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PREFACE

Last year we reflected on how 2020 might primarily be remembered as the year of the novel covid-19 pandemic. A few events of global significance punctured covid-19's monopoly of economic news: the Democrats winning the White House; an 11th-hour 'deal' being reached between the European Union and the United Kingdom a mere week before the end of the transition period; and a wrong turn in the Suez canal. However, a year on and the pandemic continues to dominate the global geopolitical landscape and remains a source of significant uncertainty. While it is clear that 2021 was also overshadowed by the pandemic, successful vaccination campaigns appear to be providing fragile grounds for economic optimism in the near future. Yet unprecedented levels of government spending combined with labour shortages and supply chain disruption mean any recovery will have to grapple with rising inflationary pressures. In the asset management world, it is clear that the sector has faced one of its greatest and most sustained tests in recent history. The need for the industry to remain adaptable and resilient has perhaps never been greater.

Leaving all of this aside, though, the importance of the asset management industry continues to grow. Nowhere is this truer than in the context of pensions, as the global population becomes larger, older and richer, and government initiatives to encourage independent pension provision continue. Both industry bodies and legislators are also increasingly interested in pursuing environmental, social and governance (ESG) goals through private sector finance. This should not be a surprise: lack of shareholder engagement has been identified as one of the key issues that contributed to the governance shortcomings during the financial crisis. Given the importance of the asset management industry in investing vast amounts on behalf of clients, the sector is the natural focus of regulatory and governmental initiatives to promote effective stewardship and take the lead in instilling a corporate cultural focus on sustainability and ESG initiatives.

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. Operational resilience – a concept focused on ensuring asset managers' holistic preparedness against any risk event, particularly significant operational risks – continues to be a significant focus point for global regulators.

It is not only regulators who continue to place additional demands on the financial services industry: the need to rebuild trust has led investors to call for greater transparency around investments and risk management from those managing their funds. Senior managers at investment firms are, through changes to regulatory requirements and expectations as to firm culture, increasingly being seen as individually accountable within their spheres of responsibility. Industry bodies have also noted further moves away from active management into passive strategies, illustrating the ongoing pressure on management costs. This may, in itself, be storing up issues for years to come.

The rise of fintech and other technological developments, including cryptocurrencies, data analytics and automated (or 'robo') advice services, is also starting to have an impact on the sector, with asset managers looking to invest in new technologies, seeking strategies to minimise disruption by new entrants, or both. While regulators are open to the development of fintech in the asset management sector, they also want to ensure that consumers do not suffer harm as a consequence of innovations. Regulators across various jurisdictions launched the Global Financial Innovation Network, which aims to facilitate collaboration and communication between regulators regarding financial innovation and to create a cross-border sandbox in which firms can test their new technologies. This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements, and adapt to the changing geopolitical landscape and respond to the ongoing uncertainties brought about by the global pandemic. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself, and the global value of assets under management continues to increase year-on-year. The industry is not in the clear, but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the 11th edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank the team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that this edition of *The Asset Management Review* will be a useful and practical companion as we face the challenges and opportunities of the coming year.

Paul Dickson
Slaughter and May
London
August 2022

Chapter 8

INDIA

Ganesh Rao, Aditya Jha and Yash Bansal[1]

I OVERVIEW OF RECENT ACTIVITY

The regulatory regime governing pooled investment vehicles in India entails the Securities and Exchange Board of India (SEBI) acting as the securities markets' regulator, inter alia, as follows.

i Alternative investment funds

Alternative investment funds (AIFs) are governed under the SEBI (AIF) Regulations, 2012 (AIF Regulations). SEBI recognised the importance of and need for a patient source of active capital provided by investment funds as well as their role in the growth of the corporate sector and governance standards. Accordingly, the AIF Regulations were notified in 2012 with the aim to establish a sophisticated framework for governing the formation and operation of all kinds of private pools of capital of institutions and sophisticated investors.[2] As at 14 June 2022, SEBI has registered 956 AIFs,[3] which, as at 31 March 2022, have raised reported commitments of around 6.413 trillion rupees, an increase from around 6.091 trillion rupees as at 31 December 2021 and 4.419 trillion rupees as at 31 December 2020.[4]

ii Mutual funds

Mutual funds are governed under the SEBI (Mutual Funds) Regulations, 1996 (MF Regulations). Mutual funds are primarily targeted towards retail investors with prudential regulations seeking to regulate all kinds of risks. The assets under management (AUM) of the Indian mutual fund industry as at 31 May 2022 stood at 37.22 trillion rupees. The AUM of the Indian mutual fund industry has grown from 6.99 trillion rupees as at 31 May 2012 to 37.22 trillion rupees as at 31 May 2022, with more than a fivefold increase in a span of 10 years, and from 19.26 trillion rupees as at 30 April 2017 to 37.22 trillion rupees as at 31 May 2022, around a twofold increase in a span of five years.[5]

1 Ganesh Rao, Aditya Jha and Yash Bansal are partners at Trilegal.
2 Concept Paper on proposed AIF regulations, available at: https://www.sebi.gov.in/reports/reports/aug-2011/concept-paper-on-proposed-alternative-investment-funds-regulation_20484.html.
3 SEBI data relating to registered AIFs, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=16.
4 SEBI data relating to activities of AIFs, available at: https://www.sebi.gov.in/statistics/1392982252002.html.
5 Per the Association of Mutual Funds in India, information available at: https://www.amfiindia.com/indian-mutual.

iii Real estate investment trusts and infrastructure investment trusts

Real estate investment trusts (REITs) are governed under the SEBI (REIT) Regulations, 2014 (REIT Regulations) and infrastructure investment trusts (INVITs) under the SEBI (INVIT) Regulations, 2014 (INVIT Regulations).

SEBI notified the REIT Regulations and INVIT Regulations in 2014, as a step towards mitigating the high pressure on banks and non-banking finance companies (NBFCs), which are regarded as traditional sources of financing, for sectors such as infrastructure and construction, which require stable long-term 'patient' capital. As at 14 June 2022, there are four REITs[6] registered with SEBI and 18 SEBI registered INVITs.[7]

iv Collective investment schemes

Collective investment schemes (CISs) are governed under the SEBI (CIS) Regulations, 1999 (CIS Regulations). The CIS Regulations were notified in order to curb the growth of a number of unregulated private schemes in the 1990s.[8] However, the CIS regime in India has not gained any notable traction. From 1999 to date, there has been only one registration.[9]

Further, asset management activities in India also include providing management or advisory services on a bilateral basis mainly to retail investors. They are regulated by SEBI as follows:

a portfolio managers under the SEBI (Portfolio Managers) Regulations, 2020 (PMS Regulations) – as at 14 June 2022, there are 372 portfolio managers registered with SEBI;[10]

b investment advisers (IAs) under the SEBI (IA) Regulations, 2013 (IA Regulations) – as at 14 June 2022, there are 1,333 IAs registered with SEBI;[11] and

c research analysts (RAs) under the SEBI (RA) Regulations, 2014 (RA Regulations) – as at 4 June 2022, there are 878 RAs registered with SEBI.[12]

In relation to the offshore funds seeking to invest in India, they are permitted to participate in the listed and debt spaces in India as foreign portfolio investors (FPIs) under the SEBI (FPI) Regulations, 2019 (FPI Regulations). The FPI Regulations, notified in 2019, have overhauled the erstwhile SEBI (FPI) Regulations, 2014 by simplifying and rationalising registration requirements. As at 14 June 2022, there are 10,801 FPIs registered with SEBI.[13]

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6 SEBI data relating to registered REITs, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=42.

7 SEBI data relating to registered INVITs, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=20.

8 Dr Dave Committee Report on CISs, available at: https://www.sebi.gov.in/reports/reports/apr-1999/dr-s-a-dave-committee-final-report-on-collective-investment-schemes_23442.html.

9 SEBI data relating to registered collective investment management companies, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=36.

10 SEBI data relating to registered portfolio managers, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=33.

11 SEBI data relating to registered IAs, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=13.

12 SEBI data relating to registered RAs, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=14.

13 SEBI data relating to registered FPIs, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=29.

For offshore funds seeking to invest in the unlisted space in India, the foreign venture capital investors' (FVCI) route is a useful route available under the SEBI (FVCI) Regulations, 2000 (FVCI Regulations). However, at present, an FVCI is permitted to invest in only 10 sectors, including infrastructure. The number of FVCIs registered has marginally increased from 254 in 2020 to 270 as at 14 June 2022;[14] FVCIs and VCFs have seen a decrease from 2.720 trillion rupees in 2020 to 2021 to 2.242 trillion rupees in 2021 to 2022.[15]

Foreign direct investment (FDI) is investment through equity instruments by a person resident outside India in an unlisted Indian company, or in 10 per cent or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company. The FDI route does not entail registration with SEBI and offers greater variety in terms of sectors, albeit requiring prior government approval in certain cases. The FDI equity inflows were approximately US$58.77 billion in 2021 to 2022.[16]

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

SEBI acts as the primary regulator for all funds and asset management or advisory activities in India, in accordance with the SEBI Act, 1992 (SEBI Act).

However, the central government, together with the Reserve Bank of India (RBI), India's central bank constituted under the RBI Act, 1934, regulates foreign investment and exchange control. Although the SEBI, RBI and central government spheres are generally demarcated, the activity of a regulated entity may be overseen by multiple regulators if there is a cross-border element.

i AIFs

The AIF Regulations define an AIF as a privately pooled investment vehicle set up in India, which raises funds from investors, whether Indian or foreign, and invests in accordance with a defined investment policy for the benefit of its investors.

The AIF Regulations exclude funds regulated under the CIS Regulations, the MF Regulations and any other regulations issued by Indian regulators. The scope of AIFs excludes, inter alia:

a holding companies;
b family trusts; and
c employee welfare and gratuity trusts.

Although investors in an AIF could be domestic or foreign, each investor is required to commit a minimum of 10 million rupees, and an AIF is required to raise a minimum of 200 million rupees (with angel funds being allowed to have a minimum corpus of 50 million rupees) by way of commitment from its investors prior to commencing operations.

14 SEBI data relating to registered FVCIs, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=25.

15 SEBI data relating to industry-wide cumulative investment of VCFs and FVCIs, available at: https://www.sebi.gov.in/statistics/investment-details/archives.html.

16 Department for Promotion of Industry and Internal Trade – FDI statistics, available at: https://dpiit.gov.in/sites/default/files/FDI_Factsheet_March_2022_23May2022.pdf.

AIFs have been classified under the following three categories with the intention of distinguishing the investment criteria, as also providing an enabling framework for regulatory concessions, if any, which are or may be extended by the authorities:

a Category I AIF: subcategories include venture capital fund (VCF) (including angel funds), small and medium-sized enterprise (SME) funds, social venture funds, infrastructure funds and special situation funds;

b Category II AIF: this category includes funds that do not specifically fall under Category I or Category III and that do not undertake leverage or borrowing other than to meet their day-to-day operational requirements. Private equity funds and debt funds typically fall under this category; and

c Category III AIF: this category includes funds that employ diverse or complex trading strategies and may employ leverage, as well as listed focused funds.

An AIF cannot have more than 1,000 investors (in the case of an angel fund, 200). Notably, no regulatory or government approvals are required for foreign investors to invest in AIFs.

The manager or sponsor is mandated to invest in the AIF in order to provide some 'skin in the game'. This is set at the lesser of 50 million rupees (or 100 million rupees for Category III AIFs) or 2.5 per cent (or 5 per cent for Category III AIFs) of the corpus of the AIF. This is a continuing interest in the AIF and cannot be set off against management fees.

The AIF Regulations impose certain investment conditions on all AIFs, with additional conditions prescribed for each category or subcategory, including in relation to minimum diversification, conflicted transactions and borrowing limitations.

AIFs are required to file reports with SEBI on a regular basis and also when there are material changes in the information previously submitted to SEBI. The manager must prepare a compliance test report (CTR) – the CTR being an exhaustive reporting of compliance imposed by the AIF Regulations. Further, SEBI has recently (subject to limited exemptions) imposed a requirement to follow a prescribed format of the private placement memorandum (PPM) and the mandatory annual external audit of the compliance of the PPM. The AIF, the managers and the key management personnel of the AIF, along with the members of the investment committee, trustees, trustee company, directors of the trustee company, directors and designated partners of the AIF, have to comply with a set code of conduct recently introduced by SEBI.

The Indian government has also established the International Financial Services Centres (IFSC) called Gujarat International Finance Tec-City (GIFT City). GIFT City serves as a special economic zone, which is deemed to be an offshore jurisdiction. GIFT City aims to incentivise offshore pooling structures to be brought within the geographical boundaries of India. The IFSC Authority (IFSCA) has issued the IFSCA (Fund Management) Regulations 2022 (FME Regulations), which have been in effect since 19 May 2022. The FME Regulations, inter alia, supersede the existing framework for setting up AIFs in the IFSC (i.e., the AIF Regulations and the circulars issued by SEBI and IFSC in this regard). As at 9 June 2022, there are 32 registered AIFs with IFSCA.[17]

17 https://www.ifsca.gov.in/AlternativeInvestmentFund.

ii Mutual funds

Mutual funds in India are necessarily established as trusts. The MF Regulations set out the eligibility criteria and also prescribe the rights and obligations of the sponsor, trustee, manager and custodian, including the contents of the trust deed and the management agreement. The MF Regulations also govern the economics, including payment of dividends, redemptions and valuation, and mandate norms and caps on fees, expenses and commissions payable to intermediaries.

Mutual funds typically cater to retail investors (with limited exceptions for private placement for specified types of schemes) by raising money from the public through the sale of the units of its schemes. Mutual funds, being retail products, are highly regulated and the offer document is required to be detailed with extensive disclosures.

The MF Regulations place restrictions on the functioning and governance of the manager, requiring that at least 50 per cent of its directors be unconnected to the sponsor or the trustee. Specific mutual fund strategies including real estate and infrastructure debt have specific conditions that they need to comply with, which are in addition to the general conditions.

iii REITs and INVITs

REITs and INVITs came into force on the same day with common objectives and, accordingly, the regimes have been fairly similar.

A public offer is required to be made for the units of the REIT or INVIT by way of an offer document, which is scrutinised by SEBI. This document typically sets forth extensive disclosures. REITs and INVITs are not permitted to have multiple classes of units or schemes.

INVITs also have the flexibility to privately place their units through a private placement memorandum scrutinised by SEBI, subject to certain conditions. Such a private placement is required to be aimed at institutional investors and bodies corporate only.

The units of the REIT (including where privately placed) mandatorily need to be listed on a stock exchange in India, with a reduced minimum trading lot of 50,000 rupees for REITs; for INVITs (the privately placed units need not be listed), the minimum trading lot for privately placed units is 10 million rupees; and, otherwise, the minimum trading lot should fall in the range of 10,000 to 15,000 rupees. The REIT Regulations and INVIT Regulations prescribe the minimum offer size, the minimum public shareholding and the minimum number of investors.

Prior to the allotment of units, the sponsors are required to transfer (or so undertake) the underlying assets or their shareholding in the entity owning such assets. The value of the assets should not be less than 5 billion rupees.

Both regulations specify minimum standards of net worth, qualifications and experience for, and rights and responsibilities of, sponsors, the manager and the trustee, and also the rights and responsibilities of the trust's valuers and auditors. Additionally, the INVIT Regulations require a project manager to be appointed and also codify the responsibilities of such project managers who will undertake operations and management of the INVIT assets.

Further, not less than 50 per cent of the board of the managers of REITs or INVITs are required to be independent and cannot be on the governing board of the manager of any other REIT or INVIT, as applicable.

The rights of unitholders have been codified in the regulations, including stipulating high standards of affirmative voting.

iv CISs

A CIS includes any scheme or arrangement under which investor contributions are pooled with a view to earning profits and in which the assets are managed on behalf of the investors. The CIS Regulations were notified in order to curb the growth of a number of unregulated private schemes in the 1990s.[18] The CIS regime has not proven popular owing to the connected restrictions. From 1999 to date, there has been only one registration.[19]

v Portfolio managers

The PMS Regulations, among other things, prescribe qualification, experience and capital adequacy conditions for registration as a portfolio manager. The PMS Regulations require that the minimum investment amount for an investor be 5 million rupees and that certain prescribed provisions be incorporated in the contract with the clients. The regulations also place an obligation on the portfolio manager to seek prior approval from the board in cases of change in control.

The discretionary portfolio managers are permitted to invest funds of their clients in the securities listed or traded on a recognised stock exchange, money market instruments, units of mutual funds and other securities prescribed by SEBI. Portfolio managers offering non-discretionary or advisory services are permitted to invest or provide advice for investment for up to 25 per cent of the assets under management of such clients in unlisted securities, in addition to the securities permitted for discretionary portfolio management. The PMS Regulations were amended on 8 December 2021 to introduce co-investment portfolio managers. A co-investment portfolio manager is a portfolio manager who is a manager of a Category I or Category II AIF, or both, and provides services only to investors of such AIFs. Co-investment portfolio managers have been introduced to facilitate a co-investment framework in respect of AIFs and are granted certain relaxations in terms of compliances or prerequisites of a portfolio manager under the PMS Regulations.

vi IAs

The IA Regulations seek to regulate entities providing investment advice to clients and to protect investors from mis-selling.

The IA Regulations exempt other regulated entities or those who provide advice incidental to their main activity from the requirement to procure registration in addition to the exemption to persons solely advising foreign clients.

To protect retail investors, the IA Regulations stipulate capital adequacy norms and other eligibility criteria, including qualification and certification requirements that require designated persons to pass National Institute of Securities Market examinations.

IAs that are non-individuals must have a net worth of not less than 5 million rupees; for individuals the amount is 500,000 rupees. IAs are required to assess the suitability of advice being provided and, to this end, are required to undertake risk profiling of each client. As with investor protection regulations in India, the IA Regulations also have extensive provisions on activity segregation, disclosure, management of conflicts of interest and implementation

18 Dr Dave Committee Report on CISs, available at: https://www.sebi.gov.in/reports/reports/apr-1999/dr-s-a-dave-committee-final-report-on-collective-investment-schemes_23442.html.

19 SEBI data relating to registered CISs, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=36.

services to the advisory clients in the securities market. The IA Regulations mandate that an agreement be entered into between the IA and the client for ensuring greater transparency with reference to advisory activities.

vii RAs

SEBI issued the RA Regulations to register and regulate dissemination of research analysis and reports (and recommendations) relating to listed or to be listed securities, which apply to proxy advisers as well. A person primarily responsible for, inter alia, making 'buy, sell and hold' recommendations would qualify as an RA.

Exemptions from registration as an RA have been provided to certain entities registered with or regulated by SEBI. However, if such persons issue research reports to the public, they have to adhere to some obligations under the RA Regulations, including on potential conflicts of interest, segregation of research activities and disclosures.

viii Offshore funds

All foreign investment in India is subject to the Foreign Exchange Management Act, 1999, its subordinate regulations (FEMA Regulations) and circulars issued by the government and the RBI. These regulations govern various aspects of foreign investment, including entry routes, sectoral restrictions and pricing guidelines. The government notified the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (NDI Rules), on 17 October 2019, superseding the erstwhile Foreign Exchange Management (Transfer of Issue of Security by a Person Resident outside India) Regulations, 2017. The NDI Rules also govern foreign investment into Indian AIFs.

As is discussed in Section I, an offshore fund seeking to make listed portfolio investments and investment in non-convertible debentures requires an FPI registration for which it must satisfy the prescribed eligibility criteria, including not being a resident of certain countries (such as those identified by the Financial Action Task Force as having deficient systems or not being signatories to the International Organization of Securities Commissions' multilateral memorandum of understanding).

An FPI's or an FPI group's listed equity holding is required to be less than 10 per cent of the total equity on a fully diluted basis of the company.

Additional permissible investments include mutual funds and CISs, derivatives and any debt securities or other instruments permitted by the RBI.

Offshore funds seeking to primarily invest in the unlisted space may choose to seek registration as an FVCI under the FVCI Regulations owing to certain benefits accorded to FVCIs that are not available to FDI investors, which include free entry and exit pricing, exemptions from certain lock-in and public offer requirements, and a broad range of permissible instruments, including debt. This is, however, limited to 10 sectors, and investments outside of these sectors must be made under the FDI route or through one of the other routes discussed above.

FVCIs are, however, subject to certain investment conditions, including investing at least 66.67 per cent of their funds in unlisted equity or equity-linked instruments. FVCIs are permitted to invest in start-ups and are permitted to invest in 10 sectors.

III COMMON ASSET MANAGEMENT STRUCTURES

As per the AIF Regulations, although Category I and Category II AIFs can be only closed-ended funds, Category III AIFs can be either closed-ended or open-ended. The AIF Regulations prescribe a minimum tenure of three years for Category I and II AIFs, with SEBI further mandating that the end of the tenure must be calculated from the final closing date of the AIF. Furthermore, the tenure of any AIF can be extended up to two years with the approval of 66.67 per cent of the unitholders by value of their investment in the AIF, and in cases in which an AIF is a large value fund for accredited investors, the tenure can be extended as mutually agreed with investors and as provided in the placement memorandum.

As regards the legal form, the AIF Regulations contemplate the establishment of the AIFs in the form of a trust, a company, a limited liability partnership (LLP) or a body corporate. However, most of the AIFs in India are typically set up in the form of trusts on account of certain legal, regulatory and tax reasons.[20]

Offshore investors may make investments in Indian AIFs (including through offshore feeders or feeders established in GIFT City) or directly in the Indian portfolio companies by setting up offshore pooling vehicles or by way of co-investment structures wherein two separate pools of capital for domestic investors and for offshore investors are intended to be raised and the investment management team is based in India.

IV MAIN SOURCES OF INVESTMENT

As at 31 March 2022, AIFs had raised commitments of about 6.413 trillion rupees. Category II AIFs alone accounted for about 80 per cent of this amount.[21] Despite the covid-19 pandemic, in 2021, there was a strong deal volume flow with a 5 per cent year on year increase despite a slowdown in the total value of investments.[22]

As at 31 May 2022, the AUM of the Indian mutual fund industry stood at 37.22 trillion rupees.[23] Although individual investors hold 55 per cent of industry assets, institutional investors account for 45 per cent of the assets, of which corporates account for 95 per cent and the rest being divided between Indian and foreign institutions and banks.[24] The net outflows under the FPI route is around 852 billion rupees as at 15 June 2022, out of which around 126 billion rupees outflow is in debt.[25]

20 As at 8 June 2022, out of the 950 AIFs registered with SEBI, only 23 were formed as LLPs and three as a company, with the remaining being registered as trusts, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=16.

21 SEBI data relating to activities of AIFs, available at: https://www.sebi.gov.in/statistics/1392982252002.html.

22 India Private Equity Report 2021, Bain and Co, available at: https://www.bain.com/globalassets/noindex/2021/bain_report_india_private_equity_report_2021.pdf.

23 Per the Association of Mutual Funds in India, information available at: https://www.amfiindia.com/indian-mutual.

24 AMFI data relating to mutual funds, available at: https://www.amfiindia.com/Themes/Theme1/downloads/home/Industry-Trends.pdf.

25 NSDL data, available at: https://www.fpi.nsdl.co.in/web/Reports/Yearwise.aspx?RptType=5.

V KEY TRENDS

Despite the poor economic situations because of the global pandemic that began in 2020, the Indian investment market still managed to close the decade on a noteworthy record. Owing to covid-19, there has been a swift transformation into a more technology-driven world, leading to soaring investments in various sectors such as education technology, financial services and life sciences, over the traditional sectors for private equity (PE)/venture capital (VC) investors such as infrastructure and real estate, among others.

Total PE/VC investment activity in 2021 was at US$77.1 billion, a 62 per cent increase over 2020 levels. The PE asset class (excluding infrastructure and real estate) demonstrated growth of 79 per cent. Although three sectors – technology US$16.3 billion, e-commerce US$15.9 billion and financial services US$11.7 billion – accounted for 57 per cent of the total PE/VC investments by value, many sectors, such as media and entertainment, education, pharmaceuticals and healthcare, showed significant growth. For the first time ever, 14 sectors notched up PE/VC investments exceeding US$1 billion.[26]

The number of active PE funds continued to grow in 2020, with global and domestic general partners (GPs) making up the bulk at 60 per cent, followed by limited partners (LPs) (i.e., institutional investors and government affiliates) and corporates. As more funds increase focus towards India, over 70 per cent of investors concur that global PE firms and LPs/sovereign wealth funds investing directly are the biggest competitive threat. Growing investor confidence in the Indian market is visible because of the increasing penetration of major GPs and LPs into India's deal value.[27]

Fund structuring seems to have become far simpler today in light of the liberalised investment and tax regime for AIFs, and given predictability over the past few years, a number of offshore investors seem to have started considering direct participation in the onshore pool, rather than investing via an offshore feeder.

The government, in its capacity as an anchor investor, has established a collaborative investment platform, namely the National Investment and Infrastructure Fund, for international and Indian investors looking for investment opportunities in infrastructure and other high-growth sectors of the country, which includes a fund of funds programme that has emerged as a significant domestic LP. Further, the Small Industries Development Bank of India has been investing in various AIFs to promote and accelerate the growth of start-ups and micro enterprises, as well as SMEs in India.

Sebi is increasing its oversight on AIFs given the pace of growth clocked by the industry, and with an aim to ensure that AIFs are being properly managed and operated and that there is no mis-selling. There is also an annual PPM audit requirement, and all filings with SEBI for seeking approval of AIFs are now required to be done through a merchant banker.

Recently, SEBI issued guidelines for large value funds (AIFs) for accredited investors (a class of those investors who are considered well-informed about the investment products) where certain relaxations have been provided such as in terms of diversification requirements and tenure of these funds, subject to certain declarations being provided by the chief executive officer (or a person holding an equivalent role or position) and compliance officer of the manager of such AIFs.

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26 PE/VC Agenda India Trend Book 2022, IVCA & EY, available at: https://assets.ey.com/content/dam/ey-sites/ey-com/en_in/news/2022/03/ey-pe-vc-india-trend-book-2022.pdf.

27 India Private Equity Report 2021, Bain and Co, available at: https://www.bain.com/globalassets/noindex/2021/bain_report_india_private_equity_report_2021.pdf.

VI SECTORAL REGULATION

i Insurance

The Insurance Regulatory and Development Authority of India (IRDAI) regulates the insurance industry in India in accordance with the Insurance Act, 1938, and IRDAI Act, 1999.

Insurance companies are permitted to invest in Category I and II AIFs. However, in the case of Category II AIFs, a minimum of 51 per cent of the funds of these AIFs are required to be invested in the infrastructure entities, SME entities, VC undertakings or social venture entities. As a general rule, AIFs that an insurance company is invested in are not permitted to invest in securities of companies incorporated outside India. The sponsor of the AIF that an insurance company is invested in is not permitted to be a part of the promoter group of the insurance company.

Investment in an AIF by an insurance company is subject to a maximum of the lower of overall exposure to AIFs of 3 per cent by a life insurance company and 5 per cent by a general insurance company, or up to 10 per cent of the size of the AIF (20 per cent for an infrastructure fund).[28]

IRDAI recently also allowed insurance companies to diversify and expand their investment portfolio by investing in (1) AIFs that undertake leverage in accordance with the AIF Regulations and (2) fund of funds subject to certain prescribed conditions, thus opening up opportunities for the AIF managers and its investors.[29]

ii Pensions

Pension funds in India are governed by the Pension Fund Regulatory and Development Authority (PFRDA) in accordance with the PFRDA Act, 2013.

Pension funds are permitted to invest in Category I and II AIFs. However, in the case of Category II AIFs, a minimum of 51 per cent of the funds of the AIFs are required to be invested in the infrastructure entities or SMEs or VC or social welfare entities. Further, a pension fund shall invest only in AIFs whose corpus is 1 billion rupees or more and that have a minimum rating of AA and above, except for government-owned AIFs. The exposure to a single AIF shall not exceed 10 per cent of the AIF size. AIFs in which a pension fund is invested are not permitted to invest in securities of the companies or funds incorporated and operated outside India. The sponsor of such an AIF should not be the promoter in the pension fund or the promoter group of the pension fund.[30]

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28 IRDAI Investments – Master Circular, Version – 02, dated May 2017, available at: https://irda.gov.in/ADMINCMS/cms/whatsNew_Layout.aspx?page=PageNo3146&flag=1.6.

29 Investments in AIF – Circular, dated April 2021, available at: https://www.irdai.gov.in/ADMINCMS/cms/whatsNew_Layout.aspx?page=PageNo4441&flag=1.

30 SEBI Circular No. PFRDA/2016/8/PFM/02, dated 8 April 2016, available at: https://www.pfrda.org.in/writereaddata/circulars/aif8e56d8df-6719-4d49-8e3e-09ee444ad220.pdf.

iii Real property

The Real Estate (Regulation and Development) Act, 2016 (RERA), enacted by the Indian Parliament, has revolutionised the real estate sector in India. The RERA mandates setting up an independent regulatory authority and requires mandatory registration of all real estate projects (residential and commercial) with the respective authority, subject to certain exceptions.

With a robust regulatory framework as the backdrop, investors have shown an inclination towards the Indian funds making investments in the real estate sector. The investments by the Indian funds in the real estate sector are majorly governed by the AIF Regulations, REIT Regulations, MF Regulations (i.e., for real estate mutual funds) and CIS Regulations, as is discussed under Section II.

iv Hedge funds

As is discussed in Section II, hedge funds established in India are required to be registered as Category III AIFs with SEBI. Such funds may also undertake leverage subject to the consent of their investors and subject to a maximum limit as may be prescribed by SEBI.

Additionally, hedge funds formed outside India and that seek to invest in Indian listed securities or derivatives segments are required to register themselves as FPIs with SEBI.

v Private equity

As is discussed in Section II, PE funds in India are generally required to be registered as Category II AIFs with SEBI. As regards the offshore PE funds, these can invest in India through FDI and FVCI investment routes, as is discussed under Sections I and II.

vi Other sectors

Banks are not permitted to invest more than 10 per cent of the paid-up capital or unit capital of a Category I or II AIF unless otherwise approved by the RBI. Further, the threshold for investments in Category I and II AIFs has been capped at 20 per cent of the bank's net worth permitted for direct investments in shares, convertible bonds and debentures, units of equity oriented mutual funds and AIFs. Banks are not allowed to invest in Category III AIFs.[31] Any sponsor contribution from an Indian entity to an AIF set up in an overseas jurisdiction, including IFSCs in India, as per the laws of the host jurisdiction, will be treated as overseas direct investment.[32]

NBFCs, regulated by the RBI, are also utilised by the asset managers for making investments. Further, asset reconstruction companies (ARCs) are empowered by the RBI to raise funds by issuing security receipts to qualified institutional buyers through securitisation trusts. Such ARCs can be used to purchase certain kinds of debt, including loans, and then work towards recovery of the debt through financial restructuring and working with management, etc.

31 RBI Circular RBI/2017-18/66 DBR.No.FSD.BC.89/24.01.040/2017-18, dated 25 September 2017, available at: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11129&Mode=0.

32 RBI Circular, RBI/2021-22/38, dated 12 May 2021, available at: https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=12092&Mode=0.

VII TAX LAW

The taxation mechanism in India is governed by the Income-tax Act, 1961 (Tax Act).

The Tax Act accords 'tax pass-through' status to Category I and II AIFs in respect of all the streams of income received by the AIF (other than income chargeable as 'profits and gains of business or profession'). This income is taxable in the hands of the investors in the AIF in the same manner as if it were the income accruing to, or received by, the investors had they invested the money directly. If the income of the AIF is characterised as 'business income', the income should be taxable at the maximum marginal rate. Further, the provisions of the General Anti-Avoidance Rule (GAAR) provided under the Tax Act are applicable to any transaction undertaken on or after 1 April 2017. As per the Tax Act, GAAR may be invoked if any arrangement is found to be an impermissible avoidance arrangement (i.e., if the main purpose of the arrangement is to obtain a tax benefit and that satisfies certain tests provided in the Tax Act).

Category III AIFs (if set up as trusts) may rely on the general principles of trust taxation and the judicial precedents in this regard to achieve tax transparency or pass-through status. The taxation of offshore investors in the AIF is governed by the provisions of the Tax Act read with the provisions of the double taxation avoidance agreement (DTAA) between India and the country of residence of such an offshore investor (subject to such an offshore investor fulfilling certain stipulated substance requirements). As a general rule, the provisions of the Tax Act are applicable to the extent that they are more beneficial than the provisions of the applicable DTAA.

Furthermore, the Tax Act provides for a levy of minimum alternate tax (MAT) on the income received by corporates at 15 per cent (plus applicable surcharge and cess). However, the MAT provisions are not applicable to a non-resident provided that (1) the assessee is a resident of a country with which India has a DTAA and the assessee does not have a permanent establishment in India or (2) the assessee is a resident of a country with which India does not have a DTAA and is not required to seek registration under the Indian corporate law.

As regards the taxation of the managers of the AIF on the management fee received for providing investment and management services to the AIF, other than direct taxes applicable on this income, goods and services tax (GST) is applicable at the rate of 18 per cent. Also, in addition to the management fee, 'carried interest/additional return' is typically paid to the manager or sponsor of an AIF as its profit share. Under Indian tax laws, carried interest, if received as a performance fee, is taxable in a similar way to the management fee. However, the managers may potentially take recourse to certain tax-efficient structures to classify this income as their return on investment made in the AIF. Recently, the Customs Excise and Service Tax Appellate Tribunal, Bangalore Bench[33] held that 'carried interest' to the manager and other expenses incurred by the VCF in the course of its operations are in the character of service income of the trust or VCF and accordingly taxed under the service tax regime. Such a recognition might have an impact under the GST regime (since provisions have largely been carried forward). This decision is being closely watched by the Indian PE/VC industry.

33 Order dated 1 July 2021 in *ICICI Econet and Internet Technology Fund v. Commissioner of Central Tax* (Service Tax Appeal No. 2900 of 2012).

VIII OUTLOOK

Over the past few years, a special committee set up to advise on matters relating to alternative investment, the Alternative Investment Policy Advisory Committee (AIPAC), has submitted reports on various policy reforms required to strengthen the alternative investment framework in the country, including the following recommendations made in July 2018:

a exemption from GST (at 18 per cent) for AIFs with 100 per cent foreign investment and India-based management operations;

b certainty on long-term capital gains tax treatment for carried interest; and

c investment in AIFs should count towards corporate social responsibility spends (which are currently mandated under Indian company law).

In the past, a number of recommendations made by the AIPAC have served as the base for regulatory reform, and therefore it may well be worth monitoring the foregoing.

Recently, a new regulatory framework relating to AIFs set up in IFSC has been introduced. This is a good step towards making AIFs in GIFT City more lucrative to investors.

Appendix 1

ABOUT THE AUTHORS

GANESH RAO

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Ganesh Rao specialises in asset management and funds. In addition to his core practice advising general partners, he regularly acts as counsel to LPs (including DFIs, pensions funds, corporations and family offices) on their investments in private funds and other investment programmes.

He has been recently featured as one of '40 under 40' India Inc's Top Young Leaders 2021 by the *Economic Times* in association with Spencer Stuart. He has been ranked as 'Band 1' in investment funds by *Chambers Asia-Pacific* in 2021. He is an Asia Pacific Regional Forum Liaison Officer of the Asset Management and Investment Funds Committee of the International Bar Association (2022). He is also recognised as a distinguished practitioner under the investment funds category by *Asialaw Profiles 2022.* In 2018, the Association of International Wealth Management of India (AIWMI) and the Indian Association of Alternative Investment Funds (IAAIF) recognised Ganesh as one of the '40 under 40' alternative investment professionals in India. He has been recognised as one of India's Future Legal Leaders by the IBLJ.

ADITYA JHA

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Aditya Jha specialises in asset management and funds. In addition to advising institutional GPs and first-time GPs, Aditya also extensively advises LPs, DFIs, family offices and fund of funds on their investments into private or alternative asset funds, including secondaries. His practice expertise includes advising on financial services, financial regulatory and securities laws, including on in-bound and out-bound investment structures and strategies.

Aditya was called 'Up-and-Coming' in investment funds by *Chambers Asia-Pacific in* 2021 and 2022. He has been listed as one of three 'Next Generation Partners' for investment funds by *The Legal 500* (2021 and 2022). He has also been recognised as one of 'India's Future Legal Leaders' by the *International Business Law Journal*, a Rising Star in *Asian Legal Business*'s 2020 edition, and featured as one of the top '40 under 40' alternative investment professionals in India by the Association of International Wealth Management of India (AIWMI) and the Indian Association of Alternative Investment Funds (IAAIF) for 2019. He is also noted for private funds by *Who's Who Legal* (2022).

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Yash Bansal is a partner and part of the corporate practice group specialising in asset management and funds.

Aside from investment funds, his practice expertise includes securities laws and exchange control laws. In addition to advising GPs on structuring and formation of investment funds and other asset management platforms, he has represented institutional LPs, DFIs and family offices on their commitments to investment funds in India as well as offshore. Yash regularly advises clients on inbound investment structuring.

Yash is recognised as one of the top '40 under 40' alternative investment professionals in India by Equalifi (erstwhile Association of International Wealth Management of India (AIWMI)) 2022.

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