SAMVĀD: PARTNERS

INSIGHTS

LIBERALISATION OF OVERSEAS INVESTMENT REGULATIONS

OPENING OF NEW OPPORTUNITIES

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(I) BACKGROUND

The Foreign Exchange Management Act, 1999 ("**FEMA**") was, pursuant to the Finance Act, 2015, amended on October 15, 2019, to grant powers to the Reserve Bank of India ("**RBI**") to prescribe permissible class(es) of capital account transactions related to debt instruments (in the form of regulations); while the Central Government were given powers to deal with permissible capital account transactions not involving debt instruments (in the form of rules).

In light of the above, on August 22, 2022, the Central Government issued the Foreign Exchange Management (Overseas Investment) Rules, 2022 ("**OI Rules**") while the RBI issued the Foreign Exchange Management (Overseas Investment) Regulations, 2022 ("**OI Regulations**") and the Foreign Exchange Management (Overseas Investment) Directions, 2022 ("**OI Directions**"). These new rules and regulations superseded the erstwhile FEMA (Transfer or Issue of Any Foreign Security) Regulations, 2004 and directions framed thereunder ("**Erstwhile ODI Regulations**") and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India) Regulations, 2015.

Briefly, the OI Rules deal with overseas investments using non-debt instruments, including investments in the equity capital of foreign entities, capital participation in limited liability partnerships, units of AIF or REITs etc.[1], while the OI Regulations deal with debt instruments. The OI Regulations and OI Directions also provide clarity on the procedure for making such overseas investments.

The OI Rules, OI Regulations and OI Directions are **effective immediately** i.e., on the date of publication in the Official Gazette.

[1] Please see Rule 5 which lists down debt instruments and non-debt instruments.

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(II) KEY AMENDMENTS[2]

1. **Definition of '*Overseas Direct Investment*' and '*Overseas Portfolio Investment*'**:

1.1. The OI Rules and OI Regulations now differentiate between direct investment and portfolio investment. The ODI investment is defined as (a) any investment in an unlisted foreign entity; (b) 10% or more of the equity capital[3] of a listed company; or (c) less than 10% of the equity capital of a listed company along with 'control'.

1.2. Any investment apart from the ODI investment will be termed as an OPI. It also excludes any investment in unlisted debt instruments or securities issued by an IFSC.

1.3. Apart from this, overseas investments made by mutual funds, AIFs or VCFs are treated as OPIs.

Note: *The differentiation between ODI and OPI seems to have been based on the lines of foreign investment and foreign portfolio investment. The Erstwhile ODI Regulations excluded portfolio investment from ODI, however, it was not very clear what exactly fell within the purview of 'portfolio investment'.*

*In the present regime, the term '*equity capital*' is defined broadly to include equity shares or any type of compulsorily convertible instruments, and hence overseas investments are permitted in all such instruments, while under the Erstwhile ODI Regulations, investments in only equity shares and compulsorily convertible preference shares were allowed.*

2. **Definition of '*control*' and '*subsidiary*'**:

2.1. The OI Rules introduces the definitions of '*control*' as under:

> "*"control" means the right to appoint majority of the directors or to control management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders' agreements or voting agreements* ***that entitle them to ten per cent. or more of voting rights*** *or in any other manner in the entity*;" (emphasis supplied).

2.2. This definition is mainly aligned to the definition of '*control*' as set out in the Companies Act, 2013, however, the shareholding threshold has been reduced to 10%, which otherwise typically is 50% or more under the Companies Act, 2013 and certain other regulations.

2.3. A linked item would be the definition of '*subsidiary*', which would in the context of OI Rules and Regulations mean "*an entity in which the foreign entity has control*".

[2] Please note that the list of amendments is not meant to be exhaustive but only sets out the major amendments. Kindly reach out to us separately for a more focused/detailed discussion on this.
[3] This is defined to mean means equity shares or perpetual capital or instruments that are irredeemable or contribution to non-debt capital of a foreign entity in the nature of fully and compulsorily convertible instruments.

Note: *The intention of the broader definitions of 'control' and 'subsidiary' seems to differentiate between ODI and OPI investments by Indian parties. This will have significant implications in the determination of subsidiaries and step-down subsidiaries.*

3. **ODI investment conditions**:

3.1. Types of issuances: Any ODI can be made by an Indian entity by way of subscription, acquisition through bidding or tender process, acquisition by rights issue or bonus issuance, capitalization due towards an Indian entity in accordance with FEMA extant regulations on the same, swap of securities or merger, demerger or scheme of arrangements.

Note: *The broad reading of the clause does not clarify whether the swap of securities can be in form of primary or secondary swap. The FEMA (Non Debt Instrument) Rules, 2019 provide that a swap of shares is usually permitted when there is a primary swap sought to be undertaken.*

3.2. Financial commitment: The total financial commitment made by an Indian entity will not exceed 400% of its net worth (as defined in the Companies Act, 2013) as on the date of the last audited balance sheet. Any investments by Maharatna, Navratna, Miniratna or subsidiaries of such public sector undertakings in foreign entities engaged in strategic sectors[4] are not subject to the above limits.

Note*: The definition of* 'net-worth' *under the Erstwhile ODI Regulations only included paid-up capital and free reserves. However, under the OI Rules, this has been aligned with the definition under the Companies Act, 2013 which includes securities premium as well. This change in definition may boost the overseas commitment limits permissible under the OI Rules.*

3.3. Investments in strategic sectors and start-ups: The OI Rules permit overseas investments only in foreign entities that have limited liability. However, investments in entities engaged in 'strategic sectors' which includes start-ups recognized under the host country/ jurisdiction, need not necessarily be structured as an entity having limited liability. However, overseas investments in start-ups of host countries can be made by an Indian entity (or group or associates in India) or resident individuals, only through internal accruals or owned funds, respectively.

Note: *Start-ups, as a different class of companies, were not recognised in the Erstwhile ODI Regulations. Providing an exception for investing in start-ups which may have unlimited liability may also boost cross-border investments. However, it remains to be seen as to what will be considered as a start-up, which is solely dependent on the legal framework of the*

[4] 'strategic sector' is defined to include energy and natural resources sectors such as oil, gas, coal, mineral ores, submarine cable system and start-ups and any other sector or sub-sector as deemed necessary by the Central Government;

host country. It will be great to see how this plays out and whether Indian parties enthused to exploit this structure.

3.4. The Erstwhile ODI Regulations restricted investments in countries identified by FAFT as non-cooperative countries and territories, which exemption has not been continued in the present regime. However, overseas investments or transfer of such investments in Pakistan or any other jurisdiction as may be advised by the Government of India would require prior government approval.

3.5. Any financial commitment by an Indian entity exceeding USD 1 (one) billion in a financial year will require prior RBI approval, even if the investments are under the automatic route, which position continues from the Erstwhile ODI Regulations.

4. **Overseas portfolio investments:**

4.1. Any Indian entity cannot make OPI above 50% of the net worth as on the date of its last audited balance sheet.

4.2. Listed companies can make OPI including by way of re-investment[5], while unlisted Indian entities can make OPI only under rights issue or bonus issuance, capitalization due towards an Indian entity in accordance with FEMA extant regulations on the same, swap of securities or merger, demerger or scheme of arrangements. Further, all overseas investments by mutual funds, AIFs or VCFs will also be treated as OPI.

Note: *Only listed companies were permitted to undertake portfolio investments under the Erstwhile ODI Regulations. Now, even an unlisted company may undertake OPI investments, in extremely limited circumstances. All investments by SEBI registered mutual funds, AIFs and VCFs will also be deemed as OPIs.*

5. **Restrictions:**

5.1. No person is permitted to undertake ODI in foreign entities engaged in real estate activities, gambling or dealing with financial products linked to the Indian Rupee without specific RBI approval. Financial products would include non-deliverable trades involving foreign currency-INR exchange rates, stock indices linked to the Indian market, etc.

5.2. <u>Financial services:</u>

5.2.1 An Indian entity engaged in financial services activity in India is permitted to make ODI in a foreign entity which is directly or indirectly engaged in financial services (which may include banking business) subject to compliance with the following conditions: (i) the Indian entity has posted net profits during the

[5] 'Reinvestment' means that the OPI proceeds are exempted from repatriation provisions as long as such proceeds are reinvested within the time specified for realisation and repatriation as per Notification No. FEMA 9(R)/2015-RB namely, Foreign Exchange Management (Realisation, repatriation and surrender of Foreign Exchange) Regulations, 2015.

preceding 3 financial years; (ii) the Indian entity is registered with or regulated by a financial services regulator in India; (iii) the Indian entity has obtained approval as may be required from the regulators of such financial services activity, both in India and the host country or host jurisdiction, as the case may be, for engaging in such financial services. Overseas investments by banks or NBFCs regulated by RBI will in addition also be subject to conditions laid down by the RBI in this regard.

5.2.2 An Indian entity not engaged in financial services activity in India may make ODI in a foreign entity, which is directly or indirectly engaged in financial services activity, except banking or insurance subject to the condition that the Indian entity has posted net profits during the preceding 3 financial years. An Indian entity not engaged in the insurance sector may make ODI in general and health insurance where such insurance business is supporting the core activity undertaken overseas by such an Indian entity.

5.2.3 If the profitability requirement in paras 3.1.1 and 3.1.2 above are not met by an Indian entity due to the impact of Covid-19 during the period from 2020-2021 to 2021-2022, then the financial results of such period may be excluded from considering the profitability period of 3 years.

Note: *The Erstwhile ODI Regulations also restricted investments in the banking business. However, presently Indian entities engaged in financial services activities have been permitted to invest in foreign entities also engaged in financial services, where overseas investment in banking business has not been specifically prohibited.*

Under the Erstwhile ODI Regulations, the conditions laid down in para 3.1.1 were to be met by an Indian entity in the financial services sector, irrespective of the sector in which the overseas investee company operated. The relaxation currently brought about will bring impetus to more financial services companies investing outside India. Inversely, a non-financial services entity was never required to meet the test of profitability while investing in an overseas entity engaged in financial services.

5.3. <u>'Bona fide business activity':</u> Any overseas investment can be made only in a foreign entity engaged in bona fide business activity directly or through a step-down subsidiary or SPV (which complies with the structural requirements of the foreign entity). For the first time, the term '*bona fide business activity*' has been defined to mean '*any business activity permissible under any law in force in India and the host country or jurisdiction, as the case may be*'.

Note: *On our reading of this provision, it appears that the business activity of a foreign entity where overseas investment is proposed to be made, needs to be permissible both in India* ***<u>and</u>*** *the host country. This will be a critical limitation since certain activities/ sectors such as cryptocurrencies or gambling while not permitted in India, is legal and permissible in other*

countries. With this restriction, investments in such sectors/ activities overseas will also stand restricted on account of prohibitions under Indian laws.

5.4. Round tripping: The OI Rules provide that an Indian resident cannot make financial commitment in a foreign entity that has invested or invests into India either directly or indirectly, resulting in a structure with more than 2 (two) layers of subsidiaries. The OI Directions clarify that no further layer of subsidiary(ies) can be added to any existing structure with 2 (two) or more subsidiaries. This restriction however does not apply to (a) a banking company; (b) a systemically important NBFC registered with RBI; (c) an insurance company; or (d) a government company.

Note: *This is a significant change brought about by the Central Government. Round tripping as such has never been defined or expressly restricted under the Erstwhile ODI Regulations, and RBI has always sought to restrict any investments made by an Indian person into a foreign entity, where the foreign entity has invested or invests in an Indian entity. To this effect, the FAQ section relating to ODI investments was amended by the RBI clarifying that round tripping transactions cannot be done under the automatic route.*

However, from a reading of the OI Rules, it appears that till the subsidiary structure relates to less than 2 (two) layers, round tripping transactions would be permitted. Also, there is confusion on how the two-layer subsidiaries are to be calculated. Please see the above comments related to the definition of 'subsidiary'.

Additionally, in relation to resident individuals, since they can make investments only in operating foreign entities (not having a step down subsidiary), the relaxation of round tripping mechanism may not be able to be extended to resident individuals.

An express clarification will be needed since it has always been an extremely sensitive topic for the Central Government and RBI. We would also need a clarification on whether existing structures complying with OI Rules would need to be regularised as required under the Erstwhile ODI Regulations.

6. **NOC from lenders and authorities**:

6.1. Any person resident in India who (a) has an account appearing as a non-performing asset; (b) is classified as a wilful defaulter by any bank; or (c) is under investigation by a financial service regulatory or by investigative agencies in India namely CBI, ED or SFIO, is required to undertake investments by procuring a no-objection certificate from the lender bank or regulatory authority.

6.2. Additionally, if the certificate has not been provided by the lender bank or regulatory authority within 60 days of application, it will be deemed that the NOC has been rejected.

Note: *A similar provision was in the ODI Regulations as well, however, any investments by such persons could be under only the approval route. By providing an NOC approval route, the Central*

Government has sought to give the responsibility to the lenders and regulatory bodies for grading the nature and severity of the offence or investigation alleged to have been committed by the resident entity. However, given the timelines involved and the already stretched banks/ regulatory bodies, the question will remain whether this NOC approval route will solve the intended issues or re-direct the concerns from the RBI to such lenders/regulatory bodies.

7. **Pricing guidelines and valuation report**:

7.1. The OI Rules now provide that any issuance or transfer of equity capital of a foreign entity (including transfer between two persons resident in India), will need to be subject to a consideration basis valuation as per any internationally accepted pricing methodology for valuation arrived on an arms' length basis.

7.2. The AD Banks are reposed with the responsibility of ensuring compliance with the pricing guidelines. For the same, AD banks will be guided by a board approved policy, which needs to be adopted within 2 (two) months of the date of the OI Rules.

7.3. The OI Directions clarify that for certain identified scenarios like merger, demerger or liquidation, where the price has been approved by a competent judicial authority as per India or host country or where the price is readily available on a stock exchange, the valuation norms may not be insisted upon by the AD Banks.

7.4. The Erstwhile ODI Regulations used to specifically provide for situations where a valuation report would be required from a SEBI registered merchant banker, chartered accountant or certified public accountant, however, the OI Rules are silent on the same.

Note: *On a plain reading, it appears that the Central Government is looking to liberalise and boost the overseas investment market. However, in the present scenario, we will need to wait and see how the AD Bankers shape up their internal board approval policies and see the conditions that may be introduced at this stage. Also, the language of the clause suggests that even OPI investments would need to follow pricing guidelines, however, the AD Banks may be able to exclude investments in listed entities from the purview of following pricing guidelines.*

8. **Deferred consideration:**

8.1. General permission has been granted under the OI Regulations for payment of consideration on a deferred basis for the subscription of foreign securities by a person resident in India or transfer of foreign securities between a person resident in India and a person residing outside India subject to the following conditions:

8.1.1. All the foreign securities are transferred or issued upfront, in relation to the total consideration.

8.1.2. The full consideration should be compliant with pricing guidelines.

8.1.3. The definite period of deferment should be captured in the agreement between the buyer and seller.

8.2. The deferred portion of the consideration would be treated as non-fund based commitment and on payment of the same, will be treated as conversion of non-fund based commitment to equity.

8.3. The deferred consideration can also be structured as an indemnity holdback amount on the terms as laid down in the agreement.

Note: *This is a much awaited amendment to the overseas investment regime since any deferred consideration mechanism under the Erstwhile ODI Regulations, required an RBI approval. Unlike NDI Rules, the present OI Rules do not provide for an upfront percentage holdback or definite deferment period but leaves this to the discretion of the parties (captured in an agreement between the parties). An additional burden is cast on the AD Bankers, however, since they are to verify the bona fides of the transaction from the review of the agreement. Undoubtedly, this has liberalised cross border investments by Indian entities, but may lend ambiguity due to heavy dependency on the discretion of the AD Bank.*

9. **Investments by Residents Individuals:**

9.1. Like under the Erstwhile ODI Regulations, any investment made by a resident individual is subject to the ceiling under Liberalized Remittance Scheme issued by the RBI.

9.2. The resident individual can make (a) ODI investment in a foreign entity (not engaged in financial services activity and **does not have any subsidiary or step-down subsidiary where the resident has control**)[6]; (b) OPI investments including by way of reinvestment. Other methods of acquisition include gifts, inheritance, acquisition of sweat equity, minimum qualification shares or shares under ESOP plans.

Note: *The Erstwhile ODI Regulations had permitted acquisition of foreign securities as consideration of professional services or in lieu of director's remuneration, which seems to have been omitted from the present OI Rules. Please also refer to our above comment on round tripping structures for resident individuals.*

9.3. Any overseas investment of less than 10% in the equity capital whether listed **or unlisted** and without control acquired by a resident individual way of sweat equity, minimum qualification shares or shares under ESOP plans, will be treated as OPI.

9.4. Gift or inheritance:

9.4.1. General permission is granted to a resident individual to acquire foreign securities by way of inheritance from a non-resident or person resident in India holding such securities in accordance with OI Rules.

[6] However, this exception does not apply to acquisition due to inheritance, acquisition of sweat equity, minimum qualification shares or shares under ESOP plans

9.4.2. A resident individual can acquire foreign securities by way of a gift from a person resident in India who is a relative and holding shares in accordance with OI Rules.

9.4.3. A resident individual can acquire foreign securities as a gift from a person resident outside India only in accordance with the Foreign Contribution (Regulation) Act, 2010.

Note: *There was no restriction on an Indian individual acquiring foreign securities by way of gift under the Erstwhile ODI Regulations and this has been liberally used for flip structures or externalisations. This is however now restricted under the OI Rules.*

9.5. ESOPs and sweat equity: A resident individual (being an employee or director) can invest money under any standard ESOP schemes or sweat equity shares offered by an overseas entity. They can also acquire ESOPs under any scheme of the Central Government.

Note: *Apart from the standard ESOP structure where employees or directors could acquire foreign securities, resident individuals (not necessarily employees or directors) were permitted under the Erstwhile ODI Regulations to hold foreign securities issued under a cashless ESOP scheme, without any remittances. This has been omitted.*

10. **Investments in IFSC:**

10.1. Under the FEMA (International Financial Services Centre) Regulations, 2015, any financial institution or branch set up in IFSC shall be treated as a person resident outside India.

10.2. Under the OI Rules, a resident Indian can make an overseas investment in accordance with the extant regulations relating to foreign securities. The exceptions to the said rule are as under:

10.2.1. Any ODI in IFSC shall require the approval of the financial services regulator by way of a specific application, which application should be decided within 45 (forty-five) days from the date thereof, and if not received shall be deemed to be approved.

10.2.2. An Indian entity not engaged in financial services activity in India, making ODI in a foreign entity, which is directly or indirectly engaged in financial services activity, except banking or insurance, who does not meet the net profit condition as provided in para 3.1 above, may make ODI in an IFSC.

10.2.3. Indian residents can make a contribution into an investment fund set up in IFSC as OPI.

Note: *Classification of investments in IFSC will propel investments made both within India and overseas.*

11. **Financial commitments by way of loan or guarantee:**

11.1. An Indian entity is permitted to lend or invest in debt instruments provided that the loans are duly backed by loan agreements and where interest rates are at arms' length basis. Under the OI Directions, AD banks have been instructed to allow remittance towards the loan to the foreign entity and/or issuance of bank guarantee to/on behalf of the foreign entities, only after ensuring that the Indian entity has made ODI and has control in the foreign entity.

11.2. Corporate guarantees may be issued to a foreign entity or any of its step-down subsidiaries in which the Indian entity has acquired control through the foreign entity, by either (a) the Indian entity, or (b) its holding company (holding at least 51% in such Indian entity) or subsidiary (where the Indian entity holds at least 51%) ("**Group Company**"). Personal guarantee by a resident individual promoter of the Indian entity or bank guarantee issued by an Indian bank, which is backed by a counter guarantee or collateral from the Indian entity or its Group Company, is also permitted.

Note: *The Central Government has permitted under the automatic route granting of guarantees for its step down subsidiaries as well. It is however unclear if bank guarantees backed by collateral from the resident promoter, can be issued.*

12. **Financial commitments by way of pledge or security:**

12.1. Under the automatic route, an Indian entity can pledge the equity capital where it has made ODI or of its step down subsidiary outside India, in favour of an AD Bank, public financial institution or overseas lender for availing fund based or non-fund based facilities for itself, or for a foreign entity in which it has made ODI or its step down subsidiaries outside India or in favour of a registered debenture trustee for fund-based facilities for itself.

12.2. A charge can be created by way of pledge, mortgage, hypothecation or any other identical mode on (a) the assets in India (including assets of its group companies or associate company, promoter or director) in favour of overseas lenders and additionally, AD Bank or public financial institution; or (b) the assets outside India in favour of an AD Bank and additionally, public financial institution or registered debenture trustees.

Note: *In addition to granting security to identified lenders, the Central Government has increased the type of lenders in favour of whom security can be created. However, it still does not include a charge or pledge being created in favour of a credit fund.*

13. **Restructuring and transfers involving write-off under automatic route:**

In case of restructuring, under the Erstwhile ODI Regulations, RBI approval was required for restructuring the balance sheet involving write off of up to 25% of the investment (in case of unlisted entities) and beyond 25% of the investment (in case of listed entities). Under the OI Rules, restructuring of the balance sheet is permitted for foreign entities which have been incurring losses for the previous 2 years, under the automatic route without RBI approval, subject to certain conditions.

14. **Reporting and delay in reporting:**

14.1. All reporting for making financial commitment as ODI, divestment or restructuring will need to be done in Form FC (newly prescribed form) within a prescribed time.

14.2. Any OPI investment or sale will need to be reported in Form OPI (newly prescribed form) within 60 days from the end of the half year (September and March end) in which investment or transfer is made

14.3. The annual filing of Form APR will continue, however, a person who holds less than 10% and without control or a foreign entity under liquidation will not be required to make Form APR filings. In case more than one person resident in India has made ODI in the same foreign entity, the person holding the highest stake in the foreign entity shall be required to submit APR and in case of holdings being equal, APR may be filed jointly by such persons.

14.4. The requirement for an Indian entity which has made ODI to submit an Annual Return on Foreign Liabilities and Assets, continues.

14.5. Any delay in reporting can be regularized by payment of late submission fees for a period of 3 (three) years from the due date. Till such time that the reporting has not been regularized, no further financial commitment is permissible by such defaulting Indian entity.

15. Grandfathered transactions: The OI Rules clarify that all investments or financial commitments made and held prior to August 22, 2022, will be deemed to have been under the OI Rules and OI Regulations.

(III) CONCLUSION

The liberalization of Indian investments (inflow and outflow) continues. This will bring about ample change in how the Central Government and RBI deal with foreign investment by Indian companies and this will support the growing Indian businesses to invest abroad.