



Luthra and Luthra
LAW OFFICES INDIA

Revised framework for overseas investment (Key highlights & takeaways)

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INSIDE

- Liberalization for round-tripping structure.
- Introduction of concept of 'control' and its significance in the context of 'subsidiary' definition, and 'round tripping' structure.
- Non-financial players allowed to invest in foreign entity engaged in financial services.
- Restriction on unlisted Indian companies to make OPI through subscription or purchase of equity shares
- Defaulters / person under investigation allowed to make investment after obtaining no-objection from lenders / investigative agency.
- Late Submission Fee introduced for delay in reporting.

AND MANY MORE.....

Following the consultations on the draft rules and regulations floated by the Reserve Bank of India (“RBI”) in August 2021, the Revised Framework¹ to govern overseas investments and acquisition & transfer of immovable property outside India has been notified on August 22, 2022. The Erstwhile Framework² has been subsumed within the Revised Framework and stands superseded except as respects things done or omitted to be done before such supersession.

The key highlights and takeaways from the Revised Framework vis-à-vis overseas investment has been briefed herein below:

1. **Foreign entity:** The erstwhile concept of ‘Joint Venture’ and ‘Wholly Owned Subsidiary’ has been substituted with the concept of foreign entity, which is defined as an entity that is formed or registered or incorporated outside India, including in International Financial Services Centre (IFSC) in India, that has **limited liability**.

*(Note: The restriction of limited liability would not apply to an entity with core activity in a ‘strategic sector’. The ‘strategic sector’ would include energy and natural resources sectors such as oil, gas, coal, mineral ores, submarine cable system and **start-ups**, and any other sector as decided by the Central Government.)*

2. **Indian entity (IE):** The erstwhile concept of Indian party (IP) (where all the investors from India in a foreign entity were together considered as IP), has been substituted with the concept of IE (where each investor entity would be separately considered as an IE). IE shall mean: (a) a company defined under the Companies Act, 2013 (“**Companies Act**”); (ii) a body corporate incorporated by any law for the time being in force; (iii) a Limited Liability Partnership formed under the Limited Liability Partnership Act, 2008; and (iv) partnership firm registered under the Indian Partnership Act, 1932.
3. **Control:** The concept of ‘control’ has been introduced under the Revised Framework, which save as provided herein, has largely been defined on the same lines as it is defined under the Companies Act, i.e., the right to appoint directors or the right to control management or policy decisions through any contractual arrangement(s). Though, unlike the Companies Act, under the revised framework: (i) ‘control’ is not defined on inclusive terms; and (ii) importantly, quantitative criteria (whereby having 10% or more voting rights is construed as control) has been included in the definition.
4. **Subsidiary / Step down subsidiary (SDS):** Subsidiary or SDS of a foreign entity has been defined as an entity in which the foreign entity has ‘control’. The subsidiary / SDS should comply with structural requirements of foreign entity i.e., such subsidiary/SDS shall also have limited liability where the foreign entity’s core activity is not in strategic sector.
5. **Equity capital:** A clear definition to the term ‘equity capital’ has been introduced. It would cover (i) equity shares (ii) perpetual capital or irredeemable instruments; (iii) contribution to non-debt capital of foreign entity in the nature of fully and compulsorily convertible instruments.

(Note: Instrument which is redeemable or non-convertible or optionally convertible shall be treated as debt).

¹ (i) Foreign Exchange Management (Overseas Investment) Rules, 2022 (ii) Foreign Exchange Management (Overseas Investment) Regulations, 2022; and (iii) Foreign Exchange Management (Overseas Investment) Directions, 2022, are collectively referred to as **Revised Framework**.

² (i) Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004; and (ii) Master Directions - Direct Investment by Residents in Joint Venture / Wholly Owned Subsidiary Abroad, are collectively referred to as **Erstwhile Framework**.

6. **Overseas Direct Investment (ODI):** ODI means investment by way of acquisition of any unlisted equity capital of foreign entity or subscription as a part of the memorandum of association (MoA) of a foreign entity, or 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.

7. **ODI by IE:** IE is allowed to make ODI for the purpose of 'bonafide business activity', by way of (a) subscription to MOA; (b) purchase of equity capital (c) acquisition of equity capital by way of rights issue / bonus issue; (d) capitalization; (e) swap of securities; (f) merger, demerger, amalgamation or any scheme of arrangement.

(Note: 'Bonafide business activity' has been explained as any business activity permissible under any laws in force in India or the host jurisdiction. The restriction of ODI to be made only in 'bonafide business activity' was included under Erstwhile Framework as well, however, no specific meaning / explanation was provided to the term 'bonafide business activity', and thus, it was open for multiple interpretation).

8. **ODI by resident individuals:** A resident individual is allowed to make ODI within the overall ceiling of Liberalized Remittance Scheme (LRS), in an **operating** foreign entity, which should not be engaged in financial services activity. Further, such foreign entity is not allowed to acquire or set up subsidiary / SDS if the resident individual has control in the said foreign entity.

(Note: Save as provided herein, the aforesaid conditions for ODI by resident individuals are largely the same as were provided under the Erstwhile Framework. Though, the Revised Framework offers a significant relaxation for it provides that restriction on setting up subsidiary / SDS would arise only where the resident individual has acquired control in first level foreign entity (provided such foreign entity is an operating entity). As opposed to this, the Erstwhile Framework, provided a complete restriction on setting up subsidiary / SDS by a foreign entity in which resident individual has made ODI (irrespective of the quantum of investment of such individual).

9. **ODI in financial services activity:** In a significant shift from Erstwhile Framework, an IE not engaged in financial services activity in India has been allowed to make ODI in a foreign entity, which is directly or indirectly engaged in financial service activity, except banking or insurance sector. However, such IE should have posted a net profits during the preceding 3 (three) financial years. Further, IE not engaged in insurance sector may make ODI in general or health insurance, where such insurance business is supporting the core activity undertaken overseas by such IE.

IE engaged in financial service activity in India, may make ODI in a foreign entity, which is directly or indirectly engaged in financial service activity, subject to the conditions which largely are the same as were provided under Erstwhile Framework viz. net profits in preceding 3 financial years, registration with financial service regulator in India, and approval from financial service regulator both in India and abroad.

Further, in a welcome move, a specific meaning to 'financial service activity' has been provided. It provides that a foreign entity shall be considered to be engaged in the business of financial services activity if it undertakes an activity, which if carried out by an IE, requires registration with or is regulated by a financial sector regulator in India.

10. **ODI in start-ups:** Any IE can make ODI in start-ups (recognized under the laws of the host jurisdiction) only from internal accruals of itself (or from internal accruals of its group or associate companies in India). Similarly, resident individuals can make ODI in overseas start-ups only from their own funds.

- 11. Overseas Portfolio Investment (OPI):** OPI has been defined to mean investment, other than ODI, in foreign securities but not in unlisted debt instruments. OPI in equity capital of listed entity, even after its delisting, would continue to be treated as OPI, unless fresh investment is made.

(Note: A joint reading of ODI and OPI definition suggests that OPI would largely comprise of: (i) investment, without control, in less than 10% of paid-up equity capital of listed foreign entity; and (ii) investment in listed debt instruments. Further, as the cap of 10% has been linked only with paid-up equity capital of listed foreign entity (and not with listed debt instruments), it appears that investment beyond 10% in the listed debt instruments of foreign entity would continue to be treated as OPI).

- 12. OPI by IE:** A listed Indian company can make OPI including by way of re-investment within the LRS limit. An unlisted IE is allowed to make OPI only by way of (a) acquisition of equity capital by way of rights issue / bonus issue; (b) capitalization; (c) swap of securities; (d) merger, demerger, amalgamation or any scheme of arrangement. Further IE may make OPI up to 50% of its net worth as on the date of its last audited balance sheet.

(Note: Unlisted IE is not allowed to make OPI by way of subscription to MoA, purchase of equity capital, or through bidding or tender process. In view of this, the other routes provided for unlisted IE to make OPI such as rights issue, bonus issue, swap etc., which routes per se are available to existing shareholders, may not be of much relevance).

- 13. OPI by resident individuals:** A resident individual is allowed to make OPI, including by way of re-investment, within the overall ceiling of Liberalized Remittance Scheme (LRS).

- 14. Financial commitment (FC):** FC has been defined to mean the aggregate amount of investment made by a person resident in India, by way of ODI, debt other than OPI in foreign entity(ies) in which ODI is made and shall include non-fund based facilities extended by such person to or on behalf of foreign entity(ies).

(Note: As OPI excludes unlisted debt, the same would be treated as FC).

- **Limit on FC:** The total FC made by an IE in all foreign entities taken together at the time of undertaking FC shall not exceed 400% of its net worth as on the date of last audited balance sheet. However, FC made by Maharatna or Navratna or Miniratna or subsidiaries of such public sector undertakings (**PSUs**) in foreign entities engaged in strategic sectors shall not be subject such FC limit.

(Note: The concept of utilizing the net worth of the subsidiary/holding company by IE has been discontinued henceforth. Further, as OPI has been excluded from FC definition, it appears that the limit of 50% of net worth for OPI, as referred in s.no. 12 above, is over and above the limit of 400% of net worth provided for FC).

Further, interestingly, as 'start-ups' have been included in 'strategic sector', the PSU are allowed to extend FC to overseas start-ups without any limit. On the contrary, ODI in 'start-ups' has been restricted to be made only through internal accruals, as referred at s.no. 10).

- **Preliminary conditions for FC (other than through equity capital):** IE may lend or invest in any debt instruments of foreign entity or extend non-fund-based commitment to or on behalf of a foreign entity including overseas SDS subject to following conditions: (i) IE is eligible to make ODI; (ii) IE has made ODI in foreign entity; (iii) IE has acquired control in such foreign entity.

- 15. Round tripping:** As opposed to the restriction under the Erstwhile Framework on ODI - FDI structure (commonly referred as round-tripping), the Revised Framework permits a person resident in India to make FC in a foreign entity (that has directly or indirectly invested into India at the time of making FC, or at any time thereafter), resulting in structure with not more than two layers of subsidiaries. The said restriction on layers of subsidiaries would, however, not apply to banking company, non-banking financial company, insurance company, and Government company.

(Note: The restriction on layers of subsidiaries so imposed is open for multiple interpretation and different structure may possibly be devised to circumvent such restriction. For instance, overseas subsidiary may restrict investment in Indian company below 10% (so that the concerned Indian company is not termed as 'subsidiary' for want of control), and such Indian company may then again invest in other target entity(ies)).

- 16. No objection from lenders and investigating agencies:** The Revised Framework allows a person resident in India who has NPA account, or is classified as wilful defaulter by bank, or is under investigation (by financial service regulator or by specified investigative agencies in India), to make FC (or undertake divestment) after obtaining no-objection from the concerned lender bank, or the investigative agency. Further, if the concerned bank or investigative agency fails to not respond within 60 days of submission of application, a deemed approval shall be presumed.

(Note: This is a significant shift from the Erstwhile Framework whereby Indian party on defaulters list of the bank, or under investigation by investigative agency, was not allowed to make ODI under automatic route.)

- 17. Pricing guidelines:** The pricing guidelines would have to be complied with in case of issue or transfer of equity capital of a foreign entity from: (i) a person resident outside India or a person resident in India to a person resident in India (who is eligible to make such investment); or (ii) from a person resident in India to a person resident outside India.

- 18. Delays in reporting:** The modality of payment of Late Submission Fees (LSF) has been introduced for delays in making prescribed filing related to overseas investment. The facility of LSF can however be availed for a maximum period of 3 years from the concerned due date for filing.

Further, similar to Erstwhile Framework, the persons resident in India has been restricted from making any further FC in a foreign entity unless any delay in reporting is regularized.

This newsletter is only for general informational purposes, and nothing in this edition of newsletter could possibly constitute legal advice, which can only be given after being formally engaged and familiarizing ourselves with all the relevant facts.

Key Contacts



RAJIV K. LUTHRA
Founder & Managing Partner
Email-rajiv@luthra.com

Contributories



Harish Kumar
Partner



Itee Singhal
Managing Associate



Nupur Gupta
Associate