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Challenges in Respect of Fema Overseas Investment Regime

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Overseas investment by persons resident in India is an important avenue for promoting global business by Indian entrepreneurs and entities and is professed as a medium of economic and business collaboration between India and other countries. The overseas investment was hitherto governed by Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004, Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India) Regulations, 2015 read with Master Direction on Direct Investment by Residents in Joint Venture (JV)/ Wholly Owned Subsidiary (WOS) Abroad.

With an aim to simplify the existing framework of overseas investment, promote ease of doing business, reduce stringent regulation and boost the spirit of liberalisation in line with the current business and economic dynamics, the Government of India through the Ministry of Finance and in consultation with the Reserve Bank of India (RBI) has introduced the new regime namely **Foreign Exchange Management (Overseas Investment) Rules, 2022**, **Foreign Exchange Management (Overseas Investment) Regulations, 2022** along with**Foreign Exchange Management (Overseas Investment) Directions, 2022** in supersession to the old rules and regulations.

The Central Government released the draft revised rules and regulations for overseas investment for public comments on 9th August, 2021 and the final Rules and Regulations along with the Directions came into force on 22nd August, 2022.

Though, the new Rules and Regulations have brought in various clarifications that were sought earlier, however, there are still some areas wherein clarity is required.

In this Article, we will be discussing some of such challenges that still exists and where clarifications need to be sought from the Government in respect of the new overseas investment regime.

I. Definition of Real Estate Activity

As per the erstwhile Foreign Exchange Management (Transfer or Issue of Any Foreign Security) (Amendment) Regulations, 2004

> *"Real estate business" means buying and selling of real estate or trading in Transferable Development Rights (TDRs) but does not include development of townships, construction of residential/commercial premises, roads or bridges.*

As per the revised Foreign Exchange Management (Overseas Investment) Rules, 2022 ('OI Rules'),

> *"real estate activity" means buying and selling of real estate or trading in Transferable Development Rights but does not include thedevelopment of townships, construction of residential or commercial premises, roads or bridges* ***for selling or leasing****.*

The only difference in the definition of real estate business/activity from earlier regime is that the words '*...for selling or leasing'* have been added at the end of the definition.

Earlier, leasing of real estate was not specifically excluded from the definition of real estate activity, hence it was presumed that leasing is not a permissible business activity for making Overseas Direct Investment (ODI).

Now, the word '*leasing*' has been included as part of the exclusion in the definition of real estate activity. However, from a simple reading of the new definition, it may be interpreted that '*leasing*' is mentioned only in connection with *construction of residential or commercial premises, roads or bridges and with development of townships*. It means, if there is construction or development of residential or commercial premises, roads or bridges for the purpose of leasing or selling, then such activity will not be included under the definition of real estate activity and overseas investment will be permitted in a foreign entity which would be engaged in any such activity.

However, the above understanding is drawn on just mere reading of the definition of real estate activity. Clarification is required from the Government on whether leasing of real estate (other than construction or development of residential/commercial premises, roads and bridges) shall be included/ excluded from the definition of real estate activity. Once such clarification is sought, it will also bring clarity as to whether overseas investment in a foreign entity engaged in activity of leasing real estate will be permitted or not.

II. Round-tripping or ODI-FDI Structure

The term "Round-Tripping" is not defined explicitly under the Foreign Exchange Management Act, 1999 (FEMA). In general parlance, 'Round-Tripping' is the process whereby capital of a country leaves the country and is then re-invested as Foreign Direct Investment (FDI) in that country. The structures resulting from such transactions are commonly called ODI-FDI structures.

There was no explicit prohibition on ODI-FDI structures under the old regime. In May 2019, round tripping was addressed by way of a response to frequently asked questions (FAQs) released by RBI. It was provided in the said FAQs that,

> *A foreign joint venture or wholly-owned subsidiary cannot be used by an Indian company or resident individual to route investments back into India.*

The FAQs were further updated on September 19, 2019, clarifying that Indian companies or resident individuals seeking exemption from the above restriction need prior approval from RBI before entering into

such transactions.

Now, the Rule 19(3) of the new OI Rules, permits persons resident in India to undertake transactions resulting in ODI-FDI structure subject to certain conditions.

As per the said Rule, *no person resident in India shall make financial commitment in a foreign entity that has invested or invests into India, at the time of making such financial commitment or at any time thereafter, either directly or indirectly, resulting in a structure with more than two layers of subsidiaries.*

As per the new regime, *person resident in India* has been permitted to make *financial commitment* in a foreign entity that has invested or invests into India, directly or indirectly, up to two layers of subsidiaries, without the RBI approval.

The term "financial commitment" is defined in Rule 2(f) of OI Rules as

> *"financial commitment" means the aggregate amount of investment made by a person resident in India by way of Overseas Direct Investment, debt other than Overseas Portfolio Investment in a foreign entity or entities in which the Overseas Direct Investment is made and shall include the non fund-based facilities extended by such person to or on behalf of such foreign entity or entities;*

Hence financial commitment is the aggregate of ODI and debt and non-debt facilities other than OPI.

Thus, if any person resident in India (Indian Entity) would make investment in a foreign entity by way of ODI/ debt fund, and if such foreign entity has invested or invests into India, directly or indirectly, then the resulting structure of the foreign entity must be in compliance with Rule 19(3) of OI Rules. In case of Resident Individuals (RIs), if any ODI is made in a foreign entity, then that foreign entity should be an operating entity and should not have any subsidiary or SDS.

However, if an Indian entity or resident individual making overseas portfolio investment in a foreign entity, whether the ODI-FDI structure would be allowable or not in such case, needs to be examined.

It can be interpreted that since the new rules have allowed the said structure in ODI subject to fulfilment of certain conditions where the Indian entity is having control in the FE, hence the same should be permitted in case of OPI (where no control exists in FE) too. In the erstwhile regime also, the ODI-FDI structure was not restricted in case where portfolio investment was made by any Indian entity or Resident Individual.

The relaxation in respect of undertaking ODI-FDI structures is a welcome step which came with relief to Indian businesses that can now expand globally and downstream their revenues to an Indian subsidiary, however, there is still ambiguity on such structures undertaken under the OPI route. A clarification from RBI or Government is required regarding the same.

III. Overseas Investment by Resident Individual (RI) in Mutual Funds

Earlier, as per the Master Direction on Liberalized Remittance Scheme (LRS), it was provided that,

The permissible capital account transactions by an individual under LRS are:

> *...(iii) making investments abroad- acquisition and holding shares of both listed and unlisted overseas company or debt instruments; acquisition of qualification shares of an overseas company for holding the post of Director; acquisition of shares of a foreign company towards professional services rendered or in lieu of Director's remuneration; investment in units of Mutual Funds, Venture*

Capital Funds, unrated debt securities, promissory notes...

It was specifically mentioned that investment in units of mutual funds abroad by a RI will be considered as permissible capital account transaction under LRS. There was no specific mention of the fact that whether the mutual funds were listed or unlisted, and hence it was understood that investment in both listed and unlisted mutual funds abroad was permitted.

Now, in pursuance of the new OI regime, the permissible capital account transactions under LRS are as below,

The permissible capital account transactions by an individual under LRS are:

i. *opening of foreign currency account abroad with a bank;*
ii. *acquisition of immovable property abroad, Overseas Direct Investment (ODI) and Overseas Portfolio Investment (OPI), in accordance with the provisions contained in Foreign Exchange Management (Overseas Investment) Rules, 2022, Foreign Exchange Management (Overseas Investment) Regulations, 2022 and Foreign Exchange Management (Overseas Investment) Directions, 2022;*
iii. *extending loans including loans in Indian Rupees to Non-resident Indians (NRIs) who are relatives as defined in Companies Act, 20139.*

Further, the new OI Rules does not specifically provide for overseas investment in units of mutual funds by a RI. Thus, there is an ambiguity in respect of overseas investment in units of mutual funds, listed and unlisted.

The aforesaid aspect can be dealt in two ways to decide whether the same is permissible or not in accordance with the OI regime.

Let's analyse the provisions of ODI and OPI separately.

A. ODI by a RI in Mutual Funds as per new OI regime

In the OI Rules, the definition of ODI is provided as below:

"Overseas Direct Investment" or "ODI" means investment by way of acquisition of unlisted equity capital of a foreign entity, or subscription as a part of the memorandum of association of a foreign entity, or investment in ten per cent, or more of the paid-up equity capital of a listed foreign entity or investment with control where investment is less than ten per cent. of the paid-up equity capital of a listed foreign entity;

It can be understood from the above definition that since ODI can only be made in equity instruments, thus ODI in mutual funds, whether listed or unlisted, cannot be made by a RI as units of mutual funds are not considered equity instruments.

However, as per Schedule V of the OI Rules, it is provided that,

a resident individual may make ODI in a foreign entity, including an entity engaged in financial services activity, (except in banking and insurance), in IFSC if such entity does not have subsidiary or step down subsidiary outside IFSC where the resident individual has control in the foreign entity.

It can be understood from the above provision that a RI may make ODI in an entity engaged in financial services activity in IFSC in India and if such an entity in IFSC further invest in a mutual fund abroad, then the same is permissible.

Thus, it can be interpreted that ODI may be made indirectly by a RI in a mutual fund, whether listed or unlisted, through an entity set up in IFSC in India.

Hence, after analysing the provisions in respect of ODI as per the new OI regime, it may be concluded that, ODI cannot be made by a RI directly in mutual funds, listed or unlisted. However, if such ODI in a mutual fund is being made indirectly by a RI, through an entity set up in IFSC in India, then the same is permissible.

B. OPI by a RI in Mutual Funds as per new OI regime

In the OI Rules, the definition of OPI is provided as below:

> *"Overseas Portfolio Investment" or "OPI" means investment, other than ODI, in foreign securities, but not in any unlisted debt instruments or any security issued by a person resident in India who is not in an IFSC.*

It is understood from the above definition that OPI is permitted in any instruments, other than those instruments in which ODI is permitted, except in debt instruments of an unlisted foreign entity.

Now, as per Rule 5(A) of OI Rules,

> *Debt instruments:*
>
> *(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;*

It is understood from the above that, units of mutual fund abroad, whether listed or unlisted, are not considered under Debt Instruments.

However, as per the Foreign Exchange Management (Debt Instruments) Regulations, 2019, units of domestic mutual funds which invest less than or equal to 50% in equity are considered as Debt Instruments.

Thus, it can be interpreted that the mutual funds which invest less than or equal to 50% in equity have been specifically removed from the ambit of Debt Instruments in the OI regime.

Further, as per Rule 5(B) of OI Rules,

> *Non-debt instruments:*
>
> *(i) all investments in equity in incorporated entities (public, private, listed and unlisted);*
> *(ii) capital participation in Limited Liability Partnerships;*

(iii) *all instruments of investment as recognised in the Foreign Direct Investment policy from time totime;*

(iv) *investment in units of Alternative Investment Funds and Real Estate Investment Trust and Infrastructure Investment Trusts;*

(v) ***investment in units of mutual funds and Exchange-Traded Fund which invest more than fifty per cent in equity****;*

(vi) *the junior-most layer (i.e. equity tranche) of securitisation structure;*

(vii) *acquisition, sale or dealing directly in immovable property;*

(viii) *contribution to trusts; and*

(ix) *depository receipts issued against equity instruments;*

It is understood from the above that investment in units of mutual funds which invest more than 50% in equity is considered as investment in Non-Debt Instruments.

Hence, it can be concluded from the above provisions that, OPI can be made only in the units of mutual funds which invest more than 50% in equity, whether such mutual funds are listed or unlisted.

The above interpretations and understanding are as per our analysis of the provisions of the new OI regime, however, clarification by RBI may be sought to bring in more clarity in respect of overseas investment by a RI in units of mutual funds, listed or unlisted.

IV. Receipt of gift of foreign securities by Resident Individual from Non-resident non-relative

In the erstwhile regime, general permission was given to a resident individual to acquire foreign securities as a gift from any person resident outside India under the RBI Master Direction on Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad

> *General permission has been granted to a person resident in India who is an individual –*
>
> a. *to acquire foreign securities as a gift from any person resident outside India;…*

In the Schedule III of the OI Rules, permission has been provided to resident individuals to acquire foreign security in the form of gift in accordance with the Foreign Contribution (Regulation) Act, 2010 (FCRA).

The Schedule III provides that,

> *A resident individual may acquire foreign securities by way of gift from a person resident outside India in accordance with the provisions of the Foreign Contribution (Regulation) Act, 2010 and the rules and regulations made thereunder.*

As per Section 2(h) of FCRA,

> *"foreign contribution" means the donation, delivery or transfer made by any foreign source –*
>
> *…(iii) any security as defined in clause (h) of Section 2 of the Securities Contracts (Regulation) Act, 1956 and includes any foreign security as defined in clause (o) of Section 2 of FEMA, 1999…*

The definition of foreign source is provided under Section 2(j) of FCRA as below,

"foreign source" includes -

...(x) a citizen of foreign country..

As per Section 4 of FCRA, it is stated that,

Nothing contained in Section 3 (Prohibition to accept Foreign Contribution) shall apply to the acceptance, by any person specified in that section, of any foreign contribution where such contribution is accepted by him, subject to the provisions of section 10, –

...(e) from his relative...

Also, as per the Rule 6 of the Foreign Contribution (Regulation) Rules, 2011, it has been stated that,

Any person receiving foreign contribution in excess of ten lakh rupees or equivalent thereto in a financial year from any of his relatives shall inform the Central Government regarding the details of the foreign contribution received by him in electronic form within three months from the date of receipt of such contribution.

Thus, as per the above provisions of FCRA, it is understood that in the case where a resident individual is receiving a foreign contribution from a foreign citizen who is a relative, the same is permissible under FCRA. However, FCRA is silent in respect of receipt of foreign contribution from a foreign citizen who is not a relative.

Also, the provisions of FCRA are not applicable on Non–Resident Indians (having an Indian passport) as per the definition of 'foreign source'. The same is also provided in the FaQs on FCRA by Ministry of Home Affairs.

Thus, receipt of foreign security by resident individual from a Non–Resident Indian (having an Indian passport) is permitted, whether such Non–Resident Indian is a relative or not.

However, there is some confusion as to whether a resident individual can receive foreign security in the form of gift from a foreign citizen who is not a relative. There was no restriction in the erstwhile regime in this respect, as it was clearly mentioned that foreign security by way of gift can be received from any person resident outside India, which included both relative and non-relative.

An interpretation can be drawn from the new provisions that, since OI Rules provide that receipt of foreign security by way of gift from a person resident outside India shall be in accordance with FCRA, and provisions of FCRA only considers receipt of foreign contribution from a foreign citizen who is a relative, it means that intention of the government may be to not permit a resident individual to receive foreign security from a foreign citizen who is a non-relative.

Thus, there is a need for a clarification from RBI or the Government to eliminate the confusion regarding permissibility of receipt of foreign securities by way of gift from person resident outside India who is not a relative.

The government has introduced various liberalizations through the new overseas investment Rules and Regulations. However, there are still certain grey areas that need clarification. It is believed that the government will bring on such clarifications in the near future as meanwhile the implementation phase is going on for the new overseas investment Rules and Regulations.

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