

Regulatory Hotline

September 12, 2024

INBOUND INVESTMENT RULES LIBERALIZED – CROSS-BORDER SHARE SWAPS SIMPLIFIED!!

- Amended Rules have simplified the cross-border share swaps for greater ease of doing business
- Encouraging FDI in White Label ATM operations to extend banking services to the underserved areas
- Standardizing and harmonizing 'control' and 'start-up' with the other laws or notifications

On August 16, 2024, the Government of India issued the Foreign Exchange Management (Non-debt Instruments) (Fourth Amendment) Rules, 2024 ("**Amended Rules**")¹ and introduced some of the key amendments to the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("**NDI Rules**")²

As a background, one of the Government's initiative is to simplify further the existing Foreign Direct Investment (FDI) and Overseas Investment (OI) frameworks as announced in the recent Union Budget 2024-25³ and these Amended Rules have come as a part of this larger initiative.

ANALYSIS AND KEY TAKEAWAYS

We have discussed below certain important amendments brought under Amended Rules and their key implications:

A. Share Swaps Simplified:

Conceptually, share swap is a cash-neutral share purchase transaction wherein the shares of one entity gets exchanged with the shares of another. In share swap arrangements, the acquirer can acquire target entity by purchasing shares from its existing shareholders and for which, instead of paying consideration in cash, the acquirer can issue its own shares to those selling shareholders. Similarly, one investor can also exchange the shares held in a particular company with the shares of another company held by another investor, resulting into acquisition of company and change of ownership and control, without the exchange of cash consideration. Sometimes, the transaction may involve exchange of consideration partially in cash and partially through swap of shares. Share swap has been the most attractive investment strategy over the past many years due to its commercial viability as compared to cash-based transactions.

Talking about cross-border share swaps, prior to Amended Rules, the NDI Rules had permitted this in a very limited way wherein, an Indian company could 'issue' its 'equity instruments' to non-residents against the swap of 'equity instruments' of another Indian company. Meaning, an Indian company can acquire equity instruments of another Indian company held by non-residents and against which, it can issue its own equity instruments to non-residents. Here, 'equity instruments', as defined under the NDI Rules, mean equity shares, fully, compulsorily and mandatorily convertible preference shares (CCPS) and fully, compulsorily and mandatorily convertible debentures (CCD) and share warrants issued by an Indian company. Since the word 'issue' indicates primary issuance of equity instruments by the company, transfer of equity instruments of an Indian company between a resident and non-resident against the swap of equity instruments held in another Indian company was not permitted under automatic route (let's call it as "**Secondary FDI-FDI**").

Further, the recently liberalised OI Rules⁴ permitted an Indian entity to make overseas direct investment (ODI) against the swap of securities. This has enabled Indian entity to acquire equity capital of a foreign entity by swapping the shares held in another Indian company or by issuing its own shares to non-resident sellers ("**FDI-ODI**") or against the equity capital held in another foreign entity ("**ODI-ODI**"). However, the NDI Rules had restricted the FDI-ODI Swap considering an Indian company could only issue its own equity instruments to non-residents against the swap of equity instruments of another Indian company. Resultantly, RBI's prior approval was essential to undertake both FDI-ODI and Secondary FDI-FDI swap transactions.

Now, the Amended Rules (particularly, new Rule 9A and amendments to Schedule I of NDI Rules) -

- Recognise 'equity capital' of foreign entity as defined under OI Rules, and specifically permit both FDI-ODI and Secondary FDI-FDI swap transactions under automatic route i.e., without the RBI's prior approval.
- In case of FDI-ODI share swaps, as clarified under OI Rules, both the legs (i.e., FDI and ODI) of swap deal should comply with all other conditionalities under FEMA (like entry route, sectoral cap, pricing, reporting etc. in case of FDI and step-down subsidiary, bonafide business activity, pricing norms etc. in case of ODI). The term 'equity capital' is defined in a much broader sense to mean 'equity shares or perpetual capital or instruments that are irredeemable or contribution to non-debt capital of a foreign entity in the nature of fully and compulsorily convertible instruments'. Further, the 'foreign entity' includes any company or any other business structure (like LLC, overseas LLP, firm or fund) which is registered or incorporated outside India and having limited liability.

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- Offer various share swap structuring options between resident and non-resident investors. For instance, resident shareholders of an Indian company can make ODI in foreign entity under primary / secondary route and transfer equity instruments held in Indian company to such foreign entity / its shareholders. Indian company can issue its own shares to foreign entity / its shareholders, against which, can acquire equity capital of foreign entity. Further, transfer of shares of an Indian company between a resident and non-resident against the swap of shares held in another Indian company is also possible now.
- Irrespective of these relaxations, Amended Rules specifically state to obtain the Government's prior approval wherever required under the NDI Rules. This is basically to cover certain restricted cases like investment from land-bordering countries or the sectors where such approval is necessary.

While OI Rules permit swap of equity capital of foreign entity other than a company also (like overseas LLP or LLC etc.), the NDI Rules have always restricted share swap option to Indian companies and Indian LLPs are kept outside the scope. Amended Rules have also continued the same treatment for Indian LLPs. So, only Indian companies can reap the benefits of relaxed share swap options.

Also, Schedule III of OI Rules currently allow swap of securities by the Indian resident individuals only on account of merger/demerger/amalgamation/liquidation. It seems to suggest that except in such special circumstances, resident individuals are restricted from making overseas investment by swapping their existing domestic investment or overseas investment held in other foreign entity. This puts the resident individuals at a disadvantageous position as compared to Indian companies.

Further, from downstream investment perspective, Rule 23(4)(b) of NDI Rules permits to use only funds received from abroad or internal accruals for making such investment so there has always been a question as to whether the FOCC (foreign owned or controlled company) can make downstream investment through share swap under automatic route. There are different views around this amongst the Authorised Dealer (AD) banks and the popular view being this is not permitted without the RBI's prior approval. Amended Rules do not specifically address this point.

B. FDI in White-label ATM Operations (WLAO)

Amended Rules has now specifically recognised and enabled FDI in WLAO sector under 100% under automatic route subject to certain conditions. These conditions states that the non-bank entity setting up White-label ATMs (WLAs) should have minimum net worth of INR 100 crores as per latest audited balance sheet and same be maintained at all times. FDI in the WLAO will be subject to the specific criteria and guidelines issued by the RBI under the Payment and Settlement Systems Act, 2007. Further, if this entity is engaged in any other financial service activity, then, it should adhere separately to minimum capitalization norms prescribed for that other financial service activity.

WLAs are designed to be accessible and convenient, especially in rural and underserved areas where bank-owned ATMs are not commonly found. They can help reduce costs for banks and offer 24/7 services. Specific recognition and FDI liberalisation reflect the regulators' intent to encourage foreign investment for expanding banking services in the areas currently lacking sufficient banking services. As this sector has FDI linked performance conditions, this is open only for the companies. LLPs having foreign investment are restricted to engage in WLAO.

C. Provisions Clarified / Standardised

- **Definition of 'Control'** - Earlier, the term 'control' was defined only under Rule 23 of NDI Rules in the context of downstream investment. However, this was used in few other places also in the NDI Rules. Now, 'control' definition has been removed from Rule 23 and inserted in Rule 2 (i.e. the section dealing with definitions) in order to standardize and to maintain consistency with other laws too. It has been revised to an extent to bring it in line with the Companies Act, 2013 and retained its original meaning from LLP's perspective.
- **Definition of 'start-ups'** – This has also been amended to specifically refer to the notification issued by the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, in line with the similar amendment in other laws too.
- **Calculation of indirect foreign investment** – It is well settled that any investment made by NRIs under Schedule IV of NDI Rules should be deemed as domestic investment at par with the investment made by residents. Hence, as per existing NDI Rules, such investment is not considered for computing indirect foreign investment. Around similar lines, it's now clarified that even the investment held by an Overseas Citizen of India (OCI), a company, a trust or a partnership firm incorporated outside India and owned and controlled by an NRI or an OCI, on a non-repatriation basis under Schedule IV of NDI Rules should not be considered for computing indirect foreign investment.

CONCLUSION :

Amended Rules have undoubtedly simplified the existing FDI framework to a greater extent and brought the same in line with recently liberalised OI framework. The simplified cross-border share swaps, recognition of white label ATM operations coupled with some of these important clarifications not only clear the existing ambiguities but also facilitate the global expansion of Indian companies through mergers, acquisitions, and other strategic initiatives, enabling them to reach new markets and grow their presence worldwide.

FDI-ODI share swap relaxation, which is a significant change, is expected to help both Indian and foreign entities to relocate to any preferred jurisdiction without having to burn their cash resources as this can affect their liquidity and profitability position. Overall, these amendments underscore the Government's commitment towards creating an investor-friendly business and regulatory climate.

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¹[https://static.pib.gov.in/ WriteReadData/specifidocs/ documents/2024/aug/doc2024816377701.pdf](https://static.pib.gov.in/WriteReadData/specifidocs/documents/2024/aug/doc2024816377701.pdf)

²[https://thc.nic.in/ Central%20Governmental%20Rules/ Foreign%20Exchange%20Management%20 \(Non-debt%20Instruments\)%20Rules,%202019.pdf](https://thc.nic.in/Central%20Governmental%20Rules/Foreign%20Exchange%20Management%20(Non-debt%20Instruments)%20Rules,%202019.pdf)

³<https://pib.gov.in/PressReleseDetailm.aspx?PRID=2046086>

⁴<https://rbidocs.rbi.org.in/rdocs/content/pdfs/GazetteRules23082022.pdf>

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