



## REGULATORY ALERT | RE-CLASSIFICATION OF FPI AS FDI

### Brief - FPI & FDI

Foreign Portfolio Investment (**FPI**), as categorically distinguished from Foreign Direct Investment (**FDI**), is understood to be done simply for gaining financial returns and not with the strategic objective of having a long-term business interest in an entity. Owing to such financial objective of these investments, the restrictions, approval requirements, sectoral limits, and other conditions, which are otherwise prescribed under [Indian] exchange control regulations for FDI, do not generally apply to FPI.

### [Indian] Exchange Control Regulations *vis-à-vis* FPI & FDI

**FPI:** In terms of [Indian] exchange control regulations, an investment made by a foreign investor through an 'equity instrument'<sup>1</sup> is considered as FPI, where such investment is made in a 'listed Indian company'<sup>2</sup> provided such investment is (a) **less than 10%** of the post issued paid-up share capital on a fully diluted basis of such listed Indian company; or (b) **less than 10%** of the paid-up value of each series of equity instruments of listed Indian company ("**10% Limit**"). The said 10% Limit applies collectively to an investor group. Further, in order to be recognised as a foreign portfolio investor, the concerned foreign investor is required to be registered with the India's capital market regulator viz. Securities and Exchange Board of India ("**SEBI**").

A Foreign portfolio investor or an investor group investing in breach of the prescribed 10% Limit have the option of divesting their holding within 5 (five) trading days from the date of settlement of trades which caused the breach. If the investor decides not to divest, then, the **entire** investment made by such foreign portfolio investor (along with the investor group) is considered as FDI.

**FDI:** Investment made by a foreign investor through equity instrument in an unlisted Indian company; or in **10% or more** of the post issued paid-up equity capital on a fully diluted basis of a listed Indian company, is treated as FDI. In India, while 100% FDI is permitted under automatic route (i.e. not requiring Government approval) in majority of the sectors, however, in certain sensitive sectors (such as Defence; Telecom; Financial Services; Multi-Brand Retail Trading etc.), FDI under automatic route is permitted up to a particular limit ("**Sectoral Cap**") and/or is allowed subject to compliance of certain sector specific conditions. Besides, there are certain sectors, wherein FDI is prohibited such as lottery business; gambling and betting; manufacturing of cigars etc. ("**Prohibited Sectors**")

Further, irrespective of the sector, Government approval is required where FDI is received from countries which shares land borders with India (namely, China<sup>3</sup>, Nepal, Bhutan, Bangladesh, Myanmar, Pakistan and Afghanistan) or where the beneficial owner of such investment is from these countries. The said approval requirement was introduced in 2020 primarily to curb opportunistic takeover of Indian companies by persons from land bordering countries, due to COVID-19 pandemic and has continued since then.

<sup>1</sup> Equity instrument means equity shares, fully & mandatorily convertible debentures which are fully paid up, fully & mandatorily convertible preference shares which are fully paid, and share warrants issued by an Indian company.

<sup>2</sup> Listed Indian company is defined as an Indian company which has any of its equity instruments or debt instruments listed on a recognised stock exchange in India and on an International Exchange.

<sup>3</sup> While Hong Kong and Taiwan do not share land border with India, receipt of FDI from these regions may entail government approval as these regions are administered by China.



## Re-classification of FPI as FDI – Operational Framework introduced

On November 11, 2024, with immediate effect, the central bank of India viz. Reserve Bank of India which primarily administers compliance of FDI & FPI norms from [Indian] exchange control regulations perspective, has, in consultation with SEBI<sup>4</sup>, introduced an operational framework for reclassification of FPI as FDI, where FPI investment crosses the prescribed 10% Limit ("**Operational Framework**").

The key contours of the Operational Framework are as under:

- Reclassification of FPI as FDI shall not be permitted in any Prohibited Sectors.
- The investment made should be in compliance with prescribed entry routes, Sectoral Caps, pricing guidelines and other attendant conditions, as applicable to FDI. In case of deviation from such requirements or where investment breaches the Sectoral Cap or where the investment is from land bordering nations, the concerned foreign portfolio investor should obtain the relevant Government approval, **before** intending to acquire equity instruments beyond the prescribed 10% Limit.
- A Foreign portfolio investor should obtain **concurrence** of the concerned Indian investee company, **before** intending to acquire equity instruments beyond the prescribed 10% Limit, to enable such investee company to comply with the conditions pertaining to Prohibited Sectors, Sectoral Caps and Government approvals.
- The intent to reclassify FPI as FDI should be clearly articulated and a copy of the aforesaid approval / concurrence shall be provided by the foreign portfolio investor to the custodian, pursuant to which the custodian shall freeze the purchase transactions by such investor, till completion of reclassification.
- For completing reclassification, the entire FPI held by the concerned foreign portfolio investor, would need to be reported, within prescribed timelines, in the following manner:

Relevant return for reporting	Responsibility of reporting	Purpose
FC-GPR	Indian investee company	Where investment beyond 10% Limit is resulting from primary purchase (i.e. fresh issuance of equity instrument by Indian company)
FC-TRS	Foreign portfolio Investor	Where investment beyond 10% limit is due to secondary purchase (i.e. acquisition of equity instrument in the secondary market)
Authorized Dealer Bank	LEC (FIL)	To report amount of re-classified FPI as divestment.

<sup>4</sup> On the same date (i.e. on November 11, 2024), the SEBI has also issued a separate circular directing the foreign portfolio investor, custodian and other capital market intermediaries to follow the process specified under the [Indian] exchange control regulations (which process has now been codified through extant Operational Framework) for re-classification of FPI as FDI.



- Upon ensuring that the reporting, as indicated above, is complete in all respects, the Custodian shall (basis request received from foreign portfolio investor) unfreeze and transfer the subject equity instruments from the demat account maintained by the foreign portfolio investor for holding FPI to the demat account maintained by such investor for holding FDI. The date of breaching the 10% Limit will be regarded as the re-classification date.

***Upon completion of re-classification, the entire investment of the foreign portfolio investor in Indian company shall be considered as FDI and shall continue to be treated as FDI even if the said investment subsequently falls below 10% Limit.***



## Conclusion

The FPIs have been significantly contributing towards foreign capital inflow into India through listed securities. As of the end of September 2024, the FPI holdings in Indian securities exceeded USD 1 trillion mark, given the lead taken by India in the global IPO landscape. India's estimated share of total listings was around 36% in the third quarter of 2024, even surpassing the United States, which held a 13% share<sup>5</sup>.

In the midst of such boom in India's capital market, the [Indian] regulators are maintaining increased scrutiny over FPI to prevent potential misuse of FPI route to by-pass the various prescribed norms. The SEBI in its consultation paper of May, 2023<sup>6</sup> recognised that the government approval requirements, as applicable for receiving FDI from land bordering nations, does not apply to FPI and thus the FPI route could potentially be misused to circumvent such approval. It was also observed that a substantial portion of equity portfolio of some FPI were concentrated in a single investee company/ company group, which have also been near static and maintained for a long time. This raises the concern and possibility that promoters of such corporate groups, or other investors acting in concert, could be using the FPI route for circumventing regulatory requirements such as that of maintaining prescribed minimum public float of 25%, increasing the risk of market manipulation in such cases.

The categorisation/re-classification of entire investment made by foreign portfolio investor as FDI upon crossing 10% Limit has long been introduced under [Indian] exchange control regulations. However, there was no clear mechanics laid out on how to ensure compliance with the requirements, particularly for past investments made in sectors that are subject to Sectoral Caps and/or entail government approval. To that extent, the Operational Framework listing out clearly, *inter alia*, the pre-requisites for re-classification, including obtaining government approval where applicable and investee company's concurrence, coupled with reporting obligations, would not only streamline the process but also enable the Indian authorities to more closely monitor the FPI investments while ensuring better compliance *vis-à-vis* FPI & FDI.

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<sup>5</sup> [India leads global IPOs, raising \\$4.3 bn in Q3 2024: Tax impact decoded | Personal Finance - Business Standard](#)

<sup>6</sup> Consultation Paper dated May 31, 2023, on framework for mandating additional disclosures from Foreign Portfolio Investors (FPIs) that fulfil certain objective criteria, to 1) guard against possible circumvention of Minimum Public Shareholding ("MPS"), and 2) to guard against possible misuse of the FPI route to circumvent the requirements of Press Note 3



*Disclaimer: This regulatory alert is only for general informational purposes, and nothing in this edition could possibly constitute legal advice (which can only be given after being formally engaged and familiarizing ourselves with all the relevant facts).*

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