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Government consults legal experts on allowing foreigners to directly invest in venture capital and PE funds

By *Sugata Ghosh*, ET Bureau | 21 Jul, 2015, 08.06AM IST

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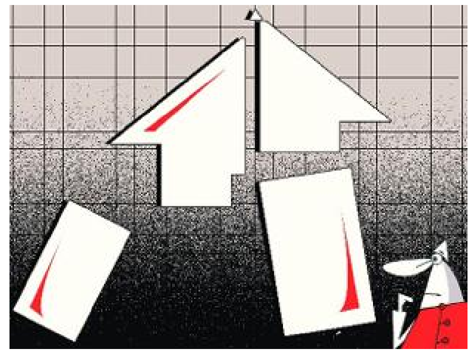

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MUMBAI: The government has sought the opinion of legal experts on allowing foreigners to directly invest in Indian venture capital (VC) and private equity (PE) funds. A direct access under the "automatic route" would quicken fund inflows, cut cost and do away with investment pooling vehicles in tax havens such as Mauritius.

Local funds, categorised as three types of Alternative Investment Funds (AIF), include VC and angel funds, funds for investing in infrastructure, small businesses and real estate, as well as the new breed of domestic hedge funds.

Bringing in overseas money in AIFs requires the permission of the Foreign Investment Promotion Board and the setting up of offshore feeder vehicles which collects funds before transferring it for investment in companies and assets in India.

"Even non-repatriable investment by NRIs in AIF requires prior FIPB approval. It's also ironical that since these funds are structured as trusts and not as companies primarily for administrative and legal reasons, they are not entitled to automatic approval.

Similarly, even where foreign investors are in minority and the control of the AIF resides in India, they should get the benefit of being treated as 'Indian owned and controlled' as in case of a company," said Siddharth Shah, partner, corporate and funds, Khaitan & Co.

Since VC and PE houses have emerged as significant institutional investors in recent times - with their long-term bets on listed companies, closely held traditional businesses as well as startups - many perceive that a robust onshore fund raising platform would make it easier for them to do business. It's in this context that the finance ministry has sought the views of people who have been advising the industry.

Vishakha Mulye, MD & CEO of ICICI Venture, the largest alternative asset manager in India, said that an automatic route for foreign investment would bring down cost as it would no longer be required to set up vehicles in Mauritius.

"A fund in India has to take a declaration from offshore investors on whether they enjoy tax exemption or are covered by any treaty," said Mulye. The AIF industry has been pitching to the government to open up foreign investment by all categories of foreign investors in at least AIFs which are not hedge funds under the automatic route as against case-bycase approval by FIPB.

According to Shah, the rationale (for the automatic route) is also that "this form of foreign capital through AIFs is more long term in nature as against portfolio investment and is generally more constructive in terms of having a positive longterm impact on the economy." "This sector is a perfect case for the government to implement its motto of 'less government more governance'," he said.

Since local hedge funds (registered with the capital market regulator as AIF III) are allowed to leverage, there is debate on whether the proposed foreign investment under automatic route should be extended to them as well.

Richie Sancheti, head of fund formation at law firm Nishith Desai Associates, suggested that if the quantum of foreign investment crosseda certain level, these funds could be treated as foreign portfolio investors (FPIs) which trade in Indian stocks and bonds.

"The intended framework should be a complete code stating the complete policy on allowing foreign contribution into AIFs...For determining the characterisation of downstream investments, only the level of foreign ownership of the corpus of the fund should be relevant for this purpose. This would be in line with the government proposal to encourage domestic management structures," said Sancheti.

ET View

China is the Worry

The reduction of foreign institutional holdings in top Indian companies is no indicator of their declining interest in Dalal Street. Though stock market valuations are elevated and growth is yet to show signs of picking up, signs are that foreigners are willing to wait a bit for the economic recovery.

The bigger risk for regional equities, including India, comes from China. If the stock market decline there precipitates, there could be a risk-off trade with global investors reconsidering their bets on emerging markets.