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The Fundamental Shift to the New ODI Regime: Anticipation of Explication from the RBI

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Abstract: ***Overseas Investments (OI) made by the Indian Residents enlarges the scope and scale of the business for Indian entrepreneurs by providing massive growth opportunities. Such ventures enhance the competitiveness and the brand value of the Indian companies through research and development, easier access to global markets, lower costs of capital and technology. The Overseas Investments are prominent catalysts in escalating foreign trade as well astechnology transfer, facilitating domestic employment along with increasing investment and growth. Keeping in view the spirit of liberalization and to facilitate the ease of doing business, the Central Government of India and RBI have been progressively engaged in improvising the procedures and have been rationalizing the rules and regulations under the FEMA Act, 1999. The new regime is said to have simplified the existing structure for the foreign investment by persons who are resident in India so as to cover a vast range of economic activities and reduce the need to obtain special permits significantly. It reduces the burden related to compliance as well as the costs of compliance.***

Keywords: Overseas Direct Investment, New ODI Regime, Foreign Exchange Management, Overseas Investment, Rules, Foreign Exchange Management, Overseas Investment, Regulations

1. Introduction

On August 22, 2022 the Ministry of Finance (MoF) together with Reserve Bank of India (RBI) notified the new regime on overseas investment (OI).

The following regime inter alia incorporates the OI Rules, 2022 [1] which are notified by the Ministry of Finance, the OI Regulations [2], 2022 which are notified by the RBI plus the Master Directions issued to persons in authority. It overrides FEMA 120 along with the circulars and instructions issued under the old regime.

The distinction between the Rules and Regulations has its source origin from the modification made to the FEMA vide the Finance Act of 2015. In accordance to this, the regulatory structure inscribed in FEMA lays down a riveting two - tier structure wherein the power for framing the rules in respect of non - debt instruments is granted, the RBI has been empowered to orchestrate the rules which are framed by the MoF.

The new regime can be classified into 3 major parts i. e., equity, debt and OI on account of resident individuals. Significant Changes and the implications are as follows:

- **Replacement of Joint Venture and Wholly Owned Subsidiaries with Foreign Entity:** The above have been replaced with the term Foreign Entity meaning any entity established or incorporated or registered outside India [3]. Unlike the Draft Rules, the new regime amplifies the meaning of foreign entity; foreign entity's incorporation is not a mandatory requirement. It is significant for LLPs situated in places like United States, which are not incorporated but are registered.

- **Control:** The Rules have brought in a new 10% voting rights test. [4] The following test supposes relevancy while determining that whether the foreign entity be taken as a subsidiary or for that matter a step - down subsidiary. As per the Rules, a subsidiary to be regarded as an entity must have control of a foreign entity in it. A foreign entity may be considered as a subsidiary by virtue of the 10% test even though it does not meet the requirement of the subsidiary test mentioned under Section 2 (87) of the Companies Act.

- **Indian Entity includes:** Companies, body corporate, LLPs and also partnership firms which are registered under the Indian Partnership Act, 1932. [5]

- **Segregation between ODI and OPI:** It can now be seen that there is a crystal – clear distinction between Overseas Direct Investment and Overseas Portfolio Investment.

ODI is a way of investment by;
- Acquisition of a foreign entity's unlisted equity capital, or
- Subscription as a segment of the memorandum of association (moa) of a foreign entity, or
- Investment in 10% or more of a listed foreign entity's paid - up equity capitalor
- Investment accompanying control of a listed foreign entity's wherein the investment is less than 10% of the paid - up equity capital.

OPI can be defined as; investments apart from ODI, in foreign securities, but which are not in any of the unlisted debt instruments or any of the security issued by a person residing in India who is not in an Indian Financial System Code (IFSC).

- **OI not to be for mela fide business activities:** It says only bona fide business activities should be conducted by the foreign entity directly or through a subsidiary in which a person resident in India makes an investment. It means business activities which are permissible under any of the laws in force in India and the host country. [6] Furthermore, the three absolutely restricted areas for ODI are: engaging in financial products in connection to the

Indian Rupee without any specific approval from RBI, gambling, real estate business.

- **Exonerate existing ODI:** It shall be deemed as per Rule 6 of the Foreign Exchange Management (OI) Rules, 2022 that any OI which was made in compliance with the old regime, to be in compliance with the new regime as well. For those OI which were in the first place not in compliance with the old regime, there is no such provision that such investments shall be compliant with the new regime as well.
- **Requirement of the NOC:** For making financial commitment a requirement for NOC has been introduced for any person who is resident in India having an NPA account, classified as a willful defaulter or is under any investigation by financial service regulator or by any investigative agencies in India. There exists a deemed approval if the agency fails to furnish the following certificate within the span of 60 days. If the agencies are targeting on prosecution or are not used to giving certificates for ODI, it will delay the entire NOC process.
- **Guidelines for pricing:** The pricing guidelines provide that the Pricing for Overseas Investment should be on arm - length basis. It should be based on the valuation undertaken as per any pricing methodology which is internationally accepted. The AD banks before they facilitate a transaction, must ensure compliance with the arm - length pricing. Along with the guidelines framed by AD banks it will be compelling to see whether they will insist on a valuation certificate from an investment banker or a CA.
- **Indian Entity can make ODI in a Foreign Entity:** Any Indian Entity which is not engaged in Financial Service Activities can create ODI in a Foreign Entity which is engaged in Financial Service Activities apart from banking and insurance, provided that few conditions are fulfilled. Financial Service Activities are the activities carried out by any entity in India requires to be registered with or regulated by a financial service regulator in India itself.
- **Calculation of the TFC Limit:** While the Total Financial Limit (TFC) has been maintained at 400% of the net worth, the inclusion of the security premium account in the definition of net worth under Section 2 (57) of the Companies Act has potentially increased the scope available to the Indian entity. The net worth of its subsidiaries or holding company can no longer be utilized by the Indian entities. The TFC limit should be determined at the time when financial commitment is been undertaken as provided by the Rules. In the old regime, the same wording was not present. A confederated reading of the Rules along with the Master Directions of FEMA [7] suggest that the old ODIs would be worked out at the old rate that was mentioned in the Form FC whereas the new ODIs would be computed at the current exchange rate. This aspect still needs clarification from the RBI.
- **Late Submission Fees:** In any case, where a person who is resident in India makes any delay in filing or submitting the form/document/return such a person may execute the same and along with that pay the Late Submission Fees through the AD Bank designated in accordance with the Regulation 11 of the OI Regulations.
- **The Mode of Payment:** Any person who is resident in India and is making an OI may make the payment by using remittances made through the banking channels, from the funds in the account which is maintained according to the provisions of the Act, by swapping of securities, by using the ADR and GDR etc.
- **ODI - FDI Structures:** The ODI - FDI structures under the new regime shall be permitted with subject to compliance in reference with the layering restrictions embarked under Rule 19 (3) which states that; no person who is a resident of India shall incur any financial obligation to any foreign entity which at the time of incurring such financial commitment or anytime thereafter, has invested or is investing, directly or indirectly in India, resulting in an architecture of more than two layers of subsidiaries. [8] The Rules suggest that to compute the number of layers of subsidiaries, any foreign entity will be considered as a subsidiary even after the requirement of the 10% test is met.
  - Although the Rules have recognized many ODI - FDI structures to be pursuant to legitimate commercial grounds, the restrictions pertaining to layering heave up more questions.
  - A clarity on how to compute the number of layers is anticipated.
  - The exemption laid down under the Companies (Restriction On Number Of Layers) Rules, 2017 for banking companies, insurance companies, NBFCs etc. has been cloned, the exemption regarding the one layer of WOS, as mentioned under the Layering Rules has not been reiterated.
  - The Layering Rules have laid down an exception for the acquisition of a foreign entity with two or more subsidiary layers in accordance with the laws of that jurisdiction but the same exemption is not provided for under Rule 19 (3). It also seems that compliance with Rule 19 (3) may be required even when acquiring an existing structure. Howbeit, it needs clarification from the Reserve Bank of India.

Moreover, RBI should illuminate on the state of ODI when it returns back in India as FDI as per Rule 19 (3) whether it will be regarded as pure FDI by compliance/ disinvestment view/ Foreign Owned or Controlled Company (FOCC) or will it be regarded as an Indian Owned or Controlled Company (IOCC) as per the stabilized FDI Policy as well as the NDI Rules, 2019.

Wherein it is not commercially feasible for the ODI - FDI structures to be in compliance with the layering restrictions, the concerned parties can reach out to RBI for a prior approval which is based on reasonable commercial justifications.

2. Conclusion

While the new regime has set out positive improvisations that could facilitate the Overseas Investments, there are few areas wherein regulatory clarity is expected. Woefully, the regulators have not aligned with the recommendations of the Sodhi Committee which stated that all the complicated rules and regulations must have specific legislative notes that make clear the regulatory intent and minimize the scope for interpretations that are divergent in nature. [9]

Another point of concern is in reference to whether or not RBI need to in any respect be regulating the number of layers provided that no other superior jurisdiction apart from Israel has same layering restrictions. Section 129 of the Companies Act makes consolidation of accounts between the holding company and its domestic as well as subsidiaries as mandatory. The enactment of substantive laws should not be done through FAQs rather it may be suggested for the MoF and RBI to eradicate the ambiguity through appropriate amendments to the rules and regulations.

There exist many vivid spots with inside the new architecture. It is anticipated that RBI might also soon pop out with a slew of FAQs in order to clarify the contentious matters.

References

[1] Foreign Exchange Management (Overseas Investment) Rules, 2022.
[2] Foreign Exchange Management (Overseas Investment) Regulations, 2022.
[3] Rule 2(1)(h)
[4] Rule 2(1)(j)
[5] Rule 2(1)(c)
[6] Explanation to Rule 9(1)
[7] Part VIII, FEMA Master Direction on Reporting, FED Master Direction No.18/2015-16, updated as on August 22, 2022.
[8] Rule 19(3)
[9] Report of the High-Level Committee to review the SEBI (Prohibition of Insider Trading) Regulations, 1992, Chaired by Justice N.K. Sodhi, December 7, 2013.