Investment Funds: India

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A Q&A guide to investment funds law in India.

This Q&A is part of the PLC multi-jurisdictional guide to investment funds. It provides a high level overview of investment funds in India, looking at both retail funds and hedge funds. Areas covered include a market overview, legislation and regulation, marketing, managers and operators, restrictions and requirements, tax and upcoming reform.

For a full list of recommended investment fund lawyers and law firms in India, see *PLC Which lawyer?*

To compare answers across multiple jurisdictions, visit the Investment Funds *Country Q&A tool*. For a full list of jurisdictional Q&As visit *www.practicallaw.com/investmentfunds-mjg*.

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Retail funds

1. What is the structure of the retail funds market? What have been the main trends over the last year?

Open-ended retail funds

The origin of the Indian retail fund industry can be traced back to 1964 when the Indian government, to increase small savings within the country and to channel these savings towards the capital markets, set up the Unit Trust of India (UTI) (a state body which for a long time remained the sole vehicle for retail investment in the capital market by Indian citizens).

In 1964, UTI launched its first open-ended equity scheme, Unit 64, which turned out to be one of the most popular mutual fund schemes in the country. In 1987, the government permitted other public sector banks and insurance companies to promote mutual fund schemes. Subsequently, in 1993, the Securities and Exchange Board of India (SEBI) introduced the SEBI (Mutual Funds) Regulations 1993, which paved the way for the entry of private sector players in the mutual fund industry.

Currently, in addition to domestic investors, the following are permitted to invest in mutual fund schemes:

- Foreign institutional investors (FII) registered with SEBI.
- Non-resident Indians.
- Certain qualified foreign investors.

As at 31 October 2011, the net assets of all mutual funds stood at INR6,866.44 billion from close to 1173 mutual fund schemes (open-ended and closed-ended) (as at 1 November 2011, US$1 was about INR49).

Closed-ended retail funds

See above, *Open-ended retail funds.*

Regulatory framework and bodies

2. What are the key statutes, regulations and rules that govern retail funds? Which regulatory bodies regulate retail funds?

Open-ended retail funds

Regulatory framework. SEBI is the regulatory authority (*see below, Regulatory bodies*). In the context of mutual funds it operates under the following statutes and regulations:

- The SEBI Act 1992, which permits SEBI to register and regulate the working of venture capital funds and collective investment schemes, including mutual funds.
- The SEBI (Mutual Funds) Regulations 1996, which regulates both open-ended and closed-ended mutual funds, including the asset management companies (AMCs) that manage mutual funds.

Regulatory bodies. SEBI is the primary market regulatory body in India and is responsible for investor protection, and the promotion, development and regulation of the Indian securities market.

Closed-ended retail funds

Regulatory framework. See above, *Open-ended retail funds: Regulatory framework*.

Regulatory bodies. See above, *Open-ended retail funds: Regulatory bodies*.

3. Do retail funds themselves have to be authorised or licensed?

Open-ended retail funds

Local funds. It is necessary to obtain SEBI's prior authorisation to set up a mutual fund in India. The sponsor of the fund must provide information to SEBI under the specific form (Form A), along with the necessary application fees.

Once registered, a mutual fund can launch schemes. To launch a scheme, it must submit the following information to SEBI:

- The approval of the fund's trustee for the launch of the scheme.
- A copy of the offering document which will be filed with SEBI.
- The filing fee.

SEBI will then review the application. SEBI may require, in the interest of investors, the AMC to carry out whatever modifications in the offering documents that SEBI deems fit. If SEBI does not suggest modifications within 21 working days from the date of filing, the AMC can issue the offering document to the public. The offering document must be updated once a year, and a copy of the changes filed with SEBI within seven days of the change.

All schemes and individual plan(s) under the schemes must comply with the following requirements:

- A minimum of 20 investors.
- No single investor with more than 25% of the whole of the scheme or plan.

If these requirements are not fulfilled within three months, the scheme or plan must be wound up.

Finally, under an existing scheme, a mutual fund can also launch different plans of different maturity periods.

Non-Indian funds. It is difficult and uncommon for a fund organised outside India to register as a mutual fund with SEBI. A mutual fund must be constituted under the Indian Trusts Act 1882 and registered under the Indian Registration Act 1908.

SEBI does not prohibit foreign funds from offering interests in India. However, for foreign funds that are corporate bodies, under Indian corporate law any company or other corporate body that offers its securities to the Indian public at large must file a prospectus with prescribed content with the Registrar of Companies.

Closed-ended retail funds

The same rules apply as for open-ended retail funds (*see above, Open-ended retail funds*). Closed-ended funds, however, cannot take advantage of the three-month period to comply with the minimum investor requirement, and must comply at the close of the offering period.

Marketing

4. Who can market retail funds?

Open-ended retail funds

Mutual funds are not permitted to deal with any intermediary to sell or market mutual fund units, unless the intermediary has passed the certification examination conducted by the Association of Mutual Funds in India (AMFI). Intermediaries include, among others, distributors, agents, brokers, and sub-brokers, and can be individuals or organisations.

Intermediaries who have obtained an AMFI certificate do not require any additional registration with SEBI to sell or market mutual fund units.

Closed-ended retail funds

See above, *Open-ended retail funds.*

5. To whom can retail funds be marketed?

Open-ended retail funds

Mutual funds can offer and sell their units to any investor. However, mutual funds may choose to restrict sales to certain investors, to comply with or avoid the application of certain anti-money laundering laws. Foreign corporate bodies that offer their securities to the public at large must comply with prospectus requirements (*see Question 3, Open-ended retail funds: Non-Indian funds*).

Closed-ended retail funds

See above, *Open-ended retail funds.*

Managers and operators

6. What are the key requirements that apply to managers or operators of retail funds?

Open-ended retail funds

The sponsor or the trustees of the mutual fund must appoint an AMC to manage the assets of the mutual fund. The AMC must satisfy certain eligibility criteria to register with SEBI, including that the (*SEBI (Mutual Funds) Regulations 1996*):

- Sponsor of the fund must have at least a 40% stake in the AMC.
- Directors of the AMC must be persons:
  - with adequate professional experience in finance and financial services related fields;
  - that have not been found guilty of moral turpitude or convicted of any economic offence or violation of any securities laws.

- The AMC must have and at all times maintain a minimum net worth of INR100 million.
- At least 50% of the AMC's board of directors cannot be associates of, or associated in any manner with, the sponsor or any of its subsidiaries or the trustees.
- The chairman of the AMC must not be a trustee of any mutual fund.

The AMC must observe the following restrictions in its normal course of business (along with other ongoing requirements) (*SEBI (Mutual Funds) Regulations 1996*):

- Any director of the AMC cannot hold the office of a director in another AMC unless that person:
  - is an independent director;
  - obtains the approval of the board of the AMC of which that person is a director.
- It must not act as a trustee of any mutual fund.
- It cannot undertake any other business activities except for activities concerning:
  - portfolio management services;
  - management and advisory services to offshore funds, pension funds, provident funds, and venture capital funds;
  - management of insurance funds;
  - financial consultancy; and
  - exchange of research on a commercial basis.

  However, these activities must not conflict with the activities of the mutual fund.
- It must not invest in any of its schemes unless it has made full disclosure of its intention to invest in the offer.
- It must file periodic reports with the SEBI and maintain certain records.
- It must seek the best execution for portfolio transactions (that is, avoid executing trades through brokers associated with the sponsor, and so on).

Closed-ended retail funds

See above, *Open-ended retail funds.*

Assets portfolio

7. Who holds the portfolio of assets? What regulations are in place for its protection?

Open-ended retail funds

A mutual fund must place and maintain its assets with a custodian registered with SEBI. The custodians are governed by the SEBI (Custodian of Securities) Regulations 1996.

Closed-ended retail funds

See above, *Open-ended retail funds.*

Legal fund vehicles

8. What are the main legal vehicles used to set up a retail fund and what are the key advantages and disadvantages of using these structures?

Open-ended retail funds

Legal vehicles. All mutual funds in India must be constituted in the form of a trust under the Indian Trusts Act 1882. The instrument of trust must be registered under the provisions of the Indian Registration Act 1908. Participants' interests in trusts are called units.

Advantages. The trust structure offers the following benefits:

- Significant operation flexibility.
- Limitation on unitholders' liability.
- It does not require annual shareholder meetings.
- It is not subject to income tax at the fund level (*see Question 13, Open-ended retail funds: Funds*).
- Exemptions are available for investors concerning income earned from the mutual fund (*see Question 13, Open-ended retail funds: Resident investors*).

Disadvantages. There are no notable disadvantages.

Closed-ended retail funds

Legal vehicles. See above, *Open-ended retail funds: Legal vehicles.*

Advantages. See above, *Open-ended retail funds: Advantages.*

Disadvantages. See above, *Open-ended retail funds: Disadvantages.*

Investment and borrowing restrictions

9. What are the investment and borrowing restrictions on retail funds?

Open-ended retail funds

Mutual funds are subject to many restrictions on investments and borrowings, including (*SEBI (Mutual Funds) Regulations 1996*):

- **Eligible investments.** The following are eligible investments for the mutual fund:
  - securities;
  - money market instruments;
  - privately placed debentures;
  - securitised debt instruments, which are either asset-backed or mortgage-backed securities;
  - gold or gold-related instruments;
  - real estate assets.

- **Investment restrictions.** A mutual fund scheme must not invest:
  - more than 15% of its net asset value (NAV) in debt instruments of a single issuer rated investment grade or above (it can invest up to 20% with the prior approval of the board of the asset management company and the board of trustees);
  - more than 30% of its NAV in money market instruments of an issuer (not applicable to investments in government securities, treasury bills and collateralised borrowing and lending obligations);
  - more than 10% of its NAV in unrated debt instruments issued by single issuer (however, such investments require prior approval of the board of trustees and the board of asset management company), provided the total investments do not exceed 25% of the NAV of the scheme;
  - in aggregate, along with other schemes of the mutual fund, more than 10% of any company's paid up capital carrying voting rights;
  - in other schemes under the same asset management company or in other mutual funds to an extent that such investment, along with other inter-scheme investment made by all schemes under the same management is more than 5% of the NAV of the mutual fund (this does not apply to funds of funds schemes);
  - in any unlisted security of an associate or group company of the sponsor;
  - in any security issued by way of private placement by an associate or group company of the sponsor;
  - in listed securities of group companies of the sponsor that are in excess of 25% of the NAV;
  - in funds of funds schemes;
  - more than 10% of its NAV in equity or equity related instrument of any company (this does not apply to index funds or sector or industry specific schemes);
  - more than 5% (for open ended) or 10% (for closed ended) of its NAV in unlisted equity shares or equity related instruments.

- **Borrowing restrictions.** Mutual funds cannot borrow, except to meet temporary liquidity demands for the purpose of repurchase or redemption of units, or payment of interest or dividends to unitholders. The amount of those borrowings cannot exceed 20% of the net assets of the scheme and the duration of the borrowings cannot exceed a period of six months. However, under an exception to the general borrowing restrictions, a mutual fund can lend and borrow securities under the specific framework prescribed by SEBI.

Closed-ended retail funds

See above, *Open-ended retail funds.*

10. Can the manager or operator place any restrictions on the issue and redemption of interests in retail funds?

Open-ended retail funds

The manager or operator cannot place any restrictions on the issue and redemption of interests in open-ended retail funds.

Closed-ended retail funds

Units of a closed-ended scheme, other than an equity-linked saving scheme, cannot be repurchased before the end of the maturity period of that scheme.

A closed-ended scheme can, however be converted into an open-ended scheme under which no restrictions can apply (*see above, Open-ended retail funds*).

11. Are there any restrictions on the rights of participants in retail funds to transfer or assign their interests to third parties?

Open-ended retail funds

There are no statutory restrictions on the rights of investors in mutual funds to transfer or assign their rights to third parties. However, most investors usually sell their units on an exchange.

Closed-ended retail funds

See above, *Open-ended retail funds.*

Reporting requirements

12. What are the general periodic reporting requirements for retail funds?

Open-ended retail funds

Investors. Mutual funds must deliver the following reports to investors:

- The offering document (*see Question 3, Open-ended retail funds: Local funds*).

- A statement of accounts, to be delivered within 30 days from the closure of a new fund offering.
- Annual and semi-annual reports.

Regulators. Mutual funds must file the following reports with SEBI:

- Audited annual statements of accounts, including the balance sheet and profit and loss account of the fund and each scheme.
- Unaudited accounts on a six-monthly basis.
- Quarterly statements of movements in the net assets of the scheme.
- Quarterly portfolio statements, including changes from the previous period, for each scheme.

Closed-ended retail funds

Investors. See above, *Open-ended retail funds: Investors.*

Regulators. See above, *Open-ended retail funds: Regulators.*

Tax treatment

13. What is the tax treatment for retail funds?

Open-ended retail funds

Funds. A mutual fund is exempt from income tax at the fund level on income and gains arising to the fund from its investments.

Dividends distributed by a mutual fund to its unitholders are taxed as follows, depending on the type of fund:

- **Money market funds or liquid mutual fund (that is, funds that invest in short-term debt securities).** The distribution by the fund is taxed at:
  - 25% on income distributed to any individual or hindu undivided family (HUF) (that is, a joint Hindu family);
  - 30% on income distributed to any other person companies, firms, and so on.
- **Other types of fund.** The distribution by the fund is taxed at:
  - 12.5% on income distributed to any individual or HUF;
  - 30% on income distributed to any other person.

Resident investors. Unitholders of mutual funds are:

- Exempt from tax on distributions that they receive from the mutual fund, and on gains from the sale of units of an equity-oriented scheme (that is, where the equity holding is more than 65% of the total portfolio) that they have held for 12 months or more and sold on a recognised stock exchange in India.

- Taxed at 10% on gains from sale of units of an equity-oriented scheme held for 12 months or more, or at 20% of the gains calculated on the basis of indexed values, whichever is less, if not sold on a recognised stock exchange in India. Indexed values are determined on the basis of a cost inflation index notified by the government for every year having regard to the consumer price index.

- Taxed at 10% on gains from sales of units of schemes (other than equity-oriented schemes), or at 20% of the gains calculated on the basis of indexed values, whichever is less, if held for 12 months or more.

- Taxed on gains arising from sale of units of equity-oriented schemes held for less than 12 months at the rate of:
  - 15% (excluding applicable surcharge and educational cess (that is, an additional tax used by the central government to provide primary and secondary education facilities to underprivileged children)), if sold on a recognised stock exchange in India;
  - 30% (excluding applicable surcharge and educational cess) if not sold on a recognised stock exchange.

- Taxed on gains from sale of units of other schemes (other than equity-oriented schemes) at 30%.

Non-resident investors. Non-resident investors are taxable in the same manner as resident investors, unless they are eligible for a lower treaty rate (*see above, Open-ended retail funds: Resident investors*).

Closed-ended retail funds

Funds. See above, *Open-ended retail funds: Funds.*

Resident investors. See above, *Open-ended retail funds: Resident investors.*

Non-resident investors. See above, *Open-ended retail funds: Non-resident investors.*

Reform

14. What proposals (if any) are there for the reform of retail fund regulation?

Recent changes include the:

- Removal of entry load in 2009 (this was a payment that investors made at the time of payment into a mutual fund).

- Consolidation of account statements (an investor will now be issued a consolidated statement for all his investments across various fund schemes of multiple mutual funds).

There is no prominent litigation in this area. However, tax litigation relation withholding tax in case of non-resident investors has been in dispute.

Hedge funds

15. What is the structure of the hedge funds market? What have been the main trends over

the last year?

Hedge funds currently do not exist in India. However, under the draft SEBI (Alternate Investment Funds) Regulations 2011, SEBI proposes to introduce a new category of Strategy Fund. Hedge funds will be included as a type of Strategy Fund and subject to specific rules on risk, and so on. How this will operate in practice remains to be seen. Under the regulations, a Strategy Fund must specify a specific investment strategy and when this is done it can invest in any class of financial instruments that fall within the specified strategy. It is rumoured that the AIF regulations will be introduced early next year.

Regulatory framework and bodies

16. What are the key statutes and regulations that govern hedge funds in your jurisdiction? Which regulatory bodies regulate hedge funds?

Hedge funds do not exist in India (*see Question 15*).

17. How are hedge funds regulated (if at all) to ensure compliance with general international standards of good practice?

There are no hedge funds in India (*see Question 15*).

Marketing

18. Who can market hedge funds?

There are no hedge funds in India (*see Question 15*).

19. To whom can hedge funds be marketed?

There are no hedge funds in India (*see Question 15*).

Investment restrictions

20. Are there any restrictions on local investors investing in a hedge fund?

There are no hedge funds in India (*see Question 15*).

Assets portfolio

21. Who holds the portfolio of assets? What regulations are in place for its protection?

There are no hedge funds in India (*see Question 15*).

Requirements

22. What are the key disclosure or filing requirements (if any) that must be completed by the hedge fund?

There are no hedge funds in India (*see Question 15*).

23. What are the key requirements that apply to managers or operators of hedge funds?

There are no hedge funds in India (*see Question 15*).

Legal fund vehicles and structures

24. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures?

There are no hedge funds in India (*see Question 15*).

25. What are the advantages and disadvantages of using onshore and offshore structures?

There are no hedge funds in India (*see Question 15*).

Tax treatment

26. What is the tax treatment for hedge funds?

There are no hedge funds in India (*see Question 15*).

Restrictions

27. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

There are no hedge funds in India (*see Question 15*).

Reform

28. What (if any) proposals are there for the reform of hedge fund regulation?

Hedge funds are not currently used in India. However, there are proposals to introduce hedge funds under the draft SEBI (Alternate Investment Funds) Regulations 2011 (*see Question 15*).

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Areas of practice. Investment funds and securities laws.

Recent transactions

- Advising open-ended and closed-ended funds.
- Advising Indian mutual funds and asset managers on setting up of operations outside India (Sundaram mutual fund, DSP Blackrock mutual fund, Reliance mutual fund, Tata mutual fund).

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- Advising open-ended and closed-ended funds for setting up their funds.
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- Advising hedge fund proposing to invest in India (Soros, Pari Washington).

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