

kcmFlash

Regulatory

August 17, 2024

Foreign Exchange Management (Non-debt Instruments) (Fourth Amendment) Rules, 2024

Snapshot

The Foreign Exchange Management (Non-debt Instruments) (Fourth Amendment) Rules, 2024, notified on 16 August 2024 by Department of Economic Affairs update the Foreign Exchange Management (Non-debt Instruments) Rules, 2019, with several key changes. These rules, effective from their publication date, redefine "control" to align with the Companies Act, 2013, and update the definition of "startup company" in accordance with current government notifications. They introduce provisions for swap of equity instruments of Indian Company against equity instruments of foreign company. Additionally, the rules clarify that investments by Indian entities owned by Overseas Citizens of India ('OCI') or by entities which are owned by Non-Resident Indians ('NRIs') or OCIs on a non-repatriation basis will not count towards indirect foreign investment. There are other consequential changes which have been holistically discussed in this Flash.

Key Amendments

In pursuance of the Union Budget 2024-25 announcement to simplify rules and regulations for Foreign Direct Investment and Overseas Investment, as one of the initiatives, the Department of Economic Affairs (DEA), Ministry of Finance, has amended Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ('the Principal Rules') vide notification dated 16 August 2024.

The Foreign Exchange Management (Non-debt Instruments) (Fourth Amendment) Rules, 2024, ('the Amendment Rules') shall come into force from 16 August 2024.

The key amendments are discussed in the subsequent pages:

Topic	Principal Rules	Amendment Rules	Impact and KCM comments
Definition of control	“control” shall mean the right to appoint majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreement or voting agreement and for the purpose of LLP, “control” shall 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.	“Control” shall have the same meaning as assigned to it in the Companies Act, 2013 and for the purposes of Limited Liability Partnership, shall 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	Earlier the word ‘control’ was defined only for the limited purpose of downstream investment and had a meaning at a little variance from that provided for in Companies Act, 2013. The term “control” has now been given a definition for overall Rules and not limited to “Downstream investments” only. The definition is now fully aligned with Companies Act, 2013 to avoid ambiguity in interpretation.
Definition of Startup Company	“startup company” means a private company incorporated under the Companies Act, 2013 and identified under G.S.R. 180(E), dated the 17th February, 2016 issued by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry	“Startup company” means a private company incorporated under the Companies Act, 2013 (18 of 2013) and identified as “startup” under the notification of the Government of India number G.S.R. 127 (E), dated the 19 February 2019 issued by the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, as amended from time to time	The Department for Promotion of Industry and Internal Trade had amended the definition of startup <i>vide</i> the notification no. G.S.R. 127 (E), dated the 19 February 2019 and hence the Amendment Rules aligns the definition under the Principal Rules with the definition provided under the notification. Further, it provides for considering the amended definition in case the same undergoes a change in the future, thereby providing for a dynamic meaning to the term ‘start-up’.
Requirement of government approval for transfer of equity instruments of an Indian company or units by Person Resident Outside India (‘PROI’) to any PROI	Prior government approval shall be obtained for any transfer in case the company is engaged in a sector which requires government approval	Prior Government approval shall be obtained for transfer in all cases wherever Government approval is applicable	Earlier, as per language, it was inferred that prior approval shall only be required in cases where the company was engaged in a sector that required government approval and not in cases of transactions where government approval was required because of its nature or other factors even if the sector was not such where government approval may be required. The amendment seems to have removed the anomaly.

Topic	Principal Rules	Amendment Rules	Impact and KCM comments
Swap of equity instruments and equity capital	Only primary transactions of issue of shares by way of Swap of equity instruments were allowed. Also, Overseas Investment Regulations 2022 provided for swap arrangements.	<p>"9A. Swap of equity instruments and equity capital. — The transfer of equity instruments of an Indian company between a person resident in India and a person resident outside India may be by way of—</p> <ul style="list-style-type: none"> (i) swap of equity instruments, in compliance with the rules prescribed by the Central Government and the regulations specified by the Reserve Bank from time to time; (ii) swap of equity capital of a foreign company in compliance with the rules prescribed by the Central Government including the Foreign Exchange Management, (Overseas Investment) Rules, 2022, and the regulations specified by the Reserve Bank from time to time: <p>Provided that prior Government approval shall be obtained for transfer in all cases wherever Government approval is applicable.</p> <p>Explanation. – For the purposes of this clause, the expression "equity capital" shall have the same meaning as assigned to it in the Foreign Exchange Management, (Overseas Investment) Rules, 2022, as amended from time to time.</p>	New Rule 9A has been inserted in the Principal Rules. The Amendment provides for transfer by way of swap of equity instruments of Indian Company for equity instruments of another Indian Company as well as foreign equity capital between a Person Resident in India and PROI subject to compliance with ODI rules and other rules and regulations prescribed by central government and RBI. Further, Schedule I of Principal Rules provide for terms and conditions for purchase or sale of equity instruments of an Indian company by a PROI. Sub-paragraph (d) of paragraph 1 of the said schedule has been amended. The Amendment Rules provide that Indian Company can issue equity instruments to a PROI against foreign equity capital subject to compliance with ODI rules and other rules and regulations. Hence now any company can issue as well as transfer shares of its own or of any company held by it to any PROI against foreign equity capital as well. This amendment would smoothen cross border arrangements by Indian entities. In the last five years, the Government has tried to liberalize its stand towards allowing swap of shares, firstly by providing for a specific provision in Non-Debt Investment Rules and subsequently in FEM (Overseas Investment) Rules, 2022. However, there were certain anomalies as regards secondary transfer on a conjoint reading. The amendment now clarifies the position permitting transfer of shares under a swap share arrangement and synchronizing
Issue of equity instruments by an Indian Company engaged in automatic route sector to PROI (Schedule I)	An Indian company may issue, subject to compliance with the conditions prescribed by the Central Government and/or the Reserve Bank from time to time, equity instruments to a person resident outside India, if the Indian	<p>"(d) An Indian company may issue, subject to compliance with the rules prescribed by the Central Government and the regulations specified by the Reserve Bank from time to time, equity instruments to a person resident outside India against, –</p> <ul style="list-style-type: none"> (i) swap of equity instruments; or 	

	<p>investee company is engaged in an automatic route sector, against, —</p> <ul style="list-style-type: none"> (i) swap of equity instruments; or (ii) import of capital goods or machinery or equipment (excluding second-hand machinery); or (iii) pre-operative or pre-incorporation expenses (including payments of rent etc.): <p>Provided that the Government approval shall be obtained if the Indian investee company is engaged in a sector under Government route and the applications for approval shall be made in the manner prescribed by the Central Government from time to time.</p>	<ul style="list-style-type: none"> (ii) import of capital goods or machinery or equipment (excluding secondhand machinery); or (iii) pre-operative or pre-incorporation expenses (including payments of rent, etc.); (iv) swap of equity capital of a foreign company in compliance with the rules prescribed by the Central Government including Foreign Exchange Management, (Overseas Investment) Rules 2022, and the regulations specified by the Reserve Bank from time to time. <p>Explanation. – For the purposes of this clause, the expression “equity capital” shall have the same meaning as assigned to it in the Foreign Exchange Management, (Overseas Investment) Rules, 2022, as amended from time to time:</p> <p>Provided that Government approval shall be obtained in all cases wherever Government approval is applicable and the applications for approval shall be made in the manner prescribed by the Central Government from time to time.</p>	<p>the provisions of Non-Debt Investment Rules with Overseas Investment Rules.</p> <p>Changes as regard prior Government approval in all cases where government approval is required (and not only where sector specific restrictions apply) have also been made, as discussed earlier.</p>
Amendments in rules for Downstream investment	<p>‘Control’ was defined for the purpose of downstream investment</p>	<p>The definition of ‘control’ has been deleted from the rule for downstream investment.</p>	<p>Since meaning of ‘Control’ has been defined in main definition section, the same has been removed from the rule for downstream investment.</p>

Topic	Principal Rules	Amendment Rules	Impact and KCM comments
Explanation to definition of 'indirect foreign investment'	An investment made by an Indian entity which is owned and controlled by NRI(s), on a non-repatriation basis, shall not be considered for calculation of indirect foreign investment.	An investment made by an Indian entity which is owned and controlled by a Non-Resident Indian or an Overseas Citizen of India including a company, a trust and a partnership firm incorporated outside India and owned and controlled by a Non-Resident Indian or an Overseas Citizen of India , on a non-repatriation basis in compliance with Schedule IV of these rules, shall not be considered for calculation of indirect foreign investment	The exclusion to the definition of 'indirect foreign investment' has been broadened to include investment by Indian entity owned and controlled by OCI or investment by Indian entity owned and controlled by companies, trusts or partnerships incorporated outside India which are owned and controlled by NRI or OCI. Such exclusion would also impact calculation of total foreign investment in Indian Company and hence it is a welcome amendment for companies engaged in sectors where sectoral cap is applicable. As per Schedule IV of the Principal Rules, investment by NRI and OCI on non-repatriation basis in equity instruments of Indian company was considered as domestic investment and hence the exclusion from the definition of 'indirect foreign investment' was needed for a logical interpretation.
Limit of aggregate foreign portfolio investment in Indian entity by PROI (Schedule I)	Aggregate foreign portfolio investment up to forty-nine percent of the paid-up capital on a fully diluted basis or the sectoral or statutory cap, whichever is lower , shall not require Government approval or compliance of sectoral conditions as the case may be, if such investment does not result in transfer of ownership and control of the resident Indian company from resident Indian citizens or transfer of ownership or control to persons resident outside India and other investments by a person resident outside India shall be subject to the conditions of Government approval and compliance of sectoral conditions as laid down in these rules.	The aggregate foreign portfolio investment up to the sectoral or statutory cap shall not require Government approval or compliance of sectoral conditions as the case may be, if such investment does not result in transfer of ownership and/ or control of the resident Indian company from resident Indian citizens to persons resident outside India and other investments by a person resident outside India shall be subject to the conditions of Government approval and compliance of sectoral conditions as laid down in these rules."	The condition of aggregate foreign portfolio investment limit which was allowed maximum up to 49% of paid-up capital of an Indian company has been done away with. Now only the sectoral conditions have to be adhered to.

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Sectoral Cap for 'White Label ATM Operations'	Did not exist	<p>Sector: White Label ATM Operations (WLAO)</p> <p>Sectoral Cap: 100%</p> <p>Entry Route: Automatic</p> <p>Other Conditions:</p> <ul style="list-style-type: none"> a) Any non-bank entity intending to set up White Label ATMs (WLAs) should have a minimum net worth of one hundred crore rupees as per the latest financial year's audited balance sheet, to be maintained at all times. b) In case the entity is also engaged in any 'Other Financial Services' referred to in Sl. No. F.10 above, then the foreign investment in the company setting up WLA shall also comply with the minimum capitalization norms, if any, for foreign investments in such 'Other Financial Services'. c) FDI in the WLAO will be subject to the specific criteria and guidelines issued by the Reserve Bank under the Payment and Settlement Systems Act, 2007 (51 of 2007)." 	ATMs set up, owned and operated by non-banks are called WLAs. Non-bank ATM operators are authorized under the Payment & Settlement Systems Act, 2007 by the Reserve Bank of India (RBI). Specific entry for foreign investment in entities engaged in setting up of WLAs has been provided by the Amendment Rules.
Definition of Control in Schedule II	In case, two or more FPI's including foreign Governments/their related entities are having common ownership, directly or indirectly, of more than fifty percent or common control, all such FPI's shall be treated as forming part of an investor group. Control includes the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights or shareholders agreements or voting agreements or in any other manner.	In case two or more FPI's including foreign Governments, or their related entities are having common ownership, directly or indirectly, of more than fifty percent or common control, all such FPI's shall be treated as forming part of an investor group	Definition of control has been removed from the explanation to clause (ii) of subparagraph (a) of paragraph 1 of Schedule II (investment by FPI) since the word 'control' has been defined in the main definition section.

Topic	Principal Rules	Amendment Rules	Impact and KCM comments
Definition of start-up for investment by FVCI (Schedule VII)	<p>(1) Subject to the terms and conditions as may be laid down by the Central Government, a Foreign Venture Capital Investor (FVCI) may purchase, —</p> <p>.... (iii) equity or equity linked instrument or debt instrument issued by an Indian 'start-up' irrespective of the sector in which the start-up is engaged. The definition of 'start-up' shall be as per Department for Promotion of Industry and Internal Trade's Notification No. G.S.R. 364(E), dated the 11 April 2018:</p> <p>Provided that if the investment is in equity instruments, then the sectoral caps, entry routes and attendant conditions shall apply.</p>	<p>(1) Subject to the terms and conditions as may be laid down by the Central Government, a Foreign Venture Capital Investor (FVCI) may purchase, —</p> <p>... (iii) equity or equity linked instrument or debt instrument issued by an Indian startup company irrespective of the sector in which the startup company is engaged:</p> <p>Provided that if the investment is in equity instruments, then the sectoral caps, entry routes and attendant conditions shall apply</p>	<p>The word 'start-up' has been replaced by startup company. Since the definition of the same has been provided in the main definition section, the reference of definition in the Principal Rules have been removed.</p>

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