Updated Master Direction on Foreign Investment in India: Clarifications to the Regulatory Framework

BACKGROUND

The Reserve Bank of India ("**RBI**") recently updated the Master Direction on Foreign Investment in India ("**Master Direction**") to address various ambiguities in the regulatory framework for downstream investments by foreign owned or controlled companies ("**FOCCs**"), cross-border share swaps, and issue of shares to foreign shareholders pursuant to a scheme of merger or amalgamation. The Master Direction also incorporates a comprehensive framework for the issue of benefit-based equity instruments by Indian companies to directors and employees' resident outside India. The Master Direction complements the existing framework under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ("**NDI Rules**"). This note highlights the key clarifications and changes to the regulatory framework for inbound investments brought about by the Master Direction.

CROSS BORDER SHARE SWAPS

The NDI Rules were amended in 2024 ("**NDI Amendment Rules**") to permit the issue or transfer of equity instruments of an Indian company in exchange for equity instruments of a foreign company. For an overview of the NDI Amendment Rules, please see our note here. The Master Direction incorporates the NDI Amendment Rules without any modifications.

INVESTMENT IN PUBLIC COMPANIES INCORPORATED IN INDIA AND LISTED ON INTERNATIONAL EXCHANGES

The Direct Listing of Equity Shares of Companies Incorporated in India on International Exchanges Scheme ("**Scheme**") was introduced into India's foreign investment regime through an amendment to the NDI Rules in January 2024. Under Chapter X read with Schedule XI of the NDI Rules, a foreign entity or investor holding equity shares of an Indian public company listed or proposed to be listed on an international exchange, (including the India International Exchange of the International Financial Services Centre and the

NSE International Exchange) (“**permissible holder**”) may purchase or sell equity shares of such company on the international exchange in accordance with the Scheme. The Scheme requires, inter alia, that: (i) in cases where the permissible holder is a citizen of a country that shares a land border with India, government approval must be obtained for any sale or purchase of shares of the Indian public company; and (ii) the permissible holder must comply with the foreign portfolio investment limits under India’s foreign exchange laws. The Master Direction incorporates the framework of the Scheme and accordingly allows for investment in securities of Indian companies listed on international exchanges by permissible holders.

ISSUE OR TRANSFER OF EQUITY SHARES TO FOREIGN SHAREHOLDERS PURSUANT TO A SCHEME OF MERGER/DEMERGER

Clause 6.15.1 of the Master Direction now permits an Indian entity to issue or transfer equity instruments to non-residents in connection with a scheme of merger or amalgamation under the Companies Act, 2013 (“**Companies Act**”). In cases where two or more Indian companies undergo a scheme of merger, amalgamation, compromise, demerger or transfer a business undertaking with the approval of the National Company Law Tribunal, the transferee company, or the resulting entity formed pursuant to such corporate restructuring, may now issue shares to the existing shareholders of the transferor company who are resident outside India. Such issue or transfer of equity instruments to existing foreign shareholders of the transferor company must comply with:

1. the entry routes, sectoral caps or any investment limits under India’s foreign exchange laws, as applicable;
2. reporting requirements, including filing of Form FC-GPR or Form FC-TRS with the RBI for any issue or transfer of equity instruments, respectively;
3. requirements of governmental approval under the approval route in case the transferor/transferee or the resulting company is likely to breach foreign investment limits pursuant to the corporate restructuring; and
4. the Securities and Exchange Board of India (Listing Obligation and Disclosure Requirement) Regulations, 2015 in case the transferor, transferee or the resulting company are listed entities.

Recently, the Ministry of Corporate Affairs of India, also amended Rule 25A of the Companies (Compromises, Arrangements and Amalgamations) Rules, 2016 (“**Companies Rules**”) to facilitate “reverse flip” structures through the fast-track route. Reverse flips involve the inbound merger or amalgamation of a foreign holding company with and into its wholly owned Indian subsidiary. For an overview of this amendment, please see our note here.

Recently, a number of Indian start-ups with foreign holding company structures, including Zepto, PhonePe, Groww and Razorpay have or are contemplating reverse flips back to India, though not necessarily through the fast-track route. The updated Master Direction together with the Companies Rules are likely to streamline the process for cross-border mergers between foreign holding companies and their Indian subsidiaries, thereby facilitating greater access to the Indian markets for overseas investors.

GUIDANCE ON DOWNSTREAM INVESTMENTS

The most significant clarification in the Master Direction relates to the framework for downstream investments. Downstream investment ("**DI**") is defined as an investment made by an Indian entity that has received foreign investment ("**Company A**"), in the equity capital of another Indian entity ("**Company B**"). Further, "indirect foreign investment" is DI received by an Indian entity from another Indian entity that is either not owned and not controlled by Indian residents or is owned or controlled by persons resident outside India, i.e., an FOCC. Control includes the right to appoint a majority of the directors on the board or control of management or policy decisions by virtue of shareholding, rights in the shareholders' agreement or any management rights. In the example above, if non-resident shareholders hold 50% or more of the shareholding of Company A or have the right to appoint a majority of the directors of Company A, then the investment received by Company B from Company A would be considered indirect foreign investment.

The Master Direction highlights the guiding principle for DI under the Indian regulatory framework: "*what cannot be done directly shall not be done indirectly*." It follows from this principle that all the conditions applicable for foreign direct investment ("**FDI**") under the NDI Rules, such as sectoral caps, investment limits and pricing guidelines, would be applicable to any DI that is an indirect foreign investment. Conversely, any arrangements available for FDI under the NDI rules, such as equity swaps and deferred payment arrangements, shall similarly be available for DI, a point that has been explicitly clarified in the Master Direction.

The Master Direction has cleared certain ambiguities with respect to DI, in particular the ambiguity on the availability of deferred payment arrangements. Historically, both Authorized Dealer banks and the RBI have taken views in several cases that certain deferred payment arrangements that were permitted in the context of FDI were not permissible for entities that had received DI and would require government approval. This led to the peculiar result that deferred payment arrangements were not available to Indian entities that were FOCCs, despite being available to foreign entities investing in Indian companies.

In addition to the clarifications in the Master Direction in relation to DI, the regulatory framework for DI set out in Rule 23 of the NDI Rules will continue to be applicable. Rule 23 requires, *inter alia*, that Company A shall not use funds borrowed from the domestic

Indian markets for the purpose of making DI. Rather, Company A may make DI in Company B only through funds brought in from abroad or from its internal accruals.

Implications

1. **On Deferred Payment under DI**: The Master Direction clarifies that the deferred payment arrangements permitted under Rule 9(6) of the NDI Rules for transfer of equity instruments between an Indian entity and a foreign entity, are now also available for DIs by FOCCs. Accordingly, if Company A were to acquire any equity shares, compulsorily convertible debentures, preference shares or share warrants in Company B, an amount of up to 25% of the total consideration may be:

    a. paid by Company A on a deferred basis within 18 months from the date of the agreement for such transfer ("**transfer agreement**");
    b. settled through an escrow account between Company A and the seller within 18 months from the transfer agreement; or
    c. indemnified by the seller for a period not exceeding 18 months from the date of payment of full consideration in cases where the total consideration has already been paid by the buyer to the seller.
    Clause 7.9.1 of the Master Direction highlights that in any transaction involving any of the payment arrangements outlined in Rule 9(6) of the NDI Rules, the share purchase or share transfer agreement, as applicable, must contain a clause enabling the parties to undertake such payment arrangement together with a mention of the conditions under the NDI Rules.

2. **Investment by swap of equity instruments**: The Master Direction further explicitly allows for share swaps between Company A and Company B to facilitate the flow of capital between the two entities involved in the DI process.

FRAMEWORK FOR ISSUE OF EMPLOYEE STOCK OPTIONS, SWEAT EQUITY SHARES AND SHARE BASED EMPLOYEE BENEFITS TO PERSONS RESIDENT OUTSIDE INDIA

The Master Direction aligns the definitions of employee stock option plans ("**ESOP**") and sweat equity shares to the Companies Act and regulations issued by the Securities and Exchange Board of India, as applicable.

Further, it provides for a comprehensive framework for share based employee benefits ("**SBEBs**"). The Master Direction defines SBEBs as equity instruments issued by an Indian company to employees or directors of its holding company, joint venture or wholly owned overseas subsidiary, who are resident outside India. The Master Direction requires such issuances of SBEBs to conform to the following conditions:

1. the issuances shall be done in accordance with the SBEBs scheme formulated by the Indian company either in terms of the Securities and Exchange Board of India Act, 1992 or the Companies (Share Capital and Debentures) Rules, 2014, as applicable;
2. the issuances shall comply with the sectoral cap applicable to the Indian company under the NDI Rules; and
3. in cases where the issuance falls under the approval route, prior government approval shall be required. The Master Direction specifically states that issuances to a citizen of Bangladesh or Pakistan shall require such approval.

   The Master Direction also clarifies that in case of grant of any ESOPs, sweat equity shares or other SBEBs to directors or employees resident outside India, the percentage of foreign investment to be held by such individuals must be calculated upfront on a fully diluted basis at the time of grant.

CONCLUSION

The recent updates to the Master Direction significantly enhance the clarity of India's foreign exchange and investment regulations. By incorporating provisions for share swaps, clearer guidelines for mergers and demergers, issue of SBEBs to directors or employees resident outside India, and a more streamlined process for downstream investments in Indian companies, the updated framework creates a more transparent environment for both foreign investors and Indian entities. Further, the Master Direction also includes a provision for requests for clarifications pertaining to the foreign investment framework from the authorized dealer bank together with the Regional Office of the RBI. This is expected to help resolve any ambiguities that may persist under the current framework.

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