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*Analysis*

# Blurring lines between FPI and FDI: Can foreign investors really acquire less than 10% listed stake off market?

## Key Takeaways

- Investors face roadblocks in picking up less than 10% listed stake off the market under the FDI route
- The shift from an investor-centric to investment-centric regime has been rather mismanaged, leading to divergent market practices
- Existing rules have been interpreted by some quarters such that only SEBI registered foreign portfolio investors can acquire less than 10% shares in a list co. (on market), and no <10% off-market acquisitions are permitted for any foreign investor
- Despite the ambiguity, our view is that <10% off-market acquisitions can be made by FDI investors – i.e., investors not registered as foreign portfolio entities – this is in line with regulatory intent

Regulatory approaches to classification of foreign investments, either as foreign portfolio investments ("**FPI**") or foreign direct investments ("**FDI**"), should be rather simple. Fundamentally, portfolio investments are shorter-term investments, lacking any element of control, and therefore, presumed to be non-strategic investments. Direct investments, on the other hand, are envisaged as lasting, longer-term investments, thus, considered to be of strategic value. However, in India, the regulatory approach to the classification of foreign investments has evolved in a dissonant manner, particularly in the context of listed securities, leading to the development of opposing viewpoints on key compliance questions. The key question which now needs a deeper examination – can a foreign investor acquire less than 10% stake in a listed Indian company off the floor of a stock exchange?

## Background

It is helpful to appreciate that regulations for FPI and FDI investments have not always been so convoluted. Rather, it was three stages of evolution in regime - pre-2016 (before amendment to FEMA20), post-2017 (after amendment to FEMA20), and post-2019 (after introduction of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("**NDI Rules**") - that contributed to this.

Prior to 2016. The regime was an investor-centric one (focused on the nature of the investing entity rather than the quantum of the investment) that grouped foreign investors into two broad buckets – registered foreign portfolio investors and all other foreign investors. Investments made by registered foreign portfolio investors were considered FPI, while investments made by all other foreign investors were deemed FDI. Accordingly, if you wanted to purchase and sell listed shares on the floor of a stock exchange, you were required to obtain registration with Securities and Exchange Board of India as a 'foreign portfolio investor'. If you did not have such registration, you could only: (A) purchase and sell listed securities off the floor[2] of a stock exchange (barring a controlling shareholder who could purchase on the exchange); and (B) sell on the floor[3] of a stock exchange.

It is noteworthy, however, that a registered foreign portfolio investor was not entirely precluded from investing under the FDI-scheme, provided that such investor made appropriate filings under FEMA (i.e. filing of reporting forms under FEMA such as FG-GPR/FC-TRS, as applicable).

Post-2017. There was a shift from an investor-centric model to an investment-centric one. Accordingly, the regulations for the first time brought in the definitions for the terms FPI and FDI whereby: (A) an FPI was identified as any investment into less than 10% of a listed company; and (B) FDI was identified as any investment into greater than 10% in a listed company (and any investments into unlisted companies), irrespective of the nature of

[1] Para 1.1.1 of the Consolidated FDI Policy reads: t. FDI, as distinguished from Foreign Portfolio Investment, has the connotation of establishing a 'lasting interest' in an enterprise…"
[2] i.e., transact on trades off the stock exchange platform through depository participant instruction slips.
[3] i.e., to transact on the stock exchange via. a broker / custodian.

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of investor.

This change in regime was driven by the recommendations of the Chandrasekhar Committee and the Mayaram Committee in 2013 and 2014, respectively. They suggested that it should not matter who the investor is, but rather the categorization should be based on an investment-linked threshold. The underlying philosophy to some extent was that the entire regulatory regime for foreign portfolio investment and the registration should be obviated at some stage. Simply put, any investment below 10% was to be FPI and anything above 10% was to be FDI.

Post-2019 and today. The current form of the regulations (the "NDI Rules") when introduced, retained the investment-centric definitions of FDI and FPI.

FPI is defined as follows: "*any investment made by a **person resident outside India** through equity instruments where such investment is **less than ten per cent** of the post issue paid-up share capital on a fully diluted basis of a listed Indian company or less than ten per cent of the paid-up value of each series of equity instrument of a listed Indian company*"

**&**

FDI is defined as follows: "*investment through equity instruments by **a person resident outside India** in an unlisted Indian company; or in **ten per cent or more** of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company*".

The NDI Rules also continue to prescribe that foreign portfolio investors can buy and sell listed securities only on the floor of the stock exchange, whereas other non-resident investors can invest through the FDI-route to: (A) both buy and sell listed securities off the floor of the stock exchange; and (B) sell listed securities on the floor of the stock exchange.[4]

Ideally, this investment-centric regime should mean that foreign investors, not being registered foreign portfolio investors, should be permitted to buy a stake of less than 10% in a listed company, as an FPI investment, off the floor of the stock exchange. However, there are opposing views on this issue and this has in turn created problems from a practical dealmaking perspective.

## And so, convolutions emerge

Based on our discussions with several AD bankers, we understand that the RBI has informed them that a non-resident investor cannot invest less than 10% through the FDI-route in any case (off or on market) as there is no distinction between the restrictions

[4] **Note**: A foreign investor may buy listed securities on the floor of the stock exchange through the FDI-route only if such foreign investor has already acquired, and remains in, control of the listed company, among other conditions.

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applicable to foreign direct investment and foreign direct investor (i.e., any foreign investor other than a registered foreign portfolio investor). RBI's reiterations / clarifications of the fact (which was already provided for under the NDI Rules as a clarificatory note) that foreign direct investors could not also hold investments in their capacity as foreign portfolio investors in the same entity (*see*: Zomato in the run-up to its IPO in 2021) have only further conflated the debate around investment route and investor-centric restrictions. Prior to this, market participants took comfort in the view that since only investment routes were restricted, it was a simply a matter of investors holding the stakes in separate custody accounts to invest under separate routes (and only after the stake collectively crossed 10%, should it have been classified as FDI).

Evidently, the definition of FPI under the NDI Rules is investor-neutral, i.e., any person resident outside India, and not merely registered foreign portfolio investors, can make FPI investments. Furthermore, we have observed various market precedents of foreign investors classifying their acquisition of less than 10% stake in a listed company as FDI, rather than FPI, in lieu of the investment-centric definitions. For instance, most recently, Caryle and Advent classified their individual stakes of 9.99% in the listed entity Yes Bank as FDI (*ref*: stock exchange filings by Yes Bank).

### Can a foreign investor purchase listed securities of less than 10% off the floor of a stock exchange without an FPI-investor registration?

The RBI's discussions with foreign bankers seems to have led them to believe that this is not possible (in part due to definitions under the NDI Rules). In our view the interpretation taken by these banks is misplaced. If this were to be the case, off-market listed acquisitions below 10% would not be permissible to begin with. As a corollary, and all listed acquisitions below 10% would need to be on-market, mandatorily requiring registration as a foreign portfolio investor, which is far from the legislative intent. Rather, the intent in switching to an investment-centric regime under the NDI Rules has been to ease the regulatory framework for foreign investors, and perhaps, ultimately de-regulate FPI-registration requirements by restricting the scope of FPI to specific investments (instead of broadening it). Therefore, any foreign investor (and not just a registered foreign portfolio investor) should be permitted to make an acquisition of less than 10% stake in a listed company as FPI. The facts on the ground also tell a similar story, where quite a few banks have facilitated <10% acquisitions in listed company under the FDI scheme by investors who are not registered with the SEBI as foreign portfolio investors..

### Conclusion

Classification of an investment as FPI offers certain exemptions, such as exemptions from compliance with certain sectoral conditions (for e.g. the 3-year lock-in which is applicable to investment in real estate development) which otherwise apply to FDI. So, naturally, some participants in the market are keen to categorize all <10% investments as FPI to avail these benefits. However, if an investor is agreeable to position his investment as FDI

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and adhere to the applicable investment conditions, there should be no reason why the investor should be prevented from doing so.

Additionally, the FPI-FDI dichotomy extends to regulatory filings as well. FPIs are now exempt from FCGPR filing (since this only applicable for FDIs), although this seems counterintuitive. Historically, all primary subscriptions (including those <10%) were reported via FCGPR (a means for the RBI to track primary investments made by entities other than foreign portfolio investors). Many bankers still continue with the same approach despite the change in law to avoid any issues at the time of further sales. But since the regime is now investment-centric, a few international banks have now indicated that <10% investments (including primary subscriptions) are free from such filings because such investments are not possible through the FDI route in the first place.

All-in-all, there are several complications in the context of a <10% acquisition of listed stake. In our view, simply put, a foreign investor can purchase less than 10% listed securities off the floor of a stock exchange without registration as a foreign portfolio investor. However, given the Zomato-case and the RBI's subsequent clarification, the same investor-entity may not be able invest into the same investee company both in its capacity as a registered foreign portfolio investor and under the FDI-route.

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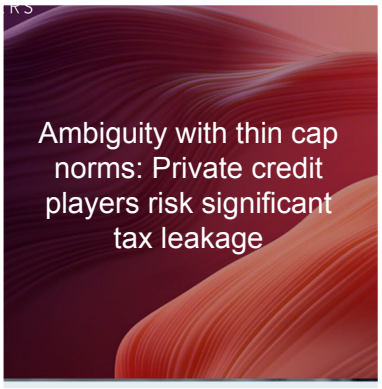
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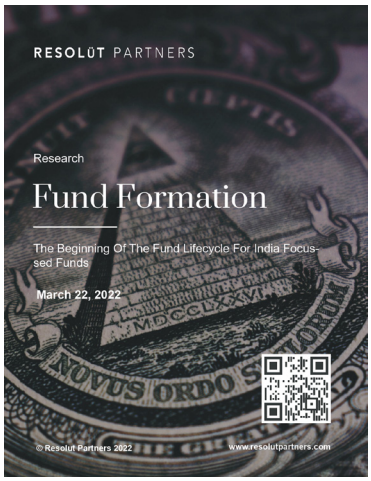









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