

ERGO

Analysing developments impacting business

OVERSEAS INVESTMENT LAW REVAMP: CONSIDERATIONS FOR INVESTMENT IN FINANCIAL SERVICES

6 September 2022

Introduction

Over the past week, the Government of India (GOI) and Reserve Bank of India (RBI) have revamped the overseas investment architecture for persons resident in India with the New OI Regime¹. Khaitan & Co. has on 24 August 2022, already shared an update on the overall framework of the New OI Regime (available [here](#)), outlining the key changes introduced through such regime. This update addresses the impact on financial services sector.

The New OI Regime, among other changes, bring in significant development for persons resident in India looking to make overseas investment in financial services sector, including in Gujarat International Finance Tec-City (GIFT) based International Financial Services Centre (IFSC). This Ergo seeks to cover specific elements in relation to overseas investment by resident individuals, Indian Entity² (engaged in financial services activity (FSA)³) and Indian Entity (not engaged in FSA) in the financial services sector under the New OI Regime.

Briefly, the New OI Regime has broadly categorized overseas investments into financial commitment (which includes overseas direct investments (ODI)) and overseas portfolio investments (OPI). The focus of the different routes is as under:

- **ODI Route** - The ODI route focuses on investment by way of acquisition of unlisted equity capital⁴ of a foreign entity⁵, or through subscription as part of memorandum of association of a foreign entity or investment in 10% (ten percent) or more of the paid-up equity capital of a listed foreign entity or investment with control where investment is less than 10%.
- **Financial Commitment** - It is the aggregate amount of investment made by a person resident in India through ODI, debt other than OPI in a foreign entity(ies) in which ODI is made and includes non-fund-based facilities extended by such person to or on behalf of such foreign entity(ies).
- **OPI Route** - The OPI route is for investment in foreign securities other than ODI, with an exclusion of unlisted debt instruments or any security issued by a person resident in India who is not in an IFSC.

¹"New OI Regime" refers to collectively (i) the Foreign Exchange Management (Overseas Investment) Rules, 2022 (ODI Rules); (ii) Foreign Exchange Management (Overseas Investment) Regulations, 2022 (ODI Regulations); and (iii) Foreign Exchange Management (Overseas Investment) Directions, 2022 (ODI Directions).

²"Indian Entity" means (i) a company defined under the Companies Act, 2013 (18 of 2013); (ii) a body corporate incorporated by any law for the time being in force; (iii) a Limited Liability Partnership duly formed and incorporated under the Limited Liability Partnership Act, 2008 (6 of 2009); and (iv) a partnership firm registered under the Indian Partnership Act, 1932 (9 of 1932).

³An entity will be considered to be engaged in 'financial services activity' or 'FSA' if it undertakes an activity which if carried out by entity in India, required registration with or is regulated by a financial sector regulator in India.

⁴"Equity Capital" means equity shares or perpetual capital or instruments that are irredeemable or contribution to non-debt capital of a foreign entity in the nature of fully and compulsorily convertible instruments.

⁵"Foreign Entity" means an entity formed or registered or incorporated outside India, including International Financial Services Centre that has limited liability: Provided that the restriction of limited liability shall not apply to an entity with core activity in a strategic sector.

Snapshot of the FSA investment framework under the New OI Regime:

Sr. No.	Particulars	Resident Individual	Indian Entity (engaged in FSA)	Indian Entity (not engaged in FSA)
1	Investment in FSA in Foreign Entity in GIFT/IFSC	Yes, under the ODI or OPI Route, subject to LRS ⁶ limits. The investment shall be made in the manner provided in items 6 and 7 below.	Yes, under the ODI or OPI Route. Investment in ODI Route is subject to the terms and conditions briefly covered in item 5 below. OPI doesn't appear to be subject to any conditions. The investment shall be made in the manner provided in items 6 and 7 below.	
2	Investment in FSA in Foreign Entity (Outside GIFT/IFSC)	Yes, under the ODI or OPI Route, subject to LRS limits. The investment shall be made in the manner provided in item 6 below.	Yes, under the ODI or OPI Route. Investment in ODI Route is subject to the terms and conditions briefly covered in item 4 below. OPI doesn't appear to be subject to any conditions. The investment shall be made in the manner provided in item 6 below.	
3	Investment Limits	Subject to the overall ceiling under the LRS i.e., USD 2,50,000/-	(i) For ODI: Up to 400% of net worth of Indian Entity (ii) For OPI: Up to 50% of net worth of Indian Entity	
4	Conditions for ODI in Foreign Entity (Outside GIFT/IFSC)	No other conditions apart from investment limit identified above.	(i) Indian Entity posting net profit during preceding 3 financial years. (ii) Indian Entity being registered or regulated by a financial services sector regulator in India. (iii) Indian Entity having obtained approval, as may be required, from concerned financial services sector regulator in both India and host jurisdiction.	(i) Foreign Entity should not be engaged in banking or insurance (excluding general and health insurance activities supporting other core business). (ii) Indian Entity posting net profit during preceding 3 financial years.
5	Conditions for ODI in a Foreign Entity in GIFT/IFSC	No other conditions apart from investment limit identified above.	(i) Indian Entity posting net profit during preceding 3 financial years. (ii) Indian Entity being registered or	Foreign Entity should not be engaged in banking or insurance (excluding general and health insurance activities supporting other core business).

⁶ LRS means Liberalized Remittance Scheme of RBI

			<p>regulated by a financial services sector regulator in India.</p> <p>(iii) Approval of financial services sector regulator concerned in India (wherever applicable), to be decided within forty-five (45) days, failing which it shall be deemed approval.</p>
6	Manner of investment in Foreign Entities	<p>ODI or OPI by way of:</p> <ul style="list-style-type: none"> (i) Inheritance (ii) sweat equity shares (iii) minimum qualification shares issued for holding a management post in a Foreign Entity (iv) shares or interest under Employee Stock Option Plan (ESOP) or employee benefit plan. <p>Resident individuals are permitted to make investment under OPI Route, including by way of contribution to investment fund and carry vehicle.</p> <p>Note: (ii), (iii) and (iv) shall be treated OPI if the acquisition of equity capital is <10%, whether in listed entity or unlisted.</p>	<p>ODI is permitted in equity capital for purpose of undertaking <i>bonafide</i> business activity by way of:</p> <ul style="list-style-type: none"> (i) subscription as part of memorandum of association or purchase of equity capital, listed or unlisted; (ii) acquisition through bidding or tender procedure; (iii) acquisition of equity capital through rights issue or bonus shares; (iv) capitalization of the amount due to the Indian Entity by the Foreign Entity, where such remittance is permitted and does not require prior approval; (v) swap of securities; and (vi) merger, demerger, amalgamation, or scheme of arrangement. <p>If listed, Indian Entity is permitted to make investment under OPI Route, including by way of contribution to investment fund. However, for unlisted Indian Entities, OPI is only permitted in (iii) (iv) (v) and (vi) above.</p>
7	Manner of Investment in Foreign Entities based in GIFT/ IFSC	<p>In addition to manner of investment items specified in item 6 above, ODI is further relaxed for investment in entities in IFSC/GIFT.</p> <p>ODI is permitted by resident individuals in all instruments of Foreign Entity engaged in FSA in IFSC (except banking</p>	<p>In addition to manner of investment items specified in item 6 above, ODI is further relaxed for investment in entities in IFSC/GIFT.</p> <p>Indian Entities may also make contribution to investment fund or vehicle set up in IFSC as OPI, which under</p>

	<p>and insurance), with no subsidiary or step-down subsidiary outside IFSC.</p> <p>Indian individual may also make contribution to investment fund or vehicle set up in IFSC as OPI.</p>	<p>item 6 above was restricted for unlisted Indian Entities.</p>
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Comment

Financial services activity defined: The New OI Regime has now defined the scope of FSA. As such, the term ‘regulated’ may be construed to bring into its ambit entities such as the investment managers of alternative investment funds, which may not necessarily hold a registration with the financial services sector regulator but are considered as deemed to be regulated by the Securities and Exchange Board of India.

Investment in financial services sector by Indian Entity not engaged in FSA: In a welcome deregulation, Indian Entities not engaged in FSA are now allowed to invest in financial services sector, subject to net profit requirements. This is a welcome move allowing the Indian Entities to either foray into financial services business outside India or merely participate by way of investment in an investment fund outside India. Previously, the regime required all entities to be registered with financial services sector regulator prior to investing in financial services sector.

IFSC made attractive: The GOI has made its intent clear to promote IFSC as a crucial overseas investment destination by (i) allowing Indian Entity not engaged in FSA to invest in IFSC through ODI route without net profit requirements; (ii) expanding the scope of OPI in IFSC by allowing Indian Entities to contribute in investment funds or vehicles; (iii) allowing resident individuals to make ODI investment in Foreign Entity (including entities engaged in FSA) subject to certain conditions; and (iv) introducing deemed approval concept within 45 days for Indian Entities regulated by a financial service sector regulator.

Reduced approval requirements: In a departure from its earlier position, the requirement for approvals from financial services sector has been made ‘as may be required’. As such, it seems that (i) no approval is required for Indian Entity not engaged in FSA for overseas investment in financial services sector; and (ii) no approval is required unless laws of Indian party or host country specifically require such approvals.

Gift of foreign securities in FSA by residents: While paragraph 2 under Schedule 3 of ODI Rules seems to limit the investment avenues available in FSA by residents, paragraph 3 under Schedule 3 of ODI Rules however appears to offer full flexibility for gift of foreign securities including in financial services sector subject to conditions laid down therein.

Net profit calculation, round tripping and other supplementary changes: In addition to the above, the New OI Regime seems to expand the net profit requirement to any business conducted by the Indian entity, and not restrict it to net profit from FSA only. The New OI Regime also seems to permit round tripping with express restriction on more than two-layer of subsidiaries only. Clarity has also been provided on what forms a subsidiary, step down subsidiary, control, etc.

Conclusion

The New OI Regime has taken a significant step towards relaxing and simplifying the overseas investment regulations for the financial services sector. At the same time, there seems to be clear push to make IFSC or GIFT an attractive destination for overseas investment and structuring and to encourage new entrants in the financial market. This will also help in preserving the valuable foreign exchange within the country.

While the New ODI Regime is a welcome move, its seamless implementation will have to be seen. As is expected, there is considerable amount of queries on interpretation, including on two-layer structures, terms such as ‘investment fund or vehicle’ and whether structures such as ‘venture capital company’, will be considered a body corporate with limited liability, or an ‘investment fund’. However, in general, the change has been welcomed with enthusiasm for now.

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