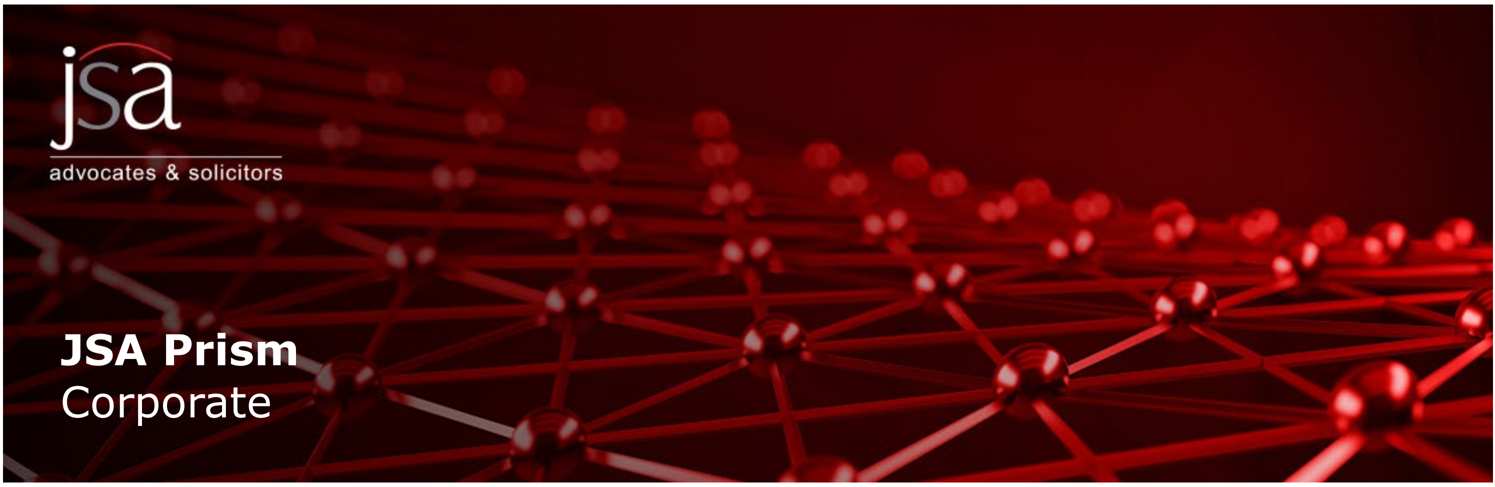

August 2022

On August 22, 2022, the Department of Economic Affairs, Ministry of Finance notified the Foreign Exchange Management (Overseas Investment) Rules, 2022 ("**OI Rules**") under the Foreign Exchange Management Act, 1999 ("**FEMA**"). Pursuant to the OI Rules, the Reserve Bank of India ("**RBI**") issued the Foreign Exchange Management (Overseas Investment) Regulations, 2022 ("**OI Regulations**") and the Foreign Exchange Management (Overseas Investment) Directions, 2022 ("**OI Directions**") (the OI Rules, the OI Regulations and the OI Directions are collectively referred to as the "**New ODI Framework**"). The New ODI Framework supersedes *inter alia* the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 ("**2004 Regulations**"), the Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India) Regulations, 2015 and the Master Direction – Direct Investment by Residents in Joint Venture ("**JV**") / Wholly Owned Subsidiary ("**WOS**") Abroad dated January 1, 2016 (collectively referred to as the "**erstwhile ODI Framework**") and subsumes all other existing rules and regulations governing outbound investment.

Background

On August 9, 2021, the RBI had released the Draft Foreign Exchange Management (Non-debt Instruments - Overseas Investment) Rules, 2021 ("**Draft Rules**") and the Draft Foreign Exchange Management (Overseas Investment) Regulations, 2021 ("**Draft Regulations**") for comments from stakeholders with the intent to liberalise and simplify the regulatory framework governing overseas investments and with a view to promote ease of doing business.

Whilst the New ODI Framework has retained some of the provisions from the Draft Rules and the Draft Regulations, there have been major modifications to them, which has the potential to overhaul the way outbound investments will be undertaken. This Prism covers the salient features of New ODI Framework impacting equity and lending transactions.

Salient Features of the New ODI Framework

Some key changes introduced by the New ODI Framework are analysed below.

1. Overseas Direct Investment and Overseas Portfolio Investment

The New ODI Framework provides a clearer distinction between an overseas direct investment ("**ODI**") and an overseas portfolio investment ("**OPI**").

The following investments are regarded as ODI:

a) **Unlisted**: acquisition of <u>any</u> unlisted equity capital of a foreign entity;

Accordingly, any investment, regardless of percentage, in unlisted equity capital of a foreign entity will now be regarded as ODI. One notable exception to the aforesaid condition is where a resident individual acquires (a) up to 10% of the equity capital, (b) if such acquisition is without gaining control; <u>or</u> (c) is by way of acquiring either (i) sweat equity shares; (ii) minimum qualification shares issued for holding of a management post in any foreign entity; or (iii) shares or interest under Employee Stock Ownership Plan ("**ESOP**")or Employee Benefits Scheme ("**EBS**");

b) **Original Subscriber**: subscription as a part of the Memorandum of Association of a foreign entity; or

c) **Listed**: investment in paid-up equity capital of a listed foreign entity where such investment is (a) in <u>10% or more</u> of the paid-up equity capital, or (b) with control even if below 10%. Additionally, where an investment is classified as ODI when it was made, it must continue to be treated as ODI even if the investment falls to a level below 10% or such person loses control in the foreign entity.

Under the New ODI Framework, OPI is defined to mean any other investment in foreign securities other than ODI. Notably, OPI in listed equity of a foreign entity even after its delisting is treated as OPI until any further investment is made.

2. Definition and use of 'control':

Unlike most other laws, even an entitlement of 10% of voting rights in an entity is now regarded as 'control' for the purposes of the New ODI Framework[1]. The definition of control has a bearing in the classification of an investment as an OPI or as an ODI as mentioned above. Further, to determine whether a foreign entity has a subsidiary or a step-down subsidiary for the purposes of the New ODI Framework, only the 'control' test appears to be relevant.

3. Strategic sectors

The Draft Rules had defined "strategic sector" to primarily include energy and natural resources sectors such as oil, gas, coal and mineral ores. However, the New ODI Framework has expanded the scope of the definition to include start-ups under its purview as well.

The restriction of limited liability structure of foreign entity is not mandatory for overseas investment by entities with core activity in any strategic sector.

Further, applications for making investments above the limits prescribed under the New ODI Framework are to be submitted to the Central Government through the RBI for strategic sectors, whereas for other sectors, the applications have to be made to the RBI through the concerned authorised dealer bank ("**AD bank**").

4. Bona fide business activity, step-down subsidiaries and 'round-tripping'

While the requirement that the overseas investment be made in an entity engaged in a *bona fide* business activity was there even under the erstwhile ODI Framework, it did not define what constitutes a *bona fide* business activity. The OI Rules expressly define "*bona fide business activity*" to mean any business activity permissible under any law in force in India <u>and</u> the host country or host jurisdiction, as the case may be. It is also clarified that a foreign entity may be engaged in a bona fide business activity either directly or through a step-down subsidiary or a special-purpose vehicle.

Under the New ODI Framework, natural persons may make ODI in an operating foreign entity which has subsidiaries/ step-down subsidiaries, provided they do not take control (e.g., investment in less than 10% of unlisted equity).

The RBI through FAQs under the erstwhile ODI Framework had clarified that an Indian entity would not be permitted to set up an overseas entity or make ODI into a foreign entity that would make or already had direct or indirect investment in India (commonly known as 'roundtripping') without prior permission from the RBI. It now appears that ODI (with no specific restriction on OPI in this regard) in a foreign entity will not require prior RBI

[1] Control is defined under the OI Rules as follows: "control" means the right to appoint majority of the directors or to control 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 10%. or more of voting rights or in any other manner in the entity. The OI Regulations further clarify, control "includes a stake of 10% or more in an entity as per the OI Rules"

approval merely because the foreign entity had a subsidiary or step-down subsidiary in India, provided (i) such ODI does not result in a structure that has more than 2 (two) layers of subsidiaries, and (ii) the foreign entity is engaged in a bona fide business activity. The test of the number of layer of subsidiaries is a continuing one.

5. Prohibited sectors and other restrictions

OI Rules specify the prohibited sectors, namely, any foreign entity either engaged in (i) any real estate activity; (ii) gambling in any form; or (iii) dealing with financial products linked to the Indian rupee without specific approval of the RBI. No ODI is permitted in such prohibited sectors without RBI approval.

Any ODI in start-ups recognised under the laws of the host country may be by an Indian entity only from the internal accruals whether from the Indian entity or group or associate companies in India and in case of resident individuals, from own funds of such an individual.

As per the erstwhile ODI Framework, there was a restriction that an Indian party could not make a direct investment (directly or indirectly through a step down subsidiary ("**SDS**")) in an overseas entity which is located in the countries identified by the Financial Action Task Force ("**FATF**") as "non co-operative countries and territories" as per list available on FATF website www.fatf-gafi.org or as notified by the RBI from time to time. This condition has now been modified to state that an Indian entity will require prior approval of the Central Government for making any financial commitment in Pakistan or in any other jurisdiction advised by the Central Government.

6. Restrictions on transfer, including lock-in period

In case of disinvestment of ODI by a person resident in India, the transfer will be restricted as follows:

a) the transferor, in case of full disinvestment other than by way of liquidation, should not have any dues outstanding for receipt, which such transferor is entitled to from the foreign entity as an investor in equity capital and debt; and

b) prior to making any disinvestment, the transferor must have stayed invested for at least 1 (one) year from the date of making ODI.

Further, any transfer is not permitted if the initial investment was not permitted under FEMA.

7. Write-off of investment

A person resident in India who has made ODI in a foreign entity may permit restructuring of the balance sheet by such foreign entity, which has been incurring losses for the previous 2 (two) years as evidenced by its last audited balance sheet.

Such restructuring of the balance sheet is subject to compliance with the reporting and documentation requirements under the New ODI Framework and subject to the diminution in the total value of the outstanding dues towards such person resident in India on account of investment in equity and debt, after such restructuring not exceeding the proportionate amount of the accumulated losses.

Further, the New ODI Framework clarifies that in case (i) the write-off exceeds 20% of the total value of the outstanding dues towards the Indian entity or investor (as the case maybe), or (ii) the corresponding original investment is more than USD 10,000,000 (United States Dollars ten million), the write-off must be duly certified as being on an arm's length basis by a registered valuer as per the Companies Act, 2013 or any other valuer registered with a regulatory authority or is a certified public accountant in the host jurisdiction, and such valuation should not be dated not more than 6 (six) months before the date of the transaction when it has to be submitted to the designated AD bank.

8. Acquisition by resident individuals by way of gift or under ESOP or EBS or sweat equity shares

The New ODI Framework has clarified that the acquisition of foreign securities by way of gift may be from a person resident in India and who is a relative (as defined under the Companies Act, 2013). For receiving foreign securities by way of gift from persons resident outside India, the restrictions under the Foreign Contribution (Regulation) Act, 2010 ("**FCRA**") would have to be complied with. It may be noted that FCRA provides certain exemptions for gifts/foreign contributions from a relative who is a person resident outside India. Resident individuals are not permitted to transfer any overseas investment by way of gift to a person resident outside India.

In addition to the above, the OI Rules allow the resident individual being an employee or a director of an office in India or branch of a foreign entity or a subsidiary in India of a foreign entity or of an Indian entity in which the foreign entity has direct or indirect equity holding, to acquire securities, without any limit, offered by such aforesaid entities under its ESOP or EBS or sweat equity, provided such offer by the concerned entity is made uniform globally.

9. Pricing guidelines

The regulations stipulate that a primary or secondary investment by an Indian party must be subject to an arm's length price. The AD bank is required to ensure compliance with the arms-length pricing taking into consideration valuation as per any internationally accepted pricing methodology. There is no specific stipulation of a floor or a cap. The intent therefore seems to be that the test of arms-length pricing should be met, without any other pricing restrictions.

10. Investment in financial services activities by an Indian company

The New ODI Framework permits an Indian company (even if not engaged in financial services activities in India) to invest in a foreign entity engaged in financial services activities, provided the Indian company has a 3 (three)year profitability track record.

11. Reporting of ODI

The New ODI Framework has set up a two-step reporting process for ODI.

The first step is when the financial commitment is made and the outward remittance is to be sent. The Indian resident, through its designated AD bank, is required to obtain a unique identification number (which now has been clarified that it will be provided by way of an auto generated email to either the authorised dealer or the Indian entity) and file Form FC for the foreign entity in which the ODI is intended to be made before sending outward remittance or acquisition of equity capital in a foreign entity, whichever is earlier.

Subsequently, the Indian resident is required to submit to its AD bank share certificates or any other relevant documents as evidence of the completed ODI, within 6 (six) months from the date of effecting remittance.

The New ODI Framework also includes obligations for periodic reporting, generally in line with the erstwhile ODI Framework, with clarifications and modifications.

In the context of making a financial commitment, the New ODI Framework provides that the giving of any guarantee/security for or on behalf of the foreign entity is to be reported in Form FC at the time of making of such financial commitment.

12. Delay in reporting

The New ODI Framework has introduced that any delay in reporting can be regularised by paying a late submission fee. This option can be exercised for a upto a maximum period of 3 (three) years. However, it is important to note that, no outward remittance or further financial commitment can be made until the delay in reporting has been regularised.

13. Deferred Payment and other relaxations

A significant relaxation under the New ODI Framework is the express permissibility of transactions involving deferral of consideration and indemnity obligations. The New ODI Framework provides payment of amount of consideration for the equity capital bought or sold may now be deferred, provided that (i) the period of deferral is a definite/ pre-agreed period from the date of the agreement, (ii) foreign securities equivalent to the amount of total consideration must be transferred or issued upfront, and (iii) the full consideration finally paid must be compliant with the applicable pricing guidelines. The deferred part of the consideration in case of acquirer being a person resident in India must be treated as non-fund based commitment. Further, buyer may be indemnified by the seller up to such amount and be subject to such terms and conditions as may be mutually agreed upon and laid down in the agreement.

The New ODI Framework also sets the stage for relaxations, flexibility and permissibility for ODI transactions involving cross-border share swaps, capitalisation of receivables, overseas mergers and amalgamations, rights issue and bonus issues, among others.

Changes under the New ODI Framework impacting lending transactions

1. Conditions for making financial commitment other than equity by an Indian party

The New ODI Framework clarifies that the following conditions have to be met for an Indian entity to make a financial commitment other than equity (which will include providing of a loan, guarantee or security):

a) the Indian entity must be eligible to make an ODI;

b) the Indian entity should have made an ODI in the foreign entity; <u>and</u>

c) the Indian entity has acquired control in the foreign entity at the time of making the financial commitment.

2. No objection certificate ("NOC") from lender bank / financial service regulator / investigative agency

The erstwhile ODI Framework provided that under the automatic route an investment/financial commitment could only be made by an Indian party which is not on the RBI's exporters caution list / list of defaulters to the banking system circulated by the RBI or under investigation by any investigation / enforcement agency or regulatory body. Where an Indian party did not comply with this condition, then an investment/financial commitment by such person could only be made with prior permission of RBI.

This condition has now been liberalised under the New ODI Framework, which provides that where an Indian entity has: (a) an account appearing as a non–performing asset ("**NPA**"); (b) is classified as a wilful defaulter by any bank; or (c) is under investigation by a financial service regulator or investigative agencies in India, namely the Central Bureau of Investigation or Directorate of Enforcement or Serious Frauds Investigation Office, then it can make an investment/financial commitment after it has obtained a NOC from lender bank/regulatory body/investigative agency.

In order to further streamline matters it also provides for a deemed no objection, where a NOC is not issued by lender bank/regulatory body/investigative agency within a period of 60 (sixty) days.

The OI Directions also clarify that where an Indian entity has already issued a guarantee in accordance with the FEMA provisions before an investigation has begun or account is classified as NPA or Indian entity is classified as a wilful defaulter and subsequently the Indian entity is required to honour such contractual obligation, any remittance due to invocation of guarantee will not constitute fresh financial commitment and no NOC will be required.

3. Requirements for debt Investments

The New ODI Framework requires that if an Indian entity is making any debt investment in an overseas entity, then there must be a loan agreement entered into for such debt investment. Further, the interest on such debt must be on an arm's length basis.

4. Persons permitted to provide guarantees

Under the erstwhile ODI Framework a guarantee could be provided by: (a) an Indian party; (b) any promoter company of the Indian party in India; (c) any group company, sister concern or associate company of the Indian party in India; or (d) any indirect resident individual promoters of the Indian party. There were no specific definitions of 'group company, sister concern or associate company' provided under the erstwhile ODI Framework and it was left to the discretion of the AD bank to satisfy itself regarding compliance of this condition.

The New ODI Framework has now streamlined this condition to provide for more clarity and objectivity. Under the New ODI Framework a guarantee can now be provided by (each being referred to as a "**Permitted Person**"):

a) an Indian entity;

b) a group company of the Indian entity in India – which has now been identified as a holding company of the Indian entity (i.e. a company which is holding at least 51% stake in Indian entity) or a subsidiary company of the Indian entity (i.e. a company in which the Indian entity holds at least 51% stake) ("**Group Company**");

c) any promoter group company of the Indian entity in India – for the purposes of the New ODI Framework 'promoter group' will be as per the definition under the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018;

d) any resident individual promoter of the Indian entity – the New ODI Framework also specifies that such individual promoter must form part of the promoter group of the Indian entity.

5. Guarantee for second or subsequent level SDS

A significant change brought about by the New ODI Framework is that an Indian entity or any other Permitted Person can now under the automatic route provide a guarantee to or on behalf of a second or subsequent level SDS in which the Indian entity has acquired control through the foreign entity. Under the erstwhile ODI Framework, such a guarantee required prior RBI approval.

6. **Computation of financial commitment limits for guarantee**s

Under the erstwhile ODI Framework, any guarantee provided by any promoter company, group company, sister concern or associate company of an Indian party was to be treated as part of the financial commitment of the Indian party.

The New ODI Framework provides that any guarantee obligations of a Group Company will be treated as a separate financial commitment of such Group Company and will not be counted towards the utilisation of the financial commitment limit of the Indian entity.

Like the erstwhile ODI Framework, the New ODI Framework has retained the requirement that any guarantee from resident individual promoter will be counted towards the financial commitment limit of the Indian entity. However, the New ODI Framework is silent on whether any guarantee from any other promoter company (which is not a Group Company) will be treated as a separate financial commitment of such promoter company or clubbed as a financial commitment of the Indian entity.

7. Bank guarantee related provisions

Under the erstwhile ODI Framework a bank guarantee could be issued by a resident bank only on behalf of an overseas JV or WOS of the Indian party, where such guarantee was backed by a counter guarantee / collateral from the Indian party.

This condition has now been liberalised under the New ODI Framework to provide that such a bank guarantee can be counter guaranteed or backed by a collateral provided by either the Indian entity or its Group Company. Further, bank guarantee can also be issued for the benefit of any SDS in which the Indian entity has acquired control through the foreign entity.

8. Security in favour of overseas lender

Under the erstwhile ODI Framework, where security was permitted to be created for the benefit of an overseas lender, such lender had to be regulated and supervised as a bank under the jurisdiction of the host country. This condition has now been dispensed with. The New ODI Framework now provides that an overseas lender should not be from a country/jurisdiction in which a financial commitment is not permitted to be made as per the New ODI Framework.

9. Security in favour of Indian debenture trustee

Under the New ODI Framework, if an Indian entity has availed fund based facilities by issue of debentures, it is now permitted to provide security in favour of a debenture trustee registered with the Securities and Exchange Board of India over: (a) shares of any foreign entity or a SDS; or (b) a charge over overseas assets of any foreign entity or SDS (other than shares).

10. Security for facilities availed by any group company, sister concern, associate company of an Indian entity

Under the New ODI Framework, pledge over shares of a foreign entity/SDS outside cannot be provided for securing any facilities (whether fund based or non-fund based) availed by any group company, sister concern, associate company of an Indian entity from any domestic or overseas lender. This was permitted under the erstwhile ODI Framework.

Similarly, charge over overseas assets of a foreign entity/SDS (other than shares) cannot be provided for securing any facilities (whether fund based or non-fund based) availed by any group company, sister concern, associate company of an Indian entity from a domestic lender. This was also permitted under the erstwhile ODI Framework.

11. Charge on domestic assets

As per the New ODI Framework a charge over the domestic assets of a sister concern of the Indian entity cannot be given as security for securing any facility (fund based or non-funded based) availed by a foreign entity/SDS from an overseas lender. This was permitted under the erstwhile ODI Framework.

Under the New ODI Framework, a charge on the domestic assets of an Indian entity, a group company, associate company, promoter, director of an Indian entity is now permitted to be created in favour of an:

a) AD bank or public financial institution in India for securing facilities (fund based or non-fund based) availed by foreign entity/SDS; and

b) overseas or Indian lender for securing facilities (fund based or non-fund based) availed by the Indian entity.

12. Computation of financial commitment limit for security creation

The New ODI Framework provides the following clarifications with respect to computation of financial commitment in connection with security creation:

a) if security is created by an Indian entity for securing facilities availed by it, then the facility amount/security value will not be reckoned towards financial commitment of the Indian entity.

b) the financial commitment of the Indian party,

   i. where pledge over the shares of foreign entity/SDS outside India is created for securing a facility availed by a foreign entity/SDS outside India; or

   ii. where charge over the overseas assets of the foreign entity/SDS outside India is created for securing a facility availed by a foreign entity/SDS outside India, will be reckoned as the value of pledge/charge (as the case may be) or the amount of the facility whichever is lesser, provided such facility has not already been reckoned towards the prescribed limit;

iii. If a charge over the domestic assets of Indian entity, or its group company, associate company, promoter or director is created for securing a facility availed by a foreign entity/SDS outside India, then financial commitment will be calculated as the value of charge or the amount of the facility, whichever is lesser, as long as such facility has not already been reckoned towards the prescribed limit.

However, what is not clear from the New ODI Framework is that if security is provided by a group company or an associate company will that be counted towards the financial commitment of such group company or associate company (like it has been clarified in the context of a guarantee) or will this be reckoned towards the financial commitment limit of the Indian entity.

Given that financial commitment is now linked to value of security, a suitable valuation will have to be carried out for the assets being pledged or charged prior to the creation of security.

13. Condition for security creation

Under the erstwhile ODI Framework, one of conditions for security creation was that the facility availed by a JV, WOS or SDS of an Indian party from domestic / overseas lender could be utilized only for its core business activities overseas and not for investing back in India. There was also a requirement to submit a certificate from the statutory auditor of the Indian party confirming compliance of this condition at the time of procuring the NOC from the AD bank. This requirement has now been dispensed with under the New ODI Framework.

14. Requirement of AD NOC

Under the erstwhile ODI Framework, security which was permitted to be provided under the automatic route could be provided after receipt of a NOC from the AD bank for the transaction. The New ODI Framework is silent on the requirement of this NoC for security creation. It will, however, be prudent to check with the relevant AD bank on the transaction for their view on the dispensation of this requirement.

Corporate Practice

JSA's corporate practice is centered around transactional and legal advisory services including day-to-day business, regulatory issues, corporate and governance affairs. We have an expert team of attorneys who advise on legal issues concerning inbound and outbound investments, strategic alliances, collaborations and corporate restructurings. We advise clients through all stages of complex and marquee assignments including restructuring, mergers and acquisitions (including those in the public space) to private equity and joint ventures. Our vast clientele includes multinational corporations and large Indian businesses in private, public and joint sector. We work closely with in-house counsel teams, investment banks, consulting and accounting firms along with multilateral agencies and policy making institutions on development of policy and legal frameworks. We provide assistance and counsel to start-ups and venture backed companies by drawing upon our in-depth understanding of how companies are incorporated, financed and grown. With an in-depth understanding of the industry combined with years of expertise, our attorneys provide innovative and constructive solutions to clients in complex transactional engagements. We emphasize teamwork across our wide network of offices across India. This allows us to benefit from the various specialisations available for the ultimate benefit of our clients. We also provide assistance in dealing with diverse corporate governance and compliance issues including FCPA /Anti-Bribery/Anti-Corruption matters and investigations.

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14 Practices and
23 Ranked Lawyers

15 Practices and
18 Ranked Lawyers

7 Practices and
2 Ranked Lawyers

IFLR1000 India Awards 2021

10 Practices and
34 Ranked Partners

Banking & Finance Team of the Year

Fintech Team of the Year

Restructuring & Insolvency Team of the Year

Among Top 7 Best Overall Law Firms in India and 10 Ranked Practices

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13 winning Deals in IBLJ Deals of the Year

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6 A List Lawyers in IBLJ Top 100 Lawyer List

Banking & Financial Services Law Firm of the Year 2022

Dispute Resolution Law Firm of the Year 2022

Equity Market Deal of the Year (Premium) 2022

Energy Law Firm of the Year 2021

Ranked #1
The Vahura Best Law Firms to Work Report, 2022

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