PRIVATE EQUITY (FUND FORMATION)

India

LEXOLOGY
Getting The Deal Through

Consulting editor
Simpson Thacher & Bartlett LLP

Private Equity (Fund Formation)

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Quick reference guide enabling side-by-side comparison of local insights, including into choice of vehicle and formation process; regulation, licensing and registration; taxation; selling and investor restrictions; money laundering rules; listing considerations; participation in private equity transactions; compensation and profit-sharing issues; and recent trends.

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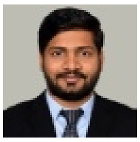

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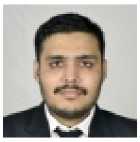

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FORMATION

Forms of vehicle

What legal form of vehicle is typically used for private equity funds formed in your jurisdiction? Does such a vehicle have a separate legal personality or existence under the law of your jurisdiction? In either case, what are the legal consequences for investors and the manager?

Private equity funds in India (known as alternative investment funds (AIFs)) can be set up in the form of a trust under the Indian Trusts Act 1882, a company under the Companies Act 2013 (the Companies Act) or a limited liability partnership (LLP) under the Limited Liability Partnership Act 2008 (the LLP Act). AIFs in India are most commonly set up as trusts due to various structural efficiencies, lesser statutory compliance requirements, ease of setup, ease of operation and tax efficiency. Under Indian law, a trust is not a separate legal personality. The trustee is the legal and beneficial owner of the trust and holds the property in trust for the benefit of investors who hold a beneficial interest in the trust. The structure of an AIF set up as a trust involves:

- a settlor who settles the trust with an initial settlement amount;
- a trustee who is appointed by the settlor and is the legal owner of the trust;
- a manager who is appointed by the trustee to manage the assets of the trust and make investments or divestments; and
- contributors who are the investors and make capital commitments to the trust.

A company and an LLP are considered as legal personalities, separate from its shareholders and partners, respectively.

In a trust construct, investors will be ‘contributors’; in an LLP they will be ‘partners’ and in a company, they will be ‘shareholders’. From a liability perspective, their obligations and liabilities will be limited to the extent of their capital commitments to the AIF.

The manager will be a separately appointed body pursuant to an agreement. The manager’s liability under the AIF Regulations will stay the same irrespective of the nature of the AIF vehicle.

Forming a private equity fund vehicle

What is the process for forming a private equity fund vehicle in your jurisdiction?

The process involves the following steps:

- identifying all the key stakeholders (ie, manager, sponsor, trustee (for trusts), merchant banker, etc);
- forming the fund vehicle;
- finalising the application form, private placement memorandum (PPM) of the first scheme of the AIF and the requisite documents and declarations; and
- filing the application with SEBI for registration of the vehicle as an AIF under the SEBI (Alternative Investment Funds) Regulations 2012 (the AIF Regulations).

Pursuant to a recent amendment to the AIF Regulations, the application to SEBI is to be filed by a SEBI-registered merchant banker who is appointed by the manager.

AIFs can seek registration as a Category I (under any one of the multiple sub-categories, eg, venture capital fund, angel fund, infrastructure fund, etc), Category II or Category III AIF, and the category must be specified while filing the application.

A comparison table on some of the key parameters for each legal form of fund vehicle is set out below.

Parameter	Nature of AIF		
Trust	LLP	Company	
Incorporati on process	Setup upon execution of the trust deed. Under the AIF regulations, the trust deed is required to be registered with the sub-registrar, which takes approximately five to seven working days. The legal or regulatory service provider may assist in the incorporation and registration of the trust deed.	Filing of the incorporation form and requisite documents online. The Registrar of Companies (ROC) issues the certificate of incorporation once the form is approved. The legal or regulatory service provider may assist in incorporation.	Filing of the memorandum of association (MOA) and articles of association (AOA), the incorporation form and requisite documents online. ROC issues the certificate of incorporation once the form is approved. The legal or regulatory service provider may assist in incorporation.
Timeline for setup	Two to three days post finalising the trust deed.	Three to four weeks.	Three to four weeks.
Minimum c apitalisatio n	No.	No.	No.
Incorporati on charges (approxima te)	10,000 Indian rupees towards the initial settlement. 2,000 Indian rupees towards registration and stamp duty.	30,000 Indian rupees.	30,000 Indian rupees.

Key stakeholders	• Trustee; • settlor; • manager; and • sponsor.	• Minimum two individual designated partners (one resident); • manager; and • sponsor.	• Minimum two shareholders and two directors (one resident) • manager; and • sponsor.
AIF application fee	100,000 Indian rupees (for all categories of AIF).		
AIF registration fee	• Category I: 500,000 Indian rupees; • Category I Angel Fund: 200,000 Indian rupees; • Category II: 1 million Indian rupees; and • Category III: 1.5 million Indian rupees.		
Timeline for SEBI approval	Three to four months from the date of application filing.		

Service providers and charges (approximate)	• Trustee (only for trust): One-time fee: 100,000 to 300,000 Indian rupees; annual management fee: 100,000 to 300,000 Indian rupees; • ongoing compliances (per annum): Company: 100,000 to 150,000 Indian rupees; LLP: 50,000 to 60,000 Indian rupees; • merchant banker: PPM review and filing of application: 300,000 to 500,000 Indian rupees; ongoing engagement: 50,000 to 200,000 Indian rupees; and • auditor or legal professional (towards annual audit of PPM): 300,000 to 500,000 Indian rupees annually. Additionally, the following service

providers are required (charges for these differ considerably depending on the service provider):

- valuer (Category I and II AIFs have to conduct valuation bi-annually. Category III AIFs must conduct monthly valuations);
- auditor; and
- custodian (Category I and II AIFs shall appoint a custodian if their corpus exceeds 5 billion Indian rupees. Category III AIFs shall appoint a custodian irrespective of their corpus).

Requirements

Is a private equity fund vehicle formed in your jurisdiction required to maintain locally a custodian or administrator, a registered office, books and records, or a corporate secretary, and how is that requirement typically satisfied?

There is no mandatory requirement of appointing a fund administrator. The manager of the AIF is responsible for managing the day-to-day activities of the AIF. While SEBI does not permit AIFs to outsource their core business activities (like investment-related activities of the AIF) and compliance functions, non-core activities can be outsourced. There are various administrator firms and third-party service providers in India who can provide these non-core services. Further, the manager needs to appoint a compliance officer for the AIF (typically an employee or director of the manager) to monitor compliances and notify SEBI of any lapses. Additionally, Category I and II AIFs have to appoint a custodian if their corpus exceeds 5 billion Indian rupees. Category III AIFs have to appoint a custodian irrespective of their corpus.

The AIF is required to maintain a registered office in India. This may typically be the registered office of the manager or the trustee (in the case of a trust).

Further, AIFs set up as an LLP or company are required to statutorily maintain certain books and records and comply with other statutory requirements such as making regular filings with the ROC. These may be done by the manager or the AIF's employees or may be outsourced to a compliance service provider. There are no statutory compliances for AIFs set up as trusts. Additionally, the AIF Regulations prescribe reporting and compliance requirements for AIFs.

Access to information

What access to information about a private equity fund formed in your jurisdiction is the public granted by law? How is it accessed? If applicable, what are the consequences of failing to make such information available?

The registration details and registered address of an AIF are publicly available on SEBI's website. Information regarding the commercials of the AIF, identities of its investors and their capital commitments is not disclosed by SEBI on any public platform.

Further, the trust deed is a public document and may be accessible through the registrar's office. However, the trust deed typically does not contain any commercial details or names of the investors and is only a broad and overarching document. Most commercial details are contained in the contribution agreement, PPM and investment management agreement, which are not available on any public platform.

For AIFs set up as an LLP or company, the investors will be partners or shareholders respectively. The details of the same (including the LLP Agreement and MOA or AOA of the company) is publicly available only on the website of the Ministry of Corporate Affairs pursuant to payment of a small fee.

Limited liability for third-party investors

In what circumstances would the limited liability of third-party investors in a private equity fund formed in your jurisdiction not be respected as a matter of local law?

A shareholder's liability under the Companies Act is limited to the amount unpaid to the company with respect to the shares held by it. Similarly, a partner's liability under the LLP Act is limited to the amount that the partner has agreed to contribute to the LLP. A shareholder or partner may be held liable if the courts lift the corporate veil, which is usually done in limited circumstances such as any unauthorised acts, fraud or negligence. While courts may lift the 'corporate veil', but considering the limited role played by the investor and that the control is being exercised by the manager, the risk of this is fairly low from a third-party investor standpoint. In the case of trusts, the liability of each contributor is specified in the trust deed and the courts will typically respect that.

Fund manager's fiduciary duties

What are the fiduciary duties owed to a private equity fund formed in your jurisdiction and its third-party investors by that fund's manager (or other similar control party or fiduciary) under the laws of your jurisdiction, and to what extent can those fiduciary duties be modified by agreement of the parties?

The manager and sponsor are obligated to act in a fiduciary capacity towards the investors of the AIF, disclose all conflicts of interest to investors as and when they arise and establish and implement written policies and procedures to identify, monitor and mitigate conflicts of interest. The manager is required to ensure transparency and periodically disclose information to investors.

Additionally, the manager is obliged under the AIF Regulations to:

- address all investor complaints;
- provide all information sought by SEBI;
- maintain all records specified by SEBI;
- take all steps to address conflicts of interest; and
- ensure transparency and make disclosures as required in the AIF Regulations.

Further, SEBI has recently introduced a code of conduct that AIFs, their managers and their key management personnel, trustee, trustee company and its directors, designated partners, directors of the AIF or members of the investment committee are required to adopt and abide by. Under the code of conduct applicable to managers of AIFs, the manager shall, inter alia, act in fiduciary capacity ensuring the decisions are taken in the interest of investors, maintain integrity, highest ethical and professional standards in all its dealings, ensure proper care and exercise due diligence and independent professional judgment in all its decisions, etc.

These fiduciary duties of the manager are set out in the AIF Regulations and therefore these cannot be modified by any agreement between parties.

Gross negligence

Does your jurisdiction recognise a 'gross negligence' (as opposed to 'ordinary negligence') standard of liability applicable to the management of a private equity fund?

Typically, the fund documents restrict the manager's liability to certain acts such as fraud, gross negligence and wilful misconduct, etc. The jurisprudence on 'negligence' suggests that Indian courts view negligence from a civil liability perspective for which a standard of care has been prescribed, whereas 'gross negligence' may be viewed in the context of criminal negligence imputing criminal liability, and not from the perspective of imputing any civil liability, and in such cases, courts will also assess whether there was any mala fide act involved or existence of moral turpitude.

Having said that, the AIF Regulations have mentioned the term 'gross negligence' in the code of conduct applicable to members of the investment committee, trustee, trustee company, directors of the trustee company, directors or designated partners of the AIF, where the aforesaid members shall not indulge in any unethical practice or professional misconduct or any act, whether by omission or commission, which is tantamount to gross negligence or fraud.

Other special issues or requirements

Are there any other special issues or requirements particular to private equity fund vehicles formed in your jurisdiction? Is conversion or redomiciling to vehicles in your jurisdiction permitted? If so, in converting or redomiciling limited partnerships formed in other jurisdictions into limited partnerships in your jurisdiction, what are the most material terms that typically must be modified?

AIFs can raise funds only on a private placement basis by issuing a private placement memorandum (PPM) to investors. The PPM must be in the template PPM format issued by SEBI in 2020 (not applicable to angel funds and schemes of AIFs in which each investor commits 700 million Indian rupees and provides a waiver from such compliance) and must contain all material information that would assist the investors to make an informed decision about making an investment in the AIF. The template PPM mandates disclosures in relation to commercial terms like transfers, investor governance rights, expenses charged to investors, removal of the manager and investor giveback, etc; however, SEBI does not impose any restrictions in relation to these terms, provided they comply with the AIF Regulations.

There are no restrictions on transfers under the AIF Regulations; however, each investor must hold the minimum regulatory investment specified in the AIF Regulations. Further, Category I and II AIFs are close-ended, therefore, no withdrawals are possible. Redemptions are permitted only in the case of open-ended Category III AIFs.

Further, any material changes to the AIF documents including changes to the fee structure or hurdle rate, etc, which may result in higher fees being charged to investors has to be approved by at least 75 per cent of investors and dissenting investors have to be given an exit option.

Additionally, the AIF Regulations limit the maximum number of investors in a scheme of an AIF to 1,000 except schemes of angel funds, which cannot have more than 200 angel investors. Further, the Companies Act shall apply to AIFs set up as companies, therefore, they will have to adhere to the private placement norms set out in the Companies Act, including the compliance requirements specified therein.

Further, conversion or redomiciling to vehicles in India is not envisaged under the AIF Regulations.

Fund sponsor bankruptcy or change of control

With respect to institutional sponsors of private equity funds organised in your jurisdiction, what are some of the primary legal and regulatory consequences and other key issues for the private equity fund and its general partner and investment adviser arising out of a bankruptcy, insolvency, change of control, restructuring or similar transaction of the private equity fund's sponsor?

The consequences of a bankruptcy, insolvency, restructuring or a similar transaction of the manager or sponsor are typically governed by the fund documents of the AIF and subject to negotiations between the fund and the investors. However, usually, a bankruptcy or insolvency of the manager or sponsor results in an automatic removal of the manager or sponsor. Further, according to the AIF Regulations, a change of control of the manager or sponsor requires prior approval of SEBI. In addition, SEBI has stated that a change in sponsor or manager (not including an internal restructuring within the group) or change in control of the manager or sponsor is a material change that can significantly influence the decision of an investor to continue to remain invested in the AIF. Therefore, in such circumstances, the manager is required to conduct a vote of the investors and in the event that it receives less than 75 per cent vote of investors, it is required to give the dissenting investors an exit option.

REGULATION, LICENSING AND REGISTRATION

Principal regulatory bodies

What are the principal regulatory bodies that would have authority over a private equity fund and its manager in your jurisdiction, and what are the regulators' audit and inspection rights and managers' regulatory reporting requirements to investors or regulators?

The principal regulatory body that regulates alternative investment funds (AIFs) in India is SEBI, with which AIFs are required to register before they can accept commitments from investors and commence operations as AIFs. SEBI is the securities market regulator of India and is established under the SEBI Act 1992. The manager does not need to be separately registered with SEBI for being eligible to act as the manager of an AIF; however, it is regulated by SEBI under the SEBI (Alternative Investment Funds) Regulations 2012 (the AIF Regulations).

SEBI is empowered under the SEBI Act 1992 and the AIF Regulations to undertake inspection of books of accounts, records and documents related to AIFs for reasons including, but not limited to, ensuring that these are maintained in the manner set out in the AIF Regulations, inspecting complaints received from investors, clients that have a bearing on the activities of the AIF and ensuring compliance with the AIF Regulations, etc. Further, SEBI has the power to conduct searches and seizures, impose penalties and issue orders against the AIF and its manager.

Additionally, AIFs and their managers set up as limited liability partnerships and companies are also regulated by the Registrar of Companies under their respective legislation.

Reporting requirements

All categories of AIFs have to submit reports to SEBI on a quarterly basis in the prescribed format. In addition, Category III AIFs have to submit a report on leverage undertaken on a quarterly basis.

Category I and II AIFs have to provide reports about the financial information of investee companies and details of material risks to investors annually within 180 days from the year-end. Category III AIFs are required to provide this information on a quarterly basis within 60 days from the end of the quarter. Further, Category I and II AIFs have to undertake the valuation of their investments bi-annually. Category III AIFs have to calculate the net asset value and disclose to investors on a quarterly basis for close-ended AIFs and a monthly basis for open-ended AIFs.

The manager and sponsor are required to make periodic disclosures to the investors from a transparency and governance perspective such as conflicts of interest, fees ascribed to the manager or sponsor, etc. Further, any changes to the key management personnel of the AIF and manager have to be intimated to SEBI and the investors. Additionally, any changes to the private placement memorandum (PPM) and other fund documents of the AIF have to be intimated to SEBI and investors on a consolidated basis within one month from the end of each financial year.

The manager is also required to prepare a compliance test report (CTR) at the end of each financial year and submit the same to the trustee of the AIF and any violation of the AIF Regulations observed in the CTR needs to be reported to SEBI.

In a recent development, to ensure compliance with the terms of PPM, all AIFs (unless they are exempt under the AIF Regulations) are mandated to carry out an annual audit of such compliance. The manager has to report the findings of the audit, along with corrective steps, if any, to SEBI and the trustee, board of directors or designated partners of the AIF.

Governmental requirements

What are the governmental approval, licensing or registration requirements applicable to a private equity fund in your jurisdiction? Does it make a difference whether there are significant investment activities in your jurisdiction?

All pooling vehicles set up for the purposes of making investments are required to make an application and register with SEBI as AIFs prior to accepting commitments from investors and commencing operations as AIFs, unless there are specific carve-outs provided under the SEBI regulations.

Registration of investment adviser

Is a private equity fund's manager, or any of its officers, directors or control persons, required to register as an investment adviser in your jurisdiction?

While there is no requirement for the AIF manager or its officers, directors or key personnel to register as investment advisers in India, the manager will have to register as a co-investment portfolio manager with SEBI under the SEBI (Portfolio Managers) Regulations 2020 if it is offering co-investment opportunities to the AIF's investors.

Fund manager requirements

Are there any specific qualifications or other requirements imposed on a private equity fund's manager, or any of its officers, directors or control persons, in your jurisdiction?

Every AIF is required to have a manager and sponsor (which could be the same entity as the manager). The manager needs to be located in India and needs to have the necessary infrastructure and manpower to carry out the activities of the manager of an AIF. Further, the manager and sponsor of the AIF are expected to satisfy the 'fit and proper person' criteria set out in the SEBI (Intermediaries) Regulations 2008 and submit a declaration to that effect to SEBI.

Further, the manager or sponsor are mandated by the AIF Regulations to maintain a continuing interest in the AIF at all times as 'skin in the game'. The continuing interest to be maintained is the lower of 2.5 per cent of the corpus or 50 million Indian rupees for a Category I and II AIF and the lower of 5 per cent of the corpus or 100 million Indian rupees for a Category III AIF.

Additionally, the key investment team of the AIF manager needs to have:

- at least one key personnel with a professional qualification in finance, accountancy, business management, commerce, economics, capital markets or banking from an institution recognised by the government or a foreign university or a Chartered Financial Analyst (CFA) charter from the CFA Institute; and
- at least five years' experience in advising or managing pools of capital or in fund, asset, wealth or portfolio management or in the business of buying, selling and dealing of securities or other financial assets.

The requirements under both points above can be fulfilled by the same person or by two separate individuals.

Political contributions

Describe any rules – or policies of public pension plans or other governmental entities – in your jurisdiction that restrict, or require disclosure of, political contributions by a private equity fund's manager or investment adviser or their employees.

There are no specific rules that restrict or require disclosure of political contributions by an AIF's manager or investment adviser or their employees in India.

Use of intermediaries and lobbyist registration

Describe any rules – or policies of public pension plans or other governmental entities – in your jurisdiction that restrict, or require disclosure by a private equity fund's manager or investment adviser of, the engagement of placement agents, lobbyists or other intermediaries in the marketing of the fund to public pension plans and other governmental entities. Describe any rules that require a fund's investment adviser or its employees and agents to register as lobbyists in the marketing of the fund to public pension plans and governmental entities.

There are no specific rules of public pension plans or other governmental entities in India restricting or requiring disclosure of engagement of placements agents or other intermediaries by an AIF's manager while marketing the AIF to public pension plans and other governmental entities. However, if the AIF is going to bear any expenses in relation to placement agents or distributors, the same needs to be disclosed in the PPM.

Bank participation

Describe any legal or regulatory developments emerging from the recent global financial crisis that specifically affect banks with respect to investing in or sponsoring private equity funds.

The Reserve Bank of India (RBI) has imposed restrictions on the ability of Indian banks to make investments in AIFs. Banks in India are not permitted to invest more than 10 per cent of the paid-up capital or unit capital of a Category I or Category II AIF without RBI approval. Higher investment would require prior approval from RBI. However, there is an overall cap of 20 per cent of their net worth that is permitted for direct investments in shares, convertible bonds or debentures, units of equity-oriented mutual funds and exposures to AIFs. Further, banks are not permitted to invest in Category III AIFs. However, subsidiaries of banks can invest in Category III AIFs up to the regulatory minima prescribed by SEBI.

TAXATION

Tax obligations

Would a private equity fund vehicle formed in your jurisdiction be subject to taxation there with respect to its income or gains? Would the fund be required to withhold taxes with respect to distributions to investors? Describe what conditions, if any, apply to a private equity fund to qualify for applicable tax exemptions.

Indian tax law provides for a special tax regime with respect to Category I and Category II alternative investment funds

(AIFs). Any income other than profits and gains from business or profession is exempt from tax in the hands of Category I and Category II AIF but taxed in the hands of investors of Category I and Category II AIF on a pass-through basis, as if such investments were directly made by the investors.

However, the income in the nature of profits and gains from business or profession is taxed in the hands of Category I and Category II AIF and exempt from tax in the hands of investors.

There are comprehensive withholding tax provisions applicable with respect to certain specified payments to Indian tax residents and on all payments to non-residents. As per the specific provisions, income (other than profits and gains from business and profession) receivable by a Category I and II AIF is exempt from withholding of tax by the payor. On the distribution of income (other than profits and gains from business or profession) by Category I and II AIF to the investors, Category I and II AIF is required to withhold tax at 10 per cent in the case of Indian resident investors and at the rates in force for the non-resident investors.

In the case of a Category III AIF, the tax implications would differ depending on whether such AIF is in the form of a company or limited liability partnership (LLP) or a trust. In the case of a company, the income arising on investments will be taxed at the applicable corporate tax rate and subsequent distribution of profits as a dividend will be taxed in the hands of the shareholder (investors). The company would be required to withhold applicable taxes prior to the distribution of dividends. An LLP will be taxed on entire income at the applicable rate and any distribution to the partners (as a share of profit) is exempt from tax in the hands of LLP as well as the partners.

However, Category III AIF is typically set up in the form of a trust with a share of each investor being defined under the investment documents. The income earned by a determinate trust could be taxed either in the hands of the trustee as a representative assessee of the investors or in the hands of the investors directly. Where the trustee is assessed as representative assessee of the investor, it should be taxed in the same manner as if the income was taxed directly in the hands of investors. There is though one exception to this principle: if the income includes profits and gains from business or profession, the entire income in respect of which the trustee is liable as representative assessee of the investor could be taxed at maximum marginal rate.

Local taxation of non-resident investors

Would non-resident investors in a private equity fund be subject to taxation or return-filing requirements in your jurisdiction?

Yes, in the case of investment in a Category I or II AIF, income (other than profits and gains from business or profession) attributable to non-resident investors will be taxed directly in their hands. The tax rate would vary depending on the nature of income ie capital gains, dividend or interest income and eligibility to tax treaty benefit, if any. Further, all the non-resident investors earning income from India need to file their annual income tax returns in India.

For non-resident investors in Category III AIF being a trust, an income tax return is to be filed in India unless the trustee pays tax as representative assessee.

If the Category III AIF is a company and the non-resident investors have only earned dividend income from India, the income tax return is to be filed in India unless the tax on such dividend is withheld as per the rates provided under Indian tax law. However, if the Category III AIF is an LLP and investors has only received a share of profit, investors should not be required to file their tax return in India.

Local tax authority ruling

Is it necessary or desirable to obtain a ruling from local tax authorities with respect to the tax treatment of a private equity fund vehicle formed in your jurisdiction? Are there any special tax rules relating to investors that are residents of your jurisdiction?

At the outset, there is an option available for the taxpayers to approach the Board of Advance Ruling to determine the tax treatment of any particular transaction. However, it is not necessary for a private equity fund in India to obtain a ruling from the local tax authorities. Further, it is not generally desired as there is clarity on the tax treatment of income earned by a private equity fund and the process is time-consuming,

On the question of tax rules for Indian tax resident investors, such investors are liable to tax on their global income in India. In terms of differentiation, distribution by a Category I and II AIF to Indian resident investors is subject to withholding of tax at 10 per cent (in all cases) as against non-resident investors (for whom the applicable rate is to be applied).

Organisational taxes

Must any significant organisational taxes be paid with respect to private equity funds organised in your jurisdiction?

From an income tax perspective, Category I and II AIFs are subject to tax on the profits and gains from business or profession. Further, stamp duty will be payable on the setup of the fund vehicle as well as the issue of units by the AIF. While the stamp duty on the setup of a trust and LLP is insignificant, the stamp duty payable for the incorporation of a company would depend on the authorised share capital of the company. Additionally, the stamp duty payable on the issue of units will be 0.005 per cent of the value of the units (ie, stamp duty of 500 Indian rupees will be payable if units are issued for 10 million Indian rupees).

Special tax considerations

Describe briefly what special tax considerations, if any, apply with respect to a private equity fund’s sponsor.

Generally, the sponsor would subscribe to the units for minimum capital commitment. The return on such units will be taxed as if the sponsor is a regular investor.

Additionally, the sponsor may be entitled to received carried interest. The tax implication for carried interest would primarily depend on whether such carried interest is in the nature of a performance fee or incentive, in which case it could be treated as business income or ordinary income or a return on investment that is taxable as a capital gain.

With respect to the management fee, the Indian manager would be taxed in India at an ordinary rate.

Tax treaties

List any relevant tax treaties to which your jurisdiction is a party and how such treaties apply to the fund vehicle.

To date, India has tax treaties in place with more than 80 countries. As a principle, if a taxpayer is a non-resident in India and tax resident of a country with which India has a tax treaty, such taxpayer could be taxed as per the beneficial provisions under the applicable tax treaty. Therefore, if the non-resident investors in the fund are eligible for any tax treaty benefit, income attributable to such investor will be taxed in India as per those beneficial provisions. The eligibility to tax treaty benefit is a mixed question of law and fact and needs to be assessed appropriately.

Other significant tax issues

Are there any other significant tax issues relating to private equity funds organised in your jurisdiction?

Under Indian tax law, where any person acquires shares or securities at a price lower than its fair value computed as per tax rules, the difference between such fair value and actual purchase price, is taxed as ordinary income for the recipient. The units in AIF fall within the definition of securities and therefore, if the price paid by the investors for the purchase of units is lower than its fair value (open market value), the difference between such fair value and purchase price is taxable in the hands of investors.

SELLING RESTRICTIONS AND INVESTORS GENERALLY

Legal and regulatory restrictions

Describe the principal legal and regulatory restrictions on offers and sales of interests in private equity funds formed in your jurisdiction, including the type of investors to whom such funds (or private equity funds formed in other jurisdictions) may be offered without registration under applicable securities laws in your jurisdiction.

Alternative investment funds (AIFs) are permitted to solicit and raise capital commitments from investors only on a private placement basis by issuing a private placement memorandum. The units cannot be issued to the public at large. AIF as a product is meant for sophisticated and private investors who have the ability to commit a large quantum of capital to the AIF and are willing to accept the high risks involved in investments made by such vehicles. Each investor has to make a capital commitment of at least 10 million Indian rupees except angel investors investing in angel funds (2.5 million Indian rupees) and accredited investors and has to comply with know your customer (KYC) norms prescribed by SEBI and the AIF manager. Further, the maximum number of investors in a scheme of an AIF is restricted to 1,000 except schemes of angel funds, which cannot have more than 200 angel investors. Further, the Companies Act shall apply to AIFs set up as companies, therefore, they will have to adhere to the private placement norms set out in the Companies Act, including the compliance requirements specified therein.

Types of investor

Describe any restrictions on the types of investors that may participate in private equity funds formed in your jurisdiction (other than those imposed by applicable securities laws described above).

There are no restrictions on the types of investors that may invest in AIFs in India. Indian, foreign and non-resident investors are permitted to invest in AIFs. Investors in AIFs typically include institutional investors, high net worth individuals, banks, pension funds, insurance companies, family offices, sovereign wealth funds and fund of funds, etc. Banks, insurance companies and pension funds, etc, have to comply with restrictions imposed by their respective regulators in respect of their investments in AIFs. Each investor has to make a minimum capital commitment to the AIF.

In August 2021, SEBI introduced the concept of ‘accredited investor’ in the SEBI (Alternative Investment Funds)

Regulations 2012. An accredited investor is a person who is granted a certificate of accreditation by an accreditation agency and who satisfies certain prescribed financial parameters. Accredited investors are exempt from the minimum 10 million Indian rupees investment threshold that is applicable to other investors.

Such investors should satisfy the following criteria for being eligible to apply for accreditation:

- in the case of an individual, Hindu undivided family, family trust or sole proprietorship, has:
  - an annual income of at least 20 million Indian rupees; or
  - a net worth of at least 75 million Indian rupees, out of which not less than half is in the form of financial assets; or
  - an annual income of at least 10 million Indian rupees and a minimum net worth of 50 million Indian rupees, out of which not less than half is in the form of financial assets; and
- in the case of body corporate, has a net worth of at least 500 million Indian rupees;
- in the case of trust (other than a family trust), has a net worth of at least 500 million Indian rupees; and
- in the case of a partnership firm incorporated under the Indian Partnership Act 1932, each partner must independently meet the applicable eligibility criteria (detailed above) for accreditation.

Further, certain investors like the central government or state governments, developmental or fund entities set up by them, qualified institutional buyers under the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018, Category I foreign portfolio investors, sovereign wealth funds and multilateral agencies, and other entities notified by SEBI would be deemed to be accredited investors, with no requirement to obtain a certificate of accreditation.

Identity of investors

Does your jurisdiction require any ongoing filings with, or notifications to, regulators regarding the identity of investors in private equity funds (including by virtue of transfers of fund interests) or regarding the change in the composition of ownership, management or control of the fund or the manager?

Yes, the AIF manager is required to file the electronic copy of each investor's KYC records with the Central KYC Records Registry. In the case of the transfer of units, the incoming investor has to comply with the KYC norms required by SEBI. India's foreign exchange regulations require AIFs issuing units to persons resident outside India to file Form InVi within 30 days of issuing the units; however, the identity of the investor to whom the units are being issued does not need to be disclosed.

Further, AIFs are required to inform SEBI if there is any change in the sponsor, manager or designated partners of the AIF or if there is any other material change from the information provided to SEBI at the time of registration of the AIF. Additionally, a change in control of the AIF, manager or sponsor requires the prior approval of SEBI.

Licences and registrations

Does your jurisdiction require that the person offering interests in a private equity fund have any licences or registrations?

No, there is no requirement for distributors or placement agents that offer interests in AIFs to obtain any licenses or registrations for undertaking such activity in relation to an AIF.

Money laundering

Describe any money laundering rules or other regulations applicable in your jurisdiction requiring due diligence, record keeping or disclosure of the identities of (or other related information about) the investors in a private equity fund or the individual members of the sponsor.

The Prevention of Money Laundering Act 2002 (PMLA) read with the Prevention of Money-Laundering (Maintenance of Records) Rules 2005 (the PMLA Rules) is India's principal legislation dealing with the prevention of money laundering. Additionally, SEBI has, in October 2019, issued a master circular with guidelines on 'Anti-Money Laundering (AML) Standards and Combating the Financing of Terrorism or Obligations of Securities Markets intermediaries under PMLA and PMLA Rules' (the SEBI Master Circular).

According to the PMLA Rules and the SEBI Master Circular, reporting entities, including AIFs, are required to maintain records of cash transactions above the monetary threshold specified in the PMLA and suspicious transactions whether or not made in cash and including, inter alia, credits or debits into from any non-monetary account such as a demat or security account maintained by the AIF.

Further, AIFs must:

- appoint a 'principal officer' and 'designated director' and the principal officer is required to furnish information in accordance with the PMLA Rules to the director appointed under the PMLA by the central government; and
- adhere to client account opening procedures and maintain records of the aforesaid transactions. The records are to be maintained for a period of five years after the business relationship between the client and AIF has ended or the account has been closed, whichever is later.

The SEBI Master Circular mandates AIFs to adopt written AML procedures in respect of client due diligence (procedures for acceptance and identification of clients and monitoring transactions, etc), maintaining and storing records of clients and transactions in compliance with PMLA and PMLA Rules, reporting of suspicious transactions to the Director of the Financial Intelligence Unit – India.

Further, the manager of the AIF is required to register with the Central KYC Records Registry and file the electronic copy of the client´s KYC records with the Central KYC Records Registry.

EXCHANGE LISTING

Listing

Are private equity funds able to list on a securities exchange in your jurisdiction and, if so, is this customary? What are the principal initial and ongoing requirements for listing? What are the advantages and disadvantages of a listing?

Yes, close-ended alternative investment funds (AIFs) are permitted to list their units on a stock exchange. The units can be listed only after the final closing of the fund and the minimum tradable lot has been prescribed under the SEBI (Alternative Investment Funds) Regulations 2012 to be 10 million Indian rupees. However, to date, no AIF has listed its units on a stock exchange. While the stock exchanges have enabled and notified the listing process, the listing agreement for the AIF under the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 has not been notified.

Restriction on transfers of interest

To what extent can a listed fund restrict transfers of its interests?

While there are no specific regulations notified that govern the listing of AIFs, practically, an AIF whose units are listed cannot restrict transfers of its interests, subject to the minimum lot size.

PARTICIPATION IN PRIVATE EQUITY TRANSACTIONS

Legal and regulatory restrictions

Are funds formed in your jurisdiction subject to any legal or regulatory restrictions that affect their participation in private equity transactions or otherwise affect the structuring of private equity transactions completed inside or outside your jurisdiction?

Yes, all alternative investment funds (AIFs) have to comply with the diversification norms prescribed in the SEBI (Alternative Investment Funds) Regulations 2012 (the AIF Regulations). The following investment restrictions apply to all categories of AIFs:

- AIFs cannot invest more than 25 per cent of their investible funds (the corpus of the scheme of the AIF net of expenditure for administration and management of the AIF estimated for the tenure of the AIF) in equity or equity-linked instruments of companies incorporated outside India, subject to conditions or guidelines issued by the Reserve Bank of India;
- Category I and II AIFs cannot invest more than 25 per cent of their investible funds in an investee company directly or through investment in the units of other AIFs; however, for large value funds for accredited investors (schemes of AIFs in which each investor (other than the manager, sponsor, employees, directors of the AIF or manager) is an accredited investor and invests at least 700 million Indian rupees in the scheme. These funds are meant only for accredited investors, and, therefore, have been granted certain relaxations under the AIF Regulations), this limit is up to 50 per cent of the investible funds;
- Category III AIFs cannot invest more than 10 per cent of the net asset value (NAV) in listed equity of an investee company and cannot invest more than 10 per cent of the investible funds in unlisted securities of an investee company, directly or through investment in units of other AIFs; however, for large value funds for accredited investors, this limit is up to 20 per cent of the NAV or investible funds in listed equity and unlisted securities respectively. Any passive breach of the aforesaid investment limit in listed equities has to be rectified within 30 days of the breach;
- AIFs that are authorised under the fund documents to invest in units of AIFs cannot offer their units for subscription to other AIFs;
- AIFs cannot invest in (1) associates or (2) units of AIFs managed or sponsored by its manager, sponsor or associates of its manager or sponsor, without obtaining 75 per cent consent of investors by the value of their investment in the AIF;
- AIFs can invest in units of other AIFs without labelling themselves as a fund of funds.
- AIFs permitted to invest in other AIFs must ensure that they do not, directly or indirectly, invest more than 25 per cent in an investee entity (for Category I and II AIFs) and 10 per cent in an investee entity (for Category III AIFs).

In addition to the aforementioned, each category and sub-category of AIF is required to comply with the following restrictions applicable to them:

- Category I AIF: they can invest in investee companies, venture capital undertakings (VCU), special purpose vehicles (SPV), limited liability partnerships, units of Category I AIFs of the same sub-category or in units of Category II AIFs;
- Category I venture capital funds: at least 75 per cent of their investible funds should be invested in unlisted equity shares or equity-linked instruments of VCUs or in companies listed or proposed to be listed on a small and medium enterprise (SME) exchange or SME segment of an exchange;
- Category I SME funds: at least 75 per cent of their investible funds should be invested in unlisted securities or partnership interest of VCUs or investee companies that are SMEs or in companies listed or proposed to be listed on SME exchange or SME segment of an exchange, or in units of Category II AIF that invest primarily in such VCUs or investee companies;
- Category I social venture funds: at least 75 per cent of their investible funds should be invested in unlisted securities or partnership interest of social ventures;
- Category I infrastructure funds: at least 75 per cent of their investible funds should be invested in unlisted securities or units or partnership interest of VCUs or investee companies or SPVs, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects, or in units of Category II AIFs that invest primarily in such VCUs or investee companies or special purpose vehicles;
- Category II AIF: they shall invest primarily in unlisted companies directly or through investment in units of Category I or Category II AIFs; and
- Category III AIF: they may invest in securities of listed or unlisted investee companies, derivatives, units of other AIFs or complex or structured products.

Compensation and profit-sharing

Describe any legal or regulatory issues that would affect the structuring of the sponsor's compensation and profit-sharing arrangements with respect to the fund and, specifically, anything that could affect the sponsor's ability to take management fees, transaction fees and a carried interest (or other form of profit share) from the fund.

There are no restrictions in the AIF Regulations that affect the structuring of the manager's or sponsor's compensation and profit-sharing arrangements with respect to the AIF. However, SEBI requires disclosure of all fees and charges that may be levied on the fund or investors in the private placement memorandum of the AIF.

UPDATE AND TRENDS

Key developments of the past year

What are the most significant recent trends and developments relating to private equity funds in your jurisdiction? What impact do you expect such trends and developments will have on global private equity fundraising and on private equity funds generally?

The past year has seen multiple developments in the alternative investment fund (AIF) space in India. Two of the most important developments are set out below.

Introduction of the concept of 'accredited investors'

In August 2021, SEBI introduced the concept of 'accredited investors' in India, through which investors satisfying the prescribed criteria under the SEBI (Alternative Investment Funds) Regulations 2012 (the AIF Regulations) can be granted 'accredited investor' status and can avail certain relaxations under the AIF Regulations, including an exemption from investing the regulatory minimum of 10 million Indian rupees. Further, SEBI has introduced a concept of 'large value funds for accredited investors' that are funds in which each investor is an accredited investor who invests a minimum of 700 million Indian rupees. Such large value funds can avail of further relaxations under the AIF Regulations including relaxed diversification norms. Through these amendments, SEBI seems to have acknowledged that such class of investors, being sophisticated investors, understand the inherent risks involved with investing in such a product and have the appetite to undertake such risk. Such investors do not require substantial regulatory protection and have been given the freedom and flexibility to structure their investments in a manner they deem appropriate. Large value funds and the regulatory relaxations that accompany them are likely to be sought after by high and ultra-high net worth investors in India and globally who will have the ability to write bigger cheques and have flexibility in structuring investments.

Co-investment framework

In November 2021, SEBI, through amendments in the AIF Regulations and the SEBI (Portfolio Managers) Regulations 2020, introduced a framework to facilitate co-investments by investors of AIFs through the portfolio manager route. Under this framework, an AIF manager who intends to offer co-investment services will have to register itself as a co-investment portfolio manager. The amendments also set out certain investment conditions and terms of co-investments that will apply to any co-investments undertaken through this route. Given that this was a long-standing demand by the AIF industry for being able to undertake co-investments, we expect co-investments to be an integral part of an AIFs strategy going forward. Further, investors will also have the ability to make a larger quantum of investment in portfolio companies along with the AIF through this route.

LAW STATED DATE

Correct on

Give the date on which the information above is accurate.

21 January 2022

Jurisdictions

Australia	Ashurst LLP
Austria	Schindler Attorneys
British Virgin Islands	Appleby
Cayman Islands	Stuarts Walker Hersant Humphries
Germany	POELLATH
India	Khaitan & Co
Japan	Nishimura & Asahi
Luxembourg	Loyens & Loeff
South Korea	Bae, Kim & Lee LLC
Spain	Alter Legal
United Kingdom	Simpson Thacher & Bartlett LLP
USA	Simpson Thacher & Bartlett LLP