Corpsec Hotline

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CONSOLIDATED FDI POLICY 2012 RELEASED - NEW BOTTLE OLD WINE!

The Department of Industrial Policy and Promotion ("**DIPP**") in India, in pursuance of its policy of consolidating all the press releases / press notes, has released the Circular 1 of 2012, being the new consolidated foreign direct investment ("**FDI**") policy ("**New FDI Policy**"), which is made effective from April 10, 2012. The New FDI Policy supersedes inter alia the earlier version of the consolidated FDI policy of 2011 i.e. Circular 2 of 2011 ("**Erstwhile FDI Policy**") and other press notes issued prior to April 9, 2012.

Along with the New FDI Policy, DIPP has also issued a press release ("**Press Release**") whereby DIPP has left a remark that "*it is felt that the need of frequent amendments to the Circular does not exist any longer*". As a result, earlier the consolidated FDI policy which was a part of review process that was undertaken two times annually; now onwards would be revised only annually. Thus, the next version of the consolidated FDI policy will now be released on March 29, 2013 (as indicated in the Press Release); however, in the intervening period, DIPP may make changes to the New FDI Policy by way of press notes.

KEY CHANGES BROUGHT BY THE NEW FDI POLICY

Following are the significant changes introduced by the New FDI Policy:

1. **Investment by FIIs in commodity exchanges under automatic route**
   Under the Erstwhile FDI Policy, foreign investment by FDI and FII combined is allowed in commodity exchanges up to 49% under the approval route. Within this cap of 49%, FDI investment is allowed up to 26% and FII investment under portfolio investment scheme ("**PIS**") is allowed up to 23%. Considering the basic nature of FII investments, DIPP has now dispensed with the condition of seeking prior approval of FIPB before any investment by FIIs into commodity exchanges. However, the FDI investment in commodity exchanges would continue to be under the approval route.

   This policy change has been aligned with the policy for FDI in infrastructure companies in the securities markets, such as stock exchanges, depositories and clearing corporations. This would certainly curtail the timeline for investments by FIIs in commodity exchanges and create liquidity and also allow for free trading in the securities of commodity exchanges, such as Multi Commodity Exchange that got listed recently in India, on the floor of the stock exchange.
2. **Clarification on '*leasing and finance*' for FDI in NBFCs**
   Currently, DIPP has allowed FDI in non-banking financial services ("**NBFC**") under the automatic route in 18 (eighteen) activities as prescribed. The activity of 'leasing & financing' is also covered under the aforesaid list. The New FDI Policy has clarified that the 'leasing & financing' activity includes only the 'financial leases' and not 'operating leases'. To decide whether a particular lease is an operating lease or financial lease depends upon the terms of the lease. The major differences between the two types of leases are:
   1. (a) In case of a financial lease, all the risks and reward gets transferred to the lessee. In this case, an asset is leased to only one lessee during the economic life of the asset and ownership of the asset normally gets transferred to the lessee at the end of the lease term. It may be noted that in case of a financial lease, the lessor is only a financier for the asset and is not interested in the asset.
   2. (b) In case of an operating lease, an asset is normally leased by a lessor to more than one lessee during the economic life of an asset to recoup the investment and to earn profit margin. In other words, after the lease period, the lessor will get back the asset and normally will give it on lease again to a new lessee for the purpose of recovering the investment and to earn the profit.

   From the clarification introduced under the New FDI Policy, it is clear that the intention of the government was always to allow FDI in NBFCs engaged only in financial leases and not in the companies which are engaged in the operating lease. This may have some consequences especially for companies engaged in auto leasing business.
3. **Conversion of amount payable on import of second-hand machinery into equity**
   Under the Erstwhile FDI Policy, conversion of amount payable for import of capital goods, machinery, equipment (including second-hand machinery) into equity shares is allowed under the approval route subject to compliance with certain conditions. The New FDI Policy has now made an exclusion in respect to the conversion of amount payable for the import of second-hand machinery into equity shares. This policy change has been done particularly to protect the interest of the Indian manufacturers of capital goods, machinery, etc. who have been affected by the import of second-hand equipment which are more often of inferior quality.
4. **Transfer of shares from non-resident Indian ("NRI") to non-resident ("NR")**
   The New FDI Policy has now expressly specified a broad restriction that any transfer of shares from a NRI to a NR

comes under the ambit of the Reserve Bank of India ("**RBI**") approval route, which is in line with the restriction already provided under the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("**TISPRO Regulations**").

It is unclear why this restriction was not streamlined with NR to NR transfer. If the said restriction was in respect of restrictive sectors where NRIs enjoy certain special status (eg. real estate) or where investments are made under the special regime available to NRIs (eg. non-repatriable investment), it may still be understandable. By having a general restriction on transfer of shares by NRIs to NR, especially when an NRI has invested under the FDI route, it would put the NRIs to a disadvantage vis-a-vis foreign individuals, who can transfer the shares to other NRs without any prior approval.

Vaibhav Parikh, Partner, Nishith Desai Associate on Tech, M&A, and Ease of Doing Business
March 19, 2025

SIAC 2025 Rules: Key changes & Implications
February 18, 2025

PAST PRESS NOTES AND CIRCULARS

In addition to the above analyzed key changes, the New FDI Policy subsuming the past press notes / circulars has inter alia incorporated the following key changes that were brought about in the recent past:

1. **Prior intimation to RBI for raising aggregate FII limits for investments under the PIS**
   As provided under the Erstwhile FDI Policy and the TISPRO Regulations, an Indian company is allowed to raise the aggregate FII investment limit from 24% to the prescribed FDI sectorial caps or statutory ceiling, as applicable, with a resolution passed by its board of directors followed by a special resolution passed by the general body of the company. The RBI had vide A.P. (DIR Series) Circular No. 94 dated March 19, 2012, clarified that while raising such aggregate investment limit, the company is required to intimate the RBI and along with such intimation submit a Certificate from the Company Secretary stating that all the relevant provisions of the Foreign Exchange Management Act, 1999 ("**FEMA**") regulations and the FDI Policy have been complied with. To bring in line with the aforesaid RBI circular, the New FDI Policy has now incorporated the requirement of prior intimation to RBI in respect to such increase of the limit of investments by FIIs under the PIS.
2. **Investment by Foreign Venture Capital Investor ("FVCI")**
   The RBI had vide A.P. (DIR Series) Circular No. 93 dated March 19, 2012, allowed FVCIs to invest in eligible securities1 by way of a private arrangement / purchase from a third party which was clearly a rollback of policy in favor of FVCIs as it overruled the restriction imposed on an FVCI against purchase of securities on a private placement basis from a third party.

   The above mentioned circular also clarified that, FVCIs are permitted to invest on the floor of the stock exchange subject to the provisions of the Securities Exchange Board of India (FVCI) Regulations, 2000 ("FVCI Regulations"). The anomaly that prevailed was that Schedule 6 of the TISPRO Regulations only permitted investments into Venture Capital Undertakings as defined under the FVCI Regulations which does not include listed securities. However, the FVCI Regulations did allow FVCIs to invest in certain initial public offerings and preferential allotments. Thus, on certain occasions, the authorized dealers, placing strict reliance on Schedule 6 of the TISPRO Regulations, raised questions on whether such investments by FVCIs were valid.

   The above changes / clarifications given by RBI have now been incorporated in the New FDI Policy.
3. **Transfer of shares and convertible debentures of companies engaged in the financial services sector**
   The RBI had issued a circular dated November 4, 2011 with respect to dispensing the condition of seeking its prior approval in case of transfer of shares from resident to non-resident and vice versa in certain cases including the transfer of shares of companies engaged in the financial services. It is clarified by the DIPP that the transfer of shares of companies engaged in the financial services which is now under the general permission is reflected in the New FDI Policy. For a detailed analysis on this topic, please visit our Corpsec Hotline 'Liberalization of Restriction on Transfer of Shares Inter se Residents and Non-Residents'.
4. **Introduction of the Qualified Foreign Investor ("QFI") Regime**
   One of the major highlights of this year has been the opening of a completely new foreign investment route through the introduction of the QFI regime. The QFI regime was introduced on January 13, 2012 by the Securities Exchange Board of India ("SEBI") vide Circular No. CIR/IMD/FII&C/3/2012 and the RBI vide A.P. (DIR Series) Circular No. 66, which permitted qualified foreign investors (defined below) to directly invest into listed equity of Indian entities, subject to certain conditions. The New FDI Policy has now included within its folds this new regime .The following are inter alia the key features of the new QFI regime:
   - Firstly, to qualify as a QFI, the person is required to be from a country which is compliant with the Financial Action Task Force Standards and is a signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding. However, it is unclear as to which countries fulfill the aforesaid criteria and to clear the ambiguity, it would be advisable for the regulators to prescribe a list of such countries, the residents of which would be eligible to qualify as a QFI.
   - Secondly, the RBI circular provides that SEBI registered FIIs and FVCIs would not qualify as a QFI. However, the SEBI circular only provides that a registered FII or sub-account would not be eligible to qualify as a QFI, and has no mention of FVCI's. This discord amongst the rules prescribed by the two regulators continues to prevail under the New FDI Policy, which bars both, FIIs and FVCIs from qualifying as a QFI.
   - Thirdly, the investment by QFIs in a company is subject to an individual investment limit of 5% and an aggregate investment limit of 10%. These limits are to be reckoned over and above the FII and NRI portfolio investment limits, however, the investment continues to remain subject to the sectorial caps prescribed by the RBI and the DIPP.
   - Lastly, the investment by QFI is subject to such QFI meeting the 'know your client' ("KYC") requirements prescribed by SEBI. For the purposes of KYC, the ultimate beneficiary would be looked at and the responsibility of obtaining the KYC information and ensuring that the QFI complies with the prescribed norms and regulations has been imposed on the depository participant.
5. **FDI in single brand retail trading**
   In January 10, 2012, the DIPP had vide Press Note No. 1 (2012 Series) permitted FDI in single brand retail trading. The New FDI Policy under point 6.2.16.4 mirrors the said press note. Please refer to our hotline titled '100% Foreign Direct Investment in Single Brand Retail Allowed!!!' for our analysis on the pros and cons of the

rules specified making FDI in single brand retail.

6. **FDI in pharmaceutical sector**
   The New FDI Policy under paragraph 6.2.25 incorporates the provisions of the Press Note No. 3 (2011 Series) issued by the DIPP, whereby FDI in existing pharmaceutical companies was shifted from the automatic route to the government route.

CONCLUSION

Barring a few, most of the changes in the New FDI Policy are in respect to incorporation of the various press notes and circulars that various regulators have issued in the recent past. The changes made by DIPP in the New FDI Policy are not substantial, despite the fact that much was anticipated by the foreign investors as a sweetener from the Indian Government in lieu of the recent uncertainties already looming large such as the impending introduction of the general anti avoidance rules and the latest budget announcements in light of the recent Vodafone judgment, etc.

Moreover, the ambiguities which were previously prevailing have not been addressed under the New FDI Policy such as the uncertainties prevailing under the real estate sector on whether lock-in is applicable to a subsequent holder or not in case the original holder has already complied with the three year lock-in, number of issues regarding FDI in single brand retail trading and QFI regime, et al.

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You can direct your queries or comments to the authors

[1] Equity, equity linked instruments, debt, debt instruments, debentures of an Initial Venture Capital Undertaking or Venture Capital Fund ("VCF"), units of schemes / funds set up by a VCF.