

Revamped Overseas Investment Regime (Part I) – A Rational Overhaul

Key Takeaways

- Round tripping no longer illegitimate - doors open for externalisation and de-SPAC transactions
- Definitional clarity on direct investments and portfolio investments
- Indian GPs get a glidepath to setup offshore pooling structures
- Big boost to GIFT City - regulatory approvals for manager setup and fund contributions eased
- Investment in offshore startups under approval; wider ambit of instruments under portfolio investments; swaps now permitted

Introduction

The central government and the RBI recently overhauled the regime[1] for offshore investments by Indian residents – in what seems like a bold move to encourage offshore expansion and M&A/ PE activity. In short, the new regime's biggest hits are as follows: (a) liberalization of investments in offshore structures with an India leg (i.e. round-tripping structures); (b) permission for offshore subsidiaries of Indian corporates to avail acquisition financing from private credit players to pursue their M&A strategies; (c) paving way for non-financial services entities to invest in financial services activities offshore; (d) allowing Indian LPs to invest in offshore PE/ VC funds; (e) removing the challenges of regulatory approvals for Indian GPs setting up funds in GIFT City; and (e) giving up the idea of JV/WOS in favour of a more rational and well defined ODI regime.

In Part I of this Series, which comprehensively examines the New OI Regime, we headline the key commercial and legal changes pertaining to equity investments.

1. Clarity on 'portfolio investment' and 'direct investment' – access to larger pool of securities permitted

Previously. Investors found themselves confused due to lacking definitional clarity in the law – would their overseas investments be categorised as direct investments or as portfolio investments? What is the ambit of portfolio investment? While the RBI's FAQs clarified that portfolio investments were limited only to investments by listed Indian entities into listed offshore entities, some sections of the market still viewed <10% investment into offshore unlisted entities as portfolio investment.

Now. The new Rules have revamped these definitions – overseas investment can now broadly fall only into two, mutually exclusive buckets: overseas direct investments (***ODI)***, or overseas portfolio investments (**OPI**). The OPI route can mainly be accessed by Indian listed entities and resident individuals. In addition, OPI also entails access to a broader range of sophisticated products (e.g., investment funds, securitization vehicles etc.) with limited exposure (i.e. up to 50% net-worth). The table below captures the key differences between the ODI and OPI regimes:

[1] The existing regulations have been replaced with Foreign Exchange Management (Overseas Investment) Rules, 2022 (***Rules***), the Foreign Exchange Management (Overseas Investment) Regulations, 2022, and the Foreign Exchange Management (Overseas Investment) Directions, 2022 (collectively ***the New OI Regime***).

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Investment Route	Permitted Instruments	Investment Limits
ODI	i. Unlisted 'equity capital'; ii. >10% equity of a listed entity; or <10% equity of a listed entity but with 'control'	'Indian Entities' (i.e., companies, LLPs and partnerships) – 400% of the investor's 'net worth'[2]. Individuals – LRS limits[3] i.e., USD 250,000
OPI	All foreign securities[4] including <10% of a listed entity without control, except unlisted debt and ODI investment	Indian Entities – 50% of the investor's net worth. Individuals, LRS limits i.e., USD 250,000

Please see Annexure 1 for a detailed comparison between the two routes.

2. Round tripping – no RBI approval necessary

Previously. Founders and unlisted entities could not access overseas private equity/ venture capital (***PE/ VC***) on account of RBI's restrictions on 'round-tripping' i.e., overseas investment into entities which had invested back into India, without the prior approval of the Reserve Bank of India (***RBI***). Several PE/ VC investors were not permitted to make direct investments into India because of restrictions under their fund documents but were keen to invest if the holding company of these businesses were outside of India.

While there was no express prohibition on round tripping and many companies in the early 2010s (e.g., Flipkart) did in fact externalize their holding structure, RBI started restricting such investments on the premise that these were not 'bona fide' investments under Regulation 6(2) of the erstwhile ODI regulations. In fact, RBI also opened-up past structures and ordered some corporates to either wind down the India leg or the offshore leg of their investment.

[2] 'Net worth' means the aggregate of the paid-up share capital, free reserves and the securities premium account. Debt/ non-fund based exposures of the Indian entity as permitted will also be calculated towards the 400% limit.
[3] Liberalised Remittance Scheme under the RBI A.P. (DIR Series) Circular No. 64 dated February 4, 2004.
[4] "Foreign security" means any security, in the form of shares, stocks, bonds, debentures or any other instrument denominated or expressed in foreign currency.

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Now. Indian companies are now freely permitted to flip their structures and access global capital, effectively allowing Indian founders to realize the best valuations anywhere around the world without the fear of 'round-tripping'. Three key changes permit this, and also facilitate Indian investors who are keen to invest into offshore funds with Indian portfolios:

First, Indian entities can now invest into offshore companies which have Indian subsidiaries, as long as their investment does not result in more than two layers of subsidiaries. While this is a significant positive, the Indian operating company may not be able to set up a subsidiary since the two-layer condition will stand breached.

Second, Indian individuals can now invest directly in such structures provided they hold a <10% stake without any 'control' rights. However, since this restriction only applies to individuals, early-stage founders who are looking to flip and retain 'control' will have to invest through a body corporate.[5]

Third, 'bona fide business activities' have now been explicitly defined to mean activities which are legal in India and the offshore jurisdiction. This dilutes the subjective discretion which was exercisable by the RBI in the absence of an express definition, on the basis of which round-tripping was proscribed.

3. Rationalizing restrictions for investments into offshore financial services

Previously. Investment into financial services entities was practically very challenging. Only Indian parties engaged in the 'financial services' sector were allowed to invest in a foreign entity engaged in the financial services sector under the automatic route, if they had the respective regulatory approval (domestically and offshore) and fulfilled certain criteria such as: (i) earning net profit during the preceding three financial years from financial services activities; (ii) registration with the regulatory authority in India for conducting financial services activities; and (iii) fulfilling the prudential norms relating to capital adequacy as prescribed by the concerned regulatory authority in India. If these could not be met, RBI approval was required, though it was not always forthcoming (in some cases it could take ~6 months).

Now.

a. Investment by non-financial services entities into financial services. All Indian Entities which are not financial services entities, and which have posted a net profit during the preceding 3 years are allowed to invest in foreign entities engaged, directly or indirectly, in financial services activities (except the banking and insurance sector, unless the insurance business supported the investor's core overseas activity). A similar deregulation was introduced several years ago, but never implemented.

[5] Indian individuals investing under the ODI route will also subject to the restriction that their investment cannot result in more than 2 layers of subsidiaries.

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b. Financial services activity defined. Financial services activity was not defined in the erstwhile ODI regime but has now been defined to mean any activity which if carried out in India would require to be regulated or registered by a financial sector regulator. One must also pay careful attention to words like 'registered' or 'regulated'. There has been significant debate on which entities are regulated but not registered in the context of financial services. One other noticeable change is that previously, net profits were required to be from the financial services activities of the Indian party. Now, the net profits of the Indian Entity from all activities are considered under the Rules.

4. Enabling offshore funds to pool from Indian investors

Previously. Since offshore funds were seen to be entities engaging in 'financial services' activities, Indian investors (non-financial) could not invest into offshore funds without RBI approval.

Now. Indian investors are now permitted to invest into offshore funds albeit with some restrictions. Unlisted Indian entities may invest into offshore funds (set up as body corporates) through the ODI route, if they have posted net profits for the past 3 years. Listed entities and resident individuals can also invest into offshore funds within the applicable exposure limits (OPI/ LRS limit as applicable).

This is a big win for Indian investors seeking to diversify their investments. India-focussed funds typically set up their pooling vehicles outside India for various legal and tax reasons. Till now, many domestic investors could not access these vehicles because of the round tripping and financial services restrictions. With this move, domestic investors can now access a broader range of offshore investments.

5. GIFT positioned as the optimal international investments fund jurisdiction for India-focussed funds

Previously. Funds in GIFT City faced two primary challenges. First, remittance of sponsor contribution was restricted. RBI only permitted up to minimum sponsor contribution to be remitted under the automatic route for GIFT AIFs. This was a challenge for larger funds (say billion dollar corpus), since investors in these funds typically require the sponsor to have a higher contribution so that there is adequate skin in the game. Second, to setup a fund manager entity, regulatory approvals were again required since the manager would qualify as a financial services entity. Even where fund managers were set up as 'branches' (which did not have to be capitalised), the branches could themselves not make any sponsor commitment into the fund.

The regulatory approvals in each case could take north of 6 months.

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City without the need for RBI approval. This reduces the set up time significantly and as such, there is no need to explore a branch structure, with the fund management entity being able to freely invest its sponsor commitments from India (within applicable investment limits).

The Rules also permit all Indian entities and individuals to invest into GIFT City, under the OPI route, within the applicable investment limits. Effectively, Indian GPs can now freely set up their pooling vehicle in GIFT, invite domestic capital without the fear of round-tripping and also attract offshore investors into GIFT without subjecting them to India related compliances (since GIFT is an offshore jurisdiction for all practical purposes).

6. Equity instruments versus non-equity instruments – a new categorisation

The Rules appear to have further divided non-debt instruments into equity instruments and non-equity instruments. As a result, three categorisations are apparent: (i) equity capital, (ii) non-debt instruments which are not equity[6], and (iii) debt instruments[7]. So, every instrument which is listed as a non-debt instrument may not qualify as 'equity capital' for instance, mutual fund units, or investment fund units.

The introduction of a new categorisation of instruments which Indian investors can now access through the OPI route shows a progressive opening up towards capital convertibility, with the check of LRS/ OPI net worth limits.

7. Enabling swap of securities – access to offshore capital made easier

A significant challenge for Indian companies in the past has been the ambiguity around share swap transactions with offshore counterparties. The regime governing foreign investments into India only permits a primary share swap – i.e., Indian companies can issue their shares to a non-resident in lieu of acquiring Indian equity instruments held by such non-resident.

The Rules now permit Indian entities to implement all forms of swap - primary and secondary – with offshore parties under the ODI route. With this move, cash-strapped companies can explore cross-border share swap arrangements as part of their divestment/ inorganic strategies.

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[6] Non-debt instruments include instruments such as equity, capital participation in LLPs, investment fund units, mutual fund units, equity tranche of securitisation structure, etc.

[7] Debt instruments include: (i) Government bonds (ii) corporate bonds; (iii) all tranches of securitisation structure which are not equity tranche; (iv) borrowings by firms through loans; and (v) depository receipts whose underlying securities are debt securities.

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8. Restrictions on investment into overseas start-ups

Previously, there were no restrictions on overseas investments into start-up companies. The Rules now prescribe that any investment into start-ups which are recognised as such in their jurisdiction, can only be made from the internal accruals (i.e., existing profits) of the Indian Entity or its group or associate companies, or only from a resident individual's own funds. This was likely done with a view to reduce exposure to high-risk investments and may significantly impact overseas venture capital efforts.

9. 'Net-worth' change increases investment limits

The Rules have broadened the ambit of 'net worth', thereby increasing the investment limit. Previously, net worth was restricted to paid up capital and free reserves. Now, amounts in the securities premium account will also be included within the computation of net worth.

10. Deferred payments permitted

It was rather counter-intuitive that earlier any inflow of equity could only follow after an outflow of consideration. This was because the erstwhile ODI regulations had been harmonized with the non-debt investment rules, where money must be received prior to issue of shares. However, such an alignment was misplaced in the context of ODI investments and seemed rather unnecessary.

Now, the principles have been rationalized such that Indian investors who have purchased equity through the ODI route and received all the equity upfront may defer the payment of consideration for a definite period specified in the acquisition agreement, subject to applicable pricing guidelines.

11. Disinvestment restrictions

A one year lock-in has been mandated for any ODI to be divested.

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Annexure – 1

Parameter	ODI (New regime)	OPI (New regime)
What can you invest into?	i. investment in unlisted equity capital ii. investment in 10% or more of the paid-up equity capital of a listed entity iii. investment less than 10% of the paid-up equity capital of a listed entity with control	i. investment in less than 10% of equity capital of listed entity ii. investment in all foreign securities other that (x) unlisted debt; and (y) investments made under the ODI regime
How can you invest?	i. subscription as part of memorandum of association ii. purchase of listed or unlisted equity capital iii. through bidding or tender procedure iv. by way of rights issue or allotment of bonus shares v. capitalisation[a] vi. the swap of securities vii. merger, demerger, amalgamation, or any scheme of arrangement[b]	<u>Unlisted Indian entity</u> i. by way of rights issue or allotment of bonus shares ii. capitalisation[a] iii. the swap of securities iv. merger, demerger, amalgamation or any scheme of arrangement [b] <u>Listed Indian Entity</u> i. All of the above, and ii. subscription as part of memorandum of association iii. purchase of equity capital, listed or unlisted iv. acquisition through bidding or tender procedure

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Limit	Indian Entities – 400% of net worth[c] Individual – LRS limits i.e., USD 250,000	Indian Entities – 50% of net worthc Individual – LRS limits i.e., USD 250,000
Treatment	Once ODI, the investment remains ODI, despite any changes in the holding	OPI can become ODI, upon i. acquiring more than 10% of that foreign entity ii. acquiring control over the foreign entity iii. upon any further investment after the foreign entity delisted
Round tripping	Allowed. The foreign entity cannot Invest in India resulting in a structure with more than two layers of subsidiaries	Allowed. No restrictions apply

[a] - within the time period, if any, specified for realisation under the Foreign Exchange Management Act, of any amount due towards the Indian entity from the foreign entity, the remittance of which is permitted under the Act or does not require prior permission of the Central Government or the Reserve Bank under the Act or any rules or regulations made, or directions issued.

[b] - as per the laws in India or laws of the host country or the host jurisdiction.

[c] - Net worth of registered partnership firm or limited liability partnership is the sum of the capital contribution of partners and undistributed profits of the partners after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the last audited balance sheet.

Net worth, other than for partnerships or limited liability partnerships, is aggregate value of the paid-up share capital and all reserves created out of the profits ,securities premium account and debit or credit balance of profit and loss account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.

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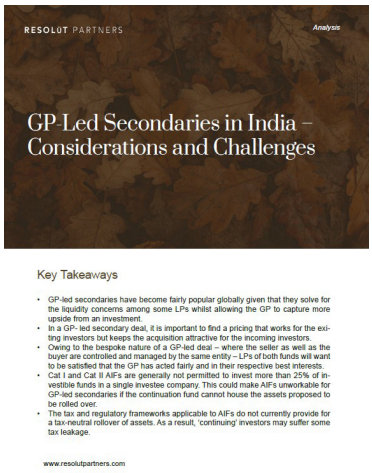
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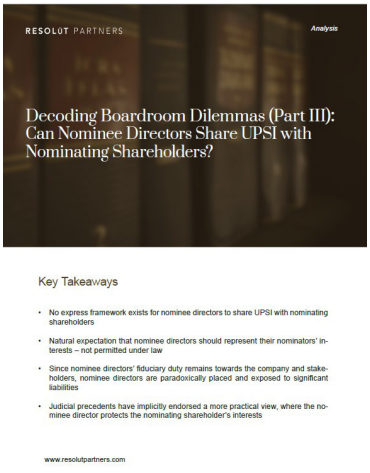
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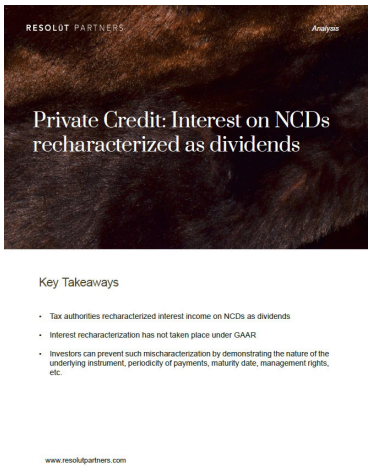


See Revamped Overseas Investment Regime (Part II) – An Overhaul of Overseas Debt Investment

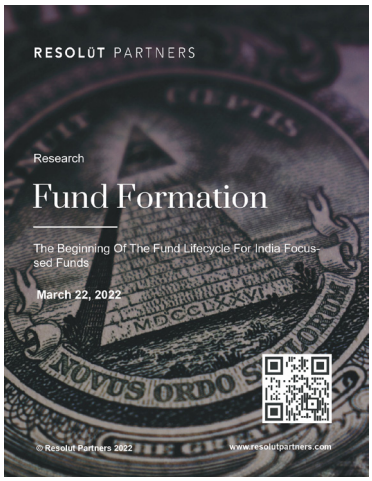
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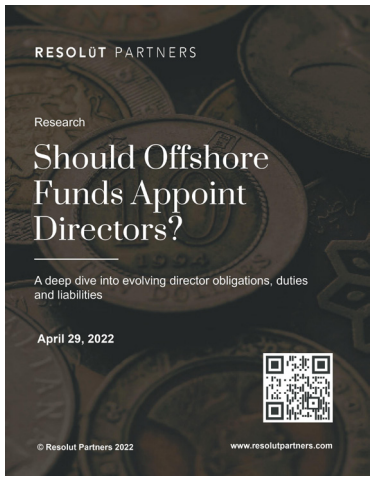






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