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Introduction

After over 4 years of the Central Government's decision to bring about changes to the foreign policy structure in India, the Government of India has finally implemented the changes proposed under the Finance Act, 2015 by dividing foreign investments into 'debt instruments' and 'non-debt instruments'. These changes were brought into force on 17 October 2019 by the introduction of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("**Non-debt Instruments Rules**") and the Foreign Exchange Management (Debt Instruments) Regulations, 2019 ("**Debt Instruments Regulations**"), which superseded the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 ("**TISPRO Regulations**") as well as the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2018 ("**ATIP Regulations**").

Debt Instruments/Non-Debt Instruments/Hybrid Instruments/Capital Instruments –Maze of Definitions

The Finance Act, 2015 had proposed amendments to the then exchange control regulations to divide the power to determine classes of permissible capital account transactions involving debt instruments for which any person may sell or draw foreign exchange and classes of permissible capital account transactions involving non-debt instruments between the Reserve Bank of India ("**RBI**") (in consultation with the Central Government) and the Central Government (in consultation with the RBI). However, the Finance Act, 2015 did not define the term 'debt instrument' or, for that matter 'non-debt instrument'.

Now, both, the Debt Instruments Regulations and the Non-Debt Instrument Rules define the term 'debt-instruments', although the definition is different in both of these legislations. In the Non-Debt Instrument Rules, the definition merely excludes all non-debt instruments[1] while, in the Debt

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[1] Non-debt instruments' have been defined in the Non-Debt Instrument Rules to mean:

1. all investments in equity instruments in incorporated entities: public, private, listed and unlisted;
2. capital participation in LLP;
3. all instruments of investment recognised in the FDI policy notified from time to time;
4. investment in units of Alternative Investment Funds (AIFs), Real Estate Investment Trust (REITs) and Infrastructure Investment Trusts (InvIts);

Instruments Regulations, the term appears to refer to different instruments for different classes of overseas investors (viz. FPIs, NRIs (on both, a repatriation and a non-repatriation basis) and Foreign Central Banks or a Multilateral Development Bank). Since the definition of non-debt instruments is constituted of an exhaustive list, whatever is not governed under this definition would be classified as a debt instrument for the purposes of the Non-Debt Instruments Rules. It is plain to see, therefore, that instruments that are considered to be "debt instruments" for the purposes of the Non-Debt Instrument Rules need not necessarily be governed by the Debt Instruments Regulations and therefore which definition of "debt instruments" is being referred to in the Foreign Exchange Management Act, 1999 (in particular sections 6 and 2A and 46 as proposed to be amended vide the Finance Act, 2015) is left open to interpretation.

If this wasn't confusing enough, the Non-Debt Instruments Rules also define the term 'Hybrid Securities' as hybrid instruments such as optionally or partially convertible preference shares or debentures and other such instruments as specified by the Central Government from time to time, which can be issued by an Indian company or trust to a person resident outside India.

Not only is the definition itself ambiguous, from a plain reading, hybrid securities appear to be a sub-set of debt-instruments, and the term itself has not actually been referred to or used anywhere in the Non-Debt Instruments Rules. The Debt Instruments Regulations on the other hand do not make any mention of hybrid securities at all which leaves one wondering how 'Hybrid Securities' will be treated and why the term has been defined in the first place.

The term equity instruments in the Non-Debt Instruments Rules has substantially the same meaning as that ascribed to the term capital instruments in the TISPRO Regulations. However, the term capital instruments (not defined in the Non-Debt Instruments Rules) appears in several places in the Non-Debt Instrument Rules, including in significant provisions such as the definition of downstream investment and conditionalities pertaining investment in certain sectors. This is, of course, in all likelihood a drafting error.

Some clarity on Debt Instruments – but what are securities?

Although a certain amount of ambiguity has resulted from the Non-Debt Instruments Rules, they also bring about certain welcome changes for Foreign Venture Capital Investors ("**FVCIs**") who now under these rules have been specifically granted permission to invest in debt instruments issued by start-ups. The TISPRO Regulations were fairly ambiguous on this point as they used the term "securities" which led to many people taking the view that FVCIs could only invest in what was then termed "capital instruments" since the term "securities" was not defined in the TISPRO Regulations. The TISPRO Regulations also had specific provisions on purchase and sale of securities other than capital instruments by a person resident outside India in a separate annexure which did not refer to or

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5. investment in units of mutual funds or Exchange-Traded Fund (ETFs) which invest more than fifty per cent in equity;
6. junior-most layer (i.e. equity tranche) of securitisation structure;
7. acquisition, sale or dealing directly in immovable property;
8. contribution to trusts; and
9. depository receipts issued against equity instruments.

include FVCIs which bolstered the above view. The Non-Debt Instruments Rules remain ambiguous on the ability of FVCIs to invest in debt instruments of entities other than start ups.

FPIs – The Good, the Bad and the Ugly

In addition to the above, certain substantial changes have been brought about with respect to investment by Foreign Portfolio Investors ("**FPIs**"). The Non-Debt Instruments Rules also propose to, with effect from 01 April 2020, revise the maximum aggregate investment FPIs are permitted to hold in Indian companies to the lower of (a) the relevant sectoral caps or (b) 24%, 49% or 74% as deemed fit by the relevant company and approved by a resolution of its board of directors and a special resolution of its members (which must be passed before 31 March 2020 if the company wishes to impose a maximum aggregate lower than the sectoral cap). While the Rules continue to permit a company to increase its threshold limit upto the sectoral cap (by passing a resolution of its board of directors and a special resolution of its members), the company cannot decrease the same after 01 April 2020 or after any subsequent increase in the limit by the company. Additionally, FPIs are now permitted to invest in sectors in which foreign investment is prohibited upto a maximum aggregate limit of 24%. This was not earlier permitted as per the TISRPO Regulations. FPIs are now also permitted to invest in domestic mutual funds, Category III AIFs and offshore funds for which no-objection certificate has been issued under the SEBI (Mutual Funds) Regulations, 1996 and which invest more than 50% in equity instruments on repatriation basis as well as in units of REITS and InvITs, on a repatriation basis.

Further, the Non-Debt Instruments Rules (in addition to retaining the provision that in the event the FPI thresholds are exceeded the FPI has the option to divest such holding within trading days) state that if such divestment is not undertaken, the entire investment of the FPI will be deemed to be a foreign investment and places the onus of reporting the same on the FPI. This is, of course, quite unfair to the investee company in question, as such a deeming provision will result in the company bearing the brunt of an FPI falling afoul of provisions of law applicable to it.

The Non-Debt Instruments Rules also introduces a new restriction on FPIs that have commonality of ownership via the concept of investor group and states that in case, two or more FPIs including foreign Governments/their related entities have common ownership, directly or indirectly, of more than 50% or common control, all such FPIs shall be treated as forming part of an investor group. The term 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.

To bring the exchange control regulations pertaining to FPIs in line with the SEBI Notification dated 10 April 2018 on clubbing of investment limits of foreign Government/ foreign Government related entities, the Non-Debt Instrument Rules provide that investment by foreign Government agencies shall be clubbed with the investment by the foreign Government or its related entities for the purpose of calculation of 10% limit for FPI investments in a single company, if they form part of an investor group. Exemptions may be granted under agreement or treaty with other sovereign governments or by an order of the Central Government. The SEBI notification sets out modalities on how this would be construed and calculated.

In certain other changes, (i) under the Non-Debt Instruments Rules, OCIs can now enrol for the national pension scheme governed and administered by Pension Fund Regulatory and Development

Authority of India; (ii) NRIs and OCIs can now invest in units of domestic funds which invest more than 50% in equity; and (iii) the terms on which long term investors such as sovereign wealth funds, Multilateral Agencies, Endowment Funds, Insurance Funds, Pension Funds and Foreign Central Banks may purchase securities have now been done away with and are to be newly prescribed by the RBI and SEBI.

Government taking control

One of the most surprising changes effected under the Non-Debt Instruments Rules is the increased control of the Central Government over foreign investments by introducing the terms 'and in consultation with the Central Government' in various provisions such as approval of transfers not covered through general permission, divestment of investments by non-resident Indians ("**NRIs**") or overseas citizens of Indians ("**OCIs**") in case of a breach of the relevant limits or sectoral caps, and issuance of shares in case of swap of equity instruments. This effectively takes away any autonomy/discretionary powers that were vested with the RBI and makes one wonder how much more tedious, an already fairly time consuming approval process, will become.

Why the Change?

One of the most radical changes brought about by these Non-Debt Instrument Rules is the merging of provisions pertaining to the acquisition or transfer of immovable property, which was earlier covered under the ATIP Regulations with provisions pertaining to foreign investment. While there is no significant change in the law pertaining to acquisition or transfer of immovable properties by a person resident outside India, such acquisition will now be viewed as a non-debt investment.

Clearer Debt Instrument Regulations

The provisions on investments by FPI, NRI, OCI, foreign central banks, and multilateral development banks, in government securities, debt, non-convertible debentures, and security receipts, among others (which were earlier part of TISPRO Regulations), have been moved to the Debt Regulations.

Under the TISPRO Regulations, while an authorised dealer was permitted to allow the remittance of sale proceeds of a security (net of applicable taxes) to the seller of shares resident outside India subject to certain condition, the Debt Instruments Regulations now go a step further and permit, an authorised dealer to allow remittances, both inward and outward, related for permitted derivatives transactions.

The Debt Regulations have also liberalised the manner in which Foreign Central Banks or and Multilateral Development Banks may purchase Government Securities subject to conditions stipulated by the RBI.

Changes bringing much needed clarity

Fortunately, some initial inadvertent errors in the Non-Debt Instruments Rules have already been rectified vide an amendment to the said Rules dated 5 December 2019. Significant among these amendments are:

- the definition of "sectoral cap" which initially made a reference to both equity and debt instruments, which could potentially have led to certain instruments being viewed as both External Commercial Borrowings and foreign investment;

- the removal of a provision which allowed FPIs to transfer instruments to persons resident outside India by way of gift; and

- the inclusion of foreign investment in single brand retail trade being permitted upto 100% under the automatic route, which in the unamended Rules read as being under the automatic route upto 49% and thereafter under the government approval route upto 100%;

Conclusion

The effort to restructure and possibly streamline the erstwhile exchange control legislations on certain capital account transactions permitted by a person not resident in India has, while liberalising/clarifying certain restrictions (such as the ability of FVCIs to invest in debt instruments of start-ups), also created some interpretative issues. This is exacerbated by the fact that the master directions and the FDI policy remain unchanged and the intention behind certain deviations from the earlier policies are unexplained. More surprising still is the fact that these Regulations and Rules have not been uploaded/are not available on the RBI website. Further clarifications are awaited from the government on these, but in light of the recent amendments made to the Non-Debt Instruments Rules, one can hope that these clarifications are intimidated.

For further clarification and details on the above, you may write to the Exchange Control team comprising of among others Ms.Siddhi Ghatlia (Partner) at sghatlia@almtlegal.com and Ms. Jenika Solanki (Associate) at jsolanki@almtlegal.com.