Foreign Direct Investment – Notification FEMA 20 ,Schedule 4, 6, 7 & 8

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1. Introduction

The previous article on Foreign Direct Investment (FDI) dealt with the overall regulations governing Foreign Investment in India under Notification No. FEMA 20(R)/ 2017-RB (hereinafter referred to as "Fema 20(R)") and Automatic route of Investment under FDI scheme by a person resident outside India (PROI) under schedule 1 of Fema 20(R). As mentioned in the previous article, we have divided the entire subject of foreign investment into several parts with series of articles, each part covering a different facet of foreign investment in India. In the current article we will be covering the following aspects of foreign investment.

i. Foreign Investment by non-resident Indian (NRI) or Overseas citizen of India (OCI) on a non-repatriation basis - Schedule 4 of Fema 20(R)
ii. Foreign Investment in a Limited Liability Partnership (LLP) - Schedule 6 of Fema 20(R)
iii. Investment by a Foreign Venture Capitalist – Schedule 7 of Fema 20(R)
iv. Foreign Investment in an Alternate Investment Fund - Schedule 8 of Fema 20(R)

2. Key definitions used in the article

i. Investment on repatriation basis: An investment, the sale/ maturity proceeds , net of taxes, are eligible to be repatriated out of India, and the expression 'Investment on non-repatriation basis', shall be construed accordingly.

ii. Non-resident Indian (NRI): An individual resident outside India who is citizen of India.

iii. Overseas citizen of India (OCI): An individual resident outside India who is registered as an Overseas Citizen of India Cardholder under Section 7(A) of the Citizenship Act, 1955.

iv. Start- up company: Means a private company incorporated under the Companies Act, 2013 and recognised as such in accordance with notification number G.S.R. 180(E) dated February 17, 2016 issued by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, subject to the following conditions:

  a) Entity incorporate in India not prior to 7 years
  b) Having an annual turnover of ≤ INR 25 crores in any preceding financial year.
  c) Working towards innovation, development or improvement of products, processes or services, or if it's a scalable business with a high potential of employment generation or wealth creation.
  d) Such entity should not be formed by splitting up or reconstruction of a business already in existence.

v. Convertible Note: An instrument issued by a startup company evidencing receipt of money initially as debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of such startup company, within a period not exceeding five years from the date of issue of the convertible note, upon occurrence of specified events as per the other terms and conditions agreed to and indicated in the instrument;

vi. Real Estate Business: Means dealing in land and immovable property with a view to earning profit therefrom and does not include development of townships, construction of residential/ commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships. Earning of rent income on lease of the property, not amounting to transfer, will not amount to real estate business.

vii. Performance linked conditions: FDI linked performance conditions are the sector specific conditions stipulated in regulation 16 of FEMA 20(R) for companies receiving foreign investment

3. Foreign Investment by NRI/OCI under Schedule 4 of Fema 20(R)

Investment by an NRI/OCI can be done on repatriation basis or on non-repatriation basis. Investment on Non repatriation basis is only permitted to an NRI/OCI and not to every PROI.

3.1. Permitted Investment under Schedule 4 of Fema 20 (R)

An NRI or OCI, including a company, a trust and a partnership firm incorporated outside India and owned and controlled by NRIs or OCIs can invest on non – repatriation basis in:

i. Any capital instrument issued by a company without any limit either on the stock exchange or outside it.
ii. Units issued by an investment vehicle without any limit, either on the stock exchange or outside it.
iii. The capital of a Limited Liability Partnership without any limit.
iv. Convertible notes issued by a start-up company.

The above investments will be deemed to be domestic investment at par with the investment made by residents.

v. Any proprietary concern or a firm in India by way of contribution to the capital.

3.2. Prohibited Investment under Schedule 4

NRI and OCI are prohibited to make any investments in:

i. Capital instruments or units of a Nidhi company
ii. A company engaged in agricultural/ plantation activities or real estate business or construction of farm houses or dealing in Transfer of Development Rights.
iii. Proprietary concern which is engaged in agriculture / plantation activities or print media or real estate business.

3.3. Transfer of shares held on non – repatriable basis

NRI and OCI holding investments under Schedule 4, may transfer the same by way of sale, gift or inheritance:

i. To any PROI who will hold it on repatriation basis (after fulfilment of pricing, reporting and sectoral cap conditions)
ii. To any person resident in India (PRII) or to an NRI/OCI on a non-repatriable basis.

**Transfer by way of gift to a PROI on repatriable basis is only permitted subject to conditions and with prior approval of RBI.

3.4. Mode of payment & Maturity proceeds

i. The amount of consideration shall be paid as inward remittance from abroad through banking channels or out of funds held in Non-resident external account (NRE)/ Foreign currency non- resident bank account (FCNR(B))/Non-resident ordinary account (NRO).
ii. The maturity proceeds (net of applicable taxes) of capital instruments purchased or disinvestment proceeds of LLP/firm/proprietary concern
iii. shall be credited only to the NRO account of the investor, irrespective of the type of account from which the consideration was paid.
iv. Any capital appreciation on such investments are also not allowed to be repatriated abroad. **However, dividend and interest income will be freely allowed to be repatriated, being of current account in nature**

3.5. Benefits pertaining to investment under schedule 4

i. Since the investment under schedule 4 is considered at par with domestic investment by a resident Indian none of the conditions pertaining to pricing, sectoral caps, reporting will be applicable which reduces the burden on investor and investee.
ii. Investment in a firm and sole proprietary firm is permitted only under schedule 4, as opposed to Schedule 1, where investment can be made only in an Indian company.
iii. There is no cap on the maximum amount of investment under schedule 4.

3.6. Issues pertaining to investment under schedule 4

i. There is no specific definition or clarification given as to what would construe as, a trust or a partnership firm incorporated outside India and owned and controlled by NRIs or OCIs.
ii. Currently only NRIs and OCIs are permitted to repatriate up to USD 1Mn per year from their NRO account. This facility is not permitted for investments made by a company, a trust and a partnership firm incorporated outside India and owned and controlled by NRIs or OCIs.
iii. Another issue arises when an Investee company has investments on repatriation basis as well as non- repatriation basis, then in such a case it is required to disclose its shareholding pattern for various purposes under FEMA (such as in Form FC-GPR, Form FC-TRS, AFLA, etc.) as well as Company law (such as Annual Return, listing requirements, etc). In such cases, how would the NRI investment be disclosed? It may be included and clubbed with resident holding. Under Company law, the NR shareholder would be required to be disclosed under NR shareholding resulting in discrepancy.

3.7. Important observation

i. NRI and OCI are not permitted to invest in debt instruments on non-repatriable basis other than a few listed debt instruments as given in schedule 5 of Fema 20(R) and investment in Non-Convertible Debentures (NCD) as allowed under the Foreign Exchange Management (Borrowing and lending in rupees) Regulations, 2000, subject to conditions.

ii. Transfer of shares can be considered only to NRI/OCI, if transferee desires to hold it on a non -repatriation basis. Valuation and reporting will only be required when such shares are transferred on a repatriation basis.
iii. In a case where sectors in which only NRI/ OCI are permitted to invest, Transferee can only be NRI/OCI when sold on a repatriation or non- repatriation basis.
iv. Although it is deemed to be an investment at par with that of a resident, conditions of prohibited sector (paragraph 3.2) will still apply to the investment.

4. <u>Foreign Investment in LLP – schedule 6 of Fema 20(R)</u>

Limited Liability Partnership ("LLP") is a hybrid entity with advantage of a company and operational flexibility of a partnership. The concept was introduced by the Ministry of Corporate Affairs through Limited Liability Partnership Act, 2008. FDI in LLP was permitted in 2011 with a lot of restrictions which were then relaxed by RBI in 2015

4.1. <u>FDI in LLP</u>

i. FDI in LLP is only permitted in those sectors where foreign investment up to 100% is permitted under automatic route and there are no FDI linked performance conditions.
ii. FDI in LLP is subject to the compliance of the conditions of LLP Act, 2008

4.2. <u>Eligible Investor</u>

A PROI or an entity incorporated outside India, may invest, either by way of capital contribution or by way of acquisition/ transfer of profit shares of an LLP, except:

i. A citizen of Bangladesh or Pakistan or
ii. An entity incorporated in Bangladesh or Pakistan
iii. A Foreign Portfolio Investor (FPI) or
iv. A Foreign Venture Capital Investor (FVCI)

4.3. <u>Modes of Investment and Pricing Guidelines</u>

i. Payment towards capital contribution of an LLP shall be made by way of an inward remittance through banking channels or out of funds held in NRE or FCNR(B) account

ii. Investment in an LLP either by way of capital contribution or by way of acquisition/ transfer of profit shares, should not be less than the fair price worked out as per any internationally accepted valuation (Eg: Discounted cash flow, Net asset value method) norm based on valuation report from a Chartered Accountant or by a practicing Cost Accountant or by an approved valuer from the panel maintained by the Central Government.

iii. In case of transfer of capital contribution/ profit share from a PROI to a PRII, the transfer shall be for a consideration which is not more than the fair price of the capital contribution/ profit share of an LLP.

4.4. <u>Downstream Investment (DI)</u>

DI by an LLP/company in an Indian company/LLP is allowed subject to following conditions:

i. Indian company is operating in sectors where 100% FDI is permitted under automatic route
ii. There are no FDI linked performance conditions.
iii. Funds for investment need to be brought from abroad or through internal accruals

(Provisions of DI has been discussed at length in the previous article)

4.5. <u>Conversion</u>

i. Conversion of an LLP having foreign investment and operating in sectors/activities where 100% FDI is allowed through the automatic route and there are no FDI-linked performance conditions, into a company is permitted under automatic route.
ii. Conversion of a company having foreign investment and operating in sectors/activities where 100% FDI is allowed through the automatic route and there are no FDI-linked performance conditions, into an LLP is permitted under automatic route.
iii. There are no reporting provisions mentioned in Fema 20(R) regarding conversion of LLP into company or vice versa. Probably in such cases filing of form FCTRS and form LLP may ideally be required simultaneously.

4.6. <u>Disinvestment Proceeds</u>

The disinvestment proceeds may be remitted outside India or may be credited to NRE or FCNR(B) account of the person concerned.

4.7. <u>Transfer of Interest in LLP</u>

i. Transfer of interest in LLP can be transferred by way of sale, subject to pricing, and reporting guidelines.
ii. Fema 20(R) does not mention anything regarding transfer of interest by way of inheritance but since inheritance is a right provided by the constitution of India, Fema regulations may not override the constitution and hence it will be permitted even if Fema 20(R) is silent on it.
iii. Fema 20(R) does not mention anything regarding transfer of interest by way of gift. Relying on the general principle that Capital Account transactions are prohibited, unless specifically permitted, since the Regulations do not specifically permit it, gift of an interest in LLP to an NRI is not permitted at all.
This would be in contradiction of section 42 of Limited Liability Partnership Act, 2008 ("Partner's Transferable Interest"), the right of a partner to a share in profit is transferable in accordance with the LLP agreement and therefore, if the LLP agreement were to provide for transfer of interest in LLP, it would be allowable under the LLP Act but restricted as per the FEMA regulations.

4.8. <u>Reporting requirements</u>

i. <u>Form LLP (I)</u>: Any amount received as consideration for capital contribution and acquisition of profit shares shall submit Form LLP (I) within 30 days from the date of receipt of consideration.
ii. <u>Form LLP (II):</u> The disinvestment/ transfer of capital contribution or profit share between a resident and a non-resident and vice versa shall be reported in Form LLP(II) within 60 days from the date of receipt of funds

iii. Form DI: Reporting of downstream investment in a company or LLP within 30 days from the allotment of capital instrument.
iv. Form FLA: An LLP which has received investment by way of capital contribution in the previous year(s) including the current year, should submit form FLA to the Reserve Bank on or before the 15th day of July of each year

LLP structures are beneficial for professionals to come together under its umbrella and work seamlessly without being burdened with the compliance requirements of a company or the personal exposure involved in a partnership firm.

5. Investment by Foreign Venture Capitalist Investor (FVCI) - Schedule 7

5.1. Introduction

i. FVCI means an investor incorporated and established outside India and which proposes to invest money in Venture Capital Funds or Venture Capital Undertaking in India and is registered with SEBI.

ii. Venture Capital Undertaking (VCU): VCU means a company incorporated in India whose shares are not listed on a recognized stock exchange in India and which is not engaged in an activity specified under the negative list specified by the SEBI. VCU is generally a new born private company which is yet to establish itself and is in need of funds and experienced advice and support.

iii. Venture Capital Fund (VCF): It is a fund established in the form of a trust or a company including a body corporate and registered with SEBI under SEBI(Venture Capital Fund) Regulations 1996 and which has a dedicated pool of capital raised in manner specified in regulations and which invests in VCU in accordance with said regulations. A VCF is also allowed to make investments in VCU subject to provisions in SEBI(Venture Capital Fund) Regulations.

5.2. Key Eligibility Conditions for FVCI

i. The applicant should have a good track record, professional competence, financial soundness, general reputation of fairness and integrity.
ii. The applicant has been granted necessary approval by the Reserve Bank of India for making investments in India; (No prior RBI approval is required for investments under Schedule 7)
iii. The applicant is an investment company, investment trust, investment partnership, pension fund, mutual fund, endowment fund, university fund, charitable institution or an asset management company, investment manager or investment management company or any other investment vehicle incorporated outside India;
iv. Main objects should permit the fund to carry on the activity of venture capital
v. The applicant has not been refused a certificate by SEBI.
vi. The applicant should be a fit and proper person.

5.3. Permitted investments by FVCI

FVCI may purchase

i. Securities, issued by an Indian company engaged in any sector as mentioned below and whose securities are not listed on a recognised stock exchange at the time of issue of the said securities;
Following are the permitted sectors for investment by FVCI
   a) Biotechnology
   b) IT related to hardware and software development
   c) Nanotechnology
   d) Seed research and development
   e) Research and development of new chemical entities in pharmaceutical sector
   f) Dairy industry
   g) Poultry industry
   h) Production of bio-fuels
   i) Hotel-cum-convention centres with seating capacity of more than three thousand.
   j) Infrastructure sector

ii. Securities issued by a start- up;

iii. Units of a Venture Capital Fund (VCF) or of a Category I Alternative Investment Fund (Cat-I AIF) or units of a scheme or of a fund set up by a VCF or by a Cat-I AIF (discussed later).
Provided if the investment is in capital instruments, then the sectoral caps, entry routes and attendant conditions shall apply.

5.4. Investment Criteria for FVCI

An FVCI registered with SEBI is permitted to make investments in following manner:

i. It has to invest at least 66.67% of its investible funds in unlisted equity shares or unlisted equity linked instruments (includes instruments convertible into equity share or share warrants, preference shares, debentures, cumolsirily or optionally convertible to equity) of VCU.

ii. It can invest only 33.33% of its funds (and not more), by-
a) Subscribing to initial public offer of VCU whose shares are proposed to be listed;
b)Investing in debt or debt instrument of the VCU provided it has already invested by way of equity in such a VCU;
c)Preferential allotment of equity shares of a listed company subject to lock in period of one year;
d)Investment by way of subscription or purchase in Special Purpose Vehicles created for the purpose of facilitating or promoting investment in accordance with these regulations.

iii. FVCI have a fixed life cycle. Every FVCI making investments in IVCU or VCF has to mandatorily disclose life cycle of its fund before making any investments. It has to further disclose all its investment strategies to the SEBI before it makes any investment in India.

5.5. Transfer/Purchase of securities by FVCI

i. FVCI can invest in eligible securities/ instruments either by way of private arrangement/purchase from third party or from the issuer of these securities or instruments.
ii. FVCI may invest in securities on a recognized stock exchange subject to the provisions of SEBI
iii. FVCI may transfer the securities/instruments to any PROI or any PRII at a mutually decided price (Pricing guidelines do not apply to a FVCI)

5.6. Mode of Investment

i. FVCI may open a foreign currency account and/or a rupee account with a designated branch of an Authorised Dealer for the purpose of making transactions only and exclusively under this Schedule.
ii. The consideration for all investment by an FVCI shall be paid out of inward remittance from abroad through normal banking channels or out of sale / maturity proceeds of or income generated from investment already made

5.7. Reporting by FVCI

Form FCGPR: An entity receiving foreign investment from an FVCI shall file form FCGPR within 30 days of receipt of money

6. Investment in Alternate Investment Fund (AIF)

6.1. Introduction

i. AIF means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which, is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors.

ii. AIFs are seen as private investment funds, and therefore, are not available through IPOs (initial public offerings) or other forms of a public issue which are applicable to Collective Investment Schemes and Mutual Funds that are registered with SEBI.

iii. Units of close ended Alternative Investment Fund may be listed on stock exchange subject to a minimum tradable lot of one crore rupees. Listing of AIF units shall be permitted only after final close of the fund or scheme.

iv. Every AIF has to mandatorily get itself registered with the Securities and Exchange Board of India (SEBI) before commencing any operations.

6.2. Types of AIF:

i. Category I: Venture Capital Funds, Start-up / Early stage funds, Infrastructure funds – These are those AIFs which are positive and beneficial to the Indian economy and enhance growth. Hence, these funds receive incentives or concessions by SEBI or the government of India. Such funds generally invest in start-ups or early-stage ventures, social ventures, SMEs, infrastructure or other sectors which are considered socially or economically important for the country.

ii. Category II: Private equity funds – Private equity (PE) funds, especially Real Estate PE funds, typically reduce the risk profile by offering diversified investment portfolios managed by experienced fund managers. Thus, it provides the dual benefit of a defensive investment alternative as well as a hedging mechanism by offering an alternative investment asset class.

iii. Category III: Hedge funds – Category III AIFs are a unique class of privately pooled funds that employ a range of complicated trading strategies including but not limited to arbitrage, margin trading, futures and derivatives trading, etc. to generate returns. This category of AIF is also allowed to utilise leverage in order to make investments in both unlisted and listed derivatives as specified by SEBI (Alternative Investment Funds) Regulation, 2012. Leading examples under this alternative investment fund category include PIPE Funds and Hedge Funds. **An AIF category III which has received any foreign investment shall make portfolio investment in only those securities or instruments in which a FPI is allowed to invest under FEMA.**

6.3. Eligible Investor

A PROI and an entity incorporated outside India (other than citizen of Pakistan and Bangladesh) is allowed to invest in an AIF in India.

6.4. Downstream Investment

If the Sponsor and Manager (both) are not owned and controlled by Indian resident citizens, or is owned or controlled by PROI then the AIF needs to follow FDI downstream investment norms.

Downstream investment by an AIF that is reckoned as foreign investment shall have to conform to the sectoral caps and conditions, if any, as applicable to the company in which the downstream investment is made.

6.5. Registration and Eligibility Criteria as per SEBI

i. An application for registration should be submitted in Form A with an application fee of Rs one lakh.
ii. MOA/Trust Deed/Partnership Deed permits carrying on the activity of AIF.
iii. Trust Deed/Partnership Deed to be registered under respective governing laws
iv. MOA/Trust Deed/Partnership Deed to prohibit making an invitation to the public to subscribe its securities.
v. The Applicant, Sponsor and Manager are “fit and proper” based on the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008
vi. The key investment team of the investment manager of the AIF should have adequate experience with at least 1 (one) key personnel having not less than 5 years of relevant experience.
vii. Manager & Sponsor has the necessary infrastructure and manpower to discharge its activities.
viii. The Applicant to clearly describe investment objective, investment strategy, proposed corpus, tenure and target investors.

Thus, AIF can be framed either as company or LLP or Trust.

6.6. <u>SEBI Guidelines Applicable to an AIF in India</u>

i. Each AIF Scheme should have a corpus of at least Rs. 20 crores (Rs. 5 crores for Angel Fund)
ii. Each investor in AIF should commit to invest at least Rs. 1 crore
iii. An employee or director of the Manager of AIF is permitted to invest at least Rs. 25 lakhs
iv. The Manager/Sponsor shall have a continuing interest in the AIF of not less than two and half percent of the corpus or five crore rupees, whichever is lower, in the form of investment in the AIF and such interest shall not be through the waiver of management fees. An employee of the Manager participating in the profits/carry of the AIF need not make any investment.
v. No AIF Scheme can have more than 1000 investors (200 investors for Angel Fund).
vi. Cat-I AIF & Cat-II AIF shall be close ended and have a minimum tenue of 3 years (maximum 5 years for Angel Fund). Category III Alternative Investment Fund may be open ended or close ended.
vii. Category I and II AIF shall invest not more than twenty five percent of the investable funds in one Investee Company and Category III AIF shall invest not more than ten percent of the investable fund in one Investee company.
viii. Although Schedule 8 of Fema 20(R) permits a Foreign Portfolio Investor (FPI) to invest in units of all categories of AIF, SEBI permits FPI to invest only in AIF lll, not more than 25% .

Thus there are twin conditions as to who can invest in AIF and where AIF can invest.

6.7. <u>Reporting under FEMA</u>

i. Form InVi: AIFs receiving Foreign Investment will be required to submit Form InVi within 30 days from the date of issue of units.

ii. Form DI: AIFs with foreign owned and controlled sponsor, manager or investment manager, are also required submit Form DI for downstream investments in an Indian entity/securities within 30 days from the allotment of capital instruments

6.8. <u>Reporting under SEBI</u>

i. Cat-I AIF, Cat-II AIF and Cat-III AIF (that do not undertake leverage) are required to filed quarterly report with SEBI within 7 days of end of quarter. Cat-III AIF that undertakes leverage is required to file report with SEBI monthly.

ii. Compliance Test Report to be submitted by the Manager with Trustee within 30 days of end of the financial year and Trustee/Sponsor to report to SEBI any non-compliance observed.

6.9. <u>AIF regime an Alternative to FPI regime for Debt Investment</u>

i. RBI through its circular A.P. (DIR Series) Circular No. 24 dated 27th April 2018 has reviewed the norms for FPI investment. Under RBI's revised norms, FPI investment in debt issues are subject to caps on allotment, exposure and size. An FPI cannot be allotted more than 50 per cent of the securities in a single debt issuance. Further, no investment in a single corporate bond can exceed 20 per cent of an FPI's corporate debt portfolio.

ii. RBI curbs on FPI investment in debt issue do not apply to investment done through the AIF route and hence due to this nowadays a lot of FPI ore opting to invest in the debt market through the AIF route, which in turn has increased the number of AIFs in India with investments rising through the AIF route.

7. Conclusion

Foreign investment is one of the key drivers of economic growth. RBI has been introducing various reforms to attract foreign investment in India. In the current article we have covered all the reforms introduced by RBI under Fema 20(R) under Schedule 4,6,7 and 8. In the forthcoming articles we will be covering a different facet of foreign Investment in India.

It may be noted that notification is designed to cover various routes of investment through its schedule, each schedule is dedicated to either

i. Set of investors to whom it applies for example:
    a) For LLP, FVCI or FPI cannot invest, FPI can invest in AIF, restricted conditions on PRII and OCI to invest through FPI.
    b) Only NRI/OCI or entities owned by them can invest on non-repatriation basis.
    c) Proprietorship and Partnership are not considered for investment on repatriation basis.
    d) FPI can invest only in AIF lll
    e) FVCI can invest in AIF I and companies.
ii. It is a listed or unlisted capital instrument
iii. It is portfolio or direct investment
iv. It is a debt or capital instrument
v. Investment is done on repatriation or non-repatriation basis
vi. with Valuation or without valuation