

INFOLEX

NEWSALERT

APRIL 2018

MINIMUM FDI LIMITS FOR UNREGULATED 'OTHER FINANCIAL SERVICES' SECTOR ANNOUNCED

1. INTRODUCTION

The Ministry of Finance has announced minimum foreign direct investment ("FDI") limits applicable to *unregulated or partially regulated* investee entities under the Government approval route in the '*other financial services*' sector, by way of a press release dated April 16, 2018 (the "**2018 Press Release**").

Further, such unregulated or partially regulated investee entities have been bifurcated into '*fund-based*' and '*non-fund based*' activities, and separate minimum FDI limits are now applicable to both.

2. 'OTHER FINANCIAL SERVICES' - BACKGROUND

Press Note 6 of 2016 by the Department of Industrial Policy and Promotion (the "**DIPP**") ("**Press Note 6**")¹ introduced the '*other financial services*' sector (the "**OFS Sector**"), to replace the erstwhile '*Non-banking Finance Companies*' ("**NBFC**") sector under the 2016 consolidated FDI policy (the "**2016 FDI Policy**")².

Before the introduction of Press Note 6, the 2016 FDI Policy permitted up to 100% FDI under the automatic route into specified activities undertaken by NBFCs, subject to certain conditionalities, including minimum capitalization norms and requirements relating to downstream investments.³

The 2016 FDI Policy distinguished between fund-based and non-fund-based activities. NBFCs engaged in non-fund-based activities were allowed to bring USD 0.5 Million upfront under the automatic route, irrespective of the amount of FDI in the company, provided such company did not set up a subsidiary to carry out any other activity.

Pursuant to Press Note 6, the NBFC sector and regime was replaced with the OFS Sector.

¹ Press Note 6 of 2016, DIPP, accessible at http://dipp.nic.in/sites/default/files/pn6_2016.pdf

² Para 5.2.26, Consolidated FDI Policy 2016, accessible at http://dipp.nic.in/sites/default/files/FDI_Circular_2016%282%29.pdf

³ These specified activities were merchant banking, underwriting, portfolio management services, investment advisory services, financial consultancy, stockbroking, asset management, venture capital, custodian services, factoring, credit rating agencies, leasing and finance, housing finance, forex broking, credit card business, money changing business, micro credit and rural credit. The minimum capitalization norms required a minimum of the following amounts to be brought upfront in case of FDI in an investee entity: (a) USD 0.5 million if the FDI was upto 51%; (b) USD 5 million if the FDI was more than 51% but up to 75%; and (c) USD 7.5 million if the FDI was more than 75% and up to 100%. In case of (c), apart from the USD 7.5 million to be brought in upfront, a total of USD 50 million was required to be invested within a period of 24 months.

Entities engaged in the OFS Sector were divided into two categories: (i) those regulated by a Financial Services Regulator⁴ ("**Regulated OFS**"); and (ii) those which were not regulated by any Financial Services Regulator, or where only part of the financial services activity was regulated, or where there was doubt regarding the regulatory oversight ("**Unregulated OFS**").

Entities entitled to receive FDI and engaged in Regulated OFS, were permitted to receive up to 100% FDI through the automatic route whereas entities engaged in Unregulated OFS *were permitted to receive up to 100% FDI only with Government approval.*

Amongst other conditions, it was further provided that FDI in the OFS Sector (both Regulated OFS as well as Unregulated OFS), be subject to conditionalities and minimum capitalization norms that may be prescribed by the concerned Financial Services Regulator or Government agency, as applicable. However, the Government did not prescribe such minimum capitalization norms pursuant to Press Note 6, until the publication of the 2018 Press Release.

The same conditions applicable to the OFS Sector under the 2016 FDI Policy, have been retained under the current consolidated FDI policy, 2018 (the "**2018 FDI Policy**"), the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017, and the RBI Master Directions – Foreign Investment in India⁵.

The Government has now announced the minimum capitalization norms applicable to Unregulated OFS.

3. NEW FDI LIMITS

Under the 2018 Press Release, the Ministry of Finance has announced various conditions in the context of FDI in Unregulated OFS set out below.

(a) Fund-based activities

FDI in fund-based activities shall be subject to a minimum FDI limit of *USD 20 million*. '*Fund-based activities*' have been listed to include merchant banking, underwriting, portfolio management services, stockbroking, asset management, venture capital, custodian services, factoring, leasing and finance, housing finance, credit card business, micro credit and rural credit.

(b) Non-fund based activities

FDI in non-fund-based activities shall be subject to a minimum FDI limit of *USD 2 million*. '*Non-fund-based activities*' have been listed to include investment advisory services, financial consultancy, forex broking, money-changing business and credit rating agencies.⁶

The 2018 Press Release clarifies that Unregulated OFS will include scenarios where the entity is not registered with the concerned Financial Sector Regulator and/or where the entity/activity is exempted under the concerned sector regulations.

⁴ 'Financial sector regulators' have been defined as the Reserve Bank of India, Securities and Exchange Board of India, Insurance Regulatory and Development Authority, Pension Fund Regulatory and Development Authority, National Housing Bank or any other financial sector regulator as may be notified by the Government of India.

⁵ RBI Master Directions – Foreign Investment in India, dated January 12, 2018, accessible at https://rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11200

⁶ The activities described as non-fund based activities, are similar to what was defined as such under the 2016 FDI Policy.

4. **INDUSLAW VIEW**

Press Note 6 contemplated that minimum capitalisation norms could be prescribed for both Regulated OFS as well as Unregulated OFS. However, under the 2018 Press Release, the Government has chosen to prescribe such norms only for Unregulated OFS.

Accordingly, the Regulated OFS sector, which has been receiving up to 100% FDI under the automatic route without meeting any minimum capitalization norms, can continue to do so even after the 2018 Press Release.

The lack of clarity in Press Note 6 and the current FDI regime relating to the Regulated OFS, in relation to *which* activities may be treated as being regulated by a Financial Sector Regulator, has not been completely alleviated by the 2018 Press Release.

However, reliance may now be placed on the 2018 Press Release, which clarifies that an entity that is not registered with a Financial Sector Regulator, or which is otherwise exempted under the relevant sector regulations, may be deemed to be an Unregulated OFS. This may continue to be a roadblock for Indian companies in the burgeoning financial technology sector, which seek foreign investment.

The new regime may be restrictive for entities such as core investment companies (“CICs”), which are otherwise bound by the Reserve Bank of India’s (the “RBI”) regulations, but are exempted from being registered as an NBFC or otherwise with the RBI.

With the 2018 Press Release, a CIC will need to meet the minimum capitalization of USD 20 million being brought in upfront to receive FDI, and such FDI shall *also* be subject to Government approval. A similar implication may also apply to investment managers of Alternate Investment Funds, and certain microfinance companies,⁷ which are not required to be registered with the relevant Financial Sector Regulators, but are bound by their regulations nonetheless.

Earlier, the minimum capitalization requirements in relation to the NBFC sector were applicable for activities which were covered under the automatic route. However, by way of the 2018 Press Release, minimum capital requirements have been imposed on a sector, which is already under the thumb of the Government approval route. Hence, it only adds a further layer of limitations to a sector which is already under Government scrutiny.

Further, a minimum FDI limit of USD 20 million on investee entities engaged in Unregulated OFS dealing in portfolio management services, stockbroking, asset management, venture capital, credit card business, micro credit and rural credit, appears to be excessive, as Indian companies in these sectors will find it difficult to raise such a high amount of FDI, in addition to receiving Government approval.

The explanation under the 2018 Press Release in relation to ‘fund and non-based fund activities’, as well as the activities listed under each sub-sector, are quite broad and are by no means exhaustive. Introduction of

⁷ Microfinance companies which fulfil the conditions under paragraph 2(i) of the ‘Master Directions – Exemptions from the Provisions of the RBI Act, 1934’ dated August 25, 2016 (accessible at <https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=10565&Mode=0>), are exempted from registration with the RBI.

these new minimum FDI limits will certainly affect investee entities (which fulfil any of the conditions under the 2018 Press Release), looking to raise funds from foreign investors.

In addition, since the specific activities listed as either '*fund-based*' or '*non-fund based*' are not defined, it could lead to ambiguity, as to whether a particular entity would be subject to these norms. For example, '*leasing and finance*' and '*credit card business*' were defined under the 2016 FDI Policy,⁸ but these have not been defined under the 2018 Press Release or the 2018 FDI Policy.

It is also unclear, whether the entire minimum FDI capital, will have to be infused by a single investor, or if it can be infused by multiple foreign investors investing simultaneously. We have hardly seen any movement in relation to FDI in the Unregulated OFS Sector since it requires Government approval and adding minimum capitalization as an additional compliance layer to the already regulated sector may only make it worse.

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Practice Areas: Corporate and Commercial, Government and Regulatory

April 25, 2018

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⁸ The 2016 FDI Policy clarified that 'Leasing & Finance' covers only financial leases and not operating leases. FDI in operating leases is permitted up to 100% under the automatic route. It was also provided that 'Credit Card business' includes issuance, sales, marketing & design of various payment products such as credit cards, charge cards, debit cards, stored value cards, smart card, value added cards, etc.