

Funds Hotline

June 09, 2024

INDIAN LP INVESTMENTS IN OVERSEAS FUNDS - RULES LIBERALISED

- Indian LPs now permitted to invest in overseas funds regulated through their manager
- Indian LP investment not limited to only units issued by overseas funds, but any instrument by whatever name

INTRODUCTION

On Friday, the Reserve Bank of India ("RBI") issued a highly anticipated circular introducing two key amendments ("Circular")¹. Firstly, it permits Indian LPs to invest in overseas funds regulated through their managers, doing away with the erstwhile condition that investment could only be made in funds that were directly regulated by the financial regulator of the host country. Secondly, it removes the restriction limiting Indian LP investment solely in units issued by overseas funds, and now allows investments in any instrument, regardless of its form.

BACKGROUND

Indian LP investment in overseas funds is governed by a combined reading of the Foreign Exchange Management (Overseas Investment) Rules, 2022 ("OI Rules") and the Foreign Exchange Management (Overseas Investment) Directions, 2022 ("OI Directions"), (together read as the "OI Framework").

Barring a few specific exemptions, the OI Framework provides that any investment into unlisted equity capital of a foreign entity should be treated as Overseas Direct Investment ("ODI"), even if such investment does not afford the investor control of the foreign entity and is less than 10% of the foreign entity's share capital.

Accordingly, on a plain reading of the OI Rules, any LP portfolio investment into an overseas fund (other than a fund set up in GIFT City) may be treated as ODI and accordingly be subject to certain key restrictions including pricing and reporting requirements. Moreover, as the OI Rules do not permit individuals to make ODI into financial services, the provisions of the OI Rules read in isolation seem to completely cut off individual LP investment into overseas funds.

However, the OI Rules are not read in isolation; they are read with the OI Directions. Prior to the amendments introduced through the Circular, Paragraph 1(ix)(e) of the OI Directions clarified that *investment (including sponsor contribution) in units of any investment fund overseas, duly regulated by the regulator for the financial sector in the host jurisdiction, shall be considered as Overseas Portfolio Investment (OPI)*.² Accordingly, a route had been carved out for listed Indian companies and resident individuals³ to make OPI into overseas funds; however, the permission was subject to the following two conditions –

- the investment had to be made in 'units' of the overseas fund; and
- the fund had to be regulated in its home jurisdiction.

Investment in Units

Most offshore funds are typically set up as corporate bodies issuing shares/stock or partnership/membership interest, rather than as trusts issuing units. As such, when the OI Framework was first released, the limiting language created confusion amongst Authorised Dealer Banks ("AD Banks") who were not sure whether OPI should be permitted into securities other than units. More recently, AD Banks have been taking a more pragmatic approach and permitting investment in overseas funds as OPI even if the instrument issued was not a unit.

Investment in regulated overseas funds

Based on the erstwhile language of Paragraph 1(ix)(e) of the OI Directions there was a general consensus in the industry as well as amongst AD Banks that OPI investment should not be permitted unless the fund itself, and not the manager, was regulated in the host jurisdiction. However, there was some ambiguity as to whether the scope of the phrase "duly regulated" extended to funds which were in substance regulated, but only *through their managers*. The approach that AD Banks generally took was to only permit remittance where the fund was *directly regulated*.

As a result, not only were Indian LPs limited in their ability to make new overseas investments, but LPs who had already committed capital before the OI Framework was introduced encountered difficulties in meeting their commitment obligations where the fund was located in a jurisdiction whose financial sector regulator did not directly regulate the fund. Moreover, new funds had to be set up in jurisdictions like the Cayman Islands, Mauritius or GIFT City, to ensure that investment from Indian LPs would be possible.

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Considering the diverse legal and regulatory framework governing investment funds across various jurisdictions, the Circular has now amended paragraph 1(ix)(e) of the OI Directions to do away with both of the above-mentioned conditions

Specifically, the original text has been replaced with the following language - "*The investment (including sponsor contribution) in units or any other instrument (by whatever name called) issued by an investment fund overseas, duly regulated by the regulator for the financial sector in the host jurisdiction, shall be treated as OPI...*"

The following explanation has also been added "*Explanation: 'investment fund overseas, duly regulated' for the purpose of this para shall also include funds whose activities are regulated by financial sector regulator of host country or jurisdiction through a fund manager.*"

By permitting OPI investments in overseas funds regulated through their managers, the RBI has granted GPs the flexibility to establish their funds in commercially favorable jurisdictions without having to worry about whether Indian investments would be permitted. This flexibility was crucial, as the financial services regulators in popular fund jurisdictions like Singapore and the US (in some cases), regulate the fund manager rather than the fund itself. In such jurisdictions, the fund is in substance still regulated to some extent, but through its manager.

With the language of Paragraph 1(ix)(e) of the OI Directions amended, Indian resident individuals as well as Indian listed companies should now be able to make OPI without ambiguity – neither with respect to whether the fund or its manager is regulated nor with respect to the nature of the instrument being issued. This will not only re-open the door for LP investment in VCC funds in Singapore as well as funds set up in Delaware, subject to the manager being regulated, but will also allow Indian employees of Indian advisory entities to participate in overseas funds.

The amendment not only allows flexibility with respect to jurisdiction, but also with respect to the legal form of the fund. As OPI is no longer limited to only investments made into units of offshore funds, GPs now have the flexibility to set up funds as Limited Partnerships, LLC, VCCs, companies, etc.

It is interesting to note that the move to allow OPI into funds regulated through their managers is consistent with the treatment of LP investment into funds established in GIFT City. While the regulatory framework governing funds in GIFT City (ie. the IFSCA (Fund Management) Regulations, 2022), regulates the manager and not the fund, Schedule V of the OI Directions clearly permits LP investment into such funds as OPI.⁴ In fact, when the OI Framework was first introduced, the fact that it was the only overseas jurisdiction in which LP investment was permitted despite the funds not being directly regulated was one of GIFT City's distinguishing features. That being said, while the requirement that an overseas fund be directly regulated has been done away with, GIFT City continues to be the only overseas jurisdiction in which unlisted Indian entities can still make OPI into investment funds under Schedule V of the OI Directions.

Overall, the Circular offers a great opportunity for Indian LPs to access a wider range of investment options and aligns the OI Directions with industry needs and international practices, fostering a more dynamic investment environment and positioning Indian LPs to seize opportunities in the global markets.

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You can direct your queries or comments to the relevant member.

¹A.P. (DIR Series) Circular No. 09, dated 07 June 2024 (RBI/2024-25/41)

²Paragraph 1(ix)(e) of the OI Directions

³The OI Directions did not extend the ability to make OPI into overseas fund to unlisted entities

⁴Rule 15, Paragraph 2(iii) of Schedule V of OI Rules.

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