

October 9, 2014

To,

Shri U.K. Sinha

Chairman,
Securities and Exchange Board of India

Subject: Request for consideration of amendment of SEBI AIF Regulations, 2012

Dear Sir,

Following the discussions we had with Securities and Exchange Board of India (SEBI) on the categorization of private equity / venture capital funds (PE / VC) in SEBI Alternative Funds Regulations, 2012 (AIF Regulations), we are writing to suggest a minor amendment in the “Explanation” of Category II AIF, which will help in harmonizing it with the erstwhile Venture Capital Funds Regulations, 1996 (VCF Regulations).

Prior to the AIF Regulations, all private equity / venture capital funds were treated uniformly under VCF Regulations. As a result, all of these funds had tax pass-through status.

The AIF Regulations introduced a subjective distinction between venture capital and private equity funds (as shown below), and categorized venture capital funds under AIF Category I and private equity funds under AIF Category II.

Chapter I, 2, (1) (z)

“**venture capital fund**” means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model;

Chapter I, 2, (1) (r)

“**private equity fund**” means an Alternative Investment Fund which invests primarily in equity or equity linked instruments or partnership interests of investee companies according to the stated objective of the fund;

However, in practice, the actual difference between venture capital funds and private equity funds is marginal and subjective, such that venture capital funds and private equity funds both typically invest across stages of investments. In fact, it appears that SEBI also realizes that fact as the AIF Regulations provides flexibility to venture capital funds to invest in listed equities.

The AIF Regulations describe Category I AIFs as “socially or economically desirable”. This signalling by SEBI, combined with the fact that “venture capital funds” as described under

VCF Regulations were given tax pass-through status, may have led the Finance Act 2013 to provide tax pass-through benefit only to “venture capital funds” under Category I.

All types of private equity and venture capital funds, regardless of their stage of investment are critical to the economy. As SEBI recognizes, private equity brings in more primary capital into companies than the public markets. Thus, the “socially or economically desirable” aspect is adequately applicable to all private equity funds Category II AIFs as well, and should not be attributed to venture capital funds under Category I AIFs only.

Tax pass-through is critical for the industry mainly because different investors in private equity / venture capital funds have different tax status. A pass-through regime has the benefit that taxation applicable to specific investors continues to be applicable accurately as the tax assessment is done at the investor level not at the pooling vehicle level (private equity / venture capital funds). Thus, the complexity in the absence of tax pass-through significantly weighs against investment decisions in private equity / venture capital funds.

Of the 106 AIFs registered, 32 are Category I, 55 are Category II, and the balance 19 Category III. Of the 55 in Category II, about 29 are private equity funds, about 20 are real estate funds and 6 are debt funds. Effectively, of the total private equity / venture capital pool that got tax pass-through earlier, only about 2% of that capital pool gets the tax pass-through status (details in annexure).

The regulators and the government of India should be open to reinstate tax pass-through to private equity funds as tax pass-through (as under section 10 (23 FB) read with 115 U of the Income-tax Act, 1961 to AIFs) does not result into any tax leakage or revenue loss to exchequer and therefore, the same is not a concession. Further, AIFs can be asked to provide details of its income and beneficiaries and the beneficiaries of AIFs income are liable to pay tax on income received based on their tax status.

In view of the above considerations, as a first step towards re-instating tax pass-through status to Category II AIFs, we suggest a small amendment in the AIF Regulations in the “Explanation” of Category II to sharpen it further and bring out the positive spillover effects of private equity funds in Category II on the economy such that regulators or the Government of India might consider providing the Category II AIFs specific incentives and concessions including but not limited to tax pass-through.

An indicative suggested draft of the amendment is provided below.

Recommended Amendment Chapter II, 4(b)

“Category II Alternative Investment Fund” which does not fall in Category I and III and which does not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in these regulations;

Explanation.—For the purpose of this clause, Category II Alternative Investment Funds


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consists of private equity funds, real estate funds and debt funds. Private equity funds are generally perceived to have positive spillover effects on the economy and for which the Board or Government of India or other regulators in India might consider providing incentives or concessions shall be included. Such funds which are formed as trusts or companies shall be construed as “venture capital company” or “venture capital fund” as specified under sub-section (23FB) of Section 10 of the Income Tax Act, 1961.

The amendment in SEBI AIF Regulations 2012 is significant as it will signal to the regulators and the Government of India the importance of private equity as a source of capital to the economy that deserves incentives and concessions in line with those for venture capital funds.

We look forward to an expeditious favourable action towards supporting the development of the PE-VC industry in India, as the industry has not only provided capital but has contributed in improving the corporate governance, creating jobs and generating taxation revenues for exchequer through direct and indirect tax contributions by portfolio companies and AIF Fund managers.

Thank you.

Respectfully,



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Annexure 1 - Relevance of PE-VC investments in the Indian economic scenario and background on AIF Regulations

1. The PE-VC industry has rapidly evolved during the last 10 years. From an annual investment volume of less than USD 0.25 billion in 2001, the Indian PE-VC industry has grown significantly to annual investment volume of USD 8-10 billion across 300-350 investment deals, thereby reaching out to a vast majority of the Indian industry. The AIF Regulations have also provided a good framework for domestic capital to flow into the industry.
2. PE investments have been a part of India's emerging story for years, during which time we have seen a multitude of events shaping the investment climate in India. PE has been a significant source of long-term risk capital for the Indian industry, especially in the last decade. It is reported that PE funds (foreign and domestic) have invested a total of US\$ 71.13 billion¹ from 2006 to July 2013. The PE-VC industry has accounted for an estimated USD 93 billion of sticky, long term foreign capital flows into the country's economy during the last 13 years. The impact of the PE sector on economic development in India is amplified by the scarcity of capital available with the entrepreneurial class and the challenges in accessing the IPO route for raising capital.
3. As exemplified by the investment data, while PE funds have invested in start-up/ early stage investments, a significant portion of PE investments have been made in the expansion/ growth stage of Indian companies. This trend would be reflected both in investment by foreign funds and by domestic VCFs/ AIFs.
4. Further, the investments in the small and mid-size companies have also remarkably increased in last few years. A significant proportion of PE-VC capital has been invested in unlisted, SME companies which have very few avenues of raising equity capital from the markets. With the increase in the number of entrepreneurs looking to raise funds, angel and seed stage funding are also expected to increase in the coming years.
5. The domestic PE/VC sector in India is a relatively new means of raising capital for Indian entrepreneurs. SEBI issued the VCF Regulations in 1996. However, investment through this route only gained momentum in 2006. As per SEBI data, domestic VCFs have cumulatively invested INR 35,987 crores and foreign investors under the FVCI route have cumulatively invested INR 45,262 crores, as on 31 March 2014². A majority of these investments, consistent with the above statistics, would be expansion/ growth capital investments made by PE funds that have been raised under the VCF Regulations.

¹ Ernst & Young research

²Source: SEBI



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A sector-wise break-up of investments (in INR, crores) by VCFs and FVCIs from inception till 31 March 2014 is provided in table below-

Sectors of Economy	VCF/ FVCI
Information Technology	5,380
Telecommunication	7,642
Pharmaceuticals	1,039
Biotechnology	327
Media / Entertainment	1,271
Services Sector	3,867
Industrial Products	2,274
Real Estate	12,053
Others	36,201
Total	70,054

6. On the regulatory front, SEBI introduced a comprehensive legal framework in the form of AIF Regulations in May 2012 repealing the VCF Regulations and grandfathering funds that have already been raised under the VCF Regulations. AIF Regulations were introduced acknowledging the sector's demand to allow fund managers the flexibility to design fund products to cater to wider investor demand/ risk profiles, to provide targeted concessions to certain funds, as well as to bring within the ambit of regulation all types of domestic pooling vehicles. Due to possible coordination gaps between SEBI and CBDT and the transition from VCF Regulations to AIF Regulations not being effectively harmonized, at the time of promulgating AIF Regulations, the 'Pass through' status of erstwhile VCFs was not appropriately carried over to the AIF Regulations. The 'Pass through' status was limited only to one sub-type of the six identified fund-types under AIF regulations. The sub-type that has been given 'Pass through' status under AIF regulations is "Venture Capital Funds" under Category I (*the definition of "Venture Capital Funds" under AIF Regulations is limited only to early-stage funds, as against the generic wider definition of the same term under erstwhile VCF Regulations not restricted to early stage funds only*), and not to others i.e. AIFs registered as Category I (other than VCF), II and III were not granted a 'Pass through' status under the Act.
7. Under the AIF Regulations, domestic funds are required to register as AIFs under three broad categories depending on their investment strategy –
- Category I - Funds that invest in startup or early-stage ventures or social ventures or SMEs or infrastructure or other sectors or areas that the government or regulators consider as socially or economically desirable. This includes VCFs, SME funds, social venture funds and infrastructure funds.
 - Category II - Funds that do not fall in Category I and III AIF and that do not undertake leverage or borrowing other than to meet the permitted day-to-day operational requirement. This includes private equity and debt funds.

- Category III - Funds that employ diverse or complex trading strategies and may employ leverage, including through investment in listed or unlisted derivatives. This includes hedge funds.
8. With the AIF Regulations now making a clear distinction between VCFs and PE funds, fund managers raising capital primarily for growth capital investments are registering as Category II AIFs. Based on the data available from SEBI, under the AIF Regulations, 106 funds have been registered till 31 May 2014. Out of these AIFs, about 85% are non-Category I - VCFs (i.e. registered under other categories/ sub-categories). In the terms of value of the share of these AIFs, nearly 98% of the total capital commitments raised by these AIFs do not represent VCFs i.e. out of a total commitment of INR 13,465 crores, only INR 264 crores is from AIF category I - VCFs. Effectively, less than 2% of the PE-VC capital pool has been given the 'Pass through' status, as against the total 100% getting the status under the erstwhile VCF Regulations. A category wise break-up of commitments/ funds raised and investments made (in INR, crores), as on 31 March 2014 is provided in table below –

Category	Commitments raised	% of Total Commitments raised
Category I		
Infrastructure Fund	5,619.25	41.73%
Social Venture Fund	428.29	3.18%
Venture Capital Fund	264.09	1.96%
SME Fund	0	0.00%
Category I Total	6,311.63	46.87%
Category II Total	6,059.08	45.00%
Category III Total	1,094.63	8.13%
All Categories Grand Total	13,465.34	100.00%

Note : The above report is compiled on the basis of quarterly/monthly information submitted to SEBI by registered AIFs.

Annexure 2–Categories of AIFs under AIF Regulations, 2012

Chapter II, 4(a)
“Category I Alternative Investment Fund” which invests in start-up or early stage ventures



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or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and shall include venture capital funds, SME Funds, social venture funds, infrastructure funds and such other Alternative Investment Funds as may be specified;

Explanation.— For the purpose of this clause, Alternative Investment Funds which are generally perceived to have positive spillover effects on economy and for which the Board or Government of India or other regulators in India might consider providing incentives or concessions shall be included and such funds which are formed as trusts or companies shall be construed as —venture capital company□ or —venture capital fund□ as specified under sub-section (23FB) of Section 10 of the Income Tax Act, 1961.

Chapter II, 4(b)

“**Category II Alternative Investment Fund**” which does not fall in Category I and III and which does not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in these regulations;

Explanation.— For the purpose of this clause, Alternative Investment Funds such as private equity funds or debt funds for which no specific incentives or concessions are given by the government or any other Regulator shall be included.

Chapter II, 4(c)

“**Category III Alternative Investment Fund**” which employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.

Explanation.— For the purpose of this clause, Alternative Investment Funds such as hedge funds or funds which trade with a view to make short term returns or such other funds which are open ended and for which no specific incentives or concessions are given by the government or any other Regulator shall be included.