Chandrawat & Partners

# FUND MANAGEMENT INDUSTRY IN INDIA

A brief guide on Funds Management Industry in India.

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# PREFACE

In recent years, credit intermediation is shifting, with the traditional dominance of the banking sector yielding ground to non-bank intermediaries, including the funds management industry. Funds management is the overseeing and handling of a financial institution's cash flow.

Funds management, also referred to as asset management covers any kind of system that maintains the value of an entity. It may be applied to intangible assets as well as tangible assets. Funds management is the systematic process of operating, deploying, maintaining, disposing, and upgrading assets in the most cost-efficient and profit-yielding way possible.

In the financial world, the term "fund management" describes people and institutions that manage investments on behalf of investors. An example would be investment managers who fix the assets of pension funds for pension investors. An investor who wants their money managed may have to pay a one-time upfront cost, which is often a portion of their entire investment and is subsequently deducted annually as a management fee.

Many investors are pleased to do this because they believe they will receive a greater return if they trust a professional to handle their money and make the decisions. Every fund comes with a prospectus or fact sheet that explains the methodology used to select investments. For example, the manager may look for emerging stocks or focus on a particular geographical region.

# MARKET SCENARIO

The fund management industry is in its nascent stages in our country. However, due to a boost in investments by high-net-worth individuals and ultra-high-net-worth individuals, the sector has been picking up pace and growing faster than ever before. India's asset and fund management market is estimated to grow at a compound annual growth rate of approximately 14% during 2022–2027. Asset management companies ("AMCs") in India owed assets under AUM worth INR 24.46 trillion in 2021, while the industry's total AUM stood at INR 39.50 trillion (INR 39.50 lakh crore) as of October 31, 2022.

The mutual fund AUM market share has increased by 26 basis points to 7.38% from 7.12% last year.The share of equity in the AUM has also risen by about 100 basis points to 42% this year. A compound annual growth rate of 16% in AUM over the past five years has been seen; however, field experts feel that the mutual funds industry in India remains significantly under-penetrated, compared to global averages.

Despite high growth, India's mutual fund AUM-to-gross domestic product ratio is a low 16%, compared to the global average of 74%. Further, equity AUM-to-market capitalization is at 6%, against the global average of 33%. The mutual fund sector's total AUM had risen 20% to INR 37.6 trillion in the current financial year, and with the addition of 31.6 million net new folios, the total count has risen to 129.5 million.

Despite the poor economic situation because of the pandemic that began in 2020, the Indian investment market still managed to close the decade on a noteworthy record. In 2022, the Assets Under Management ("AUM") of the Indian mutual fund industry stood at INR 37.22 trillion.

The Indian fund management market has reached an aggregate value of INR 50 trillion, with debt and equity mutual funds registering double-digit growth rates consistently for the last six years. The AUM in equity funds, however, grew at a faster rate of 20% in the same time period. The AUM in Exchange Trade Funds ("ETF") also grew at a furious pace of 62%, which was mainly an outcome of a lower base. Further, AUM of Alternate Investment Funds ("AIF") grew at a compounded annual rate of 8%.

As of June 14, 2022, the Securities and Exchange Board of India ("SEBI") has registered 956 AIFs, which have raised commitments of around $6.413 trillion. Currently, there are four Real Estate Investment Trusts ("REIT") and 18 Infrastructure Investment Trusts ("INVIT") registered with SEBI. The AUM of the Indian mutual fund industry has grown to 37.22 trillion as of May 31, 2022. At present, there are around 372 portfolio managers registered with SEBI. On the other hand, the Collective Investment Schemes ("CIS") regime has not proven to be successful, and there is only one registered CIS in India.

# REGISTRATION PROCESS

## 1. Registration of various funds

Funds like Venture Capital Funds (VCF), AIF, hedge funds, mutual funds, REITS, etc. are required to get registered with SEBI. The process for this registration is similar in almost all cases barring a few minor differences in respect of the fees. Following are the major steps:

**Step 1: Check the eligibility criteria:**
The company shall check its documents to determine whether it is permitted to carry out the activity concerned as per its articles and memorandum of association. The company should also check whether the sponsor or manager meets the "fit and proper criteria" as defined by the SEBI Regulations. It is required to submit the following main documents:

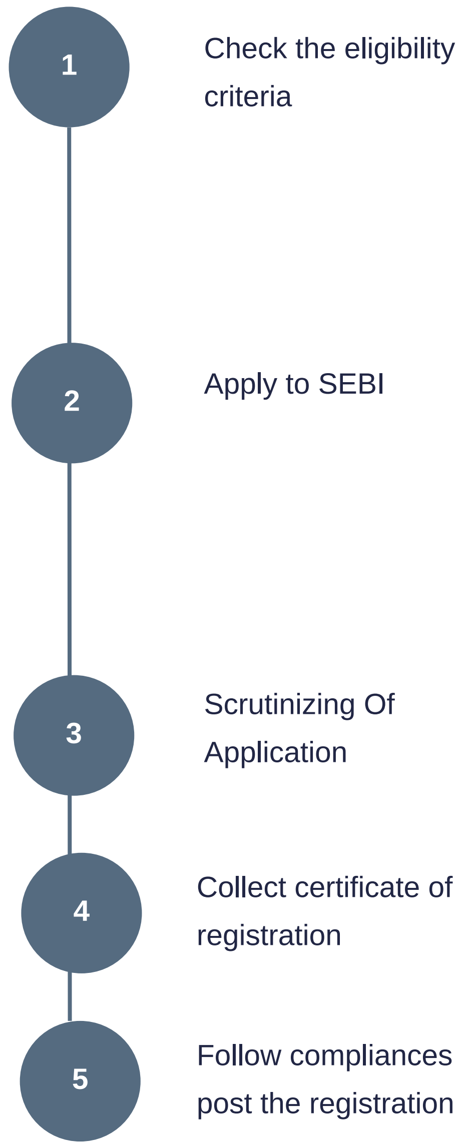
- Memorandum in the case of a company, trust deed in the case of a trust, or partnership deed in the case of a partnership firm

**Step 2: Apply to SEBI:**
The applicant shall apply through Form A given under the SEBI (AIF) Regulations, 2012, along with the necessary documents and details like the current status of registration, whether the registration was or has been cancelled in the past, the nature of the new fund, an authorization letter in case an applicant or entity has authorized any director/promoter/or any such officer to act as an authorized signatory, a cover letter, and fees by way of a draft drawn in favor of SEBI.

**Step 3: Scrutinizing the application:**
SEBI verifies the result and notifies the applicant within 21 days of receiving an application. The application is evaluated by SEBI for its correctness, and SEBI, IF satisfied with the results, approves the application.

**Step 4: Collect the certificate of registration:**
SEBI will then grant the application via the certificate of registration in Form B.

**Step 5: Maintain compliance after registration:**
SEBI's website regularly issues updates, circulars, and guidelines, which shall be complied with as and when required.



The steps above are mostly similar for all; however, an asset management company and a trustee or board of trustees are required to be established for the registration of mutual funds and REITS, along with an auditor's certificate that is to be submitted to SEBI along with other documents. The CIS registration process is also similar; however, in order to form a CIS, a company shall be incorporated under the Companies Act, 2016, registered under the SEBI (CIS) Regulations, and have a trustee appointed. All of these additional details must be submitted at the time of application.

The registration fees for each type of fund vary which are as follows:

| S.no | Category of fund management | Registration fees |
|---|---|---|
| 1. | Alternate investment fund | • Category I AIF- INR 5 lakh<br>• Category II AIF- INR 10 lakh<br>• Category III AIF- INR 15 lakh |
| 2 | Venture capital funds | INR 2 lakh |
| 3. | Angel funds | INR 2 lakh |
| 4. | Hedge funds | • Category I AIF- INR 5 lakh<br>• Category II AIF- INR 10 lakh<br>• Category III AIF- INR 15 lakh |
| 5. | Mutual funds | INR 1,500 – 4 lakh |
| 6. | REITs | INR 1 lakh |

**2. Public provident funds registration:**

Public provident funds ("PPF") are an excellent way for small investors to create long-term wealth by investing small amounts of money regularly. A PPF account is required to be opened with a bank that supports PPFs. Any Indian citizen can open a PPF account in his or her own name or a minor’s name. The following documents are required:

- an identity proof (voter ID card, permanent account number ("PAN") card, or Aadhar card) and proof of residence;
- pay-in slip and nomination form (available at any bank branch or post office);
- passport-size photographs;

A PPF account can be opened online and offline, with a bank or the post office.

**3. Pension fund registration:**

All Indian citizens and non-resident Indians can subscribe to the pension schemes under the National Pension Scheme ("NPS"), regulated by the Pension Fund Regulatory and Development Authority ("PFRDA"). The registration for this can be done through the NPS's official website using the Aadhar or PAN card. KYC (know your customer) verification and a cover letter are a must for this registration. All subscribers are required to register in a similar process after clicking through on the "non-repatriate account" option. Employees of the Indian government can register for the programme through the SANKALP platform, which was created specifically for them.

## 4. Registration as an asset management company:

Many a time, an AMC is formed that is incorporated with the main objective of managing the assets that it holds. It is a company incorporated and registered with the Ministry of Corporate Affairs as a company under the Companies Act, 2016.

**Step 1: Fill the form and submit to DNBS-**
All applicants must obtain and complete the latest CIC-ND-SI application form available on the Reserve Bank of India's (RBI) website. This form shall then be submitted to the Department of Non-Banking Supervision ("DNBS"), regional office.

**Step 2: Documents necessary for application-**
Updated documents related to registration, company, and the latest audited balanced statement shall be submitted along with the application.

**Step 3: Scrutinizing the application-**
The applicant shall wait for a reply. The application would be scrutinized by the concerned authority.

**Step 4: Collect the certificate of registration-**
The registration certificate would be issued thereafter.

1 Fill the form and submit to DNBS

2 Documents necessary for application

3 Scrutinizing of application

4 Collect certificate of registration

# LICENSE(S) REQUIRED

## License required to become a fund manager.

In order to work as a portfolio manager in India, a license is to be obtained from SEBI. A portfolio manager is a body corporate that, pursuant to a contract or arrangement with a client, advises, directs, or undertakes, on behalf of the client (whether as a discretionary portfolio manager or otherwise), the management or administration of a portfolio of securities or the client's funds.

A discretionary portfolio manager manages the funds individually and independently for each client in accordance with the needs of the client, while a non-discretionary portfolio manager manages the funds in accordance with the directions of the client. A portfolio manager can manage all types of funds, like equity, hedge funds, VCFs, mutual funds, AIFs, etc.

### Specifications:

- **Minimum capital requirement:** The portfolio manager is required to have a minimum net worth of INR 2 crore.
- **Qualification required:** An undergraduate degree such as B.Com., B.B.A., or B.B.M., or an equivalent degree in finances and investment.
- **Registration validity**: 3 years
- **Renewal:** The portfolio manager has to apply for renewal of its registration certificate to SEBI at least 3 months before the expiry of the validity of the certificate.
- **Registration fee:** INR 10 lakhs.
- **Renewal fee**: INR 5 lakh.
- **Minimum value of funds:** A portfolio can choose to accept any fund, provided it has a value above INR 5 lakh or is comprised of securities having a minimum worth of INR 5 lakh.
- **Restriction:** It is mandatory for an agreement to be entered into between the manager and the investor(s). The agreement should cover the minimum details as specified in the SEBI Portfolio Manager Regulations.

# REGULATORY FRAMEWORK

## 1. Alternate Investment Funds ("AIF")

AIFs are governed under the SEBI (AIF) Regulations, 2012. These regulations impose certain investment conditions on all AIFs, with additional conditions prescribed for each category or subcategory, including in relation to minimum diversification, conflicted transactions, and borrowing limitations. AIFs are required to file reports with SEBI on a regular basis and also when there are material changes to the information previously submitted to SEBI. The manager must prepare a compliance test report, which is an exhaustive report of compliance imposed by the AIF Regulations.

## 2. Venture Capital Funds ("VCF")

These funds are recognized as Category I AIFs and are therefore regulated by the SEBI (AIF) Regulations, 2012. Investment in VCF is subject to certain conditions such as each scheme of VCF is required to have a minimum corpus of INR 200 Million and every investor is required to invest atleast INR 10 million (except for the employees and directors of VCF who can invest a minimum of INR 2.5 million). Further, no scheme can have more than 1000 investors. Investment by VCF in securities of companies incorporated outside India are governed by Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004.

## 3. Angel Funds

The International Financial Services Centers Authority ("IFSCA") is the main regulatory body for angel funds. In April 2022, IFSCA issued the IFSCA (Fund Management) Regulations, which provide a framework for angel funds. Before this, SEBI was issuing informal guidelines to regulate the functioning and establishment of such funds. As per these regulations, a fund management entity will be able to launch an angel fund by filing a placement memorandum with the IFSCA under a green channel.

## 4. Hedge funds

Similar to VCFs, hedge funds are also recognised as AIFs and are regulated under the SEBI (AIF) Regulations, 2012, as they are categorised as Category III AIFs employing complex or diverse trading strategies. Before the AIF regulations, there were no specific regulations governing onshore hedge funds.

## 5. Collective Investment Schemes ("CIS")

CIS are governed under the SEBI (CIS) Regulations, 1999. These regulations were notified in order to curb the growth of a number of unregulated private schemes in the 1990s.

### 6. Real Estate Investment Trusts ("REIT")

REITs are governed under the SEBI (REIT) Regulations, 2014, and INVITs under the SEBI (INVIT) Regulations, 2014. A public offer is required to be made for the units of the REIT or INVIT by way of an offer document, which is scrutinized by SEBI. REITs and INVITs are not permitted to have multiple classes of units or schemes. INVITs may also privately place their units through a private placement memorandum scrutinized by SEBI before institutional investors and corporate bodies only.

### 7. Pension funds

Pension funds in India are governed by the PFRDA in accordance with the PFRDA Act, 2013. This act specifies various restrictions and specifications with regard to investments that can be made by such funds, like that they are permitted to invest only in Category I and II AIFs. Further, a pension fund can invest only in AIFs whose corpus is 1 billion rupees or more and that have a minimum rating of AA or above, except for government-owned AIFs.

### 8. Mutual funds

Mutual funds are governed under the SEBI (Mutual Funds) Regulations, 1996. These regulations lay down several criteria that need to be fulfilled in order to obtain a registration, like that every mutual fund must be registered with SEBI and must be constituted in the form of a trust in accordance with the provisions of the Indian Trusts Act, 1882. The instrument of trust must be in the form of a deed between the sponsor and the trustees, duly registered under the Indian Registration Act, 1908.

### 9. Exchange- Traded Funds

ETFs are just like stocks and can also be called a basket of securities that also trade on the stock market, and as a result, they are required to be registered with SEBI for their listing. EIFs have characteristics of both shares and mutual funds and are thus required to comply with both regulations depending upon their structure.

### 10. Portfolio managers

Portfolio managers are regulated under the SEBI (Portfolio Managers) Regulations, 2020, which prescribes qualifications, experience, and capital adequacy conditions, among others, for registration as a portfolio manager while placing obligations like the requirement to obtain prior approval from the board in cases of change in control.

In relation to the offshore funds seeking to invest in India, they are permitted to participate in the listed and debt spaces in India as foreign portfolio investors ("FPIs") under the SEBI (FPI) Regulations, 2019. For offshore funds seeking to invest in the unlisted space in India, the foreign venture capital investors' ("FVCI") route is available under the SEBI (FVCI) Regulations, 2000 (FVCI Regulations). However, at present, an FVCI is permitted to invest in only 10 sectors, including infrastructure.


# TAXATION

The tax regime in India varies for each type of investment with the main governing law being the Income Tax Act, 1961. Further, different tax rates are applicable on funds and the investors in units of these funds in accordance with the income tax act.

## 1. Mutual funds

- **Taxation on mutual funds-** The mutual fund will receive all income without any deduction of tax at source under the provisions of section 196(iv) of the act.
- **Taxation on investors-**

1. Capital gains chargeable on transfer of long-term capital assets are subject to tax at the rate of 15% (equity funds) and 20% (debt funds).
2. Under section 194K of the act, a mutual fund is required to deduct tax at source at the rate of 10% (on any income credited or paid on or after 01 June, 2002 in excess of INR 5,000 during the financial year in case of resident unit-holders. However, if the unit-holder submits a declaration as prescribed under section 197A of the act, then no tax will be deducted.
3. Dividends are taxed as per the normal slab rates.

## 2. Angel funds

Angel investors with the minimum net worth of INR 2 crore or the average returned the income of more than INR 50 lakhs in the previous 3 financial years will be eligible for 100% tax exemption on the investments that are made in the start-ups above the fair market value.

## 3. Exchange- Traded Funds

- In case of a short-term capital gain, tax is applied at 15% plus 4% cess.
- For long-term capital gains, if the profits are less than INR 1 lakh in a financial year, the investment return is completely tax-free.
- If the long-term capital gains are more than INR 1 lakh, tax is levied at 20% plus 4% cess.

## 4. Real Estate Investment Funds

- Capital gains from the sale of Indian REIT units are subject to short-term capital gains tax at 15% if held for less than one year.
- Units held for more than three years (36 months) are subject to LTCG tax at 10% if they result in an income over INR 1 lakh.
- Interest income from REITs is taxable.
- Dividend income from REITs is taxable, depending on the REIT's special tax concession status.

  a) If a special tax concession has been obtained, dividend income is taxable in the hands of the investor.

  b) If not, dividend income is not taxable.

  c) Income from amortisation of special purpose vehicles' debt is not taxable in the hands of the investor.

## 5. Public Provident Funds

- Investment in PPF is tax-free under section 80C on deposits up to INR 1.5 lakh. Further, the interest earned is also tax-free.
- Interest earned on the deposits in post office scheme is taxable.

## 6. Alternate Investment Funds

The tax implication is different for each category. Category I & II AIFs have a pass-through status. Tax pass-through status means that the income or loss (other than business income) generated by the fund will be taxed at the hand of the investor and not by the fund business. Therefore;

- all business income are taxed at AIF and not at the unit holders.
- all income other than business income like capital gains are get the pass-through exemption and the unit holder pays the tax at the applicable slab rates.

**Category III tax rates are as follows:**

| Nature of income earned by the fund | Taxability | Tax rate |
|---|---|---|
| Other than business income (like capital gains) | Passed through status- AIF doesn't pay any tax. The unitholder pays the tax. | Rates applicable to the unit holder |
| Business income | Taxed at AIF. Such income is not taxable for unitholders. | AIF formed as company or a limited liability partnership ("LLP") are taxed at the rates applicable to the company or LLP. AIF formed as trusts are taxed at the maximum marginal rate. |

### 7. Hedge funds

The category III AIF or the hedge funds in India are still not given synonymous status on tax which means that the income is taxable at the appropriate investment level and the taxation will not pass through to the hedge fund investors. The applicable tax rate is 42.74% on annual earnings over INR 5 crores.

### 8. Pension funds

Investments of INR 2 lakh per annum and returns in a tier I NPS account are exempt from tax under Section 80 C and Section 80CCD, and tier II NPS accounts are taxed at normal slab rates. In this case, government employees are only eligible for tax breaks if their investments are locked in for three years.

### 9. Venture Capital Funds

Any income of a VCF earned from investments in a trust is exempt in the hands of the VCF [subject to conditions prescribed in Section 10(23BF) of the Act]. Further, such income is taxable in the hands of the investors in the VCF, as per the applicable slab rates.

# DISPUTE RESOLUTION

Dispute resolution in the fund management industry in India is usually handled through alternate dispute resolution mechanisms like arbitration, mediation, negotiation, and conciliation. SEBI has a comprehensive mechanism to facilitate the redressal of investor grievances against intermediaries and listed companies. It follows up with the companies and intermediaries that do not redress investors' grievances by sending reminders to them and having meetings with them.

It takes appropriate enforcement actions as provided under the law (including the launch of adjudication, prosecution proceedings, and directions) when progress in redressing investor grievances is not satisfactory. SEBI has also set up an arbitration mechanism in stock exchanges and depositories for the resolution of disputes, for which investors must register themselves on the SEBI Complaints Redress System (SCORES) platform and file a complaint. SEBI does not arbitrate or decide the matter, but it facilitates and arranges arbitration.

In 2021, SEBI also launched an "Investors Charter," which defines the rights, duties, and responsibilities of the investors, especially for AIF and mutual fund investors, and even provides them with the option to file a complaint on the SCORES complaint redressal system. It also lays down that AIFs and mutual funds shall disclose their chosen method in their private placement memorandum ("PPM").

The general position is that the fund, through its manager or sponsor, can lay down the procedure for resolution of disputes between the investors, fund, manager, or sponsor through arbitration or any other mechanism mutually agreed upon by the investors and the fund. In October 2022, SEBI also asked the investment funds to declare the resolution framework agreed upon in the PPM. PPM is a key document that contains information on the investment strategy and risk management tools, among other things, and is a standard document to be filed by all AIFs.

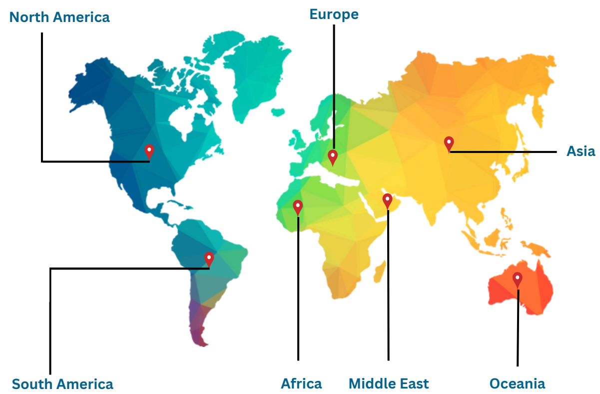
# HOW WE CAN HELP?

Our team can assist our clients in understanding the complex tax structure and provide advice on distribution arrangements, mergers, and restructuring of the trusts or funds, as well as on the prospective investments being made by the trust or fund based on due diligence, with a full range of legal services to private investment funds, investment managers, and institutional investors across the country.

We also provide legal advice in understanding the investment structure and identifying the suitable structure; providing registration and setting up of the desired investment fund; obtaining all the clearances and complying with the major yearly compliances; drafting of the major documents like the private placement memorandum, articles, and memorandum of association; and assisting in registration as a trust, company, LLP, or society as required.

Our experts also advise on the prospective investment being made by the trust or fund based on due diligence. We provide dispute resolution services and handle all court cases, representations, and filings before the court of law, rendering opinions and advising on other ad hoc matters.

## SERVING CLIENTS WORLDWIDE

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