August 2022

New rules for overseas investment by AIFs and VCFs

Introduction

Overseas investments by Alternative Investment Funds ("**AIFs**") and Venture Capital Funds ("**VCFs**") are governed by the guidelines prescribed by the Securities and Exchange Board of India ("**SEBI**") from time to time. While prior approval of the Reserve Bank of India ("**RBI**") is not needed for overseas investments, the prior approval of SEBI is required for allocation of limits for overseas investment to an AIF/VCF. The current overall investment limit for overseas investments by AIFs and VCFs is USD 1,500,000,000 (US Dollars one billion five hundred million), and these limits are allocated on a first cum first serve basis subject to a cap of 25% of the investible funds of a scheme of an AIF/VCF. An AIF/VCF is required to make investments in offshore entities within 6 (six) months from the date of SEBI granting its approval.

SEBI recently issued the guidelines for overseas investment by AIFs and VCFs ("**New Guidelines**") on August 17, 2022, which sets out a revised framework for making overseas investments by AIFs and VCFs. Prior to the issuance of the New Guidelines, and subject to other prescribed restrictions, AIFs and VCFs which were desirous of investing in offshore investee companies were permitted to make investments in such offshore entities which had an 'Indian connection' (i.e., the offshore companies which had back-office operations in India).

With the New Guidelines now in effect, such pooled investment vehicles are no longer restricted by the "India connection" requirement in relation to their offshore investments.

The New Guidelines are in addition to the earlier guidelines issued by SEBI on this subject matter (except to the extend modified by the New Guidelines).

The New Guidelines

1. **Eligibility criteria for overseas investee company:** As per the New Guidelines, AIFs and VCFs can invest in offshore companies which:

   (a) are entities incorporated in countries whose securities market regulator is a signatory to the International Organization of Securities Commissions' multilateral memorandum of understanding (Appendix A Signatories) or a signatory to the bilateral memorandum of understanding with SEBI; and

   (b) are not identified by the Financial Action Task Force ("**FATF**") in a public statement as: (i) a jurisdiction having a strategic anti- money laundering or combating the financing of terrorism deficiencies to which counter measures apply, or (ii) a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with FATF to address the deficiencies.

2. **Revised application format**: The New Guidelines have introduced a more detailed format for AIFs and VCFs applying to SEBI for allocation of overseas investment limits. The revised format requires the AIFs and VCFs to provide *inter alia* details of the overseas offshore entity, type of investments contemplated, and overseas investments made by the relevant AIF or VCF in the past.

3. **Undertakings from the AIF/VCF**: Further, unlike the previous format, the revised format prescribes for additional undertakings to be provided by the trustees/designated partners/board of directors of the applicant AIF and VCF relating to: (a) the bona fide nature of the proposed overseas investment, (b) the investment being consistent with the fund's investment objectives, and (c) compliance of the proposed overseas investment with the regulatory framework for overseas investment by AIFs/VCFs.

4. **Undertaking from the manager of the applicant AIF/VCF**: A detailed undertaking is also required to be submitted by the manager of the applicant AIF/VCF in relation to *inter alia* the following:

   (a) exercise of due diligence by the manager;

   (b) nature of proposed instrument, which should be an equity or equity linked instrument;

   (c) the proposed offshore investee company being an offshore venture capital undertaking;

   (d) the proposed offshore investee entity complying with the eligibility criteria prescribed under the New Guidelines;

   (e) the AIF/VCF not investing in joint ventures or wholly owned subsidiaries while making overseas investments;

   (f) adherence to FEMA regulations and other guidelines of the RBI in relation to a structure which involves foreign direct investment under the overseas direct investment route;

   (g) compliance with all requirements under RBI guidelines on opening of branches/subsidiaries/joint venture/undertaking investment abroad by non-banking financial companies ("**NBFCs**"), where more than 50% of the funds of the AIF/VCF has been contributed by a single NBFC; and

   (h) the transferee entity to which the AIF/VCF sells/transfers its invested offshore stake, is an entity that is eligible to make overseas investments in accordance with the Indian foreign exchange laws.

5. **Re-investment of sale proceeds**: The New Guidelines also clarify that sale proceeds received by an AIF or VCF from liquidation of its offshore investee companies would be available for re-investment.

6. **Reporting of sale/divestment:**

   (a) The New Guidelines have introduced the requirement to report to SEBI of any sale/disinvestment by AIFs or VCFs. Accordingly, SEBI has prescribed a format for reporting any sale/disinvestment by AIFs or VCFs. Such reporting is required to be made by the relevant AIF or VCF within 3 (three) working days of the disinvestment by emailing the report to aifreporting@sebi.gov.in.

   (b) Further, SEBI has prescribed a one-time reporting to be made by all AIFs and VCFs of their previous sales/disinvestment in offshore entities till date by September 16, 2022, by emailing the report to aifreporting@sebi.gov.in.

JSA Comment

The New Guidelines have certainly liberalised the previous regime which permitted AIFs and VCFs to only invest in overseas companies that had an 'Indian connection'. The liberalisation is coupled with additional safeguards and investment conditions which have been introduced for AIFs and VCFs keen on investing offshore.

SEBI has also reinforced its intention of increasing accountability of the governing bodies and managers of AIFs and VCFs participating in offshore investments as it has sought additional undertakings from them at the time of making an application for seeking limits for overseas investments.

While the liberalisation under New Guidelines is a step in the right direction, SEBI should eventually transition making overseas investments under an automatic route. The securities regulator should also consider if AIFs should be allowed to invest in debt instruments of overseas companies as the current regulatory framework only permits AIFs to invest in equity and equity linked instruments. Further, the RBI needs to consider increasing the overseas investment limits in the near term to enable Indian AIFs and VCFs to compete with funds overseas.

Investment Funds Practice

JSA advises fund managers as well as investors in funds. It has advised fund managers on structuring and establishment of a range of funds, both onshore and offshore with varied investment objectives and for investment in various types of asset classes. JSA has also advised domestic and foreign investors that invest in Indian alternative investment funds. We have been involved in the establishment of, or investments in, onshore alternate investment funds registered with SEBI, as well as offshore foreign venture capital investors and offshore private equity funds set up to make investments under the foreign direct investment route to invest in India. We have also advised on foreign portfolio investor funds established outside India which are registered with the Indian securities regulator. We advise clients on the structuring of their funds, including the choice of domicile and vehicle, having regard for the need to achieve optimum tax efficiency for the investors and the manager, marketing and regulatory considerations and any specific issues arising because of the proposed asset class(es) in which the fund will invest. We also assist our clients in their applications with SEBI for various types of fund registrations.

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