Post-Election Prognosis of the Regulatory Landscape in India for Fund Managers

By Pallabi Ghosal, Partner and Ananya Sonthalia, Senior Associate, with assistance provided by Vividha Bawa, Associate at AZB & Partners

Introduction

India, the largest democracy in the world went into general elections in May 2019. The outcome of the election was a landslide victory for the incumbent government.

Budget 2019: Major Reforms

The first budget of the Modi 2.0 government was presented in the backdrop of prevailing challenges being faced by the economy such as economic slowdown, glut in the real estate sector, growing stressed and non-performing asset situation with respect to banks and non-banking financial companies. The budget sought to address a number of the issues concerning the Indian economy and several of these initiatives have been already implemented and some remain a work in progress. This article seeks to provide a snapshot of the regulatory reforms being undertaken specifically which impact the asset management industry in India.

FPI Version 2.0

Foreign Portfolio Investors (FPI) are a large source of capital and accounted for INR389.3 billion[1] investment in the last financial year. FPIs are governed by the Indian securities regulator, the Securities and Exchange Board of India (SEBI) and are typically categorized into three categories: (i) category I FPIs such as sovereign wealth funds, government agencies, banks, and multilateral organizations; (ii) category II FPIs which are appropriately regulated broad based funds, such as mutual funds, investment trusts, and insurance/reinsurance companies (the requirement to have at least 20 investors with no single investor holding more than 49% interest in the fund being the "Broad Based Criteria"); and (iii) category III FPIs which are the residuary category.

With a view to easing 'doing business in India' and encourage FPIs to invest more in India, SEBI had set up a working group under the chairmanship of Shri. H.R. Khan, Deputy Governor (Retired), Reserve Bank of India to make recommendations inter-alia with respect to FPI registration process, know your client (KYC) and simplification of documentation, investment restrictions and other aspects. SEBI approved several of these recommendations in its board meeting in August 2019. Some of the key changes highlighted in the SEBI board meeting are as follows:

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1. https://www.fpi.nsdl.co.in/web/Reports/Yearwise.aspx?RptType=5

- Simplification of KYC documentation requirements: subject to requirement to disclose under Indian law, custodians are permitted to rely on non-permanent account number (PAN) related KYC carried out by their group entity, if such group entity is regulated and is located in a Financial Action Task Force member country.
- Re-categorisation of FPIs: while several recommendations were made by the committee to revise the eligible category for registration for various FPI entities based on their risk profile, the board meeting highlighted that there would be re-categorisation of FPI categories to only two categories of FPIs.
- Doing away with the Broad Based Criteria: the Broad Based Criteria was reviewed, and it was recommended that the broad basing should be on the basis of economic ownership interest either by way of holding units/shares or other instruments. However, basis comments from market participants, SEBI has done away with the entire concept of Broad Based Criteria.
- Simplification of registration of multiple investment manager (MIM) structures (i.e., same legal entity obtains multiple registrations with multiple investment managers): the recommendation was that in case of incremental FPI registration, the entity need not provide registration and KYC related details again for the subsequent registrations. This amendment is expected to reduce registration timelines for additional accounts under MIM structure.
- Permitting FPIs to do off-market transfer of securities which are unlisted, suspended or illiquid to a domestic or foreign investor: currently, FPIs are permitted to undertake transactions only through stock brokers. Hence, this restricts ability of FPIs to sell unlisted, suspended, or illiquid securities held by them. In order to facilitate sale of such securities, FPIs have been permitted to transfer such securities off market.

Other than the changes highlighted in the SEBI board meeting, a few other proposals were also made in the budget speech such as: (i) FPIs being permitted to invest up to the sectoral foreign investment limits against the statutory limit of twenty-four percent of the paid-up share capital in a company; and (ii) clubbing of the Non-Resident Indian (NRI) portfolio investment scheme route with the FPI route which currently is a separate route for investment into India and restricts NRI investments to not more than five percent of the paid-up share capital in a company and along with overseas citizens of India to not more than ten percent of the paid-up share capital in a company. It is expected that these proposals will also find their way into the revamped FPI Regulations, which are to be released soon.

A key development post the budget speech was the levy of a surcharge as high as thirty-seven percent on income earned by non-residents being "individuals, association of persons, body of individuals, incorporated or not, or every artificial juridical person". This surcharge directly impacted income earned by FPIs which resulted in withdrawal of more than USD 3.4 billion[2] and was eventually withdrawn in late August 2019.

These developments related to FPIs are expected to give a much-needed impetus to FPI investments and make India an attractive destination for investments via the FPI route.

AIFs are the Way to Go

Recent years have seen a phenomenal increase in the number of alternative investment funds (AIFs) being set up and seeking registration with SEBI for the purpose of investing and deploying capital in India. Many global fund managers have set up permanent offices in India and, as part of their India strategy, are setting up AIFs for onshoring their offshore capital and thereby, undertaking fund management locally. Also, India-based fund managers who otherwise advised offshore pools of capital have set up AIFs to pool capital in India.

The current regulatory framework for AIFs categorizes AIFs into three categories depending on the investment objective and strategy, viz., (i) category I AIFs which seek to invest in venture capital, infrastructure, small and medium enterprizes or social ventures and includes angel funds, a sub-category of venture capital funds which seek to invest in venture capital undertaking/start-up within the turnover thresholds prescribed under the AIF regulations; (ii) category II AIFs which are sector agnostic and can invest primarily in unlisted securities; and (iii) category III AIFs which seek to invest in listed or unlisted securities, derivatives or complex and structured products.

In a step towards recognising the importance of AIFs in capital and wealth creation, key tax incentives were given to AIFs which were eagerly awaited. These include:

- Permitting pass through of losses for category I and category II AIFs, if such losses are not losses on account of business income and if the units have been held by the unitholders for at least one year – till now, only pass through of profits was permitted to unit holders of category I and category II AIFs and losses had to be carried forward and set-off against the profits.
- Exemption from taxation of companies in respect of consideration received for issue of shares, in excess of the fair market value of such shares if such consideration was received from venture capital fund has now been extended to category I AIFs and category II AIFs.

2. https://www.livemint.com/news/india/fpi-surcharge-removal-stimulus-measures-likely-to-boost-markets-experts-1566732332264.html

> "While the government has taken certain steps in the right direction in order to promote the fund management industry and recognize the importance of AIFs as important contributors to wealth creation, the steps can at best be described as consolatory and leave a lot to be desired."

These tax incentives were a welcome move for the AIF industry. However, status quo was maintained in respect of two key reforms which have been long awaited by the AIF industry, namely, grant of tax pass-through status to category III AIFs and reduction of goods and services tax on the management fee charged by fund managers which is currently at 18%.

IFSC Related Incentives

The government introduced an International Financial Services Centre (IFSC) in Gift City, Gujarat. In March 2015, SEBI had issued guidelines for facilitating and regulating financial services relating to the securities market in an IFSC. The primary advantage of setting up businesses in IFSC was the multitude of benefits such business units received in respect of tax.

In order to operationalize the guidelines relating to the securities market in IFSC, SEBI in 2018 released the operating guidelines for AIFs set up in IFSC (IFSC AIF). Some of the key features of IFSC AIF, inter alia, are: (i) IFSC AIFs can pool capital from a person resident outside India, NRI, institutional investors resident in India and RI, subject to extant exchange control regulations; (ii) IFSC AIFs are permitted to invest in companies incorporated outside India or in India, companies incorporated in IFSC, or securities listed in IFSC; and (iii) investments by IFSC AIF can be made under FPI, foreign direct investment or foreign venture capital investment route. Recently, the scope of permissible investments for IFSC AIFs has been widened. They are now permitted to make investments in such entities as are permissible to domestic AIFs set up outside IFSC, such as, limited liability partnerships, real estate investment trusts, infrastructure investment trusts.

The key benefits available to IFSC AIFs and managers of IFSC AIFs are as follows: (i) tax risks associated with general anti avoidance rules, permanent establishment and place of effective management that surround any offshore structures put into place by Indian fund managers managing/advising on offshore pool of capital could be mitigated; (ii) AIF managers set up in IFSC could avail the benefit of exemption of goods and services tax on the management fee earned from the AIFs for managing pools of capital; and (iii) AIF managers would be eligible to avail income tax holidays for up to 100% of their income for first five years and thereafter, up to 50% of their income for the next five years, provided that AIF managers are able to build commercial substance in IFSC for claiming such tax benefits. With a view to further incentivize business in IFSC, now, the tax holidays available to units in IFSC have been further liberalized for up to 100% of their income for ten consecutive years, which can be claimed by the unit at its option, for any consecutive ten year period within fifteen years from commencement. Further, units in IFSC can now avail exemption from dividend distribution tax if such distribution is made out of accumulated profits (earlier, exemption was available only if such distribution was made from current income).

Earlier, a non-resident was not required to pay capital gains tax on transfer of securities such as bonds, global depository receipts, and rupee denominated bonds made on stock exchange in IFSC. Derivatives have now been included as a specified security to claim exemption and this benefit has now been extended to category III AIFs set up in IFSC.

While these initiatives give impetus to offshore funds and AIFs to migrate to IFSC, the lack of adequate infrastructure in Gift City, Gujarat poses practical challenges for fund managers. Also, gaps in regulations and regulatory uncertainty is causing fund managers to take a 'wait and watch' approach.

Given that: (i) the IFSC regime is in a nascent stage and remains untested, and (ii) investors in IFSC AIFs will be considered as resident tax payers, investors are currently wary of investing in IFSC AIFs.

Conclusion

While the government has taken certain steps in the right direction in order to promote the fund management industry and recognize the importance of AIFs as important contributors to wealth creation, the steps can at best be described as consolatory and leave a lot to be desired. Reacting to a slowing economy, very recently the Indian government reduced corporate taxes but this piecemeal approach keeps the industry in uncertainty which makes it difficult for fund managers to raise capital, particularly offshore capital. The need of the hour is to streamline the legal, regulatory and tax landscape in the country to avoid making continuous changes. This will give stability to the various routes of investment available today and attract more foreign capital for fund managers to manage.

About the Authors

Pallabi Ghosal is Partner at AZB & Partners

Ananya Sonthalia is Senior Associate at AZB & Partners