Amendments to FEMA rules — facilitating ease of business in the Indian landscape

Insertion of Rule 9A in the NDI Amendment Rules has now permitted transfer of equity instruments of an Indian company between a person resident in India and a person resident outside India by way of swap of equity instruments and swap of equity capital of a foreign company, observes senior corporate lawyers Tanushree Bhuwalka and Althea Pereira at Khaitan & Co.

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Following the 2024 Budget announcement, which envisaged facilitating foreign direct investment and overseas investments, the Ministry of Finance notified the Foreign Exchange Management (Non-debt Instruments) (Fourth Amendment) Rules 2024 (“NDI Amendment Rules”). This introduced certain key amendments to the Foreign Exchange Management (Non-Debt Instruments) Rules 2019 (“NDI Rules”).

As a welcome move, the amendments have now enabled ‘FDI-ODI’ swap — the swap of shares of an Indian company against the shares of a foreign company. Previously, transfer of equity instruments of an Indian company by a person resident in India to a person resident outside India against swap of shares of a foreign company (through issuance/ transfer of shares of a foreign company) was not expressly permitted and required the prior approval of the Reserve Bank of India.

Additionally, such swap of shares was only permitted between two Indian companies in which the shareholders of one of these companies were non-residents.

Insertion of Rule 9A in the NDI Amendment Rules has now permitted transfer of equity instruments of an Indian company between a person resident in India and a person resident outside India by way of swap of equity instruments and swap of equity capital of a foreign company.

This amendment is in line with the Foreign Exchange Management (Overseas Investment) Rules 2022 ("OI Rules"), where a resident individual can sell its equity capital in an overseas entity to an overseas company against shares being issued by such overseas acquirer to the resident individual.

That said, such swap structures are permitted only in the event of a merger, demerger, amalgamation or liquidation — regulators should consider liberalising the extant regime where a resident individual may make or hold overseas investment by way of swap of securities without such underlying events. In any case, even in its current form, an FDI-ODI swap allows for varied structuring options where acquisitions may be financed using all stock considerations.

As another welcome move, the definition of 'control' under the Companies Act 2013 has now been adopted in the NDI Rules — this will ensure harmonisation in legislative interpretation across various statutes, including regulations pertaining to the Securities and Exchange Board of India. With respect to LLPs, the existing definition of 'control' under Rule 23 (Downstream Investment) has been subsumed into the NDI Rules, thereby suggesting that its application shall be uniform across the NDI Rules.

The NDI Amendment Rules stipulate that the test to determine 'control' of an LLP is twofold — (i) right to appoint majority of the designated partners; and (ii) such designated partners having control over all the policies of an LLP (in exclusion to others).

The NDI Amendment Rules have also amended the existing definition of 'startup company' to align it with the Government of India's notification G.S.R. 127 (E) dated 19 February 2019, issued by the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry ("DPIIT Notification").

The amended definition increases the recognition period for an entity to be categorised as a startup to up to 10 years from the date of incorporation or registration with the turnover threshold being increased from ₹25 crore to ₹ 100 crore amongst other compliance conditions. Consequently, to alleviate ambiguity, the NDI Amendment Rules have also amended paragraph (1)(iii) of Schedule VII (which deals with investment by a foreign venture capital investor (FVCI) in equity or equity linked instruments or debt instruments issued by an Indian startup company) to delete references to the previous notification which provided a definition for the term "startup".

This alignment of the NDI Rules with the DPIIT Notification will potentially lead to increased structuring of foreign direct investments in startups, leading to further growth of the startup ecosystem. According to certain reports, India's startup ecosystem has been growing exponentially and currently occupies the third rank globally with foreign investments accounting for approximately 36% of the total investments for startups in the last decade.

Prior to the NDI Amendment Rules, Government approval or compliance with sectoral conditions was required if the aggregate foreign portfolio investment ("FPI") exceeded 49% of the paid-up capital of the resident Indian company on a fully diluted basis or the statutory or sectoral cap, whichever was lower, if such investments resulted in a transfer of ownership or control of the resident Indian company to persons resident outside India ("Control Investment").

The NDI Amendment Rules have dispensed with the requirement to comply with the threshold of 49% and provide that FPIs up to the sectoral or statutory cap which are not Control Investments will not require Government approval/compliance with sectoral conditions.

Definition of the term "investor group" has been expanded to two or more FPIs (including foreign governments) or their related entities having common ownership (directly or indirectly) of more than 50% or having common control. Further, dilution of the entry conditions will make FPIs an attractive route for investment and foster a foreign portfolio investor friendly climate.

Prior to the NDI Amendment Rules, only investments made by an Indian entity which is owned and controlled by NRI(s) on a non-repatriable basis (i.e. where divestment proceeds cannot be remitted outside India) were excluded from calculation of indirect foreign investment while evaluating downstream investments.

However, the NDI Amendment Rules have extended the ambit of this exclusion to investments made by a company, a trust and a partnership firm incorporated outside India and owned and controlled by an NRI or an OCI on a non-repatriation basis. Such investments will not be considered for the calculation of indirect foreign investment while evaluating downstream investment.

The NDI Amendment Rules are expected to create an investor friendly environment and are likely to act as a stimulus to foreign investment in India, thereby facilitating the expansion of Indian businesses. In particular, the amendments permitting cross-border share swaps are a testament to the Government's vision to bring India on the roadmap at a global level, in terms of cross border mergers and acquisitions, and other strategic transactions.

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(Edited by : Unnikrishnan)