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IVCA
INDIAN PRIVATE EQUITY
& VENTURE CAPITAL ASSOCIATION

Fund Structuring & Operations

Global, Regulatory and Tax developments impacting India focused funds

January 2015

Message from the President, Indian Private Equity & Venture Capital Association (IVCA)

The beginning of 2014 saw investor interest return for India risk. The post-election optimism led to increased fund raising for India allocations. If 2014 can be taken as a sign of things, India focused funds are in for an interesting mix in 2015.

While there are several aspects that global investors look for when selecting the fund manager, the GPs are actively seeking to develop bespoke structures, offer fund terms that facilitate alignment of interest with the investors and create liquidity opportunities. The industry however seems to facing increasing tax and regulatory challenges.

Against this backdrop, Indian Private Equity and Venture Capital Association (IVCA), a member-based national organization promotes private equity and venture capital in India and encouraging investment in high growth companies.

Nishith Desai Associates is a research-based Indian law firm that pioneered and continuously innovates fund industry structures. IVCA, jointly with Nishith Desai Associates is bringing out this compilation for the benefit of participants and industry members.

Fund Structuring & Operations features views and insights from Nishith Desai Associates on designing India focused funds. The compilation also includes guidance on fund terms, tax and regulatory aspects that impact the fund management industry.

I hope you will find this compilation helpful.

With best wishes

Arvind Mathur

President, Indian Private Equity & Venture Capital Association

Dear Friend,

The funds industry in India has seen momentous uptick with newly elected government led by Prime Minister Mr. Narendra Modi. The current pro-business environment being ushered in, has led to optimism from foreign investors towards the India story.

The investor appetite for India risk has been robust and that led to healthy fund raising for several tier 1 GPs with track records. If 2014 can be taken as a sign of things, India focused funds are in for an interesting mix in 2015. The extent of fund raising in 2nd half of 2014 has led to a dry powder overhang across the different investment strategies. 2015 should see fund managers with increased focus on deployments and secondary transactions.

The new government is committed to establishing a stable regulatory and tax climate that is conducive to foreign investment. The regulatory regime continues to be streamlined, with relaxation of pricing norms for foreign direct investments, clarity in relation to put/call options, rationalisation of the foreign portfolio investment regime and proposals for further liberalization of investment caps.

Designing a fund is not just an exercise in structuring. It's like being an architect is different from being a structural engineer. For India-focused funds, not only knowledge of Indian regulatory and tax framework is required but a deep insight into cross border legal and tax regimes is necessary, even when you are not raising funds from overseas.

The investment fund industry clearly seems to be in a very different market today. Innovative structures varied from the traditional 'blind-pool model' are fast becoming the usual. Some of the themes that continue in 2015 are the shift from 'comingled basis' of raising funds to 'separately managed accounts', deal-by-deal participation (opt-in / opt-out) and pledge-type structures. These changes are closely linked to the reduced LP tolerance for traditional terms and full fee structures for blind pool funds.

In May 2012, SEBI took steps to completely overhaul the regulatory framework for domestic funds in India and introduced the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (AIF Regulations). Among other things, the AIF Regulations have opened avenues for various fund investment strategies for raising onshore pools of capital in India.

Following closely on the footsteps of the recent observations by U.S. Securities and Exchange Commission (SEC) that there are several disconnects between "what [general partners] think their [limited partners] know and what LPs actually know", SEBI has issued a circular that consolidates guidelines on disclosures and reporting that AIFs have to make.

However, from a regulatory viewpoint, the glare from the regulator to the alternative investments space has been at its peak. Following the Global Financial Crisis, there has been an epidemic growth in law making focused on the discretionary management industry. A manager to an alternative investment fund must now contend with greater oversight and accountability to both the regulator and the investors. While bespoke terms are designed to maintain investor friendliness, given the recent observations by regulators in sophisticated jurisdictions, sight must not be lost on the disclosure norms and fiduciary driven rules that are now statutorily mandated.

In the United States, the primary laws regulating investment funds are the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Following the financial crisis of 2008, a number of legislations have been introduced. These include the Dodd- Frank Act, the Foreign Account Tax Compliance Act (FATCA) and the Jumpstart Our Business Startups Act (JOBS Act). These legislations were enacted with the twin purposes of preventing future financial crises on the one hand and facilitating the process of economic recovery on the other. From an investment fund perspective, these statutes assume importance in the context of the investor limitations and disclosure requirements that they usher into the regulatory regime.

The European Commission introduced the Alternative Investment Fund Managers Directive (AIFMD) with a view to provide a harmonized and stringent regulatory and supervisory framework for the activities of fund managers within the European Union. The AIFMD seeks to regulate non-EU fund managers who seek to market a fund, set up outside the EU to investors in the EU.

A parallel development in this connection has been the recent upheaval in the Indian tax regime. Following the Vodafone judgment, the Parliament of India introduced rules for the taxation of gains arising on the indirect transfer of capital assets. The Parliament simultaneously introduced the General Anti-Avoidance Rule which allows Indian tax authorities to re-characterize transactions on grounds of lack of commercial substance among other things.

Moreover, there is also emerging jurisprudence which suggests that the threshold of fiduciary duties to be met with by fund directors is shifting from "exercising supervision" to "making reasonable and proportionate efforts commensurate with the situations". A failure to perform such supervisory role could impose severe liabilities on fund directors for resultant business losses as would be seen in the case of Weavering Macro Fixed Income Fund (summarized in our memo that can be accessed at http://www.nishithdesai.com/old/NDA/Funds%20hotline_May3013.html) where the directors were penalized with a sum of $111 million. To add to this, there has been a very active enforcement of anti-corruption laws under the Foreign Corrupt Practices Act (FCPA) against directors and executives.

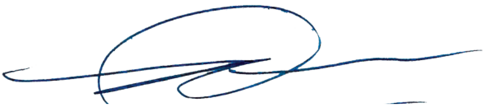
Accordingly, apart from the expectation to set up investor-friendly structures, the shift in legal paradigm in which an investment fund operates, requires that attention be given to articulating disclosures in fund documents (including recording the economic substance and justifications in the fund's board minutes) and intelligently planning investment asset-holdings. The Bangalore Income Tax Appellate Tribunal in the case of DCIT v. India Advantage Fund – VII held that income arising to a trust where the contributions made by the contributors are revocable in nature, shall be taxable at the hands of the contributors. The ruling comes as a big positive for the Indian fund industry. The ruling offers some degree of certainty on the rules for taxation of domestic funds that are set up in the format of a trust by regarding such funds as fiscally neutral entities. Globally, funds have been accorded pass through status to ensure fiscal neutrality and investors are taxed based on their status. This is especially relevant when certain streams of income maybe tax free at investor level due to the status of the investor, but taxable at fund level. Funds, including AIFs that are not entitled to pass through status from a tax perspective (i.e. not covered under Section 10(23FB) of the Income tax Act, 1961) could seek to achieve a pass through basis of tax by ensuring that the capital contributions made by the contributors is on a revocable basis.

While bespoke managed accounts are being created and structures that meet LPs' demand to be more closely aligned to the portfolio selection process are being set up, it is imperative to design funds which address the issues created by the continuously changing Indian and international regulatory and tax environment.

The shift in legal paradigm in which an investment fund operates, requires that attention be given to articulating disclosures in fund documents (including recording the economic substance) and intelligently planning investment asset-holdings. In our experience, fund documentation is critical to protecting fund managers (GPs) from exposure to legal, tax and regulatory risks. Fund counsel are now required to devise innovative structures and advise investors on terms for meeting investor's (LP) expectations on commercials, governance and maintaining GP discipline on the articulated investment strategy of the fund. All these are to be done in conformity with the changing legal framework.

The objective of this Compilation is to bring to focus, aspects that need to be considered while setting up India-focused funds and some of the recent developments that impact the fund management industry.

Regards,



Nishith Desai

NDA Fund Formation Practice

Our Approach

At Nishith Desai Associates, we are particularly known and engaged by multinational companies and funds as strategic counsel. As engineers of some of the earliest innovative instruments being used by investment funds (both private equity and venture capital) in India we proactively spend time in developing an advanced understanding of the industry as well as the current legal, regulatory and tax regime.

Choice of Fund Vehicle

Selection of the fund vehicle requires careful planning and is driven by a variety of considerations as the same would have an impact on the investors in the fund; particularly in their home jurisdictions. While deciding on the optimum structure for a fund, varied objectives such as limited liability for investors, commercial convenience and tax efficiency for investors and managers need to be considered. To meet these objectives varied entities such as pass-through trusts, limited liability partnerships, limited partnerships, limited liability companies, protected cell companies etc. can be considered. Offshore funds investing in India may require the presence of investment advisors in India to provide them with deal recommendations etc. This gives rise to tricky issues relating to the taxation of the offshore fund in India that would depend on whether the Indian advisor is regarded as a "permanent establishment" of the offshore fund in India. In this regard, we have successfully represented several funds before the Indian Authority for Advance Rulings and have obtained landmark rulings for them.

After the Organisation for Economic Co-operation and Development (OECD) issued its report on Action Plan on Base Erosion and Profit Shifting (BEPS) in 2013, there is an increased pressure to ensure observance of key tax principles like demonstrating substance, establishing tax resident status and transfer pricing principles. Tax authorities are several mature financial centers are adopting substance over form approach.

With the impending introduced the General Anti-Avoidance Rule which allows Indian tax authorities to re-characterize transactions on grounds of lack of commercial substance among other things. This has prompted a shift while structuring funds to concentrate several aspects constituting 'commercial substance' in the same entity. So unless specific investors require 'feeder' vehicles for tax or regulatory reasons, attempt is being made to pool LPs in the same vehicle that invests in the foreign portfolio. Mauritius, Netherlands, Singapore and Luxembourg continue being favorably considered while structuring India funds or funds with India allocation.

Documentation

Once a decision has been taken on the optimum structure for the fund, the same has to be carefully incorporated in the fund documents, including the charter documents for the fund entity, the private placement memorandum, the investment management agreement, the investment advisory agreement, etc. In particular, one would need to keep in mind the potential "permanent establishment" risk while drafting these documents. The private placement memorandum should also achieve a balance between the risk disclosure requirements and the marketing strategy. We also co-ordinate with overseas counsel to obtain requisite legends, to keep the fundraising exercise compliant with the laws of each jurisdiction in which the interests of the fund are being marketed.

Advisory

In addition to preparing the necessary fund documents, we also advise the fund on the local registration requirements. Domestic funds may register themselves with SEBI pursuant to which they are required to comply with certain investment restrictions and other prescribed conditions. Domestic funds are also accorded pass-through status for Indian tax purposes upon the fulfillment of certain conditions. It is not mandatory for offshore funds to register with SEBI. However, there are certain benefits available to offshore funds that register with SEBI as "foreign venture capital investors" such as flexibility in entry and exit pricing, "Qualified Institutional Buyer" status, etc. Further, with respect to funds seeking to participate in the secondary markets, apart from drafting of the information memorandum which is circulated to the investors of such fund, we have also advised and assisted them in obtaining registration as foreign portfolio investors. We also advise funds on a day to day basis from an Indian tax and regulatory perspective in relation to execution of "offshore derivative instruments" including "participatory notes".

Project Management

Several Indian investment managers who are looking at raising international funds need to offer tax efficient and regulatory compliant structures to their foreign investors that generally seek not only safety and repatriation of their original investments, but also a tax-efficient way of receiving the gains earned as well. Thus, our focus on international tax and our in-depth understanding of the legal, regulatory and tax regimes for funds in different jurisdictions has enabled us to be at the cutting edge of structuring offshore and domestic funds.

Primary Contacts

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Nishith Desai is the founder of the multi-skilled, research based international law firm and has over 40 years of experience in cross-border transactional and advisory practice. He is an international tax and corporate law expert, researcher, published author and lecturer in leading academic institutions around the world. He has advised extensively on cross-border tax and regulatory implications of wealth transfer and succession planning. Mr. Desai was a member of SEBI's committee which developed original regulations for Foreign Venture Capital Investor (FVCI) and Venture Capital Funds regime. More recently, he has been involved with the formation of the AIF Regulations.

Richie Sancheti

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Richie Sancheti heads the Funds Practice Group at Nishith Desai Associates and is based in Mumbai.

With a strong funds background, Richie advises on optimum structures for setting up onshore and offshore investment funds. He advises fund managers in connection with the formation, carry allocation program and governance of private funds. He also actively assists range of fund managers with private equity, hedge, venture capital and other investment strategies in negotiating fund terms with institutional investors.

Richie is also a member of the firm's international tax and a private equity investment practice groups and advises clients on matters including private equity transactions.

Pratibha Jain

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Pratibha Jain is a Partner and co-heads the Fund Formation practice at Nishith Desai Associates. She brings with her a breadth of international and Indian experience having worked in New York, Tokyo, Hong Kong and Mumbai. She was till recently the Vice President and Counsel for Goldman Sachs in India. She has earlier worked as an associate with Sullivan & Cromwell LLP in their New York, Tokyo and Hong Kong offices and with Skadden Arps Slate Meagher and Flom LLP in their Hong Kong office. Pratibha's educational qualifications include B.A (Economics) Hons. And LL.B. degree from Delhi University, a Bachelor of Civil Law degree from the University of Oxford, where she was a St. Catherine's College Bursary Holder; and a LL.M. degree from the Harvard Law School, where she was a Samuel Morse Lane Fellow. Pratibha has extensive experience in US and Indian securities laws. Her areas of focus include private equity, mergers and acquisitions, corporate and regulatory advisory and public policy matters.

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Nishchal Joshipura is a Partner and co-heads the Fund Formation practice at Nishith Desai Associates. He is a Chartered Accountant, an MBA and a Lawyer. Nishchal has set up multiple India focussed offshore and domestic funds both for offshore and domestic General Partners and has advised these funds on their investments in portfolio companies in India. He also heads the Real Estate Practice Group. Nishchal specializes in legal and tax structuring of cross-border transactions and assists clients on documentation and negotiation of mergers and acquisition (M&A) deals. His other practice areas include Corporate & Securities laws, Transfer Pricing, International Taxation, Globalization, Structuring of Inbound/Outbound Investments, Private Equity Investments, Structuring of Offshore Funds, Taxation of E-Commerce and Exchange Controls. He has contributed several articles in leading publications like Asialaw and has been a speaker at many domestic and international conferences

Kishore Joshi

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Kishore Joshi is heading Regulatory practice at Nishith Desai Associates. He is a member of the Corporate and Securities Practice Group and Funds Practice Group at the firm. He focuses on various aspects of exchange control regulations including setting up of offices in India, outbound investments, among others. He also handles matters related to FII. He holds a Bachelor's degree in law from Mumbai University. He has advised clients on several fund investments, issues related to corporate and securities laws, foreign direct investment and other exchange control laws. He has made several presentations on Inbound and Outbound investments. Kishore is a member of the Bar Council of Maharashtra & Goa.

About NDA

Nishith Desai Associates (NDA) is a research based international law firm with offices in Mumbai, Bangalore, Silicon Valley, Singapore, New Delhi, Munich. We specialize in strategic legal, regulatory and tax advice coupled with industry expertise in an integrated manner. We focus on niche areas in which we provide significant value and are invariably involved in select highly complex, innovative transactions. Our key clients include marquee repeat Fortune 500 clientele.

Core practice areas include International Tax, International Tax Litigation, Litigation & Dispute Resolution, Fund Formation, Fund Investments, Capital Markets, Employment and HR, Intellectual Property, Corporate & Securities Law, Competition Law, Mergers & Acquisitions, JVs & Restructuring, General Commercial Law and Succession and Estate Planning. Our specialized industry niches include financial services, IT and telecom, pharma and life sciences, education, media and entertainment, real estate and infrastructure.

Nishith Desai Associates has been ranked as the Most Innovative Indian Law Firm (2014) and the Second Most Innovative Asia - Pacific Law Firm (2014) at the Innovative Lawyers Asia-Pacific Awards by the Financial Times - RSG Consulting. IFLR1000 has ranked Nishith Desai Associates in Tier 1 for Private Equity (2014). Chambers and Partners has ranked us as # 1 for Tax and Technology-Media-Telecom (2014). Legal 500 has ranked us in tier 1 for Investment Funds, Tax and Technology-Media-Telecom (TMT) practices (2011/2012/2013/2014). IBLJ (India Business Law Journal) has awarded Nishith Desai Associates for Private equity & venture capital, Structured finance & securitization, TMT and Taxation in 2014. IDEX Legal has recognized Nishith Desai as the Managing Partner of the Year (2014). Legal Era, a prestigious Legal Media Group has recognized Nishith Desai Associates as the Best Tax Law Firm of the Year (2013). Chambers & Partners has ranked us as # 1 for Tax, TMT and Private Equity (2013). For the third consecutive year, International Financial Law Review (a Euromoney publication) has recognized us as the Indian "Firm of the Year" (2012) for our Technology - Media - Telecom (TMT) practice. We have been named an ASIAN-MENA COUNSEL 'IN-HOUSE COMMUNITY FIRM OF THE YEAR' in India for Life Sciences practice (2012) and also for International Arbitration (2011). We have received honorable mentions in Asian MENA Counsel Magazine for Alternative Investment Funds, Antitrust/Competition, Corporate and M&A, TMT and being Most Responsive Domestic Firm (2012). We have been ranked as the best performing Indian law firm of the year by the RSG India Consulting in its client satisfaction report (2011). Chambers & Partners has ranked us # 1 for Tax, TMT and Real Estate – FDI (2011). We've received honorable mentions in Asian MENA Counsel Magazine for Alternative Investment Funds, International Arbitration, Real Estate and Taxation for the year 2010. We have been adjudged the winner of the Indian Law Firm of the Year 2010 for TMT by IFLR. We have won the prestigious "Asian-Counsel's Socially Responsible Deals of the Year 2009" by Pacific Business Press, in addition to being Asian-Counsel Firm of the Year 2009 for the practice areas of Private Equity and Taxation in India. Indian Business Law Journal listed our Tax, PE & VC and Technology-Media-Telecom (TMT) practices in the India Law Firm Awards 2009. Legal 500 (Asia-Pacific) has also ranked us #1 in these practices for 2009-2010. We have been ranked the highest for 'Quality' in the Financial Times – RSG Consulting ranking of Indian law firms in 2009. The Tax Directors Handbook, 2009 lauded us for our constant and innovative out-of-the-box ideas. Other past recognitions include being named the Indian Law Firm of the Year 2000 and Asian Law Firm of the Year (Pro Bono) 2001 by the International Financial Law Review, a Euromoney publication. In an Asia survey by International Tax Review (September 2003), we were voted as a top-ranking law firm and recognized for our cross-border structuring work.

Our research oriented approach has also led to the team members being recognized and felicitated for thought leadership. Consecutively for the fifth year in 2010, NDAites have won the global competition for dissertations at the International Bar Association. Nishith Desai, Founder of Nishith Desai Associates, has been voted 'External Counsel of the Year 2009' by Asian Counsel and Pacific Business Press and the 'Most in Demand Practitioners' by Chambers Asia 2009. He has also been ranked No. 28 in a global Top 50 "Gold List" by Tax Business, a UK-based journal for the international tax community. He is listed in the Lex Witness 'Hall of fame: Top 50' individuals who have helped shape the legal landscape of modern India. He is also the recipient of Prof. Yunus 'Social Business Pioneer of India' – 2010 award.

We believe strongly in constant knowledge expansion and have developed dynamic Knowledge Management ('KM') and Continuing Education ('CE') programs, conducted both in-house and for select invitees. KM and CE programs cover key events, global and national trends as they unfold and examine case studies, debate and analyze emerging legal, regulatory and tax issues, serving as an effective forum for cross pollination of ideas.

Our trust-based, non-hierarchical, democratically managed organization that leverages research and knowledge to deliver premium services, high value, and a unique employer proposition has now been developed into a global case study and published by John Wiley & Sons, USA in a feature titled 'Management by Trust in a Democratic Enterprise: A Law Firm Shapes Organizational Behavior to Create Competitive Advantage' in the September 2009 issue of Global Business and Organizational Excellence (GBOE).

Please see the last page of this paper for the most recent research papers by our experts.

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Contents

1. Glossary of Terms

Sr No.	Term	Explanation
1.	**AAR**	Authority for Advance Ruling, Ministry of Finance, Government of India.
2.	**AIF**	Alternative Investment Fund as defined under the SEBI (Alternative Investment Funds) Regulations, 2012.
3.	**AIF Regulations**	SEBI (Alternative Investment Funds) Regulations, 2012.
4.	**AO**	Assessing Officer
5.	**CBDT**	Central Bureau of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India
6.	**CCD**	Compulsory Convertible Debentures
7.	**CCEA**	Cabinet Committee on Economic Affairs
8.	**CCPS**	Compulsorily Convertible Preference Share
9.	**Custodian**	A person who has been granted a certificate of registration to carry on the business of custodian of securities under the Securities and Exchange Board of India (Custodian of Securities) Regulations, 1996.
10.	**DDP**	'Designated Depository Participant' means a person who has been approved by the SEBI under Chapter III of the FPI Regulations.
11.	**DEA**	Department of Economic Affairs, Government of India
12.	**DIPP**	Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India
13.	**ECB**	External Commercial Borrowing
14.	**FATF**	Financial Action Task Force
15.	**FCCB**	Foreign Currency Convertible Bond
16.	**FDI**	Foreign Direct Investment
17.	**FEMA**	Foreign Exchange Management Act, 1999
18.	**FERA**	Foreign Exchange Regulation Act, 1973
19.	**FII**	Foreign Institutional Investor
20.	**FIPB**	Foreign Investment Promotion Board, Department of Economic Affairs, Ministry of Finance, Government of India
21.	**FII Regulations**	SEBI (Foreign Institutional Investors) Regulations, 1995
22.	**FPI**	Foreign Portfolio Investor
23.	**FPI Regulations**	SEBI (Foreign Portfolio Investors) Regulations, 2014
24.	**FVCI**	Foreign Venture Capital Investor
25.	**FVCI Regulations**	SEBI (Foreign Venture Capital Investor) Regulations, 2000
26.	**GAAR**	General Anti Avoidance Rules
27.	**Indian Rupee or "INR" or "Rs."**	The currency of Republic of India.
28.	**IPO**	Initial Public Offer

29.	**IOSCO**	International Organization of Securities Commissions
30.	**KYC**	Know Your Customer
31.	**LLP**	Limited Liability Partnership
32.	**NCD**	Non-convertible Debentures
33.	**NRI**	Non Resident Indian
34.	**OCB**	Overseas Corporate Body
35.	**ODI**	Offshore Derivative Instrument
36.	**Offshore Fund**	Means a pooling vehicle established outside India.
37.	**PAN**	Permanent Tax Account Number
38.	**PCC**	Protected Cell Companies
39.	**PE**	Private Equity
40.	**P-Notes**	Participatory Notes
41.	**QDP**	Qualified Depository Participant
42.	**QFI**	Qualified Foreign Investor
43.	**RBI**	Reserve Bank of India
44.	**SEBI**	Securities and Exchange Board of India
45.	**Tax Act**	Income Tax Act, 1961
46.	**TISPRO**	Foreign Exchange Management (Transfer and Issue of Security by a Person Resident Outside India) Regulations, 2000
47.	**VCF**	Venture Capital Fund
48.	**VCF Regulations**	SEBI (Venture Capital Fund) Regulations, 1996
49.	**VCPE**	Venture Capital and Private Equity
50.	**VCU**	Venture Capital Undertaking

2. Choice of Jurisdiction for Setting up an India-Focused Fund

There are several factors that inform the choice of jurisdiction for setting up a pooled investment vehicle.

A suitable jurisdiction for setting up a fund should primarily allow tax neutrality to the investors. 'Neutrality' ensures investors are not subject to any higher taxes than if they were to invest directly. From a regulatory viewpoint, the jurisdiction should allow flexibility in raising commitments, making investments and distribution of profits. Further, the jurisdiction should be suitable for all kinds of investors from whom the fund manager is seeking to raise a commitment.

The present Indian capital pool is predominantly contributed by foreign funds. Effective mobilization of the domestic pool of investors in India (consisting of institutional investors like banks, insurance companies, mutual funds and high net worth individuals) has certain hurdles.

I. Why Offshore Investors are Pooled Outside India

India follows source based taxation on capital gains and taxes thereon may not be creditable in the home jurisdiction of the offshore investors. Accordingly, offshore structures are used for offshore investors to invest into India to avoid double taxation on the same income stream. Further, India based structures with foreign participation may require regulatory approvals, compliance with pricing norms and made subject to performance conditions in certain sectors.

II. Why Onshore Investors are Pooled in India

Resident investors prefer onshore structures for the following reasons:

i. The Liberalised Remittance Scheme (LRS) issued by the Reserve Bank of India (RBI) allows Indian resident individuals to remit abroad up to $125,000[1] per financial year for any permissible current or capital account transaction or a combination of both, subject to the restrictions and conditions laid down in the Foreign Exchange Management Act 1999 (“**FEMA**”) and related rules and regulations. One such condition is that money cannot be remitted directly or indirectly to certain countries like Mauritius (which is one of the most widely used jurisdictions to invest into India). Further, for Indian residents to invest abroad into a fund which in turn invests into India could lead to round tripping issues.

ii. Regulation 7 of the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 (“**ODI Regulations**”) stipulates certain conditions to be met by Indian corporations when making investments in an entity outside India engaged in financial services activities (including fund or fund management vehicles). The conditions include, inter alia, that the Indian entity should have earned net profits during the preceding three financial years from the financial services activities; that it is registered with the regulatory authority in India for conducting the financial services activities; and that it has obtained approval

1. RBI Circular: A.P. (DIR Series) Circular No.138 dated, June 3,2014

from the concerned regulatory authorities, both in India and abroad, for venturing into such financial sector activity. However, as in the case of individual residents, Indian corporates investing abroad into a fund which in turn invests into India could raise round tripping concerns.

iii. Under a domestic fund structure, the fund vehicle (typically a SEBI registered trust entity) is not to be taxed on any income that is earned from the investments. The income earned is taxable in the hands of the investors when the venture capital fund / alternative investment fund distributes the same to the investors. Further, the characterization of income in their hands is the same as that realized/distributed by the investee company to the fund. By contrast, if distributions were to be received in the form of dividend or interest from an offshore fund structure, the resident investors would typically have to recognize the distribution as 'income' and as a result could be taxed in India (at the time of receipt).

III. Which Jurisdictions are Typically Considered for Setting up India-Focused Funds Pooling Offshore Investors

A. Mauritius

Mauritius has emerged as a favorite destination for overseas investment into Indian corporates, currently accounting for about 40 % of total foreign inflows into India.

Mauritius has special relevance because of the Bilateral Investment Protection Agreement ("**BIPA**") between India and Mauritius. Currently India does not have a BIPA with countries such as the US or the Cayman Islands. The BIPA provides a number of benefits including fair and equitable treatment, compensation for losses, protection against expropriation, ability to repatriate capital and returns, efficient dispute resolution framework, etc.

The tax treaty between India and Mauritius includes a provision that exempts a resident of Mauritius from Indian tax on gains derived from the sale of shares of an Indian company. Presently, the capital gains tax relief under the India- Mauritius tax treaty continues to be available. The Governments of India and Mauritius are, however, in the process of renegotiating the treaty. Based on publicly accessible information, it appears that the two countries are considering the inclusion of a 'limitation of benefits' (LoB) criteria within the treaty. The LoB clause is likely to stipulate an expenditure threshold for claiming the capital gains tax relief.

A similar provision exists in the India-Singapore tax treaty, which provides that a Singapore resident shall be deemed to have substance (and not be considered a conduit) if it incurs annual operational expenditure of SGD 200,000 in Singapore for 2 years prior to the transaction.

It is expected that the new LoB clause in the Mauritius treaty may be drafted on similar lines as the Singapore treaty. The expenditure threshold however is likely to vary.

On a separate note, the Mauritius FSC has also introduced domestic substance rules to be satisfied by Mauritius based GBC1 entities before January 1, 2015. Based on the new rules, FSC may consider various factors while determining whether a GBC1 entity is managed and controlled in Mauritius. These include: (i) existence of at least 2 resident directors with relevant expertise, (ii) principal bank account in Mauritius, (iii) accounting records maintained in Mauritius, and (iv) financial statements audited by a local Mauritian auditor. In addition, the FSC may take into account any one of the following criteria: (i) office premise in Mauritius, (ii) at least 1 full time employee in Mauritius, (iii) dispute resolution through arbitration in Mauritius, (iv) assets (excluding cash and shares of GBC1 company) of at least USD 100,000 in Mauritius, (v) listing on Mauritius stock exchange, and (vi) annual expenditure that is reasonably expected from a similar entity managed and controlled in Mauritius.

From our interactions with Mauritius officials, we understand that both sides are committed towards arriving at an agreement that ensures maximum certainty for investors in Mauritius.

B. Singapore

Singapore is one of the more advanced holding company jurisdictions in the Asia-Pacific region. Singapore possesses an established capital markets regime that is beneficial from the perspective of listing a fund on the Singapore stock exchange. Further, the availability of talent pool of investment professionals makes it easier to employ/ relocate productive personnel in Singapore.

The popularity of Singapore as a jurisdiction for making inbound investment into India is linked to the India-Singapore tax treaty, which provides a similar capital gains tax exemption as available under the India-Mauritius tax treaty.

The benefits of the India - Singapore tax treaty should be available to entities that are liable to tax in Singapore based on their residence, domicile or any criterion of a similar nature. However, unlike the India - Mauritius tax treaty, capital gains tax exemption under the India - Singapore tax treaty would be available only on satisfaction of specific conditions referred to as the limitation on treaty benefits (**"LoB"**).[2]

Singapore does not impose tax on capital gains. Gains from the disposal of investments may however be construed to be of an income nature and subject to Singapore income tax. Generally, gains on disposal of investments are considered income in nature and sourced in Singapore if they arise from or are otherwise connected with the activities of a trade or business carried on in Singapore. As the investment and divestment of assets by the Singapore based entity are managed by a manager, the entity may be construed to be carrying on a trade or business in Singapore. Accordingly, the income derived by the Singapore based entity may be considered income accruing in or derived from Singapore and subject to Singapore income tax, unless the Singapore-based fund is approved under section 13R and Section 13X respectively of the Singapore Income Tax Act (Chapter 134) (**"SITA"**) and the Income Tax (Exemption of Income of Approved Companies Arising from Funds Managed by Fund Manager in Singapore) Regulations 2010. Under these Tax Exemption Scheme, "specified income" derived by an "approved company" from "designated investments" managed in Singapore by a fund manager are exempt from Singapore income tax.

For fund managers considering Singapore resident structures, a combination of Singapore resident investment funds and SPVs can be considered, given the tax

2. The subsequently negotiated protocol to the India-Singapore Treaty requires that the Singapore entity must not be a shell or a conduit. A shell / conduit entity is one with negligible or nil business operations or with no real and continuous business activities carried out in Singapore.

A Singapore resident is deemed not to be a shell or conduit if it is listed on a recognized stock exchange or if its annual operational expenditure is at least SGD 200,000 per year in the two years preceding the transfer of shares giving rise to capital gains. The term "annual expenditure" means expenditure incurred during a period of 12 months. The period of 24 months shall be calculated by referring to two blocks of 12 months immediately preceding the date when the gains arise.

Separately, Article 3 of the Protocol to the India-Singapore Tax Treaty provides that, a Singapore resident company will not be entitled to the favorable treatment of taxation of capital gains on disposal of Indian securities where the affairs of the Singapore resident company are arranged with the primary purpose of taking advantage of the benefits of the capital gains tax exemption provision (i.e., entities not having bona fide business activities may be treated as being arranged with such primary purpose) or is a "shell or conduit" company.

Accordingly, if the affairs of the Singapore entity are arranged with the primary purpose of taking benefit of capital gains relief, the benefit may be denied even if the Singapore entity is considered to have commercial substance under the GAAR provisions or incurs annual operational expenditure of SGD 200,000.

exemption schemes and the tax proposals for the companies under the domestic law. The move has merits for groups that have ability to demonstrate substance (both in the entity and in Singapore as a jurisdiction). However, the eligibility criteria for claiming capital gains tax exemption under the tax treaties with India should also be carefully studied as the same may (as in case of Singapore) require some substantive conditions to be established in the jurisdiction.

C. Ireland

Ireland is a tax-efficient jurisdiction when investment into the Indian company is in the form of debt or convertible debt instrument. Interest, royalties and Fees for Technical Services (**"FTS"**) arising in India and paid to an Irish resident may be subject to a lower withholding tax of 10% under the Ireland-India tax treaty. This is a significant relief from the withholding under Indian domestic law which can be as high as 42% for interest and around 27% for royalties and FTS.

Ireland can therefore be explored for debt funds or real estate funds that provide structured debt and also film funds that provide production financing for motion pictures where cash flows received from distributors could be in the nature of royalties. However, the characterization of income would need to be assessed on a case to case basis.

D. Netherlands

With its robust network of income tax treaties, Netherlands is an established international fund domicile.

In the context of inbound investments into India, Netherlands emerges as an efficient jurisdiction for making portfolio investments. In certain situations, the India-Netherlands tax treaty provides relief against capital gains tax in India (that follows a source based rule for taxation of capital gains). Gains arising to a Dutch resident arising from the sale of shares of an Indian company to non-resident buyer would not be taxable in India. Such gains would be taxable if the Dutch resident holds more than 10% of the shares of the Indian company in case of sale to Indian residents. Even though the eligible holding is capped, the same works for FIIs / Sub Accounts /FPIs, who are restricted to participate only up to 10% of the capital of an Indian company.

For a Dutch entity to be entitled to relief under the India-Netherlands tax treaty, it has to be liable to tax in the Netherlands. This may not be an issue for entities such as Dutch limited liability companies (**"BVs"**), public companies (**"NVs"**) or Cooperatives investing or doing business in India.

In the case of KSPG Netherlands[3] it was held that sale of shares of an Indian company by a Dutch holding company to a non-resident would not be taxable in India under the India-Netherlands tax treaty. It was further held that the Dutch entity was a resident of the Netherlands and could not be treated as a conduit that lacked beneficial ownership over the Indian investments. The mere fact that the Dutch holding company was set up by its German parent company did not imply that it was not eligible to benefits under the Netherlands- India tax treaty.

It may be noted that difficulties with respect to treaty relief may be faced in certain situations, especially in the case of general partnerships (**"VOF"**) and hybrid entities such as closed limited partnerships, European economic interest groupings (**"EEIG"**) and other fiscally transparent entities.

3. [2010] 322 ITR 696 (AAR)

IV. Recent Changes

It is important to note that the choice of jurisdiction acquires even more importance as the Finance Bill, 2014 has revised the Income tax Act, 1961 to crystallize the position that, securities held by an foreign portfolio investors will be considered as "capital assets" and the gains derived from their transfer will be considered as capital gains. Therefore, funds that have so far been taking a position that such income results in business income, may need to re-visit their structures in order to ensure that they operate from jurisdictions that allow them to obtain relief on paying such tax in India.

3. Structural Alternatives for India-Focused Funds

Structuring India-focused Offshore Funds

Private equity and venture capital funds typically adopt one of the following three modes when investing into India: (1) direct investment in the Indian portfolio company, (2) direct investment in an Indian investment fund vehicle or (3) co-investment along-side the domestic fund vehicle directly in the Indian portfolio company. We explore all three models in brief below.

I. Foreign Investment Regimes

The primary routes for foreign investment into India are (a) the foreign direct investment (**"FDI"**)[4] route, (b) the foreign venture capital investors (**"FVCI"**)[5] route and the (c) foreign portfolio investment (**"FPI"**)[6] route. In a bid to simplify and rationalize the foreign portfolio investment regime, SEBI has introduced the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 (**"FPI Regulations"**). Under the FPI Regulations, SEBI proposes to harmonize foreign institutional investors (**"FIIs"**), sub-accounts and qualified foreign investors (**"QFIs"**) into a single investor class with a view to ensure uniform guidelines and provide a single window clearance for different categories of foreign investors. Each of these inbound investment regimes has been discussed in subsequent chapters.

Based on the investment strategy and sectoral focus of the concerned fund, the fund could efficiently combine the different investment regimes to make investments in India. The same may require that either the fund itself or an investment holding company obtain registration with SEBI as an FVCI or as an FPI.

A. Pure Offshore Structure

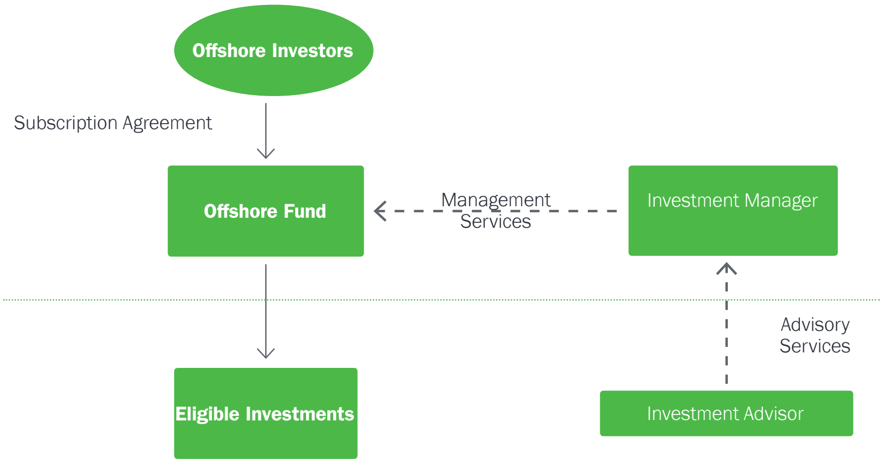
A pure offshore structure is used where there is no intent to pool capital at the domestic (i.e. India) level. Under this structure, a pooling vehicle ('Offshore Fund') can be set up in an offshore jurisdiction. Offshore investors will commit capital to the Offshore Fund which in turn will make investments into Indian portfolio companies (under one or more of the inbound investment regimes mentioned above) as and when investment opportunities arise.

The following diagram depicts a pure offshore structure:

4. This refers to investments by way of subscription and / or purchase of securities of an Indian company by a non-resident investor. While the RBI allows capital account transactions, these are subject to the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations 2000 (**"FDI Regulations"**) issued by the RBI. Thus, 'direct' investments by the offshore fund vehicles / special purpose vehicle (SPV) would need to comply with the provisions and restrictions stipulated under the FDI Regulations.

5. Given that the FVCI regime has been developed to attract venture capitalists, there are certain incentives attached to being recognised as one. This accordingly requires registration and approval from the regulators (SEBI and RBI). While granting approval to an FVCI, certain restrictions and conditions may be imposed including a restriction on the scope of investments that can be made by the FVCI. The RBI has recently been prescribing in its approval letter to FVCI applicants that the investments by FVCI entities are restricted to select identified sectors (which include, inter alia, infrastructure, biotechnology and IT related to hardware and software development). It is important to note that SEBI-registered FVCIs are specifically exempted from the RBI pricing guidelines.

6. The recently notified FPI Regulations which repeals the FII Regulations significantly revises the regulation of foreign portfolio investments into India. Under the FPI regime, SEBI has harmonized the FII, sub-account and QFI regimes into a single investor class – foreign portfolio investors and provided a single window clearance through designated depository participants ("DDPs"). The FPI Regulations classify FPIs into three categories based on their perceived risk profile. The FPI route as such is the preferred route for foreign investors who want to make portfolio investments and trade in Indian listed stocks on the floor of the stock exchange.



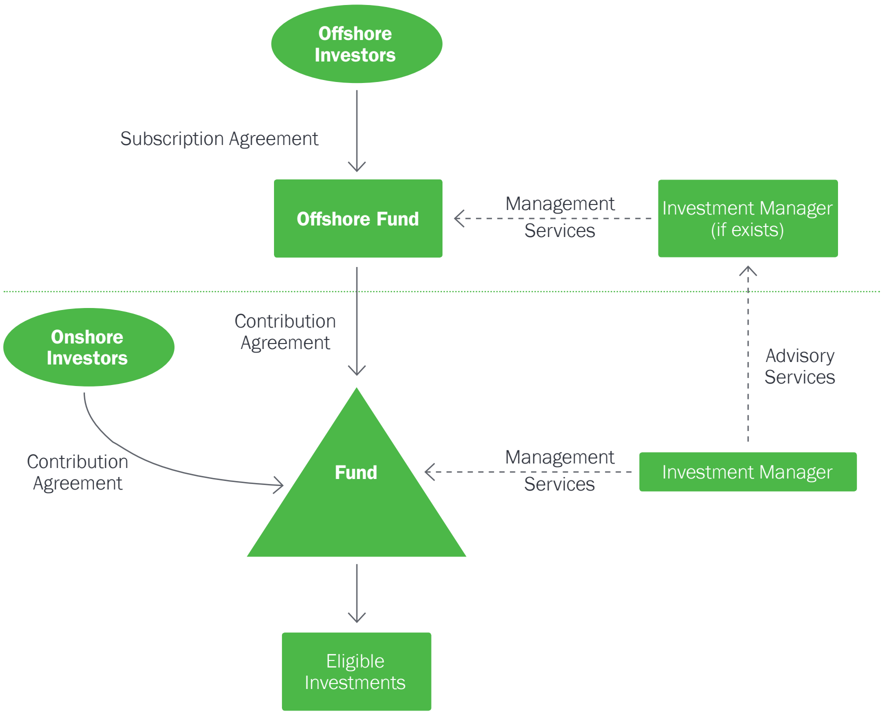
B. Unified Investment Structure

Unified structure is generally used where commitments from both domestic and offshore investors are pooled into a domestic pooling vehicle ('Onshore Fund'). Alternatively, the unified structure can also be adopted by an India based management team that seeks to extract management fee and carry allocations for the entire structure at the Onshore Fund level.

Under this structure, a trust or an LLP or a company (i.e. the Onshore Fund) is organized in India. The domestic investors would directly contribute to the Onshore Fund whereas overseas investors will pool their investments in an offshore vehicle ('Offshore Fund') which in turn invests in Onshore Fund. The Onshore Fund could be registered with SEBI under the AIF Regulations.

It is relevant to highlight that any foreign investment made by the Offshore Fund (including a capital contribution to the Onshore Fund) may require the prior approval of the Foreign Investment Promotion Board (**"FIPB"**).

The following diagram depicts a typical Unified investment structure:



C. Co-investment/Parallel Investment Structure

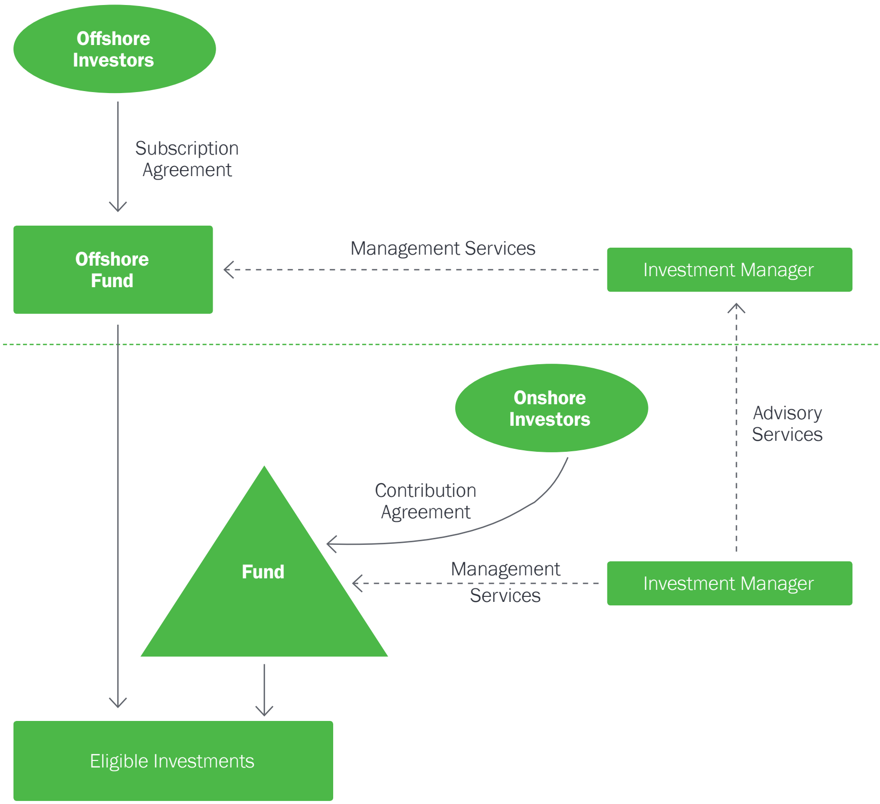
A co-investment structure is adopted where the commercial expectation is to raise two separate pools of capital for domestic investors and for offshore investors. Accordingly, separate pooling vehicles will need to be set up in India (i.e. Onshore Fund) and in an offshore jurisdiction ('Offshore Fund'). The Offshore Fund and the Onshore Fund typically have separate management structures. The Onshore Fund is managed by an India-based investment manager which entity may provide recommendations on investment opportunities to the management of the Offshore Fund on a non-binding basis.

Typically, the co-investment ratio between the Offshore Fund and the Onshore Fund is the ratio of their undrawn capital commitments.

The co-investment structure allows independent investments by the Offshore Fund and the Onshore Fund on the basis of their undrawn commitments in case the other runs out of dry powder. Further, it also provides greater flexibility to Onshore Fund allowing it to make investments irrespective of the Offshore Fund's ability to do so.

Certain tax risks exist in such a structure. The Onshore Fund and the Offshore Fund may be taxed together in India as an 'association of persons' (AOP) and thus suffer disproportionately higher tax rates.

The following diagram depicts a typical Co-investment structure:



II. Certain Tax Risks

Owing to the uncertain nature of Indian income-tax laws, there are certain tax risks that may arise to an offshore fund depending on the complexity of the structure and the level of substance demonstrated by the offshore fund. The following is a brief summary of these tax risks:

A. Association of Persons (AOP) Risk

An AOP is a 'person' recognized under Section 2(31) of the Tax Act and is therefore a separate taxable entity. The Supreme Court of India has held that in order to constitute an AOP, persons must join in a common purpose or common action and the object of the association must be to produce income - it is not enough for the persons to receive income jointly. The Supreme Court of India has held that the question whether there is an AOP must be decided upon the facts and circumstances of each case. The Indian tax authorities may claim that the control and management of an offshore fund vests with the domestic investment manager and therefore the offshore fund and the onshore fund together constitute an AOP. The consequence of constitution of an AOP would primarily be that all assessments would be conducted at the AOP level rather than qua the beneficiaries of the onshore fund.

B. Indirect Transfer of Capital Assets Risk

A recent amendment to the Tax Act has introduced a provision for the levy of capital gains tax on income arising from the transfer of shares / interest in a company / entity organized outside India which derives, directly or indirectly, its value substantially from the assets located in India. Pursuant to the said amendment, there is a possibility that Indian tax authorities may seek to tax the transfer of the shares in an offshore fund by investors outside India, or the redemption of shares by investors, notwithstanding that there is no transfer taking place in India, on the basis that the shares of the offshore fund derive substantial value from India.

C. General Anti-avoidance Rule (GAAR) Risk

GAAR empowers tax authorities to disregard or combine or re-characterize any part or whole of a transaction/arrangement such that the transaction/arrangement gets taxed on the basis of its substance rather than its form if such arrangement gets classified as an impermissible avoidance arrangement. This could result in any tax benefit being denied, including denial of treaty benefits, shifting of residency of investors and / or re-characterization of capital gains income as any other classification.

D. Tax Exposure Owing to Permanent Establishment

In a unified investment model or a parallel investment model, there could be a risk of the onshore fund or the Indian investment manager of the onshore fund being perceived to constitute a permanent establishment of the offshore fund if there is no evidence of independent decision-making at the offshore fund level.

4. Alternative Investment Funds in India

I. Introduction

Before the emergence of the Venture Capital – Private Equity ("**VCPE**") industry in India, entrepreneurs largely depended on private placements, public offerings and lending by financial institutions for raising capital. However, these did not prove to be optimal means of raising funds.

Following the introduction of the Securities and Exchange Board of India (Venture Capital Funds) Regulations ("**VCF Regulations**") in 1996, the VCPE industry has successfully filled the gap between capital requirements of fast-growing companies and funding available from traditional sources such as banks, IPOs, etc. The VCPE industry has also had a positive impact on various stakeholders – providing much needed risk capital and mentoring to entrepreneurs, improving the stability, depth and quality of companies in the capital markets, and offering risk-adjusted returns to investors.

The growth in VC funding in India can be attributed to various factors. Once the Government of India started becoming more and more aware of the benefits of the VC investments and the criticality for the growth of the different sectors such as software technology and internet, favorable regulations were passed regarding the ability of various financial institutions to invest in a VCF. Further, tax treatments for VC Funds were liberalized and procedures were simplified.

Subsequently, in 2012, SEBI took steps to completely overhaul the regulatory framework for domestic funds in India and introduced the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"). Among the main reasons cited by SEBI to highlight its rationale behind introducing the AIF Regulations are to recognize AIFs as a distinct asset class; promote start-ups and early stage companies; to permit fund investment strategies in the secondary markets; and to tie concessions and incentives to investment restrictions.

Here it is relevant to note that SEBI has adopted a practical grandfathering approach such that funds that are already registered under the VCF Regulations would continue to be governed by those regulations including for the purpose of raising commitments up to its targeted corpus. However, existing venture capital funds are not permitted to increase their targeted corpuses. Further, new funds and existing funds that are not registered under any regime would need to be registered under the AIF Regulations.

II. Alternative Investment Funds

Subject to certain exceptions, the ambit of the AIF Regulations is to regulate all forms of vehicles set up in India for pooling of funds on a private placement basis. To that extent, the AIF Regulations provide the bulwark within which the Indian fund industry is to operate.

An Alternative Investment Fund ("**AIF**") means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which:

i. is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and

ii. is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.

III. Choice of Pooling Vehicle

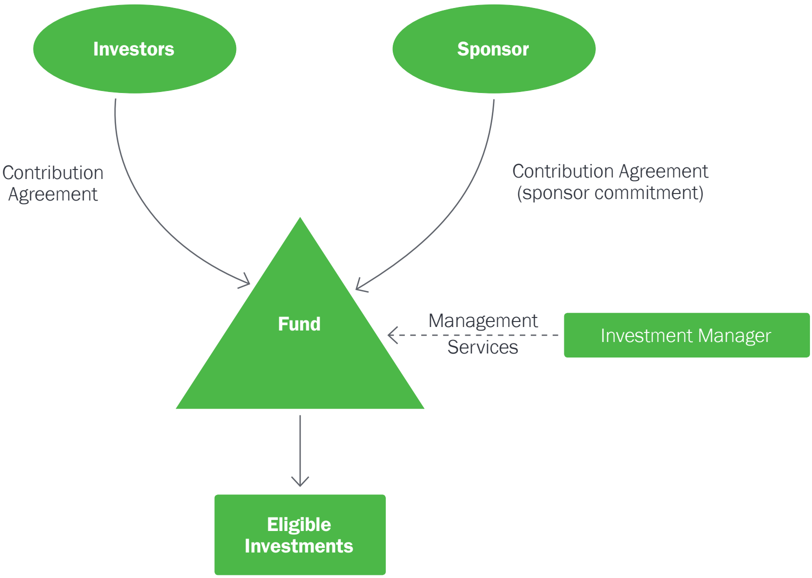
The AIF Regulations contemplate the establishment of funds in the form of a trust, a company, an LLP or a body corporate. The following table provides a comparison of these entities from an investment fund perspective:

Issue	Trust	Limited Liability Partnership	Company
General	The person who reposes or declares the confidence is called the "author of the trust"[7]; the person who accepts the confidence is called the "trustee"; the person for whose benefit the confidence is accepted is called the "beneficiary"; the subject matter of the trust is called "trust property"; the "beneficial interest" or "interest" of the beneficiary is the right against the trustee as owner of the trust property; and the instrument, if any, by which the trust is declared is called the "instrument of trust".	The concept of LLP was recently introduced in India under the Limited Liability Act, 2008 ("**LLP Act**"). An LLP is a hybrid form of a corporate entity, which combines features of an existing partnership firm and a limited liability company (i.e. the benefits of limited liability for partners with flexibility to organize internal management based on mutual agreement amongst the partners). The functioning of a LLP is governed by the limited liability partnership agreement.	A Company can be incorporated under the Companies Act, 1956 or the Companies Act, 2013. The control of the company is determined by a board of directors which is elected by the shareholders. Separate classes of securities could be issued to different shareholders that shall determine their rights and obligations (as distinct from other classes) from both the 'voting' perspective as well as from a 'distribution' perspective. The class structure however would need to be in compliance with Companies Act, 2013 as and when all relevant sections thereof are brought into effect.
Entities Involved	*The Settlor*: The Settlor settles a trust with an initial settlement. Terms of the indenture of trust ("Indenture") shall administer the functioning of the trust ("Trust"). *The Trustee*: The Trustee is in charge of the overall administration of the Trust and may be entitled to a trusteeship fee. The Trustee may also appoint an investment manager, who in turn manage the assets of the Trust and the schemes/ funds as may be launched under	*Partner*: A 'partner' represents an investor in the fund. The LLP structure is conceptually akin to a limited partner as internationally understood in a LP structure. To that extent, a partner has an obligation to fund its 'commitment' to the Fund and is entitled to distributions based on fund documents (being the LLP Agreement in this case). *Designated Partner*: Though the expression 'designated partner' is not explicitly	*Shareholders*: Shareholders hold the shares of the company and are granted special privileges depending on the class of shares they own. *Directors*: Directors have a fiduciary duty towards the company with respect to the powers conferred on them by the Companies Act and by the Memorandum of Association and Articles of Association of the company. They are trustees in respect of powers of the company that are conferred upon

7. Commonly referred to as a 'settlor'

	such Trust from time to time. *The Contributor*: The contributor is the investor to the Trust (the fund) and makes a capital commitment under a contribution agreement.	defined, however on a plain reading of the LLP it is understood that such 'designated partner shall be the person responsible and liable in respect of the compliances stipulated for the LLP.	them, for instance, powers of (a) issuing and allotting shares; (b) approving transfers of shares; (c) making calls on shares; and (d) forfeiting shares for non-payment of call etc. They must act bona fide and exercise these powers solely for the benefit of the company.
Manage-ment of entities	The Trustee is responsible for the overall management of the Trust. In practice this responsibility is outsourced to an investment manager pursuant to an investment management agreement.	The LLP itself has to manage the entities and relies on the Designated Partner in this respect. In practice, this responsibility may be outsourced to an investment manager pursuant to an investment management agreement.	The board of directors manages the entities involved. In practice this responsibility is outsourced to an investment manager pursuant to an investment management agreement.
Market Practice	Almost all funds formed in India use this structure. The regulatory framework governing trust structures is stable and allows the management to write its own standard of governance.	Barely a few funds are registered under this structure. The registrar of companies does not favor providing approvals to investment LLPs. As per section 5 of the LLP Act, 2008, only an individual or a body corporate is eligible to be a partner in an LLP.	There are no clear precedents for raising funds in a 'company' format.

The following diagram depicts an AIF that is set up in the form of a trust:



IV. Classification of AIFs

As mentioned previously in our introductory chapter, the AIF Regulations were introduced with an objective of effectively channelizing incentives. For this purpose, the AIF Regulations has defined different categories of funds with the intent to distinguish the investment criteria and relevant regulatory concessions that may be allowed to them.

A description of the various categories of AIFs along with the investment conditions and restriction relevant to each category is summarized below:

Category I AIF	Category II AIF	Category III AIF
i. Category I AIFs are funds with strategies to invest in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable. ii. Under the AIF Regulations, the following funds are designated as sub-categories of Category I	i. Category II AIFs are funds which cannot be categorized as Category I AIFs or Category III AIFs. These funds do not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in the AIF Regulations. ii. AIFs such as private equity funds or debt funds for which no specific incentives	i. Category III AIFs are funds which employ complex or diverse trading strategies and may employ leverage including through investment in listed or unlisted derivatives. ii. AIFs such as hedge funds or funds which trade with a view to make short-term returns or such other funds which are open ended and for which no specific incentives or

AIFs - venture capital funds, SME funds, social venture funds, infrastructure funds and such other AIFs as may be specified. In September 2013, SEBI introduced 'angel investment funds' as a sub-class of the venture capital fund sub-category. iii. AIFs which are generally perceived to have positive spillover effects on the economy and for which SEBI, the Government of India or other regulators may consider providing incentives or concessions shall be classified as Category I AIFs.	or concessions are given by the Government of India or any other regulator are included in the Category II AIF classification.	concessions are given by the Government of India or any other regulator are included in the Category III AIF classification.

V. Investment Conditions and Restrictions under the AIF Regulations

The AIF Regulations prescribe a general set of investment restrictions that are applicable for all AIFs and further prescribe a specific set of investment restrictions that are applicable for each category of AIFs. SEBI is authorized to specify additional criteria or requirements as may be required. The following is the list of general investment conditions applicable to all AIFs:

i. AIFs may invest in securities of companies incorporated outside India subject to such conditions / guidelines that may be stipulated by SEBI or the RBI;

ii. Co-investment in an investee company by a Manager / Sponsor should not be on more favourable terms than those offered to the AIF;

iii. Only a specific percentage of the investible funds (25% for Category I and II AIFs and 10% for Category III AIFs) can be invested in a single investee company;

iv. AIFs should not invest in associates except with the approval of 75% of investors by value of their investments in the AIF; and

v. The un-invested portion of the investible funds may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality such as Treasury Bills, CBLOs, commercial papers, certificates of deposits, etc. till deployment of funds as per the investment objective.

The following table summarizes the investment restrictions that are applicable in respect of the various categories of AIFs:

Investment Restrictions and Conditions for AIFs

Category I AIFs	i. Category I AIFs shall invest in investee companies or venture capital undertakings or in special purpose vehicles or in limited liability partnerships or in units of other AIFs specified in the Regulations. ii. A Category I AIF of a particular sub-category may invest in the units of the same sub-category of Category I AIFs. However, this investment condition is subject to the further restriction that Category I AIFs are not allowed to invest in the units of Fund of Funds. iii. Category I AIFs shall not borrow funds directly or indirectly or engage in leverage except for meeting temporary funding requirements for more than thirty days, on not more than four occasions in a year and not more than 10% of its investible funds. In addition to these investment conditions, the AIF Regulations also prescribe a set of investment conditions in respect of each sub-category of Category I AIFs.
Category II AIFs	i. Category II AIFs shall invest primarily in unlisted investee companies or in units of other AIFs as may be specified in the placement memorandum; ii. Category II AIFs may invest in the units of Category I and Category II AIFs. This is subject to the restriction that Category II AIFs cannot invest in the units of Fund of Funds; iii. Category II AIFs shall not borrow funds directly or indirectly or engage in leverage except for meeting temporary funding requirements for more than thirty days, on not more than four occasions in a year and not more than 10% of its investible funds; iv. Category II AIFs may engage in hedging subject to such guidelines that may be prescribed by SEBI; v. Category II AIFs may enter into an agreement with a merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making under Chapter XB of the ICDR Regulations; and vi. Category II AIFs shall be exempt from Regulations 3 and 3A of the Insider Trading Regulations in respect of investments in companies listed on SME exchange or SME segment of an exchange pursuant to due diligence of such companies. This is subject to the further conditions that the AIF must disclose any acquisition / dealing within 2 days to the stock exchanges where the investee company is listed and such investment will be locked in for a period of 1 year from the date of investment.
Category III AIFs	i. Category III AIFs may invest in securities of listed or unlisted investee companies or derivatives or complex or structured products; ii. Category III AIFs may invest in the units of Category I, Category II and Category III AIFs. This is subject to the restriction that Category III AIFs cannot invest in the units of Fund of Funds; iii. Category III AIFs engage in leverage or borrow subject to consent from investors in the fund and subject to a maximum limit as may be specified by SEBI; and iv. Category III AIFs shall be regulated through issuance of directions by SEBI regarding areas such as operational standards, conduct of business rules, prudential requirements, restrictions on redemption and conflict of interest.

VI. Key Themes under the AIF Regulations

A. Continuing Interest

The AIF Regulations require the sponsor or the manager of an AIF to contribute a certain amount of capital to the fund. This portion is known as the continuing interest and will remain locked-in the fund until distributions have been made to all the other investors in the fund. For a Category – I or Category – II AIF, the sponsor or the manager is required to have a continuing interest of 2.5% of the corpus of the fund or INR 5 crores whichever is lower and in the case of a Category – III AIF, a continuing interest of 5% of the corpus or INR 10 crores whichever is lower. For the newly introduced angel investment funds, the AIF Regulations require the sponsor or the manager to have a continuing interest of 2.5% of the corpus of the fund or INR 50 lakh whichever is lower. Further, the sponsor or the manager (as the case may be) is required to disclose their investment in an AIF to the investors of the AIF.

B. Minimum Corpus

The AIF Regulations prescribe that the minimum corpus for any AIF shall be INR 20 crores ("**Minimum Corpus**"). Corpus is the total amount of funds committed by investors to the fund by way of written contract or any such document as on a particular date. By its circular dated on June 19, 2014 ("**Circular**"), SEBI requires that where the corpus of an open-ended scheme falls below the Minimum Corpus (post redemption(s) by investors or exits), the fund manager is given a period of 3 months to restore the Minimum Corpus, failing which, all the interests of the investors will need to be mandatorily redeemed.

C. Minimum Investment

The AIF Regulations do not permit an AIF to accept an investment of less than INR 1 crore ("**Minimum Investment Amount**") from any investor unless such investor is an employee or a director of the AIF or an employee or director of the manager of the AIF in which case the AIF can accept investments of a minimum value of INR 25 lakh. The Circular has specifically clarified that in case of an open-ended AIF, the first lump-sum investment received from an investor should not be less than the Minimum Investment Amount.[8] Further, in case of partial redemption of units by an investor in an open-ended AIF, the amount of investment retained by the investor should not fall below the Minimum Investment Amount.[9]

D. Qualified Investors

The AIF Regulations permit an AIF to raise funds from any investor whether Indian, foreign or non-resident through the issue of units of the AIF. Accepting investments from non-resident investors requires approval from the Foreign Investment Promotion Board ("**FIPB**").

E. Maximum Number of Investors

The AIF Regulations caps the maximum number of investors for an AIF at 1,000.

F. Private Placement

The AIF Regulations require that no AIF should solicit or collect funds except by way of private placement. While the AIF Regulations do not prescribe any thresholds or rules for private placement, guidance is taken from Companies Act, 1956 (and the recently introduced Companies Act, 2013).

8. CIR/IMD/DF/14/2014
9. Ibid.

G. Tenure

While Category I and Category II AIFs can only be closed-end funds, Category – III AIFs can be open-ended. The AIF Regulations prescribe the minimum tenure of 3 years for Category I and Category II AIFs. The tenure of any AIF can be extended only with the approval of 2/3rd of the unit-holders by value of their investment in the AIF.

H. Liquidity Facility

The Circular provides that in case any 'material change' to the placement memorandum (changes that SEBI believes to be significant enough to influence the decision of the investor to continue to be invested in the AIF), said to have arisen in the event of (1) change in sponsor / manager, (2) change in control of sponsor / manager, (3) change in fee structure which may result in higher fees being charged to the unit holders and (4) change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders. In case of such 'material change', existing investors who do not wish to continue post the change shall be provided with an exit option and such existing investors will be provided not less than one month for indicating their dissent.

VII. Taxation of Alternative Investment Funds

Taxation of funds registered as a 'venture capital fund' sub-category of Category I Alternative Investment Funds

An AIF that is registered as a venture capital fund sub-category of Category I will be eligible for the exemption under section 10(23FB) of the Income Tax Act, 1961 (**"Tax Act"**). The following are the requirements that need to be fulfilled by an AIF to be eligible to claim the exemption under section 10(23FB) of the Tax Act:

i. The fund must be set up by a trust deed which is registered under the Registration Act, 1908.

ii. The fund should have been granted a certificate of registration as a 'venture capital fund' as a sub-category of Category I Alternative Investment Fund under the SEBI (AIF) Regulations, 2012.

iii. The fund must have invested at least two-thirds of its investible funds in unlisted equity shares or equity-linked instruments of venture capital undertakings (i.e. an undertaking which (a) is not listed in any recognized stock exchange at the time at which the Onshore Fund makes an investment, (b) is engaged in the business of providing services, production or manufacture of articles or things, and (c) does not include non-banking finance companies, gold financing, activities not permitted under the industrial policy of the Government of India and any other activity which may be specified by SEBI.

iv. The fund should not have invested in any venture capital undertaking in which the trustee or the settlor of the fund holds either individually or collectively equity shares in excess of 15% of the paid-up equity share capital of such venture capital undertaking.

v. The units issued by the fund should not be listed in any recognized stock exchange.

Thus, as per section 10(23FB) of the Tax Act, the income arising to a fund that fulfills the above criteria shall not be counted while computing the total income of the fund.

Taxation of funds not registered as 'venture capital fund' sub-category of Category I Alternative Investment Funds: taxation of determinate trusts

Under Indian tax law, a trust is not a separate taxable entity. Taxation of trusts is laid out in sections 161 to 164 of the Tax Act. Where the trust is specific, ie, the beneficiaries are identifiable with their shares being determinate, the trustee is assessed as a representative assessee and tax is levied on and recovered from them in a like manner and to the same extent as it would be leviable upon and recoverable from the person represented by them.

In the case of AIG (In Re: Advance Ruling P. No. 10 of 1996), it was held that it is not required that the exact share of the beneficiaries be specified for a trust to be considered a determinate trust, and that if there is a pre-determined formula by which distributions are made the trust could still be considered a determinate trust. The tax authorities can alternatively raise an assessment on the beneficiaries directly, but in no case can the tax be collected twice over.

While the income tax officer is free to levy tax either on the beneficiary or on the trustee in their capacity as representative assessee, as per section 161 of the Tax Act, it must be done in the same manner and to the same extent that it would have been levied on the beneficiary. Thus in a case where the trustee is assessed as a representative assessee, they would generally be able to avail of all the benefits/deductions etc. available to the beneficiary, with respect to that beneficiary's share of income. There is no further tax on the distribution of income from a trust.

The Central Board of Direct Taxes (“**CBDT**”) issued a circular1 dated July 28, 2014 (“**Circular**”) to provide ‘clarity’ on the taxation of alternative investment funds (“**AIFs**”) that are registered under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (“**AIF Regulations**”).

The Circular states that if ‘the names of the investors’ or their ‘beneficial interests’ are not specified in the trust deed on the ‘date of its creation’, the trust will be liable to be taxed at the ‘maximum marginal rate’.

The Bangalore Income Tax Appellate Tribunal in the case of *DCIT v. India Advantage Fund – VII* held that income arising to a trust where the contributions made by the contributors are revocable in nature, shall be taxable at the hands of the contributors. The ruling comes as a big positive for the Indian fund industry. The ruling offers some degree of certainty on the rules for taxation of domestic funds that are set up in the format of a trust by regarding such funds as fiscally neutral entities. Globally, funds have been accorded pass through status to ensure fiscal neutrality and investors are taxed based on their status. This is especially relevant when certain streams of income maybe tax free at investor level due to the status of the investor, but taxable at fund level. Funds, including AIFs that are not entitled to pass through status from a tax perspective (i.e. not covered under Section 10(23FB) of the Tax Act) could seek to achieve a pass through basis of tax by ensuring that the capital contributions made by the contributors is on a revocable basis.

VIII. Certain Tax Risks Relevant to the Domestic Funds Industry

A. Business Trust Risk

There is a risk that as per the provisions of section 161(1A) of the Tax Act, if income of a trust includes profits and gains of business, the entire income of such trust will be assessed to tax at the maximum marginal rate. It is possible that the tax authorities may consider the activity of the Fund as an organized “business” activity and accordingly, even the gains received by the Fund on sale of securities may be characterized as “business income”, if considered as proceeds from a business activity. Therefore, if the Fund is construed to be carrying on business, then such income received by the Fund would be assessable in the hands of the Trustee at the maximum marginal rate on a net basis. Currently, the maximum marginal rate is 30% (exclusive of applicable surcharge and education cess).

B. Association of Persons (AOP)

The ITA does not define an "association of persons" (AOP) per se. However an AOP is a separately taxable unit as it is included in the definition of "person" under section 2(31)(v) of the Tax Act. The term 'AOP' under the Act is not used in any technical sense but must be construed in its plain ordinary meaning.[10] The Supreme Court of India has held[11] that in order to constitute an AOP, persons must join in a common purpose or common action and the object of the association must be to produce income - it is not enough for the persons to receive income jointly. The Supreme Court further held that the question whether there is an AOP must be decided upon the facts and circumstances of each case.[12]

The consequence of constitution of an AOP would primarily be that all assessments would be conducted at the AOP level rather than at the level of the respective taxpayer.

The tax authorities may claim that the contributors of the fund constitute an association of persons and seek to tax the income of the fund by applying the maximum marginal rate at the AOP level, thereby disregarding the pass-through status of the trust.

10. Mohammed Abdul v. CIT, [1949] 17 ITR 426 (Cal).
11. CIT v. Indira Balkrishna, [1960] 39 ITR 546 (SC).
12. Ibid.

5. Trends in Private Equity

The standard of what constitutes an 'alignment of interests' between fund investors (LPs) and fund managers (GPs) of India-focused fund or India-based fund has undergone some degree of change over the years. Typically, LP participation in a fund is marked by a more hands-on approach in discussing and negotiating fund terms which by itself is influenced by a more comprehensive due diligence on the track record of the GP and the investment management team. This chapter provides a brief overview of certain fund terms that have been carefully negotiated between LPs and GPs in the Indian funds context.

I. Investment Committee and Advisory Board

Sophisticated LPs insist on having a robust decision-making process whereby an investment manager will refer investment and / or divestment proposals along with any due diligence reports in respect of such proposals to an investment committee comprising representatives of the LPs as well as the GP. The investment committee is authorized to take a final decision in respect of the various proposals that are referred to it. In view of this, the composition of the investment committee and the nature of rights granted to certain members can become very contentious. The investment committee is also empowered to monitor the performance of investments made by the fund on an on-going basis. Separately, any transaction that could involve a potential conflict of interest is expected to be referred for resolution to an advisory board consisting of members who are not associated with the GP.

II. Management Fee

Keeping with the global trend, there appears to be less tolerance among India-focused LPs to invest in a fund that provides a standard '2-20' fee – carry model. Since management fee bears no positive correlation to the performance of the investments made by the fund, LPs can be circumspect about the fee percentage. Further, issues may arise with respect to the base amount on which the management fee is computed. During the commitment period, fee is calculated as a percentage of the aggregate capital commitments made to a fund. After the commitment period, fee is calculated as a percentage of the capital contribution that has not yet been returned to the LPs. The fee percentage itself is generally a function of the role and responsibilities expected to be discharged by a GP. It is not uncommon to see early stage capital and venture capital funds charging a management fee that is marginally higher than the normal.

III. Expenses

LPs express concern with respect to the kind of expenses that are charged to the fund (any by extension, to their capital contributions). With a view to limiting the quantum of expenses that are paid by the fund, LPs insist on putting a cap on expenses. The cap which is generally expressed as a percentage of the size of the fund or as a fixed number can become a debatable issue depending on the investment strategy and objective of the fund. Separately, as a measure of aligning interests, LPs insist that allocations made from their capital contributions towards the payment of expenses should be included while computing the hurdle return whereas the same should not be included while determining management fee after the commitment period.

IV. Waterfall

A typical distribution waterfall involves a return of capital contribution, a preferred return (or a hurdle return), a GP catch-up and a splitting of the residual proceeds between the LPs and the GP. With an increasing number of GPs having reconciled themselves to the shift from the 20% carried interest normal, a number of innovations to the distribution mechanism have been evolved to improve fundraising opportunities by differentiating product offerings from one another. Waterfalls have been structured to facilitate risk diversification by allowing LPs to commit capital both on a deal-by-deal basis as well as on a blind pool basis. Further, distribution of carried interest has been structured on a staggered basis such that the allocation of carry is proportionate to the returns achieved by the fund.

V. Giveback

While there have been rare cases where some LPs have successfully negotiated against the inclusion of a giveback provision, GPs in the Indian funds industry typically insist on an LP giveback clause to provide for the vast risk of financial liability including tax liability. The LP giveback facility is a variant to creating reserves out of the distributable proceeds of the fund in order to stop the clock / reduce the hurdle return obligation. With a view to limiting the giveback obligation, LPs may ask for a termination of the giveback after the expiry of a certain time period or a cap on the giveback amount. However, this may not be very successful in an Indian context given that the tax authorities are given relatively long time-frames to proceed against taxpayers.

As bespoke terms continue to emerge in LP-GP negotiations, designing a fund may not remain just an exercise in structuring. The combination of an environment less conducive for fund raising and the change in legal, tax and regulatory environment besides continuously shifting commercial expectations requires that fund lawyers provide creatively tailored structural alternatives.

6. Fund Documentation

Fund counsels are now required to devise innovative structures and advice investors on terms for meeting investor's (LP) expectations on commercials, governance and maintaining discipline on the articulated investment strategy of the fund. All these are to be done in conformity with the changing legal framework.

To attract high quality LPs, it is essential that the fund documents (including the investor pitch and the private placement memorandum) include an articulation on the fund's governance standard. It is also essential that global best practices are taken into account when preparing such fund documents including contribution agreements, LP side letters and closing opinion, and the same is not just confined to Indian regulatory and tax aspects.

Fund documents are an important aspect of the fundraising exercise. They are also critical to determining whether a pooling vehicle is in compliance with the applicable law across various jurisdictions. For an India-focused fund or a fund with India allocation which envisages LP participation both at the offshore level and at the Indian level, the following documents are typically prepared:

I. At the Offshore Fund level

A. Private Placement Memorandum / Wrapper

The private placement memorandum (PPM) is a document through which the interests of the fund are marketed to potential investors. Accordingly, the PPM outlines the investment thesis of a fund, summarizes the key terms on which investors could participate in the fund's offering and also presents the potential risk factors and conflicts of interest that could arise to an investor considering an investment in the fund. A wrapper is a short supplement that is attached to the PPM of a domestic fund (in case of 'unified structure') to help achieve compliance with the requirements for private placement of the securities / interests of an offshore fund to investors in jurisdictions outside India. The use of a wrapper is common in the case of unified investment structures as the risks of the onshore fund are inherent in the shares/ LP interests issued to investors to the offshore fund.

B. Constitution

A constitution is the charter document of an offshore fund in certain jurisdictions. It is a binding contract between the company (i.e. the fund), the directors of the company and the shareholders (i.e. the investors) of the company.

C. Subscription Agreement

The subscription agreement is an agreement that records the terms on which an investor will subscribe to the securities / interests issued by an offshore fund. The subscription agreement sets out the investor's capital commitment to the fund and also records the representations and warranties made by the investor to the fund. This includes the representation that the investor is qualified under law to make the investment in the fund.[13]

D. Advisory Agreement

The board of an offshore fund may delegate its investment management / advisory responsibilities to a separate entity known

13. In case is the fund is set up in the format of a limited partnership, this document would be in the format of a limited partnership agreement (with the 'general partner' holding the management interests).

as the Investment Advisor or the Investment Manager. The Investment Advisory Agreement contains the general terms under which such investment advisor render advise in respect of the transactions for the fund's board. Sometimes, the investment advisor / manager of an offshore fund enters into a 'sub-advisory agreement' with an on-the-ground investment advisory entity (the sub-advisor). The sub-advisory agreement typically provides that the sub-advisor will provide non-binding investment advice to the investment advisor of the offshore fund for remuneration.

II. At the Onshore Fund level

A. Private Placement Memorandum

AIF Regulations require that a concerned fund's PPM should contain all material information about the AIF, including details of the manager, the key investment team, targeted investors, fees and other expenses proposed to be charged from the fund, tenure of the scheme, conditions or limits on redemption, investment strategy, risk factors and risk management tools, conflicts of interest and procedures to identify and address them, disciplinary history, terms and conditions on which the manager offers services, affiliations with other intermediaries, manner of winding up the scheme or the AIF and such other information as may be necessary for an investor to take an informed decision as to whether to invest in the scheme of an AIF.

SEBI has now directed fund managers to add by way of an annexure to the placement memorandum, a detailed tabular example of how the fees and charges shall be applicable to the investor and the distribution waterfall for AIFs.[14]

AIFs should also include disciplinary actions in its placement memorandum.[15] It has been clarified by SEBI that AIFs should also include a disciplinary history of the AIF, sponsor, manager and their directors, partners, promoters and associates and a disciplinary history of the trustees or the trustee company and its directors if the applicant for AIF registration is a trust.[16]

Any changes made to the placement memorandum submitted to SEBI at the time of the application for registration as an AIF must be listed clearly in the covering letter submitted to SEBI and further, such changes must be highlighted in the copy of the final placement memorandum.[17] In case the change to the placement memorandum is a case of a 'material change' (factors that SEBI believes to be a change significantly influencing the decision of the investor to continue to be invested in the AIF), said to arise in the event of (1) change in sponsor / manager, (2) change in control of sponsor / manager, (3) change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders), existing unit holders who do not wish to continue post the change shall be provided with an exit option.[18]

This change is critical for fund managers to note. Such disclosure reduces the space for 'views' being taken by a fund manager in a given liquidity event leading to distribution. This also requires that the fund manager engages more closely with the fund counsel to articulate the waterfall in a manner that they can actually implement with a degree of automation. Any deviance from the waterfall as illustrated in the fund documents could potentially be taken up against the fund manager.

14. Paragraph 2(a)(i)of the SEBI Circular CIR/IMD/DF/14/2014.
15. Regulation 11(2) AIF Regulations
16. Regulation 2(1)(c) of the AIF Regulations.
17. Paragraph 2(b)(i) of the SEBI Circular CIR/IMD/DF/14/2014.
18. Paragraph 2(b)(iv)(a) of the SEBI Circular CIR/IMD/DF/14/2014.

B. Indenture of Trust

The Indenture of Trust is an instrument that is executed between a settlor and a trustee whereby the settlor conveys an initial settlement to the trustee towards creating the assets of the fund. The Indenture of Trust also specifies the various functions and responsibilities to be discharged by the appointed trustee. The Indenture of Trust is an important instrument from an Indian income-tax perspective since the formula for computing beneficial interest is specified. The formula for computing beneficial interest is required to establish the determinate nature of the trust and consequently for the trust to be treated as a pass-through entity for tax purposes.

C. Investment Management Agreement

The Investment Management Agreement to be entered into by and between the trustee and the investment manager (as the same may be amended, modified, supplemented or restated from time to time). Under the Investment Management Agreement, the trustee appoints the investment manager and delegates all its management powers in respect of the fund (except for certain retained powers that are identified in the Indenture of Trust) to the investment manager.

D. Contribution Agreement

The Contribution Agreement is to be entered into by and between each contributor (i.e. investor), the trustee and the investment manager (as the same may be amended, modified, supplemented or restated from time to time) and, as the context requires. The Contribution Agreement records the terms on which an investor participates in a fund. This includes aspects relating to computation of beneficial interest, distribution mechanism, list of expenses to be borne by the fund, powers of the investment committee, etc. A careful structuring of this document is required so that the manager/ trustee retain the power to make such amendments to the agreement as would not amend the commercial understandings with the contributor.

III. Investor Side Letters

It is not uncommon for some investors to ask for specific arrangements with respect to their participation in the fund. These arrangements are recorded in a separate document known as the side letter that is executed by a specific investor, the fund and the investment manager. Typically, investors seek differential arrangements with respect to management fee, distribution mechanics, participation in investment committees, investor giveback, etc. An investor may also insist on including a 'most favoured nations' (MFN) clause to prevent any other investor being placed in a better position than itself. An issue to be considered is the enforceability of such side letters unless it is an amendment to the main contribution agreement itself.

IV. Agreements with Service Providers

Sometimes, investment managers may enter into agreements with placement agents, distributor and other service providers with a view to efficiently market the interests of the fund. These services are offered for a consideration which may be linked to the commitments attributable to the efforts of the placement agent / distributor.

7. Hedge Funds

'Hedge funds' lack precise definition and typically operate on an unregulated basis. The term seems to have derived from the investment and risk management strategies they tend to adopt.

The Indian regulators' comfort in allowing access to global hedge funds is of recent origin. It was only gradually that several investment opportunities were opened for investors participating under the Foreign Institutional Investors (FII) regulations that allowed for a wider gamut of strategy implementation for a hedge fund.

As already discussed in this Compilation, the FII Regulations stand repealed by the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 ("FPI Regulations") which were notified by SEBI on January 7, 2014. The FPI Regulations have been in effect from June 01, 2014.[19] This section accordingly deals with eligible participants under the FPI Regulations, the range of investment and hedge strategies that may be adopted and the scope of dealing with contract notes (swaps and offshore derivative instruments, i.e. ODIs).

On the onshore side, SEBI allowed hedge strategies as a possible investment strategy that a 'Category III' Alternative Investment Fund (AIF) could adopt. This section also deals with the basic framework within which such onshore 'hedge' funds are allowed to operate.

I. FPI Regulations

Under the FPI regime, Securities and Exchange Board of India has harmonized foreign institutional investors (**"FIIs"**), sub-accounts and qualified foreign investors (**"QFIs"**) regimes into a single investor class – foreign portfolio investors (**"FPIs"**) and provided a single window clearance through designated depository participants (**"DDPs"**). With each investor registering directly as an FPI (under the respective three categories discussed later), the sponsored sub accounts structure seems to be over.

The FPI Regulations put into effect, several recommendations made by the Committee on Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments (**"Committee"**) chaired by Mr. K.M. Chandrasekhar in 2013. The key recommendations of the Committee were to combine the erstwhile portfolio investment categories of foreign institutional investors, sub-accounts and qualified financial investors into a single investor class of "foreign portfolio investors". The other significant proposal pertained to the establishment of a self-regulatory mechanism for registration and monitoring of FPIs, which will be overseen by the DDP rather than directly by SEBI.

The Committee's report was submitted on 12 June 2013 to SEBI. After considering the recommendations of the Committee, on 7 January 2014, SEBI notified the FPI Regulations. Subsequently, SEBI has also vide a Circular dated 8 January 2013 issued operating guidelines for DDP. With the notification of the FPI Regulations, the SEBI (Foreign Institutional Investors) Regulations, 1995 (**"FII Regulations"**) stand repealed.

A. Meaning of FPI

The term 'FPI' has been defined to mean a person who satisfies the eligibility criteria prescribed under the FPI Regulations and has been registered under the FPI Regulations. No person is permitted to transact in securities as a FPI unless it has obtained a COR granted by the DDP on behalf of SEBI. An existing FII / Sub Account holding a valid COR shall be deemed

19. SEBI Circular CIR/IMD/FIIC/6/2014 dated March 28, 2014, para 4(a).

to be an FPI till the expiry of the block of three years for which fees have been paid under the FII Regulations.

In respect of entities seeking to be registered as FPIs, DDPs are authorised to grant registration by SEBI with effect from June 01, 2014. The application for grant of registration is to be made to the DDP in a prescribed form along-with the specified fees. The eligibility criteria for a FPI, inter-alia, includes:

i. The applicant is a person not resident in India[20];

ii. The applicant is resident of a country whose securities market regulator is a signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding or a signatory to bilateral Memorandum of Understanding with the SEBI;

iii. The applicant is not residing in a jurisdiction identified by the Financial Action Task Force (FATF):

   a. as having strategic Anti-Money Laundering; or

   b. combating the Financing of Terrorism deficiencies; or

   c. as not having made significant progress in addressing the deficiencies or not committed to an action plan developed with the FATF to address the deficiencies.

iv. The applicant being a bank[21], is a resident of a country whose Central bank is a member of Bank for International Settlements;

v. The applicant is not a non-resident Indian;

vi. The applicant is a fit and proper person as per the SEBI (Intermediaries) Regulations, 2008.

A certificate of registration granted by a DDP shall be permanent unless suspended or cancelled by SEBI or surrendered by the FPI. A DDP may grant conditional registration, subject to fulfilment of specified conditions.[22] For example, a conditional registration may be granted to an entity with a validity period of 180 days, to achieve the broad based criteria as required to qualify as a Category II FPI.

Category	**Category I FPI**	**Category II FPI**	**Category III FPI**
Eligible Foreign Portfolio Investors	Government and Government-related investors such as central banks, Governmental agencies, sovereign wealth funds or international and multilateral organizations or agencies.	i. Appropriately regulated broad based funds[23]; ii. Appropriately regulated persons[24]; iii. Broad-based funds that are not appropriately regulated[25];	Includes all eligible FPIs who are not eligible under Category I and II, such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

20. The term "persons", "non-residents" and "resident" used herein have the same meaning as accorded to them under the Income Tax Act, 1961.
21. In case of an applicant being a bank or its subsidiary, the DDP is required to forward the details of the applicant to SEBI who would in turn request the Reserve Bank of India to provide its comments. The comments of the Reserve Bank of India would be provided by the SEBI to the DDP.
22. One of the conditions include that the applicant is an India dedicated fund or undertakes to make investment of at least 5% corpus of the fund in India.
23. Includes mutual funds, investment trusts, insurance/reinsurance companies
24. Includes banks, asset management companies, investment managers/advisors, portfolio managers
25. This is subject to the fact that the investment manager of such broad based fund is regulated and undertakes that it will be responsible for the acts, omissions and other things done by the underlying broad-based funds.

		iv. University funds and pension funds; and v. University related endowments already registered with SEBI as FIIs or sub-accounts.	

In Category II FPI, "appropriately regulated" means "regulated or supervised in same capacity in which it proposes to make investments in India".[26] In order to find out whether an entity is regulated in the same capacity, the DDP has the option of verifying if the FPI is allowed by its regulator to carry out such activity under its license/registration granted by the regulator.[27]

If an FPI ceases to meet the eligibility requirements for a particular category, then it will be reclassified under another appropriate category and the FPI shall be required to provide the DDP with additional KYC documents. Fresh purchases would not be allowed until the additional documents are forwarded but the FPI will be allowed to sell the securities already purchased by it. [28]

B. Status of Existing FIIs / Sub-Accounts and Rollover to FPI Regime

As discussed above, the FPI Regulations provide that any FII or a sub-account which holds a valid certificate of registration shall be deemed to be an FPI until the expiry of the block of three years for which fees has been paid as per the FII Regulations. In other words, existing FIIs or sub-accounts will be deemed to be FPIs under the FPI Regulations.[29]

Further, the FPI Regulations provide that existing FIIs or sub-accounts can continue to buy, sell or deal in securities till the expiry of their registrations (as FIIs and sub-accounts respectively) or until such earlier time when the existing FIIs or sub-accounts make payment of the applicable conversion fee for converting into FPIs.[30] The FPI Regulations prescribe a conversion fee of USD 1,000 payable by the existing FII or sub-account to SEBI.[31]

In cases where an FII has multiple proprietor sub-accounts and one of them chooses to convert as FPI, then the conversion of all other sub-accounts of that FII to FPI will follow. This requirement applies only when the proprietary sub-account is the one being converted, in case of other sub-accounts, the remaining sub-accounts (whether proprietary or broad-based) do not have to convert.[32]

If an entity engages Multiple Investment Management ("**MIM**") structure, then it is allowed to obtain multiple registrations with SEBI and these applicants will be required to appoint the same local custodian. For the purposes of investment limits, these multiple registrations will be clubbed and the same position will continue in the FPI regime.[33] Investment limits will be monitored at the investor group level by the depositories based on the information provided by DDPs and

26. Explanation 1 to Regulation 5(b)
27. SEBI, FPI FAQs, Question 18
28. SEBI Circular CIR/IMD/FIIC/02/2014 dated January 08, 2014
29. Regulation 2(1)(h) r/w Regulation 2(1)(g)
30. Proviso to Regulation 3(1)
31. Part A of the Second Schedule
32. Regulation 3(1)
33. SEBI, FPI FAQs, Question 6

necessary information will be shared between the depositories.[34]

Also, a fund which has NRIs for investors will not be barred from obtaining registration as FPI under the FPI regime (as was the case in the FII regime).[35]

C. Broad Based Criteria

Under the erstwhile FII Regulations, a "broad-based fund" meant a fund, established or incorporated outside India which has at least 20 investors with no individual investor holding more than 49% of the shares or units of the fund. It was also provided that if the broad-based fund had any institutional investor, it was not necessary for such fund to have 20 investors. Further, any institutional investor holding more than 49% of the shares or units of the fund would have to itself satisfy the broad based criteria.[36]

Under the FPI regime, every fund, sub-fund or share class needs to separately fulfill the broad based criteria where a segregated portfolio is maintained Therefore where a newly added class of shares is not broad-based then the FPI will have to provide an undertaking to the DDP that the new class will become broad-based within 90 days from the date of DDP approval letter.[37]

The FPI Regulations continue to follow the broad-based criteria with two notable deviations. One, in order to satisfy the broad-based criteria, it would be necessary for a fund to have 20 investors even if one of the investors is an institutional investor. Two, for the purpose of computing the number of investors in a fund, both direct and underlying investors (i.e. investors of entities that are set up for the sole purpose of pooling funds and making investments) shall be counted. An FPI, who has a bank as an investor will be deemed to be broad based for the purposes of FPI Regulations as was the case in the FII regime.[38]

D. Investments

The FPI Regulations provide that investment in the issued capital of a single company by a single FPI or an investor group shall be below 10% of the total issued capital of the company.[39]

The FPI Regulations further provide that in case the same set of ultimate beneficial owner(s) invests through multiple FPI entities, such FPI entities shall be treated as part of the same investor group and the investment limits of all such entities shall be clubbed at the investment limit as applicable to a single FPI.[40] As per the Operational Guidelines for Designated Depository Participants (**"Operational Guidelines"**) released by SEBI, for the purpose of ascertaining an investor group, the concerned DDPs shall consider all such entities having direct or indirect common shareholding / beneficial ownership / beneficial interest of more than 50% as belonging to same investor group.[41] The investment limit of 10% and clubbing of investments has also been made applicable to offshore derivative instruments, as explained subsequently in this chapter.

Further, FIIs and FPIs are allowed to offer cash or foreign sovereign securities with AAA rating or corporate bonds or domestic Government Securities, as collateral to the recognized Stock Exchanges for their transactions in the cash as well as derivative segment of the market,

34. SEBI, FPI FAQs, Question 58
35. SEBI, FPI FAQs, Question 25
36. Explanation 2 to Regulation 5
37. SEBI, FPI FAQs, Question 49
38. Regulation 5(b)
39. Regulation 21(7)
40. Regulation 23(3)
41. Paragraph 4.2 of the Operational Guidelines

subject to norms specified by RBI, SEBI and Clearing Corporations.[42]

RBI's circular dated June 20, 2014[43] allows FPIs to take a long (bought) as well as short (sold) position up to US$10 million (or equivalent) per exchange without having to establish the existence of any underlying exposure.

Under the FPI Regulations, FPIs are permitted to invest in the following:

i. securities in the primary and secondary markets including shares, debentures and warrants of companies, unlisted, listed or to be listed on a recognized stock exchange in India;

ii. units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed on a recognized stock exchange in India or not;

iii. units of scheme floated by a Collective Investment Scheme;

iv. derivatives traded on a recognized stock exchange in India;

v. dated government securities;

vi. commercial paper issued by an Indian Company;

vii. rupee denominated credit enhanced bonds;

viii. security receipts issued by asset reconstruction companies;

ix. perpetual debt instruments and debt capital instruments, as specified by the Reserve Bank of India from time to time;

x. listed and unlisted non-convertible debentures/bonds issued by an Indian company in the infrastructure sector, where 'infrastructure' is defined in terms of the extant External Commercial Borrowings (ECB) guidelines;

xi. non-convertible debentures or bonds issued by Non-Banking Financial Companies categorized as 'Infrastructure Finance Companies'(IFCs) by the Reserve Bank of India;

xii. rupee denominated bonds or units issued by infrastructure debt funds;

xiii. Indian depository receipts; and

xiv. such other instruments specified by SEBI from time to time.

In respect of investments in the secondary market, the following additional conditions shall apply [44]:

An FPI shall transact in the securities in India only on the basis of taking and giving delivery of securities purchased or sold except in the following cases:

i. any transactions in derivatives on a recognized stock exchange;

ii. short selling transactions in accordance with the framework specified by SEBI;

iii. any transaction in securities pursuant to an agreement entered into with the merchant banker in the process of market making or subscribing to unsubscribed portion of the issue in accordance with Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;

iv. any other transaction specified by SEBI.

Budgetary Changes 2014

The Finance Bill, 2014[45] has amended the Tax Act with effect from 1st April, 2015 to the effect that securities held by an FPI will be considered "capital assets", and gains derived from their transfer will be considered capital gains. As a result of this amendment, gains arising on disposal / transfer of a range of listed

42. SEBI Circular CIR/MRD/DRMNP/9/2013, March 20, 2013
43. RBI Circular RBI/2013-14/650; A.P. (DIR Series) Circular No. 148
44. Regulation 21(4)
45. Section 3 (II) of the Finance Bill, 2014 amends the definition of "capital asset" under section 2(14) of the Tax Act.

securities including shares, debentures and eligible derivative instruments as may have been acquired under applicable laws, shall be taxed as capital gains (and not business income) under Indian domestic law.

The characterization has been a long standing point of contention under Indian tax law. This is because, under Indian tax treaties, the business income of a non-resident is not taxable in India unless the non-resident has a permanent establishment in India. In comparison, capital gains are generally taxable unless the non-resident invests through a favourable treaty jurisdiction such as Mauritius, Singapore or Cyprus. While revenue authorities have tended to treat the income of FII / FPI as capital gains on this account, the position has undergone much litigation in the past.

E. Protected Cell Companies

Prior to December, 2013, there was a blanket ban on protected cell companies ("**PCCs**"), segregated portfolio companies ("**SPCs**") or equivalent structures which used to ring-fence assets and liabilities under law) from participating under the FII route.

Based on the representations made by our firm, SEBI had provided that entities that apply for registration under the FII Regulations shall not be regarded as having an opaque structure if they are required by their regulator or under any law to ring fence their assets and liabilities from other funds / sub-funds in the entity. This applied for structures such as open-ended investment companies (OEICs) in the UK. OEICs are typically set up in the format of umbrella companies that have several 'sub funds'. Recent amendments to the OEIC regulations in the UK required that a PCC structure be adopted to ring fence liabilities between these sub-funds.

Opaque structures are not allowed to register as FPIs under the FPI regime and FPI applicants will have to submit declaration and undertakings to that effect. If an FPI's regulator or any law requires it to ring fence its assets and liabilities from other funds or sub-funds then an FPI applicant will not be considered as opaque structure merely for this reason and would be eligible to be registered as an FPI, provided it meets the following criteria:

i. the FPI applicant is regulated in its home jurisdiction;

ii. each fund or sub-fund in the applicant satisfies broad-based criteria; and

iii. the applicant has given an undertaking to provide information about its beneficial owners, if asked for it by SEBI.[46]

F. Tax Treatment of FPI Investments

The tax treatment of FPIs registered under the FPI Regulations would be similar to the treatment accorded to FIIs. Accordingly, all such FPIs would be deemed to be Foreign Institutional Investors under Explanation (a) to section 115AD and would be taxed similarly.

Taxation of income in respect of FIIs in India is addressed in section 115 AD of the Tax Act, that provided for taxation of income in the nature of interest and gains derived securities held by it. As per this provision,

i. Short term capital gains on sale of listed securities or units of equity oriented funds, subjected to Securities Transaction Tax, was taxed at 10%;

ii. Other short term capital gains were taxed at 30%;

iii. Long term capital gains on sale of listed securities or units of equity oriented funds, subjected to Securities Transaction Tax, were exempt;

iv. Other long term capital gains were taxed at 10%;

46. SEBI Circular CIR/IMD/FIIC/21/2013 dated December 19, 2013.

v. Income from interest on debt securities were taxed at 20%.

II. Participatory Notes and Derivative Instruments

A. Overview

Participatory Notes (“**P-Notes**”) are a form of Offshore Derivative Instruments (“**ODIs**”). Section 2(1)(j) of the SEBI Foreign Portfolio Investors Regulations 2014 provides that an “offshore derivative instrument” means any instrument, by whatever name called, which is issued overseas by a foreign portfolio investor against securities held by it that are listed or proposed to be listed on any recognised stock exchange in India, as its underlying.

P-Notes are issued by FIIs (and eligible FPIs). The FPI Regulations specifically exclude Category III FPIs and certain Category II FPIs (those that are unregulated broad-based funds who rely on their investment managers to obtain registration as Category II FPIs), from issuing, subscribing or otherwise dealing in ODIs.[47]

ODIs can only be issued (a) to those persons who are regulated by an appropriate foreign regulatory authority and (b) after compliance with ‘know your client’ norms. Accordingly, an FII (or an eligible FPI) seeking to issue ODIs to any person must be satisfied that such person meets these two tests.[48]

Therefore, to be perceived/ classified as reportable ODIs, the concerned offshore contracts would need to refer to an Indian underlying security and also be hedged in India to whatever extent by the issuer FII / FPI. Accordingly, unless so hedged, an ODI remains a contract note, that offers its holder a return linked to the performance of a particular underlying security but need not be reported under the disclosure norms set out under the FPI Regulations.

It is the issuing FII / FPI that engages in the actual purchase of the underlying Indian security as part of its underlying hedge to minimize its risks on the ODI issued. The position of the ODI holder is usually that of an unsecured counterparty to the FII / FPI (with inherent counterparty risks amongst others) and under the ODI (the contractual arrangement with the issuing FII / FPI) the holder of a P-Note is only entitled to the returns on the underlying security with no other rights in relation to the securities in respect of which the ODI has been issued.

The FPI Regulations provide that Category I FPIs and Category II FPIs (which are directly regulated by an appropriate foreign regulatory authority)[49] are permitted to issue, subscribe and otherwise deal in ODIs. However, those Category II FPIs which are not directly regulated (which are classified as Category-II FPI by virtue of their investment manager being appropriately regulated) and all Category III FPIs are not permitted to issue, subscribe or deal in ODIs.

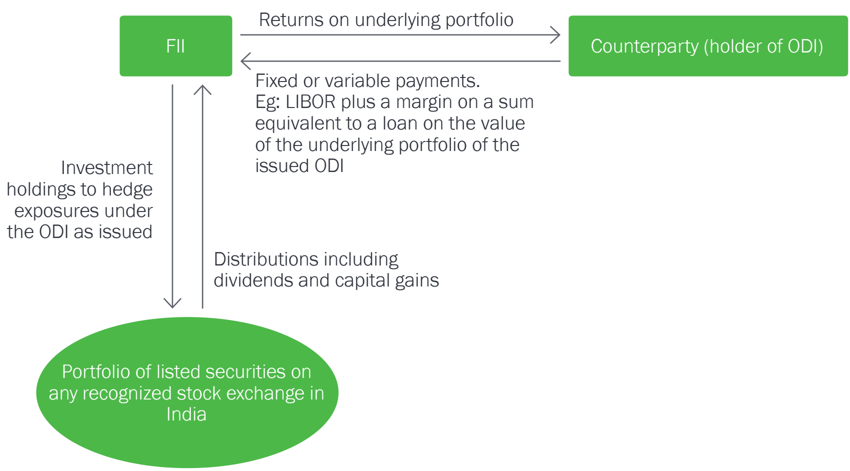
As compared to the FII regime, two differences emerge, (1) ‘unregulated’ broad based funds are not eligible to subscribe to ODIs, even if they are managed by an appropriately regulated person (which, under the FII Regulations, were eligible to hold ODIs) and, (2) Entities that qualify as regulated broad based funds, may also issue ODIs under the FPI Regulations.

- FPIs shall have to fully disclose to SEBI, any information concerning the terms of and parties to ODIs entered into by it relating to any securities listed or proposed to be listed in any stock exchange in India. On

47. Regulation 22
48. Regulation 22
49. Reference may be made to Explanation 1 to Regulation 5 of the FPI Regulations where it is provided that an applicant (seeking FPI registration) shall be considered to be “appropriately regulated” if it is regulated by the securities market regulator or the banking regulator of the concerned jurisdiction in the same capacity in which it proposes to make investments in India.

November 24, 2014, SEBI issued a circular[1] ("**Circular**") aligning the conditions for subscription of offshore derivative instruments ("**ODIs**") to those applicable to FPIs. The Circular makes the ODI subscription more restrictive.

- As per the Circular, read with the FPI Regulations, to be eligible to subscribe to ODI positions, the subscriber should be regulated by an IOSCO member regulator or in case of banks subscribing to ODIs, such bank should be regulated by a BIS member regulator.
- It states that an FPI can issue ODIs only to those subscribers who meet certain eligibility criteria mentioned under regulation 4 of the FPI Regulations (which deals with eligibility criteria for an applicant to obtain registration as an FPI) in addition to meeting the eligibility criteria mentioned under regulation 22 of the FPI Regulations. Accordingly, ODIs can now only be issued to those persons who (a) are regulated by an 'appropriate foreign regulatory authority'; (b) are not resident of a jurisdiction that has been identified by Financial Action Task force ("**FATF**") as having strategic Anti-Money Laundering deficiencies; (c) do not have 'opaque' structures (i.e. protected cell companies ("**PCCs**") / segregated portfolio companies ("**SPCs**") or equivalent structural alternatives); and (d) comply with 'know your client' norms.
- The Circular clarifies that 'opaque' structures (i.e. PCCs / SPCs or other ring-fenced structural alternatives) would not be eligible for subscription to ODIs.
- The Circular further requires that multiple FPI and ODI subscriptions belonging to the same investor group would be clubbed together for calculating the below 10% investment limit.
- The existing ODI positions will not be affected by the Circular until the expiry of their ODI contracts. However, the Circular specifies that there will not be a rollover of existing ODI positions and for any new ODI positions, new contracts will have to be entered into, in consonance with the rules specified in the Circular.[50]



50. http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/sebi-rewrites-rules-on-offshore-derivative-instruments-odi.html?no_cache=1&cHash=60c81c4a0fcc1c1ffbbe8d2aae5e2e5b

B. Position of Tax on P-Notes

Under sections 4 and 5 of the Income Tax Act, non-residents may be taxed only on income that accrues in India or which arises from sources in India. The source rules for specific types of income are contained in section 9, which specifies certain circumstances where such income is deemed to accrue or arise in India. Capital gains from the transfer or sale of shares or other securities of an Indian company held as capital assets would ordinarily be subject to tax in India (unless specifically exempted).

Under section 9(1)(i) of the Tax Act, income earned by a non-resident from the transfer of a capital asset situated in India would be deemed to have been accrued in India (i.e. be sourced in India). Therefore, a non-resident may be liable to tax in India if it earns income from the transfer of a capital asset situated in India.

In Vodafone International Holdings B.V. v. Union of India[51], the Indian Supreme Court stated that the Indian tax authorities are to only "look at" a particular document or transaction when determining the taxability thereof, thus indicating a form-over-substance approach with respect to taxation. Thus, in light of the above-mentioned determinations, an indirect transfer of capital assets situated in India, between two non-residents, executed outside India was held to be not taxable under the Tax Act.

In response to the decision of the Supreme Court, a retroactive clarification was inserted in the Tax Act by the Finance Act, 2012 to state that such foreign shares or interest may be treated as a capital asset situated in India if it "derives, directly or indirectly, its value substantially from assets located in India". The newly introduced Explanation 5 to section 9(1)(i) expands the source rule to cover shares or interest in a foreign company, the value of which is substantially derived from assets situated in India. However, while the foreign shares/interest may be deemed to be situated in India, the charge of capital gains tax may not extend to that portion of its value relating to assets located outside India. Assets located outside India do not have any nexus with the territory of India to justify taxation under the Tax Act. It is therefore necessary to "read down" the amended section 9(1)(i) based on the nexus principle.

In case of an ODI holder, while the value of the ODI can be linked to the value of an asset located in India (equity, index or other forms of underlying securities from which the swap derives its value), it is a contractual arrangement that does not typically obligate the FII /FPI to acquire or dispose the referenced security. Accordingly, contractually it is not mandatory for the FII /FPI to fully hedge its position to the swap exposure vis-à-vis the counterparties. Furthermore, even when the ODI holder redeems the ODI, the obligation (in case of a 'net' swap on a portfolio of equities) is only to pay the counterparty a net sum equal to economic return on the holding of the underlying securities over the swap period made up of any movement on the market price plus any dividends received. Therefore, there is no requirement that the FII /FPI should sell the underlying securities. Thus, a defendable case may be made out that the agreement between the issuer FII /FPI and the ODI holder, being only in the nature of a contractual arrangement without any control on the underlying securities, should not be perceived as a 'share' or 'interest' under the newly introduced Explanation 5 to section 9(1)(i) of the Tax Act.

C. Grandfathering of ODIs

The FPI Regulations provide a limited grandfathering to ODIs that were issued prior to January 7, 2014 under the erstwhile FII Regulations. ODI issued under the FII Regulations before January 7, 2014 (i.e. the date of commencement of the FPI

51. Vodafone International Holdings B.V. v. Union of India & Anr. [S.L.P. (C) No. 26529 of 2010, dated 20 January 2012]

Regulations) would be deemed to be issued under the corresponding provisions of the FPI Regulations. This grandfathering provision extends to 'existing ODI subscribers' as well as 'ODIs' issued before January 7, 2014.[52]

III. Onshore Hedge Funds

As has been previously discussed, SEBI introduced different categories of AIFs to cater to different investment strategies. Category III AIFs is a fund which employs diverse or complex trading strategies and may involve leverage including through investments in listed or unlisted derivatives.

While the general characteristics of Category III AIFs have been discussed previously, it is important to stress on certain key aspects. The AIF Regulations provide that Category III AIFs may engage in leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit specified by SEBI. On July 29, 2013, SEBI issued a circular[53] which laid down certain important rules relating to redemption restrictions and leverage.

A. Redemption Restrictions

A Category III AIF cannot impose redemption restrictions unless the possibility of suspension of redemptions has been disclosed in the placement memorandum and such suspension can be justified as being under exceptional circumstances and in the best interest of investors. This could mean that the practice of using 'gates' to limit the frequency and quantum of redemption may be impacted. Further, in the event of a suspension of redemption, a fund manager cannot accept new subscriptions and will have to meet the following additional obligations:

i. Document reasons for suspension of redemption and communicate the same to SEBI;

ii. Build operational capability to suspend redemptions in an orderly and efficient manner;

iii. Keep investors informed about actions taken throughout the period of suspension;

iv. Regularly review the suspension and take necessary steps to resume normal operations; and

v. Communicate the decision to resume normal operations to SEBI.

B. Leverage Guidelines

SEBI limits the leverage that can be employed by any scheme of a fund to two times (2x) the net asset value (NAV) of the fund. The leverage of a given scheme is calculated as the ratio of total exposure of the scheme to the prevailing NAV of the fund. While calculating leverage, the following points should be kept in mind:

i. Total exposure will be calculated as the sum of the market value of the long and short positions of all securities / contracts held by the fund;

ii. Idle cash and cash equivalents are excluded while calculating exposure;

iii. Further, temporary borrowing arrangements which relate to and are fully covered by capital commitments from investors are excluded from the calculation of leverage;

iv. Offsetting of positions shall be allowed for calculation of leverage in accordance with the SEBI norms for hedging and portfolio rebalancing; and

v. NAV shall be the sum of value of all securities adjusted for mark to market gains / losses including cash and cash equivalents but excluding any borrowings made by the fund.

52. Regulation 22(4)
53. SEBI Circular CIR/IMD/DF/10/2013

The AIF Regulations require all Category III AIFs to appoint a custodian. In the event of a breach of the leverage limit at any time, fund managers will have to disclose such breach to the custodian who in turn is expected to report the breach to SEBI before 10 AM, IST on the next working day. The fund manager is also required to communicate the breach of the leverage limit to investors of the fund before 10 AM, IST on the next working day and square off the excess exposure to rebalance leverage within the prescribed limit by the end of the next working day. When exposure has been squared off and leverage has been brought back within the prescribed limit, the fund manager must confirm the same to the investors whereas the custodian must communicate a similar confirmation to SEBI.

8. Fund Governance

A pooled investment vehicle typically seeks to adopt a robust governance structure. The genesis of this obligation (other than as may be required under applicable laws) is in the generally accepted responsibilities of fiduciary that come to managers of other peoples' money.

In a fund context, the decision making framework typically follows the following structure –

I. Investment Manager

The investment manager is concerned with all activities of a fund including its investment and divestment related decisions. These are typically subject to overall supervision of the board of directors of the fund (if set up in the format of a 'company').

II. Investment Committee

The Investment Committee (IC) scrutinizes all potential transactions (acquisition as well as exit). The IC's role includes maintaining pricing discipline, ensuring that all transactions adhere to the fund's strategy and assessing the risk -return profile of the deals.

The functions of the IC typically include review of (1) transactions that are proposed by the investment manager and (2) performance, risk profile and management of the investment portfolio and to provide appropriate recommendations to the investment manager.

III. Advisory Board

Typically, the Advisory Board's role is to provide informed guidance to the investment manager/ IC of the fund based on the information/reports shared by the investment manager with the Advisory Board.

The Advisory Board typically provide recommendations to the investment manager/ IC in relation to (1) manage conflicts of interest situations, (2) approval of investments made beyond the threshold levels as may have been defined in the fund documents, (3) investment manager's overall approach to investment risk management and (4) Corporate governance and compliance related aspects.

IV. Aspects and Fiduciaries to be considered by Fund Directors

The emerging jurisprudence suggests that the threshold of fiduciaries that is required to be met by the directors is shifting from "sustained or systematic failure to exercise oversight" to "making reasonable and proportionate efforts commensurate with the situations". A failure to perform their supervisory role could impose severe liabilities on independent directors for resultant business losses as would be seen in the case of Weavering Macro Fixed Income Fund (summarized below) where the directors were ordered to pay a sum of $111 million.

As a matter of brief background, Weavering Macro Fixed Income Fund (“**Fund**”) was a Cayman Islands based hedge fund. The Fund appointed an investment manager to 'manage the affairs of the Fund subject to the overall supervision of the Directors'. The Fund went into liquidation at which point in time, action for damages was initiated by the official liquidators against the former "independent" directors.

In the instant case, the court found evidence that while board meetings were held timely, the meetings largely recorded information that was also present in the communication to fund investors and that the directors were performing 'administrative functions' in so far as they merely signed the documents that were placed before them.

Based on such factual matrix, the court held against the directors for wilful neglect in carrying out their duties. It was also observed that based on their inactions, the defendant directors "did nothing and carried on doing nothing". The measure of loss was determined on the difference between the Fund's actual financial position with that of the hypothetical financial position had the relevant duties been performed by the directors.

The court ruled against each of the directors in the amount of $111 million.

It was also observed, that the comfort from indemnity clauses are for reasonably diligent independent directors to protect those who make an attempt to perform their duties but fail, not those who made no serious attempt to perform their duties at all.

The court observed that the directors are bound by a number of common law and fiduciary duties including those to (1) act in good faith in the best interests of the fund and (2) to exercise independent judgment, reasonable care, skill and diligence when acting in the fund's interests.

We summarize below the duties of directors based on the above judgments that should guide a director during the following phases in the life of a fund:

A. At the Fund Formation Stage

Directors must satisfy themselves that the offering documents comply with applicable laws, that all conflict of interest situations are addressed upfront, that the structure of the fund is not only legally compliant but also ethically permissible, that the terms of the service providers' contracts are reasonable and consistent with industry standards, and that the overall structure of the fund will ensure a proper division of responsibility among service providers. Directors must act in the best interests of the fund which, in this context, means its future investors.

In this respect, we believe 'verification notes' can be generated. The notes would record the steps which have been taken to verify the facts, the statements of opinion and expectation, contained in the fund's offering document(s). The notes also serve the further purpose of protecting the directors who may incur civil and criminal liability for any untrue and misleading statements therein or material or misleading omissions therefrom. Alternatively, a 'closing opinion' may also be relied upon.

B. During the Fund's Tenure

i. Appointment of Service Providers

Directors should consider carefully which service providers are selected for appointment. They should understand the nature of the services to be provided by the service providers to the fund.

ii. Agenda

The formalities of conducting proper board meetings should be observed. An agenda for such meetings should list the matters up for discussion, materials to be inspected, and inputs from the manager, the service providers and directors themselves. It should be circulated well in advance.

iii. Actions Outside Board Meetings

The directors should review reports and information that they received from the administrator and auditors from time to time to independently assess the functioning of the fund and whether it is in keeping with the fund's investment strategy and compliant with the applicable laws.

iv. Decision Making Process

Directors should exhibit that there was an application of mind when considering different proposals before it. The decision making process will also play a pivotal role in determining the substance of the Fund from an Indian tax perspective as India moves away from its principle of “form over substance” to “substance over form” post April 1, 2015. For example, in case of investor ‘side letters’ that may restrict the fund’s investments into a restricted asset class, etc., could raise issues. While execution of such ‘side letters’ may not be harmful to the fund, but an approval at ‘short notice’ may be taken up to reflect on the manner in which the directors perform their duties.

v. Minutes

Board meetings should be followed by accurately recorded minutes. They should be able to demonstrate how the decision was arrived at and resolution thereon passed. The minutes should reflect that the directors were aware of the issues that were being discussed. Clearly, a ‘boilerplate’ approach would not work.

vi. Remuneration

The remuneration for independent directors should be commensurate to the role and functions expected to be discharged by them. While a more-than-adequate remuneration does not establish anything, an inadequate recompense can be taken as a ground to question whether the concerned director intends to perform his/her duties to the fund.

vii. Conflict of interest

If related party transactions or transactions that may raise conflict of interest cannot be avoided, a policy should be outlined where events and mechanisms to identify and resolve events which could lead to potential conflicts, should be recorded. Suitable measures that demonstrate governance and that the interest of the investors would be unimpaired, should be adopted.

The rulings discussed confirm that a fund’s board has duties cast on it and the ‘business judgment rule’ may not shield from liability in all cases.

There are certain non-delegable functions for the directors to discharge on an on-going basis and none more paramount than reviewing of the fund’s performance, portfolio composition and ensuring that an effective compliance program is in place. These functions require action ‘between’ board meetings and not ‘during’ board meetings only.

9. International Tax Considerations

I. Taxation of Indirect Transfers

In India, residents are taxable on their worldwide income whereas non-residents are taxable on Indian source income i.e. income that accrues or arises, or is deemed to accrue or arise, or is received or is deemed to be received in India.

As stated above, for a non-resident to be subject to tax in India, the Income Tax Act, 1961 ("**Tax Act**") requires that the income should be received, accrued, arise or deemed to be received, accrued or arisen to him in India.[54] In this regard, section 9(1) (i) of the Tax Act provides the circumstances under which income of a non-resident may be deemed to accrue or arise in India:

Section 9(1): "The following income shall be deemed to accrue or arise in India: (i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India."

This source rule pertaining to a "capital asset situate in India" was examined by the Supreme Court of India in Vodafone International Holdings[55], which dealt with transfer of shares of a foreign company between two non-residents. It was held that a share is legally situated at the place of incorporation of the company. Therefore while the shares of an Indian company would be considered situated in India, the shares of a company incorporated outside India would ordinarily be viewed as situated outside India.

This position has undergone a change pursuant to the Finance Act, 2012 which amended section 9 of the Tax Act through the insertion of Explanation 5 cited below:

"For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India."

Therefore, under the current law, shares of a foreign incorporated company can be considered to be a "situate in India" if the company derives "its value substantially from assets located in India". The Tax Act is silent on how to compute / allocate the derivation of substantial value. Under the draft Direct Taxes Code Bill, 2010 presented before the Parliament on August 30, 2010 ("**DTC**"), it was indicated that in the context of indirect transfers, 'substantial value' would be derived in India if 50% or more of the assets are situated in India.[56] A similar recommendation was made by the committee set up to review the working of the indirect transfer tax provisions introduced by the Finance Act,

54. S.5(2) of the Tax Act.
55. (2012) 341 ITR 1.
56. See section 5(4)(g) of the DTC bill which states as follows: "Income from transfer, outside India, of any share or interest in a foreign company unless at any time in twelve months preceding the transfer, the fair market value of the assets in India, owned, directly or indirectly, by the company, represent at least fifty per cent. of the fair market value of all assets owned by the company." [Emphasis Supplied]

2012 ("**Shome Committee**").[57] However, these recommendations do not form part of the law today and thus have only persuasive value as regards interpretation of Explanation 5.

Therefore, in the absence of any binding statutory or judicial analysis, there is no clarity on the circumstances when shares of an offshore company substantially derive their value from assets located in India. Thus, there is an uncertainty on the applicability of the source rule in case of transfer of shares of an offshore company with assets in India and there is a possibility that Indian tax authorities may seek to tax the transfer or redemption of shares in an India-focused offshore fund by its investors notwithstanding that there is no transfer taking place in India, on the basis that the shares of the Fund derive substantial value from India.

Where the shares of an offshore company are deemed to be capital assets situated in India under S.9(1)(i), the entire gains arising of such transfer would be subject to the charging provisions of the Act, regardless of the extent to which such shares may also derive their value from assets and revenue abroad.

II. General Anti-Avoidance Rule (GAAR)

While a statutory GAAR has been introduced in the Tax Act, Indian tax authorities cannot apply GAAR prior to the financial year beginning on April 1, 2015. Prior to such date, guidance needs to be taken from judicially-evolved anti-avoidance principles. In the following paragraphs, we briefly summarize certain judicial anti-avoidance rules as well as the outline for the GAAR regime.

However, the Supreme Court ruling in McDowell & Co. Ltd. v. CTO[58] stated that under the Indian tax laws, even while predominantly respecting legal form, the substance of a transaction could not be ignored where it involved sham or colorable devices to reduce an entity's tax liabilities. Therefore, as per judicial anti-avoidance principles, the Indian tax authorities have the ability to ignore the form of the transaction only in very limited circumstances where it is a sham transaction or a colourable device.

In 2012, this position underwent some degree of change with the introduction of GAAR.[59] The GAAR provisions are to come into effect from April 1, 2015 and can have an impact even in respect of transactions entered beforehand, if any part of the transaction is effectuated post August 30, 2010. The GAAR provisions extend the power of the Indian tax authorities to disregard transactions even when such transactions / structures are not a "sham", if they amount to an "impermissible avoidance arrangement". An impermissible avoidance arrangement has been defined as an arrangement entered into with the main purpose of obtaining a tax benefit. These provisions empower the tax authorities to declare any arrangement as an "impermissible avoidance arrangement", if the arrangement has been entered into with the principal purpose of obtaining a tax benefit and involves one of the following elements:

A. Non-arm's Length Dealings

It refers to arrangements that create rights or obligations not normally created between independent parties transacting on an arm's length basis.

57. Report of the Expert Committee on Retrospective Amendments made by the Finance Act, 2012 to Income-Tax Act, 1961 relating to Taxation of Non- Residents on Indirect Transfer headed by Dr.Parthasarthi Shome, p.7. "(ii) The word "substantially" used in Explanation 5 should be defined as a threshold of 50 per cent of the total value derived from assets of the company or entity, as proposed in DTC Bill 2010. In other words, a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be situated in India, if the share or interest derives, directly or indirectly, its value from the assets located in India being more than 50% of the global assets of such company or entity."

58. 154 ITR 148.

59. S.95, Income Tax Act, 1961.

B. Misuse or Abuse of the Provisions of the Act

It results directly or indirectly, in the misuse or abuse of the Act.

C. Lack of Commercial Substance

Arrangements that lack commercial substance or are deemed to lack commercial substance- This would include round trip financing involving transfer of funds between parties without any substantial commercial purpose, self-cancelling transactions, arrangements which conceal, and the use of an accommodating party, the only purpose of which is to obtain a tax benefit. Arrangements are also deemed to lack commercial substance if the location of assets, place of transaction or the residence of parties does not have any substantial commercial purpose.

D. Non-Bona Fide Purpose

Arrangements that are carried out by means or in a manner which is not ordinarily employed for a bona fide purpose.

In the event that a transaction / arrangement is determined as being an 'impermissible avoidance arrangement', the Indian tax authorities would have the power to disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of such entities and the legal situs of assets involved, treat debt as equity, vice versa, and the like. The tax authorities may deny tax benefits even if conferred under a tax treaty, in case of an impermissible avoidance arrangement.

III. Business Connection / Permanent Establishment Exposure

Offshore funds investing in India have a potential tax exposure on account of having constituted a permanent establishment ("**PE**") in India. In case of a PE determination, the profits of a non-resident entity are taxable in India only to the extent that the profits of such enterprise are attributable to the activities carried out through its PE in India.

What constitutes permanent establishment. Management teams for India focused offshore funds are typically based outside India as an onshore fund manager enhances the risk of the fund being perceived as having a PE in India. Although tax treaties provide for the concept of a PE in Article 5 (as derived from the Organisation for Economic Co-operation and Development ("**OECD**") and United Nations ("**UN**") Model Convention), the expression has not been exhaustively defined anywhere. The Andhra Pradesh High Court, in CIT v. Visakhapatnam Port Trust (144 ITR 146), held that:

> *"The words "permanent establishment" postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country."*

The presence of the manager in India could be construed as a place of management of the offshore fund and thus the manager could be held to constitute a permanent establishment. Consequently, the profits of the offshore fund to the extent attributable to the permanent establishment, may be subject to additional tax in India.

What tantamount to business connection in the context of an offshore fund? 'Business connection' is the Indian domestic tax law equivalent of the concept of PE under a tax treaty scenario. The term business connection, however, is much wider. The term has been provided as an inclusive definition per Explanation 2 to Section 9(1)(i) of the Tax Act, whereby a 'business connection' shall be constituted if any business activity is carried out through a person who (acting on behalf of the non-resident) has and habitually exercises in India and has the authority to conclude contracts on behalf of the non-resident. Thus, the legislative intent suggests that (in absence of a tax treaty between India and the jurisdiction in which the offshore fund has been set up) under the business connection rule, an India based fund manager may be identified as a 'business connection' for the concerned offshore fund.

It is important to note that the phrase 'business connection' is incapable of exhaustive enumeration, given that the Tax Act provides an explanatory meaning of the term which has been defined inclusively. A close financial association between a resident and a non-resident entity may result in a business connection for the latter in India. The terms of mandate and the nature of activities of a fund manager are such that they can be construed as being connected with the business activity of the offshore fund in India.

Accordingly, offshore funds did not typically retain fund managers based in India when a very real possibility existed that the fund manager could be perceived as a PE or a business connection for the fund in India. Instead, many fund managers that manage India focused offshore funds, tend to be based outside India and only have an advisory relationship in India that provide recommendatory services.

However, in the budget speech (delivered on July 10, 2014), the then finance minister had suggested that clarity would be provided that fund managers of FPIs who are present in India would not create a tax exposure for offshore funds on account of permanent establishment in India. This measure is intended at providing an impetus to fund managers to operate from India.

Annexure I

Sector Focused Funds

I. Social Venture Funds

A. Introduction

Although existent in practice, it is only under the AIF Regulations that social venture funds were formally recognized. Under the AIF Regulations, a social venture fund is defined as, "an alternative investment fund which invests primarily in securities or units of social ventures and which satisfies social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns."

Typically, social venture funds tend to be impact funds which predominantly investment in sustainable and innovative business models. The investment manager of such fund is expected to recognise that there is a need to forecast social value, track and evaluate performance over time and assess investments made by such fund.

B. Characteristics of Social Venture Funds

Social venture funds tend to be different from venture capital funds or private equity funds not just in the investments that they make, but also in the nature of commitments that they receive from their limited partners / investors. The following is a list of some of the characteristics that a social venture fund may expect to have:

- Investors making grants (without expectation of returns) instead of investments;
- Fund itself providing grants and capital support considering social impact of such participation as opposed to returns on investment alone;
- Fund targeting par returns or below par returns instead of fixed double digit IRR;
- Management team of the Fund participating in mentoring, "incubating" and growing their portfolio companies, resulting in limited token investments (similar to a seed funding amount), with additional capital infused as and when the portfolio grows;
- Moderate to long term fund lives in order to adequately support portfolio companies.

Social venture funds also tend to be aligned towards environmental, infrastructure and socially relevant sectors which would have an immediate impact in the geographies where the portfolio companies operate.

C. Tools to Measure Social Impact

New systems have emerged that managers of social impact funds rely on to quantify the social value of investments. Some of these include:

- Best Alternative Charitable Option (BACO), developed by the Acumen Fund.
- Impact Reporting & Investment Standards (IRIS), developed by Global Impact Investing Network (GIIN).
- Global Impact Investing Rating System (GIIRS).

D. Laws Relating to Social Venture Funds Investing into India

Offshore social venture funds tend to pool capital (and grants) outside India and making investments in India like a typical venture capital fund. Such offshore funds may not directly make grants to otherwise eligible Indian opportunities, since this may require regulatory approval.

Onshore social venture funds are required to be registered as a category I AIF under the specific sub-category of social venture funds. In addition to the requirement to fulfill the conditions set out in the definition (set out above), social venture funds under the AIF Regulations are subject to the following restrictions and conditions:

- Requirement to have at least 75% of their investible funds invested in unlisted securities or partnership interest of 'social ventures'[60];
- Allowed to receive grants (in so far as they conform to the above investment restriction) and provide grants. Relevant disclosure in the placement memorandum of the fund will have to be provided if the social venture fund is considering providing grants as well;
- Allowed to receive muted returns.

II. Film Funds

A. Film Funds – An Introduction

A film fund seeks to provide select sophisticated investors with an opportunity to participate in the financing of a portfolio of content e.g. motion pictures and televisions serials.

In current times when demand for high quality films and media products has increased, such pooling platforms play the role of providing organized financing to various independent projects or work alongside studios and production houses. A unique feature is the multiple roles and level of involvement that the fund manager can undertake for the fund and its various projects.

B. Film Funding Models

Most film funds take a 'slate financing' approach wherein the investment is made in a portfolio of films/ media projects, as opposed to a specific project. However, as a variation of the typical film funding model – investors can even be introduced at the project specific level i.e. for a single production only.

In terms of risk mitigation, the slate financing model works better than a specific project model owing to risk-diversification achieved for the investor.

Apart from typical equity investments, film funds may additionally also seek debt financing pursuant to credit facilities subject to compliance with local laws. E.g. in Indian context, debt financing by offshore funds may not work.

C. Risks and Mitigating Factors

Film fund investors should take note of media industry specific risks such as - risk of abandonment of the project (execution risks), failure to obtain distributors for a particular project, increased dependence on key artists, increasing marketing costs, oversupply of similar products in the market, piracy, etc.

To mitigate such risks, diversification of the projects could be observed. Additionally, a strong and reliable green lighting mechanism could also put in place whereby the key

60. Regulation 2(1)(u) states -social venture means a trust, society or company or venture capital undertaking or limited liability partnership formed with the purpose of promoting social welfare or solving social problems or providing social benefits and includes -
    i. public charitable trusts registered with Charity Commissioner;
    ii. societies registered for charitable purposes or for promotion of science, literature, or fine arts;
    iii. company registered under Section 25 of the Companies Act, 1956;
    iv. micro finance institutions.

management of the fund decides the projects that should be green lit – based on factors such budgeted costs, available distributorship arrangements, sales estimates and so on.

D. Life cycle of a Film Fund

The life of a film in term of economic performance is generally in the range of 8 to 10 years depending upon the sources of revenue. Typically, sources of revenue of a film are –

i. Domestic and international theatrical release of the film;

ii. Domestic and international television markets; and

iii. Merchandizing of film related products, sound track releases, home video releases, releasing the film on mobile platforms, and other such online platforms.

Generally, a major portion of income from a film project is expected to be earned at the time of theatrical release of the film, or prior to release (through pre-sales). Consequently, the timing of revenue is generally fixed or more easily determinable in case of film investments, as compared to other asset classes.

The box office proceeds of a film typically tend to be the highest source of revenue and also a key indicator of expected revenue from other streams. Thus, keeping the timing of revenue flows in mind, film funds are often structured as close ended funds having a limited fund life of 7 to 9 years. The term may vary depending on the number of projects intended to be green lit or the slate of motion pictures or other media projects intended to be produced.

Typically, after the end of the life of the fund, all rights connected with the movie (including derivative rights) are sold or alternatively transferred to the service company or the fund manager on an arm's length basis. Derivative rights including rights in and to prequels, sequels, remakes, live stage productions, television programs may also be retained by the investment manager (also possibly playing the role of the producer). Such transfer or assignment of residual rights is of course subject to the nature of and the extent of the right possessed by the fund or the concerned project specific SPV.

Sources of income of a film fund and tax treatment:

i. Distributorship Arrangements

The fund or the project specific SPV, as the case may be, may license each project to major distributors across territories in accordance with distribution agreements. Pursuant to such distribution agreements, the fund could expect to receive net receipts earned from the distributions less a distribution fee payable to the distributor (which typically consists of distribution costs and a percentage of net receipts). Income of this nature should generally be regarded as royalty income. If the distributor is in a different jurisdiction, there is generally a withholding tax at the distributor level. The rate of tax depends on the tax treaty between the countries where distributor is located, and where the fund / its project specific SPV is located.

ii. Lock Stock and Barrel Sale

The project exploitation rights may be sold outright on a profit margin for a fixed period or in perpetuity (complete ownership). This amounts to the project specific SPV selling all its interest in the IP of the movie for a lump sum consideration.

iii. Use of an Appropriate Intermediary Jurisdiction

Fund vehicles have historically been located in investor friendly and tax neutral jurisdictions. The unique nature of film funds adds another dimension (i.e. intellectual property, i.e. IP) while choosing an appropriate jurisdiction. Generally, an IP friendly jurisdiction is chosen for housing the intellectual property of the fund or specific project. Further, since considerable amount of income earned by the fund may be in the form of royalties, a jurisdiction that has a favourable royalty clause in its tax treaty with the country of the distributor may be used. This assumes greater importance because the royalty withholding tax rate under the Indian Income tax Act, 1961 is 25%.

Due to its protective regime towards IP, low tax rates and extensive treaty network, Ireland has been a preferred jurisdiction for holding media related IP.

E. Role of Services Company

In a film fund structure, certain acquisition, development, production and related services may be performed by a separate entity (**"Services Company"**). The Services Company may have a contractual relationship with the fund or its project specific subsidiaries, during the term of the fund. Depending upon circumstances of each project, the fund may engage the Services Company directly or a special purpose subsidiary to provide production services. In respect of these services, the Services Company receives a fee, which can be included with the fund's operational costs. The role of the Services Company may also be fulfilled by the fund manager. The Services Company/ manager may also hold the intellectual property associated with each project that may be licensed to or acquired by the fund or its project specific subsidiaries.

F. Role of the Fund Manager

The fund manager may take up the responsibilities of the Service Company as indicated above. Once a specific project is selected and green-lit by the manager, all underlying rights necessary to produce and/ or exploit the project may be transferred to the fund. In addition to such role, the manager would also be expected to play the role of the traditional manager of pooled investment vehicle and expected to discharge its fiduciary obligations. To an extent, the same may require observing specific conflict of interest mechanisms considering the multiple functions that may be performed in the context of a film fund.

III. Real Estate Funds

Investment funds that specifically focus on real estate (**"RE Fund"**) have been in existence in the Indian funds industry under the VCF Regulations and now under the AIF Regulations. Under AIF Regulations, a RE Fund could be an AIF that is registered with SEBI as a Category II AIF since the category allows the eligible AIF to invest in equity and debt instruments.

A. Onshore Real Estate Funds: Investment Trend, Nature of Securities Subscribed and Returns

Typically, RE Funds invest in project specific single asset companies with the asset being self-liquidating, in most cases by subscribing to a mix of debt and equity instruments, as debt is favorable for investee companies to reduce book profits or tax burden. Additionally, redemption premium can be structured to provide equity upside. Nevertheless, if the income of the domestic fund is characterized as capital gains it gives a better position as compared to characterization of income as a business income or interest.

Subscription to debt instruments is also preferred because in the Indian context exit by way of an IPO is a rarity as real estate companies seldom meet the listing requirements. Also, for distribution of dividends on equity instruments, as a pre-requisite, the investee company shall require distributable profits as. This again is difficult to achieve because the real estate industry is very capital heavy.

B. Offshore Real Estate Funds

Foreign institutional investors (FIIs) are allowed to invest in listed / to be listed non-convertible debentures (NCDs) of Indian companies. Under this route, any private or public company can list its privately placed NCDs on the wholesale debt market segment of any recognized stock exchange. An FII or a sub-account of an FII entity can then purchase these NCDs on the floor of the stock exchange.

RBI and SEBI have permitted direct subscription of 'to be listed' NCDs by the FII, thus doing away with the requirement of a warehousing entity. These 'to be listed' NCDs have to listed on a recognised stock exchange within 15 days of issuance, else, the FIIs / sub-accounts are required to dispose-off the NCDs to an Indian entity / person.

The NCDs are usually redeemed at a premium that is usually based on the sale proceeds received by the real estate company, with at least 1x of the purchase price being assured to the NCD holder.

Also, since NCDs are subscribed to by an FII entity under the FII route and not the FDI route, the restrictions applicable to the FDI investors in terms of pricing are not applicable to NCD holders. The FPI Regulations have retained the flexibility to invest in listed / to be listed NCDs.

C. Real Estate Investment Trusts ("REIT")

SEBI released the REIT Regulations on September 26, 2014. REITs would serve as an asset-backed investment mechanism where an Indian trust is set up for the holding of real estate assets as investments, either directly or through an Indian company set up as a special purpose vehicle ("**SPV**"). However, the tax treatment of REITs continues to remain an issue.

The Finance Act, 2014 has made certain amendments to the Tax Act to clarify the income tax treatment of REITs. REITs will have a tax pass through status for income received by way of interest or receivable from the SPV as per s. 10 (23FC), 10 (23FD) and 115UA of the Income Tax Act, 1961.

Long term capital gains on sale of units as well as dividends received by REITs and distributed to the investor shall be tax exempt. Interest income received or receivable by the REIT from any SPVs is tax exempt and foreign investors shall be subject to a low withholding tax of 5% on interest payouts. [61]

From a sponsor's perspective, capital gains tax benefit has been given only in cases where shares of the SPV holding the real estate assets are transferred to a REIT against the units of a REIT, and not when real estate assets are directly transferred to a REIT by the sponsor. By doing so, there is an additional corporate layer imposed between the REIT and the real estate asset, which could result in a tax leakage of about 45% (corporate taxes of 30% at the SPV level and distribution tax of 15% on dividends, exclusive of surcharge and cess). To the sponsor, there is no tax benefit (but mere deferral) because she gets taxed when the REIT units are ultimately sold on the floor at a much more appreciated value, even though the units of a REIT would be listed and exempt from capital gains tax if held by other unit holders for more than three years.

The only way to achieve tax optimization seems to be by way of infusion of debt into the SPV by a REIT. In such a situation, interest from the SPV to the REIT will be a deductible income for the SPV, thus allaying both distribution taxes and corporate taxes.

61. http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/Private_Equity_and_Debt_in_Real_Estate.pdf

Interest from the SPV would be tax exempt at the REIT level and only a 5% withholding will be applicable on distributions by the REITs to the foreign unit-holders. This should help neutralize REIT taxation at India level, considering that the 5% withholding tax paid in India should also be creditable offshore.

The critical question that would then come up is how the SPV would use this debt. The debt can either be used to retire existing debt, or be structured to retire promoter equity in the SPV. If the debt is used for retiring equity, the risk of 'deemed dividend' characterization would need to be carefully considered. Though other creative structures may be devised to minimize tax exposure for the sponsor, it will be critical to 'dress up' the SPV appropriately with the right amount of debt and equity, before the SPV is transferred to the REIT.

Apart from the tax challenges set out above, there are also several non-tax issues that make the Indian REIT story unattractive. The requirement for a sponsor to have a real estate track record is likely to rule out a substantial portion of yield generating assets. This eliminates the possibility of non-real estate players such as hotels, hospitals, banks and others becoming sponsors of REITs. [62]

62. http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/reits-tax-issues-and-beyond-1.html?no_cache=1&cHash=a54570354bb5bc1969d720fba3cad33a

Annexure II

Summary of Tax Treatment for Mauritius and Singapore Based Entities Participating in Indian Opportunities

The following table summarizes the (i) requirements for eligibility under the India-Mauritius DTAA and the India-Singapore DTAA, (ii) the substance requirements that companies in Mauritius and Singapore will have to demonstrate in order to claim benefits under the two treaties and (iii) the tax rates that should be applicable to companies under the relevant tax treaties read with the provisions of the domestic tax law.

Parameters	Mauritius	Singapore
General		
Eligibility to treaty benefits	A person is considered a resident of Mauritius for relief under the tax treaty, as long as it is liable to tax in Mauritius by reason of domicile, residence or place of management. The Indian tax authorities issued a Circular (789 of 2000) stating that a tax residency certificate (TRC) issued by the Mauritius tax authorities constitutes sufficient proof of residence in Mauritius and entitlement to treaty relief. The landmark decision of the Indian Supreme Court in Union of India v. Azadi Bachao Andolan[63], upheld the validity of the aforesaid Circular 789. Following this case, a number of cases have confirmed treaty benefits for Mauritius based investors including: Dynamic India Fund I[64]; DDIT v. Saraswati Holdings Corporation[65]; E*Trade; In Re:Castleton[66] and D.B.Zwirn Mauritius Trading.[67]	The management and control of business of the pooling vehicle must be in Singapore.[68] Tax resident companies are eligible for treaty benefits subject as a practical matter to being able to obtain a tax residency certificate from the Inland Revenue Authority of Singapore
Substance Requirements	The Financial Services Commission encourages a company holding a Global Business Licence – 1 ("GBL-1") to have substance in Mauritius. Obtaining a GBL-1 s a pre-requisite to obtaining a TRC which in turn is necessary to enjoy benefits under the India-Mauritius DTAA. Among	The 'substance' requirements from an India-Singapore treaty perspective comes from within the treaty itself. The subsequently negotiated protocol to the India-SingaporeTreaty requires that the Singapore entity must not be a shell or a conduit. A shell / conduit entity

63. [2003] 263 ITR 707 (SC)
64. [2009] 111 TTJ 334.
65. [2010] 324 ITR 1 (AAR).
66. [2011] 333 ITR 32 (AAR).
67. AAR 1016/2010 dated 18th July, 2012.
68. Section 2 of the SITA, 1948

other things, the FSC considers whether the company:

i. has at least 2 directors, resident in Mauritius, who are appropriately qualified and of sufficient caliber to exercise independence of mind and judgment;

ii. maintains at all times its principal bank account in Mauritius;

iii. keeps and maintains, at all times, its accounting records at its registered office in Mauritius;

iv. prepares, or proposes to prepare its statutory financial statements and causes or proposes to have such financial statements to be audited in Mauritius;

v. provide for meetings of directors to include at least 2 directors from Mauritius; and

vi. is authorized/licensed as a collective investment scheme / closed-end fund / external pension scheme administered from Mauritius.

Further, the company must have a local administrator, a local auditor and a local custodian to ensure that all meetings of the board of directors are held and chaired in Mauritius. The same shall ensure that the central administration of the company is in Mauritius.

The FSC now expects Mauritius entities to fulfill one out of the following six additional substance requirements by January 1, 2015:

i. having office premises in Mauritius;

ii. employing at least one person full-time at an administrative/technical level;

iii. inserting a clause in its constitution providing that disputes arising from the constitution shall be resolved by way of arbitration in Mauritius;

iv. holding assets (other than cash and shares/interests in another GBL-1 company) worth at least USD 100,000 in Mauritius;

is one with negligible or nil business operations or with no real and continuous business activities carried out in Singapore.

A Singapore resident is deemed not to be a shell or conduit if it is listed on a recognized stock exchange or if its annual operational expenditure is at least SGD 200,000 per year in the two years preceding the transfer of shares giving rise to capital gains. The term "annual expenditure" means expenditure incurred during a period of 12 months. The period of 24 months shall be calculated by referring to two blocks of 12 months immediately preceding the date when the gains arise.

Accordingly, if the affairs of the Singapore entity are arranged with the primary purpose of taking benefit of capital gains relief, the benefit may be denied even if the Singapore entity is considered to have commercial substance under the GAAR provisions or incurs annual operational expenditure of SGD 200,000.

	v. having its shares listed on a Mauritius stock exchange; and vi. incurring an annual expenditure that can reasonably be expected from a similar corporation controlled / managed from Mauritius	
Tax Implications Under the Relevant Treaty		
Dividends	0% (as per the provisions of the Tax Act. Dividend distributions made by an Indian company to its shareholders are subject to a levy of Dividend Distribution Tax (DDT) at the rate of 16.995% of the dividends distributed. The DDT payable by a company is in addition to the normal corporate tax).	
Capital Gains	0%	0%[69] [70](pursuant to the provisions of the India-Singapore Tax Treaty, any capital gains earned by Singapore based entities on disposal of Indian securities should not be subject to tax in India. However, if such Singapore entities dispose any Indian securities prior to the completion of 24 months from the date of incorporation of such entity, it is likely that the gains, if any, arising from such disposal, wouldbe subject to tax in India if the "annual expenditure" is not met).
Interest	10% in respect of interest on foreign currency convertible bonds ("FCCBs")[71]; 20% in respect of interest on foreign currency debt other than FCCBs[72]; and 40% in respect of interest on debt denominated in Indian Rupees.	
Tax Implications if the Company is not Eligible to Claim Benefits under the Relevant Treaties		

69. The benefits of exemption from tax in India on capital gains earned on the sale of shares of Indian companies by a Singapore resident under the India-Singapore Tax Treaty are linked to that of the India-Mauritius Tax Agreement.

70. Singapore does not impose tax on capital gains. Gains from the disposal of investments may however be construed to be of an income nature and subject to Singapore income tax. Generally, gains on disposal of investments are considered income in nature and sourced in Singapore if they arise from or are otherwise connected with the activities of a trade or business carried on in Singapore. As the investment and divestment of assets of the Singapore based entity are managed by a manager, the entity may be construed to be carrying on a trade or business in Singapore. Accordingly, the income derived by the Singapore based entity may be considered income accruing in or derived from Singapore and subject to Singapore income tax, unless the FDI Sub is approved under section 13R and Section 13X respectively of the Income Tax Act (Chapter 134) (ITA) and the Income Tax (Exemption of Income of Approved Companies Arising from Funds Managed by Fund Manager in Singapore) Regulations 2010. Under these Tax Exemption Schemes, "specified income" derived by an "approved company" from "designated investments" managed in Singapore by any fund manager are exempt from Singapore income tax. While the Singapore Tax Exemption Schemes were initially intended to be valid until March 31, 2014, the 2014 Singapore Budget extended these schemes for an additional period of 5 years i.e. until March 31, 2019

71. FCCBs are issued under the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme 1993.

72. This could include loans made under the External Commercial Borrowings route

Capital Gains	Short-term capital gains: If securities transaction tax is paid: 16.223%* If securities transaction tax is not paid: 33.445%** Long-term capital gains: If securities transaction tax is paid: 0% If securities transaction tax is not paid: 10.815%+	Short-term capital gains: If securities transaction tax is paid: 16.223%* If securities transaction tax is not paid: 33.445%** Long-term capital gains: If securities transaction tax is paid: 0% If securities transaction tax is not paid: 10.815%+
Tax Implications in Mauritius / Singapore		
Capital Gains	0%	0% (However, if the income arising from sale of shares is characterized as business income, such income shall be taxed at the rate of 17%) [73]
Dividends	3%	0%
Interest	3%	17% (However, the Singapore entity will be entitled to tax credit for taxes paid in India on such interest income)[74]

* This rate applies where the capital gains exceeds INR 100 million. The applicable rate where capital gains exceed INR 10 million but are less than INR 100 million is 15.759%.

** This rate applies where the capital gains exceeds INR 100 million. The applicable rate where capital gains exceed INR 10 million but are less than INR 100 million is 31.518%.

+ This rate applies where the capital gains exceeds INR 100 million. The applicable rate where capital gains exceed INR 10 million but are less than INR 100 million is 10.506%.

73. As indicated above in Footnote 8, there should not be any tax on capital gains, dividend income or interest income that is derived by pooling vehicles that avail of the tax incentive schemes introduced by the Singapore government provided that the nature of investments made is such that it is covered under the tax incentive schemes.

74. Ibid.

Annexure III

Investment Regimes for Foreign Investors

Foreign investment in Indian securities is regulated by the Foreign Exchange Management Act, 1999 (“**FEMA**”). FEMA provides the statutory framework that governs India’s system of controls on foreign exchange dealings. Through it the government of India exercises its policy with respect to foreign private investment in India and all dealings by residents of India with non-residents and with foreign currency. Without permission (general or special) from the RBI, residents of India cannot undertake any transaction with persons outside India, sell, buy, lend or borrow foreign currency, issue or transfer securities to non-residents or acquire or dispose of any foreign security.

As per section 6(3)(b) of FEMA, the Reserve Bank of India (“**RBI**”) has been given the authority to prohibit, restrict or regulate the transfer or issue of any Indian security by a person outside India. Accordingly, the RBI has prescribed the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (“**FDI Regulations**”), pursuant to which no person resident outside India and no company that is not incorporated in India (other than a banking company) can purchase the shares of any company carrying on any trading, commercial or industrial activity in India without the general or special permission of the RBI.

India permits foreign investments through several routes based on the nature and extent of the foreign investment (example - strategic v. economic / portfolio investments). Limitations exist on investments in certain sectors of the Indian economy, price regulations for unlisted securities, statutory holding periods and various other restrictions on investing in Indian securities.

I. Foreign Direct Investment

A. Introduction

The FDI Regulations, the Consolidated FDI Policy and the Master Circular on Foreign Investment in India, prescribe the rules, regulations and policies governing FDI into India.

B. Instruments for FDI

As per the FDI Policy, FDI can be routed into Indian investee companies by using equity shares, fully compulsorily and mandatorily/Compulsorily Convertible Debentures (“**CCDs**”) and fully mandatorily and Compulsorily Convertible Preference Shares (“**CCPS**”). Debentures which are not CCDs or optionally convertible instruments are considered to be ECB and therefore, are governed by clause (d) of sub-section 3 of section 6 of FEMA read with Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 as amended from time to time.

Since, these CCPS and CCDs are fully and mandatorily convertible into equity, they are regarded at par with equity shares and hence the same are permissible as FDI. Further, for the purpose of minimum capitalization, in case of direct share issuance to non-residents, the entire share premium received by the Indian company is included. However, in case of secondary purchase, only the issue price of the instrument is taken into account while calculating minimum capitalization.

Herein below is a table giving a brief comparative analysis for equity, CCPS and CCDs:

Particulars	Equity	CCPS	CCD
Basic Character	Participation in governance and risk based returns	Assured Dividend – Convertible into Equity	Assured Coupon – Convertible into Equity
Liability to Pay	Dividend can be declared only out of profits	Fixed dividend if profits accrue	Fixed Interest payment - not dependent on accrual of profits
Limits to Payment	No cap on dividend	Dividend on CCPS cannot exceed 300 basis points over and above the prevailing SBI prime lending rate in the financial year in which CCPS is issued. No legal restriction on interest on CCD, however in practice it is benchmarked to CCPS limits.	
Tax Efficiency	No tax deduction, dividend payable from post-tax income - Dividend taxable @ 15%[75] in the hands of the company		Interest expense deductible – Withholding tax as high as 40% but it can be reduced to 5% if investment done from favourable jurisdiction
Liquidation Preference	CCD ranks higher than CCPS in terms of liquidation preference. Equity gets the last preference.		
Others	Buy-back or capital reduction permissible	CCPS and CCDs need to be converted to equity before they can be bought back or extinguished by the Indian company.	

C. Calculation of Total Foreign Direct Investment

Total Foreign Direct Investment (“**FDI**”) in an Indian entity is said to be equal to the sum of direct FDI and indirect FDI.

Wherein, direct FDI is equivalent to, the investment made directly by a non-resident entity.

The method of calculation of indirect FDI is briefly explained below.

i. Case 1

If the investing company which is owned and controlled by resident Indian citizens and/ or Indian Companies which are owned and controlled by resident Indian citizens makes any investment, then the foreign investment is said to be Nil.

ii. Case 2

If the investing company which is owned or controlled by “non-resident entities”, the entire investment by the investing company into the subject Indian Company would be considered as indirect foreign investment.

iii. Case 3

If the investing company is an operating-cum-investing/investing company which makes onward investment into its wholly owned subsidiary, then the indirect FDI in such wholly owned subsidiary shall be the mirror image of the percentage of direct FDI in the operating-cum-investing/investing company.

D. Pricing Requirements

FEMA also regulates the price at which a foreign direct investor invests into an Indian

75. All tax rates mentioned herein are exclusive of surcharge and education cess.

company. Accordingly, shares in an unlisted Indian company may be freely issued or transferred to a foreign direct investor, subject to the following conditions being satisfied:

- The price at which foreign direct investor subscribes / purchases the Indian company's shares is not lower than the floor price computed on the basis of the Discounted Cash Flows (**"DCF"**) method. However, if the foreign investor is subscribing to the memorandum of the company, the DCF floor price does not apply[76];
- The consideration for the subscription / purchase is brought into India prior to or at the time of the allotment / purchase of shares to / by the foreign direct investor.

RBI has permitted that shares/debentures with an optionality clause can be issued to foreign investors.

If any of the above conditions is not complied with, then the prior approval of the FIPB and/ or the RBI would be required. If the foreign investor is an FVCI registered with the SEBI, then the pricing restrictions would not apply. In addition, if the securities are listed, the appropriate SEBI pricing norms become applicable.

II. Foreign Venture Capital Investment

Given the current regulatory regime, the SPV is unlikely to seek registration as a foreign venture capital investor under the SEBI Foreign Venture Capital Investor Regulations, 2000 (**"FVCI Regulations"**) with SEBI, but may seek such registration if circumstances change. FVCI investors enjoy certain benefits as a result of such registration (including the non-applicability of pricing restrictions) which the SPV will not be able to take advantage of should the SPV elect not to seek or otherwise fail to obtain such registration. Further, under the current position of regulatory framework, the Reserve Bank of India imposes conditions that an FVCI (**"Foreign Venture Capital Investor"**) can invest in only select identified sectors. Accordingly, unless the SPV invests in Indian portfolio companies engaged in such sectors, an FVCI license may not be of any advantage. Further, if the SPV or any affiliate becomes registered as an FVCI investor, the SPV or such affiliate, as applicable, will be subject to regulations applicable to FVCI investors and any adverse change in the FVCI Regulations may have a significant effect on investments by the SPV or such affiliate in Indian portfolio companies.

FVCIs can invest directly into eligible Indian portfolio companies subject to compliance with certain investment conditions and restrictions as stipulated under the FVCI Regulations and the Indian exchange controls.

The term "VCU" has been defined to mean a domestic company whose shares are not listed in India and which is engaged in a business which does not fall within the negative list. The current negative list includes sectors such as gold financing (excluding those companies which are engaged in gold financing for jewellery), non-banking financial services (excluding those non-banking financial companies which are registered with the Reserve Bank of India and have been categorized as 'equipment leasing' or 'hire purchase companies'), activities not permitted under the Industrial Policy of the Government of India and such other activities that may be notified by SEBI in consultation with the

76. RBI clarified in its A.P. (DIR Series) Circular No. 36 dated September 26, 2012, that shares can be issued to subscribers (both non-residents and NRIs) to the memorandum of association at face value of shares subject to their eligibility to invest under the FDI scheme. The DIPP inserted this provision in the FDI Policy, providing that where non-residents (including NRIs) are making investments in an Indian company in compliance with the provisions of the Companies Act, 1956, by way of subscription to its Memorandum of Association, such investments may be made at face value subject to their eligibility to invest under the FDI scheme. This addition in the FDI Policy is a great relief to non-resident investors (including NRIs) in allowing them to set up new entities at face value of the shares and in turn reduce the cost and time involved in obtaining a DCF valuation certificate for such newly set up companies.

Indian government.

RBI has recently been prescribing in its approval letter to FVCI applicants, that the investments by FVCI entities be restricted to select sectors being infrastructure, biotechnology, IT related to hardware and software development, nanotechnology, seed research and development, research and development of new chemical entities in pharma sector, dairy industry, poultry industry, production of bio-fuels and hotel-cum-convention centers with seating capacity of more than 3,000. The scope of infrastructure for FVCI investments has been linked to the definition provided under the ECB guidelines.

In order to seek and obtain registration as an FVCI, it will be required to comply with the investment conditions and restrictions as laid down under the FVCI Regulations which are summarized herein below:

i. A FVCI is required to designate its investible funds for investment into India at the time of seeking registration. Accordingly, the investment conditions and restrictions would be applicable with respect to such investible funds. The FVCI intends to designate its entire corpus as 'investible funds' for investment into Indian securities in order to offer maximum flexibility on investments in Indian securities.

ii. The investment restrictions on FVCI are required to be achieved by the end of its life cycle.

iii. A FVCI is required to invest at least 66.67% of its investible funds in unlisted equity shares or equity linked instruments (i.e. instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity) of a VCU.

iv. A FVCI may invest up to 33.33% of its investible funds:

- by way of subscription to an initial public offering (**"IPO"**) of a VCU whose shares are proposed to be listed on a recognized stock exchange;
- in debt/debt instruments of a VCU in which the FVCI has already made an investment by way of equity;
- preferential allotment of equity shares of a listed company subject to lock in period of one year;
- the equity shares or equity linked instruments of a financially weak company (i.e. a company which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its net worth as at the beginning of the previous financial year) or a sick industrial company whose shares are listed; and
- special purpose vehicles which are created by a FVCI for the purposes of facilitating or promoting investment in accordance with the FVCI Regulations.

III. Foreign Portfolio Investors

In January 2014, the Securities and Exchange Board of India notified the SEBI (Foreign Portfolio Investors) Regulations, 2014 (**"FPI Regulations"**), which repeals the SEBI (Foreign Institutional Investors) Regulations, 1995 (**"FII Regulations"**). It significantly revises the regulation of foreign portfolio investments into India.

FPI Regulations seek to introduce a risk-based approach towards investor Know Your Customer (KYC) requirements, ease the entry process and reduce timelines for investor participants. However, the status of this approach may come up for reconsideration as the finance minister in his budget speech has suggested the introduction of uniform KYC norms and usability of records across the Indian financial sector.

However, on the key issues which foreign investors currently deal with, viz. ambiguity on the 'broad based' criteria, eligibility to issue/ subscribe to offshore derivative instruments and clubbing of investment limit, SEBI seems to have revisited the current position which may impact the industry. Interestingly, SEBI also seems to have changed the individual investment cap that an FPI can hold in Indian companies under the FPI Regulations.

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