

Key changes in Overseas Direct Investment Regime 2022 – Major Overhaul

1. Background

In keeping with the spirit of liberalization and to promote ease of doing business, the Central Government has taken a significant step with operationalization of a new Overseas Investment regime after 18 years. In this regard, Foreign Exchange Management (Overseas Investment) Rules 2022 and Foreign Exchange Management (Overseas Investment) Regulations 2022 have been notified by the Central Government (“ODI Regulations 2022”).

The new regime proposes to simplify the existing framework for overseas investment by persons resident in India by covering wider economic activity, reducing the need for seeking specific approvals and reducing compliance burden and costs.

The key changes proposed include clarity on flipping into overseas structures, introduction of definitions in relation to Overseas Direct Investment (ODI) vs Overseas Portfolio Investment (OPI), allowing investments in financial sector abroad, permissibility of deferred payments, permissibility of write off on account of disinvestment, introduction of late submission fees for delay in reporting, revision in forms of reporting etc.

The investments already made in accordance with the erstwhile ODI Regulations will be deemed to have been made under ODI Regulations 2022.

2. Key highlights of the amendments

2.1 Difference between ODI vs OPI vs financial commitment

- ODI has been defined to mean the following:
 - Investment by way of **acquisition of unlisted equity capital** of a foreign entity
 - **Subscription** as a part of the **memorandum of association** of a foreign entity
 - Investment in **10% or more** of the paid-up equity capital of a **listed foreign entity**
 - **Investment with control** (*) where investment is less than 10% of the paid-up equity capital of a **listed foreign entity**.

** Control means the right to appoint majority of the directors or control the management or policy decisions, holding more than 10% voting power in the foreign entity.*

- OPI has been defined to mean the following:
 - Investment in foreign securities that **does not constitute ODI**.
 - It does not include **investment in any unlisted debt instruments**, or **any security** issued by a person resident in India who is **not in an International Financial Services Centre (IFSC)**.

Note: It has also been provided that acquisition by a resident individual of **less than 10% of the equity capital, whether listed or unlisted**, of a foreign entity **without control** by way of acquisition of sweat equity shares, minimum qualification shares or shares through **Employee Stock Ownership Plan or Employee Benefits Scheme**.

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

Takeaways

- ❖ Portfolio investment is now clearly defined. Investment by resident individuals of less than 10% share capital in **unlisted companies** through any mode other than sweat equity shares, ESOPs etc. shall be treated as ODI and not OPI. However, reporting requirements in case of such investments are eased.

2.2 Overseas investment in debt instruments

- Overseas investment by Indian entities by way of debt or by way of non-fund based facilities is allowed only if the Indian entity¹, has made ODI and **has acquired control** in the said foreign entity.
- Further, loans should be duly backed by a **loan agreement** where the rate of **interest** shall be charged on **arm's length basis**.
- Resident individuals can make ODI or OPI as may be prescribed. However, since there are no explicit provisions, resident individuals cannot invest in overseas debt instruments.

Takeaways

- ❖ Investment in debt instruments shall not be treated as ODI. It shall be treated as financial commitment.
- ❖ Under the erstwhile regulations, overseas investment by way of debt was permissible provided there is equity investment. There was no threshold limit or requirement of having control over the foreign entity. However, under the current regulations, the Indian entity can invest in debt instruments or extend non-fund based commitments only if it has control in the said foreign entity.

2.3 Investment in financial services sector

- A foreign entity will be considered to be engaged in the **business of financial services activity** if it undertakes an activity, which **if carried out by an entity in India, will require registration with or regulated by a financial sector regulator in India**.
- An Indian Entity **not engaged in financial services activity** in India **can make ODI** in a foreign entity, which is directly or indirectly **engaged in financial services activity**, except banking or insurance activity, subject to the condition that such Indian Entity has **posted net profits during the preceding three financial years**.
- Indian Entity engaged in sector other than insurance sector business can make ODI in general and health insurance provided such insurance business is supporting the core activity undertaken overseas.

Takeaways

- ❖ The erstwhile regulations allowed only regulated entities to carry on financial service activities overseas, with the approval of the relevant regulators in India. However, as per ODI Regulations 2022, even a non-financial entity can invest in financial service activity overseas (except banking and insurance industry) if there is a track record of profits.

¹ The entity should be eligible to make ODI

❖ It is not clear whether investing activity would be treated as financial service activity. Investing activities would not require registration nor would it be regulated if the company is considered as an unregistered Core Investment Company.

2.4 Round tripping structures

- Financial commitment in a foreign entity is **not allowed** in a foreign entity that **has invested or shall invest into India**, at the time of making such financial commitment, or at any time thereafter, either directly or indirectly, resulting in a structure with **more than two layers of subsidiaries**.
- **Subsidiary or step-down subsidiary** of a foreign entity shall mean an entity in which the foreign entity has **control**.
- The above restriction shall not apply to banks, NBFCs, insurance companies, Government companies etc.

Takeaways

- ❖ Under the erstwhile regulations, such ODI-FDI structures were permissible only under the approval route. However, the same is now freely permissible provided such investment does not result in more than two layers of subsidiaries.
- ❖ It is unclear whether the condition of two layers of subsidiaries should be looked at from I Co perspective or from F Co perspective.
- ❖ It is unclear whether the condition of two layers of subsidiaries applies to overseas subsidiaries also which do not have any layer (upstream or downstream) with India. .
- ❖ If the foreign entity does not have control over the India company in which it has invested in (say investment is less than 10%), such company will not be treated as a subsidiary.
- ❖ One would have to wait and see if there are any specific KYC conditionalities that would be imposed on such structures to avoid unintended transactions.

2.5 Overseas investments by resident individuals

- A resident individual can make ODI in an **operating foreign entity** not engaged in financial services and which does not have **subsidiary or step-down subsidiary** where the **resident individual has control** in such foreign entity. This condition shall not apply if the ODI is made by way of inheritance, sweat equity shares, minimum qualification shares, acquisition through ESOPs, etc.
- Inheritance of foreign securities is allowed from a person resident in India holding such securities in accordance with exchange control provisions or from a resident outside India and shall be without any limits.
- Gift from a resident in India is allowed without any limit provided the resident is a relative.
- Gift from a resident outside India is allowed if such gift is in accordance with FCRA rules and regulations.
- Acquisition of shares or interest under ESOP or EBS or sweat equity shares by employees or directors is permissible without any limit, provided the issue is on a global uniform basis and the overseas entity has direct or indirect equity holding in the Indian entity.

Takeaways

- ❖ Though ODI-FDI structures are permitted (as explained in Para 2.4), unless the ODI by a resident individual is through inheritance, ESOPs, etc., the foreign entity cannot have a subsidiary, whether in India or abroad.

- ❖ Unlike in the case of Indian entities (not engaged in financial service activity) who can invest in an overseas company engaged in financial service activity overseas if they meet the 3 years track record condition, no such condition is stipulated for resident individuals. Therefore, resident individuals cannot invest in an entity carrying on financial service activities unless the investment is through inheritance, ESOPs, etc.

2.6 **Requirement of carrying on bona fide business activity**

- “Bona fide business activity” is defined to mean any business **activity permissible** under any **law in force in India** **and** the host country / jurisdiction.
- Investment by a person resident in India shall be made in a foreign entity **engaged in a bona fide business activity**, directly or through step-down subsidiary or the special purpose vehicle.

Takeaways

- ❖ Overseas investments shall be allowed only if the business activity is permissible not only abroad but also in India. Further, the condition of being engaged in bona fide business activity shall be looked at all levels (i.e., whether directly in the foreign entity or through step-down subsidiaries).

2.7 **Amendment in net-worth conditions**

- **Net worth** is now defined to have the same meaning as assigned to it in **Section 2(57) of Companies Act, 2013**. However, in the case of LLPs and registered partnership firms, the net worth shall be the capital contribution of partners and undistributed profits after deducting the aggregate value of accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the last audited balance sheet.

Takeaways

- ❖ Under the erstwhile ODI regulations, net worth was defined as paid up capital and free reserves. This created confusion on whether securities premium should be included or not. With this revised definition, it is clear that securities premium shall also be included.
- ❖ Further, Indian entity can no longer utilise the net worth of the holding company or the subsidiary company for undertaking financial commitment.

2.8 **Other key changes**

- ODI Regulations 2022 provides for submitting ODI filings or evidence along with the Late Submission Fee. Further, such a facility can be availed within a maximum period of 3 years from the date of publication of these regulations in the Official Gazette. It is to be noted that there is also a prohibition on further financial commitment or transfer of investment until any delay in reporting is regularized with payment of Late Submission Fees.
- The requirement of RBI approval for write off on disinvestments has been done away with.
- The requirement of RBI approval for investment by companies in loan default or under investigation has been replaced with the requirement of an NOC by these agencies or banks prior to making such investment/ financial commitment.
- The requirement of 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. If amounts invested exceed USD 10 million, valuation report needs to be furnished.
- Issue or transfer of equity capital shall be subject to a price arrived on an arm’s length basis as per internationally accepted pricing methodology. It is unclear currently as to who should certify the same.

- Indian entities can invest in listed companies if such investment does not exceed 50% of the net worth. An unlisted entity can invest in listed companies only through certain prescribed modes such as rights / bonus issue, swap, scheme of merger, demerger, etc.
- Acquisition or transfer by way of deferred payment is now permitted. The period should be decided upfront in the agreement. The deferred part of the consideration will be treated as a non-fund based commitment. The foreign securities shall be issued / transferred upfront.
- In case of ODI in overseas start-ups, the investment cannot be made out of borrowed funds. The AD bank, before facilitating the transaction, shall obtain necessary certificate in this regard from the statutory auditors/chartered accountant of the Indian entity/investor.

3. Our comments

With lesser approval requirements and significant relaxations, the ODI Regulations 2022 has certainly opened new doors for many companies to invest abroad. There are certain grey areas which need to be clarified and the same could be ironed out through FAQs / circulars.

Given that there has been a massive overhaul in the ODI Regulations, one would have to relook at their structures implemented / in implementation and check if the regulations are in line with the objectives of the structure.

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