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Liberalization of the Overseas Direct Investment Regime

Introduction

The Reserve Bank of India (“RBI”) had issued Draft Foreign Exchange Management (Overseas Investment) Regulations, 2021 inviting stakeholder comments in August 2021. The RBI has now in consultation with the Central Government revamped the regulatory regime governing overseas direct investment from India and has introduced an entirely new regulatory framework.

The offshore direct investment framework has been overhauled with a similar approach that was followed for foreign direct investment into India, which split the regulatory regime for foreign investment in debt and non-debt instruments. The Central Government has issued the Foreign Exchange Management (Overseas Investment) Rules, 2022 pursuant to Section 46 of the Foreign Exchange Management Act, 1999 (“FEMA”) which primarily govern overseas non-debt investment framework and the RBI has issued the Foreign Exchange Management (Overseas Investment) Directions, 2022 and the Foreign Exchange Management (Overseas Investment) Regulations, 2022 pursuant to Section 47 (2) of FEMA, which primarily govern overseas debt investment framework (collectively the “**Revised ODI Framework**”).

The Revised ODI Framework supersedes the erstwhile overseas direct investment regime governed under the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 (“**Erstwhile ODI Regime**”) and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India), Regulations 2015.

The Revised ODI Framework recognizes that Indian companies and businesses have considerably expanded in offshore jurisdictions in terms of scale of operations as well as revenues and asset base. The new regulatory framework will enable Indian companies to leverage their onshore and offshore balance sheets as well as their onshore and offshore assets to access both domestic and offshore forms of financing.

Regulatory Update

A brief snapshot of the key changes brought about by the Revised ODI Framework is set out below:

- **Foreign Entity:** The extant concepts of a ‘joint venture’ and ‘wholly owned subsidiary’ have now been subsumed under a single definition of a ‘foreign entity’ which refers to an entity formed or registered or incorporated outside India including an International Financial Services Centre (“**IFSC**”) in India that has limited liability. It is pertinent to note that IFSCs have been recognised in the overseas direct investment framework for the first time as a ‘foreign entity’.
- **Indian Entity:** The concept of an ‘Indian Party’ as defined under the Erstwhile ODI Regime has now been substituted with the concept of an ‘Indian entity’. The key difference being that earlier all investors from India in a foreign entity were together considered as an ‘Indian Party’, but now each investor entity will be separately considered as an Indian entity.
- **Subsidiary/Step Down Subsidiary (“SDS”):** An SDS of a foreign entity means an entity in which the foreign entity has ‘control’ and the structure of such subsidiary/SDS complies with the structural requirements of a foreign entity, i.e., such subsidiary/SDS is also a limited liability entity and the foreign entity’s core activity is not in a strategic sector. Conversely, any investee entities of a foreign entity where such foreign entity does not have ‘control’ are not to be treated as SDSs and therefore need not be reported either.
- **Control:** The Revised ODI Framework has now clarified the qualitative and quantitative test of the term ‘control’. ‘Control’ refers to the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders’ agreements or voting agreements that entitle them to ten percent or more of voting rights or in any other manner in the entity. ODI in foreign entities and SDS is permitted below the ten percent threshold also, but such investments will not be eligible for certain specified forms of financial commitments from their Indian entities.



Client Updates

- **ODI and Overseas Portfolio Investment ("OPI"):** The term "ODI" has been defined to mean investment: (i) by way of acquisition of any unlisted equity capital or subscription as a part of the memorandum of association of a foreign entity; (ii) an investment in ten percent or more of the paid up equity capital of a listed foreign entity; or (iii) investment with control where investment is less than ten percent of the paid up equity capital of a listed foreign entity. OPI on the other hand primarily means overseas investments other than ODI in foreign securities (except in unlisted debt securities or securities issued by Indian residents (except IFSCs)).

Interestingly, once classified as an ODI or OPI, the investment continues to be treated as an ODI or OPI even if does not fulfil the 'ten percent' or 'control' or listing threshold at any subsequent point in time.

- **Overseas investment:** Overseas Investment means any investment by a person resident in India in a foreign entity, either directly, through SDS or through a special-purpose vehicle. The foreign entity must be engaged in a bona fide business activity and the subsidiary or SDS of the foreign entity must also comply with the structural requirements of a foreign entity, i.e., it must have limited liability. "Bona fide Business Activities" have also been defined clearly to mean any business activity permissible under Indian laws and those of the host country. The Revised ODI Framework also prescribes the manner and detailed conditions for making ODI depending on the category of the persons making investments including overseas investment by an Indian entities and resident individuals, overseas investment by registered trusts, societies, mutual funds or AIFs, and investment in an IFSC by a person resident in India.
- **Financial commitment:** The term 'financial commitment' has now been redefined to mean the aggregate amount of investment by way of ODI, debt other than OPI (i.e. unlisted debt) and non-fund-based facilities extended by an Indian entity to all foreign entities. It has been clarified that Indian entities may lend or invest in any debt instruments issued by a foreign entity or extend non-fund based commitment to or on behalf of a foreign entity, including overseas SDSs of such Indian entity, subject to the following conditions:
 - the Indian entity is eligible to make ODI;
 - the Indian entity has made ODI in the foreign entity;
 - the Indian entity has acquired control in the foreign entity on or before the date of making such financial commitment.

The Revised ODI Framework simplifies and liberalizes the extant regime significantly with the key change being an automatic permission to issue guarantees on behalf of any foreign entity or SDS, regardless of their level, provided such entity is controlled by the Indian entity. Separately, akin to the requirements under the Erstwhile ODI Regime, prior approval of the RBI would still be required to be obtained in cases where the financial commitment by an Indian entity, exceeds USD 1 (one) billion (or its equivalent) in a financial year even when the total financial commitment of the Indian Entity is within the eligible limit under the automatic route (i.e. 400% of net worth of the Indian entity in all the foreign entities at the time of undertaking such commitment).

- **Financial commitment by way of investment by way of debt and guarantees:** An Indian entity may lend or invest in any debt instruments issued by a foreign entity subject to the requirement that such loans are duly backed by a loan agreement with the rate of interest being charged on an arm's length basis. The kinds of guarantees that may be issued and the conditions are largely the same as the Erstwhile ODI Regime. A new element to note is that if the guarantee is extended by a group company, it will be counted towards the utilisation of that group company's financial commitment limit independently, but where the guarantee is extended by a resident Indian promoter, it will be counted towards the financial commitment limit of the Indian entity.
- **Financial commitment by way of pledge**

The Revised ODI Framework has significantly relaxed the conditions for leveraging offshore securities and offshore as well as onshore assets of Indian entities, by permitting the creation of security in favour of an overseas lender regardless of whether such overseas lender is regulated as a bank or not, and also in favour of a domestic debenture trustees registered with SEBI. The Revised ODI Framework also permits the creation of a charge in favour of an overseas lender on onshore assets for facilities availed by the Indian entity and its offshore group companies.

The Revised ODI Framework specifies that overseas lenders should not be from any country / jurisdiction in which 'financial commitment' is not permissible under the Revised ODI Framework.

Set out below is a matrix setting out the permitted security that may be created by an Indian Entity in relation to any facility availed under the Revised ODI Framework:





Security by Indian entity	In whose favour	Facility availed
A) Pledge over equity capital of the foreign entity /its SDS outside India.	AD bank or a public financial institution in India or an overseas lender.	Fund/non-fund based facilities for Indian Entity.
		Fund/non-fund based facilities for any foreign entity/its SDSs outside India.
	A debenture trustee registered with SEBI in India.	Fund based facilities for Indian Entity.
B) Create charge on its assets (other than A above) in India (including the assets of its group company or associate company, promoter and / or director).	AD bank or a public financial institution in India or an overseas lender.	Fund/non-fund based facility for any foreign entity/its SDS outside India
	Overseas or Indian lender.	Fund/non-fund based facilities for Indian Entity.
C) Create charge on the assets outside India of the foreign entity/ its SDS outside India.	An AD bank in India or a public financial institution in India.	Fund/non-fund based facility for any foreign entity/its SDS outside India.
		Fund/non-fund based facility for Indian Entity.
	A debenture trustee registered with SEBI in India.	Fund/non-fund based facility for Indian Entity.

- **NOCs from Investigative Agencies and Lender Banks**

Another significant aspect to note is the requirement of a No-Objection Certificate (“NOC”) in case the person resident in India who is seeking to invest outside India has an NPA or is classified as a wilful defaulter by any bank or is undergoing investigation by any investigation agency namely the Central Bureau of Investigation, Directorate of Enforcement and the Serious Frauds Investigation Office or a financial service regulator. It remains to be seen if entities facing investigation from Competition Commission of India would be covered under this provision.

In a welcome departure from the Erstwhile ODI Regime, the Revised ODI Framework places the onus on the investigating agency or lender bank to respond to such written applications for an NOC within sixty days. Any failure to furnish such certificate within the stipulated timeline would be construed as a deemed consent to the proposed transaction.

- **Round Tripping:** The Revised ODI Framework attempts to clarify some of the regulatory uncertainty surrounding round tripping of investments by Indian entities. However, it still leaves more questions to be answered. Save for certain specified sectors, any financial commitment by a person resident in India in a foreign entity that has directly or indirectly invested or invests into India at the time of making such financial commitment (or at any time thereafter), resulting in a structure with more than two layers of subsidiaries is not permitted. It is not entirely clear if any ODI which results in round tripping but does not breach the two-layer condition would be permitted. RBI has also indicated that ‘no further layer of subsidiary or subsidiaries shall be added to any structure existing with two or more layers of subsidiaries post notification of the OI Rules/ Regulations’. Again, it is not very clear if this prohibition on

multi layered structures is intended to cover only investments which result in round tripping into India or even those multi layered structures which are entirely outside India.

- **Deferred payment consideration:** Significant relaxations have been introduced to permit payment of consideration on a deferred basis for any sale of any equity capital between a resident and a non resident, subject to compliance with the relevant pricing guidelines and the foreign securities having been transferred or issued upfront by seller to the buyer. The sellers have been also been permitted to offer indemnity to buyers in such arrangements.
- **Investment in financial services sectors:** In a departure from the Erstwhile ODI Regime, the Revised ODI Framework has now permitted Indian entities **not** engaged in a financial services sector in India to explore opportunities overseas by way an ODI in a foreign entity which is directly or indirectly engaged in financial services activity (other than banking and insurance) subject to specified conditions. Similarly, an Indian entity **not** engaged in the insurance sector has now been permitted to undertake an ODI in general and health insurance subject to compliance with stipulated conditions.
- **Investment in strategic sectors:** The term “strategic sector” as per the Revised ODI Framework includes 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 fit by the Central Government. Note that where the foreign entity’s core activity lies in any strategic sector, the restriction of limited liability structure of foreign entity shall not be mandatory. Accordingly, ODI in unincorporated companies operating in such strategic sectors has been permitted.



Implications

The Revised ODI Framework is the most extensive and comprehensive review of the Erstwhile ODI Regime as it considers the new economic and commercial landscape for corporate India. With an expanding Indian footprint in the overseas markets, the revised regime will enhance the ease of doing business outside India significantly.

The Revised ODI Framework simplifies the overseas investment regime by collapsing different regulatory requirements for credit enhancement at different layers of investments. Indian companies will now be able to access global forms of financing by leveraging

their onshore and offshore assets, and will also be able to access a much larger pool of overseas lenders, other than just banks. In a very positive development, Indian companies can also leverage their offshore assets for onshore financing including for rupee non-convertible debenture issuances without the need for any regulatory approvals.

While we continue to analyse certain areas such validity of multi layered structures outside India and exact contours of prohibition of round tripping, any further regulatory clarity on these issues will be helpful.

Please feel free to address any further questions or request for advice to:

Shardul S. Shroff

Executive Chairman

shardul.shroff@AMSShardul.com

Pallavi Shroff

Managing Partner

pallavi.shroff@AMSShardul.com

Akshay Chudasama

Managing Partner

akshay.chudasama@AMSShardul.com

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