

GIFT City Express

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RBI PERMITS INDIAN PARTY TO MAKE SPONSOR CONTRIBUTIONS TO AIFS IN GIFT CITY

The GIFT City, or Gujarat International Finance Tec-City, is India's first International Financial Services Centre ("IFSC"). It has been conceived as a world class smart city with state-of-the-art infrastructure to act as a global financial hub. The establishment of GIFT City should be instrumental in attracting to India such financial transactions that are currently being conducted by financial institutions overseas.

With this intention, the Government of India established the International Financial Services Centres Authority ("IFSCA"), a statutory unified regulatory body under the Department of Economic Affairs, Ministry of Finance, to regulate the financial products, financial services and financial institutions located / performed in the IFSC in India. The IFSCA has been working to provide a competitive and collaborative environment for the fund management industry in the GIFT City.

The SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations") require the sponsor or the manager of an AIF to contribute a certain amount of capital to the fund as its continuing interest.¹ The operating guidelines for AIFs in IFSCs ("IFSC AIF") permit a sponsor / manager of an existing AIF in India to act as a sponsor / manager of an IFSC AIF by setting up a branch in the IFSC or incorporating a company or a limited liability partnership ("LLP") in the IFSC. In this regard, the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 ("ODI Regulations") govern the rules for overseas investment by an Indian Party² ("IP") and / or resident individuals³. The ODI Regulations, *inter alia*, do not permit investment by an IP into an overseas entity engaged in financial services, under the automatic route. This has proven to be one of the key impediments in establishment of IFSC AIFs by Indian AIF managers.

In a move that seeks to both incentivise as well as expedite the setting up of AIFs by Indian managers in the GIFT City, the Reserve Bank of India ("RBI") on May 12, 2021 issued a circular permitting sponsor contribution from a sponsor IP to the funds set up in overseas jurisdictions, including IFSC AIFs ("Circular").⁴

In this hotline, we discuss the details of the Circular and the issues which still remain unaddressed.

THE CIRCULAR

The Circular states that any sponsor contribution from a sponsor IP to a fund set up in an overseas jurisdiction, including IFSC AIFs, as per the laws of the host jurisdiction, will be treated as Overseas Direct Investment ("ODI") provided that the sponsor IP fulfils the conditions provided under Regulation 7 of the ODI Regulations. Accordingly, sponsor contribution to an IFSC AIF will now be allowed to be made under the automatic route, without the need for obtaining RBI approval (subject to satisfaction of the conditions stipulated in Regulation 7).

The Regulation 7 of the ODI Regulations provides conditions for overseas investment by an IP engaged in financial services sector. Regulation 7 provides that an IP engaged in financial services sector may make investments in an entity outside India provided such IP fulfils all the conditions provided below:

1. the IP should have earned net profit from the financial services activities during the preceding three financial years;
2. the IP is registered with an Indian regulatory authority for conducting the financial services activities;
3. the IP has obtained approval from the concerned regulatory authorities both in India and abroad, for venturing into such financial sector activity; and
4. the IP has fulfilled the prudential norms relating to capital adequacy as prescribed by the concerned regulatory authority in India.

ANALYSIS

While the Circular is a welcome move since it removes regulatory impediments in setting up of an AIF in GIFT City, nonetheless there are multiple issues that have remained unresolved or require further clarifications. We have discussed these issues briefly herein.

At the outset, it is important to note that the Circular permits an IP to make sponsor contribution directly to a fund set up in an overseas jurisdiction, including an IFSC AIF and not to an investment manager set up in an overseas jurisdiction, including an IFSC. Pertinent to note that the definition of IP under the ODI Regulations does not include individuals and therefore, investment by individuals in IFSC AIFs does not form a part of the scope of Circular. Earlier this year, the RBI had issued a circular⁵ permitting remittance to IFSCs under Liberalised Remittance Scheme ("LRS"), subject to the condition that the remittance is made only for the purposes of undertaking investments in IFSCs in securities, other than those issued by entities / companies resident (outside IFSC) in India ("LRS Circular").

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Scope of judicial interference and

While the LRS Circular opened doors for investment by resident individuals it is still unclear whether resident individuals can remit money to IFSC AIFs which are further investing in India.

Further, the Circular only permits making sponsor contribution in IFSC AIFs in cases where conditions under Regulation 7 of the ODI Regulations are satisfied. For instance, the first condition under Regulation 7 requires an IP to have earned net profits from financial services activities during the preceding three financial years. This requirement, therefore, permits existing IPs only, and a newly set up IP will accordingly need prior RBI approval for making sponsor investments into the IFSC AIFs. Similarly, the second condition under Regulation 7 requires a sponsor IP to have been registered with Indian regulatory authorities for the purpose of undertaking activities relating to financial services. Consequently, unless IPs are registered as investment advisors / portfolio managers acting as investment managers to an AIF in India, they are restricted from making sponsor contributions to IFSC AIFs.

Furthermore, while the Circular permits sponsor contribution by an IP to an IFSC AIF, it makes no explicit reference to such sponsor contribution in such IFSC AIF through its investment manager entity. In a typical fund structure, one entity could play the dual role of both investment manager and sponsor. Accordingly, in the context of an IFSC AIF, the IFSC IM could also act as the sponsor by making the required sponsor contribution, received from an IP, to the IFSC AIF. In such a structure, it seems that an approval from the RBI may nonetheless be required. It is important to note that permitting an IP to upstream amounts for setting up of the investment manager in the IFSC without prior RBI approval has been one of the major asks from the industry and would certainly provide an impetus to establishment of IFSC AIFs once such permission is granted.

Keeping in mind that IFSC AIFs are regulated by IFSCA and that the circulars, directions and guidelines released by the Indian regulatory bodies, including RBI and SEBI, are applicable on such AIFs, this relaxation should be permitted. Moreover, allowing establishment of investment managers in the IFSC under automatic route will also improve ease of doing business within the IFSC which will help catalyze the onshoring of the fund management industry, which is the objective behind establishing of IFSC.

It is unclear why the Circular refers to AIFs set up in 'overseas jurisdiction'. The ODI Regulations defines AIF as per the AIF Regulations. The AIF Regulations define AIF to mean any fund established or incorporated in India i.e. a fund incorporated or established in overseas jurisdiction shall not be considered as an AIF.

Though the Circular seeks to provide the much-awaited regulatory relaxation, it demands more clarity and flexibility as regards the practical implementation of it is concerned.

– Ipsita Agarwalla, Prakhar Dua & Parul Jain

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You can direct your queries or comments to the authors

¹ For a Category I or II AIF set up in India, the sponsor or the manager is required to have a continuing interest of 2.5% of the corpus of the fund or INR 50 million, whichever is lower, while for a Category III AIF set up in India, it is 5% of the corpus of the fund or INR 100 million, whichever is lower. For a Category I or II IFSC AIF, the continuing interest obligation is 2.5% of the corpus or USD 750,000, whichever is lower, while for a Category III IFSC AIF, it is 5% of the corpus or USD 1.5 million, whichever is lower.

² Indian party has been defined to mean an Indian company, partnership firm registered under the Indian Partnership Act, 1932 or an LLP making investment in a Joint Venture or Wholly Owned Subsidiary abroad.

³ Regulation 20A and Schedule V of the ODI Regulations provide rules for overseas direct investment by resident individuals

⁴ RBI/2021-22/38; A.P.(DIR Series) Circular No. 04; available at https://rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?id=12092.

⁵ RBI/2020-21/99 A.P (DIR Series) Circular No 11 dated February 16, 2021; available at <https://www.rbi.org.in/Scripts/NotificationUser.aspx?id=12029&Mode=0>

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