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Analysing developments impacting business

LONG DUE OVERHAUL OF THE OVERSEAS DIRECT INVESTMENT REGIME

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INTRODUCTION

Overseas Investments by Indian party(ies) were *hitherto* governed by the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 (Foreign Security Regulations) and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India) Regulations, 2015 (Property Regulations) (collectively Erstwhile Regulations).

In what was long overdue, the Government of India in consultation with the Reserve Bank of India (RBI) undertook a comprehensive exercise to simplify these regulations. It was recognized that in view of the evolving needs of businesses in India, in an increasingly integrated global market, there is an imperative need for Indian corporates to be part of the global value chain.

On 22 August 2022, the Ministry of Finance notified the Foreign Exchange Management (Overseas Investment) Rules, 2022 (ODI Rules) to supersede the Erstwhile Regulations. Further, the RBI notified the Foreign Exchange Management (Overseas Investment) Regulations, 2022 to supplement the ODI Rules (ODI Regulations). The RBI also notified the Foreign Exchange Management (Overseas Investment) Directions, 2022 (ODI Directions). The ODI Rules, ODI Regulations and the ODI Directions are collectively referred to as the 'New ODI Regime'.

The revised regulatory framework for overseas investment provides for simplification of the existing framework for overseas investment and has been aligned with the current business and economic dynamics. Clarity on Overseas Direct Investment and Overseas Portfolio Investment has been brought in and various overseas investment related transactions that were earlier under the approval route are now under the automatic route, significantly enhancing '*Ease of Doing Business*' and improving access and opportunity for Indian businesses overseas.

Some of the significant changes brought about through the New ODI Regime include no prior approval requirement for (i) deferred payment of consideration; (ii) investment/ disinvestment by persons resident in India (PRI) under investigation by any investigative agency/ regulatory body (this requirement has been replaced with a no objection certificate from the relevant body, as summarized below); (iii) issuance of corporate guarantees to or on behalf of second or subsequent level step down subsidiary (SDS); or (iv) write-off on account of disinvestment.

Set out below is our analysis of the key highlights of the New ODI Regime.

ANALYSIS

Definitions of key terms: The ODI Rules have defined/ revised certain key terms as follows:

- *Overseas Direct Investment (ODI):* The term 'ODI' has been defined to now expressly include *inter alia* investment in 10% or more of the paid-up equity capital of a listed foreign entity, or investment with control where investment is less than 10% of the paid-up equity capital of a listed foreign entity.

  Once an investment by a person resident in India (PRI) in the equity capital of a foreign entity is classified as ODI, such investment will continue to be treated as ODI even if the investment falls below 10% of the paid-up equity capital or such person loses control in the foreign entity. Further, in cases of investment in debt instruments of a foreign entity, a PRI will be required to hold control of such foreign entity.

  Overseas Portfolio Investment (OPI): OPI has now been demarcated and defined to mean investment, other than ODI, in foreign securities, but not in any unlisted debt instruments or any security issued by a PRI who is not in an International Financial Services Centre (IFSC). OPI specifically excludes investments in: (i) any unlisted debt instruments; or (ii) any security which is issued by a person resident in India who is not in an IFSC; or (iii) any derivatives unless otherwise permitted by the RBI; or (iv) any commodities including Bullion Depository Receipts (BDRs). It has been clarified that OPI by a PRI in the equity capital of a listed entity, even after its delisting shall continue to be treated as OPI until any further investment is made in the entity.

- *Control:* In the context of foreign entities, a subsidiary (or step-down subsidiary) has been defined based on 'control'.

  The term 'control' has been defined as 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 10% or more of voting rights or in any other manner in the entity.

- *Subsidiary or step-down subsidiary:* The terms **'**subsidiary**'** or **'**SDS**'** of a foreign entity has been defined to mean an entity in which the foreign entity has control and the structure of such subsidiary/ SDS shall comply with the structural requirements of a foreign entity, ie, such subsidiary/ SDS shall also have limited liability where the foreign entity's core activity is not in strategic sector.

  The ODI Directions further clarify that the investee entities of the foreign entity where such foreign entity does not have control shall not be treated as SDSs and therefore need not be reported henceforth.

ODI v OPI

- The New ODI Regime has, akin to the Foreign Exchange Management (Non-Debt Instrument) Rules, 2019 introduced schedule-based investments in foreign entities. The Erstwhile Regulations did not define the term 'portfolio investments' or prescribe applicable guidelines for such investments. This term was only referred to in the context of investments by Indian listed companies under the Erstwhile Regulations. However, the ODI Rules now expressly set out the OPI investment route. The ODI

Rules defined the terms 'ODI' and 'OPI', and provide guidelines on making such investments in Schedule I and Schedule II, respectively.

- The ODI Rules expressly permit an IP (*inter alia* including unlisted companies) to invest through the OPI route as long as the IP does not exceed 50% of its net worth[1] as of the date of its last audited balance sheet[2]. In addition to these liberalizations, the ODI Directions permit listed entities to liquidate their investments made under the OPI route and reinvest such proceeds under the automatic route. To clarify, such 'reinvestments' will be exempted from repatriation provisions as long as such proceeds are reinvested within the time specified for realisation and repatriation.

Round Tripping (ODI-FDI Structure):

- The Erstwhile Regulations did not expressly provide guidelines on round tripping/ ODI-FDI structures. It was only in 2019 when the RBI clarified the requirement of a prior approval for ODI-FDI structures by way of its FAQ No 64[3].

  However, in what is a first of sorts, there seem to be certain relaxations offered as far as FDI-ODI structures are concerned. The ODI Rules/ ODI Directions now permit such transactions by Indian parties in foreign entities which do not have more than 2 (two) layers of subsidiaries, directly or indirectly. However, such restriction will not apply to the classes of companies as mentioned in Rule 2(2) of the Companies (Restriction on Number of Layers) Rules, 2017, namely, (i) a banking company, (ii) a systematically important non-registered non-banking financial company, (iii) insurance company, and (iv) a Government company.

  This is a welcome move which will enable Indian businesses to invest in global companies having an Indian presence. Needless to mention, any such investment will still be subject to other conditionalities and restrictions set out in the New ODI Regime. However, such investment would need to be for *bona fide* business purposes.

Investment in Strategic Sector:

- The ODI Rules defines the term 'strategic sector' 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. The Central Government, may, on an application made to it through the RBI, permit financial commitment in strategic sectors above the limits laid down in the ODI Rules, subject to terms and conditions it considers relevant. As a directive to the Authorized Dealer Banks (AD Banks), ODI Directions lays down an obligation on AD Banks to allow remittance for ODI in the strategic sector *only* after ensuring that the Indian entity has obtained the necessary permission from the competent authority, wherever applicable.

- It is relevant to note that start-ups will also be viewed as part of the strategic sector. ODI in start-ups (recognized as such under the host country/ host jurisdiction) can only be made through the internal accruals from the Indian entity or its group/ associate companies in India; and in case of an individual, from his/ her own funds.

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1 The term 'net worth' has been defined to have the same meaning as assigned to it in Section 2 (57) of the Companies Act, 2013

2 The term ''last audited balance sheet' means audited balance sheet as on date not exceeding 18 months preceding the date of the transaction.

3 The FAQs are available at https://m.rbi.org.in/scripts/FAQView.aspx?Id=32.

Investments in Specific Sectors:

- *Financial Services*: An Indian entity not engaged in financial services activity in India can now 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 such Indian entity has posted net profits during the preceding 3 (three) financial years. This will allow Indian businesses to access investment opportunities abroad.

- *General And Health Insurance:* 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.

No Objection Certificate by lender bank/ Regulatory Body/ Investigative Agency:

- The ODI Rules have prescribed a new pre-condition whereby, an Indian party (IP) who (i) has an account appearing as a non-performing asset; or (ii) is classified as a willful defaulter by any bank; or (iii) is under investigation by a financial service regulator or by any investigative agencies in India, will be required to obtain a no objection certificate (NOC) from the relevant lender bank/ regulatory body/ investigative agency before making any financial commitment or undertaking disinvestment. Disinvestment now also includes extinguishment of rights in shares, including write off of equity investment by way of capital reduction by the foreign entity. Under the Erstwhile Regulations, such an approval was to be sought from the RBI. This aims to protect lenders' rights in case of such defaults.

Pricing Guidelines:

- The ODI Rules have newly introduced pricing guidelines whereby the issue or transfer of equity capital of a foreign entity from (i) a person resident outside India (PROI)/ PRI to a PRI who is eligible to make such investment, or (ii) from a PRI to a PROI shall be subject to a price arrived on an arm's length basis . An obligation has been bestowed upon the AD bank(s) to ensure compliance with such pricing taking into consideration the valuation as per the internationally accepted pricing methodology. Towards this requirement, the ODI Directions have prescribed a requirement of a board-approved policy that may inter alia provide for taking into consideration the valuation as per the prescribed pricing methodology, and allow for flexibility in scenarios where pricing guidelines may not be applicable.

Other Changes:

- *Bona fide business activity*: The ODI Rules have expressly clarified that any investment outside India is only permissible for an activity considered to be *bona fide* both in India and the host country. This additional protective qualification will restrict investment into business activities that are not considered *bona fide* in India but are *bona fide* under the host jurisdictions.

- *Investment in rights issue/ bonus issue shares*: It has been clarified that an IP can renounce its rights to receive shares of the foreign entity pursuant to a rights issue/ bonus issue in favour of a PRI/ PROI.

- *Contribution to a trust:* All contributions to an overseas trust will be viewed as a non-debt instrument in terms of the ODI Rules.

- *Setting up of step-down subsidiary by resident individual*: The Erstwhile Regulations prohibited a resident individual from setting up a step-down subsidiary or investing in an entity that has existing investments in other entities. The ODI Rules now permit an individual to make ODI (subject to the limit prescribed under the RBI's Liberalized Remittance Scheme) in a foreign operating entity which is not engaged in financial services activity, irrespective of whether such foreign operating entity has a step-down subsidiary *so long* as the resident individual does not have control over such foreign operating entity.

- *Gift involving foreign securities*: A resident individual is permitted to acquire foreign securities by way of a gift from a PRI only if such PRI is a relative. The Erstwhile Regulations did not expressly provide such general permission. Further, a gift of foreign security is permitted from a PROI, subject to compliance with the Foreign Contribution (Regulation) Act, 2010.

- *Swap of shares*: ODI is now permitted for swap of shares including swap on account of merger, demerger, amalgamation or liquidation under the automatic route. The ODI Directions have further allowed resident individuals to acquire shares by way of a swap arrangement. The Erstwhile Regulations only permitted primary swap of shares.

- *Deferred consideration for ODI*: The ODI Regulations permit *ODI equity capital* by way of deferred payment for such definite period as is set out in the date of agreement, for transactions involving: (i) subscription of equity capital to an issue; (ii) acquisition of equity capital by a PRI from a PROI, or (iii) purchase of equity capital by PRI from a PRI, subject to the following conditions: (i) the foreign securities equivalent to the amount of total consideration shall be transferred or issued, as the case may be, upfront by the seller to the buyer; (ii) the full consideration finally paid shall be compliant with the applicable pricing guidelines. The deferred part of the consideration on the acquisition of equity share capital of a foreign entity shall be treated as non-fund based commitment. Further, the seller is permitted to indemnify the buyer up to such amount as may be mutually agreed and laid down in the agreement.

- *Transfer/Liquidation of overseas company*: Transfer or liquidation of the overseas company is permitted only post 1 (one) year of holding by the Indian entity. Under the Erstwhile Regulations, the overseas entity was required to be in operation for 1 (one) year and the Indian entity having filed an Annual Performance Report (APR), the New ODI Regime has clarified that a 1 (one) year holding period is required before any transfer of such overseas shares can be made.

- *Restructuring:* The requirement of an RBI approval for restructuring the balance sheet of the overseas investee company involving write off of more than 25% of the amount invested has been done away with. However, if the amount exceeds USD 10 (ten) million, a valuation report is required to be furnished.

- *Reduction in compliance burden:* The New ODI Regime also introduces the facility of late submission fee for filing various overseas investment related returns/ documents on lines similar to that for Foreign Investment and External Commercial Borrowings related transactions. This would significantly ease meeting compliance requirements.

  Also, the separate reporting requirements for setting up/ winding up of step-down subsidiaries or alteration in the shareholding pattern of the foreign entity has now been dispensed with.

- *Reporting*: The ODI Directions have introduced 'Form FC' and 'Form ODI'reporting. All persons making any financial commitment, undertaking restructuring or undertaking disinvestment in a foreign entity are now required to submit details of such transactions in Form FC. PRIs that have undertaken ODI will have to make such Form FC filing in addition to the APRs. PRIs (other than a resident individual) making OPI investment, or transferring such investment by way of sale, is now required to make such reporting in Form OPI.

  Having said so, it is relevant to note that AD Banks were not permitting outward remittance(s) by IPs until such IP was in compliance with all reporting requirements, in practice, under the Erstwhile ODI Regulations. The ODI Directions have now expressly prohibited AD bank from facilitating any outward remittance/ further financial commitment by a PRI until all delay(s) in reporting is regularised.

- *IFSC investments*: Schedule V of the ODI Rules specifically prescribe guidelines for undertaking overseas investment in an IFSC by a PRI, up to the applicable limits prescribed in the ODI Rules. PRIs are permitted to make overseas investments in IFSCs in the manner laid down in Schedule I, Schedule II, Schedule III or Schedule IV of the ODI Rules.

COMMENT

The New ODI Regime has provided long awaited overhaul to the overseas investment framework. The ODI Rules and the ODI Regulations liberalize the regulatory framework and are a welcome step towards promoting the ease of doing business.

Several players in the market that intend to make portfolio investments have been long plagued by the lack of clarity in terms of the applicable guidelines for such investments. The New ODI Regime clearly demarcates schedule-wise investments and allows for plugging of regulatory loopholes.

While there could still be some challenges in implementing the New ODI Regime, eventually it will certainly strengthen the business owner and investors' confidence in the Indian foreign exchange regime. Further, this will enable Indian investors to expand and explore various investment opportunities overseas.

- *Moin Ladha (Partner), Kevin Shah (Principal Associate), Charu Singh (Associate), Tanish Prabhakar (Associate)*

For any queries please contact: editors@khaitanco.com