Liberalizing the Outbound Investment Framework in India - A step towards Ease of Doing Business

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As a step towards liberalization and promoting ease of doing business in India, the Department of Economic Affairs, Ministry of Finance, on August 22, 2022, 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**") (hereinafter collectively referred to as "**ODI Framework**"). The new OI Framework overhauls the erstwhile FEMA (Transfer or Issue of Foreign Security) Regulations, 2004 and FEMA (Acquisition and Transfer of immovable property outside India) Regulations, 2015 ("**erstwhile ODI Framework**").

The extant ODI Framework has introduced a host of changes with an aim to simplify and provide a greater clarity on regulation of outbound investments undertaken by India entities in equity instruments and appears to be aligned with the persisting business dynamics. This post seeks to demonstrate and analyse the key changes introduced vide new ODI Framework in relation to overseas investments in equity instruments.

Snapshot of key concepts introduced under ODI Framework

1. Overseas Direct Investment ("**ODI**") v/s Overseas Portfolio Investment ("**OPI**")

Under the erstwhile ODI Framework, there was no distinction between direct investment and portfolio investment. The extant ODI Framework has clarified the difference between ODI and OPI and the manner in which ODI and OPI can be made by an Indian entity.

ODI means, (a) any investment by way of an acquisition of an unlisted equity capital of a foreign entity (excluding acquisition up to 10% by a resident individual), or (b) subscription as party of the memorandum of association of a foreign entity or (c) investment in 10% percent or more of the paid up capital of a listed company or (d) investment with control where investment is less than 10% of the paid-up equity capital of a foreign listed entity.

OPI on the other hand is defined to mean investment other than ODI in foreign securities but not in an unlisted debt instrument or any security issued by a person resident in India who is not in an IFSC.

Further, the classification between OPI and ODI is more relevant as the limits for financial commitment for ODI and OPI is different, as explained under Schedule I and Schedule II respectively of the OI Rules. In case of an ODI, the total financial commitment made by an Indian entity in all foreign entities taken together should not exceed 400% of the total net worth as on the date of last audited balance sheet, whereas in case of OPI the limit is 50% of the total net worth as on the date of last audited balance sheet.

2. Defining the test of "Control"

The OI Rules provides for a definition of "control", similar to what is provided under the Companies Act, 2013 (except for 10% threshold under voting agreements). As per Rule 2(1)(c) of the OI Rules, control means, either directly or indirectly exercising (a) right to appoint majority of directors, or (b) right to control management or

policy decisions, by a person either individually or in concert. The mode of exercising control could be by virtue of (a) shareholding, or (b) management rights, or (c) voting rights that entitle them to 10% or more of voting rights, or (d) in any other manner.

The test of control is relevant for the purpose of identifying subsidiary or a step-down subsidiary.

3. Strategic Sector and Bonafide Business Activity

The OI Rules defines 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. It further provides a carve out for investment in foreign entities engaged in the aforesaid strategic sector to not have "limited liability". The exception clearly reflects the intention of the Central Government to promote outbound investments in the said strategic sectors.

Another clarification introduced vide the ODI Framework is with respect to requirement of having overseas investments in foreign entities engaged in "bonafide business activities". The additional layer of clarification provides that bonafide business activity shall mean any business activity permissible under any law in force in India and the host country or host jurisdiction, as the case may be.

4. Prohibited sectors for overseas investments

The OI Rules strictly prohibits overseas investments in – (a) real estate activities, (b) gambling and (c) dealing with financial products linked to Indian rupee without prior approval of RBI. Further, the new ODI Framework provides that prior approval of Central Government shall be sought for making financial commitment in Pakistan or any other jurisdiction identified by the Central Government, as opposed to erstwhile ODI Framework which mandated prior approval for making direct or indirect investment in any country identified by Financial Action Task Force.

Analysing the Key Amendments regulating Overseas Investments

1. Roud Tripping *inter alia* restriction on Step Down Subsidiaries

One of the path-breaking amendments to the ODI Framework is in relation to an outbound investment structure resulting into direct/indirect investments in India. The FAQs published by RBI in relation to erstwhile ODI Framework prohibited round tripping i.e., a foreign direct investment structure where an Indian entity invests in a foreign entity and the foreign entity in turn has business operations in India through a subsidiary. Until recently, such structure would only be allowed with prior approval from RBI, to ensure that there is no tax evasion. However, in order to cater to evolving business requirements, the Central Government has liberalized the manner in which outbound investments may be structured.

As per the extant OI Rules, the aforesaid prohibition is only applicable in the event the resultant outbound investment structure results into more than two layers of subsidiaries.

2. ODI/OPI by Resident Individual

The new ODI Framework has enhanced overseas investment opportunities for the resident individuals. A person resident in India may make or hold overseas investment, subject to ceiling limit under RBI's Liberalised Remittance Scheme ($2,50,000),by way of (a) ODI in foreign entity not engaged in financial services activity and which does not have subsidiary or a step down subsidiary where resident individual may have control, provided that such condition shall not be applicable in case of overseas investment pursuant to inheritance,

acquisition of shares acquired pursuant to ESOP or any other employee benefits or acquisition of sweat equity shares, (b) OPI, by way of reinvestment, or (c) inheritance or by way of gift from the relative, or (d) swap of securities on account of merger, demerger, amalgamation or liquidation, or (e) ESOP/sweat equity shares.

The OI Rules further clarify that a resident individual may without any limit acquire foreign securities by way of inheritance or gift from a person resident in India who is a relative (as defined under Companies Act, 2013). However, a person resident in India may acquire foreign securities, by way of a gift from a person resident outside India as per the provisions of Foreign Contribution (Regulation) Act, 2010 ("**FCRA**"). FCRA may only be applicable when the shares, transferred by way of gift are qualified as "foreign contribution" and FCRA allows resident to receive foreign contribution from a relative. However, the consequence on gift of foreign securities under FCRA from a non-resident will have to be analysed further.

Further, the amendments introduced vide ODI Framework in relation to investment in equity capital provides a host of benefits to employees or director of an office/branch/subsidiary of foreign entity in India. Such an employee or director may hold direct or indirect equity holding, without any limit under ESOP/employee benefit scheme or sweat equity shares offered by overseas entity, provided such benefits are offered globally on a uniform basis.

While the OI Rules offer various modes of overseas investments to a resident individual, the OI Regulations provides a stricter compliance requirement i.e., every resident individual holding overseas investment more than 10% of equity capital (without control) in foreign entity or where the foreign entity is not under liquidation, shall submit an annual performance report with respect to each foreign entity by December 31st of the next year.

3. <u>Relaxation in transfer and divestments of overseas investments</u>

The new ODI Framework aims to minimalize restrictions and conditions on write-off of overseas investment, such that the write – off are made strictly in accordance with fair market value of the foreign entity determined by the pricing guideline and reporting requirements under the extant law. Further, any transfer on account of merger, amalgamation, demerger or on account of buyback of foreign securities shall have the approval of competent authority as per applicable laws in India or the laws of the host country.

For divestment of ODI, the transferor must fulfil the two conditions, namely, (a) transferor shall not have any dues outstanding for receipt, which transferor may be entitled to receive from foreign entity as an equity capital investor, and (b) the transferor must have stayed invested for minimum 1 (one) year.

4. <u>Acquisition by way of Deferred Payment</u>

In order to boost overseas investments, the Central Government has also permitted acquisition by way of deferred payment, subject to terms and conditions agreed between the parties. A resident in India may now acquire equity capital by way of subscription or by way of a purchase from a non-resident or from a resident (where the investment is categorised as ODI), by keeping the purchase consideration deferred for definite period of time under a share subscription or purchase agreement. Provided that, foreign securities equivalent to the purchase consideration must be transferred or issued, as the case maybe, by the seller to the buyer and full consideration to be paid shall be determined strictly in accordance with the pricing guidelines. Further, the buyer may be indemnified by the seller for deferred consideration subject to terms and conditions agreed between the parties.

In addition to above, there are a slew of changes and relaxation prescribed under the ODI Framework, namely, in relation to pricing guidelines, reporting requirements, debt investments, security creation, etc.

In sum, the new ODI Framework clearly reflects the intention of the Central Government and RBI to leverage and promote overseas investment in India. The amendments provide much needed clarity on the long-drawn industry issues and challenges in relation to outbound-inbound foreign investment structures, portfolio investments and modes of overseas investments by resident individuals.

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