



CHANGES TO THE FOREIGN INVESTMENT AND BORROWINGS REGULATIONS

Introduction

This update discusses certain key changes to India's foreign exchange regulations implemented recently.

Foreign investment in financial services

Recently, the Reserve Bank of India (the "RBI") notified an amendment to the Foreign Exchange (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 (the "Foreign Investment Regulations") permitting 100% foreign investment under the automatic route (i.e., without the permission of the Foreign Investment Promotion Board) in companies engaged in financial services activities regulated by Indian financial sector regulators such as the RBI, the Securities and Exchange Board of India (the "SEBI"), the Insurance Regulatory and Development Authority of India, the Pension Fund Regulatory and Development Authority of India and the National Housing Board.

Pursuant to this amendment, 100% foreign investment under the automatic route is now permitted in companies engaged in financial services activities that are regulated by any financial sector regulator in India and which were not a part of the eighteen (18) activities listed under non-banking financial companies (e.g., research analysts (regulated by the SEBI)). Further, the minimum capitalization norms will only be applicable as per the relevant sectoral regulations, and if no minimum capitalization norms are prescribed under the relevant sectoral regulations, the investee entity will not be required to comply with any minimum capitalization norms (i.e., the requirement to have US\$500,000 or more as minimum capital depending on the foreign equity ownership has been done away with). Please, however, note that the foreign investment regime applicable to asset reconstruction companies, banking companies, credit information companies, stock exchanges, commodity exchanges, depositories, clearing corporations, insurance companies, pension sector, power exchanges and white label automated teller machine operations remains unchanged. Moreover, foreign investment in a financial services activity not regulated by an Indian financial sector regulator will require the permission of the Foreign Investment Promotion Board.

This change will ensure that entities which are subject to lower or no minimum capitalization norms under the relevant sectoral regulations do not have to comply with higher capitalization requirements merely for the purposes of getting foreign investment. The foregoing amendments are positive and will ensure that activities that are subject to supervision by an Indian financial sector regulator do not have to comply with unnecessary and extra regulatory requirements and capitalization. We hope that the Indian government will bring changes on similar lines in other sectors appropriately regulated by other Indian regulators, which will go a long way in improving the ease of doing business in India.

External commercial borrowings by start-ups

In early 2016, the Indian government introduced the Startup India Action Plan to boost the growth of Indian start-ups. Under the Startup India Action Plan, Indian start-ups have been given several tax and regulatory benefits. On October 27, 2016, the RBI introduced a simplified route for Indian start-ups ("Simplified Route") to raise external commercial borrowings ("ECB") under the Master Direction –



External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorized Dealers and Persons other than Authorized Dealers dated January 1, 2016 (the “**ECB Policy**”). The key features of raising an ECB under the Simplified Route are as follows:

- Any entity recognized as a start-up by the Inter-Ministerial Board of Certification established under the Startup India Action Plan can avail an ECB.
- Under the Simplified Route, a start-up can raise up to US\$3 million per financial year in foreign currency or Indian Rupees. If the ECB is Indian Rupee denominated, Indian Rupees should be mobilized by the overseas lender either through a swap or an outright purchase from an Indian authorized dealer bank. Hedging is permitted for Indian Rupee denominated ECBs. In our view, the US\$3 million cap seems to have been imposed so that start-ups use the Simplified Route for immediate working capital or mezzanine debt needs. If a start-up intends to borrow a higher amount, it will have to comply with the more elaborate conditions under the ECB Policy.
- ECBs under the Simplified Route can be raised from any overseas lender who is a resident of a Financial Action Task Force (“**FAFT**”) member or a member of FAFT-style regional bodies. However, the Simplified Route cannot be used to raise ECBs from residents of FAFT blacklisted countries, overseas branches or subsidiaries of Indian banks, or overseas subsidiaries or joint ventures of an Indian company. The RBI has imposed very few restrictions on who qualifies as an eligible overseas lender (which is otherwise quite restrictive), thereby giving start-ups the ability to approach any type of financial institution for ECBs. However, most likely, start-ups will seek ECBs under the Simplified Route from foreign shareholders or banking partners of foreign shareholders.
- The minimum average maturity period for ECBs raised under the Simplified Route is three (3) years. As most start-ups will raise short-term loans for immediate business requirements, the minimum average maturity period prescribed under the Simplified Route may not be a hindrance.
- Under the Simplified Route, ECBs can be raised in the form of loans, non-convertible or optionally convertible debentures or partially convertible preference shares. If a start-up proposes to issue fixed rate bonds or floating notes, it will be unable to take the benefit of the Simplified Route and will have to comply with the comprehensive ECB Policy.
- Under the Simplified Route, the all-in-cost can be mutually agreed between the start-up and the overseas lender. Under the comprehensive ECB Policy, if an Indian entity raises an ECB having an average maturity period of three (3) to five (5) years, the all-in-cost ceiling cannot exceed 300 basis points per annum over the six (6) month LIBOR or applicable benchmark rate for the currency in question. Under the Simplified Route, start-ups are exempt from this requirement, and the all-in-cost is left to the discretion of the start-up and the overseas lender.
- Under the Simplified Route, start-ups can use the ECB for any business purposes. End-use restrictions applicable to ECBs are often the reason why Indian entities prefer financing through equity investments and not overseas loans. Only recently has the RBI permitted the use of ECBs for working capital, subject to compliance with certain prescribed conditions. As there are no end-use restrictions under the Simplified Route, this will open up a new financing option for start-ups.



- Movable assets, immovable or intangible assets, or financial securities can be provided as security for the ECB under the Simplified Route, subject to compliance with applicable Indian foreign exchange regulations. In addition, personal and corporate guarantees can also be issued, but Indian banks, financial institutions and non-banking financial companies are not permitted to issue guarantees in respect of such ECBs.
- Provisions in relation to leverage ratio and ECB liability/equity ratio under the comprehensive ECB Policy have been made inapplicable to ECBs under the Simplified Route; however, all other conditions other will apply.

Investments by Foreign Venture Capital Investors

On October 20, 2016, the RBI amended the Foreign Investment Regulations to permit SEBI- registered Foreign Venture Capital Investors (“**FVCI**”) to invest in the following without requiring prior approval of the RBI:

- Equity or equity linked instruments or debt instruments issued by an unlisted Indian company engaged in biotechnology, hardware or software development, nanotechnology, seed research and development, research and development of new chemical entities in the pharmaceuticals sector, dairy industry, poultry industry, production of bio-fuels, hotel-cum-convention centers having seating capacity of more than three thousand (3,000) and the infrastructure sector (as defined in the ECB Policy).
- Equity or equity linked instruments or debt instruments issued by an Indian start-up.
- Units of a venture capital fund, Category I alternative investment fund, registered under the SEBI (Alternative Investment Funds) Regulations, 2012 or units of a scheme or of a fund set up by any of the foregoing; provided, that, any downstream investment by such fund or scheme will have to comply with the conditions for downstream investment under the Foreign Investment Regulations.

In respect of any of the foregoing investments, FVCIs will be permitted to open foreign currency accounts or rupee accounts with Indian authorized dealer banks. Further, no transfer restrictions will be applicable for transfer of any security or instrument held by an FVCI to an Indian resident or a non-resident investor. FVCIs will now have to report their investments in Form FC-GPR required to be filed for foreign direct investments under the Foreign Investment Regulations.

The foregoing amendments are very positive and will increase the scope for investments by FVCIs in entities engaged in technology or research-related activities, which has been the focus of the “Make in India” plan of the Indian government.