Investment Funds: Monthly Digest

September 14, 2022

FRAMEWORK FOR IMPACT FUNDS REVISED

- Framework for Social Stock Exchange and the Social Impact Funds introduced by SEBI
- Erstwhile SVF regime only permitted investments only into social ventures. SIF permitted to invest in social ventures and social enterprises.
- The mandatory requirement to provide muted returns to investors of SVF removed in the new SIF framework.

INTRODUCTION

The impact investment sector in India has grown at a 26% CAGR over the last decade (year 2010-2019), from USD 323 million in 2010 to USD 2.7 billion in 2019, bringing in USD 10.8 billion cumulatively into 550+ enterprise.[1] In 2021, 294 Indian impact enterprises attracted USD 6.8 billion in equity investments.[2] However, several reports suggest that many organisations in the social sector struggle to access the capital they need.[3] The spurt in impact investment is largely driven by global institutional investors and potential of private domestic capital as a source of impact funding has not been fully tapped into.[4]

The legal regime covering impact investing in India remains fragmented with certain regulatory blind spots. The legislations affecting the impact investing sphere include the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"); the Income-tax Act, 1961 ("**ITA**"); the Companies (Corporate Social Responsibility ("**CSR**") Policy) Rules, 2014; and the Foreign Contribution Regulation Act ("**FCRA**"), 2010.

Although the individual application of each of the aforementioned legislations encourages sustainable investing to a degree, their overlap leads to uncertainty. Moreover, the absence of a social stock exchange ("**SSE**") has prevented social enterprises from efficiently and transparently raising capital.

While the AIF Regulations always provided a framework for social venture funds ("**SVFs**"), SVFs have deployed only INR 585.39 crore (USD 73.6 million) as compared to INR 25,782 crore (USD 3.25 billion) cumulatively deployed by Category I AIF.[5] the SVF regime has not been able to take off due to several reasons (discussed below).

It is to remedy the inefficiencies in unlocking the impact investing potential that on July 25, 2022, the Securities and Exchange Board of India ("**SEBI**") introduced the SSE framework and replaced the erstwhile SVF framework with the social impact fund ("**SIF**") framework through, *inter alia*, the SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2022 ("**Amendment**").

In this hotline, we analyse the Amendment and discuss the ramifications as well as potential opportunities for the impact investment space.

BACKGROUND

The erstwhile SVF framework had been established by SEBI to bridge the gap between social ventures and private capital. In essence, SEBI sought to provide a private pooling vehicle for relevant stakeholders to effectively deploy capital to social ventures. However, this vehicle was unable to generate market traction due to stringent corpus requirements of INR 20 crores (USD 2.5 million), minimum investment ceiling of INR 1 crore (USD 126,798), and a restriction on muted returns on investment. The Working Group Report on SSE states that due to the requirement to invest in unlisted securities / partnership interest, SVFs have only been used only for for-profit investments.[6]

In order to plug these gaps and enable scalable financial returns while allocating towards impact, SEBI has now replaced the SVF regime with the SIF regime through the Amendment. With a more light-touch approach, SIF framework seeks to iron out investors' concerns associated with SVFs. The table below provides a comparative analysis of the SVF and SIF regime.

S No	Particulars	SVF	SIF
1.	Permissible investments	Social venture(s)	Social venture(s) and social enterprise(s)
2.	Manner of raising	Issue of units	Issue of units or social units

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	investment		
3.	Minimum Corpus	INR 20 crore (USD 2.5 million)	INR 5 crore[7] (USD 628,968)
4.	Minimum grant threshold	INR 25 lakhs (USD 31,449)	INR 10 lakhs (USD 12,579)
5.	Minimum investment	INR 1 crore (USD 126,798)	INR 2 lakhs (USD 2,515) for SIFs which exclusively invests in NPOs registered / listed on a SSE[8]
6.	Forward granting	Forward granting permitted to social ventures	Forward granting permitted to social ventures or social enterprise
7.	Returns	Mandatory to provide muted or restricted returns to SVF investors	No such requirement

The Amendment provides SIFs the ability to invest both in social venture as well as social enterprise. Social venture have been defined under the AIF Regulations to *inter-alia* include a public charitable trust, societies registered for charitable purposes or section 8 companies. Social enterprise has been defined under the newly added Chapter X-A by the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**LODR Regulations**") to mean either a Not for Profit Organization ("**NPO**") or a For Profit Social Enterprise ("**FPE**") that meets the eligibility criteria specified in the LODR Regulations.[9] The LODR Regulations provide that to be identified as a social enterprise, such enterprise shall establish primacy of its social intent.[10] It is to be noted that corporate foundations, political or religious organizations or activities, professional or trade associations, infrastructure and housing companies (except affordable housing) are not eligible to identify as social enterprises under the LODR Regulations.[11]

The Amendment further allows SIF to raise money through issuance of social units. In this regard, social units have been defined to mean units issued by a SIF or schemes of a SIF to investors who have agreed to receive only social returns or benefits and no financial returns against their contribution.

ANALYSIS

The Amendment is a move in the right direction. The SIF framework (by removing the earlier mandatory restriction of providing muted or restricted returns to investors) should help attract additional mainstream capital in the impact investing space. Therefore, SIFs should be able issue different class of units. This should enable investor preference and allow symmetry between LP needs and capital requirements.

Reductions in corpus size, minimum ticket size (in specified cases) and grant size should help expand the investor base. Nevertheless, SEBI could consider reducing the overall ticket for investment in SIF investing in FPEs or NPOs not listed on SSEs which is still INR 1 crore (USD 126,798).

The Amendment now enables SIF to invest into both FPE and NPO which should help increase the possible use cases and enable adoption of innovative structures in this space. Further, the flexibility provided by the Amendment permitting SIFs (or schemes therein) launched exclusively for NPOs to deploy 100% of their investible funds into securities of NPOs listed on SSE[12] should further increase the amount of funds available to NPOs. While flexibility for investment in FPE and NPOs is appreciated, SIFs should also be permitted to invest in debt instruments. This should enable SIFs to extend credit to entities involved in outcome funding or blended finance transactions.

Despite the laudable advancements by the Amendment, there are still a handful of challenges to unlocking the full potential of impact investing that would require a holistic change across legislations. For example, while the AIF Regulations allow SIFs to receive grants, both from domestic as well as foreign sources, the provisions of the FCRA clearly state that no foreign contributions can be received by any organization in India without taking specific approval from the Ministry of Home Affairs.[13] Thus, despite SVFs being purely regulated under the AIF Regulations for the purposes of receiving grants and making investments using such grants, the provisions of FCRA only envisage non-profit entities to receive foreign grants. Similarly, corporates should be allowed to invest money allocated towards CSR (i.e., 2% of the net profits of applicable companies) into SIFs. This should enable utilisation of a ready source of capital for SIFs.

Some enabling changes should also be made under the ITA, like providing a section 80G exemption to investments in SIF, amendments permitting charities to onward grant to FPEs without the risk of losing tax exemption etc. may also be considered.

CONCLUSION

Charging at the heart of issue, the new SSE and SIF framework should jointly act as a one-stop shop for social enterprises to raise capital. While, SEBI seems to have taken the first step in the right direction, the development of impact investment in India depends on how legal, regulatory and tax framework is shaped in future.

– Ipsita Agarwalla, Nandini Pathak & Rahul Rishi

You can direct your queries or comments to the author

[1] Unlocking Impact Capital: Indian Family Officer, Impact Investors Council, available at https://iiic.in/wp-content/uploads/2021/01/Unlocking-Impact-Capital-The-Indian-Family-Office-Edition.pdf

[2] 2021 in Retrospect: India Impact Investment Trends, Impact Investors Council, available at http://iiic.in/wp-content/uploads/IIC_2021_in_retrospect.pdf

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[3] Shamika Ravi, Emily Wright, Prerna Sharma, and Izzy Jones, The Promise of Impact Investing in India, Brookings Indiam available at

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[4] Unlocking Impact Capital: Indian Family Officer, Impact Investors Council, available at

https://iiic.in/wp-content/uploads/2021/01/Unlocking-Impact-Capital-The-Indian-Family-Office-Edition.pdf

[5] Cumulative net figures as at the end of June 30, 2022, SEBI available at

https://www.sebi.gov.in/statistics/1392982252002.html

[6] Working Group Report on Social Stock Exchange

[7] Regulation 10 (b), SEBI (AIF) Regulations, 2012.

[8] Regulation 10 (c), SEBI (AIF) Regulations, 2012.

[9] Regulation 292A (h), SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018.

[10] Regulation 292E (1), SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018.

[11] Regulation 292E (3), SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018

[12] Regulation 16 (4) (ba), SEBI (AIF) Regulations, 2012.

[13] Section 24 of FCRA