

## IMPACT OF FOREIGN EXCHANGE MANAGEMENT (NON-DEBT INSTRUMENT) RULES, 2019 ON FOREIGN INVESTORS

The Ministry of Finance *vide* its notification dated 17<sup>th</sup> October, 2019 issued the Foreign Exchange Management (Non-debt Instrument) Rules, 2019 (*hereinafter referred to as "Rules"*), in supersession of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 (*hereinafter referred to as "FEMA 20R"*) and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2018.

The Rules bring about a number of investor friendly changes to provide the investors a smooth investment experience. As a welcome change, the Rules state that the valuation of convertible instruments is to be done only at the time of their issuance and not at the time of their conversion.<sup>1</sup> This reduces the equity downside risk that the investor would otherwise face due to a dual valuation.

FEMA 20R required an affirmative vote by at least seventy-five percent shareholders (*hereinafter referred to as ("Special Resolution")*), to be passed for increasing the total investment capacity of Indian Companies for accepting foreign portfolio investment, beyond 24% (twenty-four percent), upto the applicable sectoral caps.<sup>2</sup> The Rules remove the need for an Indian Company to pass a Special Resolution for accepting foreign portfolio investment and automatically enhance the quantum of investment that may be accepted by Indian Companies from foreign portfolio investors<sup>3</sup>, with effect from 1<sup>st</sup> April, 2020 as per sectors and sectoral caps laid down under them<sup>4</sup>. This removal of a Special Resolution is expected to create more opportunities for foreign portfolio investors for investment in Indian



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<sup>1</sup> Explanation to clause 11 of FEMA 20R has been removed.

<sup>2</sup> Schedule 2 1 (1), proviso, FEMA 20R.

<sup>3</sup> 1 (a) (ii) of Schedule 2 of the Rules.

<sup>4</sup> Table mentioned under Schedule I.

Companies, with lesser regulatory burden on Indian Companies.<sup>5</sup>

FEMA 20R and the Rules, both provide that investment constituting less than 10% (ten percent) of the post issue paid up equity capital, on a fully diluted basis, of a listed Indian Company (“**FPI cap**”) is a foreign portfolio investment while an investment in the paid up equity capital, on a fully diluted basis, of an Indian Company, in excess of the FPI cap shall be foreign direct investment.<sup>6</sup> If the FPI caps was breached by the foreign portfolio investor then FEMA 20R provided that the foreign portfolio investment would be deemed to be foreign direct investment.<sup>7</sup> While the Rules hold a similar position<sup>8</sup>, there is now a window of 5 (five) trading days<sup>9</sup> for divestment of shareholding, in excess of the FPI cap, given to the foreign portfolio investors. This provides flexibility to the foreign portfolio investor to divest the investment in excess of the FPI cap so as to avoid any change in the nature of investment.

Foreign venture capital investment has also seen a few favourable changes pursuant to the inception of the Rules. More investment options have been created for foreign venture capital investors as they can invest in start-ups engaged in any sector and have to adhere to the Sector Specific Conditions which was not there earlier.<sup>10</sup>

Mutual funds having more than 50% (fifty percent) investment in equity governed by Securities and Exchange Board of India (“**SEBI**”) have been recognised as investment vehicles.<sup>11</sup> This provides the foreign investor another investment vehicle through which investment can be made. Further, the Rules discuss the concept of hybrid instruments, which may provide more investment options to foreign investors.<sup>12</sup> It must also be noted that unlike the prior legal position, the Rules differentiate between “*debt*” and “*non-debt*” instruments.<sup>13</sup> The construct of *non-debt instruments* also includes “*contribution to trusts*” within its ambit.<sup>14</sup> However, further clarity is awaited on these Rules to understand the implication that they will have on foreign investors.<sup>15</sup> The Rules state that B2B e-commerce

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<sup>5</sup> Schedule 2 (1) (i) of FEMA 20R read with Schedule II (1) (a) of Rules.

<sup>6</sup> Section 2 (xvii) and 2 (xix) of FEMA 20R. Section 2 (r) and 2 (t) of the Rules. Explanation ii to Clause 10 (1) of FEMA 20R.

<sup>7</sup> Section 2 (xvii) and 2 (xix) of FEMA 20R. Section 2 (r) and 2 (t) of the Rules. Question no. 9 and Question no. 6 of FEMA 20 R FAQ's accessible at <https://www.rbi.org.in/scripts/FAQView.aspx?Id=26#Q8>

<sup>8</sup> Section 2 (xvii) and 2 (xix) of FEMA 20R. Section 2 (r) and 2 (t) of the Rules.

<sup>9</sup> 5 trading days, as per Schedule II. (iii) of the Rules.

<sup>10</sup> Schedule VII 1. (iii) of the Rules, read in comparison with Schedule 1 (1) (b) of FEMA 20R.

<sup>11</sup> Section 2 (ae) of the Rules.

<sup>12</sup> Section 2 (x) of the Rules.

<sup>13</sup> Section 2 (f) and Section 2 (ai) of the Rules.

<sup>14</sup> Section 2 (ai) (viii) of the Rules.

<sup>15</sup> The term non-debt instruments has not been used in the Rules, yet.

activities can only be undertaken by Indian Companies. The implication of this change is that a foreign company cannot undertake B2B e-commerce activities.<sup>16</sup>

It must be noted that Rules have been notified as “rules” and not as “regulations”. Hence, if there is any contradiction in interpretation of these rules, with any other regulations, these rules will prevail over the other regulations. While we await further clarification from the Government, these Rules are a welcome change to foreign investors.

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<sup>16</sup> Schedule 1, 15.2.3 of NDI Rules. (Previous position under FEMA 20R- R 15.2.3 (b) of B. Sector Specific policy for total foreign investment)