relating to single-brand retail trading and contract manufacturing were aimed at increasing India's competitiveness and making it a manufacturing hub, thereby creating more jobs. These policy announcements had also garnered a lot of global attention. However, it is curious that the Government did not use this opportunity to notify the changes to the regulatory regime. Therefore, a clarification from the Central Government on this aspect is keenly awaited.*
8. The fine print of the Non-Debt Instruments Rules indicates the Government's intentions on the e-commerce business. The changes appear to indicate that a foreign investor is required to establish a legal entity in the form of a company in India. Other forms of legal entity are not allowed to be set up by a foreign investor. This is largely in line with the Government's policy on the e-

commerce sector which contemplates establishment of a company to undertake e-commerce.

6. **Reporting of Foreign Investment Transactions**: In exercise of the powers granted to it by the Notified Sections and the Non-Debt Instruments Rules which provides that the reporting requirements for any investment shall be as specified by the RBI, the RBI has framed the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 ("**Reporting Regulations**").
7. *The Reporting Regulations provides the regulatory guidance regarding the mode of payment and remittance of sale proceeds involving non-debt instruments and the reporting obligations related to the same. The Reporting Regulations and is largely in line with the TISPRO Regulations. However, the fact that the regulations governing remittance and reporting regulations are now consolidated in one regulation would be useful to the stakeholders and is a welcome change in that sense.*

CONCLUSION

While the Non-Debt Instruments Rules does not per-se alter the regulatory framework governing foreign investment transactions dramatically, it highlights the shift in the regulatory approach going forward. Therefore, one could expect a more streamlined approach between the RBI and the Central Government regulating foreign investments. However, the Government should step in to address some of the anomalies and inconsistencies pointed out above, particularly, those relating to sectoral caps and conditions, to avoid any further confusion on these aspects.

Footnote

1. Views expressed are personal and do not necessarily reflect the views of the Firm.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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