ALLEN & OVERY

India in focus

Foreign investment into India

1. Introduction

According to the 2021 UN World Investment Report[1], India was the fifth largest recipient of foreign investment globally in 2020, attracting inflows of USD64 billion last year. This represents growth of over 25% compared to its 2019 figures, despite the global impact of COVID-19.

The growth of investment into India in recent years can be attributed to various factors, including easing of Indian foreign investment regulation. Foreign investment in Indian companies across the majority of sectors is now possible without the need for prior regulatory approval. Further, previous restrictions on investment into a number of sectors have been relaxed (including in the insurance sector, as explored in a previous India in Focus **article**).

2. Regulatory framework and nature of restrictions

Foreign investment in India is governed primarily by the Foreign Exchange Management Act 1999 as amended from time to time (**FEMA**), various regulations and notifications issued under FEMA as well as related foreign policy press notes and releases issued by the Indian government (the **Government**).

Under FEMA, investment by any person who is resident outside India into the capital of an Indian company or Indian limited liability partnership is considered foreign investment.

Restrictions applicable to foreign investors depend on: (i) the quantum of the proposed investment; and (ii) the sector into which the investment is being made.

Investment into some industries such as tobacco manufacturing, atomic energy generation and gambling is completely prohibited[2].

In addition, investors from any country bordering India (including China and Pakistan), or investors with beneficial owners situated in such a country, must follow the Government Route (see Section 4.1 of this article), irrespective of the sector of the investment.

Breach of India's foreign investment regulations can attract a penalty of up to three times the amount involved in the contravention[3], with daily charges for continuing breaches. FEMA is also broad in that liability can be imposed on every person who was "in charge of" or "responsible to" the Indian target company at the time of the breach. Further, depending on the specific rule breached, a breach of FEMA can also have consequences for the validity of the transaction – for example, the Government can order an unwinding of the transaction with respect to the relevant Indian target company.

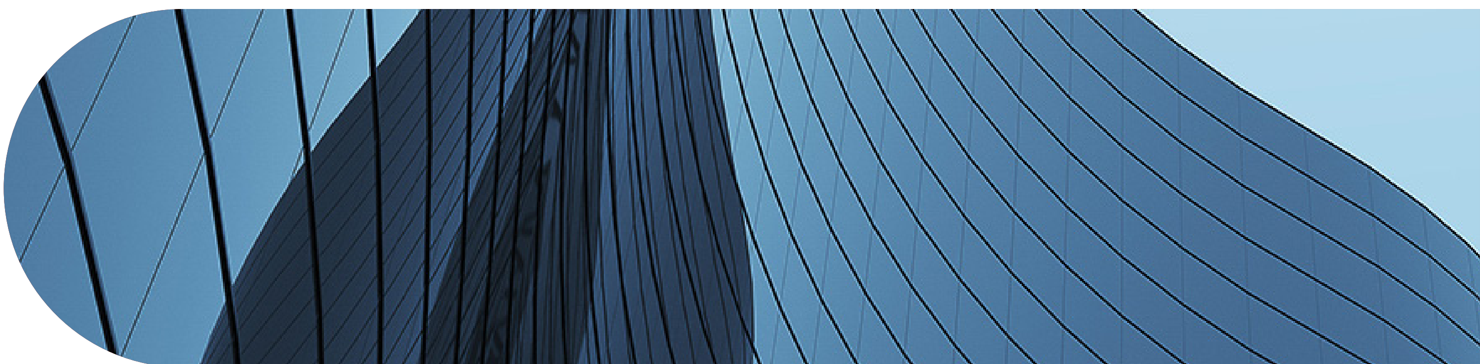
[1] https://unctad.org/system/files/official-document/wir2021_en.pdf
[2] A full list of prohibited sectors is provided at paragraph 5.1 of **this** FDI policy document.
[3] If the contravention amounts cannot be quantified, there is a fine of INR200,000 (approximately USD2600) plus a daily penalty of INR5,000 (approximately USD60).

3. Classification of foreign investment

The type of investment by a non-resident into a target Indian company determines how it is classified under the Indian foreign investment regime, and therefore the rules applicable to it.

Type of foreign investment		Classification
1. Equity shares or similar[4] (**Equity Instruments**) in a. An unlisted company; or b. a listed company, if the investment is 10% or more of the post issue paid-up share capital (on a fully diluted basis) of the relevant Indian company.	➔	Foreign Direct Investment
1. Equity Instruments in a listed company where the investment is: a. less than 10% of the post issue paid-up share capital (on a fully diluted basis) of the relevant Indian company; or b. less than 10% of the paid-up value of each series of capital instruments of the relevant Indian company. 2. Government securities.[5] 3. Corporate debt securities which are listed or to be listed (in the form of non-convertible debentures or bonds).[6] 4. Derivatives (including exchange traded futures and options, foreign exchange forwards and interest rate swaps).	➔	Foreign Portfolio Investment
1. Investment in: a. securities issued by companies in certain "sunrise" sectors including biotechnology, nanotechnology, information technology related to hardware and software development, and infrastructure;[7] b. instruments issued by start-ups, irrespective of the sector; or c. units of an Indian venture capital fund or Category-I Alternative Investment Fund, or in a fund/scheme set up by the fund.	➔	Foreign Venture Capital Investment

Irrespective of the type of investment, Indian foreign exchange rules impose various pricing and valuation guidelines on investments into Indian companies by non-residents, including price floors linked to the concept of fair market value. This will be further explored in an upcoming article in our India in Focus series.



[4] Includes fully paid-up, compulsorily and mandatorily convertible debentures, fully paid-up, compulsorily and mandatorily convertible preference shares or share warrants. With respect to equity shares, these can be partly or fully paid up.
[5] Includes Treasury bills. Details of the specific caps (depending on the type of government security), which are frequently revised, can be found **here**.
[6] Details of the specific caps can be found **here** – there is a cap set for outstanding stock as well as absolute investment limits.
[7] This is not only limited to Equity Instruments, but also optionally convertible debentures or preference shares, and in certain circumstances to non-convertible debentures. The relevant sectors are software, information technology, production of basic drugs in the pharmaceutical sector, bio-technology, agriculture and allied sectors or such other sectors as notified to the Government.

4. Requirements for each classification of foreign investment

4.1 Foreign direct investment

Foreign direct investment (**FDI**) into Indian companies can be carried out through one of the following routes:

a. the **Automatic Route**, which permits investors to proceed without regulatory approval from either the Reserve Bank of India (**RBI**) or the Government; or

b. the **Government Route**, which means that various regulatory approvals are required, depending on the industry sector into which the foreign investment is proposed to be made.

In the majority of sectors (including tourism and hospitality, railway and ports infrastructure, and mining), foreign investors can invest in up to 100% of the Indian company under the Automatic Route.

The Government Route only needs to be followed in certain circumstances, which usually depends on the sector and size of the proposed investment. There are prescribed investment thresholds which affect whether government approval is required. For example, in certain sectors such as pharmaceuticals, defence and biotechnology, investments of more than 74% in the relevant Indian target company require the investor to follow the Government Route. A stricter threshold is set for industries such as air transport services, for which investments of more than 49% require the Government Route to be followed. In certain sectors, including digital media and print media, investments are not permitted under the Automatic Route at all, and instead, the Government Route must be followed in order to invest in Indian companies operating within such sectors. These thresholds are periodically reviewed and revised.

The Government's Department for Promotion of Industry and Internal Trade (**DPIIT**) is responsible for processing the Government Route applications and coordinating with the relevant competent authority depending on the sector of the investment. Approvals are expected to be granted by the DPIIT within eight and ten weeks of the application. Applications are at the discretion of the relevant competent authority and the DPIIT. In approving the FDI proposal, the relevant authority and the DPIIT would ordinarily consider factors such as inflow and outflow of foreign exchange, general benefit to the Indian economy, potential for large-scale employment and other sector-specific considerations.

Regardless of whether the Government Route or the Automatic Route is followed, an Indian company receiving foreign investment under the FDI regime must notify the RBI in a prescribed form no later than 30 days from the date of receipt of the investment from a non-resident.

4.2 Foreign portfolio investment

If the investment is classified as foreign portfolio investment (**FPI**), the investor is required to register it as such with the Securities and Exchange Board of India (**SEBI**). If the investor's shareholding following the investment exceeds 10% of the investee company's share capital, the entire holding (rather than the increment above 10%) would be characterised as FDI rather than FPI.

There are two categories of registration for FPI, which are regulated by the SEBI (Foreign Portfolio Investors) Regulations 2019 as amended (**SEBI Regulations**). The category of FPI determines the level of restrictions applicable to the investor, including the KYC requirements and the available level of position limits in stocks and derivatives. The advantages of qualifying as a Category I FPI include the less stringent KYC requirements, as well as the higher position limits in stocks and derivatives which are available to Category I FPIs.

Category I FPIs include governments and government-related investors (such as sovereign wealth funds and central banks, or agencies which are majority controlled by such investors), pension funds, banks and asset management companies. Category II FPIs are foreign portfolio investors which are not eligible to fall into the list of Category I FPIs specified in the SEBI Regulations and include corporate bodies, charitable organisations, individuals and family offices.[8]

4.3 Foreign Venture Capital Investment

A foreign venture capital investor (**FVCI**) must register with SEBI prior to investing into Indian venture capital funds or undertakings. However, once such foreign venture capital investor is SEBI registered, it may invest in up to 100% of the capital of the relevant company, without requiring further approval (noting that permission may be granted subject to terms and conditions as may be considered necessary).

FVCIs also benefit from exemptions to various pricing restrictions issued by the RBI at the time of entry as well as exit (which will be further explored in an upcoming article in our India in Focus series).

5. Commentary

In the latest World Bank "Doing Business" report, India's ranking improved 14 places to 63rd among 190 economies. The easing of Indian foreign direct investment regulation in recent years has certainly contributed to this improvement and many commentators have indicated that the Government is increasingly recognising the importance of foreign direct investments into the economy.

[8] Full details of the type of parties which qualify as Category I foreign portfolio investors and Category II foreign portfolio investors can be found in paragraph 5 of Chapter II in the SEBI **Regulations**.

6. Key contacts

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