

Inputs on RBI's draft framework for according approval to Indian residents to invest in overseas tech funds

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1 Introduction

On September 30, 2016, the Reserve Bank of India (RBI) published on its website a draft framework for according approval to an Indian Party investing in overseas Startups through an Overseas Technology Fund (*draft framework*) under the *FEMA*, seeking public comments. The draft framework (a) proposes to allow Indian residents to invest in Overseas Technology Funds (OTFs) with the previous approval of the RBI; and (b) specifies the conditions that Indian residents must satisfy to be granted such an approval. This note contains our comments and inputs on the draft framework.

We submit that the draft framework suffers from four problems:

1. It lacks any economic rationale supporting a case for allowing Indian residents to invest in some kinds of funds, namely OTFs and not others.
2. It is inconsistent with the principles of public administration and rule of law.
3. It lacks clarity on basic concepts on which it hinges, namely, the concepts of OTFs and overseas start-ups.
4. It is excessively restrictive.

We have elaborated our inputs in Section 2 of this note.

2 Inputs on the draft framework

Absence of economic rationale : There is no economic rationale supporting a case for allowing Indian residents to invest in some kinds of funds and not others. Interventions in the policy governing capital outflows, must be supported by a consistent economic rationale linked to identified market failures. Similarly, relaxations in such policy must be crafted in accordance with sound principles of public economics. Specifically, there are two problems with the draft framework in connection with the lack of an economic rationale.

- *No identified market failure:* *FEMA 120* lacks an identified market failure for imposing restrictions on capital outflows. The rules governing capital outflows differ depending on various factors having no connection with the market failures associated with capital outflows. For instance, the rules differ depending on the legal constitution of the Indian entity desiring to make the investment¹,

¹For instance, the rules for offshore investment by individual Indian residents and proprietary concerns differ from the rules for offshore investment by companies. Similarly,

the instrument sought to be invested in², and the sector in which investment is sought to be made³.

By artificially distinguishing between investments in funds which it terms as OTFs and other funds, the draft framework perpetuates the abovementioned approach of imposing restrictions and relaxing them, without any economic rationale. In the given case, neither the restriction on Indian residents on investing in offshore funds nor the proposed relaxation allowing them to invest in OTFs, are linked to any market failure (or in the latter case, the absence of it).

- *Imposes residency based measures on capital flows:* The IMF has, in its paper titled *Liberalizing Capital Flows and Managing Outflows* summarised the existing literature and understanding of capital flow measures in partially capital account convertible countries. On the basis of this and global experience in the administration of capital controls on outflows, it makes recommendations for designing a policy framework for governing capital outflows by countries that do not have a fully convertible capital account. The policy framework recommended under this paper is summarised below:

1. In countries that have substantially liberalised their capital account, capital outflows must be managed primarily with macro-economic and financial sector policies.
2. Capital flow management measures on outflows can be considered in (i) crisis or near crisis conditions; or (ii) to provide breathing space while more fundamental policy adjustment is implemented. These are temporary in nature and must be lifted once the crisis is controlled.
3. Even when capital flow measures are implemented, they must be *not* be residency-based. Examples of residency-based capital flow measures are measures on residents' investments and transfers abroad, such as limits on residents' investments in financial instruments abroad.

the rules for offshore investment by listed companies differ from those governing offshore investment by unlisted companies.

²For instance, investments by Indian residents are categorised into investments in a joint venture or wholly owned subsidiary abroad or investment in unlisted debt or investment in listed securities. Different rules apply for each of these instruments. Thus, for instance, only listed Indian entities and mutual funds are permitted to invest in a limited set of listed securities abroad.

³For instance, where the Indian resident proposes to invest in the financial sector abroad, it has to fulfill additional criteria such as having a profit track record, etc.

Contrary to the evolved understanding on capital flow measures, the draft framework imposes residency-based measures such as allowing Indian residents to invest in units of OTFs and not in units of other kinds of funds, allowing listed companies to so invest and not others, and so on and so forth.

Inconsistent with the principles of public administration and rule of law

: The draft framework is fundamentally inconsistent with the rule of law on account of two main reasons:

- Ad-hocism: The draft framework gives the following reason for allowing Indian residents to invest in OTFs:

Reserve Bank has been receiving references from various Indian parties to invest in Overseas Technology Funds which in turn will further invest in overseas technology startups. Such proposals generally do not meet the eligibility norms for making the overseas direct investment under the automatic route It is proposed that the Reserve Bank will deal with such requests under the approval route ...

The reason for relaxation is linked to repeated requests from Indian residents to invest in OTFs. It perpetuates the ad-hoc nature of relaxations that has pervaded the Indian regulatory framework governing capital controls in India.

- Approval route mechanism: The draft framework perpetuates the approval route mechanism in *FEMA 120*.⁴ A mature regulatory framework governing capital outflows should leave no scope for the exercise of discretion. The criteria for allowing or not allowing investment abroad must be clearly laid out in the law. Once an Indian resident satisfies such criteria, the investment must be allowed without having to approach any authority for approval. This reduces transaction costs of investing abroad as well as the scope for exercising ad-hoc discretion.

By mandating Indian residents to approach the RBI for approval for investing in OTFs, even where the Indian resident satisfies the criteria specified in the draft framework, the draft framework perpetuates the approval route mechanism. The rule must be straightforward: Indian residents who satisfy the requirements

⁴For instance, an Indian resident proposing to make a financial commitment exceeding USD 1 billion, requires to obtain the prior approval of RBI. Similarly, where an Indian party proposes to invest in a foreign entity, through a share swap, the approval of the Foreign Investment Promotion Board is required.

specified by RBI may invest abroad, without having to approach the RBI for approval.

Lack of clarity : In addition to the two substantive issues listed above, the draft framework suffers from several drafting deficiencies, which in turn, increases the scope of discretion and abuse:

1. Definition of OTFs: Although the primary purpose of the draft framework is to regulate investment in an OTF, it does not define the concept of an OTF. To the best of our knowledge, there is no globally accepted terminology called an OTF, even as per industry practice. Given that the proposal is entirely linked to allowing investment by Indian residents in OTFs, precisely defining an OTF becomes paramount for its uniform and objective operation and compliance.⁵
2. Definition of overseas startup: The draft framework states that the OTF shall invest in overseas technology startups. It further states that the definition to be accorded to the term *startup* shall vary across jurisdictions based on the definition allotted to it in the various jurisdictions. It is submitted that the concept of startup is generally not defined in any jurisdiction, including India. This adds to the vagueness and ambiguity of the draft framework.
3. Sources of investment: The draft framework states that only internal accruals or accruals from group or associate companies of the Indian company in India may be used for investing in OTFs, and that funds borrowed from the banking system shall not be permitted. Again, while bank borrowed funds have been disallowed from being invested in OTFs, borrowings raised through say, bond issuances have not been explicitly barred. According different treatment to substantively the same economic transaction, defies all economic rationale. Downward investment by an Indian resident of a loan taken from a bank should, if at all, be a matter of prudential regulation and not capital controls.
4. Definition of core business: The draft framework specifies that the business of the entity in which the OTF makes investment, must be aligned with the *core business* of the Indian resident. However, the term core business has not been defined. Whether this core business shall include only the primary objectives of the Indian company as mentioned in its Memorandum of Association or even the ancillary objectives may be included, is not specified. Further,

⁵This argument is without prejudice to our argument that a proposal to allow Indian residents to invest in some funds, and not others, lacks any economic rationale and must be substantially revised.

it has also not been specified whether only the primary business of the foreign entity ought to be aligned with the core business of the Indian company or an Indian company may invest in an overseas startup as long as one of the many business activities of the startup are aligned with the core business of the Indian company. It is submitted that, being an important element of the application of the draft framework, clarity on these aspects is critical toward the uniform application of the draft framework.

5. Some direct investments in *overseas startups* under automatic route: Paragraph B(vi) of the draft framework, states that ‘*in case the Indian party holds more than 10% direct stake in an overseas startup, UIN may be allotted by the AD bank under the automatic route.*’. It is unclear whether a 10% direct investment in an overseas startup is under the automatic or approval route. If it is the former, then it is unclear why the same cannot be made under the automatic route under the existing *FEMA 120*, as investment in an operational entity would not trigger the approval route at all.

Excessively restrictive : The draft framework imposes several restrictions on Indian residents investing in OTFs, which are not backed by any economic rationale. Some of these restrictions are illustrated below:

1. The draft framework allows only listed companies to invest in OTFs. Again, this restriction is not backed by any economic rationale. Mandating separate rules for investment, depending on the constitution of the entity, is redundant.
2. Indian companies which have “long overdue export” bills are disallowed from investing in OTFs. An investment in a foreign security is an investment decision just like an investment in an Indian security. In a mature market economy, long overdue export bills cannot be a ground for disallowing an Indian resident from investing abroad.
3. The draft framework states that OTFs in which Indian residents have invested, shall invest only in those overseas technology startups that are aligned with the core business of the Indian investing entity. This wrongly assumes that the Indian resident will, at all times, be in a position to control the activity of the OTF. Given that an OTF may be a widely held fund, such a restriction would be incapable of monitoring or enforcing, both for the investing entity as well as the regulator itself.

Investing abroad offers Indian investors, all residents of India, reduced risk through diversification of holdings. The question of timing of capi-

tal account liberalisation is not the subject of this note. However, even at this stage of limited capital account convertibility, there is scope for simplifying the regulatory framework governing capital outflows, streamlining it to reflect a consistent economic rationale and bringing in sound principles of rule of law in the administration of this framework. This need has been recognized by expert committees constituted by the Government.⁶ For instance, the *Report of the Committee on Financial Sector Reform*, states:

We also need to make it easier for our individuals and institutions to invest abroad. For individuals, the primary task may be to simplify procedures, and liberalize the kinds of assets and managers that can be invested in. For our institutions like pension funds, we have to convince various constituencies that a portfolio diversified across the world is safer than a portfolio concentrated only in India, and has better risk properties (for one, it retains value when the Indian economy suffers a downturn). Regulatory authorities then have to allow institutional portfolios to become broadly and internationally diversified.

Despite this, even at this advanced stage of liberalisation, the framework governing capital outflows is excessively restrictive. For instance, it places restrictions on the kind of consideration that an Indian resident may accept for her investment abroad, the kinds of instruments that Indian residents may invest in, kinds of activities and structures that the offshore entity in which an Indian resident has invested may engage in, controls on sale of shares in offshore companies held by Indian residents, etc.

Another element of central planning in the current regulatory framework is the approval route under *FEMA 120*. Investments by Indian residents abroad, which do not fall under any of the specified categories in *FEMA 120*, are under the approval route (i.e. mandated to obtain the approval of RBI). The factors which RBI takes into consideration for granting approval, are not supported by any economic rationale relating to capital outflows. For instance, in considering such applications, RBI will consider the *prima facie* viability of the joint venture in which the investment is proposed to be made, the contribution to external trade and other benefits that will accrue to India through such investment, financial position and business track record of the Indian resident, etc. None of these factors have any link to any market fail-

⁶See, for instance, the *Report of the Committee on Fuller Capital Account Convertibility*, the *Report of the Working Group on Foreign Investment* and the *Report of the Financial Sector Legislative Reforms Commission*

ure associated with capital outflows, nor are they supported by any imminent crisis warranting such controls.

Investment by an Indian resident in any fund is a means of diversification of her portfolio. By creating artificial distinctions between OTFs and funds which are not OTFs, allowing only listed entities with a profit track record and having a certain size to invest in OTFs, mandating approval for making such investment even when the specified criteria are satisfied, etc., the draft framework perpetuates the overly restrictive and complicated regulatory framework for capital outflows.

3 Recommendations for improvising the draft framework

In light of the above, we submit the following inputs for revising the draft framework:

1. The draft framework must not create an artificial distinction between OTFs and funds which are not OTFs. There is no economic rationale supporting such a distinction. Indian residents must be given the benefit of diversifying their portfolios by allowing investment in funds managed and investing abroad, notwithstanding the kinds of companies that the funds pick.
2. The draft framework must not distinguish between investment by listed and unlisted Indian companies in funds managed and investing abroad. Also, it must move away from a central planning philosophy by allowing only Indian companies of a certain size to invest in funds managed and investing abroad. Thus, networth requirements and profit track record must not be determinants of whether the company will be allowed to diversify its portfolio by investing in a fund managed and investing abroad.
3. The draft framework must lay down the criteria for investing abroad by incorporating them in *FEMA 120*. Once these criteria are satisfied, the Indian resident must be able to make the capital outflow, without having to obtain the prior approval of RBI.

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