RBI REVAMPS RULES ON OVERSEAS INVESTMENT: THE NEW REGIME

1. INTRODUCTION

1.1 On August 22, 2022, the Government of India through the Ministry of Finance and in consultation with the Reserve Bank of India ("**RBI**") notified the Foreign Exchange Management (Overseas Investment) Rules, 2022 ("**OI Rules**"), Foreign Exchange Management (Overseas Investment) Regulations, 2022 ("**OI Regulations**") and the Foreign Exchange Management (Overseas Investment) Directions, 2022 ("**OI Directions**"). The OI Rules, the OI Regulations and OI Directions (hereinafter collectively referred to as the "**OI Guidelines**") have been notified with the purpose of overhauling the existing regulatory framework in relation to overseas investments and acquisition of immovable property outside India and are notified in supersession of the Foreign Exchange Management (Transfer or Issue of any Foreign Security) (Amendment) Regulations, 2004, Master Direction – Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India) Regulations, 2015 ("**Previous ODI Regime**").

2. KEY PROVISIONS INTRODUCED BY THE OI GUIDELINES

I. Introduction of new concepts

2.1 Foreign entity

(i) The concepts of 'Joint Venture' ("**JV**") and a 'Wholly Owned Subsidiary' ("**WOS**") have been replaced with the concept of a 'foreign entity', which is defined as an entity formed or registered or incorporated outside India, including in International Financial Services Centre ("**IFSC**") in India, that has limited liability. While this definition is conceptually similar to the definitions of 'JV' and a 'WOS', the concept of 'limited liability' has been newly introduced which means a structure such as a limited liability company, limited liability partnership, etc. where the liability of the person resident in India is clear and limited. In case of a foreign entity being an investment fund or vehicle and set up as a trust outside India, the liability of the person resident in India is required to be clear and limited and not exceeding the interest or contribution in the fund.

2.2 Overseas Direct Investment ("**ODI**") and Overseas Portfolio Investment ("**OPI**")

(i) The OI Guidelines provide precise distinction between the nature of overseas investments which constitute ODI and OPI. Under the Previous ODI Regime, there was no segregation between a direct investment and a portfolio investment and no clear definition of portfolio investment. Under the new regime, ODI means: (a) acquisition of any unlisted equity capital or subscription as a part of the memorandum of association of a foreign entity, or (b) investment in 10% or more of the paid-up equity capital of a listed foreign entity, or (c) investment *with control* where investment is less than 10% of the paid-up equity capital of a listed foreign entity. OPI means any overseas investment which is not ODI, other than investment in any *unlisted debt instruments* or any security issued by a person resident in India who is not in an IFSC.

2.3 'Control' and 'Subsidiary/Step Down Subsidiary'

(i) The OI Rules have introduced the definition of 'control', where the acquisition of 10% or more of the voting rights of a foreign entity has been included as a benchmark to establish control. This is

significant from the perspective of ascertaining which entity may be a 'subsidiary' or a 'step down subsidiary' of a foreign entity, which mean any entity in which the foreign entity has control. The OI Rules mandate that the structure of every subsidiary/step down subsidiary need to comply with the structural requirements of a foreign entity, i.e., such subsidiary/step down subsidiary are also required to have limited liability where the foreign entity's core activity is not in the strategic sector. The concept of control (being linked to 10% of the voting rights) is also relevant to identify an ODI investment, assess eligibility for investments by a resident individual in a foreign entity having subsidiaries and permissibility of restructuring an existing investment.

2.4 Strategic sector

(i) A strategic sector includes energy and natural resources sectors like oil, gas, coal, mineral ores, submarine cable systems, and startups, and any additional sector notified by the Central Government. Investments in such sectors do not require the foreign entity to have 'limited liability' and such investments may be made in unincorporated entities as well. This provision clearly sets out the Central Government's intention of identifying certain foreign sectors as key sectors where overseas investment is sought to be promoted.

2.5 Bonafide business activity

(i) ODI may be permitted only in a foreign entity which carries on a bonafide business activity, which means any business activity permissible under any law in force in India and the host country or host jurisdiction, as the case may be. Since the definition of 'bonafide business activity' does not provide any specifics, it will be helpful for stakeholders if the RBI clarifies that the activity of investing into another entity with or without being regulated or registered with any other regulator may be considered as a bonafide business activity in itself, based on the assumption and the argument that it is permitted under law.

II. Key provisions regarding undertaking overseas investments

2.6 Statutory recognition of OI-FDI structures

(i) The OI Rules have clearly established that investment in any foreign entity is restricted if such foreign entity has a step down subsidiary (linked to "control" under the OI Rules) in India and such investments results in a structure having more than two layers of subsidiaries. Such structure had not been clearly identified under the Previous ODI Regime and had been addressed only by way of an FAQ, where a clarification was issued that the RBI will consider such structures on merits under the *approval route*. This is a path-breaking development as it permits a combination of overseas investment followed by a foreign direct investment back into India, subject to being restricted to two layers.

2.7 Investments by resident individuals

(i) The OI Guidelines clearly identify and list out exhaustive modes of overseas investments by resident individual who are natural persons. Under the Previous ODI Regime, there was lack of clear rules in this regard, apart from certain specific norms pertaining to acquisition of shares pursuant to an ESOP, shares acquired to qualify for a management role in a foreign entity and receipt of shares pursuant to gift, inheritance or under the Liberalized Remittance Scheme ("**LRS**"). The OI Guidelines now provide investment opportunities for resident individuals to acquire foreign securities (subject to overall ceiling under LRS, if applicable) by: (a) remitting money and investing through OPI, including reinvestment; (b) remitting money and investing through ODI, albeit only in an operating company (not engaged in financial services) and with no subsidiary if the individual has control over the foreign entity *provided that, such conditions are not applicable in case of ODI pursuant to inheritance,*

acquisition of sweat equity, acquisition of qualification shares and shares acquired pursuant to ESOP or any other employee benefits; (c) by way of inheritance or by way of a gift from resident relative or a non-resident in accordance with Foreign Contribution (Regulation) Act, 2010 ("**FCRA**"); (d) by way of ESOP/Employee benefit or sweat equity as per conditionalities.

(ii) Its pertinent to note that resident individuals may now undertake ODI or OPI only in accordance with the OI Guidelines, and the provisions of LRS will not apply. To the extent the OI Rules state that the monetary limits prescribed under LRS shall be applicable, such limits shall apply to the relevant investments.

(iii) One of the key changes introduced by the OI Guidelines is in relation to a gift of foreign securities to a person resident in India. Under the Previous ODI Regime, a general permission had been provided to an individual resident in India to acquire foreign securities by way of gift from a person resident outside India. However, the OI Guidelines now state that any gift of foreign securities from a person resident outside India to an individual resident in India may be made only in accordance with FCRA. This is a key restriction imposed upon investments by resident individuals, especially since there is no clarity on the compliances required to be fulfilled under the FCRA. The FCRA norms are applicable only where foreign securities are acquired by people to whom FCRA applies as 'foreign contribution' from foreign source. While FCRA allows a resident to receive foreign contribution from a relative, a gift for personal use is not deemed to be foreign contribution and only a 'citizen' of a foreign country is understood as a foreign source. The exact impact of the FCRA on a gift of foreign securities from a non-resident will need to be analyzed in detail. A 'relative' in each case shall be as defined under the Companies Act, 2013.

2.8 <u>OPI by all Indian entities and resident individuals</u>

(i) The Previous ODI Regime allowed portfolio investments only by listed Indian companies. The OI Guidelines allow OPI by a listed Indian entity, including by way of reinvestment (where OPI proceeds are exempted from repatriation as long as they are reinvested within the time specified for realisation and repatriation as per the Foreign Exchange Management (realisation, repatriation and surrender of foreign exchange) Regulations, 2015, by an unlisted Indian entity in accordance with the conditions set out in the OI Rules, by a resident Indian individual subject to overall limits prescribed under the LRS, by investments made by Mutual Funds, Venture Capital Funds ("**VCFs**") and Alternate Investment Funds ("**AIFs**") and investments (including sponsor contribution) in units of any investment fund overseas. Therefore, a wider investment opportunity for portfolio investments has been introduced under the OI Guidelines.

2.9 <u>Ease of transfer and divestment of overseas investments</u>

(i) The Previous ODI Regime imposed several conditionalities and eligibility requirements in relation to transfer and divestment of overseas direct investments by way of a write-off or where the divestment proceeds were less than the original investment amount, including overseas JV/WOS being listed on an overseas stock exchange, Indian party having a prescribed net worth and a prescribed investment size in the JV/WOS. The OI Guidelines have removed any separate restrictions and conditions on write-off of investments provided that, such write-off is made in accordance with the fair market value for the foreign entity arrived as per internationally accepted valuation methodology, which is indicative of easing of business processes by the Central Government and the RBI and letting market forces be at play.

2.10 <u>Investment in financial services sector</u>

(i) The OI Guidelines allow all Indian entities, whether or not engaged in the business of financial services in India, to invest in a foreign entity which is <u>directly or indirectly</u> engaged in the business

of financial services. An Indian entity not engaged in the business of financial services may also invest in a foreign entity engaged in financial service (except banking and insurance business) subject to posting net profits during the preceding three financial years, which was not permitted under the Previous ODI Regime. Further, there is a relaxation on account of the Covid-19 pandemic with respect to the financial years 2020-21 and 2021-22 where such years can be excluded while considering the preceding three financial year requirement. Resident Indian individuals can also invest in such foreign entities in case of ODI pursuant to inheritance, acquisition of sweat equity, acquisition of qualification shares and shares acquired pursuant to ESOP or any other employee benefits.

(ii) The OI Guidelines also clarify that a foreign entity shall be considered as engaged in the business of financial services if it undertakes an activity, which if carried out by an entity in India, requires registration with or is regulated by a financial sector regulator in India. Therefore, whether any foreign entity is engaged in the business of financial services will need to be examined on a case to case basis, keeping in mind the financial services activities which require registrations under Indian law.

2.11 Deferred consideration

(i) Payment of consideration may be deferred for a definite period, which will need to be agreed upfront, from the date of the agreement subject to the entire foreign securities being transferred or issued upfront and the full consideration is payable in compliance with applicable pricing guidelines. The deferred part of the consideration will need to be treated and reported as a non-fund commitment to the RBI. Allowing deferred consideration will permit alternate transaction structures and ease of funding in relation to overseas investments.

2.12 Overseas investments by mutual funds, VCFs and AIFs

(i) Under the Previous ODI Regime, detailed conditionalities were included for overseas direct investments by mutual funds. Further, only domestic VCFs and AIFs were permitted to invest in equity and equity linked instruments of off-shore venture capital undertakings subject to overall limits of USD 500 million. While mutual funds have been permitted to invest overseas subject to an overall limitation of USD 7 billion, the OI Guidelines do not contain detailed conditions as regards such investment. All AIFs registered as such with the Securities and Exchange Board of India ("**SEBI**") are eligible to make overseas investments subject to an overall limitation of USD 1.5 billion. All such investments by mutual funds, VCFs and AIFs are subject to the supervision of, and any additional conditions which may be imposed by the SEBI.

2.13 Overseas investments in IFSC

(i) The OI Guidelines have introduced an entirely new mechanism for overseas investments by persons resident in India in IFSC. Such investments may be made by Indian entities and resident Indian individuals in accordance with the conditions prescribed under the OI Rules. There is a restriction on resident individuals to make overseas investments in IFSC if the relevant foreign entity has a subsidiary/step down subsidiary outside the IFSC where the resident individual has control over the foreign entity.

III. Other key developments under the OI Guidelines

2.14 Grandfathering of previous ODI investments

(i) Any ODI or financial commitment made in accordance with the rules or regulations applicable prior to the notification of the OI Guidelines, remains valid and may be sold, transferred, or divested in

accordance with and subject to compliance with the OI Guidelines. This is a welcome relief provided under the new regime where previous investments are allowed to remain as is and with no further actions required from the investors or investee entities.

2.15 Lending, investment into debt or non-fund based commitments

(i) The OI Guidelines have included an additional condition to be fulfilled by an Indian entity as regards providing loans, investing into debt instruments, or providing any other non-fund based commitment to a foreign entity, which pertains to acquiring control in such foreign entity at the time of making such financial commitment.

(ii) However, the OI Guidelines have now allowed non-fund based commitments (such as guarantees) to be provided on behalf of any overseas subsidiary/step down subsidiary. Under the Previous ODI Regime, Indian parties were required to be obtain approval from the RBI to extend guarantees on behalf of subsequent level step down subsidiaries.

2.16 Clarity in relation to existing concepts

(i) The OI Guidelines have provided a much-needed clarity on certain concepts which remained undefined and were subject to varying interpretations under the Previous ODI Regime, which include:

(a) ***Authorised dealer banks*** -- explained to specify domestic branches of such authorised dealer banks;

(b) ***Financial commitment*** – simplified and modified in accordance with the OI Rules;

(c) ***Net worth*** – the corresponding definition under the Companies Act, 2013 will apply, addressing the perennial question that the share premium shall be considered as part of the calculations;

(d) ***Equity capital, debt instruments and non-debt instruments*** – equity capital being clearly defined as equity shares, perpetual capital or instruments which are irredeemable or contribution to non-debt capital in the nature of fully and compulsorily convertible instruments. Exhaustive lists of debt instruments and non-debt instruments have been set out in the OI Rules.

The OI Directions clarify that that any instrument which is redeemable or non-convertible or optionally convertible shall be treated as debt for the purpose of the OI Guidelines. This is a significant change since historically, resident individuals have subscribed to and invested in instruments which are redeemable in foreign entities. However, the OI Directions also provide that resident individuals cannot provide debt as financial commitment. Therefore, the route for a resident individual of sending funds overseas as a loan to an overseas entity (with an eventual aim to receive capital instruments) appears to have been plugged.

2.17 Roles of the Central Government and the RBI

(i) The roles of the Central Government and the RBI have been clearly spelt out and their responsibilities delineated regarding matters which require approvals, where the administrative powers to accord approvals have been conferred upon the RBI except in relation to thresholds for financial commitment in strategic sectors for which the application shall be made to, and permission needs to be obtained from the Central Government. This is welcome step to inform stakeholders that overseas

flow of funds may be regulated and there is clear demarcation of powers between the Central Government and the RBI.

2.18 Overseas investment into gambling activities have been prohibited.

2.19 Concept of late submission fee (LSF) has been introduced giving an opportunity to stakeholders to regularize reporting of non-compliances within a period of three years from the due date of reporting/submission under the OI Regulations. This facility has also been extended to delays in reporting under the previous regulation for a period of three years from the date of notification of the OI Regulations.

3. INDUSLAW VIEW

3.1 The OI Guidelines have simplified the regime on overseas investments and provided much-needed clarity on certain concepts which were previously subject to interpretations by various stakeholders, including in relation to OI-FDI structures, control, modes of investment by a resident individual natural person and allowing deferred payments. Allowing investments by entities not engaged in the business of financial services to invest in the financial services sector abroad and the new regime for investments in IFSC are also welcome moves, being lauded by all. Having said that, as highlighted above, certain concepts including bonafide business activities, business of financial services, the impact of the FCRA on gift structures and investments in optionally convertible or redeemable instruments requires further clarity.

3.2 The intention of the Central Government also appears to be the enhancement of overseas investment opportunities for Indian entities and individuals and allowing investors to implement alternate investment structures. Also, the grandfathering of investments made under and in accordance with the Previous ODI Regime has been of much relief to resident investors. Clarity provided to stakeholders from a supervisory and enforcement perspective will also go a long way to reinforce faith of resident investors in the Government's commitment to promote and provide ease in making overseas investments.

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