

Regulatory Hotline

July 16, 2025

INDIA'S FDI FRAMEWORK EMBRACES BONUS SHARES IN PROHIBITED SECTORS

- The Amended Rules now expressly permit Indian companies engaged in FDI-prohibited sectors to issue bonus shares to existing non-resident shareholders.
- Unlike Press Note 2 (2025), the Amended Rules explicitly grant retrospective effect to this clarification, thereby regularising past bonus issuances to foreign shareholders in prohibited sectors.

On June 11, 2025, the Department of Economic Affairs, Ministry of Finance, Government of India, issued the Foreign Exchange Management (Non-debt Instruments) (Amendment) Rules, 2025 ("**Amended Rules**")¹, modifying Rule 7 of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("**NDI Rules**")². This amendment now permits Indian companies engaged in sectors where Foreign Direct Investment ("**FDI**") is prohibited, to issue bonus shares to pre-existing non-resident shareholders, subject to specific conditions.

As background, the Department for Promotion of Industry and Internal Trade (DPIIT) had earlier, on April 7, 2025, released Press Note No. 2 (2025 Series) ("**PN2**")³ inserting a similar clarification under Para 1 of Annexure 3 of the Consolidated FDI Policy Circular of 2020 ("**FDI Policy**")⁴, effective from the date of the applicable FEMA notification. The Amended Rules, issued subsequently, now accord statutory backing to this clarification.

Under Para 2 of Schedule I of the NDI Rules, read with Paragraph 5.1 of the FDI Policy, sectors such as lottery, gambling and betting, chit funds, real estate, tobacco manufacturing, and others specified therein, are prohibited from receiving FDI. Notably, restrictions on gambling and betting (including casinos and lotteries) date back to the FDI Policy Circular of 2000, while FDI prohibition in tobacco manufacturing was introduced through Press Note 2 (2010 Series)⁵.

THE PRE-CLARIFICATION REGIME

Prior to the introduction of sectoral prohibitions, certain Indian companies operating in now-prohibited sectors had already received FDI and such non-resident shareholders continued to hold stake post-prohibition also, under a grandfathered status. However, after the imposition of FDI prohibition, the eligibility of such non-resident shareholders to participate in bonus or rights issues in these prohibited sectors, in proportion to their pre-existing shareholding remained a grey area. Since such issuances to non-residents constitute capital account transactions under FEMA, they require specific regulatory approval unless expressly permitted. In the absence of clear regulatory guidance, the companies engaged in prohibited sectors were, in some instances, required to seek clarifications or prior approvals from the regulators before proceeding with bonus issuances, thereby creating uncertainty and adding to the compliance burden.

As far as other sectors are concerned, where FDI is permitted subject to the entry route, sectoral cap, and other conditions (including FDI-linked performance requirements), Indian companies operating in such sectors have general permission to issue rights and bonus shares to non-resident shareholders, subject to adherence to sectoral cap, if any and in compliance with other applicable laws i.e., Section 63 of the Companies Act, 2013 and in case of listed entities, also the applicable SEBI Regulations..

WHAT HAS BEEN CLARIFIED?

The Amended Rules now unequivocally permit Indian companies in prohibited sectors to issue bonus shares to existing non-resident shareholders, provided such issuance does not alter the shareholding pattern and the bonus issuance complies with the applicable laws i.e., Section 63 of the Companies Act, 2013 and in case of listed entities, also the applicable SEBI Regulations.

Notably, the Amended Rules go a step further than PN2 by explicitly confirming the retrospective applicability of the clarification. This ensures that bonus shares previously issued by companies in prohibited sectors to their existing foreign shareholders are now deemed regularised. In contrast, PN2, despite being framed as a clarification, did not expressly address its retrospective scope, leaving room for interpretation that it applied only to future issuances. As a result, past issuances may have been seen as requiring regularization through the FEMA compounding route.

OUR ANALYSIS:

The clarification issued through Amended Rules is certainly a significant regulatory shift.

From the perspective of Indian companies engaged in prohibited sectors, this clarification facilitates them to restructure capital (by way of capitalisation of reserves) thereby, rewarding their long-term foreign investors, without

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violating the FDI norms. Bonus issuances help such companies to maintain existing FDI shareholding, enabling ongoing participation by foreign investors without attracting fresh FDI. Also, grandfathering of past bonus share issuances, which was previously a grey area, eliminates the risk of regulatory penalties or forced unwinding.

From the foreign investor's standpoint, permissibility of bonus issuances help increase their absolute shareholding i.e. number of shares, potentially enhancing value of their holding without the need to infuse additional capital. The retrospective application strengthens investors' confidence, particularly amongst the long-standing JV arrangements.

While the bonus and rights issuance receive same treatment under the FDI Policy, the Amended Rules limit this relief to bonus issuances alone and not extended to rights issuance by the companies engaged in prohibited sectors to their existing foreign shareholders even when their shareholding can remain unchanged. This reflects the regulators' willingness to take a nuanced and matured approach even in sensitive sectors by differentiating between economic inflow and non-cash corporate actions. As a result, such companies may still be able issue rights shares only to their existing domestic and not to foreign shareholders, potentially leading to a gradual dilution of foreign equity in prohibited sectors due to regulatory constraints.

PN2 VS. PN3: A CAUTION ON OVEREXTENSION

In the context of Press Note No. 3 (2020 Series) on April 17, 2020 ("PN3")⁶, a geography-based entry route condition which mandated prior government approval for any investment from the land-bordering countries ("LBC Investors"), a question arises – can the PN2 clarification be extended to bonus issuance involving LBC Investors under PN3? This issue can be looked at in two scenarios. First scenario relates to eligibility of LBC Investors to participate in bonus issuance in *prohibited sectors* who continued to hold stake post-prohibition also and second scenario would be the eligibility of LBC Investors to participate in bonus issuance in all other *non-prohibited sectors*.

Considering that PN2 read with Amended Rules specifically allow bonus issuance *only in prohibited sectors* and grandfathers such bonus issuances occurred in the past, this appears to implicitly allow bonus issuances already made to or proposed to be made to the LBC investors as per first scenario and approval requirements under PN3 may not trigger.

However, with respect to the second scenario, while the rationale for allowing only bonus issuance to prohibited sectors under PN2 can be argued to be applied logically even to non-prohibited sectors involving LBC investors, there are two key distinctions to be considered here. Firstly, PN2 and PN3 are governed under separate provisions under NDI Rules i.e., Rule 7(2) for PN2 and Rule 6(a) for PN3. Secondly, PN3 transactions remain under heightened regulatory scrutiny and approval process, given the geopolitical sensitivity around them. Therefore, unless the government issues a formal clarification, extending the PN2 relief to PN3 cases under second scenario (i.e. in non-prohibited sectors) would be unsafe.

That said, in our view, to better align PN3 with India's commitment to enhancing ease of doing business, any follow-on investments by the LBC Investors who held shares in Indian companies prior to the introduction of PN3, if made solely to maintain their pre-PN3 shareholding, whether through exercise of investor protection rights or through a rights or bonus issue, should be relaxed from the prior government approval. This exemption would protect existing foreign investors from dilution and at the same time, preserve the legislative intent behind PN3.

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¹<https://egazette.gov.in/WriteReadData/2025/263729.pdf>

²https://rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=12099

³https://dpiit.gov.in/sites/default/files/pn2_07April2025.pdf

⁴<https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020.pdf>

⁵https://dpiit.gov.in/sites/default/files/pn2_2010_0.pdf

⁶https://dpiit.gov.in/sites/default/files/pn3_2020.pdf

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