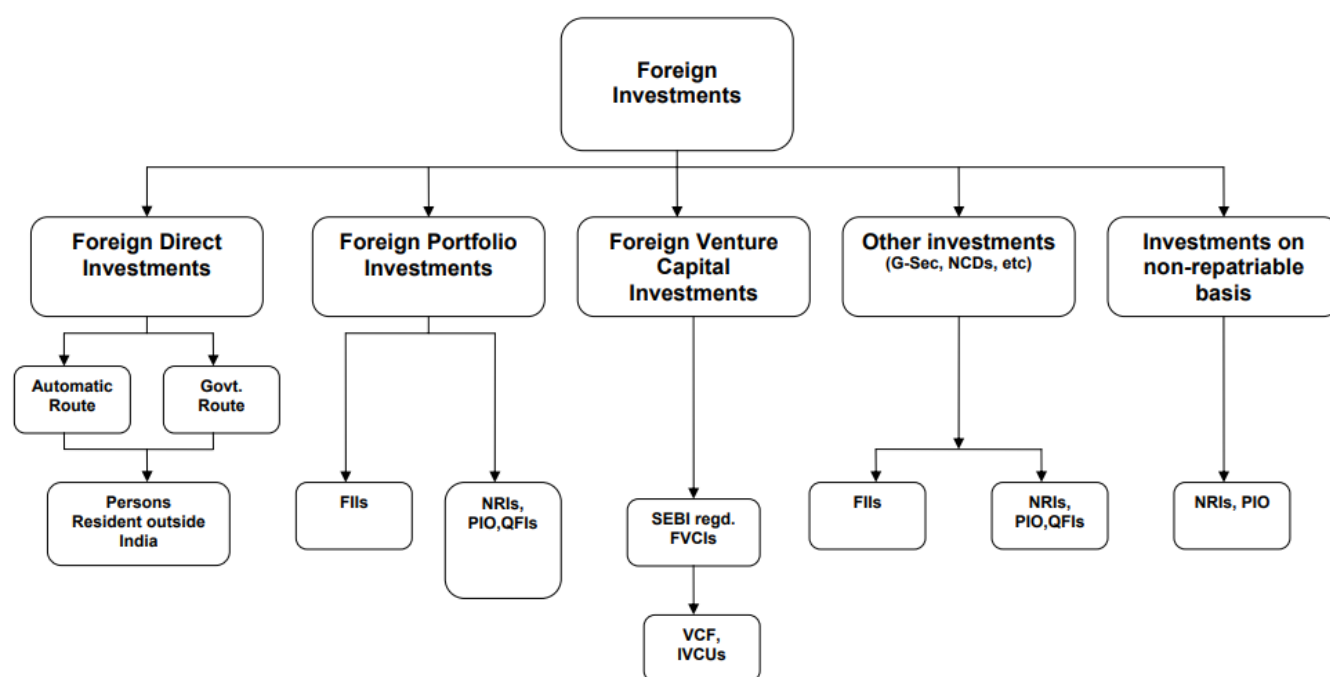


## Reclassification of FPI to FDI

### Why in news?

The Reserve Bank of India (RBI) introduced a streamlined operational framework to allow foreign portfolio investors (FPIs) to convert their investments to foreign direct investment (FDI).



*Foreign investment in India is governed by sub-section (3) of Section 6 of the Foreign Exchange Management Act, 1999.*

### What are FDI and FPI?

	Foreign Direct Investment (FDI)	Foreign Portfolio Investment (FPI)
<b>Definition</b>	Investment made by foreign investors to obtain a substantial interest in the enterprise located in a different country.	Investing in the financial assets of a foreign country, such as stocks or bonds available on an exchange.
<b>Nodal Ministry</b>	Consolidated FDI Policy is drafted Department for Promotion of Industry and Internal Trade (DPIIT), Ministry of Commerce and Industry.	Finance Ministry
<b>Type</b>	Direct Investment	Indirect Investment
<b>Market</b>	Inflows in primary market	Inflows in secondary market

<b>Role of Investors</b>	Active Investor	Passive Investor
<b>Degree of Control</b>	Direct control over the company management	No direct control but can influence board meeting decision.
<b>Term</b>	Long term investment	Short term investment
<b>Investment Instruments</b>	Direct Capital Investment involving mergers, acquisitions, or partnerships	Stocks, ADRs, GDRs, bonds, mutual funds, and exchange traded funds
<b>Entry and Exit</b>	Difficult	Relatively easy
<b>Risks Involved</b>	Stable	Volatile

## What are the Pros and cons of FPI?

*Single FPI Regime came into effect from 1st June, 2014 by subsuming FIIs, their sub-accounts and qualified foreign investors (QFIs).*

Pros	Cons
<ul style="list-style-type: none"> <li>• Increases Capital availability.</li> <li>• Entry and exit are relatively easy.</li> <li>• Quick return on investment.</li> <li>• Increase the liquidity of domestic financial markets.</li> <li>• Encourages investment in growth opportunities.</li> <li>• Bring foreign exchange into the economy</li> </ul>	<ul style="list-style-type: none"> <li>• Volatility in markets when large outflows occur during market downturns.</li> <li>• No direct control on management.</li> <li>• Exposure to political risk</li> </ul>

## What is the new regulatory framework on FPI?

- FPI threshold - Under Foreign Exchange Management (Non-debt Instruments) Rules, 2019, investment made by the FPI should be less than **10 %** of the total paid-up equity capital.
- **Crossing threshold** - FPIs exceeding a **10% stake** in a company must divesting their holdings or reclassifying such holdings as within 5 trading days following the transaction that breaches the limit.
- **Approvals** - It is subject to approvals from both the Indian government and the invested company.
- **Increased disclosure requirements** - To ensure compliance, the RBI requires full reporting under the *Foreign Exchange Management Regulations, 2019*.
- They need to identify and disclose their ownership structure and the ultimate beneficial owners.
- **SEBI's revised guidelines** - It mandates that any FPI choosing reclassification must notify its custodian.
- The custodian will then facilitate the transfer of securities to the designated FDI account, ensuring compliance with all reporting requirements.
- **Prohibited sectors** -The facility of reclassification shall not be permitted in any sector prohibited for FDI, such as defense and telecom, to protect national security.

## FDI Prohibited Sectors



Lottery Business including Government/private lottery, online lotteries, etc.\*



Gambling and Betting including casinos\*



Chit Funds



Nidhi Company



Trading in Transferable Development Rights (TDR)



Real Estate Business or Construction of farm houses\*\*



Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes



Sectors not open to private sector investment- atomic energy, railway operations (other than permitted activities mentioned under the Consolidated FDI policy)

### What are the implications of the framework?

- **Streamline foreign investments** - Providing a structured path to retain the investment , When an FPI, along with its investor group, inadvertently crosses the threshold.
- **Market stability** - This shift could bring more stability and reduce market volatility associated with short-term foreign investments.

*FPIs have pulled out over Rs 1.36 lakh crore from the cash market since October 1 this year.*

- **Enhanced governance** - The compliance requirements, especially those related to beneficial ownership, improve transparency in the market.
- **Increased compliance costs** - Stricter disclosure norms and other regulatory requirements increase compliance costs for foreign investors.
- **Promotion of long-term investment** - By encouraging FPIs to convert substantial

investments into FDI, the government aims to promote long-term foreign investments.

- **Change in investment patterns** - The restrictions may redirect FPI interest toward non-sensitive sectors with fewer ownership caps.
- Sensitive sectors might experience reduced foreign investment due to regulatory hurdles and caps on ownership.
- **Prevent tax evasion** - The rules aimed to prevent any attempts at tax evasion or money laundering.

### What lies ahead?

- Focus on maintaining transparency while ensuring India remains competitive in attracting foreign capital.
- Reduce market volatility to make resilient economic foundation less susceptible to short-term market shocks.

### References

1. [Mint | Framework for Reclassification Of FPI](#)
2. [RBI | Master Circular on Foreign Investment in India](#)

