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Analysis



What's Holding Back Indian Fund Managers From Raising Global Capital?

Key Takeaways

- Indian fund managers, thus far restricted, may now be able to setup India-focussed offshore funds
- Is investment by resident individuals in offshore funds now restricted, even under LRS? Not quite – we address the ambiguity
- Will GIFT now emerge as the most favoured jurisdiction for setup of India-focussed funds?

Introduction

The Indian general partner/fund manager has been conspicuously absent from the global fundraising stage. Their constant challenge—accessing global capital either in India or through offshore funds, coupled with an overseas investment regime which has historically been one of the most restrictive amongst major fund jurisdictions.

While the introduction of new rules and regulations rolled out late into August 2022[1] should provide some much-needed relief to Indian fund managers, it also creates new obstacles, particularly for individual investors and for the fund managers who rely on them.

In this analysis, we explore the impact that the changes are likely to have on the Indian fund managers and set out a few solutions for policymakers to consider.

The Erstwhile Position

Indian fund managers have largely faced three challenges under the earlier overseas investment regime.

First, Indian GPs could not set up offshore funds investing into India due to the infamous 'round-tripping restriction, which prevented fund managers from making sponsor commitments into funds they set up—a typical skin-in-the-game requirement for such funds. The threat of round-tripping itself resided in the interpretation of the term 'bona fide investment': the RBI, in its various show causes notices against roundtripping structures took the position that the overseas investments regime was intended only for offshore investments, and therefore any investment back into India would not be 'bona fide'.

Second, any investment into a financial services entity, including funds, required regulatory approvals (and could only be done by a financial services entity), which approval practically never came if the offshore entity proposed to invest into India. Those that did setup offshore funds used complex structures such as an accommodating foreign party or an administrator that could setup and hold the offshore fund manager through self-managed vehicles – though this wouldn't work in jurisdictions like Singapore which required strict KYC compliances to setup and hold the fund management vehicle.

Third, offshore investors have historically shown little willingness to pool into Indian fund vehicles for several reasons, one key hesitation being the need to take Indian tax registration and subject themselves to Indian tax assessments.

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[1] Foreign Exchange Management (Overseas Investment) Rules, 2022 (ODI Rules) and the Foreign Exchange Management (Overseas Investment) Regulations, 2022.

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What Changed?

The new overseas investments regime provides solutions for at least two of these issues.

First, the overhang of 'round-tripping' is now gone – fund managers, and other investors, can now directly invest into funds which invest back into India. The new overseas investments regime defines 'bona fide investment' as any investment which is legal in the target country, thus allaying the RBI's own interpretation (which led to the prohibition on round-tripping).

Second, regulatory approvals for investment into financial services entities have also been dispensed with under the new regime, save for the requirement of a three-year profitability track record. The net-net effect of the deregulation is that Indian fund managers which are not regulated in India as financial services entities (e.g., advisory entities adivising offshore managers) can now setup offshore funds that invest back into India without any regulatory approvals.

These rather straightforward changes should provide a significant impetus to fund managers to now setup offshore.

Can Individuals Invest In Funds Under LRS?

Essentially, there are two routes under which individuals can invest overseas: (a) the ODI route, which applies to investments into unlisted equity; and (b) the OPI route, which applies to other investments which do not fall under the ODI route.[2]

Unfortunately, under the ODI route, individuals are not permitted to invest into financial services entities (which includes offshore funds)[3] without RBI approval. This brings us to the OPI route—in which investments cannot be into unlisted equity, while most offshore funds typically only issue either unlisted equity or equity-like instruments. Effectively, this closes the route for investment into offshore funds by individuals.

The only opening comes from the RBI's master directions, which provide that investment into 'units' of a fund is permitted, presumably where the fund is setup as a trust (since trusts typically issue units). Since most offshore funds are setup with equity-like structures,

[2] 'ODI' refers to Overseas Direct Investment, which covers unlisted equity investments. Equity capital has been defined to mean "equity shares or perpetual capital or instruments that are irredeemable or contribution to non-debt capital of a foreign entity in the nature of fully and compulsorily convertible instruments". 'OPI' refers to Overseas Portfolio Investment, which covers investment into non-debt instruments which are not unlisted equity. These include listed equity, investment fund units, mutual fund units, equity tranche of securitisation structure, etc.

[3] The test of a financial services entity under the ODI Rules is whether the entity being invested into would have been regulated by an Indian financial sector regulator if it had operated in India – funds in India are currently regulated by the SEBI (AIF) Regulations, 2012.

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individual investment into funds seems to be practically curtailed, and the RBI needs to clarify how individuals should proceed.

Is An Indian AIF Still Commercially required?

Indian fund managers have historically faced significant challenges while pooling offshore capital into Indian funds. Now, these fund managers will be able to pool offshore to invest both abroad and in India.

Unfortunately, Indian fund managers regularly rely on HNIs (high-net worth individuals) and family offices for investments—and it's likely that these GPs will continue to rely on them when building up corpuses for their new offshore funds. With HNIs unable to invest into offshore funds under the current scheme of the law, fund managers may still have to set up a domestic AIF for them, alongside a separate offshore fund for offshore investors.

Is GIFT City The Biggest Beneficiary?

GIFT City's biggest benefit has for long been the various tax holidays and exemptions which fund managers can avail but has been held back in large part by the applicability of restrictive overseas investment rules.

The new overseas investment regime should provide a much needed push to GIFT with the inclusion of specific dispensations. Namely, the three-year profitability track record condition (otherwise applicable) has been dispensed with for those setting up fund managers in GIFT, thus allowing even first time fund managers without a track record to also setup in GIFT.

Another overarching benefit for GIFT City is that Indian individuals (along with all other Indian residents) have been given a specific dispensation to invest into GIFT City under the OPI route, irrespective of whether fund is set up as an LLC, LLP or a trust.

The challenge however is that LRS and net-worth linked limits continue to apply for Indian investments into GIFT. If GIFT is to be a successful pooling jurisdiction, these should ideally be deregulated—investments from India into GIFT cannot be treated the same as investments into Singapore, for instance. Therefore, there is a need to either exempt investor-wise limits for investments at least into GIFT City.

A Few Thoughts For Regulators...

To expand globally, Indian fund managers will need the support of their historical bastions—the HNIs and family offices, and it falls upon the RBI to develop balanced solutions which enable Indian GPs to freely pool offshore from both Indian and offshore investors. This may entail placing repatriation requirements on individuals i.e., asking Indian individuals investing into offshore funds to repatriate, for example, 60% of their

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earnings (in exchange for the ability to freely invest within limits).

Similar balancing acts are also required for Indian investments into GIFT City, to truly set it apart from its global counterparts. Perhaps, in lieu of relaxed investment limits, GIFT funds may be similarly asked to invest a certain portion of their corpus within India.

Innovative solutions like these will truly place Indian GPs on the centre-stage and elevate domestic and offshore faith in GIFT City as a global funds jurisdiction. Towards this end, the RBI must continue treading on a multi-faceted footing, developing facilitative laws alongside regulators such as SEBI and the IFSCA.[4] Downstream, it's the Indian start-ups, founders, and Indian innovation which will benefit most.

[4] International Financial Services Centres Authority

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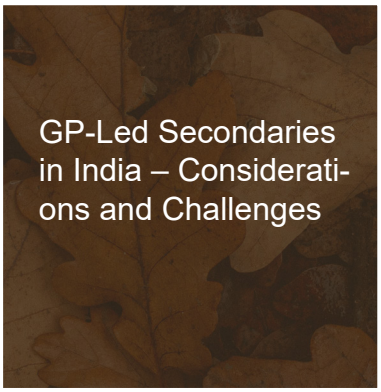

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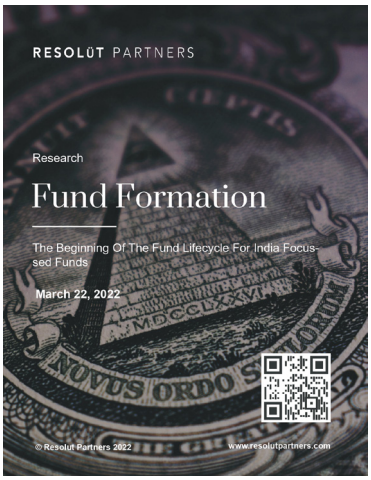



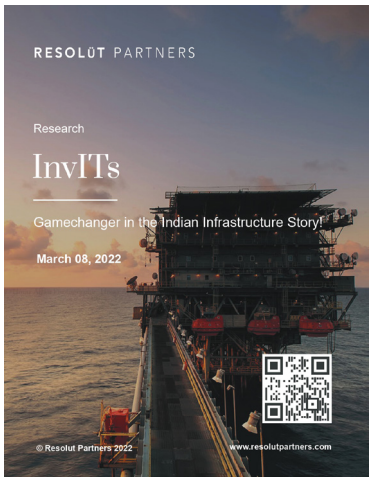

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