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KEY HIGHLIGHTS IN THE CONSOLIDATED POLICY ON FOREIGN INVESTMENTS IN INDIA

1. Introduction

The Department of Industrial Policy & Promotion (the "**DIPP**") had, in supersession of the erstwhile policy on foreign investments in India (the "**Erstwhile FDI Policy**") released the consolidated policy on foreign investments in India (the "**FDI Policy, 2016**") which is effective from June 07, 2016. Vide the FDI Policy, 2016, the DIPP has consolidated all the Press Notes released by it in the last year and further attempted to provide much needed clarification with respect to some of the items. For our analysis of Press Note 9 of 2015, Press Note 12 of 2015 and Press Note 3 of 2016 please refer to our earlier Infolex Newsalerts[1]. Here, we have attempted to capture the key highlights of the FDI Policy, 2016 over and above the revisions suggested in the aforementioned Press Notes. Soon after the FDI Policy, 2016, DIPP has issued Press Note 5 of 2016 which seeks to further liberalize a few sectors listed under the FDI Policy, 2016 (the "**Press Note 5**")[2].

2. Key Highlights of the FDI Policy, 2016 and Press Note 5

2.1. Deferred Payment

The Erstwhile FDI Policy stated that prior permission of the Reserve Bank of India (the "**RBI**") is required for transfer of capital instruments by the non-resident acquirer involving deferment of payment of the amount of consideration. RBI amended the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 ("**TISPROI**") by notifying the TISPROI (Seventh Amendment) Regulations, 2016 on May 20, 2016[3] (the "**TISPROI Seventh Amendment, 2016**"). Pursuant to the TISPROI Seventh Amendment, 2016, RBI permitted deferred payment in case of transfer of shares involving non-residents subject to following conditions:

[1]Press Note 9 of 2015 (Review of the existing foreign direct investment policy on partly paid shares and warrants) available at http://induslaw.com/publications/pdf/alerts-2015/september-23-15.pdf?src=Website&Month=23Sept2015
Press Note 12 of 2015 (Review of foreign direct investment policy on various sectors) available at http://induslaw.com/publications/pdf/alerts-2015/november-2015-final.pdf?src=30Nov2015
Press Note 3 of 2016 (Guidelines for foreign direct investment on e-commerce) available at http://induslaw.com/publications/pdf/alerts-2016/april-2016.pdf?src=Webiste&CTA=ReadMore
[2] Press Note 5 of 2016 (Review of foreign direct investment policy on various sectors) available at http://dipp.nic.in/English/acts_rules/Press_Notes/pn5_2016.pdf
[3] No. FEMA. 368/2016-RB

2.1.1. Not more than 25% of the total consideration can be paid by the buyer on a deferred basis;
2.1.2. Deferment cannot be for a period exceeding eighteen months from the date of the transfer agreement;
2.1.3. An escrow arrangement can be executed for this purpose for an amount not more than twenty five per cent of the total consideration for a period not exceeding eighteen months from the date of the transfer agreement;
2.1.4. If the total consideration is paid by the buyer to the seller, the seller may furnish an indemnity for an amount not more than 25% of the total consideration for a period not exceeding 18 months from the date of the payment of the full consideration;
2.1.5. Total consideration finally paid for the shares must be compliant with the applicable pricing guidelines.

It is important to note that the TISPROI Seventh Amendment, 2016 do not mandate but allow creation of escrows to park the money to be paid as deferred payment in the 18 month period. However, the intention of placing a cap of 25% on the amount which can be paid towards indemnity and a restriction that such indemnity cannot be provided for more than 18 months, is not clear. This will mean that the standard purchase transactions which generally include indemnity clauses not capping the indemnity amount payable or capping at anything more than 25% of the total consideration shall require RBI approval. This will act as a disincentive for foreign investors since their ability to be covered for risks in relation to such purchases is restricted only to 25% of the total purchase consideration.

It is probably fair to assume that the regulator intended that in case of an indemnity amount exceeding the 25% threshold, RBI approval will be required at the time of actually making such payments and not at the time of entering into share transfer contracts. It seems unlikely that the regulator intended that contractual indemnity not exceed 25% of the purchase consideration or that indemnity claims only be invoked within 18 months from the date of the share transfer contracts since this would be inconsistent with the prescribed statutory limitation period. Accordingly it may be possible to take the view that share purchase contracts can continue to be entered without any prior RBI approval providing for no indemnity limits or for indemnity limits beyond 25% and for longer time periods than 18 months but any payments beyond the stipulated amounts or time periods would require RBI approval at the time of payment. However it would be best if RBI can give greater clarity on this.

It is interesting to note that the above circular of RBI has not been taken into account in the FDI Policy, 2016, which still provides that any deferment of payment in transfer of capital instruments involving non-residents shall require RBI approval.

2.2. Investment Vehicle

The FDI Policy, 2016, has introduced a definition of an 'Investment Vehicle' to mean "*an entity registered and regulated under relevant regulations framed by The Securities and Exchange Board of India ("**SEBI**") or any other authority designated for the purpose and shall include Real Estate Investment Trusts ("**REITs**") governed by the SEBI (REITs) Regulations, 2014, Infrastructure Investment Trusts ("**InvIts**") governed by the SEBI (InvIts) Regulations, 2014 and Alternative Investment Funds ("**AIFs**") governed by the SEBI (AIFs) Regulations, 2012.*"

While the restriction on Foreign Direct Investment ("**FDI**") in trusts except Venture Capital Funds ("**VCF**") continues to apply, now as a consequence of introducing *Investment Vehicles*, an exception has been created to allow FDI in Investment Vehicles incorporated as trusts.

2.2.1. Foreign Investment by Investment Vehicles.

The FDI Policy, 2016 permits foreign investment from persons resident outside India (other than individuals being citizens of or any other entity registered / incorporated in Pakistan or Bangladesh), including an Registered Foreign Portfolio Investor ("**RFPI**") or non-resident Indians ("**NRI**") in Investment Vehicles. In addition to the InvIts, REITs and AIFs, the FDI Policy, 2016 also includes AIFs notified under Schedule 11 of TISPROI as being entitled to receive foreign investment from a person resident outside India. Schedule 11 to TISPROI was amended by a recent amendment, inter alia, seeking to promote investments by AIFs, and this seems to be in furtherance of the same objective.

The FDI Policy, 2016 also clarifies that 'Real Estate Business' shall not include, *inter alia*, REITs registered and regulated under the SEBI (REITs) Regulations 2014.

2.3. Calculation of Foreign Investment in an Investment Vehicle

FDI Policy, 2016 talks about computation of total foreign investment and includes investment in fully, compulsorily and mandatorily convertible preference shares and fully, compulsorily and mandatorily convertible Debentures or units of an Investment Vehicle.

The FDI Policy, 2016 provides that downstream investment by an Investment Vehicle shall be regarded as foreign investment if either the sponsor or the manager or the investment manager is not Indian 'owned and controlled' as defined in Regulation 14 of TISPROI as amended by the TISPROI (Second Amendment) Regulations, 2016 ("**TISPROI Second Amendment, 2016**") dated February 15, 2016. The proviso states that for sponsors or managers or investment managers organized in a form other than companies or LLPs, SEBI shall determine whether the sponsor or manager or investment manager is foreign owned and controlled. This may cause certain hardships in the absence of an objective test to determine the residential status of a sponsor or manager or investment manager if the entity is not a company or an LLP. While there are no restrictions on the sponsor or manager or investment manager being organized in a form other than a company or an LLP, it will be administratively difficult for such entities to approach SEBI to determine the residential status, which in turn will affect the investments made by the AIF. This exposes such entities to subjective determination of residential status, which in turn has a bearing on the investments of the AIF. Further, if there are any changes in the constitution of the sponsor or manager or investment manager, it may again require validation of SEBI, pursuant to such change.

It is interesting to note that ownership and control of trustees (in case the Investment Vehicle is organized as a trust) is not a criterion for determining whether the downstream investment will be considered foreign investment, given that trustees may have wide powers with respect to the actions undertaken by a trust. It is also interesting to note that a 'sponsor' under the SEBI (AIFs) Regulations, 2012 has been defined as a person or persons who set up the AIF and includes promoter in case of a company and designated partner in case of a limited liability partnership, but the definition does not specify trustees in case of a trust.

An explanation under Annexure 5 explains the computation of foreign investment for an AIF. It says 'Control' of the AIF should be in the hands of 'sponsors' and 'mangers/investment managers', with the general exclusion of others. In case the 'sponsors' and 'managers/investment managers' of the AIF are individuals, for the treatment of downstream investment by such AIF as domestic, 'sponsors' and 'managers/investment managers' should be resident Indian citizens.

Another explanation clarifies that the extent of foreign investment in the corpus of the Investment Vehicle will not be a factor to determine as to whether downstream investment of the Investment Vehicle concerned is foreign investment or not. The FDI Policy, 2016 also states that any downstream investment by an Investment Vehicle as per the FDI Policy that is reckoned as foreign investment shall have to conform to the sectoral caps and conditions / restrictions. Similarly, downstream investment in an LLP by an Investment Vehicle that is reckoned as foreign investment has to conform to the provisions of Schedule 9 of TISPROI as well as the Erstwhile FDI policy.

The Investment Vehicle receiving foreign investment shall be required to make such report and in such format to RBI or to SEBI as may be prescribed by them from time to time

2.4. Sweat Equity Shares

The TISPROI (Fourth Amendment) Regulations, 2015[4] (the "**TISPROI Fourth Amendment, 2015**") incorporated a definition and introduced the concept and definition of "sweat equity" to mean such equity shares as issued by a company to its directors or employees at a discount or for consideration other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called. This definition is aligned with the definition under the Companies Act, 2013 (the "**2013 Act**") and has been carried forward to the FDI Policy, 2016. Further, the guidelines with respect to issuance of employee stock options ("**ESOPs**") as enumerated in the TISPROI read with TISPROI Fourth Amendment, 2015 have also been carried forward to the FDI Policy, 2016 and have been made applicable to issuance of sweat equity shares to non-residents.

2.5. Employee Stock Options ("ESOPs")

The Erstwhile FDI Policy did not contain a definition of ESOPs. The TISPROI Fourth Amendment, 2015 introduced the definition of employee stock options to mean the option given to the directors, officers or employees of a company ("**Eligible Employees**") or of its holding company or joint venture or wholly owned overseas subsidiary/subsidiaries, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price. It was further clarified in the TISPROI Fourth Amendment, 2015 that the issue of ESOPs under applicable law should be in compliance with the sectoral cap applicable to the issuing company and where foreign investment is under the approval route, such issue shall require prior approval of the Foreign Investment Promotion Board ("**FIPB**"). Further it was stated that ESOPs could be issued to residents of Pakistan subject to prior approval of FIPB. The understanding of ESOPs as captured in the TISPROI Fourth Amendment, 2015 has now been incorporated in the FDI Policy, 2016.

It is pertinent to note here that the definition of ESOPs is not aligned with the definition under the 2013 Act in the sense that the 2013 Act does not include Eligible Employees of a joint venture entity. It needs to be noted here that the 2013 Act did permit for ESOPs to be issued to Eligible Employees of an associate company[5] which included joint venture entities. However, this provision pertaining to ESOPs to be issued to Eligible Employees of associate companies was removed vide the Companies (Share Capital and Debentures) Amendment Rules, 2015 w.e.f. March 18 2015. Further, the 2013 Act

[4] Notification No. FEMA.344/2015 RB dated June 11, 2015

[5] Section 2 (6) of the 2013 Act defines an Associate Company in relation to another company to mean a company in which that other company has a significant influence but which is not a subsidiary company of the company having such influence and includes a joint venture company. Significant influence means control of at least twenty per cent. of total share capital, or of business decisions under an agreement

contemplates ESOPs to be given to Eligible Employees of any subsidiary and not specifically a wholly owned subsidiary as is contemplated under the TISPROI Fourth Amendment, 2015 and the FDI Policy, 2016. One would have hoped that the FDI Policy, 2016 would attempt to remove these inconsistencies, however, the same does not seem to be the case. These inconsistencies continue to remain in the FDI Policy, 2016.

2.6. Venture Capital Fund

The definition of VCF has been revised in the FDI Policy, 2016 to state that VCF means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model and shall include an angel fund as defined under Chapter III-A of SEBI (AIF) Regulations, 2012. Under the Erstwhile FDI Policy, VCF was defined to mean a fund established in the form of a trust, a company including a body corporate and registered under SEBI (VCF) Regulations, 1996, which (i) has a dedicated pool of capital; (ii) raised in the manner specified under the Regulations; and (iii) invests in accordance with the Regulations. This revision has been incorporated to align the concept of VCFs under the SEBI (AIFs) Regulations, 2012 (the "**2012 Regulations**") which brought the entire regime governing the VCFs under the 2012 Regulations.

2.7. Investment by Foreign Venture Capital Investor ("FVCI")

The TISPROI (Third Amendment) Regulations, 2016 (the "**TISPROI Third Amendment, 2016**") provided that FVCIs can invest in any Indian company engaged in the sectors mentioned in Schedule 6 of TISPROI Regulations and startups irrespective of the sector in which they are engaged, under the automatic route. Earlier FVCIs could only invest in VCFs or Indian Venture Capital Undertaking under Schedule 6 of TISPROI Regulations. For our detailed analysis of the TISPROI Third Amendment, 2016, please refer to our earlier Infolex Newsalert[6]. To this extent, the revisions incorporated vide the TISPROI Third Amendment, 2016 have been carried forward to the FDI Policy, 2016. It may be noted here that the FDI Policy, 2016 does not go on to define a 'startup'. However, reference may be made to the TISPROI Third Amendment, 2016 which provides for a definition of 'startup'[7].

Further, in line with the TISPROI Third Amendment, 2016, it has been clarified that FVCIs can also invest in Category I AIFs. It may be noted here that Category I AIFs include VCFs. This revision once again appears to have been incorporated in order

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[6] For a detailed analysis of the TISPROI Third Amendment, 2016, please refer to http://induslaw.com/publications/pdf/alerts-2016/may-18-05-2016.pdf.

[7] 'Startup' shall mean an entity, incorporated or registered in India not prior to five years, with an annual turnover not exceeding INR 25 Crores in any preceding financial year, working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property. Provided that such entity is not formed by splitting up, or reconstruction of a business already in existence.
For this purpose:

i. 'entity' shall mean a private limited company (as defined in the 2013 Act), or a registered partnership firm (registered under section 59 of the Partnership Act, 1932) or a limited liability partnership (under the Limited Liability Partnership Act, 2008.
ii. the expression 'turnover' shall have the same meaning as assigned to it under the 2013 Act.
iii. An entity is considered to be working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property if it aims to develop and commercialize (a) a new product or service or process; or (b) a significantly improved existing product or service or process that will create or add value for customers or workflow.

Provided that it will not include the mere act of developing (a) products or services or processes which do not have potential for commercialization; or (b) undifferentiated products or services or processes or (c) products or services or processes with no or limited incremental value for customers or workflow.

to align with the fact that the VCFs are now classified as Category I AIFs pursuant to the 2012 Regulations. Accordingly, since FVCIs were permitted to invest in VCFs under the Erstwhile FDI Policy, the clarification has been provided to state that they can continue to invest in Category I AIFs.

Furthermore, the Erstwhile FDI Policy stated that in case a VCF was a trust, the foreign investment by a FVCI required FIPB approval. However, where the VCF was a company, the FVCI could invest in such company subject to compliance with pricing guidelines, reporting requirements, mode of payment, minimum capitalization norms etc. This requirement to take FIPB approval in case of an investment by a FVCI into a VCF trust has been eliminated in the FDI Policy, 2016 and accordingly, the policy with respect to the investment by FVCIs has been liberalized.

2.8. Investment by Qualified Foreign Investor ("QFI")

The concept of Qualified Foreign Investor has been removed in the FDI Policy, 2016. This revision again seems to be in nature of a clarification since with effect from June 1, 2014, QFIs have been brought under the regime governing Foreign Portfolio Investors pursuant to the SEBI (Foreign Portfolio Investors) Regulations, 2014.

2.9. Establishment of branch office, liaison office or project office

A new paragraph has been added to the FDI Policy, 2016 through Press Note 5 through which it has been clarified that for establishment of branch office, liaison office or project office or any other place of business in India if the principal business of the applicant is Defence, Telecom, Private Security or Information and Broadcasting, approval of RBI is not required, in cases where FIPB approval or license/permission by the concerned Ministry/Regulator has already been granted.

Authors: Suneeth Katarki, Aakash Dasgupta and Ankita Gupta.

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