ANALYSIS

TRILEGAL

NEW REGIME ON OVERSEAS INVESTMENT

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1 Introduction

After 11 months of the draft overseas investment rules having been published by the Reserve Bank of India (**RBI**), the Indian Government, pursuant to discussions with industry players and bodies corporate finally notified on 22 August 2022 the Foreign Exchange Management (Overseas Investment) Rules 2022, the Foreign Exchange Management (Overseas Investment) Regulations, 2022 and the Foreign Exchange Management (Overseas Investment) Directions, 2022 (collectively, the **New Regime**).

Contrary to the expectations set by the draft rules, the New Regime offers a far more cogent and comprehensive overseas investment framework for Indian corporates and individuals. The Central Government and the RBI have attempted to align the investment framework with the recent trends in the market, including: (i) externalisation of business to foreign locations to attract more investment; (ii) out-bound mergers and acquisitions of foreign companies with Indian subsidiaries; (iii) guarantee, indemnity and deferred consideration; (iv) increased usage of employee stock options and sweat equity to incentivise workforce; and (v) investment in strategic sectors and startups.

By amending the regime governing overseas investment, the Indian government has taken a small yet significant step towards addressing the issues faced by Indian corporates and residents investing in global markets. While retaining focus on prevention of money laundering, the regulations have tried to clarify concepts like round tripping, control and deferred consideration which till now were decided by the Reserve Bank of India on a case-to-case basis.

The key changes introduced by the New Regime include:

a. introducing definitions of overseas portfolio investment (**OPI**), overseas direct investment (**ODI**), control, strategic sector, subsidiary and step-down subsidiary (being the biggest and most consequential change);

b. relaxing the regulations governing round tripping, deferred consideration and investments by Indian corporates in financial services;

c. dispensing with the requirement to obtain RBI approval before issuing guarantees to step down subsidiaries and writing off investments; and

d. focusing on timely reporting while introducing the concept of a late submission fee.

While not delving into the changes themselves, this update highlights the impact of the New Regime on Indian corporates, entities and individuals and provides an insight into the practical challenges they may continue to face.

2 Impact on Indian Entities

- *Bona fide Business*: The New Regime bolsters the intention of the regulator to ensure that overseas investment is only made into *bona fide* businesses. However, the definition of *bona fide* business has been restricted to any business activity permissible under any law in force in India **and** the host jurisdiction. This

may be problematic for corporates looking to invest in activities that are not expressly permissible in India, for instance, investing into sectors like for profit education, railways, certain forms of defence, etc.

- *Loans*: Historically, Indian entities have been permitted to lend to companies in which they have any amount of equity participation (including portfolio investments of less than 10%). However, the New Regime now permits Indian entities to only lend to their direct subsidiaries (i.e., entities in which they have management control or hold 10% or more of voting rights). This restriction seems at odds with the general permission granted to Indian entities to provide guarantees in favour of any subsidiary or step-down subsidiary.

- *Financial Services*: Indian entities that are not engaged in financial services are now permitted to invest in: (a) foreign entities that are directly or indirectly engaged in financial services activity (except banking and insurance) if the Indian entity has posted net profits during the preceding three financial years; and (b) in general and health insurance if such insurance business compliments its core activity (for instance, companies in the healthcare sector) and the Indian entity has the net profits set out in (a) above. Two important considerations that follow are: (i) whether investments in special purpose vehicles that only hold securities in another company will be construed as investment in financial services, which basis preliminary feedback is not likely to be the case; and (ii) financial services are defined in the construct of Indian law, i.e., its activities require registration with or is regulated by a financial sector regulator in India. It remains unclear if digital assets like cryptocurrency which are not yet regulated would fall within the purview of financial services. It would have been more prudent to have relied on the host country's definition of financial services; a practice that has been adopted in the New Regime in relation to start-ups.

- *Existence of Step-Down Subsidiaries in India*: The New Regime has resolved the '*round tripping*' issue that restricted Indian corporates from investing in companies that had or intended to have subsidiaries in India. They are now permitted to acquire control in such foreign entities, provided the structure does not directly or indirectly result in more than two layers of subsidiaries. Subsidiaries have been defined to include both Indian and foreign entities. This leads to a few possible interpretations:

  a. if the foreign entity is considered as a '*subsidiary of the Indian entity*', the foreign entity can only have one more subsidiary below it, whether in India or outside India; or

  b. if the foreign entity is not considered as a '*subsidiary of the Indian entity*', the foreign entity itself can have two levels of subsidiaries, whether in India or outside India.

  Based on discussions with authorised dealer banks (**AD Banks**), we understand that the RBI is likely to compute the layers by starting at the first overseas subsidiary and excluding the Indian subsidiary into which the foreign investment is made. For instance, if the Indian entity has a subsidiary in UK which in turn has a subsidiary in Singapore, the UK subsidiary will be considered as the first layer and the Singapore entity will be considered the second layer. The Singapore entity in turn will be permitted to invest into an Indian subsidiary. Further, the interplay of the regulations around round tripping and the Companies Act, 2013 (which expressly exempts foreign subsidiaries from layering restriction) is yet to be tested.

  Leaving aside the ambiguities, the introduction of this concept will remove a major hurdle for Indian corporates (especially those in the technology sector): (a) looking to invest in or acquire foreign companies with Indian subsidiaries/holdings; (b) externalising their business to lucrative locations to attract foreign investment or benefit from special schemes.

3 Impact on Indian Individuals

- *ODI v OPI*: The New Regime defines ODI as (a) acquisition of unlisted equity capital or subscription to the memorandum of association of a foreign entity; or (b) investment in 10% or more of the paid-up share capital of a listed company; or (c) acquisition of 'control' (i.e., acquiring management control or voting rights above 10%) of a listed company. OPI, on the other hand, has been defined as investment other than ODI and cannot be made in (i) unlisted debt instruments; (ii) any securities issued by a person resident in India that is not in an international financial services centre; (iii) derivatives (unless permitted by the RBI); and (iv) commodities.

  Any investment in equity capital of an unlisted company is considered ODI. The only exceptions to this are acquiring shares of less than 10% as qualification shares or under a sweat equity plan or employee benefits scheme. This means that shares acquired by resident individuals in an unlisted company by way of gift will be classified as ODI and the attendant conditions (like, investing in financial services, step down subsidiary) will be applicable. Accordingly, resident individuals can no longer explore the gift option to acquire control in foreign companies that have subsidiaries. Further, several reporting obligations have become applicable to individuals, which is cumbersome. Since one of the objectives of the New Regime is to facilitate investments in start-ups, a specific exemption for investment in startups where control is not acquired should have been carved out under the definition of ODI.

- *Equity Capital*: The New Regime restricts the definition of equity capital to instruments that are irredeemable or compulsorily convertible. This means redeemable and optionally convertible instruments would be considered to be debt and resident individuals would not be able to subscribe to such instruments as they are restricted from lending to foreign entities. In the context of investments into India, it seems reasonable to restrict foreigners from subscribing to redeemable instruments as such instruments provide them with an assured return. However, applying the same logic to investments outside India seems irrational. The other issue with the definition is that the treatment of commonly used securities in start-ups (like SAFE - simple instrument for future equity), which are neither compulsorily convertible nor irredeemable instruments, is unclear.

- *Subsidiaries and Step-Down Subsidiaries*: While the regulations around round tripping have been relaxed for Indian entities, resident individuals still cannot acquire control in companies that have subsidiaries or intend to have subsidiaries. Since the definition of subsidiary includes foreign subsidiaries, it is unclear why resident individuals are restricted from acquiring control in companies that only have subsidiaries outside India. Having said that, the New Regime allows resident individuals to explore alternatives to achieve a similar structure, for instance, (i) acquiring shares under a sweat equity or employee benefit scheme; or (ii) setting up a partnership firm, limited liability partnership or a company to invest in foreign entities that have Indian subsidiaries.

- *Gifts*: Individuals can now acquire shares through gift only from (i) relatives resident in India; or (ii) persons outside India, subject to compliance with the Foreign Contribution (Regulation) Act, 2010 (**FCRA**), including for those acquiring gifts exceeding INR 1,000,000 reporting obligations prescribed under the FCRA. Further, a resident individual is not permitted to transfer such gifts to a person resident outside India.

- *Employee Stock Options*: The New Regime brings much-needed clarity around employee stock options and employee benefit schemes. Foreign bodies corporate rely on equity-linked incentive schemes to attract and retain talent. Under the erstwhile regime, there were several interpretations suggesting that RBI's approval was required for: (i) a resident individual acquiring membership interest in a limited liability

partnership or limited liability company incorporated outside India; (ii) reinvesting dividend received on foreign securities acquired under an employee benefit scheme; (iii) acquiring management control or voting rights above 10% (as otherwise, the restrictions associated with ODI around step down subsidiary would have applied). The New Regime now allows (i) to (iii) above which not only opens the door for externalisation structures (explained above) but also extends meaningful incentives to the workforce of global companies based in India.

4 Other Key Considerations

Other than those outlined above, certain other aspects of the New Regime remain unclear.

a. The fate of passive investments of more than 10% made under the previous regime remains to be seen- It is unclear if they would henceforth be considered as ODI. If yes, then perhaps the RBI may require residents to divest their holding in such companies if the same is in violation of the New Regime. For instance, if a resident individual acquired 11% through a gift, would she be required to divest her holding if the foreign entity has a subsidiary?

b. Clarity is needed on whether the restrictions around step-down subsidiary would be enforced on a resident individual who initially acquired shares in a foreign company through inheritance or under an employee benefit scheme and thereafter increased his/her holding through a rights issue or capitalisation. Similarly, it is unclear if these restrictions would apply if a resident individual received further shares through a rights/bonus issue despite the initial investment being classified as OPI.

c. AD Banks have been given a free hand by the regulations to frame policies around (a) documents required for compliance with the pricing guidelines; (b) documents to support the *bona fides* of a write-off on investment; and (c) the situations in which a valuation would not be required. While AD Banks have been given 2 months' time to formulate these, in the short term, it has stalled some on-going transactions and more, importantly, has created a risk of leveraging one AD Bank's policy against the other.

While the New Regime can be described as '*cautious liberalisation*', the effort in creating a regime that is more credible and grounded in today's reality needs to be appreciated. However, it would have to be seen how the RBI will address some of the challenges highlighted above.