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CORPORATE ADVISORY – AMENDMENTS TO THE INDIAN EXCHANGE CONTROL REGULATIONS

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The Ministry of Finance (Department of Economic Affairs), on August 16, 2024, notified the Foreign Exchange Management (Non-debt Instruments) (Fourth Amendment) Rules, 2024 ("Amendment Rules"), to bring about key amendments to the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("NDI Rules"). In this article, we have explained, in brief, the changes implemented to the NDI Rules vide the Amendment Rules.

1. CHANGES IN THE DEFINITIONS IN THE NDI RULES:

- Control:

  Previously, the definition of "control" under the NDI Rules was included only in the specific provisions where the term "control" was used (for example – in the provisions relating to downstream investments, and in the provisions relating to foreign portfolio investments), and there was no common definition of "control". The Amendment Rules have deleted the usage of the term "control" in the specific provisions of the NDI Rules and introduced a new umbrella definition of "control".

  The new definition of "control" has been aligned to the meaning prescribed in the Indian Companies Act, 2013 (in case of companies), and in case of a Limited Lability Partnership ("LLP"), "control" is defined to mean – "the right to appoint majority of the designated partners, where such designated partners, with specific exclusion to others, have control over all the policies of an LLP".

- Startup company: The definition of a "startup company" under the NDI Rules has been amended to align with the updated definition of a startup company introduced by the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry ("DPIIT").

  The previous definition of a "startup company" in the NDI Rules made a reference to a 2016 notification issued by the DPIIT, which classified a startup as an entity – (i) which has been incorporated for no longer than 5 years; (ii) with turnover not exceeding INR 25 crore in any of the financial years; and (iii) which is working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property.

  The Amendment Rules introduced a new definition of a "startup company", which now

refers to the DPIIT's updated and latest criteria for a startup entity, which was introduced in its 2019 notification. The 2019 notification classifies a start-up as an entity - (i) which has been incorporated for no longer than 10 years; (ii) with turnover not exceeding INR 100 crore in any of the financial years; and (iii) which is working towards innovation, development, or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.

2. GOVERNMENTAL APPROVAL FOR TRANSFER OF EQUITY INSTRUMENTS:

The pre-amended NDI Rules provided that prior Governmental approval was required to be obtained for the transfer of equity instruments of an Indian company between two non-residents when the Indian company was operating in a sector which required Governmental approval.

However, there were already regulations in place which mandated obtaining prior Governmental approval for the transfer of the Indian company's equity instruments even if the Indian company operated in a sector which was under the automatic route for foreign investments. For example – in case the shares of an Indian company are transferred from a non-resident to a Chinese company, then prior Governmental approval needs to be obtained for such a transfer, even if the Indian company is operating in a sector which under the automatic route.

As a result of the Amendment Rules, the NDI Rules now mandate that prior Governmental approval is required to be obtained “in all cases wherever Governmental approval is applicable”, thus harmonizing the transfer provisions under the NDI Rules with existing Indian regulations.

3. INTRODUCTION OF PROVISIONS RELATING TO SWAP OF EQUITY INSTRUMENTS:

The existing NDI Rules permitted an Indian company to “issue” equity instruments to a person resident outside India against the swap of the equity instruments of another Indian company. There was a lacuna in the law regarding the “transfer” of existing equity instruments of an Indian company from a person resident in India and a person resident outside India against the swap of the shares of another Indian company. Further, while the overseas investment framework of India permitted the swap of the equity instruments of a foreign entity (against the shares of an Indian company), this was not expressly provided in the NDI Rules.

This created legal uncertainty regarding such swap transactions. However, the Amendment Rules introduced a new Rule 9A to the NDI Rules which specially permits the transfer of equity instruments between a person resident in India and a person resident outside India, through swap arrangements involving two Indian companies, and swap arrangements involving an Indian company and a foreign company.

For example – A resident Indian selling the shares of an Indian company (Company ABC) to a non-resident can now receive the shares of a foreign company (Company XYZ) from the non-resident as payment for the transfer of Company ABC's shares.

Further, amendments have also been made to Schedule I of the NDI Rules to give effect to the above swap provisions.

4. DOWNSTREAM INVESTMENTS BY OCI-OWNED ENTITIES:

Investments made by an Indian entity (which is foreign owned) in another Indian entity is a regulated activity, and such investments are classified as indirect foreign investments (or more commonly referred to as “downstream investments”). However, there were exemptions provided if the downstream investments were made by Indian entities which are owned and controlled by Non-resident Indians (“NRIs”), on a nonrepatriable basis, and such investments were not to be considered when determining the indirect foreign investment in the end investee Indian entity.

The Amendment Rules have now, for the purpose of determining the indirect foreign investment in the end investee Indian entity, expanded the scope of this exemption to exclude investments made by: (i) Indian entities which are owned and controlled by NRIs or Overseas Citizens of India (“OCIs”), on a non-repatriable basis; and (ii) Indian entities which are owned, on a non-repatriable basis, by foreign companies, foreign trusts, and/or foreign partnership firms, that are set up by NRIs or OCIs.

For example – An NRI/OCI located in the US sets up a company in the US (Company A). Company A then incorporates an Indian company (Company B) and owns 100% of Company B, on a non-repatriable basis. Subsequently, Company B further invests in another Indian company (Company C). By virtue of the Amendment Rules, the investments made by Company B in Company C will not be considered for calculating the total indirect foreign investment in Company C.

5. CHANGES IN THE INVESTMENTS LIMITS PRESCRIBED ON FPIs:

Under the pre-amended NDI Rules, the aggregate investments by Foreign Portfolio Investors (“FPIs”) under the automatic route (i.e., without prior regulatory approval) was permitted up to 49% of the shareholding of the Indian company, or the sectoral cap, whichever was lower, provided that there was no transfer of ownership and control of the Indian company from an Indian resident to the FPI.

The Amendment Rules have removed this 49% threshold, and now investments by FPIs are permitted up till the sectoral cap limits, provided that there is no transfer of ownership and/or control of the Indian company from an Indian resident to the FPI. This change will essentially allow FPIs to invest in sectors which had a sectoral cap higher than 49%, thus opening up the Indian economy for further FPI inflows. However, there is still some ambiguity regarding the shareholding percentages that an FPI can hold in an Indian company pursuant to a transfer from an Indian resident, as the new provisions provide that there can be no transfer of “ownership”, and there is a need for clarity from the regulator in this regard.

It is also interesting to note that FPIs can hold up to the sectoral cap in case of a transfer of shares of an Indian company from a non-resident to the FPI, even if such investment leads to the transfer of ownership and/or control of the Indian company.

6. FDI IN WHITE LABEL ATMs:

White label ATMs are ATMs which are set-up, owned and operated by non-banking entities. Earlier, 100% Foreign Direct Investment (“FDI”) was permitted under the automatic route under India's Consolidated FDI Policy, 2020 (“FDI Policy”), however, this was not specifically captured in the NDI Rules.

The inclusion of FDI in White Label ATMs in the NDI Rules harmonized the NDI Rules with the existing regulatory framework in India.

CONCLUSION

The introduction of the Amendment Rules brought about much needed clarity and liberalization in the Indian regulatory framework, especially in relation to transactions involving swap arrangements. These changes to the NDI Rules are in-line with the Indian government's aim to facilitate foreign investments into India, and to make India an attractive investment opportunity, and a foreign-investor friendly environment.