भारतीय प्रतिभूति और विनिमय बोर्ड
Securities and Exchange Board of India

Report submitted by Alternative Investment Policy Advisory Committee

1. To solicit the comments/views from public on suggestions pertaining to the second report submitted by Alternative Investment Policy Advisory Committee.

Background:

2. SEBI had constituted a standing committee 'Alternative Investment Policy Advisory Committee' (AIPAC) under chairmanship of Shri. N. R. Narayana Murthy in March 2015. AIPAC has submitted its second report to SEBI with various recommendations stated therein.

Public Comments:

3. In order to take into consideration the views of various stakeholders, public comments are solicited on the said report as placed at Annexure. Comments may be emailed on or before **December 22, 2016**, to **aif@sebi.gov.in** or sent by post, to:-
Deputy General Manager
Division of Funds – I
Investment Management Department
Securities and Exchange Board of India
SEBI Bhavan
Plot No. C4-A, "G" Block,
Bandra Kurla Complex,
Bandra (East), Mumbai - 400 051

4. Comments/ suggestions may be provided in the format given below:

Name of entity / person / intermediary/ Organization			
Sr. No.	Clause No.	Suggestions	Rationale

Issued on: December 01, 2016

The Alternative Investment Policy Advisory Committee

Second Report

1st November, 2016

Table of Contents

Preface

Since the first report of the Alternative Investment Policy Advisory Committee (AIPAC) was produced, the members of AIPAC have continued to work hard at the second report.

The second report covers critical areas for the development of Alternative Investment Funds (AIFs) in India. The report includes recommendations for enhancing the confidence of those who invest in AIFs. This is achieved by superior governance, better performance and transparency. Recommendations for greater disclosure by AIF managers have been made.

I was heartened to note that the Government considered and implemented some of the recommendations in the tax sphere which were made by the first AIPAC report. This report continues the work and makes suggestions for further tax reforms. These reforms, together with superior governance, will, I am sure, help in the sound growth and development of India's AIF sector.

The recommendations follow the spirit of promoting ' ease of business' in the AIF arena. If implemented, it will enable all eco-system players, including domestic and offshore limited partners, to play their roles most effectively. This will ultimately lead to a healthy investing environment and a greater supply of long-term, stable capital to start-ups and a wide range of other businesses vital to India’s economic development.

The report also contains some Next Practices like the manner of application of the Accredited Investor' concept and permanent capital vehicles. I am glad that Committee members continue to push the envelope to develop India’s AIF sector.

Domestic funding of AIFs has grown rapidly by approximately Rs. 15,000 crores i.e. 108 % during the last 12 months, according to data released by SEBI. This can be attributed to two factors. Firstly, the reforms made by the Indian Government in line with the recommendations of the first AIPAC report. Secondly, the robustness of Indian economic growth has been a positive factor. This is a most encouraging trend and justifies further work by AIPAC in order to realise the full potential of the AIF asset class for India’s economic development.

Future work of AIPAC will consider areas such as recommendations for the growth of start-ups in India as well as do more analysis in the area of exits and crowd funding. I also welcome suggestions from Committee members and market players to recommend areas which AIPAC can consider for further analysis in order to make recommendations. The ultimate objective is to create an enabling environment for a sound Alternative Investment Fund asset class in India.

Finally, I wish to thank very much all AIPAC members and other professionals who burnt the midnight oil to produce this report.

Thank you.

N. R. Narayana Murthy
Chairman,
Alternative Investment Policy Advisory Committee

Alternative Investment Policy Advisory Committee: List of Members

Sr. No.	Name	Organization & Designation
1.	Mr. N.R. Narayana Murthy	Founder, Infosys Ltd.
2.	Mr. Ashish Kumar	Director, CBDT, MoF
3.	Mr. Nikhil Varma	Deputy Secretary, DEA, Ministry of Finance
4.	Mr. Sudarshan Sen	ED, Reserve Bank of India
5.	Dr. Kshatrapati Shivaji	Chairman & Managing Director, SIDBI
6.	Mr. Sanjay Nayar	Member & CEO, KKR India Advisors Pvt. Ltd.
7.	Dr. Saurabh Srivastava	Founder, Indian Angel Network
8.	Mr. Devinjit Singh	MD, The Carlyle Group, India
9.	Mr. Manish Chokhani	Senior Advisor, TPG Growth
10.	Mr. Gautam Mehra	Partner, PwC India
11.	Mr. Akshay Mansukhani	Partner, Malabar Investments
12.	Mr. Mani Iyer	Director, Incube Ventures Pvt. Ltd.
13.	Mr. Abid Hassan	Product Manager, Qplum
14.	Mr. K.E.C Rajakumar	MD & CEO, Ascent Capital Advisors
15.	Mr. Sudhir Sethi	Founder Chairman & MD, IDG Ventures India, iSPIRT Foundation
16.	Mr. Gopal Srinivasan	Chairman, IVCA, Chairman and MD, TVS Capital Funds Limited
17.	Mr. Manish Kejriwal	Managing Partner, Kedaara Capital Advisors LLP
18.	Mr. Arvind Mathur	Chairman, Private Equity Pro Partners
19.	Mr. Rajat Tandon	President, Indian Private Equity & Venture Capital Association(IVCA)
20.	Mr. Krishnamurthy Subramanian	Associate Professor of Finance, ISB
21.	Mr. Krishnan Subramaniam	Partner, Ernst & Young
22.	Ms. Nandita Agarwal Parker	Managing Partner, Karma Capital Management LLC
23.	Mr. Ananta Barua	Executive Director, SEBI
24.	Smt. Barnali Mukherjee	Chief General Manager, SEBI

Acknowledgement

This report of the Alternative Investment Policy Advisory Committee (AIPAC) has been made possible with the support and contributions of many individuals.

The Committee would like to gratefully acknowledge the valuable support of SEBI and the contribution of its professionals – S. Raman, Ananta Barua, Barnali Mukherjee, Naveen Kumar Gupta, Dharmendra Jain and several other SEBI staff who helped convene the meetings of AIPAC. The Committee also acknowledges the efforts and the contribution of Gopal Srinivasan, Saurabh Shrivastava, Professor Subramaniam Krishnan- ISB, Gautam Mehra- PwC, Subramaniam Krishnan- EY, Sowmya Narasimhan, Anindo Sarkar, Siddharth Shah, Rohan Rai, Tejash Gangar, B.V. Krishnan, Naozad Sirwalla, Simrun Mehta, Ashima Suri, Bhavin Shah, Priyanka Agarwal, Sanjay Chauhan, Aashit Shah, Sahil Shah, Akshay Mansukhani, Rohan Rai and Arvind Mathur.

The AIPAC sub-committees which contributed to the second AIPAC report included the Sub-Committee on Investor Management, the Sub-Committee on Taxation, and the Sub-Committee on Promoting Onshore Fund Management.

Chapter - I

Introduction to the Alternative Investment Funds Industry

I

Introduction to the Alternative Investment Funds Industry

1. Alternative Investment Funds (AIFs) perform a chain of activities beginning with the mobilisation of the savings of individuals directly, or indirectly through institutions, like pension funds, insurance companies, banks and endowments and investing them in promising enterprises, add strategic value to portfolio companies, monitor the investments and exit with the aim of realising a reasonable risk-adjusted return. The fund managers of AIF's are fiduciaries acting in the best interests of investors in the AIFs they manage.

2. This is not only a valuable service for both savers and portfolio companies, but also for the Indian economy as it creates jobs, improves governance and promotes innovation and economic growth.

3. For Alternative Investment Funds to perform this invaluable role, the regulatory framework must be an enabler and foster ease of doing business. A key objective of the Alternative Investment Policy Advisory Committee (AIPAC) is to make recommendations for the regulatory framework to be an effective enabler. In addition, AIPAC has analysed and made recommendations for each element of the AIF sector's fund mobilization and investment chain.

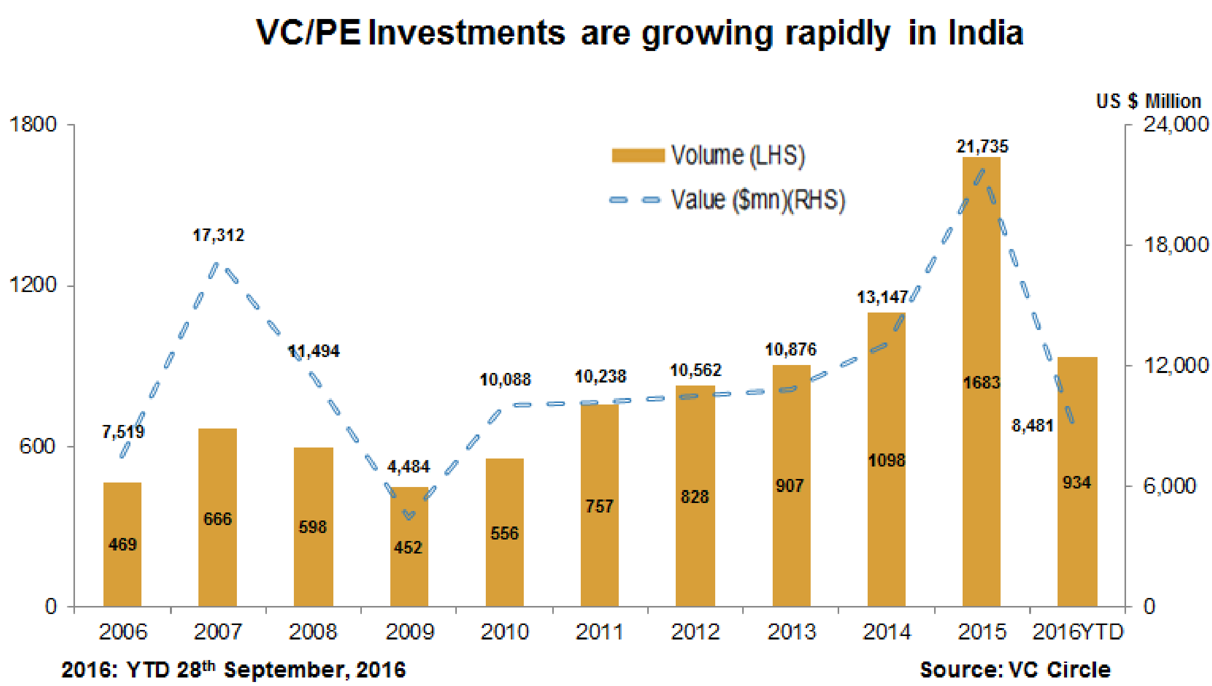
4. Alternative Investment Funds, include venture capital and private equity funds, which provide stable, long-term capital and have fund lives ranging typically up to 10 years or more. AIFs include funds with a wide range of investment objectives and investment strategies. These include investing in new ventures, social ventures, start-ups, growth enterprises, infrastructure, real estate, debt funds and other investment strategies, including angel investing through angel funds.

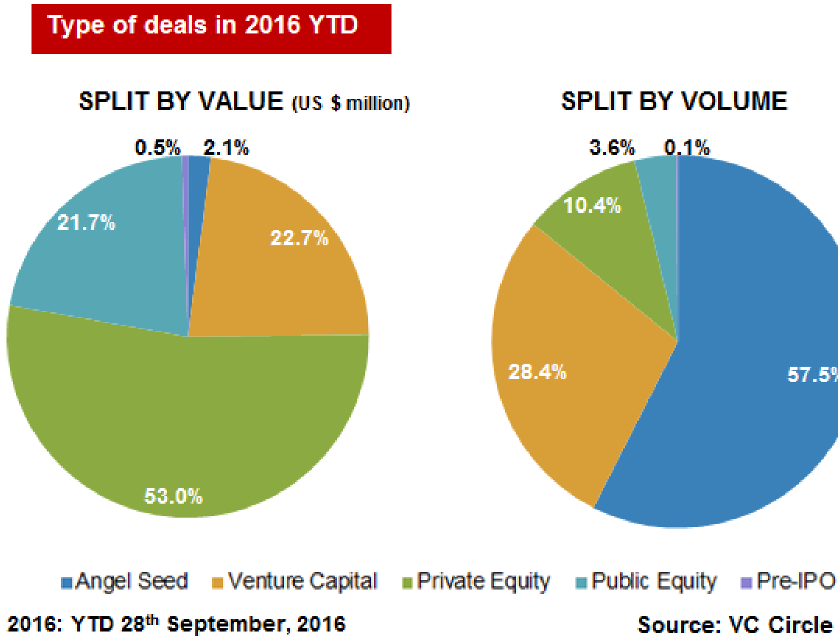
5. Alternative Investment Funds are regulated by the Securities & Exchange Board of India (SEBI) under its Alternative Investment Funds Regulations, 2012 and 2013, and related notifications. Reforming and aligning these and other regulations, such as those covering the tax regime, pension funds and insurance companies, will be key drivers in making a success of the AIF sector and pave the way for much greater contribution by AIFs to India's development, economic growth and start-up policies.

6. The venture capital and private equity industry has contributed considerably to India's economic growth. Between 2001 and 2015, venture capital and private equity of more than $103 billion was invested in Indian companies. These investments were made in

more than 3,100 companies across 12 major sectors, including those critical for the country's development. The enterprises have ranged from start-ups to mature, mid-size companies. A significant portion of these investments have been made by global fund managers operating India-focused offshore funds, global fund managers operating in India and Indian fund managers operating offshore funds, investing in the form of foreign direct investment (FDI).

7. The graphs below show that venture capital and private equity investing reached $ 21 billion in 2015, nearly double the level of 2010. The pie charts below show that venture capital played a major role in the first 9 months of 2016 and supported the growth of start-ups at various stages of their lifecycle.





8. Data in Table 1 below shows that Alternative Investment Funds regulated by SEBI have invested nearly Rs. 25,000 crores. Nearly sixty percent of this amount is in the form of Category II AIFs. Over 250 Alternative Investment Funds have been established under SEBI's AIF regulations, the largest of which are Category II AIFs.

Table 1: India: Alternative Investment Funds: Cumulative net figures

(As of 30th September 2016) Rs. In Crores

Category	Commitments raised	Funds raised	Investments made
Category I			
Infrastructure Fund	6787.81	2323.91	1691.02
Social Venture Fund	806.76	483.41	349.23
Venture Capital Fund	11100.25	1915.31	1454.97
SME Fund	207.83	170.79	21.84
Category I Total	**18902.65**	**4893.42**	**3517.06**
Category II	38028.12	17544.12	15334.91
Category III	8081.85	6578.23	6010.22
Grand Total	**65012.62**	**29015.77**	**24862.19**

Table 2: SEBI Registered Alternative Investment Funds

(As of 30th June, 2016)

Category	No. of AIFs
Category I - Infrastructure Fund	10
Category I - Social Venture Fund	7
Category I - Venture Capital Fund	54
Category I - SME Fund	8
Category II	140
Category III	34
Total	**253**

Table 3: Growth in Funds Raised by Domestic AIFs

Categories				**(Rs. In Crores)**
	Funds raised by AIFs as of 30th Sept 2016	***Funds raised by AIFs as of 30thSept,2015***	***Absolute Increase between 30th Sept, 2016 over 30th Sept, 2015***	***Percentage increase between 30th Sept, 2016 over 30th Sept. 2015***
Category I				
Infrastructure Fund	2323.91	1970.25	353.66	17.95%
Social Venture Fund	483.41	259.52	223.89	86.27%
Venture Capital Fund	1915.31	808.28	1107.03	136.96%
SME Fund	170.79	123.79	47	37.96%
Category I Total	**4893.42**	**3161.84**	**1731.58**	**54.76%**
Category II	**17544.12**	**7859.78**	**9684.34**	**123.21%**
Category III	**6578.23**	**2921.6**	**3656.63**	**125.15%**
Grand Total	**29015.77**	**13943.22**	**15072.55**	**108%**

9. The bulk of private equity and venture capital investments have come from overseas through jurisdictions such as Mauritius and Singapore. Table 3 above shows that domestic funding of AIFs has grown rapidly by approximately Rs. 15,000 crores i.e. 108 % during the last 12 months, according to data released by SEBI. This can be attributed to two factors. Firstly, the reforms made by the Indian Government in line with the recommendations of the first AIPAC report. Secondly, the robustness of Indian economic growth has been a positive factor. With the signing of the protocol relating to the India-Mauritius Double Tax Avoidance Agreement (DTAA), India can become a more attractive destination for domiciling India-centric funds. For this to happen, some of the reforms recommended in this report will play a critical role. The aim should be to create a conducive regulatory environment for offshore limited partners to invest in SEBI-

registered AIFs and for offshore General Partners to be based in India. A liberalized, stable regulatory and tax regime will underpin this development.

10. The risk appetite of this asset class has helped shape several new industries, such as mobile telecommunications, information technology services, social media and ecommerce. Portfolio companies of venture capital and private equity funds have contributed significantly to India's economic development through outcomes such as :

    a. **Stronger Job Creation Record:** Venture capital and private equity have helped accelerate job growth. In the five years following initial investment, companies backed by private equity grew direct employment faster than companies not backed by private equity.

    b. **Superior Financial Performance:** In the two years following initial investment, revenues of portfolio companies grew 28% more than revenues of companies not backed by venture capital and private equity in a comparable period. In addition, their profits were stronger.

    c. **Greater Export Earnings:** Venture capital and private equity investors focused on building capabilities in their portfolio companies, resulting in increased export earnings. This strategy also helped reduce risks associated with the volatility of domestic growth and exchange rate changes.

    d. **More Acquisitive and Global Mind-set:** In the sample set, 80% of the companies participated in their first cross-border M&A only after receiving venture capital or private equity funding. Venture capital and private equity fund managers shared their experience, knowledge and networks to help companies acquire strategic partners.

    e. **Superior Corporate Governance and Higher Tax Contribution:** Portfolio companies of venture capital and private equity funds generally improved their corporate governance. Private companies with revenues less than INR 7.5 billion linked to VC/PE contributed 18.8% of the corporate tax receipts for companies of a similar size, more than 13.1% of total revenue within this group.

Chapter - II

Introduction to the Report and Executive Summary

II

Introduction to the Report and Executive Summary

A. Introduction

1. This report addresses the reforms various Government agencies and regulators need to consider to promote the Alternative Investment Fund (AIF) asset class including venture capital and private equity which are key sources of long term capital.

2. If implemented these reforms will help accelerate the flow of domestic and offshore long-term capital to AIFs which, in turn, would be invested in Indian start-ups and growth companies in a wide range of sectors vital to the development of the Indian economy.

3. The *raison d'etre* for developing AIFs is the jobs they help create in their portfolio companies, their commitment to provide capability capital and encouragement of good governance and best practices of management and reporting. The potential magnitude of capital which can be mobilized through private equity and venture capital funds is significant for the economy.

4. The report recommends reforms in the following areas:

   i) Investor Management to enhance investor confidence;
   ii) Taxation of AIFs for ease of doing business and ensuring certainty;
   iii) Measures to attract offshore fund managers to manage in India;
   iv) Mobilising long-term capital from domestic pension funds and insurance companies;
   v) Introducing permanent capital vehicles to increase the flow of long term capital for a wide range of mid-market companies ; and
   vi) Categories I & III Alternative Investment Funds

B. Investor Management to Engender Investor Confidence

5. Investor confidence is the *sine qua non* of capital markets. Confidence is engendered by adequate and timely disclosure and effective governance arrangements which ensure that investor concerns receive constant and primary attention in fund management. To achieve the objective of attracting large inflows of long-term funds, the AIF industry needs to equip itself to cater to the needs of the diverse set of investors which invest in AIFs.

6. The report identifies three critical factors to enable current and potential investors to make informed decisions about the suitability and risk-return profiles of various types of AIFs: (i) disclosure of relevant fund-level information to AIF investors; (ii) enhanced fund-level governance; and (iii) disclosure of aggregate data on industry-level returns performance by vintage year of AIFs. The report recommends, enhanced disclosures to investors, disclosure for superior governance and performance data for AIFs to be made available to enable greater investor participation

C. Tax Reforms

7. The first AIPAC report had recommended a number of tax measures, some of which were implemented by the Government of India. After the first AIPAC report was released, the Government entered into a Protocol with the Government of Mauritius to amend the Indo-Mauritius Double Tax Avoidance Tax Agreement. The changes have opened a unique window for India to help further develop the domestic AIF industry.

8. A set of sound and stable tax policies with clarity and certainty will attract more capital to AIFs domiciled in India and regulated by SEBI. This report makes further tax reform recommendations to foster ease of doing business by AIFs. These cover the need for clarity and consistency in taxation. ‘ Ease of Doing Business ‘ is a major policy plank of the Government and its application in the AIF sphere will help catalyze significant capital flows from both domestic and international investors.

D. Angel Fund & AIF Regulations

9. Angel funds are the cradle of the start-up eco-system. They have begun to play a more important role in the Indian start-up eco-system. They help find and fund promising start-ups and provide professional mentorship.

10. Given the large size of India, more angel funds need to be created where high-caliber angels can provide funding and add value to budding entrepreneurs. This report clarifies recommendations for reforms in SEBI’s regulations for Angel Funds.

E. Summary of Recommendations

1. Recommendations for Enhanced Disclosures by Alternative Investment Funds

11. The second AIPAC report recommends greater mandatory disclosure in private placement memoranda of the following areas by AIFs which raise capital from retail investors with ticket sizes of less than Rs. 10 crores per investor:

    - Organization of the AIF and its decision making process
    - Track record of returns in previous Funds
    - Computation of returns
    - Investment strategy and investment objectives
    - Key Fund terms
    - Valuation, investee due diligence and documentation process
    - Process for the transfer of units to guide investors on how they can exit the fund during the life of the fund. This will contribute to the development of a secondary market for fund units.
    - How liquidity issues will be dealt with at the end of the fund's life if it has not been able to exit from all its investments.

12. Quarterly reports to AIF investors shall include:

    - Summary Management discussion and analysis letter
    - Financial Package
        - Balance sheet
        - Period-end schedule of investments
        - Statement of Operations
        - Statement of Cash flows
        - Partners' capital account statement

13. The process for the transfer of units should be clearly stated in the placement memorandum to provide a mechanism for investors to transfer units before the end of a Fund's life.

14. Certain disclosures should also be made on final closing which is necessary to provide added comfort to investors.

2. Recommendations for the Superior Governance of AIFs

15. The report recommends AIFs to form an Investor Advisory Committee from the outset to address the following vital matters:
    (a) Conflicts of interest
    (b) Issues arising during the life of a fund
    (c) Issues arising at the end of the life of a fund
    (d) Whether the overall functioning of the fund is consistent with the fiduciary responsibilities of the fund manager

16. It is recommended that SEBI amend AIF regulations, 2012 to make the Governance Committee mandatory for funds which raise capital from retail investors with ticket size of less than Rs. 10 crores.

3. Recommendations on AIF Returns Performance Data

17. It is recommended that a centralized body be created to report the performance metrics of funds on an aggregate basis (vintage year wise) by using the information obtained from the periodic reporting by AIFs to SEBI. This will enable performance of individual fund managers to be benchmarked relative to aggregate industry returns performance data.

18. The report recommends enhancements in the periodic- monthly or quarterly- reporting by AIFs to SEBI such that individual fund performance data can be captured which, in turn, can be used to create industry benchmarks.

4. Recommendations for Tax Reforms of AIFs

19. The key recommendations in the area of taxation of AIFs, including private equity and venture capital funds are:

a) Treating gains from transfer of unlisted shares held by AIFs as capital gains, irrespective of transfer of control and management. This will ensure certainty of taxation and remove the ambiguity surrounding taxation of these gains as business income.

b) Aligning the fund management safe harbour provisions to prevailing practices and characteristics of the global private equity and venture capital industry. This will enable the managers of offshore funds to be based in India without the risk of adverse tax consequences to the offshore funds which, in turn, will bring the benefits of domestic location to the Indian economy.

c) Extending pass- through taxation to Category III AIFs. The core principles of taxation of pooled investment vehicles are one level taxation and pass-through taxation which the Government has implemented in Category I & II AIFs. This will bring certainty on the tax front and will also ensure that the incidence of taxation falls on fund investors, rather than on fund vehicles i.e. AIFs.

d) Introducing a Securities Transaction Tax ("STT") regime for AIF taxation which will ensure certainty and ease of doing business and help raise substantial revenues.

5. Recommendations for the Promotion of Rupee Capital Flows from Domestic Institutional Investors

20. In mature capital markets, domestic institutional investors like pension funds and insurance companies underpin the development of AIFs because they are the ultimate natural source of stable, long term capital. It is to their credit that the Indian regulatory bodies, the Insurance Regulatory & Development Authority (IRDA) and the Pension Fund Regulatory and Development Authority (PFRDA), have issued circulars in 2013 and 2016, respectively, which enable allocations by pension funds and insurance companies to AIFs.

    This report recommends that the circulars be aligned with the SEBI regulations. It is recommended that both IRDA and PFRDA issue suitable clarifications to the effect that insurers and pension funds will have the permission to invest in Category II AIFs so long as such AIFs invest *primarily* in *unlisted investee companies* and in accordance with SEBI's AIF Regulations.

6. Recommendation to Enable Permanent Capital Vehicles

21. There is an increasing need for vehicles that provide capital to the mid-corporate and micro, small, medium enterprises segment. MSMEs are the engine of growth and employment generation in the country. They contribute to 40% to India's manufacturing output and materially to the labor force. There is a gap of over Rs. 2.5 lakh crore of debt capital for MSMEs. Bank lending to MSMEs has been declining over time with no signs of trend reversal. Traditional capital markets options are also not a viable solution for MSMEs leading to a large identified gap and need for debt capital. Accordingly, it has been recommended that SEBI consider enunciating a regulatory framework for Mid-Markets Permanent Capital Vehicles under Category II AIFs in light of the special characteristics of such vehicles.

7. Recommendations to Promote Angel Investments by Angel Funds

22. The success of angel funds requires flexibility in their operations and their ability to raise

funds, to diversify their portfolios by investing in start-ups at various stages, by diversifying geographically and not being artificially restricted in designing their exit strategies. Accordingly it is recommended that SEBI consider measures to:

(i) Lower the holding period of angel investments to 1 year from the current 3 year requirement;

(ii) Extend the period for investing a minimum of Rs 25 lakhs per investor to the life of the fund or at least 5 years from the current 3 year requirement;

(iii) Lower the minimum investment in a portfolio company to Rs 25 lakhs from the current minimum of Rs. 50 lakhs;

(iv) Allow angel funds to have a maximum of 200 members;

(v) Allow at least 10% of the angel fund's portfolio investments to be companies that may have been incorporated more than 3 years prior to the investment; and

(vi) Allow Angel funds to invest in overseas venture fund undertakings the same percentage of their corpus as permitted for Category I AIFs.

8. Recommendations for Category III AIFs

23. It is recommended that Category III AIFs be permitted to:

(i) anchor participation in certain Initial Public Offerings (IPOs);

(ii) invest in foreign securities, with an Indian connection, within limits set by RBI and by SEBI for venture capital funds;

(iii) compute 'investible funds' by reference to market values; and

(iv) determine leverage as per the formulae and methods used by the Alternative Investment Fund Management Directive (AIFMD).

9. Recommendation for Liberalizing the Ownership Test to Determine Indian Owned & Controlled Fund Managers

Reserve Bank of India's regulations require that investments of private equity and venture capital funds in portfolio companies will be regarded as foreign investments if the fund manager, or the sponsor, are not Indian owned and controlled. Consequently, the extent of shareholding in portfolio companies will be subject to certain restrictions mandated by India's Foreign Direct Investment (FDI) policy. This means that equity ownership caps mandated by India's FDI policy will apply if the fund manager or the sponsor are not Indian owned and controlled.

In determining the Indian Owned and Controlled status of the Fund Manager or the Sponsor, it is recommended that:

The shareholding of portfolio Investors (FPIs) be excluded in the computation of foreign ownership of listed affiliates, or parent companies, of the investment manager, or sponsors of AIFs.

Chapter - III

Catalyzing Stable Capital Flows

III
Catalyzing Stable Capital Flows

Introduction

This chapter makes non-tax policy recommendations aimed at increasing the flow of long-term capital from both domestic and international investors in Alternative Investment Funds (AIFs) which will be invested in a wide range of businesses in India. Recommendations in this chapter cover the following areas:

(i) Greater disclosure and superior governance of AIFs;
(ii) Enabling domestic pension funds and insurance companies to invest in Category II AIFs;
(iii) Offering permanent capital vehicles as Category II AIFs;
(iv) The process for identifying accredited investors; and
(v) Liberalizing the ownership test for fund managers and sponsors of AIFs

A. Investor Management

I Introduction

1.1 The AIF Regulations have assisted the development of AIFs in India. Since inception, about 253 AIFs are registered with SEBI with a capital commitment of over Rs. 50,000 crores. Despite the global slowdown, the investment environment in India is positive. AIFs have played a significant role and helped drive the growth of the Indian economy. Indian companies today have a large appetite for growth capital in light of economic reforms. AIFs provide capital to creative and innovative ventures. To help satisfy the capital needs of enterprises, long-term and stable risk capital is of the essence. The need for further reforms to promote the supply of growth capital in this promising market is well warranted as AIFs can considerably boost the supply of long-term risk capital in India.

1.2 The Securities & Exchange Board of India (SEBI) established the Alternative Investment Policy Advisory Committee (AIPAC) in March, 2015 with the main purpose to advise SEBI on issues related to the further development of AIFs and the start-up ecosystem in India. Under the chairmanship of Shri N.R. Narayana Murthy, AIPAC had issued its first report to SEBI on December 31, 2015, which

SEBI in turn issued to the public at large for comments on January 20, 2016. The first report is currently under consideration by SEBI.

1.3 The first report of AIPAC outlined changes in the AIF Regulations to increase the presence of alternative investment vehicles, on the one hand, and to unlock foreign and domestic pools of capital for investment, on the other hand. The report addressed issues pertaining to parity in taxation norms with global standards and easing of regulations that constrain fund operations. The progress achieved by the implementation of the first report provides an opportunity to push the envelope further. This opportunity is further reinforced by the current economic environment in India as well as the attendant need for long-term, active capital for enterprises in India.

1.4 Given this opportunity, the objective of the second AIPAC report (Report) is to recommend additional reforms for investor management, within the SEBI framework, to “bring in large pools of foreign and domestic capital for investment in AIFs”. Currently, AIF’s typically have three types of “investors”. (1) Retail investors/HNIs with low investment ticket size (ranging over Rs. 1 – Rs. 2 crores) with limited understanding of the asset class; (2) Indian Institutional investors with ticket sizes ranging from Rs. 5 – Rs. 10 crores, with limited experience in the industry; and (3) foreign institutional investors with ticket sizes greater than Rs. 10 crores with greater experience.

1.5 To achieve the objective of attracting large pools of long-term funds, the industry needs to equip itself in order to cater to the needs of the diverse set of investors it attracts. To fulfill this objective, we identify three critical factors: (i) disclosure of relevant fund-level information to its investors; (ii) enhanced fund-level governance and (iii) aggregate data on industry-level performance to inform and thereby attract current and potential investors.

1.6 Disclosure of fund-level information enables investors to make informed choices whilst investing with the fund managers by (i) limiting possible perceptions among investors that the General Partners (GPs) may not provide material information about the fund; and (ii) strengthening the alignment of incentives of the GPs with those of the Limited Partners (LPs). In theory, worries about conflicts of interest between GPs and LPs stem from the combination of agency costs and asymmetric information, which characterise any agency relationship such as the one between GPs and LPs. For instance, LPs may worry that once they part with their capital, the GP may potentially manage the fund in a way that maximizes his/her own self-interest. Specifically, LPs may worry about under-exertion of effort, managerial deficiencies, or, the overuse of leverage and risky instruments by GPs.

1.7 Performance-based compensation, which includes management fees and carried interest, can attenuate problems stemming from the lack of monitoring, asymmetric information, which stems from GPs knowing significantly more about the specific details of the fund as well as its investments than LPs, can exacerbate problems associated with agency costs. Given these concerns, standardised disclosure on fund-level information to its investors can significantly strengthen the alignment of incentives of the GPs with those of the LPs and help reduce investor concerns.

1.8 Greater information disclosure in the context of private equity cannot be an unadulterated benefit. By its very nature, private equity involves investments made for the long run by experts who exercise their judgment. Such judgments, in turn, has been honed over several years of experience and acquired knowledge. Given the nuances involved in exercising good judgment, indiscriminate disclosure could lead to untimely liquidations/exits at significant costs to the fund and its investors.

1.9 Enabling better governance of AIF's, represents the second cog in the wheel. Governance assumes critical importance because the general partners of a fund face a variety of common issues. A good governance mechanism can be seen as a proactive or preferred form of investor protection, as there is a better chance when such governance prevails for problems to be identified and resolved swiftly before they escalate further. Thus introducing next generation governance practices for various issues faced by funds during the original fund life and during any extension period, will enhance the investment experience for AIF investors.

1.10 Disseminating trustworthy data on industry-level performance can inform current and potential investors about the risk-return profile of investing in AIFs. Potential investors often inhibited by the risks involved in investing in AIFs. A concern is that the *a priori* expectation that an investor has about the performance of an AIF may not translate into realised performance *a posteriori.* These concerns rise when the investor does not have access to trustworthy information about the historical performance of the industry.

1.11 Discretionary disclosure by specific funds/fund houses cannot substitute for trustworthy information for several reasons. First, such discretionary information may be more forthcoming in good times than in bad, or when risks appear to be lower. Second, at any point in time, the better performing funds may be more forthcoming in disclosing performance information than their peers who lag in performance. Finally, because poorly performing funds usually stop reporting, the investor only receives information about surviving funds, which leads to the problem of "survivor bias." The trust-deficit originating from such skewed information about industry performance can aggravate the concerns of potential investors and thus limit their participation in AIFs.

1.12 The trust-deficit thus can be avoided by the regulator delegating to a single, certified entity the responsibility of disseminating information on industry performance. The information can be made trustworthy if all the above AIF biases are eschewed. The entity entrusted with the responsibility of disseminating this information would maintain a meticulous record of important data pertaining to all funds – even those that have been discontinued or liquidated. Such information aggregated over all funds would then be used to provide information that reflects the entire distribution of performance from the best performing funds to the worst performing ones. Disclosure of fund level information and superior governance can combine together to facilitate informed decision-making among investors and can thus be instrumental in bringing a wide swath of investors to invest in AIF.

1.13 In view of the above, it is apt to put forward this Report to SEBI. The committee consists of members from all fora of the industry. The sub-committee on Investor Management has worked bearing in the mind the requirements of LPs i.e. investors in AIFs as well as the General Partners i.e. fund managers to enhance the fund raising environment for AIFs in India.

II. Recommendations

2.1 The recommendations are aimed at enhancing fund flows into AIFs in India by the adoption of global best practices. The recommendations can be classified into three broad areas:

a. <u>Enhanced disclosures to investors</u>

i Disclosures to be made in the private placement memorandum (‘PPM’); and

ii Disclosures to be provided to investors consistent with global practices.

An amendment to AIF Regulations 2012 is recommended, to make these disclosures mandatory for funds which raise capital from retail investors with ticket size of less than Rs. 10 crores.

b. <u>Disclosures for enhanced governance of AIFs</u>

i The governance mechanism to deal with matters which are outside the purview of Privately Placed Memoranda (PPMs) but within SEBI regulations and which do not require super majority voting by unit holders; and ii The process with respect to the transfer of units, to enable investors to transfer their units before the end of the Fund's life should be disclosed in PPMs.

It is recommended that SEBI amend AIF Regulations, 2012 to make these disclosures mandatory for AIFs which raise capital from retail investors with ticket size of less than Rs. 10 crores.

c. Disclosure of performance data for AIFs to be made available to enable greater investor participation

The ecosystem relating to AIF returns performance data can be catalyzed by SEBI by making the following amendments in the AIF regulations to;

- Collect performance data from AIFs by amending the information required in periodic reports submitted by funds to SEBI; and

- Create a central body which will report the performance metrics of funds on an aggregate basis, vintage year-wise, on the basis of the information obtained from the periodic reporting by AIFs.

2.2 Disclosures in Placement Memoranda

The AIF Regulations requires certain disclosures that the fund managers are required to make in the placement memorandum at the time of marketing an AIF. Currently, some of the key disclosures which are required in private placement memoranda of AIFs are as follows:

- Material information about the fund and the fund manager;
- Potential investors;
- Schedule of detailed fees and expenses along with the distribution waterfall;
- Life of the fund;
- Conditions or limits on redemptions;
- Investment strategy;
- Risk management tools;
- Key service providers;
- Conflicts of interest and procedures to identify and address them;
- Disciplinary history;
- Terms and conditions on which the fund manager offers services; and
- Manner of winding up of the fund.

The extant AIF Regulations do not require fund managers to provide detailed disclosures on some matters which are critical to investors. Additionally, the past performance of the fund managers (if any) is a key consideration and plays an important role in helping an investor make a decision to invest in an AIF. Further, based on global practices as well as considering the nascent stage of the Indian market, there is a need to raise the confidence of investors and provide them the information needed to make informed investment decisions prior to investing in an AIF.

Recommendation - In order to increase investor confidence and to enable investors to take an informed decision whilst investing in a fund, certain additional disclosures should be required to be made by fund managers in the placement memoranda. These disclosures should mainly be on the following topics:

- Organization of the fund and its decision making process
- Past performance
- Method adopted in calculating returns
- Investment strategy and investment objectives
- Key terms
- Valuation, due diligence and documentation process
- Process for transfer of units to guide investors on how they can exit the fund during its life. This will also help develop a secondary market for fund units.
- How liquidity issues will be dealt with at the end of the fund's life **(see section 2.5 below)**

The detailed disclosures to be part of the PPM are set out in **Annexure 1**.

2.3 Disclosure to Investors Consistent with Global Practices

It is of paramount importance that the investors in a fund are informed of the fund status along with its key parameters and its performance on a periodic basis.

Currently, clause 22 of AIF regulations 2012, requires an AIF to disclose the following information to investors:

- Financial, risk management, operational, portfolio and transactional information regarding fund investments shall be disclosed periodically to investors;
- Fees charged by an associate of the fund manager to the fund or to investee companies;
- Any inquiries/legal action in any jurisdiction by a regulatory body as and when it occurs;
- Any material liability arising during the AIF's tenure shall be disclosed, as and when occurs;
- Any breach of any provision of the PPM, or any agreement made with the investors, if any, as and when it occurs;
- Change in control of Sponsor / fund manager / investee company;
- Report including financial information of investee companies and material risks and how they are managed shall be submitted on an annual basis by Category I and II and Category III shall provide quarterly reports to investors;

- Significant change in the key investment team; and
- Description of the valuation procedure and the methodology for valuing assets.

In addition to this, clause 23 of AIF Regulations 2012 requires AIFs to provide to its investors a description of its valuation procedure and the methodology for valuing assets. This is required to be undertaken once every six months, by an independent valuer appointed by Category I and II AIFs and on a quarterly basis by Category III AIFs.

Recommendation – While existing regulations intend to cover various aspects of reporting to investors, in order to bring in consistency, standardization, benchmark and structure, we have developed a set of disclosures to be made by AIFs on a quarterly basis. This is expected to lead to greater efficiencies, improve uniformity and transparency and lower expenses in administering and monitoring AIF investments by investors. The core contents of the quarterly reporting package shall include:

- Summary Management discussion and analysis letter
- Financial Package
  - Balance sheet
  - Period end schedule of investments
  - Statement of Operations
  - Statement of Cash flows
  - Partners' capital account statement
  - Appropriate footnote disclosures
- Supplemental Management Reports
  - Executive summary – firm level and fund level
  - Supplemental Schedule of investments
  - Portfolio company update

The detailed disclosures recommended under each of the core content is laid out in **Annexure 2.**

In addition to this, certain disclosures should also be made by the fund on final closing which is necessary to provide added comfort to investors. The set of disclosures to be made on final closing is laid out in **Annexure 3**

2.4 Mechanism to deal with matters which are outside the purview of PPMs but within SEBI regulations and do not require super majority voting by Unitholders

The majority of AIFs are long-term and illiquid in nature. LPs invest based on their confidence in a GP and understanding of the strategy and parameters of investments. Not all the circumstances and outcomes can be anticipated in a PPM. LPs need to ensure that proper mechanisms are in place to work through unanticipated conflicts as well as changes in the investment team or other fund parameters. There is also a need to have a constant interactive relationship between GPs and LPs to deal with conflicts which arise during, or after the life of the fund during the extension period, when it may not be possible to reach all investors.

Recommendation – In order to deal with various issues that arise during or after, the life of a fund during any extension period, we recommend that an Investor Advisory Committee should be formed at the outset, which will operate till the end of the fund's life and during any extension of its life. The issues dealt by the Investor Advisory Committee will include;

(a) conflicts of interest
(b) issues arising during the life of the fund
(c) issues arising at the end of the fund's life
(d) Whether the overall functioning of the fund is consistent with the fiduciary responsibilities of the fund manager

The role of the Investor Advisory Committee is not to directly manage, nor to audit, but to provide a sounding board for GPs and a voice for LPs, when appropriate.

2.5 Exits from Fund interests during a Fund's Life

During the tenure of a fund, some investors need liquidity from what is inherently an illiquid asset class. This typically happens 5-6 times in a year and 25-30 times during the life of a fund. In India there are no regulations for secondary transfers of fund interests i.e. units. Transfers are made at the sole discretion of the investment manager.

Recommendation – The process for the transfer of units should be clearly set out in the placement memorandum to enable investors to transfer their units before the end of the fund life.

2.6 Enhancing performance data available for AIFs to enable greater investor participation

A primary need of prospective investors in newly formed funds is adequate information to make fully informed investment choices. The information ecosystem must ensure that information such as the history of the fund manager, estimated sources of profits and details of the risks entailed must be furnished before an investment in a new fund.

Accordingly, the information ecosystem must disclose enough financial and operational details of both the fund and its manager to the LP. The private funds market suffers from principal-agent problems between the investors or the Limited Partners (LPs) and the fund managers or the General Partners (GPs). The primary principal-agent problem occurs in the form of moral hazard, where the GP may not always act in the best interest of the LP. This breach of trust may occur in the form of shirking, sub-optimal investment decisions or excessive risk taking. While this agency problem is addressed to some extent by tying the compensation of the managers with the profits of the fund, it may still discourage certain investors from investing. The information asymmetry that causes this principal agent problem arises due to the absence of periodic and standardized reporting of a private fund's performance by its managers.

Recommendation – Given that performance measurement and reporting is a key component to enable investors to make informed decisions, the following recommendations have been made in order to create a sound information ecosystem for the AIF. The implementation of the recommendation involves two steps;

- Gathering information from funds by making necessary amendments in the periodic reports filed by funds with SEBI
- Creating a central body that will report the performance record of funds on an aggregate basis (vintage year-wise) on the basis of the information obtained from the periodic reports of the funds.

I. The existing AIF regulations make periodic reporting to SEBI mandatory for all funds. According to these norms, Category I, II and III (without leverage) report on a quarterly basis. The Category III funds operating, with leverage, report on a monthly basis. The existing norms stipulate that metrics such as corpus value, invested values, industry wise breakup, details of investors and leverage be reported. However, certain additional information is required to be reported to SEBI for the calculation of performance data. Accordingly, we have suggested the modification of the existing reporting format to include certain additional parameters as described in **Annexure 4**.

II. Creation of a centralized body to report the performance data of funds on an aggregate basis (vintage year wise) on the basis of the information obtained from the periodic reporting of the funds in **Annexure 4.** The individual fund performance data has no tangible meaning unless it is compared to a relevant benchmark. Customized benchmarks that reflect the risk adjusted performance of entire alternative asset class needs to be prepared. This requires a central body to aggregate all the funds' data and prepare the relevant indices. Another reason for having a central performance reporting body is to avoid information biases that may occur. For example, survivor bias occurs when a fund which is performing badly stops reporting altogether. This can be effectively controlled by removing the history of the fund's performance in calculating the relevant benchmarks. That requires the presence of a central body aggregating the performance of all individual funds. The relevant benchmarks can be by the central body as set out based on the principles set out in **Annexure 5**.

Annexure 1: Additional disclosures to be made in the PPM

Subject	Disclosures in the PPM
Past performance of the Manager and the management team	• Past returns delivered by funds previously managed or advised by the Manager calculated (i) on a gross and net (of taxes) basis; and (ii) after deducting costs and expenses incurred by the fund in divestments and distribution to investors and any reserves set aside by the fund (i.e. The past returns are returns that the fund made on its investments, or the returns that the investors made in the fund) including the IRR achieved by the fund • Description of the valuation method used to arrive at the past returns along with assumptions and qualifications • Assets under management currently or previously managed by the Manager • Past performance of the Manager in the sectors in which the fund proposes to invest • Details of the transactions / deals in which the current investment team was involved • Information relating to the replacement of the management team in the previous funds of the Manager including any unsuccessful attempts and details thereof • Investments proposed to be rolled over from the previous funds to the current fund and details thereof • Details of the other fund(s) managed or advised by the Manager including name of such fund(s), features of the fund like industry / sector / investment stage / geographic focus, etc. (as may be applicable), total corpus of the fund, total amount drawndown, total amount of undrawn capital (if any, with reasons thereof), total amount invested and re-invested, the total number of investments, average investment size • Expected IRR percentage for the unrealized portion of the investments (with basis, valuation report, etc.)

Use of proceeds and allocation	• Estimated use of proceeds
	• Estimated asset allocation details
	    ○ By types of asset classes
	    ○ By Geography

Risk Factors	• Concentration risk: risk involved in not diversifying investments across asset classes or geographies or industry sectors

Subject	Disclosures in the PPM
	• Liquidity risk: Risk of not being able to liquidate assets at the close of fund; risk associated with illiquidity of units of the fund • Business risk arising from the nature of investee companies • Default risk arising from default of credit assets of the fund • Currency risk on the foreign investors arising from fluctuating exchange rate in relation to the commitments raised from foreign investors.
Transfer of units	• Mechanism for permitting the transfer of units of the fund. Such mechanism may include: o Restrictions on transfer, if any o Process involved in the approval / rejection for transfer of units o Conditions to be fulfilled prior to transfer o Eligibility criteria for the transferees o KYC norms, if any, to be met by the transferees; o Process required to be followed for the transfer of units o Maintenance of records for transfer of units o Provisions related to purchase of units by the Manager (including leverage, if any) • Brief description on liquidity management system
Mechanism proposed to be adopted to deal with illiquidity risks	• Details as to how and when the Investor Advisory Committee (IAC) shall be formed • The eligibility criteria of the members for membership of the IAC • The roles and powers of the IAC • Manner of conducting meetings of the IAC and its costs • The decision making process of the IAC • Reporting requirements of the Manager towards the IAC • Whether Manager would be entitled to management fees for the extended term of the fund
Organisation of the fund and decision making process of the fund	• Process involved in making decisions for investment in, and divestments from, the investee companies • Policy in relation to nomination of representatives on any of the committees of the fund (investment committee (IC) or advisory board (AB)), if any • Roles and functions of the IC, if appointed by the fund • Details of the composition of the IC and reporting relationships between the IC and the Manager • Detailed profile, remuneration details, location of each

Subject	Disclosures in the PPM
	member of the IC • Decision making process within the IC • Roles and functions of the AB, if appointed by the fund • Details of the composition of the AB and reporting relationships between the AB and the Manager • Detailed profile, remuneration details, location of each member of the AB • Information regarding the chairman of the IC, AB, board of directors of the Manager
Investment strategy and investment objective	• Focus investment sectors of the fund, focus on any particular investment stage/industry sector/geographical region • Difference between the current investment strategy and the past fund strategies, and reasons for such change • Investment considerations such as target investment size and target percentage stake, target number of investments, average holding period for an investment and exit strategies • Details regarding the rights and controls that the fund would aspire to have as a shareholder in an investee company • Details regarding exit mechanisms to be adopted in relation to investments
Valuation, due diligence and documentation	• Valuation policy for determining the value of the investments as well as units of the fund • Valuation method(s) proposed to be used for investments by the fund • Minimum IRR percentage threshold below which the fund would not invest • List of external service providers (legal, technical, financial / accounting etc.) who would be assisting the Manager in the due diligence process • Policy on follow-on investments, if any
Monitoring / follow up of investments / communication to contributors	• List of activities involved in monitoring and follow-up of investments • Proposed value additions of the Manager to the investments • Details on the reporting structure / procedure for the contributors (quarterly / half yearly / annual), Bulletins (attach sample) , Detailed valuation report, Guidelines for calculating NAV, Information that the fund will be providing at the time of drawdowns, Frequency of meetings between the IC and the Manager to update the contributor.
Details of the Manager	• Shareholding pattern of the Manager including details of

Subject	Disclosures in the PPM
	employees who are also shareholders • Years of existence and operation of the Manager. If the Manager is a newly set up entity, then years of experience of the investment team of the Manager in the areas of fund management and investment • Organisation structure/chart of the Manager • Details of key persons along with key person event, if any • Policy regarding carried interest and each eligible employees share in carried interest • Change in distribution policy or method in relation to carried interest to the Manager or such other consequences in case of a key person event • Association of the investment team of the Manager with other funds and their role in the performance of such other funds
Key terms of the fund	• Legal status of the fund (i.e. trust form or company form or LLP form) • Tax status of the fund • Income taxed at fund level or at the level of the contributors • Details of the trustee or custodian, if any • Duration of the investment period or commitment period • Target corpus of the fund • Minimum subscription amount • Clawback provision (with illustrations), if any • Reasons and rationale behind incurring proposed fund setup costs, Details of pipeline of deals under consideration • Details of warehousing details, if any; Role of the Manager in co-investment structures and the allocation of costs between the funds in such co-investment structures
Miscellaneous	• Information regarding the placement agents, costs and expenses of such placement agents as well as who shall bear the costs and expenses of such placement agents • Information regarding the Manager or the fund or the sponsor associated with any of the placement agents engaged by the fund, if any

Annexure 2: Reporting to Limited Partners

I. Summary Management Discussion and Analysis letter

(Provided quarterly with each package, unaudited)

- Management discussion of key drivers of activity and performance during the quarter that bridges the activity between the two period ends
  - Summary of capital activity (cash flows)
  - Transactions closed or pending
- Explanation of extraordinary movements
- Discussion of material events in portfolio companies (that would impact the fund as a whole) and/or with the General Partner
  - Including portfolio company defaults, LPA breaches, etc.
- Discussion of any material changes in risk factors at the *fund level*, including:
  - Concentration risk at fund level
  - Foreign exchange risk at fund level
  - Leverage risk at fund level
  - Realization risk at fund level
  - Extra-financial risks, including environmental, social and corporate governance risks at the fund level
  - This information should be provided annually, though more immediate reporting may be required for material events

II. Financial Package

A. Balance Sheet

(Provided quarterly, audited annually)

The balance sheet should include the following components:

- Current period end vs. prior audited period end columns
  - Comparative column should be for most recent audit period
  - Requires comparative or prior year end schedule of investments

- Inclusion of receivables and payables to affiliates
- Inclusion of investments at cost and fair value
- Inclusion of fund level debt

B. Schedule of Investments

(Provided quarterly with each package, unaudited)

- Full detail on unrealized investments
- Detail should be at legal entity level, not LP share

- Name of the Investment
    - Name can be omitted if absolutely required, but a unique identifier must be used and be consistent from quarter to quarter; investments should not be grouped
- Debt and Equity positions should be reported separately
    - Include number of shares if applicable
    - Should the investment be structured in a more complicated manner, detail may be moved to the individual Portfolio Company Update
- Fund Ownership % (fully diluted)
- Initial Investment Date
- Numeric Data on each investment to include:
    - Total committed to investment
    - Total invested (A)
    - Current cost (B) (including equity and debt breakdown)
    - Reported Value (C)
    - Realized proceeds (D)

<u>C. Statement of Operations</u>

(Provided quarterly, audited annually)

- Show current period, year-to-date and since inception information
    - Since inception information is not required by certain accounting standards; information need not be included in audited package if details are outlined in either the Footnotes or detailed Partner's Capital Account Statement
- Breakout investment income
- Separate portfolio interest and dividends independent of other interest
- Breakout of expenses
- Separate fees into their individual components, including management fees, broken deal fees, advisory/director fees, monitoring fees, etc.
- Net operating gain/loss
- Breakout of gains/(losses) on investments
- Breakout of realized/unrealized gain/loss (independent of F/X, showing F/X independently)

<u>D. Partner's Capital Account Statement</u>

(Provided quarterly, audited annually)

- Consolidated reporting, if applicable, for all Limited Partner investments, including alternative investment vehicles
- Current period, year-to-date and since inception information

- Breakout of the Total Fund by LP, GP and Total
- Bridge the prior net asset value to the current net asset value
    - Disclose any adjustments made prior to Beginning Balance
- Components to include:
    - General Partners' balances
    - Accrued carried interest should partnership liquidate
    - Breakout of contributions and distributions for the relevant period
    - Net changes in partners' capital resulting from operations
- Commitments of Limited Partner, General Partner and Total Fund
- Schedule of changes in *individual* unfunded commitment

<u>E. Footnotes</u>

(Relevant footnotes provided quarterly, all footnotes provided annually)

Footnote disclosures would include (and not be limited to):

Note 1 - Organization / Fund Details

- Key dates (including formation, termination, extensions, commitment period and follow-on period dates), structure, commitment amounts and other relevant fund details
- Tables may be included if they further understanding of the organizational structure

Note 2 - Significant Accounting Policies

- Accounting principles, fair value measurement and other relevant details

Note 3 - Partners' Capital

- Limited Partners' and General Partners' commitments (including apportionment of drawdowns and investments based on capital contribution)
- Tables may be included if they further understanding of the commitment structure

Note 4 - Management Fee and Other Fee Breakdown

- Management fees / broken or consummated deal fees / monitoring fees / fee offsets
- Description of "other" fees

Note 5 - Related Party and Other Transactions

- Detail of related party transactions and/or receivables/payables
- Notation of fund level debt and other potential obligations or guarantees

Note 6: Financial Highlights

- Net IRR at the fund level

Note 7: Carry Detail

- Fund level carry paid and/or accrued; amount escrowed if applicable

- Detailed description of carry calculation (waterfall)
    - Include table if more appropriate

Note 8: Compensation Arrangement

- Describe the compensation structure (salary, bonus, group/individual performance incentives, profit sharing, equity ownership, carried interest, etc.) for all the team members.
- Details on the allocation of the carried interest among Principals and others inside/outside the organization.
- Provide details on any separate compensation arrangements outside the Fund.

Note 9: Advisory Board

- List of members (if not against any legal or LPA restrictions)
- Notation of action items or votes taken

Note 10: Subsequent Events

- Included if material namely:
    - Changes in Fund Parameters such as Commitment Period / Tenure of the Fund / amending other clauses of PPM or Contribution Agreement
    - Changes in General Partners
    - Significant Staff Departures

Note 11: Risk

- Details of review or assessment of conflicts of interest performed. Identify any findings, as well as any changes or proposed actions to address the findings.

III. Supplemental Management Report

A. Executive summary – Firm- Level and Fund- Level data

(Fund Level data provided quarterly, firm level data updated annually)

The executive summary, preceding supplementary pages covering the details of all active investments in the portfolio, would include the following:

Firm Data

- Assets under management
- Assets defined as total value of current investments plus unfunded commitments
- Active funds
- Active portfolio Companies

Fund Level Data

- Total commitments
- Total drawdowns since inception
- Gross drawdowns

- Remaining commitments
- Total number of investments since inception
- Total distributions
- Percentage of total drawdowns
- Gross distributions as percent of gross drawdowns
- Percentage of committed capital
- Gross distributions as percent of total commitments

Key Valuation Metrics

- TVPI: Total Value to Paid In
- RVPI: Residual Value to Paid In
- DPI: Distributions to Paid In

- Historical Fund Performance
- Portfolio breakdown by industry and region

B. Supplemental Schedule of investments

(Provided quarterly, audited annually)

- Full detail on realized and unrealized investments
- Security Type / # of shares (if not reported elsewhere)
- LP Ownership % (fully diluted)
  - This is the only column in this schedule that is Limited Partner specific with the intent of determining the results of opt-outs in the Fund. This information can also be depicted in a separate schedule for ease of reporting. LP ownership can be represented as % of total invested
- Initial Investment Date (if not reported earlier)
- Final Exit Date for realized investments
- Investment Data (at fund level, if not reported elsewhere)
- Valuation Driver
  - Primary driver of valuation methodology such as market multiples, DCF, public market price, etc. Sample list only an indicator of possible descriptions; final list at GP's discretion.

- Performance Metrics
  - Period change in valuation
  - Period change in cost
  - Unrealized gains/(losses) & accrued interest

- Movement summary
  - Primary driver of movement, not an indicator of full valuation methodology. Sample list only an indicator of possible descriptions; final list at GP's discretion.

•Current period investment multiple
•Prior period investment multiple
•Since inception Net IRR

C. Portfolio Company Update

Supporting materials to the Quarterly Reporting package would include supplementary pages covering the details of all active investments in the portfolio. These pages would be preceded by an executive summary (discussed above) that highlights the key information on the portfolio companies to follow. Information in quarterly reports should be structured consistently with information provided through other channels,

- Company Overview
  - Company description and headquarters
  - Industry (GICS classification)

- Acquisition details (table or chart)
  - Including initial investment date, multiples, equity breakdown
  - Acquisition thesis ; Co-Sponsors (including individual ownership % if readily available)
  - Deal partners at GP (including titles and Board seat, if any)

- Current metrics (table or chart of trailing-twelve months information)
- Including revenue, EBITDA, debt, CAGR
- Company Assessment (On Plan, Above Plan, Below Plan; regulatory issues notwithstanding)
- Expectations (notwithstanding prohibitions against forward-looking statements or commercially sensitive information)
  - Cash flow needs or distributions
  - Exit assumptions; date/type
- Financial Tables: Investment structure & Capitalization table
- Financial results : Calculations: DPI, RVPI, TVPI, DCC, PICC
- Value added by the Fund in addition to providing capital to the portfolio companies:

Name	Nature of association*	Phone /Cell Number	Email address	Brief summary on the nature of association and the outcome

Annexure 3: One-time reporting to investors on final closing

A. Financial Parameters

1. Target corpus as per PPM

2. Date of First Closing with aggregate commitments
   Date:
   Amount (Rs. crore):

3. Date of Final Closing with aggregate commitments
   Date:
   Amount (Rs. crore):

4. Time taken to achieve Final Closing from the date of First closing:

As per PPM	Actuals	Reasons for variation, if any
___ months from the date of First closing	__ months from the date of First closing	

5. List of Contributors with Amounts Committed:

Investors categories -	Amount in Rs. crore
Sponsor	
General Partner (‘**GP’**)	
Limited Partners (classification as under):	
Institutional investors	
High Net worth Individuals	
Corporate investors	
Family Houses	
Pension Funds	
Overseas Institutions	
Overseas Individuals	
Total	

6. Sponsor’s Contribution

Particulars	As per mandatory AIF guidelines of SEBI	Actuals
Name of the Sponsor		

7. How GPs finance their contributions? Describe how any Principal or affiliate of the GP will invest in the Fund (outside of the GP's commitment).

8. Difference in commercial terms offered to different class of investors.

9. Policy on incentives to GPs including the following:
    1. Describe how the GP's contribution for investments is allocated among the team.
    1. How is the carried interest vested for those parties that participate? What happens to the unvested carry of former Team Members?

B. Non- financial Parameters

1. Date of SEBI registration certificate and also specify the Category as I/II and sub classification as Angel/SME/Social Venture Fund, etc.

2. Investment Committee – Constitution (Strength of the Committee, out of which how many are internal members and external members)

3. Advisory Board – Constitution (Strength of the Board, out of which how many are internal members and external members)

4. Accounting:
    a. Provide details of the auditor of the Fund:
        - Firm's Name
        - Fund(s) Audited
        - Contact Person First Name
        - Phone Number /Cell Number
        - Email Address
    b. Is the Fund's audit firm affiliated with the Manager or any of its current or former Team Members?
    c. Does the Fund's audit firm only provide the Fund and Manager (plus the Manager's Principals and affiliates) with audit services?
    d. Will carry payments and allocation associated with the Fund be audited (as part of an annual audit of the GP and its Fund)?

5. Details of IT Package / Software implemented for investment management.

6. Risk / Compliance

    a. Discuss the Fund's risk management. What types of risks are monitored and how are they measured? Are there dedicated employees assigned to the risk monitoring function?

b. Describe the regulatory bodies that have oversight of the Fund, including any Investment Advisor or Broker-Dealer registrations. Identify the Fund's policies for remaining compliant with these bodies.

7. References

a. LP Advisory Board Members / Investment Advisory Committee (IAC)

Provide a list of LP Advisory Board members in the Fund:

- Institution Name
- Investor Type (Public Pension, Endowment, SWF, etc.)
- Name
- Phone Number/Cell Number
- Email Address
- Committed to Fund? (y/n)

b. Placement Agents

List all placement agents and fundraising advisors used during fund placement:

- Firm's Name
- Contact person Name
- Phone Number /Cell Number
- Services Provided
- Fund Name
- Payment Structure/Amount
- Registration Number of the Firm

Annexure 4: Performance Statistics to be reported to SEBI

1. Creation of Performance Statistics: Measure of Fund Returns

i. **Internal Rate of Return (IRR):** The IRR may be thought of as an intrinsic return of a fund. In other words, every rupee invested in the fund has to generate this particular rate of return to generate the cash flows that are distributed form the fund.

ii. **Total Value to Paid in capital (TVPI) (Total distributions + NAV)/Total contributions:** This is a metric for the value generated by the fund till date. It is a direct measure of value, realized and unrealized, per rupee invested till date.

iii. **Distributions to Paid in capital (DPI) (Total distribution/Total contributions):** This is a multiple of the amount distributed per rupee invested till date.

iv. **Residual value to Paid in capital (RVPI) (NAV/Total contributions):** This is the residual value of the fund (value after distributions) as a multiple of the total paid in capital.

AIF regulations make periodic reporting by all funds mandatory. Category I, II and III (without leverage) report on a quarterly basis. The Category III funds operating with leverage report on a monthly basis. Return measures should also form part of the reports submitted by funds. This needs to be included in the existing periodic reporting XBRL formats filed by funds currently.

Example illustrating the method of computation of the Return Measures

Calculation of IRR, TVPI, DPI and RVPI since inception

Consider a fund with vintage year 2010 with the following history:

Fund	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Capital Calls (INR Cr)	-100	-200	-100			
Distributions (INR Cr)				100	300	400
Residual Value (INR Cr)	100	400	800	750	500	150

a) IRR Since Inception

- Assume discount rate (r)
- PV of capital calls = 100/(1+r) + 200/(1+r)^2 + 100/(1+r)^3
- PV of distributions = 100/(1+r)^4 + 300/(1+r)^5 + 400/(1+r)^6
- PV of Residual Value = 150/ (1+r)^6
- NPV of fund = PV of distributions + PV of residual value – PV of capital calls
- IRR = value of r which makes NPV = 0
- IRR in this case is 28%

b) <u>DPI, RVPI, TVPI Since Inception</u>

- DPI = (Distributions till date)/ (Total capital calls till date)
  = (100+300+400)/(100+200+100) = 2
- RVPI = (Residual Value as of date) /(Total capital calls till date)
  = 150/(100+200+100) = 0.375
- TVPI = (Distributions + Residual Value)/ (Total capital calls) = DPI + RVPI = 2.375

c) <u>Horizon return (say two year horizon from 2013 to 2015)</u>

- HPR = (Total distributions in horizon period) + (NAV at end of period – NAV at beginning of period)/(NAV at beginning of period)

= ((300 + 400) + (150-750))/ 750 = 13.33%

Annexure 5: Creation of Relevant Performance Benchmarks

In the case of a private equity or a venture capital fund, the performance of funds must be compared with that of funds of the same vintage year. This is because funds generate different returns at different stages of their maturity and different macro-economic conditions. Typically in the early stages of a fund, negative or low returns occur due to capital drawdowns and a portfolio that is yet to mature. Over time returns are higher when the mature portfolio starts generating returns and distributions are made. Consequently, PE/VC funds may be classified by the stage, industry and geographical region of the fund.

The following return benchmarks are recommended to be reported by a return dissemination central body:

a) Pooled Values of IRR, TVPI, RVPI, DPI, Horizon returns

The pooled values of the above return measures are useful benchmarks against which the return of individual funds can be compared. These are calculated by simply aggregating the cash flows of all the funds that are considered in the benchmark. The metrics are calculated from the final cash flows on similar lines as the individual fund return measures are calculated.

b) Public Market Equivalent values

The public market equivalent (PME) is a popular benchmarking measure for private equity funds. The PME of the individual returns are calculated by mimicking a similar drawdown and distribution schedule of funds but which are invested in a public market ETF instead of the private fund.

c) Distribution of performance metrics

For each performance metric, the values for all the individual funds are calculated. Then the 10, 25, 50, 75 and 90 percentiles may be reported.

Draft Circular

CIR/IMD/DF/[●]/2016 Date: [●]

To
All Alternative Investment Funds

Dear Sir / Madam,

Sub: Change in Reporting Norms for Alternative Investment Funds (AIFs) to the Board and introduction of Reporting Norms for AIFs to the investors

1. The Board, vide Circular No. CIR/IMD/DF/10/2013 dated July 29, 2013, has, *inter alia,* prescribed Annexure I as a format of reporting to be made on a quarterly basis by Category I and Category II AIFs and the Category III AIFs which do not undertake leverage. The Board, vide this Circular proposes to change the format of reporting by the AIFs to the Board.

2. In this regard, it is specified as under:

   2.1 Submission of reports to SEBI

   (i) From the date of this Circular, all Category I and II AIFs and the Category III AIFs which do not undertake leverage shall submit a report to SEBI on a quarterly basis in the format as specified in **Annexure I**.

   (ii) From the date of this Circular, all Category III AIFs which undertake leverage shall submit a report to SEBI on a monthly basis in the format as specified in **Annexure II**.

3. This Circular is issued in exercise of powers conferred under Section 11(1) of the Securities and Exchange Board of India Act, 1992 to protect the interests of investors in securities and to promote the development of, and to regulate the securities market.

4. This Circular is available on SEBI website at www.sebi.gov.in under the categories "Legal Framework" and "Alternative Investment Funds".

Yours faithfully,
[*Name*]
[*Designation*]
Investment Management Department
Tel No. [●]
Email id – [●]

Annexure I

Format of reporting to SEBI by Category I AIFs, Category II AIFs and Category III AIFs which do not undertake leverage to SEBI

					Cumulative funds raised under the scheme				Cumulative investments made under the scheme				Tenure of the				
Name of the scheme	Target corpus	Total corpus as on date	Investible funds as on date	Open/Close ended	At the beginning of the quarter	Additions during the quarter	Redemptions in the quarter	At the end of the quarter	At the beginning of the quarter	Additions during the quarter	Divestments during the quarter	At the end of the quarter	scheme (in years)	IRR	TVPI	DPI	RVPI

Annexure II

Format of reporting to SEBI by Category III AIFs which undertake leverage

					Cumulative funds raised under the scheme				Cumulative investments made under the scheme				Tenure of the				
Name of the scheme	Target corpus	Total corpus as on date	Investible funds as on date	Open/Close ended	At the beginning of the quarter	Additions during the quarter	Redemptions in the quarter	At the end of the quarter	At the beginning of the quarter	Additions during the quarter	Divestments during the quarter	At the end of the quarter	scheme (in years)	IRR	TVPI	DPI	RVPI

B. Domestic Capital Pools: Institutional Investors- Pension Funds & Insurance Companies

I. Introduction

1. Both pension funds and insurance companies are amongst the largest investors in venture capital and private equity funds in the world. They have access to long term savings of individuals. They need matching long term assets. Both pension funds and insurance companies will grow rapidly in India in the coming years. They will be a major source of long term domestic capital for investment by professional fund managers thru the structure of Alternative Investment Funds.

2. The relevant regulatory bodies in India have issued circulars to enable investment by pension funds and insurance companies in AIFs. The analysis below shows that investments by both these sets of institutions have not taken place in Category II AIFs which is the largest category of AIFs.

3. This section makes recommendations for certain clarificatory notifications by the respective regulatory bodies which are given in the annexures.

II. Background & Analysis: Pension Funds

4. The Pension Fund Regulatory Development Authority (PFRDA) issued a Circular dated 8 April 2016 (Ref: PFRDA/2016/8/PFM/02) with the subject *'Investment in Alternative Investment Funds'* (the "**2016 Circular**"). The 2016 Circular provides the NPS Scheme permission to invest in Category I and II AIFs. In the context of Category II AIFs, the 2016 Circular provides that at least 51% of the funds shall be invested in either infrastructure entities, or SMEs, or venture capital, or social welfare entities.

5. Pertinently, the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"), in the context of Category II AIFs, only provide that they shall invest *primarily* in *unlisted investee companies* [Regulation 17(a)]. An 'investee company' is defined to mean any company, special purpose vehicle or limited liability partnership or body corporate or real estate investment trust or infrastructure investment trust in which an AIF makes an investment. As such, the AIF Regulations do not prescribe any additional investment conditions linked to the sector or stage of investment by the AIF. As such, there is no limitation in the AIF Regulations that restrict investments by Category II AIF in infrastructure entities, or SMEs, or venture capital, or social welfare entities.

6. It appears, based on the above, that the restriction imposed on Category II AIFs to invest 51% of their funds in infrastructure entities, or SMEs, or venture capital, or social welfare entities is an anomaly as the same contradicts the AIF Regulations.

7. Statistics released by the Securities and Exchange Board of India clearly indicate that a majority of capital commitments raised by AIFs since the year 2012 have been raised in Category II AIFs (~Rs 32,700 crores vs total commitments of ~Rs 50,450 crores across all AIF Categories). A significant majority of Category II AIFs that have raised capital commitments so far have followed an investment strategy that is very similar to the investment strategy followed by Venture Capital Funds regulated under the erstwhile Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996.

8. AIFs are becoming an important vehicle to channelize domestic and foreign capital into private enterprises. Significant Government/ Regulatory policy action continues to be taken to make AIFs an attractive/ efficient investment vehicle. This is also exemplified by the Government of India registering the National Investment and Infrastructure Fund as a Category II AIF.

9. Further, in the global context too pension funds and retirement systems have been a major source of capital for private equity as an asset class. This has significantly contributed to the growth and maturity of the private equity industry by bringing long term sustainable source of capital as well as improved governance.

III. RECOMMENDATION

10. The anomaly highlighted above is acting as a significant deterrent to the deployment of capital by the NPS Scheme in AIFs especially Category II AIFs (which are mainly private equity and debt funds). It is recommended that a suitable clarification to the effect that the NPS Scheme will have the permission to invest in Category II AIFs so long as such AIFs invest *primarily* in *unlisted investee companies* and in accordance with the AIF Regulations will go a long way in improving the risk return profile of the NPS Scheme investment in AIFs and in also helping the formation of domestic pools of growth and development capital that is critical for India’s success.

A draft letter making the above recommendation is given in **Annexure 1**

IV. Insurance Companies

Background & Analysis

11. The Insurance Regulatory Development Authority (IRDA) issued a Circular addressed to the Chief Executive Officers of all Insurers (**"Insurers"**) dated 23rd August 2013 (Ref: IRDA/F&I/CIR/INV/172/08/2013) with the subject *'Permission to Insurers to Invest in Category I & II Alternative Investment Funds'* (the "**2013 Circular**"). The said Circular followed a Circular issued on 18 March 2013 permitting Insurers to invest in Category I AIFs with some restrictions.

12. The 2013 Circular provides Insurers permission to invest in Category I and II AIFs. In the context of Category II AIFs, the 2013 Circular provides that at least 51% of the funds shall be invested in either infrastructure entities, or SME entities, or Venture Capital Undertakings, or Social Venture entities.

13. Pertinently, the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"), in the context of Category II AIFs, only provide that they shall invest *primarily* in *unlisted investee companies* [Regulation 17(a)]. An 'investee company' is defined to mean any company, special purpose vehicle or limited liability partnership or body corporate or real estate investment trust or infrastructure investment trust in which an AIF makes an investment. As such, the AIF Regulations do not prescribe any additional investment conditions linked to the sector or stage of investment by the AIF. In contrast the term 'Venture Capital Undertaking' has a distinct meaning which is only relevant to investments by Category I AIFs.

14. It appears, based on the above, that the restriction imposed on Category II AIFs to invest 51% of their funds in infrastructure entities, or SME entities, or Venture Capital Undertakings, or Social Venture entities is an anomaly as the same contradicts the AIF Regulations.

15. Statistics released by the Securities and Exchange Board of India clearly indicate that a majority of capital commitments raised by AIFs since the year 2012 have been raised.

16. In Category II AIFs (Rs. 38028.12 crores vs total commitments of Rs. 65012.62 crores across all AIF Categories as of 30th September, 2016). A significant majority of Category II AIFs that have raised capital commitments so far have followed an investment strategy that is very similar to the investment strategy followed by Venture Capital Funds regulated under the erstwhile Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996.

17. AIFs are becoming an important vehicle to channelize domestic and foreign capital into private enterprises. Significant Government/ Regulatory policy action continues to be taken to make AIFs an attractive/ efficient investment vehicle. This is also exemplified by the

Government of India registering the National Investment and Infrastructure Fund as a Category II AIF.

18. Further, in the global context too insurance companies have been a major source of capital for private equity as an asset class. This has significantly contributed to the growth and maturity of the private equity industry by bringing long term sustainable source of capital as well as improved governance.

V. RECOMMENDATION

19. The anomaly highlighted above is acting as a significant deterrent to the deployment of capital by Insurers in AIFs especially Category II AIFs (which are mainly private equity and debt funds). It is recommended that a suitable clarification to the effect that Insurers will have the permission to invest in Category II AIFs so long as such AIFs invest *primarily* in *unlisted investee companies* and in accordance with the AIF Regulations will go a long way in improving the risk return profile of Insurers investment in AIFs and in also helping the formation of domestic pools of growth and development capital that is critical for India's success.

A draft letter making the above recommendation is given in **Annexure 2.**

Annexure 1

Mr. Hemant Contractor

Chairman

Pension Fund Regulatory and Development Authority

B-14/A, Chatrapati Shivaji Bhawan

Qutab Institutional Area

Katwaria Sarai

New Delhi-110016

India

Attn: ___________

Dear Sir,

Sub: **Permission for NPS Schemes to invest in Category II Alternative Investment Funds**

Introduction

The Alternative Investment Fund (**"AIF"**) industry regulated by the Securities and Exchange Board of India (the **"SEBI"**) highly appreciates the initiatives by the Pension Fund Regulatory and Development Authority (the "**PFRDA**") to enable NPS Schemes [Other than Govt. Sector (CG &SG), Corporate CG, NPS Lite and APY] to invest in AIFs (**"NPS Scheme"**).

The Alternative Investment Policy Advisory Committee (**"AIPAC"**) constituted by the SEBI meets frequently to consider and propose various reforms in regulations affecting the sound development and growth of AIFs in India. The AIPAC is chaired by Shri N.R. Narayana Murthy, the founder of Infosys. In addition, AIPAC includes representatives of the SEBI, the Ministry of Finance, experienced fund managers, legal and tax professionals.

The AIPAC has analysed the PFRDA circulars dated 8 April, 2016 and the 4th of November, 2016 enabling the NPS Scheme to invest in AIFs based on which we wish to make the following recommendation for PFRDA's consideration.

Background & Analysis

The PFRDA issued a Circular dated 8 April 2016 (Ref:PFRDA/2016/8/PFM/02) with the subject *'Investment in Alternative Investment Funds'* (the "**2016 Circular**"). The 2016 Circular provides the NPS Scheme permission to invest in Category I and II AIFs. In the context of Category II AIFs, the 2016 Circular provides that at least 51% of the funds shall be invested in either infrastructure entities, or SMEs, or venture capital, or social welfare entities.

Pertinently, the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"), in the context of Category II AIFs, only provide that they shall invest *primarily* in *unlisted investee companies* [Regulation 17(a)]. An 'investee company' is defined to mean any company, special purpose vehicle or limited liability partnership or body corporate or real estate investment trust or infrastructure investment trust in which an AIF makes an investment. As such, the AIF Regulations do not prescribe any additional investment conditions linked to the sector or stage of investment by the AIF. As such, there is no limitation in the AIF Regulations that restrict investments by Category II AIF in infrastructure entities, or SMEs, or venture capital, or social welfare entities.

It appears, based on the above, that the restriction imposed on Category II AIFs to invest 51% of their funds in infrastructure entities, or SMEs, or venture capital, or social welfare entities is an anomaly as the same contradicts the AIF Regulations.

Statistics released by the Securities and Exchange Board of India clearly indicate that a majority of capital commitments raised by AIFs since the year 2012 have been raised in Category II AIFs (Rs. 38,028.12 crores vs total commitments of Rs. 65,012.62 crores across all AIF Categories as of 30th September, 2016). A significant majority of Category II AIFs that have raised capital commitments so far have followed an investment strategy that is very similar to the investment strategy followed by Venture Capital Funds regulated under the erstwhile Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996.

On 4th November, 2016 PFRDA issued a circular announcing that a separate Asset Class A has been introduced for Alternate Investments. The circular clearly states that this asset class includes SEBI registered Category I & II AIFs. While this is a welcome move, para 4 of the circular states that the 4th November, 2016 must be read with the circular issued on 8th April, 2016. This linkage introduces some ambiguity in as much as the restrictions contained in para 4 of the 8th April, 2016 will still apply. For the sake of clarity, we recommend that PFRDA issues a clarification that all Category I & 2 AIFs are eligible for inclusion in Asset Class A provided they are SEBI registered.

AIFs are becoming an important vehicle to channelize domestic and foreign capital into private enterprises. Significant Government/ Regulatory policy action continues to be taken to make AIFs an attractive/ efficient investment vehicle. This is also exemplified by the Government of India registering the National Investment and Infrastructure Fund as a Category II AIF.

Further, in the global context too pension funds and retirement systems have been a major source of capital for private equity as an asset class. This has significantly contributed to the growth and maturity of the private equity industry by bringing long term sustainable source of capital as well as improved governance.

RECOMMENDATION

1. The anomaly highlighted above is acting as a significant deterrent to the deployment of capital by the NPS Scheme in AIFs especially Category II AIFs (which are mainly private equity and debt funds). It is recommended that a suitable clarification to the effect that the NPS Scheme will have the permission to

invest in Category II AIFs so long as such AIFs invest *primarily* in *unlisted investee companies* and in accordance with the AIF Regulations will go a long way in improving the risk return profile of the NPS Scheme investment in AIFs and in also helping the formation of domestic pools of growth and development capital that is critical for India's success.

2. PFRDA to issue a new clarificatory circular stating that all Category I & 2 AIFs are eligible for inclusion in Asset Class A provided they are SEBI registered and that para 4 of circular dated 8th April, 2016 will not be applicable.

Once again we congratulate PFRDA for the positive measures it is taking.

We look forward to a positive response with respect to the aforementioned request.

Yours sincerely,

Annexure 2

The Insurance Regulatory and Development Authority

Parisharam Bhavan, 3rd Floor

Basheer Bagh,

Hyderabad – 500 004

India

Attn: ___________

Dear Sir,

Sub: **Permission for Insurers to invest in Category II Alternative Investment Funds**

Introduction

The Alternative Investment Fund (**"AIF"**) industry regulated by the Securities and Exchange Board of India (the **"SEBI"**) highly appreciates the initiatives by the Insurance Regulatory and Development Authority (the "**IRDA**") to enable insurance companies to invest in AIFs.

The Alternative Investment Policy Advisory Committee (**"AIPAC"**) constituted by the SEBI meets frequently to consider and propose various reforms in regulations affecting the sound development and growth of AIFs in India. The AIPAC is chaired by Shri N.R. Narayana Murthy, the founder of Infosys. In addition, AIPAC includes representatives of the SEBI, the Ministry of Finance, experienced fund managers, legal and tax professionals.

The AIPAC has analysed IRDA circulars enabling Insurers to invest in AIFs based on which we wish to make the following recommendation for IRDA's consideration.

Background & Analysis

The IRDA issued a Circular addressed to the Chief Executive Officers of all Insurers (**"Insurers"**) dated 23 August 2013 (Ref:IRDA/F&I/CIR/INV/172/08/2013) with the subject *'Permission to Insurers to Invest in Category I & II Alternative Investment Funds'* (the "**2013 Circular**"). The said Circular followed a Circular issued on 18 March 2013 permitting Insurers to invest in Category I AIFs with some restrictions.

The 2013 Circular provides Insurers permission to invest in Category I and II AIFs. In the context of Category II AIFs, the 2013 Circular provides that at least 51% of the funds shall be invested in either infrastructure entities, or SME entities, or Venture Capital Undertakings, or Social Venture entities.

Pertinently, the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"), in the context of Category II AIFs, only provide that they shall invest *primarily* in *unlisted investee companies* [Regulation 17(a)]. An 'investee company' is defined to mean any company, special purpose vehicle or limited liability partnership or body corporate or real estate investment trust or infrastructure investment trust in which an AIF makes an investment. As such, the AIF Regulations do not prescribe any additional investment conditions linked to the sector or stage of investment by the AIF. In contrast the term 'Venture Capital Undertaking' has a distinct meaning which is only relevant to investments by Category I AIFs.

It appears, based on the above, that the restriction imposed on Category II AIFs to invest 51% of their funds in infrastructure entities, or SME entities, or Venture Capital Undertakings, or Social Venture entities is an anomaly as the same contradicts the AIF Regulations.

Statistics released by the Securities and Exchange Board of India clearly indicate that a majority of capital commitments raised by AIFs since the year 2012 have been raised in Category II AIFs (Rs. 38,028.12 crores vs total commitments of Rs. 65,012.62 crores across all AIF Categories as of 30th September, 2016). A significant majority of Category II AIFs that have raised capital commitments so far have followed an investment strategy that is very similar to the investment strategy followed by Venture Capital Funds regulated under the erstwhile Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996.

AIFs are becoming an important vehicle to channelize domestic and foreign capital into private enterprises. Significant Government/ Regulatory policy action continues to be taken to make AIFs an attractive/ efficient investment vehicle. This is also exemplified by the Government of India registering the National Investment and Infrastructure Fund as a Category II AIF.

Further, in the global context too insurance companies have been a major source of capital for private equity as an asset class. This has significantly contributed to the growth and maturity of the private equity industry by bringing long term sustainable source of capital as well as improved governance.

RECOMMENDATION

The anomaly highlighted above is acting as a significant deterrent to the deployment of capital by Insurers in AIFs especially Category II AIFs (which are mainly private equity and debt funds). It is recommended that a suitable clarification to the effect that Insurers will have the permission to invest in Category II AIFs so long as such AIFs invest *primarily* in *unlisted investee companies* and in accordance with the AIF Regulations will go a long way in improving the risk return profile of Insurers investment in AIFs and in also helping the formation of domestic pools of growth and development capital that is critical for India's success.

We look forward to a positive response with respect to the aforementioned request.

Yours sincerely,

____

C. Mid-Market Permanent Capital Vehicles

Mid-Market Permanent Capital Vehicles (MMPCVs) are proposed to be set up under SEBI regulation as Category II AIFs. An MMPCV is a permanent pool of capital. It is designed to meet the capital needs of mid-corporate and micro, small and medium enterprises ("MSME").

1. Rationale of MMPCVs

1.1 There is an increasing need for financing and investing vehicles that provide capital to the mid-corporate and micro, small and medium enterprises. MSMEs are the engine of growth and employment generation. They contribute to 40% of India's manufacturing output[1], and materially to the labor force. There is an identified gap of over Rs. 2.5 lakh crore[2] of debt capital for MSMEs.

1.2 Bank lending to MSMEs has declined over time with no signs of the reversals. Traditional capital markets funding options are also not a viable solution for MSMEs leading to a large identified need for debt capital. MMPCVs are a viable option to address this capital gap in the MSME segment.

2. RESEARCH APPROACH AND METHODOLGY

2.1 The working group relied heavily on secondary reports published by eminent organizations such as IFC and RBI to evaluate the impact of the MSME share in the economic growth of India. The demand-supply gap for capital, both debt and equity, was quantified through secondary research.

2.2 The group evaluated the mid-market sector in other developed countries and the role of access to cheap finance as an enabler. The experience of developed markets in Europe and the US in providing capital to the sector following the global financial crisis was looked at. Non-traditional sources of capital in the sector in the US and Europe were evaluated to seek possible solutions in the Indian context.

2.3 Opinions of industry experts within the US markets were sought to understand the nature and context of the various pools of capital available to the sector. The key issues pertaining to these pools including typical investor/ issuer behavior and the regulatory landscape as an enabler were also considered. Inputs from local regulatory authorities were sought to evaluate various aspects of the proposed solution. Indian legal and tax

[1] SME Knowledge Banking Guide, IFC (2010)

[2] MSME Finance in India, IFC Report, Nov 2012, April 2016

experts were consulted on the feasibility of the suggested outcomes.

3. INTERNATIONAL EVOLUTION AND SUCCESS

3.1 Internationally, the US has been the benchmark in creating non-bank funding platforms to address the need for capital. Banks have pulled away from being material capital providers. After the financial crisis, bank balance sheets have materially shrunk and have paved the way for non-bank funding platforms, such as business development companies (BDCs, under the US Investment Company Act Of 1940).

3.2 These non-bank platforms have stepped up to "fill-the-gap" and act as risk-takers and providers of consistent capital. The permanent capital nature of MMPCVs is an appropriate format to utilise in this context, as it has benefits to issuers, investors and asset managers.

4. PROPOSED SOLUTION

4.1 In an economy like India, where MSMEs contribute to 40% to India's manufacturing output[3], MMPCVs can help continue the development of the Indian capital markets by mediating the capital need of MSME's.

4.2 The permanent nature of MMPCVs helps provide long-term, flexible capital to MSMEs, and is aimed at continuous access to funds.

4.3 The high-dividend distribution requirement and the possibility to make continuous offerings, optionally listing the units, and externally managing these vehicles, makes it interesting for accredited investors as a new asset class to invest in.

4.4 It is pertinent to note that this proposed solution of a permanent capital platform have faced some criticisms in the US. These issues are selective and not wide spread. We have identified these issues and we attempt to address them in India by way of appropriate regulations.

[3] See note 1 above.

5. RECOMMENDATIONS

5.1 Currently the requirement to invest specifically in mid-market securities is not covered in SEBI's AIF II Regulations. It is recommended that MMPCVs are introduced as a new sub - category of Alternative Investment Funds II ("**AIF II A**").

5.2 In addition to the already prescribed conditionality applicable to AIFs II, we recommend that the following additional conditions are made applicable to MMPCVs. We believe that these conditions will aim to address the issues which have been identified on a global level and also facilitate investments by MMPCVs in MSMEs.

(i) Mid- Market Focus: A MMPCV must invest 70% of its assets in "eligible" assets. Eligible assets comprise of securities from issuers that are neither an investment company nor a company which would be an investment company (except for certain exclusions). Such issuers should not:

- have any class of securities listed on an any stock exchange; or
- have a class of securities listed on an exchange, but have an aggregate market value of less than Rs. 2000 crores.

(ii) Sponsor Commitment & Track Record: Currently, the requirement for sponsor commitment is not covered in the AIF II Guidelines. For the MMPCVs to be registered as a sub-category of AIF II, we recommend that it shall have a minimum sponsor/manager commitment of 2.5% of such MMPCV's net worth or Rs. 5 crore, whichever is more.

(iii) Subsequent Offer: In addition to the presently prescribed condition of initial offer by way of a private placement with a minimum investment size of Rs.1 crore; we recommend that continuous offering shall be permitted for MMPCVs. This will help address liquidity and growth requirements on regular basis of MSMEs as it is important to provide a continuous window to access capital for MSMEs.

(iv) Compulsory Distribution: A minimum of 90% of distributable cash surplus shall be allowed to be distributed to the investors of MMPCVs. However, such distributions shall be permitted only from cash profits and not from any capital or leverage availed by a MMPCV. This distribution strategy will make it interesting for high net worth individuals and retail investors to invest in MMPCVs.

(v) Fees: Management fee shall only be charged on capital units. While the AIF II Guidelines permit the manager/sponsor to receive fees and carry, there is no cap or restrictions on fees which can be charged by the manager/sponsor.

(vi) Leverage: To make MMPCVs more attractive and beneficial to MSMEs, we recommend that MMPCVs are allowed to source leverage only upto 1x of capital.

(vii) Listing: We recommend that mandatory listing be required for the MMPCVs within 10 years from the initial closing of the fund raise. In the event such listing is not achieved within 10 years, the MMPCVs shall complete redemption within the next two years. This condition will ensure that MMCVs provide liquidity to investors.

6. THE PROPOSED TAX REGIME FOR MMPCVs

Following the twin objectives of tax certainty and ensuring a one level tax and since MMPCVs are pooling vehicles which would be registered with SEBI as AIFs, the following is the recommended regime:

(i) Tax should be payable on distribution by the MMPCVs, either as a withholding tax (for unlisted vehicles) or as a distribution tax (for listed vehicles) as discussed below.

(ii) There should be no withholding of tax on payment made by investee companies to MMPCVs.

(iii) Investors should be subject to capital gains tax on transfer of units of MMPCVs in accordance with existing law on similar securities, which is as follows:

- For unlisted units

Nature of gains	Units of unlisted MMPCV	
	Resident	Non-resident
Short Term Capital Gains (i.e. 24 months or less)	As per applicable slab rate (30% being highest)	40%/30% or Treaty rate, whichever is beneficial
Long Term Capital Gains (i.e. more than 24 months)	20% (with indexation)	10% or Treaty rate, whichever is beneficial

- For listed units

Nature of gains	Units of Listed MMPCV	
	Resident	Non-resident
Short Term Capital Gains (i.e. 12 months or less)	15% (subject to Securities Transaction Tax (STT))	15% or Treaty rate, whichever is beneficial (subject to STT)
Long Term Capital Gains (i.e.	Exempt. However, transaction is subject to STT.	

more than 12 months)	

Withholding tax/Distribution tax

Scenario I: MMPCV is an unlisted vehicle

Aligned to the taxation for Category II AIFs, income should be taxable in the hands of investors on a "pass through" basis and deemed to be of the same nature and proportion as in the MMPCVs hands. Payments to resident investors by MMPCVs should be subject to withholding at the rate of 10 (ten) percent. Payments to non-resident investors by MMPCVs should be subject to withholding at the prevailing rate in effect at the time of such investment. No withholding of tax should apply in respect of income which is not chargeable to tax under the provisions of Income Tax Act.

Scenario II: MMPCV is a listed vehicle

Aligned to the recommendation contained in this Report for taxation of listed Category II AIFs, income should be exempt in the hands of the MMPCVs, and they should pay distribution tax on the surplus distributed to the investors. On the basis that there is expected to be a significant interest in this product from non-resident investors, who are otherwise entitled to a benevolent tax rate of 5% on interest income through other investment avenues, it is recommended that such distribution tax be charged at the rate of 15 (fifteen) per cent. There should be no further tax in hands of the investors on the distributions received from MMPCV.

D. Accredited Investors

Preamble

1. Long-term and stable risk capital is essential to finance investment an emerging economy, for sustainable development and to meet the growing demands of a large population. In India, a mere 10-15% of the total equity capital required by start-ups, medium enterprises and large companies is funded through domestic sources. Traditional funding sources, such as banks and non-bank financial companies, are constrained by risk-aversion, which limits their ability to supply risk capital. There is a critical need to unlock other domestic pools of capital which can be routed through Alternative Investment Funds which are professionally managed vehicles. There is a vital need to widen the pool of investors which are eligible to invest in AIFs.

The Problem

2. Investment products like AIFs require the participation of sophisticated investors. Currently there is no scientific mechanism to identify investors who are sophisticated enough to understand and accept complex investment products.

3. SEBI's AIF regulations require the use of the 'ticket size' of an investment as a criteria to identify sophisticated investors. In addition to the ticket size criteria, there is a need for a mechanism to identify investors to whom complex investment products can be made available.

Possible Solution

4. The progressive economic environment which India is architecting and rapidly building on has the solutions. Based on the progress being made on digital India & the government's goal of ease of doing business (investing), it would be logical to exploit digital technology and give an "Investing Aadhar" to individual HNI investors to ascertain the sophisticated investor status.

5. The core principles are:

- Leveraging the Digital framework of India, such as the new Central KYC Records Registry (CKYCR)
- Improving the ease of investing for investors and strengthen their financial risk management
- Increasing financial inclusion by making sophisticated financial products available to a wider base, namely HNIs.

6. In various countries the concept of "Accredited Investors" is used where an investor who has a certain minimum income, or asset, or net worth, is considered to be an Accredited Investor who can make investments in vehicles such as AIFs. Such investors are usually self-certified. In USA, 'a natural person with income exceeding US$200,000 in each of the two most recent year' is said to fit the definition of the term "Accredited Investor".

AIPAC's Proposal for 'Accredited Investors'

7. Consistent with global practice, it is proposed that individuals who satisfy the following conditions be recognised as Accredited Investors:

- Capable of identifying potential investments and their underlying risks;
- Possess sufficient financial sophistication to assume the risks associated with the offerings; and
- Have a sound financial track record i.e. reported total income exceeding Rs. 50 lakhs annually in three out of the five assessment years, immediately preceding the assessment year in which the investment is proposed to be made.

8. It is also proposed to link the Permanent Account Number (PAN) of the investor in the electronic database of revenue authorities, with the total income (including exempt income) of the investor, in a manner such that it is easier to determine whether the investor qualifies as an Accredited Investor.

9. These investment products are to be sold only to Accredited Investors, who will be evaluated and vetted through a proper KYC process by registered KRAs or other depository participants (DPs).

Potential Application

10. Today, in the absence of an Accredited Investor regime, many financial service providers use multiple proxies to determine the suitability of an investor. For example:

- 'Accredited Investors' for subscribing to an IPO: While investing in IPOs, HNI investors are determined through a proxy of their investment amount. For the new Start Up exchange, HNI investors are determined through a higher size of trading lot vis-a-vis the regular exchange. Such proxies are futile and an Accredited Investor regime can be a uniform platform for an income- based check of suitability across various product categories.

- 'Accredited Investors' for Angel investing: Currently angel investments are not regulated. These are usually private transactions that happen over the counter. The Accredited Investor framework can be utilized to move these transactions to a more regulated exchange framework. Angel investments made by these Accredited Investors in shares of start-ups & dematerialized through a recognized depository, should be permitted to avail exemption from Angel Tax.

- 'Accredited investor' can be a mechanism for complex investment and financial products such as start-up listing, new credit system to be introduced by RBI, peer to peer lending etc.

Process Flow

11. The suggested process for accreditation is described below:

i. At the time of registering on www.incometaxindiaefiling.gov.in (Income Tax Department's assessee e-Portal), an option will be provided to the assessee to register himself/herself as an Accredited Investor.

ii. The assessee will be asked if he wants to be an Accredited Investor & only when the assessee complies will he be opted in as an Accredited Investor.

iii. The assessee will then complete the registration procedure by providing PAN details, e-mail ID, mobile number (to authenticate his credentials through an OTP password procedure), etc. & verifying he has opted in to be an Accredited Investor; this information will then be shared with others.

iv. After completely filling in the details, the assessee will be informed whether he is eligible or not to be an Accredited Investor.

v. Once he is cleared to be an Accredited Investor, the assessee shall go through a simple online test of about 15 questions to ascertain his basic knowledge of investing. The questions are oriented as much towards instructing the individual on good practices of investing as much as to test his knowledge. If the assessee is unable to pass the test, he can take the test within a week (as an example).

vi. Once the assessee clears the test (for example, 10 out of 15 questions), Income Tax database (CBDT) will create an Accredited Investor flag in their database, against each PAN number, which will say "Y" or "N".

vii. The accreditation information of the investor will be captured at the time of the KYC record creation / updating in the Central KYC Records Registry which is owned by CERSAI in accordance with powers conferred under the PMLA Act. The information will be captured as a "Y" or "N" answer to any query about the Accredited Investor. For example, a domestic fund raising money from accredited HNIs will be able to provide PAN number of the investor and get a yes or no answer in return about that individual's accreditation status.

viii. The Central KYC Records Registry will then integrate with CBDT for authentication of accreditation status and/or any update on account of change in the investor's accreditation status. Privacy of exact income information is maintained in this manner and a mere yes or no answer is revealed.

Conclusion

Based on the above architecture, it would be logical to qualify investors based on income levels and acumen along with a minimum investment requirement. It is now possible to leverage India Stack to easily implement an “Accredited Investor” system in India, and as the 4th layer of consent comes online, this would be further empowered.

E. Managing Alternative Investment Funds in India: Foreign Ownership Test

I. Introduction: Need for Liberalization

1. Indian fund managers and sponsors are disadvantaged due to the level of foreign ownership at their parent listed level. The current rules issued by the Reserve Bank of India largely mean that Indian Financial services sponsors like ICICI and HDFC--pioneers of India's Alternative Investment Fund industry - will face restrictions in managing foreign pools of capital in Indian domiciled AIFs. This would, clearly, be counterproductive to managing in India.

2. In furtherance of the Government's intent to attract foreign investment in Indian investment vehicles, the Reserve Bank of India had issued notifications dated 16th November 2015 (No. FEMA 355/2015-RB) and 15th February 2016 (No. FEMA 362/2016-RB) allowing foreign investment in Indian regulated investment vehicles (including Alternative Investment Funds or AIFs).

3. The notification provides that downstream investments i.e. investments in portfolio companies by AIF's shall be regarded as foreign investment if neither the Sponsor nor the Manager nor the Investment Manager is Indian 'owned and controlled'. In other words, if the Sponsor or the Manager or the Investment Manager is not Indian 'owned and controlled', the entire downstream investment by the AIF will qualify as foreign investment and be subject to the restrictions on foreign investments.

4. The above rule creates significant challenges for many AIFs which are sponsored and managed by Indian banks, Non-Banking Financial Companies, or holding companies of such financial institutions, which are listed on recognized stock exchanges in India. In many such cases, given the significant level of Foreign Portfolio Investors' (FPIs) ownership, the institutions fail to meet the criteria of being Indian owned and controlled. Consequently, the investments made by AIFs sponsored by such institutions or their subsidiaries have to comply with the rules applicable to foreign investment.

II. Recommendation for an Appropriate Ownership Test

5. In view of the fact that financial institutions, fund managers and sponsors have been active in raising capital in AIFs and have successfully raised significant capital from domestic and foreign investors it is necessary that no hurdles be placed in their future fund managing and raising efforts.

6. It is recommended that a more appropriate test to determine ownership be provided for sponsors and fund managers that belong to a group that is listed on Indian stock exchanges.

7. It is recommended that the ownership test be defined on the following lines:

Test of Ownership: Foreign Portfolio Investors acquire small percentage stakes in listed companies and are passive investors exercising no control on their investee companies. Accordingly, while determining the foreign ownership in widely held listed companies (or their direct or indirect subsidiaries), the stake held by Foreign Portfolio Investors (FPIs) should be excluded i.e. foreign ownership should be computed based on the composition of domestic investment and foreign investment made under the Foreign Direct Investment (FDI) route, only. A 'widely held' listed company should be considered to be one where no single foreign (non FPI) shareholder along with his/its affiliates has a shareholding exceeding 10%.

By way of an illustration, where an Indian listed company has a shareholder composition comprising 50% FPI investors, 24% FDI investors and balance 26% domestic investors, the Indian listed company should be treated as Indian owned so long as no single FDI investor along with his/its affiliates has a shareholding exceeding 10%.

III. Rationale & Justification

8. The rationale and justification for making the proposed changes are:

(i) **Promotion of fund raising efforts by experienced AIFs**. Many of the fund managers and sponsors affected have mobilized substantial amounts of domestic and international capital. This experience is beneficial to India as the fund managers and sponsors are geared to raising significant amounts of much-needed long term capital in the future as well. Accordingly, it is vital that the regulatory framework does not pose any hurdles in their future fund raising efforts;

(ii) **Policy of Liberalisation**: A more liberal regime is needed given that private equity and venture capital is long-term capital. The Government has liberalised its policies in several areas. Enunciating the recommended test of ownership will be consistent with the liberalization trend in India. The reform will be very well received internationally and domestically by fund managers and limited partners ultimately leading to greater flows of international and domestic capital to India; and

(iii) **The Government Applies an Ownership Test which is similar in the Insurance Sector:** There should be parity between the ownership test in RBI's TISPRO norms and the one covering the insurance sector. The Government has already provided for a similar ownership test, which correctly excludes the shareholding of Foreign Portfolio Investors, in determining the ownership of insurance companies. Regulation 11 of the **Insurance Regulatory and Development Authority (Registration of Indian Insurance Companies) Regulations, 2000**, and the related Explanation which was added by IRDA subsequently to address the issues faced by the entities whose parents were foreign owned by virtue of high FPI participation.

"11. Manner of calculation of twenty six percent equity capital held by a foreign company.—

(1) For the purposes of the Act and these Regulations, the calculation of the holding of equity shares by a foreign company either by itself or through its subsidiary companies or its nominees (hereafter referred to as foreign investor) in the applicant company, shall be made as under and shall be aggregate of:-

i. *the quantum of paid up equity share capital held by the foreign company either by itself or through its subsidiary companies or nominees in the applicant company;*
ii. *the quantum of paid up equity share capital held by other foreign investors, non-resident Indians, overseas corporate bodies and multinational agencies in the applicant company; and*
iii. *the quantum represented by that proportion of the paid up equity share capital to the total issued equity capital of an Indian promoter company mentioned in sub-clause (i) of clause (g) of regulation 2 held or controlled by the category of persons mentioned in sub-clauses (i) and (ii) of this sub regulation.*

Explanation: For purposes of calculation referred to above, account need not be taken of the holdings of equity in an Indian promoter company held by foreign institutional investors, other than the foreign promoters of the applicant and their subsidiaries and nominees, and Indian mutual funds to the extent the investment of foreign institutional investors and Indian mutual funds are within the approved limits laid down by the Securities and Exchange Board of India under its rules, regulations or guidelines issued from time to time.

(2) Every insurer who has been granted registration under the Act shall, within 15 days of the end of every quarter, furnish to the Authority a statement indicating changes exceeding 1% of the issued capital in the holding of the shares in his company and those of the promoter.

……………….."

Draft Notification for Amendments in TISPRO Regulations, 2000

It is recommended that Explanation 1 of para 4 of the RBI notification issued on 16th November, 2015 (No. FEMA 355/2015-RB) amending the TISPRO Regulations, 2000, should be amended as follows:

Explanation 1: For purposes of determining level of foreign ownership of the Sponsor or the manager or investment manager of an AIF referred to above, account should not be taken of the holdings of equity in an Indian promoter company of such Sponsor or the manager or investment manager which is held by foreign institutional investors or foreign portfolio investors or non-resident Indians under the portfolio investment scheme unless these shares are held by the foreign promoters of the applicant and their subsidiaries and nominees, and Indian mutual funds to the extent the investment of foreign institutional investors and Indian mutual funds are within the approved limits laid down by the Securities and Exchange Board of India under its rules, regulations or guidelines issued from time to time.

In case the 'sponsors and 'managers/investment managers' of the AIF are individuals, for the treatment of downstream investment by such AIF as domestic, 'sponsors' and 'managers/investment managers' should be resident Indian citizens.

While determining the foreign ownership in widely-held listed companies (or their direct or indirect subsidiaries) including a banking company as defined under the Banking Regulation Act, 1949, the stake held by Foreign Portfolio Investors (FPIs) should be excluded i.e. foreign ownership should be computed based on the composition of domestic investment and foreign investment made under the Foreign Direct Investment (FDI) route, only. A 'widely held' listed company should be considered to be one where no single foreign (non FPI) shareholder along with his/its affiliates has a shareholding exceeding 10%.

Explanation 2: The extent of foreign investment in the corpus of the Investment Vehicle will not be a factor to determine as to whether downstream investment of the Investment Vehicle concerned is foreign investment or not."

Chapter - IV

A. Taxation Reforms

A. Taxation Reforms

A. Introduction

1. The Securities and Exchange Board of India (SEBI) had constituted the Alternative Investment Policy Advisory Committee (AIPAC) in 2015, under the chairmanship of Shri N. R. Narayana Murthy, with the objective to advise SEBI on measures for the development of the alternative investment and start-up ecosystem in India. SEBI released its first report on 20th January 2016 (AIPAC Report) laying down the roadmap for immediate improvements and long term progress of the Venture Capital – Private Equity (VCPE) industry by creating a more favourable tax and regulatory environment.

2. Of the many recommendations made in the AIPAC Report, the following proposals relevant to the alternative fund industry have made their way in form of amendments vide Finance Act 2016 or clarifications through Circulars issued by the Central Board of Direct Taxes (CBDT):

- Tax withholding at 10% by SEBI registered Category I and II Alternative Investment Funds (AIFs) to be applicable only to Indian residents; for non-residents, the tax withholding will be at the applicable domestic law or tax treaty rate, whichever is more beneficial;
- Remedy of nil/lower withholding certificate from tax authorities in respect of income of AIFs credited/paid to investors;
- Reduced tax rate of 10% on long term capital gains arising from the transfer of shares of private limited companies in the hands of non-residents;
- Reduction of holding period for unlisted shares from three years to two years;
- Clarification for non-foreign portfolio investors vis-à-vis treatment of gains from investments in listed securities and unlisted shares;
- Inclusion of period of holding of debentures (pre-conversion) in computing the period of holding of shares of a company, received on conversion of debentures and
- Introduction of Rule 10V of the Income-tax Rules, 1962 (guidelines) which provide clarity on the conditions to be complied for availing the safe harbour for onshore management of offshore funds and providing a pre-approval mechanism for obtaining certainty of tax outcome.

3. While the Government of India has embarked on a reform oriented approach and there is significant momentum, the reforms proposed in this report, if implemented, will provide further stimulus to alternative investments, including private equity and venture capital.

Core principles

4. The recommendations of the Committee are founded on **core best practice principles** as discussed below:

i Ease of doing business is important

Ease of doing business increases investor confidence enabling AIFs to provide stable risk capital to a larger universe of portfolio companies more effectively and in greater amounts. This leads to a robust platform, innovation in indigenous technologies, provides jobs, and generates revenues and earnings which can be ploughed back for growth and expansion.

ii Ease of investing in India directly

Attracting significant amounts of stable, long-term foreign capital will help to meet the capital needs of growing ventures and add value in several ways, such as improving governance processes, providing access to networks, helping scale enterprises and ensure well-run and well-governed businesses.

iii Ease of managing offshore funds in India

The model of mobilising domestic capital and related management, which exists in developed economies, results in a thriving AIF industry. Fostering a similar model in India will benefit the Indian economy leading to the creation of a robust eco-system and help boost entrepreneurship, job creation and GDP growth.

iv Adopt global best practices and innovate "NEXT" (best) practice

AIFs are still an evolving sector in the Indian financial services landscape. The recommendations in this report are based on the core principle of adopting global best practices and where required, innovating the 'next' best practice. These recommendations are framed with the view that every next practice created is not just a global gold standard, but is also innovative and based on careful thought and consideration.

Given the above principles, the policy initiatives recommended in this report would help to achieve the following key objectives:

5. Make the AIF system work effectively as it is a primary investment vehicle to raise both domestic as well as foreign capital which can be allocated across various sub-categories of AIFs ranging from venture capital, infrastructure, private equity, real estate and other asset classes.; and

6. Non-resident investors should continue to experience ease of doing business and ideally embrace the idea of managing offshore funds in India.

B. Summary of Recommendations

I Critical Issues that require immediate implementation

A. Make the tax pass through system work effectively and efficiently

a) Treat gains from transfer of unlisted shares held by AIFs as capital gains, irrespective of transfer of control and management

b) Proportionate service tax exemption for expenses of AIFs (management fees, other fees) as they relate to foreign investor contributions in AIFs.

c) Extension of Tax Pass through to Category III AIFs

B. Making the fund management safe harbour provisions effective

a) In the guidelines for the purpose of section 9A of the Income-tax Act, 1961 (the Act), it should be expressly clarified that conditions should not be applicable to the entities that meet the criteria to be registered as Category I or Category II Foreign Portfolio Investors (FPI) in accordance with the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014

Further, to promote onshore fund management, the investor diversification conditions should be diluted

b) The threshold of 26% voting rights in an investee company to determine whether the fund controls or manages a business carried out in India should be removed as it will be a hurdle for several VCPE funds that hold a significant stake in investee companies.

c) Only aggregate direct participation or investment by resident Indians in the Fund should be considered

d) Include Investment Managers of AIFs and Asset Management Companies of Mutual Funds as eligible fund managers for safe harbour

II ***Other Recommendations***

C. Clarification on investments by AIF

a) Pass through tax status to be extended to net losses incurred at AIF level i.e. losses incurred by AIFs should be available for set-off to its investors

b) Exemption should be provided to AIFs from (a) section 56(2)(viib) on issue of shares at a value higher than fair market value and (b) section 56(2)(viia) on purchase of shares at a value lower than fair market value

c) Remove tax compliance of filing annual return by foreign investors in AIFs

d) Allow management expenses for AIF investments to be capitalized as 'cost of improvement.

D. Unit based taxation: Define separate taxation rules for listed AIFs to provide for a unit based taxation system where the fund itself is exempt from tax on its income and the taxation is a combination of distribution tax on income distributions and capital gains tax on unit redemptions/ transfers.

E. Clarification for no taxability on conversion of preference shares and inclusion of the period of holding of convertible preference shares (pre-conversion) in the period of holding of equity shares received on conversion.

F. Ease in obtaining certificates under section 197 of the Act in a time bound manner especially for treaty exempt investors with suitable administrative guidance on availability of tax treaty relief.

G. Clarification on indirect transfer provisions for multi-layered investment structures. Indirect transfer provisions should not be applicable in cases where:
(a) transfer/ redemption is directly or indirectly in consequence of or by reason of transfer of capital assets situated in India; or
(b) transfer/ redemption of share or interest does not alter the ownership of the transferor in the transferee.

7. The proposed amendments to the Act have been included in this report wherever possible. It is vital that the recommendations of the sub-committee are coherently coordinated and

harmonized across different regulators such as the Reserve Bank of India (RBI), the CBDT, the Ministry of Finance and others. For AIFs to work seamlessly, they need to be treated equally and on par by all stakeholders and regulators.

III. *Critical Issues that require immediate implementation*

A. **Make the tax pass through system work effectively and efficiently**

A. Treat gains from the transfer of unlisted shares held by AIFs as capital gains, irrespective of transfer of control and management

i. Traditionally, the issue of treatment of investment exit gains (whether taxable as business income or capital gains) has been a subject matter of litigation. There have been several judicial pronouncements on whether gains from transactions in securities should be taxed as “business profits” or as “capital gains”. However, these pronouncements, while laying down guiding principles, have largely been driven by the facts and circumstances of each case.

ii. The intention of the SEBI (AIF) Regulations, 2012 is to promote investments. As per the extant regulatory framework, a SEBI registered AIF is a privately pooled investment vehicle which collects funds from investors for investing in accordance with its defined investment policy for the benefit of its investors.

iii. Category I and II AIFs predominantly invest in unlisted investee entities with a medium to long-term investment horizon (typical holding periods ranging from 2-5 years). The investments by such AIFs are made out of funds collected from their investors and they are not permitted to borrow to make investments.

iv. The current tax code for AIFs could lead to unintended litigation on treatment of income at of AIFs Given the intent of SEBI (AIF) Regulations is not to allow carrying on of business, the income earned by an AIF from its investment activity cannot be treated as business income and hence there is no need to provide for taxation of business income at the AIF level.

v. Recently, in the context of unlisted shares, the CBDT has clarified[4] that the income arising from transfer of unlisted shares will be treated as ‘capital gains’, irrespective of period of holding except in the following situations where the Assessing Officer would take an appropriate view:
   - the genuineness of transactions in unlisted shares itself is questionable;
   - the transfer of unlisted shares is related to issue pertaining to the lifting of the corporate veil;

[4] No. 225/ 12/ 2016/ ITA.II dated 2 May 2016

- the transfer of unlisted shares is made along with the control and management of underlying business.

vi. While the aforesaid clarification puts to rest a long drawn controversy over the treatment of income arising from sale of unlisted shares as 'capital gains' or 'business income', the exclusion for 'transfer of shares along with control and management of the underlying business' can lead to fresh controversy since there is no clear definition of what constitutes 'control and management'.

vii. To gain more clarity, it would be pertinent to note that in various CBDT Circulars[5] the test provided to distinguish between shares held as investments and shares held as stock in trade has been linked to treatment of securities in the books of accounts, intention of the purchaser, quantity of securities purchased and sold, frequency of transactions etc. In none of these circulars, the test for treatment of exit gains has been linked to 'control and management of underlying business. Further, even in judicial precedents on the subject, it has been held that where purchase of shares in a company results in acquisition of a right to manage/ control the investee company, then, the shares shall not be considered as stock-in-trade and the transaction would still be considered as a capital account transaction.

viii. Further, the decision of the Chandigarh Tribunal in the case of *Sumeet Taneja v. Addl CIT (ITA No. 1101/ Chd/ 2009)*[6] – upheld by the High Court as well, is clearly distinguishable from investments made by VCPE funds which are financial investors in the company and not engaged in any business activity. Further, the arguments against the applicability of the High Court judgment in the context of financial investors has been attached as an Annexure.

ix. Even the regulatory framework under which AIFs invest only refers to the activity of investment in securities and not to the activity of carrying out any business activity i.e. the regulatory framework for AIFs entitle them to make investments in securities. It does not indicate that AIFs are managing/ controlling the business operations of such investee companies. Further, AIFs predominantly invest in unlisted investee entities with a medium to long-term investment horizon (typical holding periods ranging from 2-5 years) and hence, their intention is only to earn financial income and not trading income. AIFs are not traders in shares and do not engage in frequent purchase and sale of shares. Accordingly, AIFs do not satisfy the principles that have been laid down in various judicial pronouncements and CBDT Circulars to classify their income as business income.

x. The objective of an AIF is always to raise capital, invest the capital in investee

[5] CBDT Instruction No. 1827 dated August 31, 1989, Circular No. 4 of 2007 dated June 15, 2007 and Circular No. 6 dated February 29, 2016.

[6] Wherein it has been held that transfer of shareholding by promoters was in the nature of sale of business assets and not capital assets because the share purchase agreement not only provides transfer of shares but also envisages transfer/ renunciation of control over the company, transfer of employee database, products database, customer proposals, contracts, non-usage of brand equity, non-compete clauses etc. and accordingly, the income arising from the transaction of sale of shares was treated as 'business income' and not as 'capital gains'.

companies and return the capital and gains to the investors through the AIFs make and hold investments in portfolio companies with an objective of long term capital appreciation. At times, depending on the capital needs of the promoters and the investment strategy of the AIFs, they may end up acquiring stakes which may be in excess of 20% and may even exceed 51%. Notwithstanding their stake in the investee companies, the objective of an AIF is to merely provide financial capital to investee companies.

xi. The regulatory framework of FPIs and AIFs is similar and under both the regulations the intention of such entities is to make investment in securities. Therefore, where the investment gains of a FPI are deemed to be treated as capital gains (even when they are held only for 1 day), the investment gains of an AIF which invests for a longer period of time should also be deemed to be treated as capital gains.

xii. From the above, it is clear that where the investment in investee companies is held as investment and not as stock-in trade in the books of the VCPE funds including where the funds hold majority/ controlling stake in the investee companies, in all situations the gains derived by an AIF should be treated as capital gains and not as business income. This clarification by the Government would provide certainty and consistency in treatment of income earned by AIFs from the disposal of securities held by them.

xiii. It is therefore important that the treatment of income arising from the transfer of securities held by AIFs be clearly spelled out to be capital gains without giving any potential for adverse interpretation. This much deserved clarification would provide certainty and consistency in the treatment of income earned by AIFs from disposal of securities.

Recommendation:

(a) The provisions relating to the taxability of business income earned by an AIF at the AIF level should be deleted. It should be deemed that income earned by the AIF should be taxable under the head “capital gains” or “income from other sources” and not “business income”.

(b) The definition of capital asset under section 2(14) of the Income-tax Act, 1961 should be amended to provide deemed characterization for securities held by an AIF as a ‘capital asset’ thereby, treating the gains arising from the sale thereof, as ‘capital gains’ and not ‘business income’.

(c) The exception with respect to ‘transfer of shares along with control and management of underlying business’ (provided in the CBDT clarification) should be expressly removed at least in the context of AIFs i.e. gains arising from the transfer of unlisted securities with or without the transfer of control and management of the underlying business should be taxed as ‘Capital gains’ and not as ‘Business income’.

Proposed Amendment:

10(23FBA) - Any income of an investment fund ~~other than the income chargeable under the head "Profits and gains of business or profession"~~;
~~(23FBB) any income referred to in section 115UB, accruing or arising to, or received by, a unit holder of an investment fund, being that proportion of income which is of the same nature as income chargeable under the head "Profits and gains of business or profession".~~
Explanation.—For the purposes of clause~~s~~ (23FBA) ~~and (23FBB)~~, the expression "investment fund" shall have the meaning assigned to it in clause (a) of the Explanation 1 to section 115UB;';

CHAPTER XII-FB
SPECIAL PROVISIONS RELATING TO TAX ON INCOME OF INVESTMENT FUNDS AND INCOME RECEIVED FROM SUCH FUNDS

115UB. ~~(4) The total income of the investment fund shall be charged to tax—~~
~~(i) at the rate or rates as specified in the Finance Act of the relevant year, where such fund is a company or a firm; or~~
~~(ii) at maximum marginal rate in any other case~~

2(14) - Capital asset means –
(a) property of any kind held by an assessee, whether or not connected with his business or profession;
(b) any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992
(c) any investment held by an investment fund

Explanation 2: For the purpose of this clause –
(a) the expression "Foreign Institutional Investor" shall have the meaning assigned to it in clause (a) of the Explanation to Section 115AD
(b) the expression "Investment Fund" shall have the meaning assigned to it in clause (a) of the Explanation 1 to Section 115UB
(c) the expression "securities" shall have the meaning assigned to it in clause (h) of Section 2 of the Securities Contracts (Regulation) Act, 1956

Proposed Clarification

This will require clarification in CBDT Instruction No. 225/ 12/ 2016/ ITA.II dated 2 May 2016. The relevant extract of the proposed clarification is as follows:

F. No. _______

Government of India

Ministry of Finance
Department of Revenue (CBDT)
North Block, New Delhi, dated ____

To,
____

Subject: Partial modification of the instruction no. 225/ 12/ 2016/ ITA.II dated 2nd May 2016 regarding consistency in taxability of income/loss arising from transfer of unlisted shares under Income-tax Act - regarding

1. Regarding characterization of income from transfer of unlisted shares, the Central Board of Direct Taxes, has issued instruction no. 225/ 12/ 2016/ ITA.II dated 2nd May 2016 wherein with a view to avoid litigation, maintain a uniform approach, it was clarified that any income arising from transfer of unlisted shares was to be treated as capital gains irrespective of the period of holding of such assets. However, it was also inter alia clarified that the aforesaid treatment would not apply in the case where transfer of unlisted shares is made along with the control and management of underlying business.
2. The Board has since received representations on the treatment of the securities held by Alternative Investment Funds (AIFs). AIFs typically raise capital from third party investors, make investments and return the capital / profits to the investors. AIFs invest with an objective of achieving long term capital appreciation. AIFs are also regulated by SEBI. Considering the above, to provide clarity on the treatment of gains on transfer of unlisted securities held by AIFs, it is clarified that the conditions in clause 3(iii) of the aforesaid order would not be applicable in the case of AIFs.
3. The above may be brought to the notice of all for necessary compliance.

Xxxxxx
Xxxxxxxxxxxx

Copy to:

1. Xxxxxxx
2. Xxxxxxx

Xxxxxx

B. <u>Proportionate service tax exemption for AIF expenses (management fees, other fees) as they relate to foreign investor contributions in AIFs and Proposed 12% GST Rate for AIFs</u>

i. In India, taxation of services is presently governed by the provisions of Chapter V of the Finance Act, 1994 (service tax legislation). Further, the Goods & Services Tax (GST) legislation is proposed to be implemented in India. Recently, the Model GST Law has been released to the public inviting suggestions and recommendations. GST shall be a tax levied in India on the supply of goods and services. The taxing principle under the present service tax legislation is expected to continue under the proposed GST legislation, i.e. destination based consumption tax.

ii. Under the present service tax legislation, services whose place of supply (determined in terms of the relevant rules) is in India are subject to effective service tax at 15%.

iii. Further, services provided by service providers located in India to service recipients located outside India can qualify as exports and be treated as zero-rated services, subject to the fulfilment of the following prescribed conditions cumulatively:
   a. Service provider is located in India
   b. Service recipient is located outside India
   c. Service should not be an exempted service, as per the service tax legislation
   d. Place of supply of service should be outside India in terms of the relevant rules
   e. Payment for services is received by service provider in convertible foreign exchange
   f. Service provider and recipient should be separate legal entities and not merely different establishments of the same legal entity

iv. A Fund is, in essence, the pooling of the contributions of its investors for the purpose of investment and therefore should not be viewed as distinct entity separate from its investors. However, for the purpose of levy of service tax in India, a Fund is viewed as a distinct person. Accordingly, under the present service tax legislation, services provided by a fund manager (and other service providers) to a Fund located in India are taxable, irrespective of the location of its investors.

v. It is relevant to note that in such a scenario, the taxing principle of service tax, i.e. consumption-based taxation, is not being met in respect of overseas investors. This is on account of the fact that the Fund is considered for determination of the consumption of the services provided by the fund manager, whereas the actual effective consumption of the said services is by the investors and not the Fund.

vi. If the principle of effective consumption were to be followed, the services to the extent of the investments made by the overseas investors would be outside the purview of service tax in India, as the place of supply of the said services is outside India, i.e. the location of the effective service recipient (overseas investors). Further, the said services shall also qualify as exports and be treated as zero rated services as all of the conditions prescribed for the export qualification are being met in essence, for example, the fee for asset management services is provided from the very pool of investments made by the investors which includes contributions made by overseas investors in convertible foreign exchange. Therefore, the condition of receipt of consideration in convertible foreign exchange is, in principle, being met in the present case.

vii. The choice of AIF as a vehicle to raise foreign capital is, inter-alia, impacted by the service tax charge on the fund's expenses.

Recommendation:

A relaxation should be granted to AIFs to the effect that AIF should be considered as pass-through entities and the investors in the AIFs be deemed as service recipients of the services provided by a fund manager/ service provider. Similar benefits are available to fund managers in other large financial centres (for example, Singapore).

With the recent announcement that foreign investment would be permitted in SEBI regulated AIFs, this relaxation would be a critical factor in foreign investors' choice of a domestic fund manager vs. a foreign fund manager.

GST: Due to non-availability of input tax credit of Service tax/ GST on expenses/ procurements made by AIFs; the cost of investing in AIFs would increase

i. In India, the taxation of services is presently governed under the provisions of Chapter V of the Finance Act, 1994 (service tax legislation). Further, the Goods & Services Tax ('GST') legislation is proposed to be implemented in India with effect from 1 April 2017.

ii. With the introduction of GST, the tax base will be widened, as most of the goods and services will be taxable, with minimum exemptions. In the case of AIFs, the most significant expenses on which Service Tax/ GST would be levied is the services received from the fund managers located in India.

iii. Since, AIFs do not have any output indirect tax liability i.e. service tax/ GST, any service tax/ GST paid on procurements will ultimately become a cost to the AIF. An AIF, though a commercial set up, is distinct and unique in its operations i.e. unlike other commercial ventures, an AIF being a pooling vehicle, represents the interest of its investors. Therefore, a tax paid by an AIF affects the investment by the investors, militates against the investment objectives that are sought to be promoted by AIFs. Adverse effects of this nature can reduce the supply of long term capital to AIFs. Importantly, unlike manufacturers or other service providers, who can avail credit, the GST paid by an AIF is likely to be an ultimate cost in its hands. On account of the above reasons, it is recommended that this sector may be taxed at the GST rate of 12%.

iv. From an income-tax standpoint, the investors in AIFs are not allowed a tax deduction for most of the expenses incurred by the AIFs. Accordingly, the cost of investing in AIFs will significantly increase if the GST rate is fixed at a level higher than the present service tax rate of 15%.

v. The GST Council has decided on a four tier GST rate structure that would be 5%, 12%, 18% & 28%. Most of the goods and services would fall in 12% and 18% bracket, with services mostly likely to be taxed at 18%. Considering the important financial intermediation role performed by AIFs in channeling investments into seed capital, early stage and growth companies, services to AIFs should be chargeable at the lower rate of 12 per cent. AIFs play an important role by providing long-term stable capital to engines of growth as shown in this report.

Recommendation:

Fund management and other services to AIFs should be chargeable to GST at the rate of 12%

C. Extension of Tax Pass through to Category III - AIFs

i. The Finance Act 2015 introduced a special tax regime for Category I and II AIFs by the insertion of a new chapter, i.e. Chapter XII-B in the Act. The amendments to the Act conceptually attempt to provide a "pass-through" tax status to Category I and II AIFs for the income earned (except for business income).

ii. However, the "pass-through" tax status has not been accorded to Category III AIFs.

iii. AIFs are vehicles set-up to pool investments from various investors and to invest across different asset classes using different investment strategies. The income that is sought to be taxed is the income of the investors. The taxation of an income, or the taxpayer itself, should not change, merely because an investor decides to use a professional asset manager to make investment decisions for him vis-à-vis directly making those investment decisions. Further, the manner of taxation should also not change, where an investor invests in an AIF, instead of investing in his own name, using a SEBI registered portfolio manager.

iv. The basis of pass-through, or no pass-through, seems to be derived based on the type of investment strategy and the underlying activity of the AIF. If at all, although it is debatable, the investment strategy should be used to decide on the nature of income but not the pass-through status.

v. In any case, it is clear that irrespective of the investment strategy, the policy of the Government is to have one-level tax in terms of the income arising from / to the AIF – i.e., either the AIF will be taxed or the investor, but not both (on the basis that the AIF is a pass-through, usually in the form of a trust).

vi. The class of investors who make investments in AIFs is generally one of high net worth and taxpaying investors, so the question of tracking those investors should not generally arise. In any case, given the safety net in the withholding tax imposed on distributions by the AIF to the investors, the tracking should ordinarily not be a challenge.

vii. Category III AIFs introduced an investment product that was hitherto not available in the Indian financial sector. A clear tax code for taxation of such AIFs based on the pass-through tax principle will be critical for the success of this investment product in the medium to long-term.

Recommendation:

(a) The tax rules applicable to "investment funds" in Chapter XII-B of the Act should be extended to Category III AIFs with suitable modifications to eliminate the distinction between the tax treatment of business income and income under other heads in the hands of the AIF / its investors.

(b) As such, given that under the pass-through tax principle, the incidence of taxation of income derived by the AIF would, be passed to the investor with the same character as applicable to the AIF, there should be no revenue loss to the Government on account of this recommendation.

Proposed Amendment

Section 115UB

Explanation 1 — For the purposes of this Chapter:

(a) "investment fund" means any fund established or incorporated in India which has been granted a certificate of registration as a Category I or a Category II or a Category III Alternative Investment Fund and is regulated under the Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012….

D. Making the fund management safe harbour provisions effective

1. Offshore funds invest billions of dollars into Indian listed as well as unlisted companies. In order to avoid the risk of being characterized as a permanent establishment, most offshore funds are managed outside of India with the talent to manage such pools also sitting outside India. While the investment is being made in India, the fees for managing such investments would be paid to investment management entities outside India. Section 9A of the Act was introduced into the Act with an objective to encourage onshore management of offshore funds leading to increased employment and increased income being generated in India.

2. Further the portfolio companies into which the investments are made generate employment and contribute to the tax exchequer by paying taxes on the income earned by them.

3. While the benefits that can be reaped by enabling a liberal tax regime are huge, the strict investor concentration and safe harbor conditions have so far acted as a dampener and has not led to any interest from offshore funds in setting up onshore fund management activities in India.

4. It is therefore imperative to assess whether practically these conditions can be met by offshore funds and whether they are required if India were to develop international class financial centres like Singapore, Hong Kong, London.

Withdrawal of exemption under the India-Mauritius DTAA

5. The test of commercial substance of pooling, concentration etc. assumed a higher importance under an era where entities were routing their investments through low tax jurisdictions such as Mauritius, Cyprus etc. However, with the amendment to the India Mauritius Double Taxation Avoidance Agreement vide the protocol and impending re-negotiation of treaty with countries such as Mauritius, the tax arbitrage which was sought to be achieved by merely setting up investment holding vehicle in Mauritius / Cyprus would not be possible. Every investor irrespective of their composition is now required to pay taxes under the Act.

6. The conditions imposed under section 9A read with the Rule 10V are not in line with the commercial imperatives of the offshore funds and the relaxation of the conditions would pave the path for onshore management of offshore funds.

7. It should be the endeavour of the Government to frame rules which are easier to

be met by the Funds and have less ambiguity. Therefore, the stringent conditions prescribed under section 9A for availing the beneficial treatment along with the recommendations have been stated as under:

a) Clause e, f and g of sub-section 3 of section 9A

1. *Clause e - "the fund has a minimum of twenty-five members who are, directly or indirectly, not connected persons"*

   Clause f- "any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding ten per cent"

   Clause g - "the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than fifty per cent"

2. In connection with the aforesaid clauses, the guidelines on application of section 9A of the Act i.e. Rule 10V of the Income-tax Rules 1962, provides that where investments in an Eligible Investment Fund (EIF) has been made directly by an institutional entity, the number of members and the participation interest in the EIF shall be determined by looking through the said entity provided that the institutional entity –
   i. independently satisfies the conditions mentioned in clauses (c), (e), (f) and (g) of sub-section 3 of section 9A;
   ii. has been setup solely for the purpose of pooling funds and investment thereof; and
   iii. is resident of a country or specified territory with which an agreement referred to in sub-section (1) of section 90 or sub-section (1) of section 90A has been entered into.

3. While the guidelines are helpful, the look through provision is restrictively worded since it suggests that only one level look through is permitted. In most VCPE funds, there may be few layers of pooling vehicles above the fund vehicle and further the fund itself may make investments using special purpose vehicles for various commercial considerations.

4. Further, there are many instances where the fund managers wish to manage a small set of investors who could provide them with relatively large pools of capital to manage. The following are illustrative situations of providing good cases for management of offshore funds in India, but where the diversification of investor base may not be relevant:
   - Management of a large global family office.
   - Management of a part of the funds allocated by a large investor (e.g. sovereign wealth fund or a pension fund) to be managed by a domestic fund manager.
   - Global proprietary funds of development and other financial institutions (like

banks and insurance companies) being managed by domestic asset managers in India.

- New fund managers who wish to raise a new Fund may be able to achieve diversification only after they have established a reasonable track record.
- All new funds could have anchor investors who would clearly hold more than 5% of the total holding. These anchor investors are critical for the success of the fund raising exercise
- The diversification of fund investors may be achieved over multiple fund closings but the asset management has to start immediately from first closing of the fund

5. Further, we believe the management of funds in India should not lead to a differential tax treatment for investors merely because some of those funds managed are diversified, and some are not.

6. There are many domestic asset managers who wish to manage global pools of capital but who may not be able to meet diversification related conditions given the regulatory restrictions in marketing and distribution of the financial products in various jurisdictions.

7. The Securities and Exchange Board of India, after a lot of industry deliberations, has prescribed categories and types of funds that can invest in India and conditions attached to the same. The existing regulatory framework to allow foreign investments either under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 (SEBI FPI Regulations) or Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000 (SEBI FVCI Regulations) is comprehensive and there are detailed monitoring mechanisms to track the quality of investors and the sectors in which the investment flows. Further, as per the SEBI FPI Regulations, a fund is considered as 'broad based' if it is established or incorporated outside India and has at least twenty investors with no investor holding more than 49% of the shares or units. Further, it also provides that if a broad based fund has an institutional investor who holds more than 49% of the shares or units in the fund, then such institutional investor must itself be a broad based fund.

8. Hence, in order to simplify the compliance with the aforesaid conditions, an automatic exemption could be provided from investor diversification norms to funds that meet the criteria to be registered as Category I or Category II FPIs or FVCIs.

Recommendation:

Given the constraints discussed above, it is appropriate to dilute the investor diversification related conditions.

Additionally, in the guidelines for the purpose of section 9A of the Act, it should be expressly clarified that:

i. Conditions should not be applicable to the entities that meet the criteria to be registered as a Category I or a Category II FPIs in accordance with the SEBI FPI Regulations or FVCIs in accordance with the SEBI FVCI Regulations.
ii. The term 'member' be interpreted in a manner to include investors and beneficiaries.

Further, exclusions/ changes could be provided for applying the diversification related conditions. An illustrative list of exclusions/ changes is provided below:

- The diversification conditions should be applied only after the fund makes a final closing, or alternatively these should not be applied for the initial three years of setting-up.
- One should consider direct and indirect investors – there could be more investments from investors like fund of funds or institutional investors having several beneficiaries/ members.
- Diversification rules should not be applicable where a majority of the investors comprise of institutional investors like sovereign wealth funds, large pension funds, banks, insurance companies etc.
- There should be exclusion for anchor investors – these could mean initial two or three investors in the fund.
- Lastly, the diversification rules used by SEBI for FPIs are robust and well understood by the industry in terms of implementation. Our recommendation is to merely align the requirements of diversification under the Act and the FPI Regulations

Proposed Amendments in section 9A:

(e) The fund has a minimum of ~~twenty five~~ ten members who are, directly or indirectly, not connected persons

Following proviso to Section 9A(3)(e) should be inserted-

Provided that the conditions specified in clauses (a) to (m) shall not apply to:

i) entities registered as FPIs or FVCI under the applicable SEBI regulations;
ii) where a majority of the investors comprise of institutional investors like sovereign wealth funds, large pension funds, banks, anchor investors, insurance companies, etc.
iii) A fund in the initial three years of setting-up or date of final closing for receiving investor monies whichever is earlier

(f) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding ~~ten~~ forty-nine percent

Provided that if the fund has an institutional investor who holds more than forty nine percent participation interest, then this condition shall be deemed to be satisfied if such institutional investor itself satisfies the condition in clause (e) of sub-section (3) of Section 9A.

(g) ~~the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than 50 per cent;~~

Insert clause (n)

(n) the fund is a broad based fund

(9) For the purposes of this section,—

(f) "Broad Based Fund" shall mean a fund, established or incorporated outside India, which has at least twenty investors, with no investor holding more than forty-nine per cent of the shares or units of the fund.

Provided that if the broad based fund has an institutional investor who holds more than forty nine per cent of the shares or units in the fund, then such institutional investor must itself be a broad based fund.

b) Clause k of sub-section 3 of section 9A

1. *"The fund shall not carry on or control and manage, directly or indirectly, any business in India."*

2. In the guidelines notified for application of section 9A, it has been stated that a fund shall be said to be controlling or managing a business carried out by any entity, if the fund directly or indirectly holds more than 26% of the share capital or voting rights or interest in the entity.

3. VCPE funds may occasionally or as their core strategy take minority, significant minority or majority equity stakes in investee companies. Several funds adopt a combination of strategies. Even funds that do not take significant shareholding in investee companies could have minority shareholder protection rights exercise of which could give some degree of control over the investee company to the fund.

4. At times, VCPE funds (especially buyout funds) acquire a controlling stake in the investee companies without any intention of actively controlling or managing its business. Also, in a scenario, where foreign investors hold 20% to 25% of the shareholding in an Indian entity and have also invested by way of compulsory convertible instruments, pursuant to the conversion of these instruments, these investors will end up holding more than 26% of the shareholding in the said entity

without any change by it in the control or management of business in India or from India.

5. Further, in certain sectors, financial investors need to have control to protect their substantial investment (e.g. stressed asset funds, infrastructure funds, etc). Whatever maybe the investment strategy, the fund remains a financial investor that makes the investment for an eventual sale to a financial or strategic investor.

6. The intention of restricting section 9A to only diversified funds and not to strategic foreign investors or Indian companies indirectly is achieved through the diversification of shareholding requirements in clauses (e), (f), (g) and indirect Indian shareholding restriction in clause (c).

7. The threshold of 26% voting rights in an investee company to determine whether the fund controls or manages a business carried out in India, will be a hurdle for several VCPE funds that hold significant shareholding in investee companies. VCPE funds being one of the major intended beneficiaries of the safe harbour would be precluded from registering under section 9A of the Act where the above condition is not modified.

Recommendation:

In order to promote the safe harbour for VCPE funds, it is recommended to delete clause k of sub-section 3 to section 9A of the Act and sub-Rule 4 of Rule 10V, as a qualification condition to avail section 9A.

c) Clause c of sub-section 3 of section 9A

1. *"The aggregate participation or investment in the fund, directly or indirectly, by persons resident in India does not exceed five percent of the corpus of the fund."*

2. In the guidelines notified for application of section 9A, it has been stated that where the direct investor in the fund is the Government/Central Bank/Sovereign Fund/multilateral agency/appropriately regulated investor (in the form of pension fund/university fund/bank/collective investment vehicles like mutual funds), the fund is required to obtain a written declaration from the direct investor regarding participation by resident Indians and accordingly, determine the indirect participation by such resident Indians in the fund.

3. In case of all other direct investors (who are not natural persons), the fund is required to undertake appropriate due diligence to ascertain indirect participation by resident Indians in such a fund.

4. VCPE Funds typically would not enquire into an investor's country of residence from a tax standpoint and therefore, an enquiry into each investor's tax residence may

not be feasible for the funds to undertake. While the guidelines do provide useful direction on this, practically, at a global level, it would be challenging for the funds to obtain the declarations stating therein the participation by various Indian residents.

5. Further, in case of a multi-tiered structure (say in case of Fund-of-Funds) or institutional investors, it would be difficult and a cumbersome process for the fund to undertake appropriate due diligence to ascertain the indirect participation by Indian residents.

6. Given the above, the said clause would pose practical challenges for the funds to comply with and therefore, would prove a deterrent in promoting onshore fund management for offshore VCPE funds.

Recommendation:

In order to promote safe harbour for VCPE Funds, the condition in clause (c) should be limited to only direct participation by resident Indians.

Proposed Amendment in clause (c) to section 9A(3):

(c) The aggregate participation or investment in the fund, directly ~~or indirectly~~, by persons resident in India does not exceed five percent of the corpus of the fund.

d) Exclusions for Investment Managers of an AIF

1. The definition of specified regulations in section 9A of the Act only includes 'Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993 and Securities and Exchange Board of India (Investment Advisers) Regulations, 2013. The definition of specified regulations does not include Investment Manager of an AIF registered under the SEBI (AIF) Regulations.

2. Given the Governments objective of promoting fund management activity from India and also attract additional foreign investment under the AIF route, it is important to include Investment Managers of AIFs which are registered under the SEBI (AIF) Regulations, as fund managers for the purpose of section 9A(4) of the Act.

3. In this context, it should also be noted that SEBI has undertaken initiatives to enable Asset Management Companies [covered by SEBI (Mutual Funds Regulations)] to manage offshore funds for investing in India. Hence, in line with the SEBI's initiative, it is also important to include Asset Management Companies of mutual funds (who can naturally engage in carrying out fund management activity) as fund managers for the purpose of section 9A(4) of the Act.

Recommendation:

CBDT should notify managers referred in SEBI (AIF) Regulations, 2012 and SEBI (Mutual Funds) Regulations, 1996, for the purposes of specified regulations in section 9A(8)(e) of the Act.

IV. Other Recommendations

Clarification on investments by AIF

a) Pass through tax status to be extended to net losses incurred at AIF level i.e. Losses incurred by AIFs should be available for set-off to its investors

1. Conceptually, pooling vehicles are formed to derive two advantages; (a) to engage experienced professionals for investment management; and (b) to achieve economies of scale. Thus, investors who invest in AIFs could have chosen to directly invest in portfolio companies of their own accord.

2. Tax implications thus play an important role for the investor to choose one form over the other i.e. pooling vehicles or direct investing. The above-mentioned advantages will be lost if the tax impact on investing through AIFs is higher.

3. Under the AIF Regulations, Category I and II AIFs are close-ended funds and the tenure of a specific fund / scheme is determined at the time of its launch. Typically, an AIF's tenure would not exceed 10 years from its launch. Based on the provisions, where Category I and II AIF incur net losses on investments towards the end of its life or has unabsorbed losses, which cannot be utilised by the AIF, such losses would lapse. The investors would in this scenario be taxed on an amount that would be greater than the "real" taxable income derived by them from their investment in the AIF, causing the AIF alternative becoming unattractive to an investor vis-a-vis direct investments.

4. In line with the pass through for losses provided to investors in securitization trusts, the pass through of losses should also be extended to investors in AIF (which is also a pooling vehicle similar to securitization trust). In order to avoid any misuse, it could be provided that in case of transfer (excluding transactions which are not regarded as transfer under section 47 of the Act) of units by the investors in the AIF, the net loss proportionate to the units transferred shall not be passed on to the new investors.

Recommendation:

A pass through tax regime should not distinguish between gains and losses. Therefore, similar to the pass through for net income, net losses incurred by all the categories of AIFs, under any head of income, should also be allowed to be passed on to the investors.

Proposed Amendment:

Section 115UB

(2) Where in any previous year, a person, being a unit holder of an investment fund, transfers the units to another person (excluding transfers referred to in section 47) and the net result of computation of total income of the investment fund [without giving effect to the provisions of clause (23FBA) of Section 10] is a loss under any head of income and such loss cannot be or is not wholly set-off against income under any other head of income of the said previous year, then—

(i) ~~such loss shall be allowed to be carried forward and it shall be set-off by the investment fund in accordance with the provisions of Chapter VI; and~~

~~(ii)~~ such loss shall be ignored for the purposes of sub-section (1) in respect of transferor/transferee of such units.

b) Exemption for AIFs from (a) Section 56(2)(viib) on issue of shares at a value higher than fair market value and (b) Section 56(2)(viia) on purchase of shares at a value lower than fair market value (FMV)

1. Section 56(2)(viia) of the Act provides that where shares are purchased at a value lower than the FMV of a company, not being a company in which public are substantially interested, then the difference between the transaction value and the FMV is taxed in the hands of the purchaser. Further, section 56(2)(viib) of the Act provides that where a company, not being a company in which public are substantially interested, issues shares at a consideration which exceeds the FMV of such company, then the difference is taxed as income in the hands of the issuing company.

2. Presently, section 56(2)(viib) of the Act provides a specific exemption for companies where the consideration for issue of shares is received from inter-alia Venture Capital Funds (VCFs) and VCF under Category I-AIF. Further, while such an exclusion has been provided to VCFs, the benefit has not been extended to section 56(2)(viia) of the Act. In other words, these provisions apply to all AIFs (except VCF's under Category I) when they purchase shares of a closely held company, or to the investee companies where they issue shares to AIFs at a price higher than its fair market value.

3. AIFs, being institutional investors, have a fiduciary responsibility to invest in transactions on an arm's length basis, and given that they are subject to the supervision of SEBI and have investor reporting obligations, it is reasonable to assume that the price for acquisition / subscription is determined on a reasonable

basis, considering all factors associated with the investee companies' and sector's past performance and future potential. Thus, the transaction entered into by AIFs can be assumed to be in compliance with FMV principles and hence the rigour of section 56(2)(viia) & 56(2)(viib) should not be applicable to AIFs.

Recommendation:

All AIFs and their investee companies should be exempted from the rigor of Sections 56(2)(viia) and 56(2)(viib) of the Act.

Proposed Amendment in section 56(2)(viia)

After first proviso to section 56(2)(viia) add the following proviso -

Further provided that this clause shall not apply to any such property received by an investment fund

Amend Explanation to section 56(2)(viia) as under –

For the purpose of this clause -

(a) "fair market value" of a property, being shares of a company not being a company in which the public are substantially interested, shall have the meaning assigned to it in the Explanation to clause (vii).

(b) "Investment Fund" shall have the meaning assigned to it in clause (a) of the Explanation 1 to Section 115UB.

Proposed notification exempting Investment Funds from section 56(2)(vii)(b)

In exercise of the powers conferred by the clause (ii) of the proviso to clause (viib) of sub-section (2) of section 56 of the Income-tax Act, 1961 (43 of 1961), the Central Government, hereby notifies the 'classes of persons' for the purposes of the said clause as being the 'Investment Fund' who makes any consideration exceeding the face value for issues of shares of a company.

Explanation. – For the purposes of this notification, "Investment Fund" shall have the meaning assigned to it in clause (a) of the Explanation 1 to section 115UB.

c) Remove tax compliance of filing annual return for foreign investors in AIF

1. In November 2015, the Reserve Bank of India had issued a notification allowing foreign investments in AIFs under the automatic route i.e. without any Government approval. The move to allow foreign investment in AIFs under the automatic route was made with an objective to attract more foreign investment through AIFs.

2. In addition the Finance Act, 2016, was amended to provide that in case of non-resident investors in Category I and II AIFs, the tax withholding will be at the rates in force i.e. at tax rates as per the provisions of the Act or the applicable Double Tax Avoidance Agreements (DTAA), whichever is more beneficial to the investor and not at the rate of 10%. As a result of this amendment, in case of a non-resident investor in an AIF, the entire tax liability of such investor will be deducted at source by the AIF on accrual/ distribution and, there should be no additional tax payable by such investor in India on account of its investment in the AIF.

3. Despite the fact that the entire tax liability of non-resident investors in the AIF will be deducted at source by the AIF, such investors are still required to obtain a Permanent Account Number (PAN) and file a return of income in India. This additional compliance will discourage several non-resident investors from making direct investments in India and thereby, diluting the effectiveness of the aforesaid policy initiative.

4. The CBDT recently has released a Notification, which prescribes Rule 37BC of the Income-tax Rules 1962 for relaxation from withholding of tax at higher rates in the absence of PAN of non-resident deductees and lays down the information and alternative documents required to claim such relaxation.

5. In order to encourage the growth of AIFs as an asset class and to attract more foreign investment directly through the AIF route, it is recommended that where a foreign investor's only source of income in India is from investment in an AIF, and, the entire tax liability of such investors is deducted at source by the AIF on accrual/ distribution, then, the requirement to file a return of income should be eliminated.

6. The aforesaid relaxation is similar to the relaxation provided in section 115A of the Act to non-resident investors earning certain prescribed income on which tax deductible at source has been deducted (such as interest on ECBs on which tax is deducted at source in accordance with the provisions of section 194LC of the Act).

7. The aforesaid relaxation does not cause any tax revenue loss as tax would be withheld as appropriate and it would significantly add to 'ease of investing' in India.

Recommendation

Insert sub-section (8) on section 115UB of the Act relaxing the requirement of filing the return of income by non-resident unit holders of an AIF.

Proposed Amendment

115UB. (8) It shall not be necessary for an assessee referred to in sub-section (1) to furnish under sub-section (1) of section 139 a return of his or its income if –

a) The assessee is a non-resident (not being a company) or a foreign company;
b) his or its total income in respect of which he or it is assessable under this Act during the previous year consisted only of income referred to in sub-section (1); and
c) The tax deductible at source under the provisions of Chapter XVII-B has been deducted from such income.

d) Allow management expenses for AIF investments to be capitalized as 'cost of improvement

1. A formal reading of the Act only allows costs related to the acquisition of securities to be treated as capitalized expenses as they relate to the actual acquisition of the title to the security. Costs in relation to the disposal of the capital asset are allowed to be deducted as 'cost of transfer' from the sale consideration.

2. AIFs/investors spend a significant amount of time working closely with unlisted businesses to manage and improve the investment. Currently, there is no provision for capitalizing expenses related to the management and improvement of the capital asset during the holding period of the security.

3. This means in effect that AIFs/investors have to write off the management fees as expenses, which means that they are not available to be offset against capital gains that may eventually result from the investment. In case of foreign LPs, these costs are allowed to be capitalized overseas (US model) and thus, this issue is particularly relevant to domestic LPs and domestic GPs.

4. The issue is further exacerbated by the fact that management expenses (typically in the range of 2% of managed funds) are also subject to service tax. Assuming a 10 year hold period for an AIF investment, 2% management fees annually, and mark-ups on management fees of 20% and 14% for transfer pricing and service tax – the amount to be capitalized is considerable (10 yrs x 2 % x 1.20 x 1.14) = 27% of initial cost of investment. This cost currently has to be written off and cannot be offset against the capital gains that it produces.

Recommendation:

(a) Option 1: Allow expenditure which is capital in nature, made towards improvement of the capital asset, to be capitalised as "cost of improvement".

(b) Option 2: Allow a standard deduction of 3% of cost of acquisition of capital asset irrespective of the actual expenditure incurred.

Proposed Amendment:

(a) Option 1: Where expenditure is capital in nature, made towards improvement of the capital asset , such expenditure should be capitalized as "cost of improvement"

Modify section 55 (1)(b)(1)(ii) of the Act to read as under:
"in any other case, means all expenditure of a capital nature incurred in making any additions or alterations *'or improvement'* to the capital asset by the assessee after it became his property, and, where the capital asset became the property of the assessee by any of the modes specified in sub- section (1) of] section 49, by the previous owner, but does not include any expenditure which is deductible in computing the income chargeable under the head…."

Notification required
"Improvement expenditure" for a capital asset would include expenditure of a capital
nature in relation to:

- *Management Advisory*
- *Legal and Professional*
- *Administrative expense directly identifiable to capital asset.*

(b) Option 2: Allow a Standard deduction of 3% of cost of acquisition of capital asset irrespective of the actual expenditure incurred

Section 48: Mode of computation.
8. The income chargeable under the head "Capital gains" shall be computed, by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset the following amounts, namely :—
(i) expenditure incurred wholly and exclusively in connection with such transfer;
(ii) the cost of acquisition of the asset and the cost of any improvement thereto:
(iii) a sum equal to three per cent of the cost of acquisition of the asset where asset is in the nature of securities of an unlisted company or units in a mutual fund/investment fund

V. Unit-based Taxation for Listed AIFs

1. SEBI (AIF) Regulations allow the listing of the units of close ended AIFs on a stock exchange i.e. all AIFs, except an open ended-Category III AIF, can be listed on a stock exchange. While the present AIF Regulations enable listing of AIFs subject to conditions, the taxation policy for AIFs is not conducive to a listed AIF.

2. In case the units of the AIFs are listed on the stock exchange, the investors may keep changing from time to time during any financial year. It may happen that the set of investors at the time of investment by the AIF may be different from those at the time of earning of the income by the AIF, which, in turn, may differ from those when the AIF distributes such income to the investors.

3. From a tax perspective, the following is important:

   a. Category I and II AIFs are provided a 'pass-through' tax status for the income earned (except for business income and losses). Such AIFs are also required to deduct tax at the rate of 10 per cent (in case of resident investors) and at rates in force (in case of non-resident investors) on any income paid or credited to the investors.

   b. Category III AIFs (primarily include hedge funds or funds which trade with a view to make long term / short term returns) are not provided a specific 'pass-through' tax status and hence are governed by the complex trust taxation provisions under the Act, as per which taxation depends upon whether such AIF is set up as a determinate trust (in which case 'pass-though' taxation is available) or an indeterminate trust (in which case tax is payable at the trust level at the Maximum Marginal Rate).

4. As a result, the current tax policy for AIFs in the context of a listed AIF may create significant anomalies. For example, it could happen that the AIF has deducted tax at source for a set of investors on certain income which it has not distributed and such income is distributed at a later stage when the investors in the AIF has changed. This leads to significant complexity on taxation of listed AIFs and its investors under current tax law.

5. Substantial capital can potentially be raised from domestic investors into listed AIFs which has made a portfolio of illiquid investments in order to provide much needed liquidity for investors which have a preference for liquidity. Historically, the contribution of SEBI registered AIFs in the total investments made by VCPE funds in India, has been insignificant. By allowing foreign investment (including investments by NRIs) in AIFs under the automatic route coupled with the exemption from sectoral caps and conditions for downstream investments by India-sponsored and managed AIFs, a significant shift in the quantum of foreign investments through AIFs is expected. Specifically, the entire pool of ~INR 70,000 crores assets under management under the Portfolio Management Service (PMS) route can switch to the investment under the AIF route.

Recommendation:

Define separate taxation rules for listed AIFs. Ideally, a listed AIF would need to have tax provisions that provide for a unit based taxation system where the fund itself is exempt from tax on its income and the taxation is a combination of distribution tax on income distributions and capital gains tax on unit redemptions/ transfers. Specifically, the taxation of listed AIFs could be made similar to listed mutual funds.

Proposed Amendments:

Amendment 1: Income of the listed AIFs to be exempt from tax

Insert new section 10(23DB)

10(23DB) subject to the provisions of Chapter XII-FB, any income of an investment fund listed on a recognized stock exchange.

Explanation – For the purposes of this clause, -

(a) “investment fund” shall have the meaning assigned to it in clause (a) of Explanation 1 to section 115UB.

(b) “recognised stock exchange” shall have the meaning assigned to it in clause (ii) of Explanation 1 to clause (d) of sub-section (5) of section 43.

Amendment 2: Income of investors in listed AIFs to be exempt from tax

Insert new section 10(23DC)

10(23DC) any distributed income, referred to in section 115UBA, received by a unit holder from the investment fund listed on a recognized stock exchange

Explanation – For the purposes of this clause, -

(a) “investment fund” shall have the meaning assigned to it in clause (a) of the Explanation 1 to section 115UB.

(b) “recognised stock exchange” shall have the meaning assigned to it in clause (ii) of the Explanation 1 to clause (d) of sub-section (5) of section 43.

Amendment 3: Tax on income distributed by listed AIFs

Insert new section 115UBA

Tax on distributed income to unit holders.
115UBA.

(1) Notwithstanding anything contained in any other provision of this Act, any amount of income distributed by the investment fund listed on a recognized stock exchange to its unit holders shall be chargeable to tax and such investment fund shall be liable to pay additional income-tax on such distributed income at the rate of thirty per cent.
Provided that nothing contained in this sub-section shall apply in respect of any income distributed to a unit holder of an equity oriented investment fund in respect of any distribution made from such fund.

Explanation – For the purpose of this sub-section,-

1. "equity oriented investment fund" means a fund where the investible funds are invested by way of equity shares or equity linked instruments to the extent of more than sixty five percent of the corpus of the investment fund.
2. "corpus" and "equity linked instruments" shall have the meaning assigned to it in clause (h) and clause (j) of Regulation 2 of the Securities and Exchange Board of India (Alternative Investment Fund) Regulation, 2012, made under the Securities and Exchange Board of India Act, 1992 (15 of 1992).

(2) The person responsible for making payment of the income distributed by the investment fund, as the case may be, shall be liable to pay tax to the credit of the Central Government within fourteen days from the date of distribution or payment of such income, whichever is earlier.

(3) The tax on distributed income so paid by the investment fund shall be treated as the final payment of tax in respect of the amount distributed or paid and no further credit therefor shall be claimed by the investment fund or by any other person in respect of the amount of tax so paid.

(4) No deduction under any other provision of this Act shall be allowed to the investment fund or the unit-holders in respect of the amount which has been charged to tax under sub-section (1) or the tax thereon.

(5) Where the person responsible for making payment of the income distributed by the investment fund, fails to pay the whole or any part of the tax referred to in sub-section (1), within the time allowed under sub-section (2) of that section, he or it shall be liable to pay simple interest at the rate of one per cent every month or part thereof on the amount of such tax for the period beginning on the date immediately after the last date on which such tax was payable and ending with the date on which the tax is actually paid.

(6) If any person responsible for making payment of the income distributed by the investment fund, does not pay tax, as is referred to in sub-section (1), then, he or it shall be deemed to be an assessee in default in respect of the amount of tax payable by him or it and all the provisions of this Act for the collection and recovery of income-tax shall apply.

Amendment 4: Amendments to section 2(42A), section 10(38) and section 111A of the Act

Section 2(42A) “short term capital asset” means a capital asset held by an assessee for not more than thirty-six months immediately preceding the date of transfer:

Provided that in the case of 23[a security (other than a unit) listed in a recognized stock exchange in India] or a unit of the Unit Trust of India established under the Unit Trust of India Act, 1963 (52 of 1963) or 24[a unit of an equity oriented fund] or a zero coupon bond or units of an investment fund listed on a recognized stock exchange, the provisions of this clause shall have effect as if for the words "thirty-six months", the words "twelve months" had been substituted.

Section 10(38) – any income arising from the transfer of a long-term capital asset, being an equity share in a company or a unit of an equity oriented fund [or a unit of a business trust] or a unit of an investment fund listed on a recognized stock exchange where-

Section 111A – Where the total income of an assessee includes any income chargeable under the head “Capital gains”, arising from the transfer of a short-term capital asset, being an equity share in a company or a unit of an equity oriented fund or a unit of a business trust or a unit of an investment fund listed on a recognized stock exchange, and-

Appropriate amendments should be made in Chapter VII of the Finance (No. 2) Act, 2004 to introduce STT rates on transactions executed on the stock exchange.

Amendment 5: Amendment to MAT provisions

Amend Explanation 2 to section 115JB of the Act

Explanation 2 – For the purpose of clause (a) of Explanation 1, the amount of income-tax shall include-

(i) any tax on distributed profits under section 115-O or on distributed income under section 115R or on distributed income under section 115UBA

VI. No taxability on conversion of preference shares and inclusion of the period of holding of convertible preference shares (pre-conversion) in the period of holding of equity shares received on conversion

1. VCPE Funds prefer to use convertible preference shares/ debentures over equity shares, since these instruments provide the investor the flexibility to link the formulae for conversion into equity shares with the performance of the company on a pre-defined date in the future. In such cases, the conversion typically happens 12 to 18 months prior to the "offer for sale" or an "Initial Public Offer" event. Other commercial factors also drive such investors to initially structure their investment in the form of a convertible instrument.

2. Typically, the total holding period of the investment is in the range of 3 to 5 years, i.e. the investments are long term in nature.

3. A question that arises in these situations is whether the act of conversion of preference shares into equity shares would be regarded as a "transfer" under section 2(47) of the Act, and thus be liable for capital gains taxation in the hands of the shareholders, or whether the capital gains would arise only when the shares, after conversion, are sold or otherwise transferred.

4. Circular [dated 12 May 1964 (F. No. 12/1/64-IT (AI)] provides that where one type of share is converted into another type of share, there is, in fact, no 'transfer' of a capital asset within the meaning of Section 2(47) of the Income-tax Act, 1961. However, when such newly converted share is actually transferred at a later date, the cost of acquisition of such share for the purposes of computing the capital gains shall be calculated with reference to the cost of acquisition of the original share of stock from which it is derived.

5. While the aforesaid circular is helpful and there are judicial precedents which support the above, since this position is not expressly clarified in the law there are conflicting judicial precedents and hence could lead to litigation.

Recommendation:

In order to provide certainty and mitigate litigation risk, it is recommended to expressly provide that conversion of preference shares into equity shares shall not be regarded as a transfer and hence exempt from tax. This is consistent with the exemption from tax provided to bonds or debenture, debenture-stock, or deposit certificates in any form, of a company which are converted into shares or debentures of that company.

Proposed Amendment:

This will require amendment to following section:

47(x) - any transfer by way of conversion of preference shares, bonds or debentures, debenture-stock or deposit certificates in any form, of a company into shares or debentures of that company

6. Consequently, for the purpose of determining the period of holding of equity shares received on conversion of convertible preference shares, it should be clarified that the period of holding convertible preference shares should also be considered, thereby aligning the treatment of such equity shares with equity shares received on conversion of convertible debentures (as provided in Rule 8AA).

Proposed Amendment:

This will require the following amendment in Rule 8AA:

8AA. (*1) The period for which any capital asset, other than the capital assets mentioned in clause* (i) *of the* Explanation 1 *to clause* (42A) *of section 2 of the Act, is held by an assessee, shall be determined in accordance with the provisions of this rule.*

(2) In the case of a capital asset, being a share or debenture of a company, which becomes the property of the assessee in the circumstances mentioned in clause (x) *of section 47 of the Act, there shall be included the period for which the preference shares, bond, debenture, debenture-stock or deposit certificate, as the case may be, was held by the assessee prior to the conversion*.

OR

Proposed clarification:

This will require clarification in the CBDT circular dated 12 May 1964. The relevant extract of the aforesaid circular along with the proposed clarification is as follows:

Relevant Extract of the Circular

F. No. 12/1/64 – IT (AI)
GOVERNMENT OF INDIA
MINISTRY OF FINANCE
(DEPARTMENT OF REVENUE AND COMPANY LAW)
NEW DELHI, the 12th MAY, 1964.
. . .

From Shri G. R. Desai,
Deputy Secretary to Govt. of India

To All Commissioners of Income Tax

Sir,

Sub:- Conversion of one kind of shares of the Company into another kind – Capital gains and bonus tax – Finance Act, 1964

Attention is invited to Section12 of the Finance Act, 1964, which introduces new sub-section (2) in section 45 of the Income-tax Act, 1961, so as to provide for the charging of tax on capital gains on allotment of shares by a company by way of bonus. Section 14 of the Finance Act, 1964 introduces a new sub-clause (v) in sub-section (2) of section 55 of the Income-tax Act, 1961, laying down the method for determining the cost of acquisition of a new share which becomes the property of the assessee on conversion of one type of share into another type of share. A question has been raised whether the transaction of conversion of one type of share into another attracts the capital gains tax under section 45(1) or the bonus tax of 12.5% or the capital gains tax on the issue of bonus shares under section 45(2). The position in this regard is as follows:

(i) Where one type of share is converted into another type of share (including conversion of debentures into equity shares), there is, in fact, no 'transfer' of a capital asset within the meaning of Section 2(47) of the Income-tax Act, 1961. Hence, any profits derived from such conversion are not liable to capital gains tax under Section 45(1) of the Income-tax Act. However, when such newly converted share is actually transferred at a later date, the cost of acquisition of such share for the purposes of computing the capital gains shall be calculated with reference to the cost of acquisition of the original share of stock from which it is derived.

In determining the holding period of the newly converted share at the time of transfer, the period for which the share was held before the conversion, should also be included

VII. Ease in obtaining certificates under section 197 of the Act in a time bound manner especially for treaty exempt investors with suitable administrative guidance on availability of tax treaty relief

1. Section 197 of the Act contains the provisions relating to issuance of certificate for lower / non-deduction of tax at source. Given the fact that the certificate under section 197 of the Act is important from a cash flow perspective, the CBDT has issued instructions to field officers for disposing the application within 30 days of the filing of the application.

2. In practice, it is observed that in many instances the certificate is not issued in a timely manner. Even in cases where the certificate is issued, it is delayed and comes into force only from the latter half of the financial year. Further, if the application is made by an assessee having taxable income and paying advance tax, the application is invariably rejected.

3. From a VCPE perspective, such delays and uncertainty around the outcome of the applications have a significant impact on transaction timelines. For example, in a transaction where shares of an Indian Company are being acquired from a Mauritius resident seller (holding a valid Tax Residency Certificate and hence eligible for capital gains exemption under the India Mauritius Tax Treaty), typically, transactions have to be closed in 60-75 days once due diligence is completed. Any delay in the closure of a transaction can have a huge impact on the valuation and hence the gain or loss implications in the hands of the buyer/ seller. In such situations when there is a delay in the issue of a certificate under section 197 of the Act, there is a direct impact on viability of the transaction and could also result in the buyer deducting tax at a higher rate when the seller is eligible for a lower tax rate.

4. As a result of above, the investor suffers undue hardship and from a foreign investor perspective it also impacts the perception of ease of doing business in India.

5. Accordingly, it is important that there is strict adherence to the timelines so as to ensure speedy disposal of the applications.
6. Further, the tax authorities should take into consideration the treaty benefits available to an investor while issuing the lower/ non-deduction of tax at source certificates.

Recommendation:

An application for a certificate under section 197 should be disposed-off within 30 days from the date of application. If the certificate is issued during a financial year, it should cover transactions which have not already suffered TDS during the FY.

Further, the CBDT should issue an instruction to clarify that where Circular No 789 dated 13.04.2000 and Circular: No. 1/2003, dated 10-2-2003 is satisfied, the tax officer should issue the certificate under section 197 without any delay.

Proposed Amendment:

Insert sub-section 3 in section 197 of the Act:

197.

(3) [***]

(3) Every certificate under sub-section (1) shall be issued before the expiry of thirty days from the end of the month in which such application was received and shall be applicable for the financial year in which it is issued.

VIII. Clarify indirect transfer provisions for funds/ investors

1. The Finance Act, 2015, provided clarification on several aspects relating to the indirect transfer provisions under section 9 of the Act. However, on the up-streaming of profits in a multi-tiered structure and the mandatory obligation on the Indian Company of reporting any 'indirect transfer' in relation to its share capital, still remains to be addressed.

2. It may be noted that the genesis of the indirect transfer rules was the decision of the Supreme Court of India in the case of Vodafone International Holdings BV[7] (Vodafone) and to overturn the decision of the Supreme Court. The intent of insertion of the indirect transfer rules and amending the source rule was to bring to tax in India offshore transactions (as in the case of Vodafone) which derive their value from Indian assets and where the Indian assets are not transferred directly, but interests in the entity/ies (incorporated overseas) holding the Indian assets are transferred. Thus, the premise for the amendment was to bring within the purview of Indian tax, transfers of substantial interests in Indian operations; ostensibly through the transfer of shares in offshore investment holding companies.

3. However, given the language, the indirect transfer rules apply where the value of the shares of the foreign company is substantially derived from Indian assets held, directly or indirectly by such foreign company, without considering the level of investment by the

[7] The Supreme Court of India in the case of Vodafone International Holdings BV (Vodafone), based on the facts of the case, held that gains arising to a foreign company from the transfer of shares of a foreign holding company which indirectly held underlying Indian assets did not amount to transfer of a capital asset situated in India and hence not taxable in India.

foreign company in the Indian company (where the investment is not substantial in the context of the total shareholding of such Indian company).

Indirect transfer in a multi-tiered structure

4. In a multi-tiered structure, once the offshore entity divests an asset in its portfolio (pursuant to a transfer that qualifies as a taxable direct transfer), a series of capital redemptions are made in the entities in the chain holding structure, resulting in taxable indirect transfers in India. Moreover, in such structures, the taxation is applicable at each income distribution so long as there is an underlying Indian asset/ interest. Accordingly, the gains can be subject to indirect transfer tax at multiple levels, resulting in a situation of economic double taxation.

5. Further Explanation 5 to section 9(1)(i) deems any income arising outside India from any transaction in respect of any share or interest in a foreign company or entity, which has the effect of transferring, directly or indirectly, the underlying assets located in India, as income accruing or arising in India. This can trigger indirect transfer provisions even when there is no change in the shareholders. For example, where the offshore entity has not divested any Indian asset, but is redeeming/ repurchasing its capital without altering the ownership of the shareholders, the indirect transfer provisions will get triggered.

Recommendation:

Given the above intent, in order to ensure complete clarity and to dispense with concerns of the VCPE industry, it could be clarified that indirect transfer provisions should not be applicable in cases where -

(a) transfer/ redemption is directly or indirectly in consequence of or by reason of transfer of capital assets situated in India; or
(b) transfer/ redemption of share or interest does not alter the ownership of the transferor in the transferee.

Reporting obligation on Indian company

6. Section 285A of the Act inserted vide the Finance Act, 2015, provided for reporting requirements for the Indian investee company, in the above scenario the Indian company would need to report the transaction of sale of units/ shares by investors in the off-shore funds.

7. Further, the CBDT has recently released the Notification No. 55/ 2016 dated 28 June 2016 which provides the manner of determination of fair market value and reporting requirement (by introducing Rule 114DB to the Income-tax Rules, 1962), for an

Indian concern with respect to the indirect transfer provisions contained in section 9(1)(i) of the Act. Rule 114DB requires the Indian concern to file Form 49D in the prescribed format and time and maintain a list of documentation to substantiate the information furnished in Form 49D.

Considering the exhaustive list of information and documentation along with penal consequences for default (as envisaged in section 271GA), it is an extremely onerous obligation on the Indian concern and it is farfetched that the Indian concern will be able to collate all such information.

8. There are a large number of Indian companies that have raised capital from VCPE funds that invest in Indian companies through layers of investment holding entities. On grounds of confidentiality, the information on the investment holding entities and group entities is unlikely to be placed at the disposal of the Indian concern.

9. All Indian concerns, through or in which the foreign company or the entity whose share/interest is the subject matter of transfer, are required to comply with the reporting obligation. There would be several situations where the VCPE funds have multiple Indian concerns in or through which they hold India assets. Each such entity may or may not be a significant contributor to the value of the foreign company or entity's shares/interest. Also, such Indian concerns may be held through various immediate/intermediate holding entities. The provisions of Rule 114DB will require that such compliance is done by each concern on a duplicated or overlapping basis.

Recommendation:

1. Provide flexibility to comply with the reporting obligation under Rule 114DB i.e. the reporting obligation should be complied either by the Indian concern or the transferor or transferee where the transfer of share/interest in the foreign company/ entity is covered by provisions of section 9(1)(i) of the Act.

2. Provide a simple reporting obligation which shall comprise of base information such as details of transferor, transferee, subject matter of transfer and its valuation (similar to practice followed by Peru and Chile).

3. The obligation of Indian concern should be restricted to the extent such Indian concern possesses information and/or documents. There should be no penal consequences in the event of failure to report, except when there is a misrepresentation.

4. The Indian concern may be obligated to furnish information only in a case where the transfer is liable to tax under section 9(1)(i) of the Act. It may be explicitly provided that if the transferor is entitled to the small shareholders exemption or avails treaty exemption or if transfer is exempt in terms of section 47 of the Act; there may be no corresponding obligation on the Indian concern as the transfer would not attract tax under section 9(1)(i) of the Act.

Proposed Amendment:

Furnishing of information or documents by transferor or transferee or an Indian concern in certain cases.

285A. Where any share of, or interest in, a company or an entity registered or incorporated outside India derives, directly or indirectly, its value substantially from the assets located in India, as referred to in Explanation 5 to clause (i) of sub-section (1) of section 9, and such company or, as the case may be, entity, holds, directly or indirectly, such assets in India through, or in, an Indian concern, then, the transferor or transferee of the share of, or interest in, a company or an entity registered or incorporated outside India or the Indian concern shall, for the purposes of determination of any income accruing or arising in India under clause (i) of sub-section (1) of section 9, furnish within the prescribed period to the prescribed income-tax authority the information or documents, in such manner, as may be prescribed

[**Penalty for failure to furnish information or document under section 285A**

271GA. If any Indian concern or the transferor or transferee, which is required to furnish any information or document under section 285A, fails to do so, the income-tax authority, as may be prescribed under the said section, may direct that such Indian concern or the transferor or transferee shall pay, by way of penalty,—

(i) a sum equal to two per cent of the value of the transaction in respect of which such failure has taken place, if such transaction had the effect of directly or indirectly transferring the right of management or control in relation to the Indian concern;

(ii) a sum of five hundred thousand rupees in any other case.

Annexure 1

Analysis of the High Court (HC) ruling in Sumeet Taneja case[8]

I. Distinguishable facts:

1. Type of Seller

The seller in the case of the HC ruling was the promoter and Managing Director of the company and in charge of the operations of the company. Conversely, an AIF is a passive investor (being a pooling vehicle set up for investment purposes). Typically, the investors in an AIF (financial investors) neither have the expertise nor are they actually involved in the day to day operations of the company. At most, they may appoint a Nominee Director to be informed about the operations of the company and to safeguard their interests as a shareholder. Such Nominee Directors are not involved in the operations of the investee company.

2. Rights and Covenants

In the HC ruling, as a part of the sale transaction, various restrictive covenants were enforced upon the seller viz. to refrain from participating in the management of the company, blanket ban on engaging in any similar business activity in a specified area for a defined period; non solicitation of business; non poaching of employees, handing over employee, product and customer data base, customer support contracts and prospective client proposals, renunciation of brand equity, logos, trademarks, partnerships, affiliations, domain names etc. It not usual for an AIF to give any such rights when they exit the portfolio company.

AIF as an investor is typically not bound by covenants enunciated in the Ruling. The rights which the seller had to forego in the Ruling were more at the operational and business level as opposed to an AIF which have investor level rights (refer **table below** for list of limited rights that an AIF has) and to that extent there is a fundamental difference between the two.

[8] TS-423-HC-2013 (Punjab and Haryana)

Pre-emptive rights of shareholders under SHA*			
Affirmative Rights	**<20%**	**20%<>50%**	**>50%**
Issue of shares/ Liquidation preferences/ Pricing	✓	✓	✓
Business Acquisition/ Setting up subsidiaries	✓		✓
Strategic Financial Alliance		✓	
Amalgamation/ Restructuring/Buy-back	✓	✓	✓
Amendment to AoA/MoA			✓
Variation of Rights			✓
Board representation	✓		✓
Managerial appointment/ removal		✓	✓
Related Party Transactions	✓		✓
Liquidation	✓	✓	
Business Plan		✓	✓
Dividend/Utilisation of surplus funds		✓	✓
Sale/Investment in Undertaking/IPR		✓	✓
Borrowings/ Mortgages/Guarantees	✓	✓	✓

II. Tax Considerations

A. Transfer of shares is not transfer of business of the company

- The Company was engaged in call centre business and taxpayers were merely shareholders/directors of the company. It is a settled proposition that a company and shareholders are distinct from each other; business carried on by a company under normal circumstances, cannot be regarded as business carried on by shareholders. The HC Ruling upheld the view adopted by lower authorities that transfer of shares by taxpayers constituted transfer of business. Recently, the Karnataka HC in case of Bhoruka Engineering Industries Ltd[9] held that the sale of shares in a company having land as only asset cannot be treated as sale of underlying land.

[9] [2013] 36 taxmann.com 82 (Karnataka)

- The Supreme Court (SC) in the case of Vodafone International Holdings B.V[10] held that while ascertaining the legal nature of the transaction, the Revenue/Court has to '**look at**' the entire transaction as a whole and not adopt a 'look through' approach. Even if assuming the subject matter of transfer was business and/or management/control over business, still, the same constituted a capital asset and income from transfer thereof was assessable as capital gains.

- In the case of Panchratan Hotels Pvt. Ltd;[11] the HC held that a change in the management control of a company, by transfer of shares from one group of shareholders to another, does not amount to succession of the business of the company. As a company is a separate juristic person, change in its shareholding does not affect the ownership of the business of the company.

B. Rights of management or control in an Indian company is a capital asset

- Explanation to section 2(14) of the Act stipulates that the rights of management or control in relation to an Indian company is to be regarded as a capital asset. Similarly, the 'right to carry on any business' is considered as a capital asset and the computation mechanism for the cost of acquisition of such right is provided in Section 55(2)(a) of the Act. Whilst the argument on Section 2(14) of the Act was taken by the asseseee, the Ruling is silent on this important issue.
- Also, in the Ruling, the appellate courts have held that the entire consideration received by the seller is to be treated as business income under Section 28(va) of the Act. However, it is pertinent to note that the said Section stipulates that any sum receivable under an agreement for not carrying out any activity in relation to business is to be charged as business income provided such transfer of right to carry on business is not chargeable under the head 'Capital Gains'. Thus, taxation rights under section 28(va) is subordinate to chargeability under the head 'Capital Gains, and arises only in a situation where 'right to carry on business' is not in the nature of a capital asset. Thus, one needs to first assess if the income from transfer of right to carry on business is chargeable to capital gains tax. Only in the absence of such a scenario, can the income be charged as business income. In other words, section 2(14) and section 55(2)(a) of the Act take precedence over section 28(va) of the Act.

Given the above, even if an AIF is contended to have transferred 'rights of management or control' or 'right to carry on any business' of an Indian company, it needs to be treated as a capital asset liable to capital gains tax.

[10] (2012) 341 ITR 1 (SC)
[11] ITA No. 13 of 2004 dated 26 August 2009, Himachal Pradesh HC

Chapter - IV

B. An Alternative View of Taxation & Promoting Onshore Fund Management in India

IV

B. An Alternative View of Taxation & Promoting Onshore Fund Management in India

A. Introduction

1. This chapter recommends a Securities Transaction Tax regime for various categories of Alternative Investments. It describes the difficulties arising from the current tax regime and which confront all the key players in the AIF ecosystem, namely investors in funds, the Alternative Investment Funds and the revenue authorities. The chapter also provides cogent reasons for the need for a suitable STT regime for hedge funds- which fall under Category III Alternative Investment Funds of SEBI AIF regulations. The chapter includes the justification and rationale for the proposed recommendations and includes draft amendments for consideration by the relevant Government authorities. In essence, the chapter recommends a complete revamp in the manner in which AIFs and their investors are taxed in India**.**

B. Recommendation I: Introduction of Securities Transaction Tax ("STT") for Category I and Category II AIF

2. It is imperative that the existing uncertainties on the tax treatment of Alternative Investment Funds are removed and a stable and tax regime be prescribed. While the revenue authorities could try and remove the uncertainties by issuing clarifications and continue with the existing tax regime that may not completely eliminate the uncertainties and administrative difficulties. The tax treatment needs to be completely revamped.

3. A simplified regime of taxation of investors in mutual funds has significantly helped in the growth of mutual funds with minimal issues and litigation. AIFs, like mutual funds, pool capital raised from investors which is invested in accordance with a stated investment criteria. Given the similarities in the structure of mutual funds and AIFs, a similar tax regime i.e. Securities Transaction Tax (STT) should apply to transactions in units of AIFs.

4. The simplified regime for private equity and venture capital funds, as is the case of Foreign Portfolio Investors (FPIs) who invest in listed securities and are subject to Securities Transaction Tax, would provide great impetus to the growth of the alternatives fund

management industry i.e. AIFs. Experience has shown that some of the key advantages of the Securities Transaction Tax regime are ease of compliance and reduction in tax litigation.

5. To harmonize the taxation of mutual funds and Investment Funds and to simplify tax compliance of both the investors as well as the Investment Funds, it is proposed to bring Investment Funds (i.e. Alternative Investment Funds) under the ambit of STT.

6. It is recommended that, in lieu of the current tax regime, investors in Alternative Investment Funds should be made liable to pay STT which would be collected at three transaction stages i.e. firstly, at the time of entry, at which point the investor purchases units, secondly, when income is distributed during the unit holding period, and, finally, when the investor exits by the transfer of units. Thus it is recommended that the Government should institute a regime under which, STT would apply at the following points in the AIF transaction cycle:

- Point A: Investor invests in the Fund.
- Point B: Fund distributes income / redeems units to investors.
- Point C: Investor transfers units of the Fund.

7. In short, it is recommended that investors in Alternative Investment Funds should be made liable to pay STT at various points in the transaction cycle, as mentioned above, and consequently income arising to investors, whether on distributions / redemption / transfer of units should be exempted from tax in their hands.

C. Rationale and Justification

8. While AIFs have provided much needed long term and stable private capital, the tax and regulatory environment in which they operate has become more and more complex and litigation prone. On the contrary, the tax treatment of Foreign Portfolio investors, investing in listed securities, has tended towards greater certainty. For instance, two Government clarifications have provided much needed certainty to Foreign Portfolio Investors (previously known as Foreign Institutional Investors i.e. FIIs). These are: (i) the income earned by FIIs to be treated as capital gains; and (ii) clarification on the applicability of MAT to FIIs. These clarifications have gone a long way in providing certainty to Foreign Portfolio investors. In contrast the tax treatment of income earned by SEBI registered VCFs and AIFs has seen a chequered history and has been anything other than certain.

9. In addition to the complexities surrounding the withholding and tax treatment of domestic investors, foreign investors have also been having to deal with stringent scrutiny of relief / benefits under Double Taxation Avoidance Agreements. These difficulties have discouraged

Fund Managers from setting up Indian pooled and domiciled funds. Instead capital is pooled and domiciled outside India, and invested in India under the Foreign Direct Investment (FDI) route. Investments under the FDI route are not subject to any of the restrictions and difficulties mentioned in the next section.

10. The introduction of a Securities Transaction Tax ("STT") can help alleviate the concerns. The implementation of a STT-based tax regime for AIFs gains paramount importance after the negotiation of the DTAA with jurisdictions such as Mauritius and Singapore. If implemented, an STT regime for private equity and venture capital funds, including AIFs, could yield STT tax revenues of $1.8 billion during the next 15 years (see Appendix 1)

11. The specific difficulties arising from the current fax regime for venture capital and private equity funds, their investors and the revenue authorities are given below.

a) Difficulties Faced by Alternative Investment Funds

12. **Lack of parity on withholding tax provisions for residents and non-residents**: Resident investors suffer a 10 percent withholding tax on gross distributions made by AIFs which includes distribution of income in the nature of gains from the sale of listed company's shares held for more than one year (which is exempt from tax), dividend income (which is exempt from tax) etc. However, withholding from distributions made to non-resident investors shall be made at the rates in force (including rates applicable on account of a tax treaty). Hence, there is a lack of parity in the treatment given to residents and non-resident investors thereby discouraging domestic investments.

13. **Blockage of resident investors funds due to withholding requirement of 10 percent even in respect of exempt income**: Resident investors suffer TDS on all income distributed by the Fund thereby resulting in tax on exempt income as well. Resident investors are left with no option but to claim the TDS as a refund by filing a return of income. Refund claims of the investors are blocked until the refund is paid thereby lowering the return on capital on investments from the Fund.

14. **Administrative inconvenience for the Funds**: In order to realize refund claims and complete assessment proceedings Fund would need to continue to exist for notwithstanding the fact that most funds are established with a limited life.

15. **Compliance burden on the Funds**: The tax related compliance requirements of Funds has not been reduced over the years. The Fund is still required to file a return of income and in addition is required to submit Forms 64A and 64B detailing the income distributed by the Fund. This is in addition to the requirement of submitting TDS returns on income distributed to the Fund which is otherwise not required to be done by other assesses.

b) Difficulties Faced by Investors

16. **Claim of refund and return filing requirement**: Most non-resident investors would have no other business activity other than participating in a VC / PE fund. Despite this, they will be required to file in India return of income irrespective of whether they have taxable income or not. This could act as a deterrent to large institutional investors.

17. **Stress on working capital of investors:** Blocked tax deducted at source claims on exempt income creates unnecessary stress on working capital.

18. **High withholding tax rate**: The 10 per cent withholding tax rate is high considering that the actual tax payable by the investors could be less. A high withholding tax rate would reduce the effective Internal Rate of Return to the investors as the excess tax deducted would have to be claimed as a refund, the grant of which is delayed.

c) Difficulties Faced by Revenue Authorities

19. **Burden on Revenue Authorities**: Increased scrutiny of returns filed by the PE/VC Funds and in the investors towards income and TDS adds to the administrative burden of the revenue authorities of scrutinizing returns containing exempt income;

20. Administering tax credits and ensuring that the Form 26AS credits match with the credits claimed by the investors adds to the existing reconciliation of mismatches between TDS claims and Form 26AS;

21. **Revenue leakage** on account of interest on refunds which was never to be charged;

22. **Litigation**: Increase in litigation leading to poor tax collection and inefficient utilization of tax authorities in dealing into such litigation.

Proposed Amendments

Amendment – 1: Distributions by AIFs to be treated as a taxable transaction in securities liable to STT

Amendments required in the Finance Act 2004 (Chapter VII):

Amending the Chapter VII of Finance (No. 2) Act, 2004 to include distribution from Investment Funds as a taxable transaction in securities:

Definitions

A) In section 97 of the Finance (No.2) Act, 2004,-

Insert the following definition as sub-section (1):

"Investment Fund" shall have the meaning assigned to it in clause (a) of the explanation to section
115UB of the Income-tax Act, 1961"

B) In section 97 re-insert the current sub-section (1) defining Appellate Tribunal as sub-section (1A)
C) In section 97 of the Finance (No. 2) Act, 2004,–

in sub-section 13, after sub-clause (b), the following sub-clauses shall be inserted:
"(c) purchase of a unit in an Investment Fund
(d) any distribution made on sale or redemption of an unit in an Investment Fund"
(d) any distribution made otherwise by an Investment fund"

Charge of Securities Transaction Tax

D) In section 98 of the Finance (No. 2) Act, 2004, in the Table, after serial number 7 and the corresponding entries thereto, the following shall be inserted, namely:—

Sl. No.	Taxable Securities Transaction	Rate[12]	Payable by
(1)	(2)	(3)	(4)

[12] Or such other rate as may be appropriate

"8	(a) Purchase of a unit of an Investment Fund	0.25%	the purchaser
	(b) Distribution of income representing long term capital gains, made to a unit holder by an Investment Fund on redemption or otherwise	0.25%	the unit holder
	(c) Distribution of income other than long term capital gains, made by an Investment Fund on redemption or otherwise	1%	the unit holder
	(d) Sale of a unit of an Investment Fund being a long term capital asset, to any person other than the Investment Fund in which such units are held	0.25%	the seller
	(e) Sale of a unit of an Investment Fund being a short term capital asset, to any person other than the Investment Fund in which such units are held	1%	the seller

Value of taxable securities transaction

E) In section 99 of the Finance (No.2) Act, 2004, after sub-clause (b) insert the following clauses (ba)-

"(ba) in the case of purchase of units of an Investment Fund, the price at which such units are purchased;

(bb) in the case of distribution on account of redemption of units of an Investment Fund, such amounts as are distributed to the unit holder including the principal amount redeemed;
(bc) in the case of distribution by an Investment fund other than the distribution referred in clause (bb) above, the amounts so distributed to the unit holder;

(bd) in the case of sale of units of an Investment Fund by the unit holder to any person other than the Investment Fund in which such units are held, the price at which such units are sold"

Collection and Recovery of Securities Transaction Tax,

F) In section 100 insert the following sub-section (2B) after sub-section (2A)

"The prescribed person in the case of every Investment Fund shall collect the securities transaction tax from every person who purchases or sells or redeems the unit of an Investment Fund"

Recognised stock exchange or Investment Fund or Mutual Fund to furnish prescribed return

G) In sub-section (1) of section 101 - insert the following words after the words "every recognised stock exchange" –

"Prescribed person in the case of every Investment Fund"

Amendment – 2: Amendments required in the Income Tax Act, 1961

i) **Exempting the income from Investment Fund (AIF) under section 10:**

A) In Section 10 of the Income-tax Act, after clause (38), the following clause shall be inserted, namely:-

“(38A) any distribution received by an assessee, being a unitholder of an Investment fund referred to in Explanation to section 10(23FBA), either on redemption or otherwise and where such distribution is chargeable to securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004.

(38B) any income received by an assessee, being a unitholder of an Investment fund referred to in Explanation to section 10(23FBA), on sale of units in an Investment Fund to any person other than the Investment Fund in which such units are held and where such sale is chargeable to securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004.”

Other Consequential Amendments

A) **Amending the period of holding in the securities held in and by an Investment Fund**

In sub-section 42(A) of the Income-tax Act, insert the following proviso after the second proviso-
“Provided further that in the case of share or other securities of a company (not being a share listed in a recognised stock exchange) held by an Investment Fund or a unit of an Investment Fund specified under clause (23FBA) of section 10, the provisions of this clause shall have effect as if for the words "thirty-six months", the words "Twenty four months" had been substituted”

B) **Amending Section 115UB**

In Section 115UB of the Income-tax Act, after sub-section (7), the following sub-section shall be inserted, namely:-
“(8) Nothing contained in sub-sections (1) to (7) shall apply to any distributions by an Investment fund, where the distribution from such an Investment Fund is chargeable to securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004

(9) It shall not be necessary for an assessee being a unit holder of an investment fund to furnish under sub-section (1) of section 139 a return of his or its income if:

a) His or its total income in respect of which he or it is assessable under this Act, during the previous year consisted only of distributions from an investment fund, chargeable to securities transaction tax under Chapter VII of the Finance (no.2) Act, 2014"

C) Avoiding redundant exemptions in section 10

In Section 10 of the Income-tax Act,-

(a) for clause (23FBA), the following clause shall be substituted, namely:-

"(23FBA) any income of an investment fund;

Explanation.—For the purposes of this clause, the expression "Investment fund" shall have the same meaning as assigned to it in clause (a) of the Explanation 1 to section 11UB"

(b) clause (23FBB) shall be omitted:-

D) Avoiding the Tax Deduction at Source by Investment Funds (Section 194LBB)

In Section 194LBB of the Income-tax Act, the first paragraph shall be numbered as sub-section

(1) and after sub-section (1) so numbered, the following sub-section shall be inserted, namely:-

"(2) Nothing contained in sub-section (1) shall apply to distributions by an Investment fund, where such distribution is chargeable to securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004"

E) Exempting a portfolio company from the tax on share premium amount when invested by an Investment Fund (AIF) (as is the case when invested by a venture fund)

In section 56 of the Income-tax Act, in sub-section (1), in clause (viib), after clause (ii) of the Proviso, the following clause shall be inserted, namely-

(iii) by a company from an Investment fund referred to in Explanation to section 10(23FBA)

C: Recommendation 2: Introduction of Securities Transaction Tax ("STT") for Category III Alternative Investment Funds

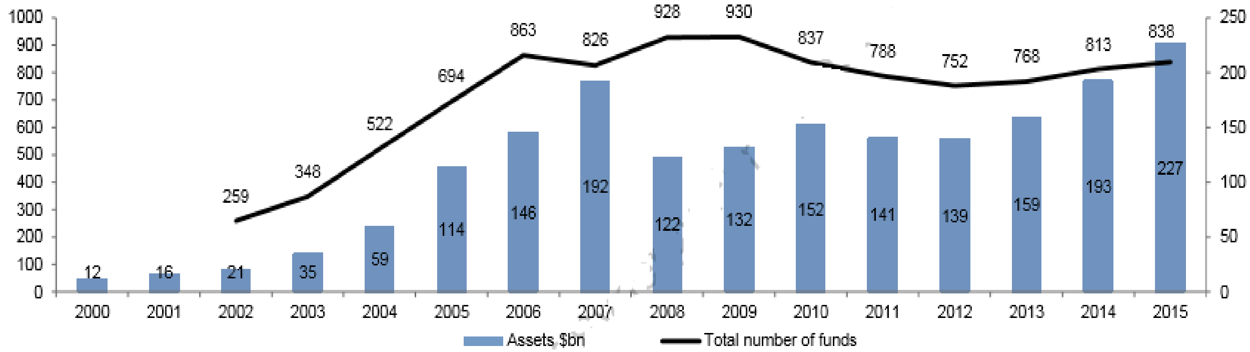
23. Category III **Alternative Investment Funds** include hedge funds under SEBI AIF regulations. In India the hedge fund industry has not yet developed to its full potential due to various factors, including the lack of certainty in taxation. A transformative change on the taxation front can greatly facilitate their growth. A fair, transparent and enabling tax regime could result in India's hedge fund industry potentially growing at 20% per annum from its current low base. Ultimately their assets under management could surpass $25 Billion or INR 166,750 crores in 10 years.

24. The rationale and advantages of the STT regime have been amplified in the earlier section. In order to simplify and bring ease of compliance and remove ambiguity in taxes, the introduction of the STT regime (on entry and redemption for each investor) will ensure smooth payment and collection of taxes. This proposal will ensure stable cash flows for the government and since they are source based, it represents a superior tax policy, which is a win-win for the fund manager, the investors and the Government.

Justification for Developing the Hedge Fund Industry in India & Alternative Investment Funds in the Indian Context

25. The current size of the AIF Category III Funds in India is an estimated INR 3,816 crores as of 30th June, 2016. This is much smaller that the approximately Rs. 100,000 crores invested under Portfolio Management Schemes (PMS). The global hedge fund industry has $3 Trillion in assets under management as of 2015 (AsiaHedge and HFR Global Hedge Fund surveys). From 2007 to 2015, China's equity hedge fund assets under management have risen from an estimated USD13.5 Billion to USD45 Billion in 2015, taking China's market share from 6% in 2007 to 18% in 2015 in the Asia-Pac hedge fund industry. During this period, the share of India's equity hedge funds declined from 5% to 2% today. The Chinese hedge fund industry has also grown strongly at a roughly 19% compounded rate since 2007.

Total Assets in Asia-Pacific Hedge Funds ($bn, 2000 – 2015)



26. Hong Kong and Singapore, which have zero capital gains tax, have experienced tremendous growth in the hedge fund and financial services industry. Currently, Indian AIF's are at a nascent stage with potential to grow larger. Consequently, the taxes collected can rise if the tax structure is simplified and made fair by implementing an STT regime for Category III AIFs. 27. Examples from other industries have proven that a fair tax regime led to exponential growth of industry and over time resulted in higher collection of tax revenue.

27. Securities Transaction Tax, which is source based taxation, has the potential of leading to an exponential growth of this industry in India in line with international jurisdictions such as Singapore, Hong Kong, US and the UK.

Rationale for a Vibrant Hedge Funds Industry

28. There is a strong rationale for developing a vibrant hedge funds industry in India. The rationale for this is the several benefits associated with a hedge fund industry which are explained below:

- **Alternative source of funding:** Hedge funds are a potential alternative source of funding for India's economic growth and development. They are attractive to large institutional investors such as sovereign wealth funds, pension funds, endowments, trusts and family offices. Hedge funds typically start their corpus with proprietary capital of the fund manager. This 'skin- in- the- business', brings about a natural alignment of interest between the fund manager and fund investors;

- **Counterweight to Volatile International Capital Flows**: The creation of a large domestic institutional AIF industry, including hedge funds, would act as a counterweight to volatile foreign portfolio flows and contribute to stability in the Indian equity market. Domestic AIFs can lower the help impact of speculative activity. Daily trading in equity derivatives is 20x the daily trading volume in the cash segment;

- **Superior Governance**: Hedge funds strategies include activist investment strategies which aim to improve the quality of governance in portfolio companies, thereby bringing about improvements in their performance and enhanced efficiencies in their operations;

- **Diversity of Investment Strategies Meets the Investment & Risk Management Needs of Investors**: Hedge funds play a critical role by offering a wide array of investment strategies, thus increasing the number of participating investors and enlarging pools of capital available. For investors, hedge funds also serve a risk-management role, since their returns can be uncorrelated to those in equity markets. Markets work best when investors draw on a diverse set of strategies and securities to manage risk. Private pools of regulated capital provide valuable liquidity to financial markets under normal conditions and especially during periods of market stress and downturns;

- **Price Discovery**: The variety of investing strategies that hedge funds employ, strengthen capital markets by improving opportunities for price discovery. "Short selling contributes to the market's process of finding correct prices and its valuable to have hedge funds do this," said Jeremy Seigel, Prof of Finance at Wharton School of Business. "By buying irrationally cheap assets and selling irrationally expensive ones, they shift market prices until irrationalities disappear, thus ultimately facilitating the efficient allocation of the world's capital." ;

- **Lower Cost of Capital**: Countries with highly developed hedge fund industry have seen more efficient capital markets and a much **lower cost of capital**. This is desirable as India currently suffers from high cost of capital (double digit across sectors) and a high equity risk premium; and

- **Job Creation**: A strong hedge fund ecosystem will help create many jobs within the financial industry. This will lead to high value job creation in the financial services industry in India. The diagram below shows the areas in the hedge fund eco-system where jobs will increase as the hedge fund industry grows.

The Proposed Securities Transaction Tax on Category III AIFs: Collection Stages

29. To simplify tax compliance by investors and category III AIFs, it is recommended that category III AIFs are brought under the ambit of STT. Further, the investors of the category III AIFs should be made liable to pay STT on the distribution made by the category III AIFs to the investors and consequently such distributions should be exempted from tax in the hands of the investors.

30. It is recommended that STT be collected at 5 stages of the typical Category III AIF investment transaction cycle, in lieu of the current tax regime covering AIFs, as follows:

- Point A: Investor invests in the Fund.
- Point B: Fund buys securities, equity and derivatives over the course of the year.
- Point C: Fund sells securities pay STT on both equities and derivatives.
- Point D: Transaction-Fund distributes income to investors.
- Point E: Transaction-Investor redeems money / transfers units of the Fund.

31. In addition to the above, a 15% service tax on brokerage amount is also paid, as also an incremental service tax on the asset management fees paid out to the domestic fund manager.

32. In this manner the government collects the tax on the entire gain made by the fund when the investor redeems his or her investment from the fund.

33. It is important to highlight that in category III AIFs, the money received by such AIFs would be invested in underlying listed securities. As per the current law, such AIFs would be subject to STT for transacting in listed securities. Further, considering the volume involved at the category III AIF level, there is already a good amount of STT liability created at the time of transacting in underlying listed securities. The proposed rates of STT are over and above the STT that a category III AIF would otherwise pay for transacting in listed securities.

34. Additionally, there are also funds which are registered as CAT III AIFs and which adopt a 'long' strategy for investment in listed securities. A significant portion of their income is in the nature of long term capital gains which is otherwise exempt under existing tax law. Since investors earning long term capital gains would otherwise not have paid any income-tax at the time of disposing the listed securities, it is proposed not to levy any STT at the time of distribution of such income.

Proposed Amendments

Amendment – 1: Amendments required in the Finance Act 2004 (Chapter VII – Securities Transaction Tax):

Distributions by AIFs to be treated as a taxable transaction in securities liable to STT

Amending the Chapter VII of Finance (No. 2) Act, 2004 to include distribution from CAT III Investment Funds as a taxable transaction in securities:

Definitions

A) In section 97 of the Finance (No.2) Act, 2004, after sub-section (3A), the following definition shall be inserted:

"(3B) "CAT III Investment Fund" shall have the meaning assigned to it in the Explanation to Section 10(23FBAA) of the Income-tax Act, 1961"

B) In section 97 of the Finance (No. 2) Act, 2004, in sub-section 13, after sub-clause (b), the following sub-clauses shall be inserted:

"(c) purchase of an unit in a CAT III Investment Fund; or
(d) any distribution made on redemption of an unit in a CAT III Investment Fund; or
(e) any distribution made otherwise by a CAT III Investment Fund; or
(f) sale of an unit in a CAT III Investment Fund"

Charge of Securities Transaction Tax

C) In section 98 of the Finance (No. 2) Act, 2004, in the Table, after serial number 7 and the corresponding entries thereto, the following shall be inserted, namely:-

Sl. No.	*Taxable Securities Transaction*	*Rate*	*Payable by*
(1)	*(2)*	*(3)*	*(4)*
"8	*a) Purchase of an unit of a CAT III Investment Fund*	*0.05%*	*the purchaser*
	b) Distribution representing long term capital gains as referred to in Section 10(38) of the Income-tax Act, 1956 , made by a CAT III Investment Fund on redemption or otherwise	*Nil*	*-*
	c) Distribution other than referred to in clause b above, made by a CAT III Investment Fund on redemption or otherwise	*0.25%*	*the unit holder*
	d) Sale of an unit of a CAT III Investment Fund being a long term capital asset, to any person other than the CAT III Investment Fund in which such units are held	*0.05%*	*the seller*
	e) Sale of an unit of a CAT III Investment Fund being a short term capital asset, to any person other than the Investment Fund in which such units are	*0.25%*	*the seller*

Value of taxable securities transaction

D) In section 99 of the Finance (No.2) Act, 2004, after sub-clause (b) insert the following clauses-

"(ba) in the case of purchase of units of a CAT III Investment Fund, the price at which such units are purchased;
(bb) in the case of distribution on account of redemption of units of a CAT III Investment Fund, such amounts as are distributed to the unit holder including the principal amount redeemed;
(bc) in the case of distribution by a CAT III Investment Fund other than the distribution referred in clause (bb) above, the amounts so distributed to the unit holder;
(bd) in the case of sale of units of a CAT III Investment Fund by the unit holder to any person other than the Investment Fund in which such units are held, the price at which such units are sold"

Collection and Recovery of Securities Transaction Tax,

E) In section 100 insert the following sub-section (2C) after sub-section (2B)

"(2C) The prescribed person in the case of every CAT III Investment Fund shall collect the securities transaction tax from every person purchases or sells or redeems the unit of a CAT III Investment Fund"

Recognised stock exchange or Investment Fund or Mutual Fund to furnish prescribed return

F) In sub-section (1) of section 101 - insert the following words after the words "every recognised stock exchange" –

"or prescribed person in the case of every CAT III Investment Fund"

Amendment – 2 : Amendments required in the Income Tax Act, 1961

Exempting the income from CAT III Investment Fund under section 10:

In Section 10 of the Income-tax Act, after clause (38), the following clauses shall be inserted, namely:-

"(38A) any distribution received by an assessee, being a unitholder of a CAT III Investment Fund as referred to in Explanation to section 10(23FBAA), either on redemption or otherwise and where such distribution is chargeable to securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004.

(38B) any income received by an assessee, being a unitholder of a CAT III Investment Fund referred to in Explanation to section 10(23FBAA), on sale of units in a CAT III Investment Fund to any person other than the CAT III Investment Fund in which such units are held and where such sale is chargeable to securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004."

Exempting the income of CAT III Investment Fund under section 10:

In Section 10 of the Income-tax Act, after clause (23FBB), the following clauses shall be inserted, namely:-

"(23FBAA) any income of a CAT III Investment Fund;

Explanation.—For the purposes of this clause, "CAT III Investment Fund" 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 has been granted a certificate of registration as a Category III Alternative Investment Fund and is regulated under the

Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012, made under the Securities and Exchange Board of India Act, 1992 (15 of 1992);"

Other consequential amendments:

A) Amending the period of holding in the securities held in and by an Investment Fund

In sub-section 42(A) of Section 2 of the Income-tax Act, insert the following proviso after the second proviso-

"Provided further that in the case of share or other securities of a company (not being a share listed in a recognised stock exchange) held by a CAT III Investment Fund or a unit of a CAT III Investment Fund specified under clause (38A) of section 10, the provisions of this clause shall have effect as if for the words "thirty-six months", the words "Twenty four months" had been substituted"

B) Exemption from filing return of income

Notification providing exemption from filing return of income by a Category III Alternative Investment Fund

MINISTRY OF FINANCE
(Department of Revenue)
(CENTRAL BOARD OF DIRECT TAXES)
NOTIFICATION
New Delhi, the _____, 2016
No. [●]
INCOME-TAX

S.O. 1703(E).—In exercise of the powers conferred by the proviso to sub-section (1) of section 139 of the Income-tax Act, 1961 (43 of 1961), the Central Government hereby notifies that it shall not be necessary for an assessee being a unit holder of a Category III Alternative Investment fund as defined under clause (23FBAA) of section 10 of the said Act to furnish under sub-section (1) of section 139 a return of his or its income if:

- His or its total income in respect of which he or it is assessable under this Act, during the previous year consisted only of distributions from a Category III Alternative Investment Fund as defined in explanation to clause (23FBAA) of section 10, chargeable to securities transaction tax under Chapter VII of the Finance (no.2) Act, 2014"

This notification shall come into force from the date of its publication in the Official Gazette.

Appendix 1

Tax collected if STT was levied on VCPE investments (Projected taxes collected over a 15 year period)

STT on investment			**0.25%**
STT on distribution			**0.25%**
STT on short term capital gains			**1.00%**
Capital Invested per year(USD million) as per actuals for FY2015			**15,000**
Average Holding period for an Investment (years)			**5**
Average Return on Investment			**170%**
(USD million)	**STT on Investment**	**STT on Distribution**	**Total Tax collected**
Year 1	**38**	**83**	**120**
Year 2	**38**	**83**	**120**
Year 3	**38**	**83**	**120**
Year 4	**38**	**83**	**120**
Year 5	**38**	**83**	**120**
Year 6	**38**	**83**	**120**
Year 7	**38**	**83**	**120**
Year 8	**38**	**83**	**120**
Year 9	**38**	**83**	**120**
Year 10	**38**	83	120

Year 11	**38**	83	120
Year 12	**38**	83	120
Year 13	**38**	83	120
Year 14	**38**	83	120
Year 15	38	83	120
Total tax			**1806**

<u>**Assumptions:**</u>
1. USD 15 billion PEVC investments per year (same as in 2015)
2. The fund will hold the investment for 5 years and divest it after.
3. An average multiple of 1.7x on realization of exit
4. STT is levied both during investment and distribution
5. STT on short term gains is at 1.0% (gross); assumed 10% of total distributions

V

Category I Alternative Investment Funds-Angel Funds

	Recommendation	Rationale
I.	**Angel Investments**	
	a. The stipulation that angel investors must remain invested in a company for a minimum of 3 years should be brought down to 1 year, if at all a minimum holding period is required or create carve out in the existing clause.	• Angel Investment rounds average Rs 3Cr • Most companies need a VC round of much larger sums(Rs 15 to 25 Cr) in 12 to 24 months, especially if they are doing well • VCs and corporates making the next round, prefer to clean out the earlier shareholding of 30 odd angel investors, finding it messy • Hence such a restriction will be against the interests of entrepreneurs as they need to raise more monies from VCs who will decline to do so if they cannot buy out the angels' investment. • It does not match with the overall intention of creating liquidity to investors thru such SEBI initiatives as ITP, MSME Exchange
	b. Clause mandating angel investor to invest Rs 25 Lakhs over a period 3 years to be amended to invest over the life of the fund or at least 5 years	• Investing Rs 25 Lakhs over a period 3 years may often be difficult as a sufficient number of opportunities available may not occur in areas of interest • Further, deals are majorly oversubscribed so even if willing, an investor can miss out as there will be periods where there are not enough opportunities available and the competition is also huge.
	c. Clause mandating angel funds to invest a minimum Rs 50 lakhs in a company to be brought down to Rs 25 lakhs	• With govt. focus on startups, there are many startups sprouting which require a smaller amount for validating their proposition • Bringing down the limit to Rs 25 lakhs will help start ups
	d. AIF regulation to be amended to allow a scheme to have a maximum of	• The limit of 49 was meant to be in-line with Companies Act, 1956 wherein over 50

	200 members	investors would make it deemed public. • Since this provision has been changed to 200 shareholders, the AIF Regulations should be amended to have a maximum of 200 investors.
	e. The provision that angel funds shall invest only in venture capital undertakings which have been incorporated in the preceding three years from the date of investment to be amended to allow at least 10% of the angel fund's portfolio investments to be companies that may be more than 3 years	• Given the government start up definition is 5 years we should allow investments in companies incorporated up to 5 years ago to bring it in line with govt definition • Allow least 10% of the angel fund's portfolio investments in companies more than 5 years old as many companies pivot their business models
	f. Angel funds should also be allowed to invest in overseas venture fund undertakings the same percentage of their corpus as Category I AIFs.	• Other AIF can invest 15% of the corpus in companies that are not registered in India. Extend the same to Angels as well.

VI
Category III Alternative Investment Funds

A. Introduction

1. Category III Alternative Investment Funds (AIFs) are those which employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives. Various types of funds such as hedge funds, PIPE Funds, etc. are registered as Category III AIFs. Category III AIFs may be open ended or close ended.

2. This chapter addresses some of the concerns faced by Category III Alternative Investment Funds which are regulated by SEBI. Specifically, recommendations have been made to address the following four areas:

(i) Participation in Initial Public Offerings (IPOs);
(ii) Investing in foreign securities;
(iii) Ten Percent Restriction on Investible Funds; and
(iv) Leverage

B. Participation in IPOs

Background:

3. In IPOs in India, there are no allocations earmarked for AIFs. In contrast, mutual funds are currently allowed to anchor an IPO, even if the lead manager is a group company. As per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009, SCHEDULE XI (point 10(k)), neither the merchant bankers nor any person related to the promoter/promoter group/merchant bankers can apply under Anchor Investor category in a public issue. The only exception given by SEBI is for Mutual Fund entities related to Merchant Banker.

4. Also, all IPOs have an allocation for Qualified Institutional Buyers (QIB) and within the QIB allocation, there is a further allocation made specifically to Mutual Funds. Furthermore, one third of the allocation to anchor investors is reserved for mutual funds. The inability to access quality investments by way of an anchor investor in certain IPOs is a handicap for AIF managers, particularly for Category III AIFs.

Recommendation

5. It is recommended that:
- AIF's be allowed to anchor an IPO, even if the lead manager is a group company
- AIF's be given an allocation in IPOs
- Provide for an allocation for AIFs within the allocation for anchor investors in IPOs

Rationale

6. The rationale for these recommendations are:

(i) providing equal treatment for AIFs with Mutual Funds will ultimately allow for greater capital flows in to AIFs;
(ii) investing a proportion of committed capital in listed companies is common in the global PE & VC industry; and
(iii) anchoring IPOs will contribute to enhanced confidence for other investors since AIFs are managed by professional fund managers; and
(iv) limiting price volatility as AIF's are long-term investors.

Suggested Amendments:

1) It is recommended that the following amendments are made to circular No. LAD-NRO/GN/2009-10/15/174471 of SEBI dated 26th August 2009.

Section 42 (2) (c): not more than fifty percent to qualified institutional buyers, five percent of which shall be allocated to mutual funds; two percent of which will be allocated to Category III AIFs.

Provided further that in addition to five percent and two percent allocation available respectively in terms of clause (c), mutual funds and Category III AIFs shall be eligible for allocation under the balance available for qualified institutional buyers

Section 86 (1) (a): Minimum of ten percent of eligible securities shall be allotted to mutual funds and four percent of eligible securities shall be allotted to Category III AIFs: Provided that if the mutual funds and Category III AIFs do not subscribe to the said minimum percentage or any part thereof, such minimum portion or part thereof may be allotted to other qualified institutional buyers;

Book building process Part A (10) (d): one-third of the anchor investor portion shall be reserved for domestic mutual funds; one-fifth of the anchor investor portion shall be reserved for Category III AIFs

Part B: FORMAT OF BID DATA DISPLAYED ON STOCK EXCHANGE, in table 2) Details of Allocation to Investors other than Anchor Investors, add following row:

1) (c) Category III AIFs.

2) SEBI will have to issue the following notification pertaining to restrictions on anchor investors:

"The restriction envisaged in Schedule XI, Part (A), 10(K) of Sebi (ICDR) Regulations, 2009, shall not be applicable to Category III AIFs sponsored by entities related to merchant banker."

C. Investing in Overseas Securities

Background

7. SEBI Circular dated 1 October 2015 allows venture capital funds (VCF) to invest in overseas firms with Indian connections to the extent of 25% of their investible funds. This is allowed on a first –come- first- served basis depending on the availability in the overall limit of $500 million.
8. Further, as per SEBI circular No.7/104753/07 dated September 26, 2007 Mutual Funds are eligible to make investments in overseas securities subject to an aggregate cap of $5 billion and $300mn per mutual fund.
9. This creates an uneven playing field for Category III AIFs as far as investment opportunities are concerned.

Recommendation:

10. Allow Category III AIFs to invest in global securities subject to aggregate caps similar to VCFs.

Rationale

11. Having the same investment opportunity set as Mutual Funds can attract more

inflows into Category III AIFs. Furthermore, this would lead to geographical diversification of investments which can be used for lowering volatility of returns.

Suggested Notification:

It is recommended that SEBI issues an addendum to circular CIR/IMD/DF/7/2015 dated 1 October 2015 to reflect the following:

Section 2 (D) Overseas Investment by Category III AIFs registered under SEBI Regulations 2012.

Reserve Bank of India (RBI) vide its A.P.(DIR Series) Circular No.48 dated December 09, 2014 has permitted an Alternative Investment Fund (AIF), registered with SEBI, to invest overseas in terms of the provisions issued under the A.P. (DIR Series) Circulars No. 49 and 50 dated April 30, 2007 and May 04, 2007 respectively.

In accordance with the aforesaid RBI circular, it is stated as under:

- AIFs may invest in ADRs/ GDRs/ foreign securities and overseas ETFs, subject to overall limit of USD 500 million (combined limit for all Category III AIFs)
- Such investments shall not exceed 25% of the investible funds of the scheme of the AIF
- This shall be allowed on a first come first serve basis depending on the availability in the overall limit of $500mn.

Permissible investments

- ADRs/ GDRs issued by Indian or foreign companies
- Equity of overseas companies listed on recognized stock exchanges overseas
- Initial and follow on public offerings for listing at recognized stock exchanges overseas

Disclosure Requirements

The following disclosure requirements shall be mandatory for Category III AIFs proposing overseas investments.

-

- The Intention to invest in foreign securities shall be disclosed in the offer documents of the AIF. The attendant risk factors and returns ensuing from such investments shall be explained clearly in offer documents. AIFs shall also disclose as to how such investments will help in the furtherance of the investment objectives of the schemes. Such disclosures shall be in a language comprehensible to an average investor in an AIF.
- The exposure to such investments shall be disclosed to all investors and SEBI as part of quarterly disclosures to investors and to SEBI (SEBI quarterly report)

D. Ten Percent of Investible Funds Restriction

Background:

12. Chapter III of the SEBI (Alternative Investment Funds) Regulations, 2012 ('Regulations') Clause 15(d) of Chapter III states that Category III Alternative Investment Fund shall invest not more than ten percent of the investible funds in one Investee Company. Such definition prescribes various Investment Conditions and Restrictions which needs to be adhered to while making investments by an Alternate Investment Fund ('AIF'). The term "investible funds" is defined under Chapter I, clause 2(p) as corpus of the Alternative Investment Fund net of estimated expenditure for administration and management of the fund. Further the term corpus is defined under Chapter I, clause 2(h) as the total amount of funds committed by investors to the AIF by way of a written contract or any such document as on a particular date.

Recommendation:

13. Amend the ten percent restriction of 'investible funds' in one Investee Company to reference the 'market value' of such securities at the time of investment.

Rationale:

14. It is prudent if the limit is calculated on the market value of the portfolio as on the date of investment. Going by the literal interpretation, the aforesaid limit is to be monitored on the corpus which is defined as the initial amount committed by the investors and not on the market value of the portfolio.

For example, if the Fund has raised a corpus of Rs.100cr during the allotment, the value of which has increased to Rs.150cr due to market movement, under current regulations the limit of 10% will be applied on the initial amount raised i.e. Rs.100cr whereas, since the market value of investments of the portfolio of the scheme is Rs.150cr as on the date of investment.

Suggested Amendments:

It is recommended that In SEBI (AIF) Regulations 21 May 2012, Chapter 3 section 15 (General Investment Conditions), the following changes need to be made in point (d).

(d) ~~Category III Alternative Investment Fund shall invest not more than ten percent of the corpus in one Investee Company~~(d) Category III Alternative Investment Fund shall not invest in one Investee Company more than ten percent of the market value of the Fund at the time of such investment.

E. Leverage

Background:

15. As per current AIF regulations, calculation of leverage is governed as per SEBI circular CIR/IMD/DF/10/2013 dated July 29, 2013 and the leverage allowed by Category 3 AIFs is limited to 2x NAV (on netted basis). Further, offsetting of positions is governed by circular No. MFD/CIR/21/ 25467/2002 dated December 31, 2002. This has led to ambiguity on how exposures are calculated and offset. There is no clarity on calculation of exposures and offsetting rules for all derivative instruments. The way exposures are calculated based on current norms exposes the markets to severe systemic risks particularly through long put options.

Recommendation:

16. SEBI circular dated 29 July, 2013 needs to be amended to make the calculation of exposure and offsetting rules unambiguous based on the type of derivative instrument. We can borrow rules used in AIFMD regulations employed by regulators in the EU.

Rationale:

17. Clarity on calculation of exposure and netting norms will eliminate the possibility of misreporting critical metrics to the regulators. By ensuring that regulators and the fund managers are on the same page as far as these leverage calculations are concerned, we will also eliminate the risk of an inadvertent breach of regulations by

the Category III AIF manager employing leverage. This additional clarity will also draw in more fund managers in the long- short category which happens to be one of the largest hedge fund categories in the world.

18. By rationalizing the calculation of exposure levels, we will also be lowering the systemic risk resulting from over exposure to long puts.

Suggested Amendments:

It is recommended that Section 3.4 "Prudential Norms" in the SEBI circular of Jul 29, 2013, under the title "Calculation of Exposure and NAV", sections II and sections IV be modified as indicated below.

Section 3.4 Prudential Requirements

Calculation of exposure and NAV

Sub-section II:

Exposure shall generally be calculated as below:

a) Futures

- Bond future: Number of contracts * notional contract size * market price of the cheapest-to-deliver reference bond

- Interest rate future: Number of contracts * notional contract size

- Currency future: Number of contracts * notional contract size

- Equity future: Number of contracts * notional contract size * market price of underlying equity share

- Index futures: Number of contracts * notional contract size * index level

b) Exchange traded plain vanilla options (bought/sold puts and calls)

- Plain vanilla bond option: Notional contract value * market value of underlying reference bond * delta
- Plain vanilla equity option: Number of contracts * notional contract size* market value of underlying equity share * delta
- Plain vanilla interest rate option: Notional contract value * delta

c) In case of any unlisted or OTC derivative exposure, the exposure is calculated as the notional market value of the contract

d) Option deltas if published by the exchanges must be used to calculate exposure. In cases where deltas are not published, the delta may be calculated using a standard Black-Scholes (Exhibit A) calculator with the appropriate RBI Repo rate as the risk free rate and the historical one year volatility of the underlying.

Sub-section IV:

Offsetting of positions shall be allowed for calculation of leverage for transactions entered into for hedging and portfolio rebalancing as below.

a) Netting is allowed on the same underlying and expiry

b) A broad/sectoral index can be netted off against its underlying in the same weighted proportion as they constitute the index

c) A equity portfolio that is well diversified across sectors and without undue concentration risk may be netted off against a broad market Index based in the Beta of the portfolio.

d) Interest Rate Derivatives:

Each interest rate derivative shall be allocated to the appropriate maturity range of the following maturity bases ladder:

1) Maturity Ranges:

    1. 0-2 years
    2. 2-7 years
    3. 7-15 years
    4. > 15 years

2) The long and short equivalent underlying asset positions shall be netted within each maturity range. The amount of the former which is netted with the latter is the netted amount for that maturity range.

3) Starting with the shortest maturity range, the netted amounts between two adjoining maturity ranges shall be calculated by netting the amount of the remaining unnetted long (or short) position in the maturity range (i) with the amount of the remaining unnetted short (long) position in the maturity range (i+1).

4) Starting with the shortest maturity range, the netted amounts between two remote maturity ranges separated by another one shall be calculated by netting the amount of the remaining unnetted long (or short) position in the maturity range (i) with the amount of the remaining unnetted short (long) position in the maturity range (i + 2).

5) The netted amount shall be calculated between the remaining unnetted long and short positions of the two most remote maturity ranges.

6) The AIF shall calculate its exposures as the sum of absolute values:

    - 0% of the netted amount for each maturity range;
    - 40% of the netted amounts between two adjoining maturity ranges (i) and (i+1);
    - 75% of the netted amounts between two remote maturity ranges separated by another one, meaning maturity ranges (i) and (i+2);

- 100% of the netted amounts between the two most remote maturity ranges; and
- 100% of the remaining unnetted positions.

Exhibit A

Black-Scholes Formula

Call option (C) and put option (P) prices are calculated using the following formulas:

$$C = S_0\, e^{-qt} * N(d_1) - X\, e^{-rt} * N(d_2)$$
$$P = X\, e^{-rt} * N(-d_2) - S_0\, e^{-qt} * N(-d_1)$$

where N(x) is the standard normal cumulative distribution function.

The formulas for d1 and d2 are:

$$d_1 = \frac{ln(\frac{S_0}{X}) + t\,(r - q + \frac{\sigma^2}{2})}{\sigma\sqrt{t}} \qquad d_2 = d_1 - \sigma\sqrt{t}$$

S_0 = underlying price (INR per share)
X = strike price (INR per share)
σ = volatility (% p.a.)
r = continuously compounded risk-free interest rate (% p.a.)
q = continuously compounded dividend yield (% p.a.)
t = time to expiration (% of year)

Chapter - VII

Recommendations for Implementation by Regulatory Agencies

VII

Recommendations for Implementation by Regulatory Agencies

<table>
<tr><th>S. No.</th><th>Organization</th><th>Recommendation</th></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td>1.</td><td>SEBI</td><td>
Enhanced Disclosures by Alternative Investment Funds
The second AIPAC report recommends greater mandatory disclosure in private placement memoranda of the following areas by AIFs which raise capital from retail investors with ticket sizes of less than Rs 10 crores per investor:

Organization of the AIF and its decision making process
Track record of returns in previous Funds
Investment strategy and investment objectives
Key Fund terms
Valuation, investee due diligence and documentation process
Process for the transfer of units to guide investors on how they can exit the fund during the life of the fund. This will contribute to the development of a secondary market for fund units.
How liquidity issues will be dealt with at the end of the fund’s life it has not been able to exit from all its investments.

Quarterly reports to investors shall include:

Summary Management discussion and analysis letter
Financial Package

Balance sheet
Period end schedule of investments
Statement of Operations
Statement of Cash flows
Partners’ capital account statement

The process for the transfer of units should be clearly stated in the placement memorandum to provide a mechanism for investors to transfer units before the end of a Fund’s life.
Certain disclosures should also be made on final closing which is necessary to provide added comfort to investors.
</td></tr>
</table>

2.	**SEBI**	**Superior Governance of AIFs** The report recommends AIFs to form a Governance Committee from the outset to address the following vital matters: (a) Conflicts of interest (b) Issues arising during the life of the fund (c) Issues arising at the end of life of the fund (d) Whether the overall functioning of the fund is consistent with the fiduciary responsibilities of the fund manager It is recommended that SEBI amend AIF regulations, 2012 to make the Governance Committee mandatory for funds which raise capital from retail investors with ticket size of less than Rs 10crores.
3.	**SEBI**	**AIF Returns Performance Data** It is recommended that a centralized body be created to report the performance metrics of funds on an aggregate basis (vintage year wise) by using the information obtained from the periodic reporting by AIFs to SEBI. This will enable performance of individual fund managers to be benchmarked relative to aggregate industry returns performance data. The report recommends enhancements in the periodic- monthly or quarterly- reporting by AIFs to SEBI such that individual fund performance data can be captured which, in turn, can be used to create industry benchmarks.
4.	**SEBI**	**Enable Permanent Capital Vehicles** There is an increasing need for vehicles that provide capital to the mid-corporate and micro, small, medium enterprises segment. MSMEs are the engine of growth and employment generation in the country. They contribute to 40% to India's manufacturing output and materially to the labor force. There is a gap of over Rs. 2.5 lakh crore of debt capital for MSMEs. Bank lending to MSMEs has been declining over time with no sig of trend reversal. Traditional capital markets options are also not a viab solution for MSMEs leading to a large identified gap and need for de capital. Accordingly, it has been recommended that SEBI consider enunciating a regulatory framework for Mid-Markets Permanent Capital Vehicles under Category II AIFs in light of the special characteristics of such vehicles.
5.	**SEBI**	**Proposed Tax Regime for Mid-Market Permanent Capital Vehicles**

		In order to make MMPCVs beneficial both for investors and MSMEs, it is important to ensure it is beneficial from a taxation perspective. The following is the recommended regime: <u>Pass-through:</u> MMPCVs should be eligible for pass-through status. Income should be taxable in the hands of investors and deemed to be of the same nature and proportion as in the MMPCV's hands. Given the fact that MMPCVs are targeted to invest in MSMEs and could avail leverage, they should be granted complete pass through irrespective of characterization of such income. **Scenario I: MMPCV is an unlisted vehicle** <u>Withholding Tax:</u> It is recommended that payments to resident investors by MMPCVs should be subject to withholding at the rate of 10 (ten) percent. Payments to non-resident investors by MMPCVs should be subject to withholding at the prevailing rate in effect at the time of such investment. No withholding of tax should apply in respect of income which is not chargeable to tax under the provisions of Income Tax Act. There should be no withholding of tax on payment made by investee companies to MMPCVs. **Scenario II: MMPCV is a listed vehicle** Distribution Tax: MMPCVs shall pay distribution tax on the surplus distributed to the investors at the rate of 15 (fifteen) per cent. This is on the basis that there is expected to be a significant interest in this product from non-resident investors, who are otherwise entitled to a benevolent tax rate of 5% on interest income through other investment avenues. There should be no further tax in hands of the investors on the distribution received from MMPCV.
6.	**SEBI**	**Promote Angel Investments by Angel Funds** The success of angel funds requires flexibility in their operations and their ability to raise funds, to diversify their portfolios by investing in start-ups at various stages, by diversifying geographically and not being artificially restricted in designing their exit strategies. Accordingly it is recommended that SEBI consider measures to: i. Lower the holding period of angel investments to 1 year from the current 3 year requirement; ii. Extend the period for investing a minimum of Rs 25 lakhs p investor to the life of the fund or at least 5 years from the current year requirement. iii. Lower the minimum investment in a portfolio company to Rs 25 lakhs

		from the current minimum of Rs. 50 lakhs. iv. Allow angel funds to have a maximum of 200 members. v. Allow at least 10% of the angel fund's portfolio investments to be companies that may have been incorporated more than 3 years prior to the investment. vi. Allow Angel funds to invest in overseas venture fund undertakings the same percentage of their corpus as permitted for Category I AIFs.
7.	**SEBI**	**Category III AIFs** It is recommended that Category III AIFs be permitted to: I. Anchor participation in certain Initial Public Offerings (IPOs); II. Invest in foreign securities, with an Indian connection, within limits set by RBI and by SEBI for venture capital funds; III. Compute 'investible funds' by reference to market values. IV. Determine leverage as per the formulae and methods used by AIFMD.
8.	**CBDT** – *Income Tax* **CBEC** – *Service Tax*	**Tax Reforms of AIFs** 1. Certainty on treatment for taxation of gains on sale of unlisted shares as capital gains 2. Proportionate service tax exemption for AIF expenses 3. Pass through tax status to extend to Category III AIF 4. Making fund management safe harbour provisions effective **Other Issues** 1) Clarification on investments by AIF a) Pass through tax status to be extended to net losses incurred AIF level b) Exemption for AIFs from (a) Section 56(2)(viib) on issue of shar at a value higher than fair market value and (b) Section 56(2)(vi on purchase of shares at a value lower than fair market value c) Remove tax compliance of filing annual return for forei investors in AIF d) Allow management expenses for AIF investments as 'cost improvement' 2) Unit based taxation • Exempt listed AIF from tax on its income • Taxation is a combination of distribution tax on incon distributions and capital gains tax on unit redemptions/ transfer 3) No taxability on conversion of preference shares, inclusion of holdi period of preference shares (pre-conversion) in the holding period equity shares

		4) Speed up the process of issuing lower/ nil withholding certificate 5) Clarification on indirect transfer rules for multi-layered structure
9.	**CBDT** – *Income Tax*	**Category I & II AIFs: Proposed STT Rates**
10.	**CBDT** – *Income Tax* **CBEC** – *Service Tax*	**Category III AIFs: Proposed STT Rates**
11.	**PFRDA & IRDA**	**Promotion of Rupee Capital Flows from Domestic Institutional Investors** In mature capital markets, domestic institutional investors like pension funds and insurance companies underpin the development of AIFs because

Category I & II AIFs: Proposed STT Rates

Sl. No.	Taxable Securities Transaction	Rate	Payable by
1.	Purchase of a unit of an Investment Fund	0.25%	Purchaser
2.	Distribution of income representing long term capital gains, made to a unit holder by an Investment Fund on redemption or otherwise	0.25%	Unit holder
3.	Distribution of income other than long term capital gains, made by an Investment Fund on redemption or otherwise	1.00%	Unit holder
4.	Sale of a unit of an Investment Fund being a long term capital asset, to any person other than the Investment Fund in which such units are held	0.25%	Seller
5.	Sale of a unit of an Investment Fund being a short term capital asset, to any person other than the Investment Fund in which such units are held	1.00%	Seller

Category III AIFs: Proposed STT Rates

Sl. No.	AIFs Taxable Securities Transaction	Rate	Payable by
1.	Purchase of units of CAT III Investment Fund	0.05%	Purchaser
2.	Distribution representing long term capital gains as referred to in section 10 (38) of the Income-Tax Act, 1956, made by a CAT III Investment Fund on redemption or otherwise	Nil	-
3.	Distribution other than referred to in point 2 above, made by a CAT III Investment Fund on redemption or otherwise	0.25%	The unit holder
4.	Sale of units of a CAT III Investment Fund being a long term capital asset, to any person other than the CAT III investment Fund in which such units are held	0.05%	the Seller
5.	Sale of units of a CAT III Investment Fund being a short term capital asset, to any person other than the Investment Fund in which such units are held	0.25%	the Seller

		they are the ultimate natural source of stable, long term capital. It is to their credit that the Indian regulatory bodies, the Insurance Regulatory & Development Authority (IRDA) and the Pension Fund Regulatory and Development Authority (PFRDA), have issued circulars in 2013 and 2016, respectively, which enable allocations by pension funds and insurance companies to AIFs. This report recommends that the circulars be aligned with the SEBI regulations. It is recommended that both IRDA and PFRDA issue suitable clarification to the effect that Insurers and pension funds will have the permission to invest in Category II AIFs so long as such AIFs invest primarily in unlisted investee companies and in accordance with the AIF Regulations.
12.	**DEA and RBI**	**Draft Notification for Amendments in TISPRO Regulations, 2000** It is recommended that Explanation 1 of para 4 of the RBI notification issued on 16th November, 2015 (No. FEMA 355/2015-RB) amending the TISPRO Regulations, 2000, should be amended as follows: Explanation 1: For purposes of determining level of foreign ownership of the Sponsor or the manager or investment manager of an AIF referred to above, account should not be taken of the holdings of equity in an Indian promoter company of such Sponsor or the manager or investment manager which is held by foreign institutional investors or foreign portfolio investors or non-resident Indians under the portfolio investment scheme unless these shares are held by the foreign promoters of the applicant and their subsidiaries and nominees, and Indian mutual funds to the extent the investment of foreign institutional investors and Indian mutual funds are within the approved limits laid down by the Securities and Exchange Board of India under its rules, regulations or guidelines issued from time to time. In case the 'sponsors and 'managers/investment managers' of the AIF are individuals, for the treatment of downstream investment by such AIF as domestic, 'sponsors' and 'managers/investment managers' should be resident Indian citizens. While determining the foreign ownership in widely-held listed companies (or their direct or indirect subsidiaries) including a banking company as defined under the Banking Regulation Act, 1949, the stake held by Foreign Portfolio Investors (FPIs) should be excluded i.e. foreign ownership should be computed based on the composition of domestic investment and foreign investment made under the Foreign Direct Investment (FDI) route, only. A 'widely held' listed company should be considered to be one where no single foreign (non-FPI) shareholder along with his/its affiliates has a shareholding exceeding 10%.

		Explanation 2: The extent of foreign investment in the corpus of the Investment Vehicle will not be a factor to determine as to whether downstream investment of the Investment Vehicle concerned is foreign investment or not.

Abbreviations

AIF	*Alternative Investment Fund*
AI	*Accredited Investor*
AIFM	*Alternative Investment Fund Manager*
AIFMD	*Alternative Investment Fund Manager Directive*
AIPAC	*Alternative Investment Funds Policy Advisory Committee*
AUM	*Assets under Management*
CBDT	*Central Board of Direct Taxes*
CCD	*Compulsorily Convertible Debentures*
CCPS	*Compulsorily Convertible Preference Shares*
Crore	*1 Crore = 10 million = 100 Lakhs*
DDT	*Dividend Distribution Tax*
DTAA	*Double Tax Avoidance Agreement*
DII	*Domestic Institutional Investor*
EIF	*Eligible Investment Fund*
ETF	*Exchange Traded Fund*
ESOP	*Employee Stock Option Plan*
FA	*Finance Act*
FCNR	*Foreign Currency Non-Resident bank account*
FDI	*Foreign Direct Investments*
FEMA	*Foreign Exchange Management Act*
FMV	*Fair Market Value*
FOF	*Fund-of-Funds*
FPI	*Foreign Portfolio Investor*
FVCI	*Foreign Venture Capital Investor*
GDR	*Global Depository Receipt*
GP	*General Partner*
GST	*Goods & Services Tax*
HUF	*Hindu Undivided Family*
IAC	*Investor Advisory Committee*
IIT	*Infrastructure Investment Trust*
IT Act	*Income Tax Act, 1961*
IRDA	*Insurance Regulatory & Development Authority*
IRR	*Internal Rate of Return*
LACS	*One Lac = 100 Thousand*
LP	*Limited Partner*
LLP	*Limited Liability Partnership*
LTCG	*Long-term Capital Gains Tax*
MMPCV	*Mid-Market Permanent Capital Vehicle*
NR	*Non-resident*
NRI	*Non-resident Indian*
NRE	*Non-Resident External bank account*
NRO	*Non-Resident (Ordinary) bank Ac*
PE	*Private Equity*
PFRDA	*Pension Fund Regulatory Development Authority*
PIO	*Person of Indian Origin*
PLCC	*The ratio of contributions to date measured against committed capital*
PPM	*Private Placement Memorandum*
QIB	*Qualified Institutional Buyer*
QIP	*Qualified Institutional Placement*
RBI	*Reserve Bank of India*
REIT	*Real Estate Investment Trust*
RVPI	*Residual Value to Paid-In Capital*
SEBI	*Securities Exchange Board of India*
SEC	*Securities & Exchange Commission*
STCG	*Short-term Capital Gains Tax*
STT	*Securities Transaction Tax*
SVF	*Social Venture Funds*
TDS	*Tax Deducted at Source*
TISPRO	*Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations 2000*
TVPI	*Total Value to Paid-In Capital*
VC	*Venture Capital*
VCF	*Venture Capital Fund*