KHAITAN &CO ADVOCATES SINCE 1911

UPDATE

ERGO

Analysing developments impacting business

CLARIFICATION ON INVESTMENT IN OVERSEAS FUNDS

12 June 2024

Introduction

The Ministry of Finance, on 22 August 2022, notified the Foreign Exchange Management (Overseas Investment) Rules, 2022 (ODI Rules) to supersede the erstwhile regulations. Further, the RBI notified the Foreign Exchange Management (Overseas Investment) Regulations, 2022 (ODI Regulations) and the Foreign Exchange Management (Overseas Investment) Directions, 2022 (ODI Directions) to supplement the ODI Rules.

The new framework was introduced to: (i) simplify the overseas investment regime in the country; (ii) align it with the current business and economic dynamics of the country; and (iii) provide ease of doing business to Indian corporates and individuals. Keeping up with this notion, the Reserve Bank of India, on 7 June 2024, brought about two amendments to the ODI Directions by liberalising investment in overseas funds by Indian corporates and resident individuals.

Erstwhile Provision

As per the erstwhile provisions, overseas portfolio investment (OPI) (*including sponsor contribution*) into an overseas fund was permitted, subject to the following conditions:

- the investment could only me made in units of an overseas fund; and
- the overseas fund had to be regulated by the concerned financial regulator in the host jurisdiction.

Similarly, an unlisted entity could only make an OPI in units of an investment fund / vehicle in an International Financial Services Centre where such fund / vehicle was regulated.

Such a provision created ambiguity amongst investors and authorized dealer banks (AD Banks) on whether investment in funds that were, in substance, regulated but only through their fund manager, could be permitted. As such, investments opportunities in jurisdictions like Singapore and Delaware were automatically constrained, as in these jurisdictions it is the fund manager that is regulated instead of the fund itself. Owing to such restrictions, various new funds were formed in the Caymen Islands, Isle of Man and Mauritius to enable Indian investors to make investments in an overseas fund.

Separately, as overseas funds are usually set up as corporate bodies or partnerships and issue shares or membership respectively, investment in such funds became restrictive as investment in overseas funds could only be made in its units. However, recently certain

liberal AD Banks have taken a pragmatic approach and have permitted OPI in instruments other than the units of a fund, thereby creating a conundrum in the industry.

Analysis of the Amendment

The amendments to the ODI Directions have effectively removed both the conditions that the erstwhile provision imposed on Indian corporates and resident individuals for investment in overseas fund. The amended language of paragraph 1(ix)(e) of the ODI Directions, as stated in the amendment, is as follows:

> *"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. Accordingly, in jurisdictions other than IFSCs, listed Indian companies and resident individuals may make such investment. Whereas in IFSCs, an unlisted Indian entity also may make such OPI in units or **any other instrument** (by whatever name called) issued by an investment fund or vehicle, in terms of schedule V of the OI Rules subject to limits, as applicable.*
>
> *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**."*

Accordingly, OPI in an overseas fund that is regulated through their fund manager is now permitted. This opens a wide array of commercially favorable and stable jurisdiction such as Singapore and Delaware for making such investments. This will also provide opportunities for investors to invest in Variable Capital Company (VCC) funds in Singapore and Delaware, so long as the activities are permitted by a financial services regulator in that jurisdiction.

Separately, the amendments also provide flexibility with respect to the legal form of the fund. Now, investment in any form of fund (ie, corporate bodies or partnerships), is permitted. As OPI is no longer limited to only investments made into units of overseas funds, general partners now have the flexibility to set up funds as Limited Partnerships, VCC, body corporates, etc.

Overall, the amendment is a welcome move as the Indian investors will have a wide array of options for investment, thereby providing them access to a wider market. Further, several investors in the market who intended to make investments in overseas funds were plagued by the lack of clarity on the applicable laws for making such investment. The amendments will strengthen the investors' conviction in the foreign exchange regime and will enable them to venture into various investment opportunities overseas. While technically, the amendments resolve various ambiguities in the subject, there are still certain bottlenecks for opening investment wealth accounts by Indian listed entities, and the same should be addressed as well.

- *Moin Ladha (Partner) and Tanish Prabhakar (Senior Associate)*

For any queries please contact: editors@khaitanco.com