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Understanding recent clarifications in India's foreign investment rules

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Introduction

Section 11 of the Foreign Exchange Management, 1999 (FEMA) empowers the Reserve Bank of India (RBI) to issue directions to authorised persons to *inter alia* lay down the modalities as to how the foreign exchange transactions should be undertaken.

Prior to 2016, the RBI issued '*Master Circulars*' consolidating circulars/ notifications. Since January 2016, the RBI has transitioned to issuing '*Master Directions*' on all regulatory matters consolidating instructions on rules and regulations framed by the RBI under various statutes, including those related to banking issues and foreign exchange transactions. Any change in the rules, regulation or policy is communicated during the year by way of circulars/ press releases, and the Master Directions are suitably updated to reflect these changes.

Recently, the RBI has issued certain clarifications in the Master Direction on "Foreign Investment in India" dated 4 January 2018 (New Direction).

We have summarised the key clarifications below:

Deferred consideration and swap for FOCC transactions

The New Direction has clarified that the arrangements which are available for direct investment under the Foreign Exchange Management (Non Debt Instrument) Rules, 2019 (NDI Rules) such as investment by way of swap of equity instruments/ equity capital, payment arrangements/ mechanism as per Rule 9(6) of the NDI Rules shall also be available for the purpose of downstream investment by foreign owned and controlled companies (FOCCs)

There have been inconsistencies in the reading of the NDI Rules specifically concerning possible payment arrangements (swap of equity instruments or deferred considerations) for transactions involving FOCCs. As a result, FOCCs, have been taking a conservative approach over the last few years and avoiding swap/ deferred consideration structures. The New Direction explicitly states that all arrangements available for direct Foreign Direct Investment (FDI) are applicable to downstream investments as well. As such, deferred consideration, as outlined under Rule 9(6) of the NDI Rules and swap of equity instruments/ equity capital are permitted for FOCC transactions.

Having said that, this clarification lays down that the downstream transaction structure should not circumvent the provisions contained under Rule 23 of the NDI Rules including the restriction in using borrowed funds, thereby reinforcing the guiding principle that "what cannot be done directly, shall not be done indirectly". This update also significantly broadens the scope for FOCCs and provided a much awaited clarification, aligning downstream investment mechanisms with those available for direct FDI investments.

Treatment of inherited assets under Section 6(5) of FEMA

The New Direction has further clarified that in case of the demise of a resident and consequent transmission of equity instruments held by such person to a non-resident legal heir by way of inheritance, the inherited equity instruments shall be held on non-repatriation basis, and no reporting will be applicable for such transmission.

While this approach/ guidance was being provided by on a case to case basis in such transfers, the RBI has now included this in the New Direction to ensure clarity for all parties.

Alignment with the NDI Rules and other notifications

The New Direction has also included the definition of the terms such as "Indian company", "control", "convertible note", "ESOP", "sweat equity shares", "share based employee benefits", "share warrants", "Indian company", etc to align it with the previously issues circulars/ notifications issued by the Central Government.

Permission to invest funds to meet NOF requirements

Another key change includes the general permission to Indian investee company(ies) (whose proposed activities are regulated by a financial sector regulator) to receive foreign investment to comply with the criteria of minimum net owned fund requirement. For instance, non-banking financial companies (NBFCs) are required to have a net owned fund of INR 2 crore for seeking registration with the RBI. However, the NDI Rules does not permit investors to acquire equity instruments in a company engaged in *unregulated/ unlicensed* financial services without seeking prior approval from the Government of India.

Any investment a company proposed to register as an NBFC required prior approval from the Department of Economic Affairs, Government of India which is a lengthy and cumbersome process. However, in light of this clarification, investors will be permitted to capitalise the Indian company to enable it to seek registration with Indian regulators, without having to seek prior approval.

It is important to note that the New Direction states that these funds cannot be utilised for any other purpose/ activity. If the registration/ license is not granted by the respective regulator, the investment received must be repatriated back to the investor. This ensures that these funds are not misused by the investee entity to circumvent FDI requirements.

Comments

Overall, the New Direction by the RBI is a commendable effort to address the evolving needs of the foreign investment landscape in India. By providing clear guidelines and aligning various provisions with existing rules and notifications, the RBI has reinforced its commitment to creating a more transparent, efficient, and investor-friendly regulatory framework. These changes are likely to bolster investor confidence, attract more foreign capital, and contribute to the sustained growth of the Indian laws focused on the ease of doing business in India.

- *Moin Ladha (Partner), Charu Singh (Senior Associate)*

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