JSA Prism
Corporate

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Reclassification of Foreign Portfolio Investment to Foreign Direct Investment

The Reserve Bank of India ("**RBI**"), *vide* circular dated November 11, 2024 ("**Circular**") has introduced a operational framework for reclassification of Foreign Portfolio Investment ("**FPI**") to Foreign Direct Investment ("**FDI**"). This reclassification applies when an FPI by an investor exceeds the prescribed threshold of 10% of the total paid-up equity capital of the Indian investee company on a fully diluted basis.

While the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ("**NDI Rules**") mandated that FPIs exceeding the prescribed threshold must be divested failing which it would be treated as FDI, there were no guidelines regulating the reclassification of such FPIs into FDI. The Circular provides clarity regarding this reclassification process while ensuring that such conversion is in adherence to the operational framework outlined in the Circular. The directions under the Circular have become operative with immediate effect.

Key considerations

For reclassification of FPI by an investor into FDI, the operational framework provides the following:

1. the facility of reclassification is only permitted in sectors that do not prohibit FDI.
2. the investor must obtain necessary approvals from the Government of India, including approvals required for investment from land bordering countries, to ensure that the acquisition beyond the prescribed limits is made in accordance with the provisions applicable to FDI). This includes ensuring compliance with the relevant entry route, sectoral caps, investment limits, pricing guidelines, and other conditions under the NDI Rules. Additionally, the investor must obtain the concurrence of the Indian investee company to ensure that the investee company also complies with the provisions and conditions applicable to FDI, prior to acquiring equity instruments above the prescribed threshold;
3. any FPI choosing reclassification must notify its custodian; and
4. the custodian will freeze the purchase transactions by the FPI investor in the Indian investee company, until the reclassification is complete. If the necessary approvals/concurrence have not been obtained by the investor, the investment beyond the prescribed threshold must be compulsorily divested within 5 (five) trading days from the date of settlement of the trades causing the breach.

Post-reclassification

The entire investment held by the FPI must be reported within the timelines specified under the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019. Following the reporting, the investor must submit a request to its designated custodian to transfer the equity instruments of the relevant Indian company from its demat account maintained for holding of FPIs into its demat account maintained for holding FDI.

Upon completion of all aspects of the reclassification process, the custodian will unfreeze the equity instruments and process the request. The date of breach when the FPI exceeds the prescribed threshold will be considered as the date of reclassification. Note that the entire investment of the FPI investor in the Indian company will be considered as FDI and will continue to be treated as FDI even if the investment falls below 10% subsequently.

Introduction of corollary changes by the Securities and Exchange Board of India

The Securities and Exchange Board of India ("**SEBI**"), in a circular also dated November 11, 2024, recognised the reclassification of FPI to FDI in compliance with the extant foreign exchange rules and related circulars. Upon receiving an investor's request on intent to reclassify, the custodian must inform SEBI and freeze any further purchase transactions by the investor in the equity instruments of the Indian company until the reclassification process is completed in the manner prescribed by RBI. Once the investor submits a request to transfer its equity holdings from the FPI demat account to a demat account designated for holding FDI investments, the custodian will process the transfer, provided that all reclassification reporting requirements, as prescribed by the RBI under the framework, have been duly completed.

Conclusion

The RBI framework aims to improve India's investment climate by reducing complexities, and encouraging foreign investors to stay engaged with the Indian market. It is also likely to make India a more attractive destination for foreign capital, particularly for large investors who want to avoid divestment once they exceed the 10% threshold. By making it easier for investors to reclassify their shareholdings, the RBI is also encouraging more strategic, long-term investments rather than short-term, speculative portfolio investments.

Corporate Practice

JSA's corporate practice is centered around transactional and legal advisory services including day-to-day business, regulatory issues, corporate and governance affairs. We have an expert team of attorneys who advise on legal issues concerning inbound and outbound investments, strategic alliances, collaborations and corporate restructurings. We advise clients through all stages of complex and marquee assignments including restructuring, mergers and acquisitions (including those in the public space) to private equity and joint ventures. Our vast clientele includes multinational corporations and large Indian businesses in private, public and joint sector. We work closely with in-house counsel teams, investment banks, consulting and accounting firms along with multilateral agencies and policy making institutions on development of policy and legal frameworks. We provide assistance and counsel to start-ups and venture backed companies by drawing upon our in-depth understanding of how companies are incorporated, financed and grown. With an in-depth understanding of the industry combined with years of expertise, our attorneys provide innovative and constructive solutions to clients in complex transactional engagements. We emphasize teamwork across our wide network of offices across India. This allows us to benefit from the various specialisations available for the ultimate benefit of our clients. We also provide assistance in dealing with diverse corporate governance and compliance issues including FCPA /Anti-Bribery/Anti-Corruption matters and investigations.

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