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MASTER DIRECTION ON FOREIGN INVESTMENT IN INDIA

The Reserve Bank of India ("**RBI**") had issued a master circular on Foreign Investment in India on July 1, 2015 and further updated it on October 30, 2015 ("**Master Circular**").
The RBI has recently issued master directions on Foreign Investment in India ("**Master Directions**").

The Master Directions incorporate the Foreign Exchange Management (Transfer or Issue of a Security by a Person resident Outside India) Regulations, 2017 issued vide Notification No. FEMA 20(R)/2017-RB dated November 7, 2017 ("**FEMA 20**").

Further, the Master Directions reflect the circular issued by RBI on September 16, 2003 regarding de-recognition of overseas corporate bodies as an investor class.

Certain important changes have been highlighted hereunder:

1. Conditions Of Optionality Clause:

The Master Circular stated that equity shares and compulsorily and mandatorily convertible preference shares/debentures to be issued to a person resident outside India were allowed to contain optionality clauses, subject to certain conditions, such as:

'……(b)After the lock-in period, as applicable above, the non-resident investor exercising option/right shall be eligible to exit without any assured return, as under:

- *In case of a listed company, the non-resident investor shall be eligible to exit at the market price prevailing at the recognised stock exchanges;*
- *In case of unlisted company, the non-resident investor shall be eligible to exit from the investment in equity shares of the investee company at a price as per any internationally accepted pricing methodology on arm's length basis, duly certified by a Chartered Accountant or a SEBI registered Merchant Banker.*

The guiding principle would be that the non-resident investor is not guaranteed any assured exit price at the time of making such investment/ agreements and shall exit at the fair price computed as above at the time of exit, subject to lock-in period requirement, as applicable."

The Master Directions now specify that, '*the guiding principle would be that the person resident outside India is not guaranteed any assured exit price at the time of making such investment/ agreement and shall exit at the price prevailing at the time of exit.'* Therefore, the exit price shall be determined as per the price that is prevailing at the time of exit, as opposed to the computation that was mentioned in the Master Circular.

2. Transfer By Way Of Pledge:

The Master Circular laid down the provisions for pledging the shares by a promoter of a company; pledging shares in favour of an authorised dealer bank, overseas bank and a non-banking financial company. The Master Directions provide for any other transfers provided the same is done with the prior approval of RBI along with submission of the following documents:

i. A copy of the board resolution passed by the non-resident company/ies approving the pledge of security acquired in terms of FEMA 20 (number/ percentage of securities to be pledged) of the investee company held by them for securing the loan facility in favour of the lender/s.
ii. A copy of the board resolution passed by the investee company approving pledge of securities acquired in terms of FEMA 20 in favour of the lender for the loan facility availed by the investee company.
iii. A copy of the loan agreement/ pledge agreement containing security clause duly certified by the company secretary, requiring the pledge of shares of the investee company.
iv. The details of the facility availed/ proposed to be availed.
v. The details of reporting of the acquisition of the security as prescribed in terms of FEMA 20, if any.

3. Purchase/ Sale Of Capital Instruments Of An Indian Company:

i. Issue of equity shares against funds payable:

The Master Circular stated that issue of shares against funds payable does not require prior permission of the Government of India or RBI provided that '*the equity shares shall be issued in accordance with the extant FDI guidelines on sectoral caps, pricing guidelines etc. as amended by RBI, from time to time*'.
As per the Master Directions, the Clause reads as follows:
'*An Indian company may issue equity shares (excluding partly paid shares) to a person resident outside India against any funds payable by it to such person, the remittance of which is permitted under the Act or the rules or the regulations framed or directions issued thereunder or does not require prior permission of the Central Government or the Reserve Bank under the Act or the rules or the regulations framed or directions issued thereunder subject to the following conditions:*
(a) Issue of such shares that require Government approval or import dues deemed as ECB or trade credit or payables against import of second hand machinery will be dealt in accordance with respective guidelines…'.

Therefore, the RBI has expressly excluded partly paid shares from the aforementioned Clause and has stated that issue of shares falling in the categories listed hereinabove shall have to comply with the respective guidelines.

ii. Mode of payment and refund:

While the timelines for issuing the capital instruments have been reduced by the RBI from 180 (One hundred and eighty) to 60 (Sixty) days via FEMA 20, the Master Directions lay down certain conditions for refund of the consideration in case the shares are not allotted within the aforementioned time. It states that refund may be permitted by an authorised dealer provided it is satisfied:

- with the bonafides of the applicant;
- that the funds were received as per the mode of payment prescribed, i.e., the amount of consideration should be paid as inward remittance from abroad through banking channels or out of funds held in NRE/ FCNR(B)/ Escrow account maintained in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016;
- that no part of remittance represents interest on the funds received.

4. Ceiling On Holdings Of Foreign Portfolio Investor ("FPI"):

The total holding by each FPI, should be less than 10 per cent of the total paid-up equity capital on a fully diluted basis or less than 10 per cent of the paid-up value of each series of debentures or preference shares or warrants issued by an Indian company and the total holdings of all FPIs put together should not exceed 24 per cent of paid-up equity capital on a fully diluted basis or paid up value of each series of debentures or preference shares or warrants.
It has been clarified in the Master Directions that, in order to arrive at the ceiling on holdings of FPI, capital instruments acquired both through primary as well as secondary market will be included. However, the ceiling will not include investment made by the FPI through off-shore Funds, Global Depository Receipts and Euro-Convertible Bonds.

5. Short Selling By FPIs:

As per the Master Circular, short selling of equity shares by FIIs (foreign institutional investors) was not be permitted for equity shares of Indian companies which were in the ban list and/ or caution list of the RBI.
However, the Master Directions have revised this condition to state that as follows:
'*The short selling of equity shares by FPIs is permitted for equity shares of those companies where there is at least 2% headroom available for total foreign investment and/or aggregate FPI limit or is not in the caution list or ban list published by the Reserve Bank or any restrictive list published by any authority designated to do so by the Reserve Bank or SEBI'.*
The Master Directions further require that the custodian banks report all transactions pertaining to short selling of equity shares and lending and borrowing of equity shares by FPIs in their daily reporting.

Conclusion

While the RBI has introduced significant structural changes to the Master Directions in comparison to the Master Circular, it has maintained consistency with the recent FEMA 20. The Master Directions elaborate on the various concepts introduced by FEMA 20 in addition to incorporating further conditions in respect of the same.

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