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SEBI MODIFIES GUIDELINES FOR OVERSEAS INVESTMENTS BY ALTERNATIVE INVESTMENT FUNDS AND VENTURE CAPITAL FUNDS

26 August 2022

Introduction

In a significant step forward, which offers flexibility as well as additional compliance requirements to the Alternative Investment Funds (AIFs) and Venture Capital Funds (VCFs), the Securities and Exchange Board of India (SEBI) vide its Circular No. SEBI/HO/AFD-1/PoD/CIR/P/2022/108 dated 17 August 2022 (SEBI 2022 Circular) has relaxed the guidelines for overseas investments by AIFs and VCFs. The guidelines issued under the SEBI 2022 Circular must be complied with in addition to such conditions or guidelines that may be stipulated by the Reserve Bank of India (RBI) and SEBI from time to time.

Under the guidelines for overseas investment¹, an AIF or VCF desirous of making an overseas investment is required to obtain an allocation for the proposed amount of investment from the overall limit of USD 1,500,000,000 (US Dollars One and Half Billion)² for all AIFs and VCFs as well as obtain a No Objection Certification from SEBI in the prescribed format under the SEBI 2022 Circular.

Part A - Relaxations introduced on Overseas Investments

Removal of Indian Connection requirement

Within the ambit of paragraph 3(ii) of the SEBI 2007 Circular, read with paragraph 2(A)(e)(i) and paragraph 2(B)(c)(iv) of the SEBI 2015 Circular, there is a requirement to only make investments in such companies which have an 'Indian Connection', which is interpreted as overseas companies which have front office overseas while back office operations are in India. Under the SEBI 2022 Circular, the requirement to have an Indian Connection has been removed for AIFs and VCFs making overseas investments.

Jurisdiction specific guidelines

While the requirement to have an Indian Connection has been removed, AIFs and VCFs are only permitted to invest in investee companies overseas which are incorporated in countries where the securities market regulator is either:

¹ SEBI Circular No. SEBI/VCF/CIR no. 1/98645/2007 dated 09 August 2007 (SEBI 2007 Circular) (accessed [here](#)), read with SEBI Circular No. CIR/IMD/DF/7/2015 dated 01 October 2015 (SEBI 2015 Circular) (accessed [here](#)).

² Limit prescribed under Circular No. SEBI/HO/IMD/DF6/CIR/P/2021/565 dated 21 May 2021 (SEBI 2021 Circular) (accessed [here](#)).

1. a signatory under Appendix A of the International Organization of Securities Commission's (IOSCO) Multilateral Memorandum of Understanding (such as Luxembourg, Malaysia, and Netherlands)³; or
2. a signatory to the bilateral Memorandum of Understanding (MOU) with SEBI (such as USA, Mauritius, Singapore, and Indonesia)⁴.

Further, the SEBI 2022 Circular has also introduced a negative list of countries where the AIFs and VCFs are not permitted to invest in investee companies overseas of such countries, which have been identified in the public statement of Financial Action Task Force (FATF) as either:

1. a jurisdiction having strategic anti-money laundering or combating the financing of terrorism deficiencies to which counter measures apply (such as Syria, UAE, and Cayman Islands)⁵; or
2. a jurisdiction that has not made sufficient progress in addressing the deficiencies or a jurisdiction that has not committed to an action plan developed with FATF to address the deficiencies (such as South Sudan and Myanmar).

There may be certain overlapping countries which are either a signatory under IOSCO or have a bilateral MOU with SEBI (such as UAE and Cayman Islands) and are also on the negative list detailed above. In such cases, it is unclear whether investments in the jurisdiction will be permitted.

Permitting reinvestment of proceeds from liquidation of investments

The AIFs and VCFs are now permitted to reinvest the principal amount out of the sale proceeds generated from the liquidation of overseas investments, without requiring a fresh application to SEBI for allocation of investing limits. This would however be subject to the fund documents permitting such reinvestment.

Illustration

If an AIF has received approval from SEBI and has invested USD 500,000 (US Dollars Five Hundred Thousand) in an overseas investee company and this investment has been liquidated for USD 1,000,000 (US Dollars One Million) after some years, then the AIF can use the sale proceeds from such disinvestment and reinvest the principal amount of up to USD 500,000 (US Dollars Five Hundred Thousand) already allocated to it, in another overseas investee company and not the entire sale proceeds of USD 1,000,000 (US Dollars One Million).

AIFs are permitted to invest up to 25% of their investible funds overseas, subject to the overall limit permitted by SEBI. Therefore, it should be interpreted that the quantum of 25% of the investible funds will be calculated on an ongoing basis by the Fund.

Sale of overseas investment to persons eligible to make overseas investments under FEMA

It is also important to note that AIFs and VCFs are permitted to transfer or sell the investment in an overseas investee company only to those persons who are eligible to make overseas investments, as per the guidelines issued under the Foreign Exchange

³ International Organization of Securities Commission, IOSCO MoU: Appendix A (current signatories) - 127, accessed [here](#).

⁴ Securities and Exchange Board of India, Bilateral MOUs, accessed [here](#).

⁵ FATF, Jurisdictions under Increased Monitoring - June 2022, accessed [here](#).

Management Act, 1999 (FEMA). While the language suggests that the overseas investments may be transferred to persons resident in India, this however should not preclude the AIFs or VCFs from transferring the investments to persons resident outside India unless a new set of guidelines for sale of overseas investments are expected from the RBI.

Part B - Compliances introduced for Overseas Investments made by AIFs

The SEBI 2022 Circular prescribes the following additional compliances to be complied with by the AIFs and the VCFs:

1. AIFs and VCFs are required to file an application to SEBI for allocation of overseas investment limit in the prescribed format. This application has to be filed alongside undertakings from the trustee or the board or the designated partners of the AIFs or VCFs and the investment manager of the AIF or the VCF, in the format prescribed. It is interesting to note that while the investment managers of AIFs and VCFs take these decisions, trustee or the board or the designated partners of the AIFs or VCFs are also required to provide certain undertakings whilst making overseas investments which will bring them under the SEBI lens for scrutiny if and when required.
2. AIFs and VCFs are required to furnish the details of sale or disinvestment of the overseas investments to SEBI in the prescribed format within a period of 3 working days of the disinvestment.
3. All AIFs and VCFs are required to, within a period of 30 days from the date of this circular (i.e., 17 August 2022), report all the overseas investments which have been sold or disinvested by AIFs and VCFs since their inception.

The aforesaid reporting requirements will allow SEBI to monitor and update the overall limits for overseas investment to all AIFs and VCFs. Having said that, the timeline prescribed for reporting disinvestment of the overseas limit is short and may be onerous on the AIFs and VCFs to comply with, given that the RBI, under the Foreign Exchange Management (Overseas Investment) Regulations, 2022, has prescribed a timeframe for reporting such disinvestments to be 30 days from the date of receipt of disinvestment proceeds.

Comments

In the recent months, there have been representations from the funds industry to raise the limit on overseas investments by AIFs and VCFs from the current limit of USD 1,500,000,000 (US Dollars One and half Billion) as set by the SEBI 2021 Circular. However, SEBI has not raised the overseas investment limit of the funds.

The reasons the limit has not been raised appears to be because doing so may put a serious strain on the foreign exchange reserves of India which have already fallen to reach their lowest in the past one and half year and the Indian Rupee has seen a fall of more than 7.5% in 2022. The fall in foreign reserves and the US Dollar becoming more expensive compared to the Indian Rupee are also key reasons why the provision for reinvestment of proceeds from liquidation of overseas investment has been inserted. There is a need for increasing the limit of offshore investments to a particular AIF, within the industry-wide limit prescribed, as the corpus of the AIF grows.

With the elimination of the requirement for an Indian connection for overseas investments, the regulator has now taken a pragmatic approach and aligned its objective with that of the fund management industry (to boost returns for its investors)

and in line with global standards. This move will help facilitate investments overseas by Indian AIFs.

This circular will significantly benefit the funds industry in India as it permits Indian AIFs and VCFs to invest in an even wider range of sectors overseas as earlier only companies in the tech sector had the tendency to have frontend-backend structures. Furthermore, the SEBI 2022 Circular seeks to boost India's credibility as a genuine and robust investment regime by prohibiting investments in countries which are not FATF compliant and permitting investments only in the countries where the relevant market regulator is a signatory of IOSCO or has a bilateral MOU with SEBI. This will increase the acceptance of Indian funds globally.

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