Analysis

GIFT City – Analysing New Fund Management Regulations and why GIFT City still doesn't work

Key Takeaways

- IFSCA proposes significant shift in regulatory regime for investments funds - shift from investment vehicle towards fund management entity (FME).
- Replacement of Category I, II and III AIFs under present AIF Framework with investment schemes viz. Venture Capital Scheme, Restricted Scheme (Non-Retail) and Retail Schemes.
- Streamlined approval process of investment schemes by introduction of 'Green Channel'.
- Single point registration (as FME) as opposed to multiple registrations in different regulations.
- Offers significant room for growth and innovation of new financial products in a sandbox environment.

Background

The International Financial Services Authority (***IFSCA***) – the unified regulator for GIFT City – recently released the draft IFSCA (***Fund Management***) regulations, 2022 (***Draft Regulations***). The Draft Regulations propose a wholesale overhaul of the investment funds regime in GIFT City in line with the regulatory model that has been adopted by major global jurisdictions such as the European Union. The most salient feature is the shift from a regime focused on the investment vehicle to one that is focused on the fund manager. The reforms set out in the Draft Regulations follow several other tax and regulatory measures introduced by the IFSCA and the Government of India to facilitate the development of GIFT City as a highly reputable international funds jurisdiction.

Whilst the formal rollout of the Draft Regulations will certainly be a landmark event, it is worth noting that GIFT City has not yet taken off as a preferred investment funds jurisdiction along the lines of traditional funds jurisdictions such as Mauritius, Singapore, Luxembourg and the Cayman Islands. This Analysis briefly examines the key features in the Draft Regulations against the position under the existing regime and review some of the challenges that continue to plague the growth and development of GIFT City as an international investment funds jurisdiction.

The Fund Management Framework

The proposed regulations outline significant departures from the current conception of the funds industry in India. Broadly, these are the changes on which draft regulations are based:

1. ***Fund-Management Based Regime from Fund Based Regime:*** The existing regulatory framework for investment funds in India is primarily focused on the investment vehicle i.e. AIFs of various categories. Consequently, there are rules that permit and restrict various activities and operations of funds. For instance, a Category I / II AIF is generally not permitted to invest more than 25% of investible funds in a single investee company. Managers and sponsors of an AIF are held to account if the AIF trips any of the rules and restrictions to which it is subject. Thus, the oversight on managers is largely indirect. However, the Draft Regulations focus on regulating the

fund manager and provide a comprehensive framework for registration of Fund Management Entities ("**FMEs**"). Once an FME is registered, it will be permitted to launch different 'investment schemes' on a continuing basis (rather than having to apply for registration of a new AIF each time a new fund needs to be set up under the existing framework). For completeness, it should be noted that investment schemes under the proposed regime will receive the same tax treatment as AIFs registered with SEBI.

2. ***Accelerated Approval Timelines***: A key area of concern for sponsors looking to set up private funds in India is the lengthy approval process. Depending on the investment strategy of the fund, approval from the domestic regulator tends to take up to 4 months on average. During this period, the sponsor is unable to carry out any meaningful operations on behalf of the fund. Against this backdrop, the Draft Regulations propose two helpful measures. First, Restricted Schemes (Non-Retail Schemes) (which would cover almost the entire gamut of funds that are classified as AIFs under the existing framework) are permitted to commence operations 21 days after filing a placement memorandum with the IFSCA (subject to incorporating any comments provided by the IFSCA within the 21-day timeline). Second, a green channel has been introduced for: (i) Venture Capital Schemes; and (ii) Restricted Schemes (Non-Retail Schemes) that accept commitments only from accredited investors. Such schemes may be opened for subscription from investors immediately upon filing the placement memorandum with the IFSCA.

3. ***Single Registration and Unified Regulatory Framework:*** The proposed regulations create a singular registration for performing the role of traditional investment manager, provide portfolio management services, manage REITs, InvITs and family offices. This increases regulatory certainty in day to day functioning and simplifies compliance. Procedurally, FMEs can seek registration in the following three categories, linked to the kind of schemes they seek to pursue – viz., Authorized FMEs (primarily for venture capital schemes); Registered FMEs (Non-Retail) (for privately placed schemes in different asset classes and portfolio management services); and, Registered FMEs (Retail) (for schemes pooling money from retail and non-retail investors, portfolio managers, ETFs, etc.)

Other Tax Benefits/Incentives in the Framework

The current draft policy builds upon the several other relaxations and tax measures provided in the past to incentivize activity in GIFT City. These include:

1) ***Preferential Long Term Capital Gains (LTCG) Rate.*** Any income of a Category III AIFs enjoys a preferential tax on capital gains at the fund level (long term at 10% and short term at 15%) and are exempt from other taxes in India. Interest income is also taxed at 10% in GIFT City. Under the Draft Regulations, schemes focused on investments in securities primarily of listed entities (including for undertaking diverse or complex trading strategies) will be deemed to be Category III AIFs for income-tax purposes and will thus be eligible to avail of these preferential tax rates. This compares favorably to international jurisdictions with which India has tax treaties, such as Ireland, Mauritius, Singapore, etc.

2) ***Business Tax Exemption.*** Units set up in GIFT City are entitled to a 100% deduction of income generated from the business for which the unit was set up in GIFT City for 10 consecutive years. The income of an FME from investment and portfolio management services will qualify to receive this benefit.

3) ***No PAN for Foreign Investors.*** Non-resident investors do not need to obtain a PAN (Indian tax registration) when investing through an AIF. There is also no requirement for such investors to file

Indian taxes. Global LPs have generally been wary of taking a PAN, and have preferred to invest in offshore pooling vehicles which in turn procure the PAN. Removing the need to procure a PAN has therefore been a significant shot in the arm for GIFT City to attract global investors.

4) ***Diversification and Leverage Relaxations.*** Unlike funds incorporated in the rest of India, funds set up in GIFT City funds are not subject to borrowing restrictions and diversification requirements. This effectively permits a GIFT City fund to invest all its capital in a single investee company, which opens the doors for captive funds and activist investment strategies.

5) ***Ancillary Tax Exemptions.*** The Indian tax regime also provide a range of exemptions for ancillary taxes such as securities transaction taxes, stamp duty (through reimbursement), commodities transaction tax, etc.

6) ***No Capital Gains for NR Transfers.*** All inter-se transfers among non-resident Indians of securities traded on GIFT City exchanges are exempt from capital gains taxes.

Challenges

Whilst the Draft Regulations foretell a much needed reform, deeper issues plague the development of GIFT City as a funds jurisdiction that can truly rival the efficiencies provided by international financial services centres elsewhere in the world. Some of these are summarized below:

1) ***Issue of Perspective***. At some level, the biggest challenge appears to be one of perspective. The various regulatory regimes introduced in GIFT City must be measured for efficiency and nimbleness against international financial jurisdictions such as the Cayman Islands, Mauritius, Singapore and Luxembourg among others. There is little sense or value in comparing regimes in GIFT City against their counterparts in the rest of India. In other words, the IFSCA's competition is the nimble, efficient regulator in other international financial services centres; not the domestic regulator (SEBI). GIFT City doesn't match up to those standards yet. It also lacks the infrastructure that Singapore or Luxembourg may offer to attract global talent pool.

2) ***Challenges faced by Category III AIFs in availing of the LTCG.*** The 10% LTCG benefit is only available to Category III AIFs that are registered in GIFT City. Category I and Category II AIFs are pass-through structures and are thus ineligible to receive this benefit. However, tax advisors have taken the view that a Category III AIF should be open-ended to minimize the scope of regulatory scrutiny. Open ended Category III AIFs are required to disclose monthly NAVs to investors alongside detailed quarterly reports on the fund's performance and risk assessment. Compared with annual disclosures for other funds, the frequency of disclosures is a costly and time-consuming exercise. As mentioned above, the Draft Regulations provide that Restricted Schemes (Non-Retail Schemes) that invest in securities primarily of listed entities (including for undertaking diverse or complex trading strategies and for permitted investments under longevity finance) will be eligible for the same benefit as Category III AIFs. However, this may not solve for whether close-ended schemes that adopt such strategies will encounter heightened regulatory scrutiny.

3) ***Additional SEZ Approvals.*** The SEZ Act is applicable to GIFT City and therefore, a separate approval from the SEZ authority is required for setting up a fund in GIFT City. These approvals are separate from, and in addition to, the general approval required by the regulator (i.e the IFSCA). Whilst the Green Channel and the deemed approval provisions contemplated under the Draft Regulations are welcome, they only resolve part of the challenge relating to timelines.

4) ***FPI Registration.*** *While* equity is taxed homogenously at 10%, GIFT City is substantially tax incentivizing for private debt funds looking to invest in the Indian high yield corporate bonds. GIFT City domiciled credit funds need to procure a foreign portfolio (FPI) registration for investing in corporate bonds, just as any other non-resident would require, removing the edge that GIFT City could have had over other offshore jurisdictions. From a practical standpoint, investing through GIFT City makes most sense for debt investors where the interest withholding could reduce from as much as 40% to 10%.

5) ***Limitation of Trust Structures***. Fund investors (LPs) and GP's have often found the trust structure in India to be complex and cumbersome to manage due to intermediaries like trustees, settlors, etc. The expert committee recommended the introduction of Variable Cell Companies (VCCs) as an alternative pooling vehicle. VCCs allow for simpler infusion of funds (like a trust) with the flexibility of a company-like management structure, removing the need for intermediaries. The Draft Regulations, however, have not incorporated the VCC concept. Introduction of VCCs in GIFT City (along the lines of the VCC structure in Singapore and equivalent structures in Mauritius and the Cayman Islands) would be helpful for the investment funds industry in India.

6) ***Tax Incentive in GIFT v. Tax Treaties***. One of GIFT City's biggest support system could also be the most critical dissuading factor for offshore funds. GIFT City is currently enjoying tax exemptions which emanate from the Income-tax Act as against a diplomatic agreement like a tax treaty with Mauritius or Singapore. To that extent, diluting the tax inventive regime in GIFT City could be done with a mere parliamentary amendment as against a tax treaty which cannot be unilaterally amended.

While GIFT City continues to attract foreign investors looking to invest in India, the challenges set out above need to be addressed to fully optimize its presence as an international investment funds jurisdiction. Substance requirements have been eased, but further tax clarity and comfort from unnecessary tax scrutiny on substance may be helpful. For debt investors particularly, fund managers should be able to elect whether they want the pass through treatment or not. Importantly, the need for Category II AIFs to procure an FPI registration seems rather unnecessary since the fund (and now the fund manager) is anyway under robust regulation. Addressing such practical nuances is likely to make GIFT City the favored jurisdiction for investments into India paving the way for it to become the base for financial sponsors looking to invest in the region.

A BRIEF SNAPSHOT OF PRESENT AIF FRAMEWORK IN IFSC *VIS-A-VIS* PROPOSED IFSCA (FUND MANAGEMENT) REGULATIONS, 2022 HAS BEEN ENUMERATED IN THE BELOW TABLE:

S. No.	Factors	Existing Regime	Proposed Regime		
1.	**Categorization**	Funds can be of 3 categories *viz.* • Category I AIFs • Category II AIFs • Category III AIFs	Introduced 3 types of schemes, which may be launched through a fund as a pooling vehicle *viz*:		
			Venture Capital Scheme	**Restricted Scheme (Non- retail)**	**Retail Scheme**
2.	**Meaning**	**Category I** AIFs which invest in start-up or early-stage ventures or social ventures or SMEs or infrastructure. **Category II** AIFs which do not fall in Category I and III. **Category III** AIFs which employ diverse or complex trading strategies	Schemes that invest primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings etc.	Can invest in: a) Start-ups, Social ventures, SME Funds etc. b) Securities primarily of listed entities including for undertaking diverse/complex trading strategies. c) Investment which does not fall under the clause (a) and (b) above. These schemes can only be privately placed with select investors.	Can invest in Social Ventures, Infrastructure, ESG sector, specific sectors certain themes such as infrastructure certain asset class (equity/debt scheme) or towards certain solution (retirement, schemes for children education, etc.) These schemes can invite funds from public investors as well.
3.	**Managing Body**	Investment Manager specifically designated for each fund	Authorized FME	Registered FME (Non-Retail)	Registered FME (Retail)
4.	**Open/Close Ended**	Cat I and II are close ended. Cat III can be open ended or close ended.	Close ended	Can be open ended or close ended.	Can be open ended or close ended.
5.	**Corpus for each fund/ scheme**	**<** 3 million USD	< 5 million USD upto a maximum of USD 200 million	< 5 million USD	< 5 million USD

6.	**Minimum Investment by investor**	150,000 USD	250,000 USD	150,000 USD	Close ended schemes investing more than 15% in unlisted securities - 10,000 USD Open-ended – None No restriction to close-ended funds investing less than 15% in unlisted securities
7.	**Approval Process**	Approval Required (usually takes 8-9 months to secure all approvals)	Green Channel – scheme starts immediately on filing placement memorandum	Deemed Approval – Scheme starts if no comments on placement memorandum are received within 21 days	Approval Required
8.	**Borrowing/ Leverage**	Permitted	Permitted	Permitted	Cannot borrow except to meet temporary liquidity requirements.
9.	**Portfolio Management services**	Separate approvals and registrations required. Restrictions apply on an Investment Manager performing Portfolio Management services.	Registered FMEs (both non-retail and retail) can use the same license to carry out Portfolio Management services as well.			
10.	**Special Situation Funds**	Can be launched as Category I AIFs, but no special exemptions or provisions available in GIFT City	Not Applicable	A sub-category of non-Retail schemes. The pooling vehicle is considered as a Category I AIF for tax purposes.	Not Applicable
11.	**Exchange Traded Fund (ETF)**	Governed separately under SEBI Mutual Fund Regulations, 1996. No GIFT City related exemptions provided.	Recognized as a specific sub-category for retail schemes with specific regulations for commodity ETFs, debt ETFs, equity ETFs, hybrid ETFs, and actively managed ETFs. Can be open ended or close ended.			
12.	**InvIT & REIT**	Governed under separate regulations (InvIT Guidelines, REIT Guidelines, the Trusts	Not Applicable	Can be launched as a retail or non-retail scheme. Units of non-retail schemes may be unlisted or privately listed, similar to the regime in rest of India. This permits investment in yield-based	

		Act, the Registration Act, FEMA)		schemes like infrastructure and real estate through GIFT City.
13.	**Tax Treatment**	Category I and II AIFs are pass through – all investments are charged at the hands of the investor. No preferential rate applies for foreign investors. Category III AIFs receive a preferential tax rate of 10% on long term capital gains.[1]	Treated as Category I AIFs in the existing regime for tax purposes.	Depending upon the nature of investment, may be treated as Category I/II/III AIFs as in the existing regime, for tax purposes.

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About our Fund Formation practice:

Our core practice is centred around funds and asset management, and we have extensive expertise in advising on the various aspects in the lifecycle of an investment fund…read more.

[1] Practically, advisors have taken the view that this can be only the case with open ended funds. Please see article below for details.