# Investment Funds: Monthly Digest

October 28, 2022

## NEW OVERSEAS INVESTMENT LAWS IN INDIA, FUND FORMATION AND RAISING

### INTRODUCTION

In an attempt to simplify and boost overseas investments by Indian residents, the Government of India[1], Securities and Exchange Board of India ("**SEBI**")[2], and Reserve Bank of India ("**RBI**")[3] have introduced flagship changes to the legal regime with respect to overseas investments by Indian residents including alternative investment funds ("**AIF**") registered under the SEBI (Alternative Investment Funds) Regulations, 2012 (the "**AIF Regulations**").

In this edition of the monthly digest, we have discussed these changes to the extent they are relevant to AIFs which invest outside India, and also overseas funds (including funds set up in the IFSC (as defined below)) which raise investments from Indian investors.

### BACKGROUND

***AIFs investing in overseas opportunities***

Overseas investment by a person resident in India is a regulated activity under the Foreign Exchange Management Act, 1999 ("**FEMA**").[4] AIFs were permitted to invest in foreign securities[5] subject to the erstwhile FEM (Transfer or Issue of any Foreign Security) Regulations, 2004 ("**Erstwhile ODI Regulations**") (modified as Foreign Exchange Management (Overseas Investment) Rules, 2022 ("**OI Rules**")) and the directions and guidelines notified by the RBI and SEBI in this regard.[6]

The RBI had clarified that AIFs interested in making overseas investment were required to only approach SEBI for an approval without the need to obtain a separate permission from RBI.[7]

SEBI had introduced the overseas investment channel for AIFs pursuant to its first set of guidelines in October, 2015 whereby it had announced that the total exposure available to all AIFs (and venture capital funds under the erstwhile SEBI regulations) for seeking allocation towards overseas investment would be USD 500 million ("**Original Guidelines**").[8] This was a one-time bandwidth not open to replenishment upon being exhausted. Further, exits by AIFs from their overseas investments would not open up the bandwidth. This limit was increased subsequently a couple of times pursuant to industry representations, and the current limit stands at USD 1500 million.[9] SEBI had also mandated that the per-AIF exposure to overseas investments shall not exceed 25% of the investible funds of such AIF / scheme.

Further, SEBI had mandated in the Original Guidelines that such overseas investment will be in offshore venture capital undertakings (i) being foreign companies, whose shares are not listed on a recognized stock exchange in India or overseas; and (ii) which have an Indian connection (e.g. company which has a front office overseas, while back office operations are in India).

In order to demonstrate 'India connection' to SEBI as quickly as possible, AIFs requested many foreign investee companies to drop subsidiaries in India for certain minimal back-office operations. It was not always structurally possible to drop down Indian subsidiaries for such overseas businesses and in those cases, the time taken to convince SEBI of the India connection by the AIF would far exceed the time bound requirement of capital by such overseas companies.

In many cases, AIFs would have to give up the opportunity to consummate these overseas deals due to protracted discussions with SEBI, or only their feeder vehicles or parallel vehicles set up and managed outside India for pooling monies from overseas investors would get the benefit of these overseas investments while the Indian investors pooled into the domestic AIF would miss out. In this regard, SEBI has amended the Original Regulations which have been discussed in detail in Part I below.

***Investment by Indian investors into overseas funds***

In terms of investment made by Indian investors in overseas funds, recently, the Ministry of Finance (Department of Economic Affairs) and the RBI have respectively released the OI Rules and the Foreign Exchange Management (Overseas Investment) Regulations, 2022 ("**OI Regulations**").

In addition to the introduction of the OI Rules and OI Regulations, the RBI has also issued the Foreign Exchange Management (Overseas Investment) Directions, 2022 ("**OI Directions**") which are to be read in conjunction with OI rules and the OI Regulations. (collectively the OI Rules, OI Regulations and the OI Directions read as the "**OI Framework**"). OI Directions are typically issued as guidance for the AD Banks i.e. to provide further clarity to the

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existing law, however, do not have the effect of overruling the law passed by the Government and RBI.

The OI Framework, now categorizes (a) Overseas Direct Investments ("**ODI**"), and (b) Overseas Portfolio Investment ("**OPI**"), by an individual resident Indian as permissible capital account transactions, which are required to be carried out in accordance with the OI Framework.

The OI Rules deem any investment or financial commitment outside India made in accordance with FEMA or the rules or regulations made thereunder to have been made under the OI Rules and OI Regulations, thereby permitting grandfathering of overseas investments made as per the Erstwhile ODI Regulations. In what comes as one of the most anticipated changes, the OI Rules have permitted overseas investment by resident Indians in International Financial Services Centre ("**IFSC**"), subject to certain conditions. There are several other changes that have been brough about in the OI Framework which enhance the ease of investments for Indian investors in the IFSC AIFs. Such key changes in the framework have been discussed in detail in Part II below.

***Formation of AIFs in IFSC***

Under the Erstwhile ODI Regulations, investment managers in India are permitted to have a branch or a subsidiary in the GIFT City in the IFSC. In this regard, International Financial Services Centre Authority (Fund Management) Regulations, 2022 ("**FME Regulations**") require that the fund management entity ("**FME**") in the GIFT City continuously maintains its net worth as per thresholds provided in the FME Regulations. Hence, the Indian investment manager is required to remit funds to the FME (which can be formed as an LLP or a company) to satisfy the net worth requirement. Under the Erstwhile ODI Regulations, such remittance can be done via the automatic route or the approval route. To remit funds under the automatic route[10] the following conditions are required to be satisfied:

a. *Indian party has earned net profit during the preceding three financial years from the financial services activities;*
b. *Indian party is **registered** with the regulatory authority in India for conducting the financial services activities;*
c. *Indian party has obtained approval from the concerned regulatory authorities both in India and abroad, for venturing into such financial sector activity; and*
d. *Indian Party has fulfilled the prudential norms relating to capital adequacy as prescribed by the concerned regulatory authority in India.*

Majority of the investment managers in India faced an issue in remitting funds to the IFSC as one of the conditions requires the investment manager to be registered with a regulatory in India. However, under the AIF Regulations, only the AIF is required to be registered with SEBI and the investment manager is deemed to be regulated by SEBI.[11] Hence, they were required to remit funds via the approval route. The OI Rules have provided the much-needed respite as now the entities regulated or registered by a regulator in India are permitted to remit funds to the IFSC if they satisfy the conditions provided in the OI Rules. This has been covered in detail Part III below.

## PART I: OVERSEAS INVESTMENTS BY AIFS

***Revised application form***

As compared to the Original Guidelines, the application form in the Revised Guidelines is more robust in terms of disclosures as well as declarations.

Additional details include disclosure of connection between any investor of the AIF and the overseas investee company, and such investor's pro-rata share in the investment, type of instrument, nature of investment and previously invested amount in overseas companies, the proposed investment is bona fide in nature, undertaking by the manager that (i) the proposed investment is in equity or equity linked instrument; (ii) the securities market regulator of the country of incorporation of the overseas company is an Appendix A signatory to IOSCO's multilateral MoU or a signatory to bilateral MoU with SEBI and not identified in FATF's public statement as a jurisdiction having a strategic AML/CFT deficiencies to which counter measures apply or has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with FATF to address the deficiencies (such conditions under (ii) the "**Country Conditions**").

One of the declarations states that 'it shall be ensured' in case of sale of stake of the AIF in an overseas company that the buyer is eligible to make overseas investments, as per extant FEMA guidelines. If read literally, this is a confusing declaration because it does not impose any obligation on the AIF to ensure the eligibility, and it does not specify that only if buyers are Indian, this requirement should apply. However, if we apply the originalist theory to interpret, it seems that SEBI would require the AIF to obtain an undertaking from the buyer, if they are a person resident in India under FEMA, that the buyer is eligible to make overseas investments as per the extant FEMA guidelines.

***No India connection needed***

In what is being considered a welcome move by the industry, SEBI has done away with the requirement of demonstrating an India connection of the overseas companies in which the AIF wishes to invest pursuant to the Revised Guidelines.

This should lead to quicker deal-making by AIFs for their offshore exposure, and allow exposure of Indian investors to better opportunities. This would also allow better opportunities for Indian GPs to construct a more diversified portfolio whereby they may track and mentor entirely foreign businesses.

***Country Conditions***

As discussed earlier, there are Country Conditions applicable now for AIFs to invest in overseas investee companies. These conditions should not pose any practical difficulties. The securities market regulators of 127 out of 195 countries are Appendix A signatories to IOSCO's multilateral MoU as per the data available on IOSCO's website.[12] Even if these Country Conditions were not required under law, AIFs which have institutional LPs would be required by such LPs to abide by the same conditions while scoping for any investee entities.

***Renewal of Industry Limits***

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Prior to the Revised Guidelines, the overall industry limit of USD 1500 million to be allocated to AIFs on a first come basis would be permanently exhausted once allocated to and utilized by the AIF applicants to SEBI. Pursuant to the Revised Guidelines, it seems that SEBI would now renew or replenish the allocated limit for the industry upon exits by AIFs of their previous overseas investments, to the extent of the original investment made.

For example, if as of August, 2022, USD 1450 million has already been allocated by SEBI to different AIFs where such AIFs have made investments worth USD 1450 million overseas pursuant to SEBI's allocation, and some of these AIFs have also exited investments originally made of USD 20 million, then (i) prior to the Revised Guidelines, the available limit would continue to be USD 50 million for new applications; whereas (ii) pursuant to the Revised Guidelines, the available limit would now be USD 70 million for new applications.

Prior to the Revised Guidelines, it seems that SEBI was freeing up the limits only when the allocated portion of the limit was going unutilized by the applicants, i.e. they took the approval from SEBI but did not go ahead with the investment, or only went ahead partly with the investment. SEBI required reporting of unutilized limits for overseas investments by AIFs within 2 working days upon expiry of 6 months from the date of such approval. So, the approval remained valid for 6 months.[13]

AIFs will now be required to report their sale / divestment details of their overseas investments to SEBI within 3 working days of the divestment so that SEBI is equipped to update the available limit for new applications.

While no flexibilities have been introduced in terms of increasing the limit from USD 1500 million to a higher amount, or allowing higher exposure to overseas investments by AIFs than 25% of their investable funds, this is a positive step by SEBI in order to ensure that new applications continue to get processed within the current limits. The reporting window is quite short and AIFs will need to be mindful of this in their closing checklist / step list while selling their overseas stakes. Further, Existing AIFs who have already exited overseas investments are required to report their divestment to SEBI by September 16, 2022 (i.e. within 30 days of the Revised Guidelines).

## PART II: INVESTMENT BY INDIAN INVESTORS INTO OVERSEAS FUNDS

### *Investment in overseas funds, outside IFSC*

The OI Rules provide flexibility for an Indian Entity *regulated* by a financial services regulator to make ODI under the automatic route. This is a welcoming change as under the Erstwhile ODI Regulations only Indian entities *registered* with the relevant regulatory authority were permitted to make ODI under approval route. Accordingly, Indian Entities, like managers of SEBI registered AIFs who are not registered but only regulated by SEBI, were required to apply to RBI for an approval for making ODI. Now, these managers are permitted to set up foreign managers or funds under the automatic route, subject to satisfying the net profit criteria and receiving a NOC from the financial regulator in the jurisdiction where such activities are intended to be carried out as detailed here:

a. an Indian entity engaged in financial services activity investing in a non-IFSC foreign entity engaged in financial services needs to *inter-alia* obtain approvals from the financial services regulator in India as well as the regulator in the jurisdiction in which the ODI is intended to be made ("**NOC**").[14]

b. an Indian entity not engaged in financial services activity in India investing in a non-IFSC foreign entity engaged in financial services (other than banking and insurance companies) needs to have posted net profits during the preceding 3 financial years ("**Profitability Criteria**").[15]

### *Investment in overseas unlisted funds, outside IFSC*

Under the Erstwhile ODI Regulations, while resident individuals were not permitted to set up Joint Ventures or Wholly Owned Subsidiary engaged in financial service activities, they were only permitted to make portfolio investments (i.e. less than 10% shareholding without control) under Liberal Remittance Scheme ("**LRS**") into unlisted shares of foreign companies set up and funds and unlisted units of foreign venture capital funds.

However, now under the OI Rules the definition of ODI includes investment in all unlisted foreign securities, irrespective of shareholding or whether such acquisition is coupled with control over the foreign entity. Accordingly, any investment made by an Indian person in the unlisted shares, units or partnership interest of an overseas fund should qualify as ODI, even if the investment results in a less than 10% shareholding of the fund without control.

The issue arises because a resident individual is not permitted to make ODI in a foreign entity which is engaged in financial services. Although, OPI by these individuals is still permitted in entities engaged in financial services, OPI under the OI Rules has been restricted to only mean investment in *listed* securities resulting in less than 10% shareholding without control.

Accordingly, on a bare reading of the OI Rules individual investors (or "**LPs**") are restricted from making investments in foreign unlisted funds. This is a significant issue for the managers (or "**GPs**"), not only with respect to structuring of potential offshore funds intended to have investments from Indian individuals, but even more significantly for existing structures which have already obtained LP commitments, which individual LPs may now not be able to fund.

This restriction also impacts certain GP carry structures which rely on the GP's ability to make portfolio investment under LRS either into the foreign management entity or directly into the offshore fund. Typically, these GPs receive their carried interest on redemption of their shares as capital gains.

That being said, it is important to note that despite what seems like a total restriction for individuals investing in foreign unlisted entities engaged in financial services, the OI Directions provide that investments (including sponsor commitments) in units of any investment fund overseas, duly regulated by the regulator for the financial sector in the host jurisdiction, shall be considered as OPI. Therefore, a combined reading of OI Rules and OI Directions, indicate that resident individual LPs are permitted to make OPI investments (i.e. less than 10% shareholding, without control) in an offshore fund, if such fund is duly regulated in its host jurisdiction[17] A similar view may also be taken in the context of carry structures where GPs may be able to make OPI investment into a regulated fund; however, it may not be possible to structure such carry through the investment manager anymore.

### *Investment in overseas funds in IFSC by resident individuals*

Schedule V of the OI Rules allow ODI by resident individual LPs in entities engaged in financial services activities in IFSC provided that such entity does not have subsidiary or step-down subsidiary outside IFSC where the resident individual LP has control in the foreign entity. This would therefore permit the individual GP to make its contribution in the fund incorporated in the IFSC. However, Paragraph 2(iii) of Schedule V of the OI Rules provide that investments made by persons resident in India (including individuals) in an investment fund or vehicle set up in an IFSC shall be treated as OPI, Schedule V (Para 2(iii) and (iv)) makes the distinction between investments in funds and investments in entities engaged in financial sector activities even though funds can be also included in the latter and be treated as ODI. Hence, it creates confusion in terms of whether an individual investing in IFSC would be investing by way of ODI or OPI. We understand that the intention of the rules to provide this distinction is to assume that any investment which provides the investor control shall be characterised as ODI. In this regard, since investments by individuals is OPI any such investment would ensure that the investors are not able to access control over the IFSC fund despite holding more than 10% of the units of such investment fund.

## PART III: FORMATION OF AIF IN IFSC

An entity formed, registered or incorporated in the IFSC with limited liability, including an investment fund or vehicle (as clarified in the OI Directions),[16] is defined to be a foreign entity in the OI Rules ("**IFSC Entity**").[17]

The OI Rules have generally applied the conditions for investment by persons resident in India into foreign entities (explained above), to investment by such persons in IFSC Entities as well.[18] However, there are certain special provisions which apply only with respect to investment in IFSC Entities engaged in financial services activities (and do not apply to investment in other foreign entities).[19] This section discusses such special provisions.

### *ODI into IFSC Entities*

As per the special provisions for ODI into IFSC foreign entities (in addition to the Indian entity engaged in financial services activity investing in a non-IFSC foreign entity engaged in financial services), investment by:

a. an Indian Entity engaged in financial services activity, if the NOC is not decided within 45 days from the date of the duly complete application for NOC, then the approval or NOC is deemed to be given; and

b. an Indian Entity not engaged in financial services activity, insofar as the investee IFSC Entity is not engaging in banking or insurance activity, the Profitability Criteria is not applicable.

The time efficiencies introduced with respect to the NOC is a welcomed relief to Indian fund managers who must wait for both SEBI and IFSCA NOCs before remitting funds to their IFSC manager entity. Specifically, in the context of SEBI, these NOCs have been taking up to 4-5 months, which has caused significant delays in the capitalization of the fund manager in IFSC and subsequent launch of the fund in IFSC. This provision is also an important step towards ease of doing business in India and should help enable setting up offshore structures in the IFSC with greater speed. Further, the relaxation from the Profitability Criteria is a much awaited relief for first time GPs who often do not have pre-existing entities in India which can be used to set up the fund manager in the IFSC. This further increases the attractiveness of IFSC for Indian GPs looking to set up offshore funds as compared to foreign jurisdictions such as Mauritius or Singapore for which the Profitability Criteria must be met.

## SUMMARY AND CONCLUSION

The industry is hopeful that the removal of 'India connection' condition combined with the recycling of the industry bandwidth would allow more overseas investment applications to be cleared by SEBI, and more quickly. While the reporting windows are short, the mode of reporting is simply by an e-mail to SEBI. There are no detailed filings required to be made physically to SEBI. This should be achievable, as long as it is embedded into the closing process. Further, the ease of investment in entities/funds set up in IFSC shall incentivise fund managers in India to set up funds in the IFSC and to avail various tax and regulatory exemptions provided there.

However, the condition that overseas funds (other than funds in IFSC) must be regulated by the financial services regulator of the host country for Indian resident individuals to invest into such funds under the OPI route is becoming a practical issue. Given that most jurisdictions register and regulate the fund manager, rather than the fund entity itself such condition requires the resident individuals to obtain a legal opinion from the local counsel to the effect that the funds despite not being granted a license by the local regulatory authorities are deemed to be regulated by the virtue of their manager being regulated. In this regard, it might be helpful to receive clarity from RBI given that the local counsels are generally reluctant to provide such opinions given the regulatory landscape in India.

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You can direct your queries or comments to the authors

[1] Foreign Exchange Management (Overseas Investment) Rules, 2022 *available at*
*https://egazette.nic.in/WriteReadData/2022/238239.pdf*

[2] SEBI/HO/AFD-1/PoD/CIR/P/2022/108

[3] Foreign Exchange Management (Overseas Investment) Regulations, 2022 *available at*
*https://egazette.nic.in/WriteReadData/2022/238242.pdf*

[4] Section 6, FEMA

[5] Regulation 15(1)(a), AIF Regulations

[6] Regulation 26, **Erstwhile** ODI Regulations

[7] RBI/2014-2015/344, A.P. (DIR Series) Circular No.48

[8] CIR/IMD/DF/7/2015

[9] SEBI/HO/IMD/DF6/CIR/P/2021/565

[10] Regulation 7 (1) of the ODI Regulations

[11] SEBI in its clarification letter dated June 15, 2018 to a large industry body has clarified that "an entity may be considered to be regulated by SEBI to the extent of its activities as sponsor/manager of a SEBI registered AIF.

[12] https://www.iosco.org/about/?subSection=mmou&subSection1=signatories

[13] SEBI/HO/IMD/DF1/CIR/P/2018/103/2018

[14] Para 2(1)(iii) of Schedule I, OI Rules

[15] Para 2(2) of Schedule I, OI Rules

[16] (1)(i) of Part I of Annex-I of the Foreign Exchange Management (Overseas Investment) Directions, 2022

[17] Rule 2(1)(h) of the OI Rules

[18] Para 1(2), Schedule V, OI Rules

[19] Rule 15 and Schedule V, OI Rules