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Regulatory

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RBI issues Operational framework for reclassification of Foreign Portfolio Investment to Foreign Direct Investment

Snapshot

The RBI issued guidelines detailing the operational framework for reclassifying Foreign Portfolio Investments to Foreign Direct Investments upon breaching the 10% individual holding limit under the Foreign Exchange Management (Non-debt Instruments) Rules, 2019. FPIs exceeding this threshold must either divest holdings within prescribed timelines or reclassify as FDI after obtaining necessary approvals and adhering to FDI norms, including sectoral caps, pricing guidelines, and reporting requirements via forms FC-GPR and FC-TRS. Post-reclassification, the investment would be governed under Schedule I of the NDI Rules. The reclassification shall be considered from the breach date and such investments shall remain classified as FDI even if reduced below 10% later.

Operational framework for reclassification of Foreign Portfolio Investment to Foreign Direct Investment

Reserve Bank of India ('RBI') *vide* **A.P. (DIR Series) Circular No. 19 notified vide RBI/2024-25/90 dated November 11, 2024**, released operational framework / guidelines for reclassification of foreign portfolio investment to foreign direct investment ('FDI'). The operational framework provides the necessary clarity and requirements for the purpose of actionable activities and compliances to be taken up on breach of the foreign portfolio investment holding resulting in the same being categorized as FDI.

Investments by Foreign Portfolio Investors ('FPIs') is governed by Rule 10, read along with Schedule II of Foreign Exchange Management (Non-debt Instruments) Rules, 2019 notified on October 17, 2019 ('NDI Rules'), as amended from time to time.

Salient features of investment by FPI as per Rule 10 read with Schedule II of NDI Rules are as follows:

- Total holding by each FPI or an investor group (individual limit) shall be less than 10 percent of the total paid-up equity capital on a fully diluted basis or less than 10 per cent of the paid-up value of each series of debentures or preference shares or share warrants issued by an Indian company. Total holdings of all FPIs put together, including any other direct and indirect foreign investments in the Indian company shall not exceed 24 per cent of paid-up equity capital or debentures or preference shares or share warrants (as the case may be). The said aggregate limit of 24% has been substituted by applicable sectoral cap with effect from 1 April 2020. The aggregate limit with respect to an Indian company in a sector where FDI is prohibited is limited to 24 per cent.
- FPIs investing in breach of the prescribed limit shall have the option of divesting their holdings within five trading days from

the date of settlement of the trades causing the breach or, if the FPI chooses not to divest, then the entire investment in the company by such FPI and its investor group shall be considered as investment under FDI and the FPI and its investor group shall not make further portfolio investment in the company concerned. The FPI through its designated custodian shall bring the same to the notice of the depositories as well as the concerned company for effecting necessary changes in their records, within seven trading days from the date of settlement of the trades causing the breach.

Operational Framework / Guidelines – a Brief Summary

The operational framework for reclassification of foreign portfolio investment to FDI in case of breach of the 10 percent individual limit by the FPIs has been notified vide this Circular. The directions prescribed in the operational framework, have become effective from the date of issuance of the release of the said Circular.

In case an FPI intends to reclassify its foreign portfolio investment into FDI, **the following operational framework / guidelines will have to be followed / undertaken:**

- The facility of reclassification shall not be permitted in any sector prohibited for FDI.
- FPI will have to obtain the approvals / permissions before acquiring equity instruments beyond the prescribed limit:
 - Necessary Government approvals, as applicable so as to ensure that the investment adheres to entry route, sectoral caps, investment limits, pricing guidelines, and other attendant conditions for FDI under Schedule I to the NDI Rules.
 - Clearance from the Indian investee company for re-classification of the investment into FDI so as to enable the
- company to be compliant with conditions pertaining to sector specific provisions under FDI.
- FPI has to clearly state its intent to reclassify the existing foreign portfolio investment into FDI and also needs to provide a copy of the specific approvals, if any, along with having the concurrence to its Custodian.
- In cases where the necessary prior approvals / concurrence have not been obtained (for any reason whatsoever) by the FPI, the investment beyond the prescribed limit will have to be compulsorily divested within the prescribed time (as prescribed under Schedule II of NDI Rules).
- Reporting compliances for reclassification of the entire foreign portfolio investment holding into FDI are as follows:
 - The Indian investee company shall have to report in form FC-GPR where the investment beyond the prescribed limit is resulting from fresh issuance of equity instruments.
 - The FPI has to report in form FC-TRS, where the investment breaches the prescribed limit on account of acquisition of equity instruments by such FPI in the secondary market.
 - AD bank concerned shall report the amount of reclassified foreign portfolio investment as divestment under the LEC (FII) reporting.
- Subsequent to the FDI reporting compliances, the FPI has to approach its Custodian with a request for transferring the equity instruments of the Indian company from its existing demat account held for foreign portfolio investment to a new demat account to be maintained for holding FDI.
- The date of investment causing breach in such cases may be considered as the date of reclassification.

- In case of breach of prescribed limits, the entire investment of the FPI in the Indian company will be considered as FDI and continue to be treated as FDI even in cases where the investment falls to a level below ten percent subsequently.
- The FPI along with its investor group shall be treated as a single person for the purpose of reclassification of foreign portfolio investment.
- The reclassification / divestment of the holding has to be completed within the prescribed time (as prescribed under Schedule II of NDI Rules).
- Post reclassification of foreign portfolio investment to FDI, the said investment will be governed by provisions under Schedule I of the NDI Rules (i.e.) Purchase or sale of equity instruments of an Indian company by a person resident outside India.

KCM Comments

RBI through the above circular has streamlined the process for conversion of foreign portfolio investment into FDI when investments by such FPI exceed the prescribed threshold of 10%. Simultaneously SEBI on the same lines has also issued a circular dated 11 November 2024 prescribing the procedure for reclassification of foreign portfolio investment into FDI when investment threshold is breached. The operational framework shall ensure better and streamlined compliance with the procedures and enhance ease of doing business.

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For further analysis and discussion, you may please reach out to us.

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