

Investment Funds: Monthly Digest

August 03, 2021

FOREIGN INVESTMENT – RECENT TRENDS AND ISSUES

Investment in India by non-residents requires conformity with India's foreign exchange regulations. Most aspects of foreign currency transactions with India are governed by the Foreign Exchange Management Act, 1999 ("FEMA") and the delegated legislations thereunder. Investments in, and acquisition of securities of, Indian companies by non-resident entities and individuals, are governed by the terms of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ("FEMA Non-Debt Rules"), and the provisions of the annual Consolidated Foreign Direct Investment Policy Circular ("FDI Policy") issued by the Department for Promotion of Industry and Internal Trade ("DPIIT") in the Ministry of Commerce and Industry, Government of India ("GoI")¹. The Department of Economic Affairs, Ministry of Finance, has the power to regulate equity investments in India, however, the authority to monitor such transactions, including regulating modes of payment for such transactions still vests with the Reserve Bank of India ("RBI").

BACKGROUND

A person resident outside India, broadly, has three entry routes to make investments in India, viz., Foreign Direct Investment ("FDI"), Foreign Portfolio Investment ("FPI") and Foreign Venture Capital Investment ("FVCI").

Foreign Direct Investment

As per FEMA Non-Debt Rules, FDI is defined as investments through equity instruments by a person resident outside India in (a) an unlisted Indian company; or (b) 10% of more of the paid-up equity capital, on a fully diluted basis², of a listed Indian company.³ No specific registration is required from any regulatory authority to invest under this route, however, for investments in certain sectors, prior GoI (i.e. through the concerned administrative agency / department) approval may be required to be obtained.

Foreign Portfolio Investment

The Securities and Exchange Board of India ("SEBI") notified the SEBI (Foreign Portfolio Investors) Regulations, 2019 ("FPI Regulations") replacing the 2014 FPI Regulations. The FPI Regulations, together with the Operational Guidelines, and the FEMA Non-Debt Rules govern FPI investments by overseas investors and facilitate implementation of the FPI Regulations. The FPI Regulations have streamlined the categorization of FPIs by doing away with the erstwhile three categories and clubbing them into two. The other important change has been the removal of the concept of broad-based criteria, and the categorization of an FPI is now dependent upon whether such FPI or its investment manager is based in an FATF compliant jurisdiction.

Foreign Venture Capital Investment

The overseas investors can make investments under the FVCI route pursuant to obtaining registration with SEBI under the SEBI (Foreign Venture Capital Investors) Regulations, 2000 ("FVCI Regulations"). This route can be utilized by the non-residents who intend to invest in the ten permitted sectors without being subject to the pricing guidelines and pre-issue capital lock-in requirements.

In this issue of monthly digest, we shall be discussing the recent trends with respect to FDI and FPI investments and the issues being faced by the investors on account of the regulatory ambiguity prevalent thereunder.

FDI AND FPI INVESTMENT BY A FOREIGN INVESTOR IN AN INDIAN COMPANY

Issue: Whether the same overseas investing entity can make both, FDI and FPI investments in an Indian investee company?

Analysis: Rule 2(s) of FEMA Non-Debt Rules defines 'foreign investment' as an investment by a person resident outside India on a repatriable basis in equity instruments of an Indian company or to the capital of an LLP. A note to the explanation to the said rule states as follows: "a person resident outside India may hold foreign investment either as FDI or as FPI in any particular Indian company". This note has been a subject matter of different interpretations and viewpoints and was a grey area even when Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 was in force. In our view, this note merely provides flexibility to FPI entities to invest under either of the FDI or FPI routes and does not restrict foreign portfolio investor entities to invest under only one of the routes. A similar language also appears in Schedule II(1)(a)(v) of FEMA Non-Debt Rules relating to FPIs which states as follows: "A FPI may purchase equity instruments of an Indian company through public offer or private placement, subject to the individual and aggregate limits specified under this Schedule". The use of "or" in the language does not mean that if an FPI entity has participated in private placement, it cannot participate in a public offer and *vice versa*. It merely provides flexibility to the FPI entities to invest in both the public offers as well as private placement.

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Regulation 20(8) of the FPI Regulations allows foreign portfolio investors to invest in Indian securities as a person resident outside India' in accordance with FEMA and the rules and regulations thereunder. Further, Rule 6(a) of the NDI Rules allows 'persons resident outside India' to subscribe, purchase or sell equity instruments of an Indian company under the FDI route. Thus, the conjoint reading of Rule 6(a) with Regulation 20(8) of the FPI Regulations seems to suggest that the foreign entities holding an FPI registration should be able to invest under the FDI route as long as they are not using their FPI registration or FPI route to make such investment. Furthermore, RBI Master Direction on Reporting under FEMA stipulates that while FPI under Schedule II to FEMA Non-Debt Rules or any FPI within the meaning of Rule 2(t) of FEMA Non-Debt Rules is required to be reported in Form LEC(FII) on a daily basis, any Indian company which issues equity instruments to foreign portfolio investors and which is considered as FDI within the meaning of Rule 2(r) of FEMA Non-Debt Rules, has to be reported in Form-FCGPR. The bare reading of this provision seems to suggest that an overseas entity is allowed to invest in an Indian company under both, FDI and FPI routes.

An ambiguous language and an unclear legislative intent behind the provision has been creating a commercial roadblock at times for overseas investors resulting in such investors investing through two separate overseas entities or alternatively opting for an indirect synthetic exposure in the form of offshore derivative instruments ("ODIs") such as participatory notes, swaps, equity linked notes, etc. There have been instances where AD Banks have been comfortable allowing a foreign entity to invest in an Indian company, both under FDI and FPI routes, through separate FDI and FPI accounts. However, in the recent past, the AD Banks have been taking a conservative stand and have not permitted such investments through the same FPI entity.

Especially, in recent times, where there has been an uptick in Indian companies going for initial public offering ("IPO"), several overseas investors, through their respective FPI entities, have been eyeing on making investments in an Indian company pre-listing under the FDI route and then subsequently, upon such entity getting listed, taking exposure through the same FPI entities (from which FDI investments were made), under the FPI route, either as a Category I or a Category II FPI under the FPI Regulations (such entities looking to procure FPI license either before or after the FDI investment or using an existing one).

BENEFICIAL OWNER DETERMINATION UNDER PRESS NOTE 3

Issue: Whether the term 'beneficial owner' has been defined under any statute?

Analysis: The Gol through Press Note 3 (2020 Series) dated April 17, 2020 ("PN 3") and notification dated April 22, 2020 amended its FDI policy to curb the opportunistic takeovers / acquisitions of Indian companies. Accordingly, any investment being made from Bangladesh, China (including Hong Kong and Macau), Pakistan, Nepal, Myanmar, Bhutan and Afghanistan or where the beneficial owner of an investment into India is situated in or is a citizen of any of the aforesaid countries, it shall require prior approval of the Gol regardless of the sector / activities in which investment is being made.

Neither PN 3 nor FEMA Non-Debt Rules define the term 'beneficial owner'. The said term, however, is defined under the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 ("PML Rules") and the Companies (Significant Beneficial Owners) Rules, 2018, as amended from time to time ("SBO Rules"). While the threshold under the SBO Rules for a significant beneficial owner is 10%, the PML Rules, *inter alia*, stipulate a threshold of 25% for the ultimate beneficial owner of a company. On account of this uncertainty and absence of any clarifications from the Gol, initially for most times, the AD banks were obtaining declarations that the investment under the automatic route (i.e. without prior Gol approval) were in compliance with PN 3 if the aggregate shareholding by person(s) from neighbouring countries was over 25%. Subsequently, they started applying the reduced percentage of 10%, which now, in some cases has even gone to 1% ownership by person(s) of neighbouring countries, in order to approach the Gol for prior approval for making the investments.

Considering there is no clarity on the meaning and scope of the term 'beneficial owner', different AD banks have been taking different stands as per their own comfort which, at times, muddles the foreign global investors and creates a barrier in their investment into India.

SUBSCRIPTION TO OFFSHORE DERIVATIVE INSTRUMENTS BY FPIS

Issue: Whether a Category II FPI under the FPI Regulations eligible to subscribe to ODIs?

Analysis: Regulation 21(1)(b) of the FPI Regulations states that ODIs can be issued to persons eligible for registration as Category I FPIs, including an entity eligible for such license by virtue of its investment manager being situated in an FATF member jurisdiction⁴. Moreover, in such cases, the investment manager is not required to be actually registered as a Category I FPI with SEBI.⁵ Hence, an unregulated fund from an FATF member country or an entity from a non-FATF member country, having an investment manager located in an FATF member country, registered as a Category II FPI with SEBI should be able to subscribe to the ODIs since such fund / entity should be eligible to register as a Category I FPI with SEBI, without surrendering its Category II FPI license. However, few Designated Depository Participants ("DDPs") or custodians seem to be taking a different stand in this regard. Certain DDPs or custodians seemingly are of the view that since a fund or an entity already holds a Category II FPI license, unless this license is surrendered to SEBI, such FPI will not be entitled to a Category I license, thereby, ultimately impacting its eligibility for obtaining a Category I FPI registration. Therefore, only a Category I FPI or an entity eligible to be registered as a Category I FPI (and not holding a Category II FPI license), including an unregulated entity located in FATF member country or an entity located in a non-FATF member country, whose investment manager is situated in an FATF member country, should be eligible to subscribe to ODIs.

Having said the foregoing, we believe that the eligibility condition should not be equated with the entitlement condition and Category II FPIs, as stated above, should be able to subscribe to ODIs. A clarification from SEBI is warranted in this regard to render clarity to the provision.

CONCLUSION

The above-mentioned ambiguities have been in existence for a while now and often create legal and commercial hurdles in an overseas investor's decision of considering India as a lucrative investment jurisdiction. While the Gol, RBI and SEBI, in recent times, have been proactive in their efforts of bettering India's unlisted and listed space in order to attract foreign investment and making India a global investment hub, it is about time that such uncertainties are also paid heed to and resolved in a timely and efficient manner.

– **Prakhar Dua, Kishore Joshi & Nishchal Joshipura**

You can direct your queries or comments to the authors

¹ The FDI Policy governing foreign investments in India is currently laid down in the Consolidated FDI Policy Circular of 2020 bearing F.No. 5(2)/2020 effective from October 15, 2020.

² 'Fully diluted basis' means the total number of shares that would be outstanding if all possible sources of conversion are exercised.

³ Rule 2(r) of FEMA Non-Debt Rules.

⁴ Regulations 5(a)(iv)(II) and 5(a)(v) of the FPI Regulations.

⁵ An investment manager based in an FATF member nation is required to be registered as a Category I FPI only in situations where an unregulated fund from an FATF member country or an entity from a non-FATF member country seeks to apply for a Category I FPI license under the FPI Regulations with SEBI.

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