Social Impact Investing in India

A Supplement to Corporate Social Responsibility & Social Business Models in India : A Legal & Tax Perspective

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1. Introduction

The social sector plays a vital role in supporting various social and economic needs in India through a field-based approach. In the context of India, where economic growth has not been able to cross the last mile and with socio-economic disparities widening, the social sector has now started to explore the market-based approach to tackle the challenges of inclusive growth and sustainable development.

The decade from 2002 to 2012 was arguably the fastest growing in India's post-liberalized economic history, as GDP grew at 7.6 percent annually. During this high growth phase, household consumption too saw a healthy rise in real terms. Fixed investment too reached an all-time high of almost one-third the GDP.[1] India's rapid economic growth made it one of Asia's most promising markets.

With the change in government at the Centre, there has been rising expectations and aspirations and India's growth is expected to further strengthen to reach up to 7.5 percent in 2016. India's growth is likely to benefit from strong domestic demand, policy reforms on ease of doing business, foreign direct investment, and lower petroleum prices and manageable inflation. India is expected to continue to be a major economy and a serious player in emerging market economies.[2]

The economic growth has been quite lop-sided with regions and demographics witnessing varied levels of economic well-being and deprivation. The highest paid working class population (which is almost 10% of the entire wage earning population) currently earns 14-15 times more than the least paid working class population.

1. McKinsey & Company Insights India Report October 2014: India's economic geography in 2025: states, clusters and cities
2. IMF: World Economic Outlook, October 2015

This is in sharp contrast to other developing economies like Indonesia, Brazil and China, for where the earnings in the top bracket were five to six times higher than those in the bottom rung.[3]

Given the existing income inequality which can lead to market distortions and slowdown in domestic demand, inclusive growth will become an important tool to achieve long-term economic dividends. To achieve this, the key drivers are likely to be:

- The Agrarian sector, and in particular,farm productivity. Increasing investment in the infrastructural side of the agrarian sector, improving access to market, rationalization of price supports, expanding the adoption of new technologies, and streamlining agricultural administration and extension services can help to achieve annual yield of 5.5 percent.[4]
- Healthcare and sanitation: Improvement in health and sanitation facilities is one of the key drivers of the economy. There is an urgent need to accelerate improvement in access to and utilization of health, family welfare and nutrition services with a special focus on under-served and underprivileged population. According to D&B's forecasts, total government expenditure on health is expected to remain low at 1.5% of GDP in FY20 and infusion of private capital is going to be the key driver.[5]
- Financial inclusion. India needs to infuse the market with 0.10 billion new non-agrarian jobs over the next 10-15 years to accommodate a growing population which is educated and unemployed. India also needs to reduce its employment generation's

3. Special Focus: Inequality in Emerging Economies, OECD 2011
4. McKinsey Global Institute Report February 2014: From poverty to empowerment: India's imperative for jobs, growth, and effective basic services
5. D&B India 2020 Economy Outlook

over-dependence on agriculture.[6] Promoting small entrepreneurial and small scale employability through better access to credit will be a key determinant.[7]

In most cases, social sector organizations face resource constraints and are not always equipped to replicate the successes of modern business approaches. Lack of business expertise, coupled with underutilization of resources leads to systemic underperformance. As marketsexpand , new opportunities for generating livelihoods and sustainability begin to emerge. The introduction of capital typically is a precursor to the expansion of consumer choices. Thus, meeting the socio-economic demands in itself is a prime driver for creating social impact. It is, therefore, no surprise that the market opportunity for impact investment is vast. A recent study examined five sectors of special importance to wage-earners living on less than $250 per month (water, health, housing, education and financial services). The study estimated that, over the next decade and a half, these sectors could absorb $400 billion to $1 trillion in capital and generate $183 billion to $667 billion in profits.[8] South Asia is one among the top three regions where impact investment commitments are expected to witness a steep rise.

It is this systemic underperformance that impact investing tries to resolve by infusing capital along with business-management practices so that organizations are able to maximize their resources and achieve the desired outcomes. Impact investment into social entrepreneurial approaches, with appropriate scale, scope and focus can go a long way in complementing social sector organizations in bringing about sustainable development. Given the priority sector requirements and significant deficiencies in public spending, there are multiple market opportunities for investments, collaborations and exits for social entrepreneurs to develop innovative and differentiated businesses to foster inclusive growth.

Impact investing looks at raising funds and making investments in entrepreneurs who work to solve socio-economic challenges using market economy. Social impact investing drives entrepreneurs to build self-sustaining systems to serve a wide array of the population and provide returns (both social and capital) on such investments. The ability to deliver benefits on a large scale is the wellspring of impact investment's appeal.

6. McKinsey Global Institute Report February 2014: From poverty to empowerment: India's imperative for jobs, growth, and effective basic services

7. IMF Financial Access Survey, 2011

8. Impact Investing: Harbinger of a Brighter Future and a Friendlier Bond Market? ISBInsight

2. Evolution of Social Impact Investing in India

India is considered a breeding ground for (social) impact investing due to the enormous size of its demography and the unfulfilled demands for social and economic services. The reduced public investment in priority sectors like primary education, health, housing, water and sanitation etc. has allowed the growth of the private entrepreneurial space. In recent past, private capital has flowed into key sectors of the economy with special focus on microfinance, health services, education and other allied sectors. The impact investing space also saw few key players like Incube, Charioteer and Unitus Seed Fund partaking substantial investments, thereby further signaling the availability of private capital for long-term sustainability goals. While there has been no apparent dearth of private capital to spurt social innovations, the emergence of dedicated social investment funds is a rightful recognition of the importance of social impact funds to India's economy and job creation. There are certainly some unique characteristics of these new impact funds, and have been able to make a policy impetus in areas that require a dedicated flow of investments.

India is certainly one of the most vibrant economies in the world and the rise of the entrepreneurial eco-system has allowed impact investing to set its foot firmly here. Recent studies indicate that impact equity accounted for almost one-fifth of overall equity transactions in India in 2014-15. In fact, impact equity investments are expected to grow by 30% in coming years.[9] Survey results show that impact investment in India, going forward, will target livelihood, education and health services.

9. A Natural Destination, Asia Asset Management Journal, June 2014 Vol. 19 No.6

3. Alternative Investment Funds in India

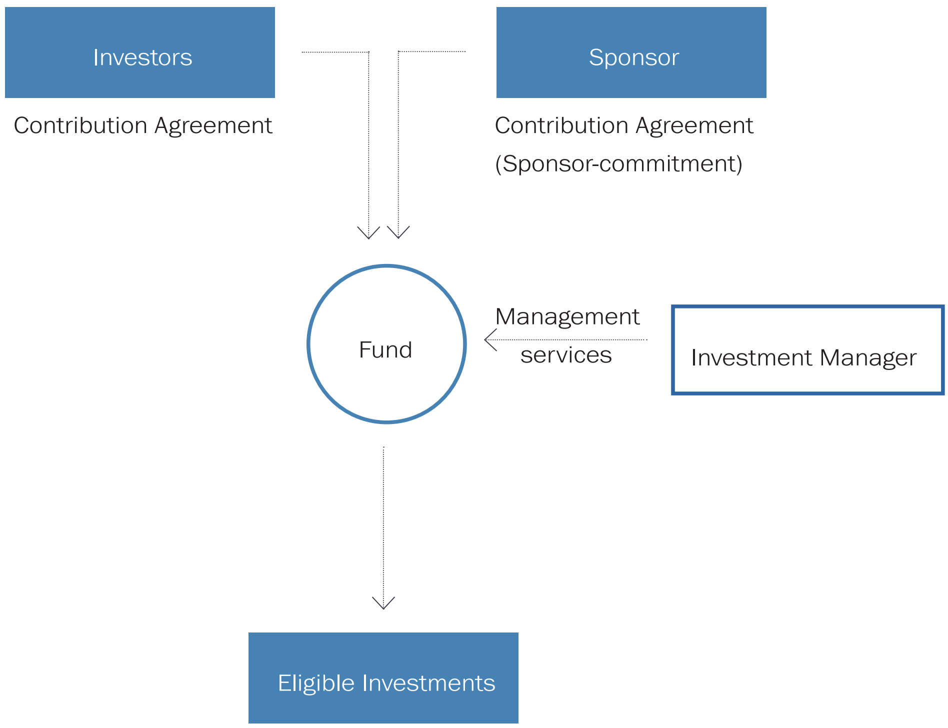
In the year 2012, SEBI enacted the Alternative Investment Funds (AIF) Regulations which included 'social venture funds'. AIFs are funds established in India for the purpose of pooling capital from Indian and foreign investors for investing as per a pre-decided social impact policy. Subject to certain exceptions, the ambit of the AIF Regulations is to regulate all forms of vehicles set up in India for pooling of funds on a private placement basis. To that extent, the AIF Regulations provide the bulwark within which the Indian fund industry is to operate.

An AIF means any fund established or incorporated in India in the form of a trust or a company or a LLP or a body corporate which:

i. is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and

ii. is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.

Figure 1: The following diagram depicts the social venture fund that is set up in the form of a trust



4. Social Venture Funds

Although existent in practice, it is only under the AIF Regulations that social venture funds were formally recognized. Under the AIF Regulations, a social venture fund is defined as, "an alternative investment fund which invests primarily in securities or units of social ventures and which satisfies social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns."

Typically, social venture funds tend to be impact funds which predominantly invest in sustainable and innovative business models. The investment manager of such a fund is expected to recognize that there is a need to forecast social value, track and evaluate performance over time and assess investments made by such funds.

I. Laws Relating to Social Venture Funds in India

Offshore social venture funds tend to pool capital (and grants) outside India and make investments in India like a typical venture capital fund. Such offshore funds may not directly make grants to otherwise eligible Indian opportunities, since this may require regulatory approval.

Onshore social venture funds are required to be registered as Category I AIFs under the specific sub- category of social venture funds. In addition to the requirement to fulfill the conditions set out in the definition (set out above), social venture funds under the AIF Regulations are subject to the following restrictions and conditions:

- Requirement to have at least 75% of their investible funds invested in unlisted securities or partnership interest of 'social ventures'[10]
- Allowed to receive grants (in so far as they conform to the above investment restriction) and provide grants. Relevant disclosure in the placement memorandum of the fund will have to be provided if the social venture fund is considering providing grants as well
- Allowed to receive muted returns

II. Characteristics of Social Venture Funds

Social venture funds tend to be different from venture capital funds or private equity funds not just in the investments that they make, but also in the nature of commitments that they receive from their limited partners / investors. The following is a list of some of the characteristics that a social venture fund may expect to have:

- Investors making grants (without expectation of returns) instead of investments;
- The Fund itself provides grants and capital support considering social impact of such participation as opposed to returns on investment alone;
- Fund targeting par returns or below par returns instead of a fixed double digit IRR;
- Management team of the Fund participating in mentoring, "incubating" and growing their portfolio companies, resulting in limited token investments (similar to a seed funding amount) with additional capital infused as and when the portfolio grows;
- Moderate to long term fund lives in order to adequately support portfolio companies.

Social venture funds also tend to be aligned towards environmental, infrastructure and socially relevant sectors which would have an immediate impact in the geographies where the portfolio companies operate.

10. Regulation 2(1)(u) of the AIF Regulations states – "social venture fund" means a trust, society or company or venture capital undertaking or limited liability partnership formed with the purpose of promoting social welfare or solving social problems or providing social benefits and includes -

i. public charitable trusts registered with Charity Commissioner;
ii. societies registered for charitable purposes or for promotion of science, literature, or fine arts;
iii. company registered under Section 25 of the Companies Act, 1956/Section 8 of the Companies Act, 2013;
iv. micro finance institutions.

5. Market Opportunities

Typically a social impact fund (**"Impact Fund"**) is like a growth partner with limited shelf-life. The Impact Fund makes investment in growth stage companies in priority sector. The promoter of the Impact Fund could also be a *not-for-profit* or a foundation that supports and nurtures socio-economic inclusion through targeted grants.

The Impact Fund is focused on investing in business models that work with the lower income group across financial inclusion, priority sector lending, healthcare, education, livelihood etc. The Impact Fund invests in early and growth stage investments in priority sector. While making majority investment, the Impact Fund fund also uses the balance amount for expenses and follow-on investments. With timely financial support, most of the investees manage to grow substantially and yield positive social and economic returns. In many cases, the projected exit proceeds from the investment portfolio yield better than expected returns in on the invested capital w.r.t cash-on-cash returns.

I. Investment Strategy

Based on the market scenario, am Impact Fund would typically focus on priority sector enterprises to develop a diversified portfolio across the following sub-segments, for example:

- SME financing;
- Affordable healthcare;

II. SME Financing

India has a huge entrepreneurial class of people who run their business with no formal source of financing. Thus, there is a great demand-supply gap which needs to be tapped. There is a tremendous opportunity in the SME financing segment with products such as asset financing, working capital financing, venture debt, loan against mortgage etc.

III. Affordable healthcare

With dismal investment in public healthcare and a huge demand for quality healthcare services, there is a high demand-supply gap in the healthcare sector. The total GDP allocation towards healthcare is dismal is India, while the out-of-pocket expenditure by households was close to 70 per cent. Surprisingly, health insurance caters to less than 10% of the population. Social impact funds could look at financing affordable healthcare service providers.[11] Thus, the investment approach for a Fund should be centered on access, affordability and quality.

IV. Trends in Impact Investing[12]

The standard of what constitutes an 'alignment of interests' between fund investors (LPs) and fund managers (GPs) India-focused fund or India-based fund has undergone some degree of change over the years. Typically, LP participation in a fund is marked by a more hands-on approach in discussing and negotiating fund terms which by itself is influenced by a more comprehensive due diligence on the track record of the GP and the investment management team. This chapter provides a brief overview of certain fund terms that have been carefully negotiated between LPs and GPs in the Indian funds context.

Investment Committee and Advisory Board Sophisticated LPs insist on having a robust decision- making process whereby an investment manager will refer investment and / or divestment proposals along with any due diligence reports in respect of such proposals to an investment committee comprising representatives of the LPs as well as the GP.

11. McKinsey Report 2012: India Healthcare: Inspiring possibilities, challenging journey

12. Fund Structuring & Operations, Nishith Desai Associates

The investment committee is authorized to take a final decision in respect of the various proposals that are referred to it. In view of this, the composition of the investment committee and the nature of rights granted to certain members can become very contentious. The investment committee is also empowered to monitor the performance of investments made by the fund on an on-going basis. Separately, any transaction that could involve a potential conflict of interest is expected to be referred for resolution to an advisory board consisting of members who are not associated with the GP.

V. Management Fee

In keeping with the global trend, there appears to be less tolerance among India-focused LPs to invest in a fund that provides a standard '2-20' fee – carry model. Since management fees bear no positive correlation to the performance of the investments made by the fund, LPs can be circumspect about the fee percentage. Further, issues may arise with respect to the base amount on which the management fee is computed. During the commitment period, fee is calculated as a percentage of the aggregate capital commitments made to a fund. After the commitment period, fee is calculated as a percentage of the capital contribution that has not yet been returned to the LPs. The fee percentage itself is generally a function of the role and responsibilities expected to be discharged by a GP. It is not uncommon to see early stage capital and venture capital funds charging a management fee that is marginally higher than the normal.

VI. Expenses

LPs express concern with respect to the kind of expenses that are charged to the fund (any by extension, to their capital contributions). With a view to limiting the quantum of expenses that are paid by the fund, LPs insist on putting a cap on expenses. The cap which is generally expressed as a percentage of the size of the fund or as a fixed number can become a debatable issues depending on the investment strategy and objective of the fund. Separately, as a measure of aligning interests, LPs insist that allocations made from their capital contributions towards the payment of expenses should be included while computing the hurdle return whereas the same should not be included while determining management fee after the commitment period.

VII. Waterfall

A typical distribution waterfall involves a return of capital contribution, a preferred return (or a hurdle return), a GP catch-up and a splitting of the residual proceeds between the LPs and the GP. With an increasing number of GPs having reconciled themselves to the shift from the 20% carried interest normal, a number of innovations to the distribution mechanism have been evolved to improve fundraising opportunities by differentiating product offerings from one another. Waterfalls have been structured to facilitate risk diversification by allowing LPs to commit capital both on a deal-by- deal basis as well as on a blind pool basis. Further, distribution of carried interest has been structured on a staggered basis such that the allocation of carry is proportionate to the returns achieved by the fund.

VIII. Giveback

While there have been rare cases where some LPs have successfully negotiated against the inclusion of a giveback provision, GPs in the Indian funds industry typically insist on an LP giveback clause to provide for the vast risk of financial liability including tax liability. The LP giveback facility is a variant to creating reserves out of the distributable proceeds of the fund in order to stop the clock / reduce the hurdle return obligation. With a view to limiting the giveback obligation, LPs may ask for a termination of the giveback after the expiry of a certain time period or a cap on the giveback amount. However, this may not be very successful in an Indian context given that the tax authorities are given relatively long time-frames to proceed against taxpayers. As bespoke terms continue to emerge in LP-GP negotiations, designing a fund may not remain just an exercise in structuring. The combination of an environment less conducive for fund raising and the change in legal, tax and regulatory environment besides continuously shifting commercial expectations requires that fund lawyers provide creatively tailored structural alternatives.

6. Fund Documentation

Fund counsels are now required to devise innovative structures and advise investors on terms that meet LP expectations on commercials, governance and maintaining discipline on the articulated investment strategy of the fund. All these are to be done in conformity with the changing legal framework.

I. At The Offshore Fund Level

A. Private Placement Memorandum

The PPM is a document through which the interests of the fund are marketed to potential investors. Accordingly, the PPM outlines the investment thesis of a fund, summarizes the key terms on which investors could participate in the fund's offering and also presents the potential risk factors and conflicts of interest that could arise to an investor considering an investment in the fund.

B. Constitution

A constitution is the charter document of an offshore fund in certain jurisdictions. It is a binding contract between the company (i.e. the fund), the directors of the company and the shareholders (i.e. the investors) of the company.

C. Subscription Agreement

The subscription agreement is an agreement that records the terms on which an investor will subscribe to the securities / interests issued by an offshore fund. The subscription agreement sets out the investor's capital commitment to the fund and also records the representations and warranties made by the investor to the fund. This includes the representation that the investor is qualified under law to make the investment in the fund.[13]

D. Advisory Agreement

The board of an offshore fund may delegate its investment management / advisory responsibilities to a separate entity known as the Investment Advisor or the Investment Manager. The Investment Advisory Agreement contains the general terms under which such investment advisor render advice in respect of the transactions for the fund's board.

II. At The Onshore Fund Level

A. Private Placement Memorandum

AIF Regulations require that a concerned fund's PPM should contain all material information about the AIF, including details of the manager, the key investment team, targeted investors, fees and other expenses proposed to be charged from the fund, tenure of the scheme, conditions or limits on redemption, investment strategy, risk factors and risk management tools, conflicts of interest and procedures to identify and address them, disciplinary history, terms and conditions on which the manager offers services, affiliations with other intermediaries, manner of winding up the scheme or the AIF and such other information as may be necessary for an investor to take an informed decision as to whether to invest in the scheme of an AIF.

B. Indenture of Trust

The Indenture of Trust (Indenture) is an instrument which is executed between a settlor and a trustee whereby the settlor conveys an initial settlement to the trustee towards creating the assets of the fund. The Indenture also specifies various functions and responsibilities to be discharged by the appointed trustee.

13. In case the fund is set up in the format of a limited partnership, this document would be in the format of a limited partnership (with the 'general partner' holding the management interests).

C. Investment Management Agreement

The Investment Management Agreement is entered into by and between the trustee and the investment manager (as the same may be amended, modified, supplemented or restated from time to time). Under the Investment Management Agreement, the trustee appoints the investment manager and delegates all its management powers in respect of the fund, (except for certain retained powers that are identified in the Indenture) to the investment manager.

D. Contribution Agreement

The Contribution Agreement is to be entered into by and between each contributor (i.e. investor), the trustee and the investment manager (as the same may be amended, modified, supplemented or restated from time to time) and, as the context requires. The Contribution Agreement records the terms on which an investor participates in a fund. This includes aspects relating to computation of beneficial interest, distribution mechanism, list of expenses to be borne by the fund, powers of the investment committee, etc. A careful structuring of this document is required so that the manager /trustee retain the power to make such amendments to the agreement as would not amend the commercial understandings with the contributor.

E. Investor Side Letters

It is not uncommon for some investors to ask for specific arrangements with respect to their participation in the fund. These arrangements are recorded in a separate document known as the side letter that is executed by a specific investor, the fund and the investment manager. Typically, investors seek differential arrangements with respect to management fee, distribution mechanics, participation in investment committees, investor giveback, etc. An investor may also insist on including a 'most favored nations' (MFN) clause to prevent any other investor being placed in a better position than itself. An issue to be considered is the enforceability of such side letters unless it is an amendment to the main contribution agreement itself.

F. Agreement with Service Providers

Sometimes, investment managers may enter into agreements with placement agents, distributor and other service providers with a view to efficiently market the interests of the fund. These services are offered for a consideration which may be linked to the commitments attributable to the efforts of the placement agent/distributor.

7. Management of The Fund

I. The Board

Consisting of its members, (the "directors") is responsible for the management of the affairs of the Fund. To assist them with the operations of the Fund, the Directors can appoint an investment advisor. Further, the directors can delegate certain administrative duties to the administrator.

II. Investment Advisor

Pursuant to an investment advisory agreement among the fund and the investment advisor, the investment advisor provides the board with non-binding, non-exclusive advice and recommendations regarding the management and operations of the fund. Typically, advice and recommendations of the investment advisor are subject to the final decision of the board. Pursuant to the advisory agreement, the investment advisor receives an advisory fee from the Fund. With respect to actions taken by the investment Advisor in its capacity as investment advisor, the Fund would indemnify the investment advisor for losses and expenses in connection therewith.

III. The Investor Panel

The Fund would constitute an investor panel which will comprise representatives of the investors.

IV. The Sub-advisor

The sub-advisor provides non-binding, non-exclusive advice and recommendations to the investment advisor in respect of the investment fund advised or managed by the investment advisor. At its discretion, the investment advisor may reject the advice and recommendations provided by the sub-advisor.

V. The Administrator

The Fund can delegate certain administrative duties with respect to the Fund to the administrator. The administrator carries out the day-to-day administrative activities of the Fund and, subject to the board's supervision, has responsibility for the administration of the Fund's affairs, except with respect to the investment advisory responsibilities performed by the investment advisor. These administrative responsibilities include receiving and processing subscriptions for shares, arranging and issuing capital call notices to investors, arranging for the payment of the Fund's expenses, processing transfers of shares, maintaining the Fund's books and records, including the register of shareholders, coordinating with the Fund's auditors for the audit of the Fund's books and the preparation of its statutory and tax filings, if any, and preparing and distributing reports to each shareholder.

The administrator receives a fee for the services it provides to the Fund, which is paid by or on behalf of the Fund. The Administrator may subcontract with other parties for administrative and certain other services.

VI. Investment Process

Investment process consists of investment opportunities, evaluation and engagement with portfolio companies, post investment and planning of exit.

VII. Sourcing Strategy

The promoter can explore opportunities through various means, including:

- Direct relationship with entrepreneurs
- Industry networks
- Incubators
- Investment bankers

VIII. Evaluation Process

A strong assessment process can be created followed by due diligence. Once the deal is sourced, it needs to be put through the following stages:

i. Initial screening

ii. Investment analysis

iii. Investment Committee deliberation

iv. Elaborate due diligence

v. Approval of the Board

IX. Operational Engagement

The operational engagement encompasses business and financial monitoring, strategic advisory, capacity building and case-specific involvement.

X. Exit

Based on investment returns, market scenario and potential of scalability, an exit option can be exercised either through a strategic sale or by sale to financial investors. The decision to exit is based on multiple factors, including performance, position of the company vis-à-vis industry structure, any material change in regulations, external market sentiments, appetite of incoming investors/buyers, etc.

8. Ways to Enhance Credit For Impact Investment

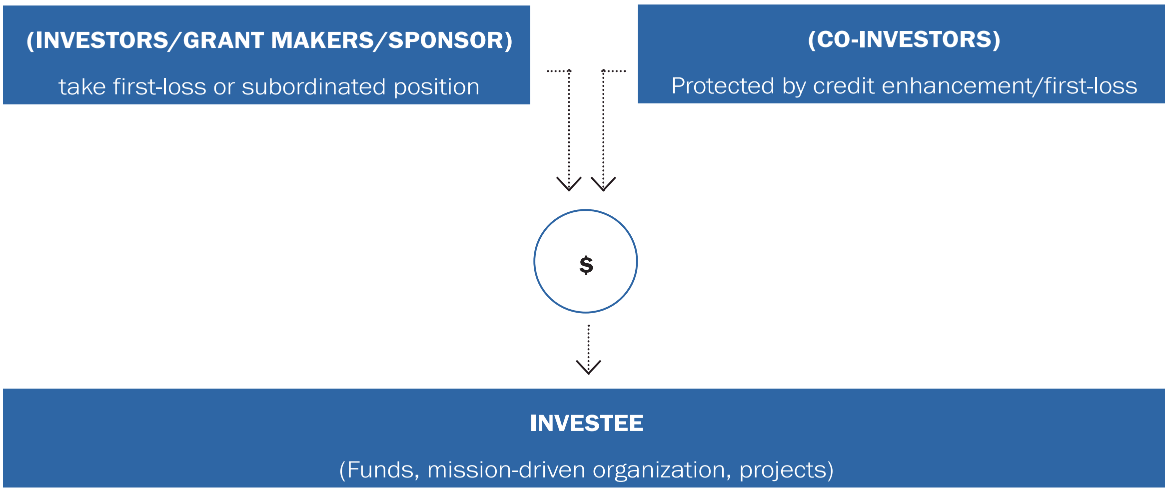
As social impact investing espouses muted returns in order to achieve greater social impact, investors have been increasingly looking at leveraging credit enhancement mechanisms to catalyze the participation of co-investors. Investors, therefore, have been using a broad range of tools to boost credit enhancement for their co-investors and one innovative tool which has been used quite successfully is catalytic first-loss capital (**"CFLC"**).

CFLC refers to socio-economically driven credit enhancement which is pumped into the impact fund by an investor. Using this credit enhancement mechanism, the principal

investor agrees to bear first losses in an investment in order to catalyze the participation of co-investors that otherwise would not feel encourage to co-invest into the fund.

The CFLC has gained wider recognition in impact investing discourse, especially among investors who are mission driven and intending to use their existing capital to achieve more impact. In fact, a number of recent transactions have used the CFLC model in reducing capital risk, advancing social goals using commercially scalable capital and stimulating investment opportunities and activities in untapped markets.

Figure 2: Catalytic first-loss capital



CFLC has three distinct features:

- **It identifies the principal i.e. the investor that will bear first losses**
  The amount of loss covered is set out in the investment document and is agreed upon upfront
- **It is catalytic**
  By improving co-investors' risk-return profile, other investors are catalyzed into participating in the fund
- **Purpose-driven**
  CFLC channelizes capital towards attaining certain socio-economic outcomes as well as demonstrate the commercial viability of investing into a hitherto untapped market

CFLC is a tool that can be used in the impact fund structure through a range of instruments as indicated in the table below:

INSTRUMENT	DESCRIPTION
Equity	By taking the most junior equity position in the overall capital structure, the principal investor takes first losses (also seeks riskadjusted returns); this includes common equity in structures that include preferred equity classes
Grants	A grant provided for the express purpose of covering a set amount of first-loss
Guarantees	A guarantee to cover a set amount of first-loss
subordinated debt	The most junior debt position in a distribution waterfall[14] with various levels of debt seniority (with no equity in the structure)[15]

Source: Global Impact Investing Network

Thus, the principal investor in the impact fund, by offering protection to other investors can enhance capital inflow and also afford to take greater financial risk in return for social impact. Using CFLC mechanism, investors having deeper knowledge of sectorial nuances are able to make informed investments.
Given their sectorial knowledge, these investors are typically international funding agencies, high-net worth individuals, governments and development finance institutions (DFIs).

14. A type of scheme in which higher-tiered investors receive payment (interest/principal/dividends) in full first before the next tier receives any payment

15. Even if there is no equity in the structure, there may be a reserve account

9. Social Impact Bonds:

Social Impact Bonds (**"SIBs"**) arose as a potential answer to several issues faced by social sector organizations and institutional challenges faced by funding agencies. It is no secret that non-profits constantly face operational and financial strain due to limited capital flow and funding agencies are often dependent on the government for local support, which more often than not, is mired with lack of transparency, risk aversion, lack of expertise and red-tapism.

These multiplicity of institutional deficiencies impede social outcomes and end up leakages in funders' and tax-payers' money towards social programs. As an impact investor and/or a funding agency, it was imperative for a more robust system where stakeholders carried the right skill set with appropriate financial understandings of social projects, with efficient execution of projects coupled with financial disbursements that would be directly linked to successful achievement of social outcomes.

Thus, with countries, governments and funding agencies struggling to find innovative and effective ways to fund social projects, a new type of financial mechanism is emerging in the form of SIBs. Though relatively new, SIBs have gained reasonable traction among various quarters, including government bodies, multi-lateral donor agencies and financial institutions across the globe.

SIBs are structured to enable flow of private investment into socially relevant interventions or programs that provide tangible returns to risk investors and yield cost-saving social outcomes. Most of the SIBs follow a standard template wherein payment is tied to investors achieving desired social outcomes solely within the parameters and controls set forth by the funding agencies.

Although a typical SIB model is often referred to as **"Pay for Success"** payments, there could be different variations of this model. For example, in the context of India, SIB could be modelled as a Pay-for-Success multi-stakeholder arrangement in which impact investors provide the upfront risk capital either by way of pooled-capital or through upfront capital funding to fund social projects. Further, the government agency and/or philanthropic bodies could play the role of outcome payers where re-payments to be made only if social outcomes are achieved. In Indian context, domestic government agencies and/or outcome funders may identify a social issue that it wants to focus on such as prevention of early child marriages or primary education or public health etc.

The intermediary organization raises funds from risk investors and also appoints service providers to implement the program. The outcome funder then enters into an agreement with the aforesaid intermediary organization. Furthermore, an independent project evaluator is also identified and appointed to conduct and verify the outcome-metrics.

Upon successful achievement and verification of the outcome-metrics, the outcome funders/ government agencies makes payment to the investors through the intermediaries. The outcome payment typically consist of the original investment coupled with returns on such investments. However, if the desired social outcomes are not achieved, the government agencies/outcomes funders may choose to not make any payments to the intermediary and the investors may risk losing their investments in part or full, depending on the terms of the SIB arrangements.

Thus, in a typical SIB Pay for Success model, the outcome funder generally shifts the risk of economic loss from non-performance of the contract to risk/private investors through the intermediaries. But in certain cases the SIB model may also tweaked to shift the risk of loss from the outcome funder to service providers. Thus, many subtle variations in SIB models remain which may be due to country-specific market needs and investors' risk appetite.

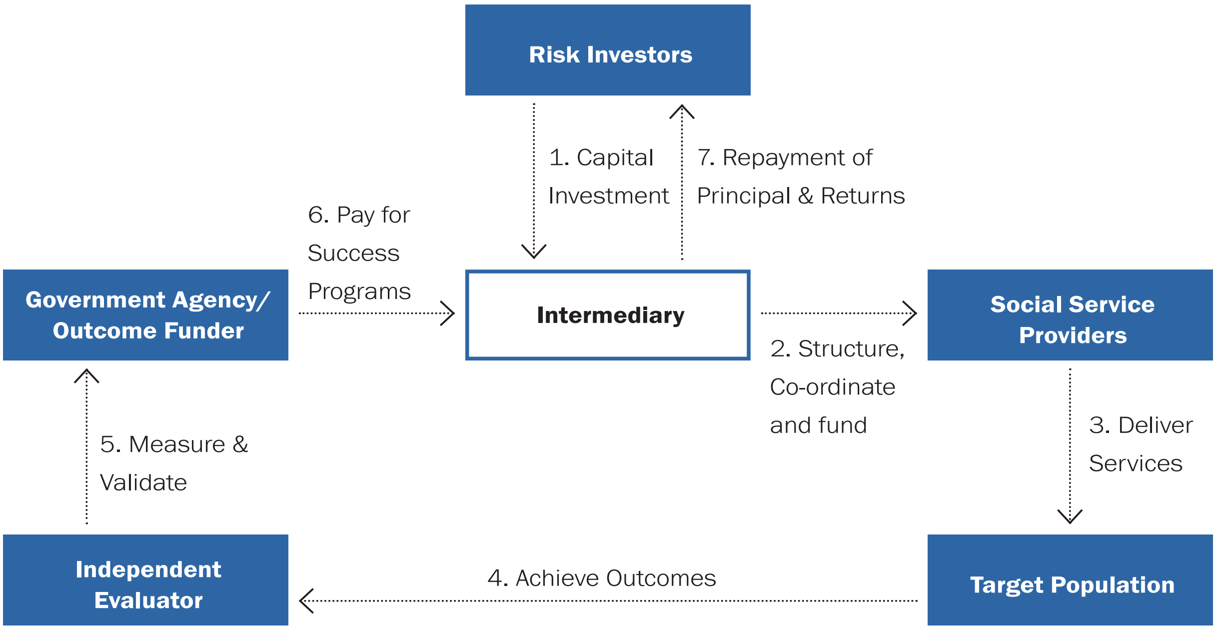


Figure 3: Pay for Success Model[16]

I. The potential of SIBs in India

SIBs have tremendous potential to solve India's tethering social problems. And given the underfunding that social sector organizations are currently undergoing due to certain foreign contributions restrictions, the SIB structure has the potential to infuse funding into these social projects through private investments in a more efficient and effective manner. In fact, SIBs in India have the potential to unlock additional and alternate source of funding and stay clear of regulatory hassles that traditional donor-donee organizations face.

For instance, the SIB structure can incentivize sophisticated investors to pool in funds either at an off-shore as well as on-shore level for financing social projects and ensure financial returns on their investments. In addition, the service providers can receive the capital upfront from the investors, which in a way also hedges them against irregular and unpredictable government support or a decline in charitable donations due to regulatory factors. Furthermore, with an increased risk tolerance on investments by such private investors, it depoliticizes the funding processes that funding agencies have hitherto faced in relation to foreign contribution regulations in India. As the outcome funding under the SIB model is always tied towards social outcomes, the risk of politicization gets heavily discounted and ensures smooth flow of funds.

It can also allow the outcome funders the flexibility to focus on multiple social projects per their liking and priority instead of putting all their funding into a single recipient basket. This type of multiple outcome-focused arrangement can enable the service providers to work on multiple social projects with project intermediaries in a more targeted manner. In order to manage risk capital, private investors can also conduct due diligence and mandate certain quality controls to be implemented by service providers.

In the context of India, the SIB model could be re-modelled as a Public Private Partnership Project (**"PPP Project"**) with government agencies and/or India-based funders playing the role of domestic outcome funders.

16. Diagram adopted from ***What is Pay for Success?*** NONPROFIT FIN. FUND, http://www.payforsuccess.org/learn/basics/#what-is-pay-for-success [https://perma.cc/KX4U-RMME].

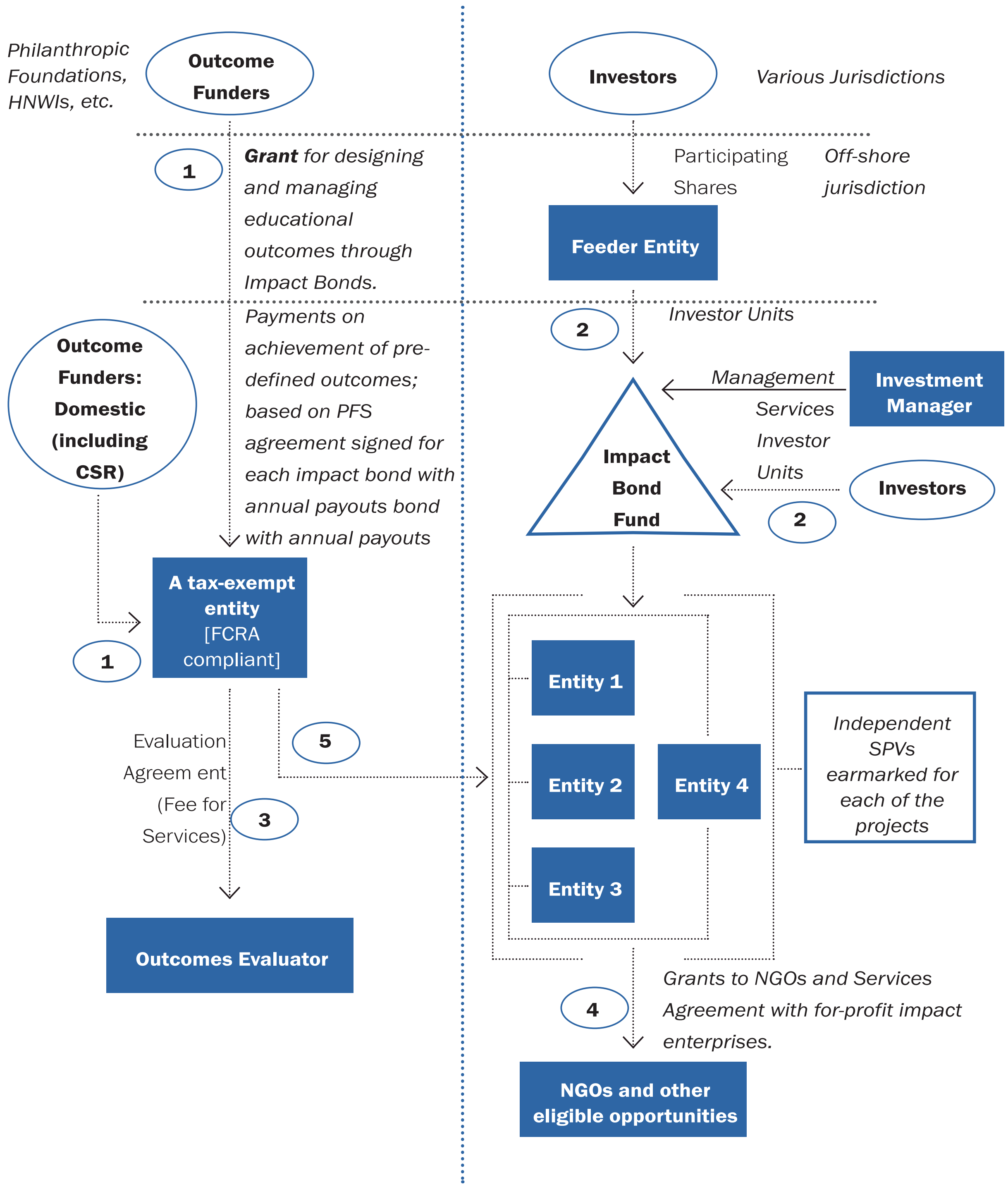


Illustration 2: India-centric SIB PPP Model

II. Structure of the SIB PPP Model

The above model represents a collaborative effort among domestic and foreign outcome funders, government agencies, intermediaries, risk investors, NGOs and project evaluators.

In the current model, the outcome funders could potentially be: (i) domestic funder(s); (ii) foreign funders; (iii) government departments or agencies. The present model is structured in a way to enable leveraging funds from domestic as well as overseas outcome funders. Availability CSR money due to mandatory allocation towards CSR under the Companies Act, 2013 provide for an additional source of capital. If tapped rationally, the SIB-financed programs emanating out of CSR allocations can potentially make a meaningful impact on a range of social issues.

III. Steps involved in channelization of funds

Step 1: Global Outcome funders as well as domestic funders may pool-in grant and provide funds to a non-profit tax-exempt entity in India. The tax-exempt entity plays the dual role of fiscal agent as well as project manager. The tax-exempt entity should be eligible to receive foreign contributions.

Step 2: Off-shore investors (from various jurisdictions) can pool capital and make investments into am off-shore feeder entity. At On-shore level, an Impact Bond Fund (**"IBF"**) can be set up where domestic investors would directly contribute to the Onshore Fund/ SVF while overseas investors will pool their investments in an offshore vehicle which, in turn, invests in IBF.

Step 3: the tax-exempt entity appoints an independent evaluator to measure the outcome-metrics on a pre-determined rigorous methodologies.

Step 4: The SVF may make grants and cash allocations to project specific entities (existing or new LLPs and companies, as the case may be) by way of grants to NGOs and enter into services arrangements with for-profit impact enterprises. In parallel, the tax-exempt entity enters into a Payment for Success Agreement for each impact bonds with annual payouts with the project specific entities.

Step 5: Upon objective determination of achieving agreed-upon outcomes, the tax-exempt entity makes payment for each project which consist of original capital plus a return on their investment.

IV. The possible limitation of SIBs in the context of India

To begin with, how does one define and measure social outcomes that are non-partisan, independent and full proof needs to be addressed. As the outcome payment will be intrinsically linked to social outcomes, the objective measurement and assessment by independent evaluators should be thorough and reliable. Further, unlike traditional philanthropic funding where disbursements are tied to social inputs or outputs, the Pay-for-Success should tie payments solely to results.

As many outcome funders may want to simply reward inputs and outputs, the service providers should stay clear of such pitfalls of merely increasing the volume of inputs/ outputs and focus more on achieving social outcomes. Furthermore, it should be ensured that stakeholders from the investors as well as the outcome side should be totally excluded from the project evaluation process to avoid any conflict of interest and collusion issues.

Another potential issue with the SIB model in India could be due to involvement of multiple outcome funders and the complexity of identifying and measuring outcomes for each of these projects. In fact, given the scale and priorities of different outcome funders, the flow of outcome funds may come in a non-linear fashion and at different stages of the project cycle. Thus, any scope of standardization of the project to rationalize operational costs will have to well thought-out and implemented.

V. Regulatory and tax issues in SIBs

The tax consequences for investors who would participate in a SIB-funded program are not clear under the existing provisions of the Income-tax Act, 1961 (**"ITA"**). Under the current laws, the SIBs are treated as tax-favored investments and may not benefit from preferential tax rates, tax-exempt treatment, or be allowed charitable deductions on providing grants to the pooled vehicle.

VI. Tax uncertainty

The current provisions of the ITA does not specifically address the taxation of SIB investments, their tax treatment should be distinguished from applicable rules governing financial instruments. In fact, for the purposes of taxation under the ITA, the characterization of instrument is significant. Thus, SIBs can plausibly be characterized basis different interpretations and treatments under the provisions of ITA. This may expose SIB risk investors to unpredictable tax compliance risks and liability.

For instance, it needs to be seen whether the ITA would treat SIBs as a debt or as a financial instrument. As SIBs are suffixed as "bonds", and the rate of return prescribed are generally "muted", it may be characterized as debt. As SIB payments to intermediaries are made upon achievement of a pre-agreed outcome, the method of repayment may be considered akin to debt.

Alternatively, SIBs may also be characterized as equity. The reason being, SIBs may not necessarily provide an unconditional promise to pay the investors at a fixed maturity date, which becomes an important factor in characterizing whether it would be a debt or equity. As outcome payment is dependent on successful delivery of social outcomes, the payment for which is certainly not unconditional. Further, the risk investors may or may not receive profits out of the outcome payments, which also gives SIB an equity flavor.

Surprisingly, the SIB arrangement may also be considered as a derivative instrument as it contains several key elements that are common to derivatives. Firstly, the SIB, similar to a derivative instrument, seeks to shift financial risk to another party. The SIB, similarly, computes outcome payments based on the value of the underlying transaction, and requires the risk investor to undertake deployment of a fixed principal amount upfront, while the outcome funder is contractually obligated to make future (and variable) payments basis the value of the underlying transaction at a particular date.

VII. Tax exemption

The provisions of ITA provides for exemptions on paying taxes on interest earned from tax-free bonds, currently the same is not envisaged for SIBs. Under the ITA, bonds that are tax-free are typically issued by the government and is not envisaged to inure benefits to any private business or persons. However, considering the uniqueness of the SIB model where the government may end being one of the primary outcome funder, it will be interesting to see whether any tax-exempt status may also be awarded to SIBs. It may also be interesting to see whether the tax incentives that are currently extended to charitable donations for government recognized social projects are also extended to donations made towards vehicle carrying out SIBs investments.

While SIBs have tremendous potential for cater to social sector needs, tapping private capital in an effective and efficient manner is going to be important. Government's willingness to participate in SIB projects may prove to be the real litmus test for private risk investors in trying to re-shape social sector ecosystem in India. While there certainly is a need to treat SIB investments on a more charitable footing w.r.t ITA, the current laws in India does not necessarily discourage the growth of SIB backed social projects. With the additional capital pool that SIBs can bring, large scale social interventions with meaningful fiscal prudence can be achieved.

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We are a research and strategy driven international firm with offices in Mumbai, Palo Alto (Silicon Valley), Bangalore, Singapore, New Delhi, Munich, and New York. Our team comprises of specialists who provide strategic advice on legal, regulatory, and tax related matters in an integrated manner basis key insights carefully culled from the allied industries.

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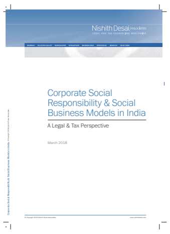

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Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Our dedication to research has been instrumental in creating thought leadership in various areas of law and public policy. Through research, we develop intellectual capital and leverage it actively for both our clients and the development of our associates. We use research to discover new thinking, approaches, skills and reflections on jurisprudence, and ultimately deliver superior value to our clients. Over time, we have embedded a culture and built processes of learning through research that give us a robust edge in providing best quality advices and services to our clients, to our fraternity and to the community at large.

Every member of the firm is required to participate in research activities. The seeds of research are typically sown in hour-long continuing education sessions conducted every day as the first thing in the morning. Free interactions in these sessions help associates identify new legal, regulatory, technological and business trends that require intellectual investigation from the legal and tax perspectives. Then, one or few associates take up an emerging trend or issue under the guidance of seniors and put it through our "Anticipate-Prepare-Deliver" research model.

As the first step, they would conduct a capsule research, which involves a quick analysis of readily available secondary data. Often such basic research provides valuable insights and creates broader understanding of the issue for the involved associates, who in turn would disseminate it to other associates through tacit and explicit knowledge exchange processes. For us, knowledge sharing is as important an attribute as knowledge acquisition.

When the issue requires further investigation, we develop an extensive research paper. Often we collect our own primary data when we feel the issue demands going deep to the root or when we find gaps in secondary data. In some cases, we have even taken up multi-year research projects to investigate every aspect of the topic and build unparallel mastery. Our TMT practice, IP practice, Pharma & Healthcare/Med-Tech and Medical Device, practice and energy sector practice have emerged from such projects. Research in essence graduates to Knowledge, and finally to *Intellectual Property*.

Over the years, we have produced some outstanding research papers, articles, webinars and talks. Almost on daily basis, we analyze and offer our perspective on latest legal developments through our regular "Hotlines", which go out to our clients and fraternity. These Hotlines provide immediate awareness and quick reference, and have been eagerly received. We also provide expanded commentary on issues through detailed articles for publication in newspapers and periodicals for dissemination to wider audience. Our Lab Reports dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction. We regularly write extensive research articles and disseminate them through our website. Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with much needed comparative research for rule making. Our discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged. Although we invest heavily in terms of time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

As we continue to grow through our research-based approach, we now have established an exclusive four-acre, state-of-the-art research center, just a 45-minute ferry ride from Mumbai but in the middle of verdant hills of reclusive Alibaug-Raigadh district. **Imaginarium AliGunjan** is a platform for creative thinking; an apolitical eco-system that connects multi-disciplinary threads of ideas, innovation and imagination. Designed to inspire 'blue sky' thinking, research, exploration and synthesis, reflections and communication, it aims to bring in wholeness – that leads to answers to the biggest challenges of our time and beyond. It seeks to be a bridge that connects the futuristic advancements of diverse disciplines. It offers a space, both virtually and literally, for integration and synthesis of knowhow and innovation from various streams and serves as a dais to internationally renowned professionals to share their expertise and experience with our associates and select clients.

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