DPNC GLOBAL

REGULATORY UPDATES

RECLASSIFICATION OF FOREIGN PORTFOLIO INVESTORS (FPIs) INVESTMENT INTO FOREIGN DIRECT INVESTMENT (FDI)

The Reserve Bank of India (RBI) has unveiled a simplified operational framework to facilitate the transition of investments by foreign portfolio investors (FPIs) to foreign direct investment (FDI) when their equity holdings in Indian companies exceed the prescribed 10% threshold.

This regulatory change aims to address situations where an FPI, along with its investor group, surpasses this limit, offering a structured mechanism to realign such investments under India's FDI regulations.

As per Schedule II of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019, FPIs can invest in the Indian capital markets and hold equity instruments of listed Indian companies, subject to adherence to the aggregate holding limits-

- An FPI or an investor group is permitted to hold up to 10% of the total paid-up equity capital of an Indian company on a fully diluted basis.
- The cumulative FPI investment may reach up to the sectoral cap applicable to the Indian company unless the company reduces such cap to 24%, 49%, or 74%, as deemed appropriate, through resolutions passed by the board of directors and shareholders.

However, the FPIs investing in breach of the above limits shall have the option of divesting their holdings within five trading days from the date of settlement of the trades causing the breach. In case the FPI chooses not to divest, then such investment shall be considered as a Foreign Direct Investment (FDI).

While earlier regulations specified compliance requirements, the operational processes lacked clarity. To bridge this gap, SEBI and RBI have introduced a comprehensive operational framework through SEBI Circular No. SEBI/HO/AFD/AFD-POD-3/P/CIR/2024/152 and RBI Circular A.P. (DIR Series) Circular No. 19, both issued on November 11, 2024. The key elements of this framework are summarized below:

1. APPROVALS AND COMPLIANCES

a) **Government Approvals**: FPIs must obtain requisite government approvals, including those for investments originating from bordering countries, and comply with FDI regulations, including entry routes, sectoral caps, investment limits, pricing guidelines, and the conditions outlined under Schedule I of the Rules.

Accordingly, when an FPI chooses to reclassify its holdings as FDI in a sector that falls under the government approval route, it is mandatory to secure prior approval from the Central Government before initiating the reclassification process.

b) **Company Concurrence**: The FPI must secure consent from the Indian investee company for reclassification, enabling the company to ensure compliance with FDI restrictions, sectoral caps, and government approval requirements.

In the event that the FPI has not obtained the necessary prior approvals or concurrence, the investment exceeding the prescribed limit must be divested within the specified timeframe, as required.

2. REPORTING REQUIREMENTS

The entire re-classified investment, must be reported within the timelines set by the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, as follows:

- **FC-GPR: -**The Indian company must report in Form FC-GPR within 30 days of issue of the issuance of new equity instruments to the FPI that result in exceeding the prescribed limit i.e. 10% of the total paid-up equity capital of an Indian company on a fully diluted basis.

- **FC-TRS: -**The FPI must report in Form FC-TRS within 60 days of transfer or remittance of funds if the breach of prescribed limit is from acquiring equity instruments in the secondary market.

The AD bank will report the reclassified foreign portfolio investment as divestment under the LEC (FII) reporting.

3. CLEAR INTENT & FREEZING OF PURCHASES

The FPI must notify its intention to reclassify the existing investment as FDI and submit copies of all necessary approvals and concurrence to its custodian, who will then report the same to SEBI.

Upon receiving the required documents, the custodian will freeze any purchase transactions until the reclassification process is fully completed.

Note: If the necessary approvals or concurrence are not obtained, the FPI must divest the excess shares within the specified timeframe.

4. RECLASSIFICATION PROCESS:

- Upon completion of the reporting, the FPI must instruct its custodian to transfer the equity instruments to its FDI demat account.
- The custodian will ensure all reporting requirements are fulfilled and then unfreeze and process the transfer.
- The reclassification date will be deemed as the date the investment exceeds the prescribed limit.
- The entire investment of the FPI in the Indian company will be classified as FDI, even if it later falls below the 10% threshold.
- For reclassification purposes, the FPI and its investor group will be considered as single entity.

Post reclassification of foreign portfolio investment to FDI, the said investment shall be governed by Schedule I to the Rules.

5. ALIGNMENT OF RBI AND SEBI GUIDELINES ON FPI TO FDI RECLASSIFICATION

The Reserve Bank of India's (RBI) recent move complements a similar update from the Securities and Exchange Board of India (SEBI), which revised its guidelines for reclassifying FPI investments to FDI.

Effective May 30, 2024, SEBI’s updated procedures require FPIs to comply with the Foreign Exchange Management Act (FEMA) and other relevant regulations when pursuing reclassification. SEBI mandates that once an FPI exceeds the 10% equity threshold, it may opt to convert its holdings into FDI, provided all regulatory criteria are fulfilled.

According to SEBI's revised guidelines, an FPI opting for reclassification must inform its custodian, who will then freeze any further equity transactions in the company until the reclassification is completed. The custodian will facilitate the transfer of securities to the designated FDI account, ensuring full compliance with all reporting requirements.

CONCLUSION:

The RBI and SEBI's updated guidelines provide a clear and structured framework for the reclassification of FPI investments to FDI, ensuring regulatory compliance and smooth transition when an FPI exceeds the 10% equity threshold in Indian companies. The revised procedures require adherence to the Foreign Exchange Management Act (FEMA), sectoral caps, and government approval routes, where applicable. These updates streamline the reclassification process, offering FPIs a transparent pathway to align their investments with FDI regulations, thereby fostering greater investment stability and compliance in the Indian market.

For more details, refer to the below RBI Notification and SEBI Circular dated 11th November, 2024:

1) RBI Notification

2) SEBI Circular

DISCLAIMER

The summary information herein is based on RBI & SEBI Circulars dated 11.11.2024. While the information is believed to be accurate, we make no representations or warranties, express or implied, as to the accuracy or completeness of it. Readers should conduct and rely upon their own examination and analysis and are advised to seek their own professional advice. This note is not an offer, advice or solicitation. We accept no responsibility for any errors it may contain, whether caused by negligence or otherwise or for any loss, howsoever caused or sustained, by the person who relies upon it.

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