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May 11, 2015

Mr. Ananta Barua
Executive Director
Investment Management Department
Securities and Exchange Board of India
Bandra Kurla Complex
Bandra (East)
Mumbai, India

RE: Follow-Up to ICI Global Meeting on Key Regulatory Issues for Cross-Border Portfolio Investments

Dear Mr. Barua:

Thank you for meeting with my industry colleagues, BMR & Associates LLP, and me on November 13, 2013 to discuss Indian income-tax and regulatory issues of concern to members of ICI Global.[1] We appreciate greatly the time that Mr. Rohit Dubey, Mr. Sandeep Kriplani, Ms. Priyanka Mahapatra, and you spent with us and the forthright and informative discussion.

We traveled from the United States to meet with you to emphasize the need for our members – US funds that are regulated under the Investment Company Act of 1940 and similar non-US regulated funds publicly offered to investors, such as UCITS (collectively, "Regulated Funds") – to have tax and regulatory certainty when investing in Indian securities. The regulatory certainty and clarity we seek will improve investor confidence, enhance the Regulated Funds' investment experience, and promote cross-border portfolio (non-controlling) investment in India.

This letter addresses four of the specific regulatory policy issues we discussed during our meeting, as well as one additional issue. These issues remain important to our members that are already investing in Indian securities, as well as to members exploring the possibility of investing in India. While our meeting with you was held prior to the introduction of the SEBI (Foreign Portfolio Investors)

[1] The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.4 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

Regulations, 2014 ("FPI Regulations"), the issues discussed below have not been fully addressed through the introduction of the FPI Regulations. We apologize for the delay in filing our representation of the matters that were discussed with you.

The following five issues are discussed in Annexure A: (1) the requirement to invest in Indian securities at least five percent of the corpus of a new mutual fund or sub-fund which does not meet the "broad-based" criteria at the time of seeking registration as a Foreign Portfolio Investor ("FPI"); (2) the multi-share class pre-approval requirement; (3) Indian regulatory and tax issues related to fund reorganizations in the home country; (4) the margin requirements for investments in Government Securities ("G-Secs"), and (5) the reinvestment rules for G-Secs purchased using limits obtained at auction. These issues and our request are summarized briefly below.

1. The broad-based fund requirement for a new fund. A new fund or sub-fund that does not meet the broad-based requirement from day one and proposes to invest in Indian securities is required to meet an additional condition of investing at least five percent of its corpus in Indian securities until it satisfies the broad-based test. If the new fund does not meet the broad-based condition within six months of procuring its registration, it then needs to register as a Category III FPI, as opposed to the preferred Category II FPI. The minimum five percent investment criterion is not a workable solution for many Regulated Funds because the fund may have dedicated a percentage lower than five percent of its corpus towards Indian investments and changing that allocation is neither desirable nor feasible.

Request: We request that SEBI authorize Designated Depository Participants ("DDPs") to adjust the five percent requirement downward, on a case-by-case basis, depending on the investment objective and strategy of a particular Regulated Fund. In addition, we request that SEBI provide one year for a new Regulated Fund to meet the broad-based criterion instead of the current six month period.

2. The multi-share class pre-approval requirement. Even under the new FPI regulations, Regulated Funds are required to obtain prior approval if they desire to add a new share class. SEBI has delegated the responsibility for granting approvals for additional share classes to DDPs. Obtaining such an approval (previously granted by SEBI) has, at times, taken a relatively long time, e.g. up to one month. This requirement impedes the launch of a new share class of a Regulated Fund and can have detrimental ramifications for a Regulated Fund, its investors, and its investment firm sponsor.

Request: We request that SEBI allow Regulated Funds to make a declaration – either as part of the FPI application process or subsequently – stating that a common portfolio of securities, including any Indian securities, is maintained across any and all classes of shares issued by the Regulated Fund (e.g., they do not operate segregated pools of capital) and thereafter only require such funds to provide notice to SEBI, or a DDP, upon the launch of a new share class.

3. Fund reorganizations. In order to address business and corporate governance issues, US mutual funds may elect to reorganize their legal structure. Such a reorganization typically involves shifting a trust from one US State to another, or converting a corporate structure to a trust structure. These

reorganizations are *not* being done for tax reasons. In several cases of reorganizations SEBI treats the restructured Regulated Fund as a new FII/FPI and requires the new Regulated Fund to obtain a new FII/FPI license. Obtaining a new license imposes an unnecessary administrative and cost burden on the fund. In addition, there are tax issues and tax leakages that are suffered by the fund due to the reorganization (which we describe below and have also raised with the tax authorities).

Request: We request that in the case of a simple name change, a change in state domicile, or change in corporate form SEBI permit the FII/FPI license to be migrated to the restructured fund when certain conditions are met. We have already written to the Indian tax authorities highlighting the Indian tax issues faced by our members in fund reorganizations and we are following up with them to have the matter resolved.

4. The margin requirements for investments in Government Securities. Regulated Funds that are not located in Asia face operational hurdles in terms of meeting Indian margin requirements and the timing of the margin payments with respect to G-Secs.

Request: As an alternative, we request that, the Irrevocable Payment Commitment rules currently in force which are extended only to the purchase of shares and convertible debentures be extended to transactions in G-Secs as well. This would significantly reduce the hurdles faced by Regulated Funds.

5. Re-investment of proceeds received on sale or maturity of Government Securities. SEBI has in the recent past issued a circular[2] that has summarized clarifications regarding the investment limits for G-Secs and the manner in which proceeds from sale or maturity of G-Secs should be reinvested. While SEBI has relaxed the requirements pertaining to investment in Government Securities, in practice, the reinvestment rules have significant negative consequences for foreign investors, such as Regulated Funds, that have purchased G-Secs using limits obtained at an auction.

Request: We request that SEBI revise the current reinvestment guidelines, in order to allow FPIs that have purchased G-Secs using limit to freely reinvest proceeds from the sale or maturity of those securities without having to go through the auction process should the debt utilization rate change, provided that they do so within a specified period of time.

* * *

Once again, thank you for meeting with us. If we can provide you with any additional information, please do not hesitate to contact my colleague Eva Mykolenko, Associate Chief Counsel – Securities Regulation (emykolenko@ici.org or 1-202-326-5837), or me at your convenience.

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[2] Circular No CIR/IMD/FIIC/19/2014 dated October 9, 2014.

Alternatively, please do not hesitate to contact our Indian tax and regulatory advisors: BMR & Associates LLP at your convenience. The contact details of BMR & Associates LLP are follows: Mr. Russell Gaitonde: Partner (+91 22 6135 7045) and Mr. Sudeep Sirkar: Associate Director (+91 22 6135 7089).

Yours faithfully,

/s/ Keith Lawson

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Enclosures: Annexure A: Detailed response to five specific issues that are being faced by Foreign Institutional Investors/Foreign Portfolio Investors that conduct portfolio investments in Indian securities.

cc: Mr. S. Madhusudanan, Deputy General Manager, Division of Foreign Institutional Investors and Custodians
Mr. Rohit Dubey, Assistant General Manager, Division of Foreign Institutional Investors and Custodians
Ms. Sandeep Kriplani, Assistant General Manager, Division of Foreign Institutional Investors and Custodians

ISSUE 1

The requirement to invest in Indian securities at least 5 percent of the corpus of a new fund which does not satisfy the broad-based criteria at the time of seeking registration.

1. THE GENESIS OF THE ISSUE

Under the former SEBI (Foreign Institutional Investors) Regulations, 1995 ("FII Regulations") a fund proposing to register as a sub-account for implementing portfolio investment in Indian securities was required to satisfy the broad-based criteria, i.e. the fund would need to have at least twenty investors, with no single investor holding more than forty-nine percent of the shares or units of the fund. If the fund had institutional investors, it would not be necessary for the fund to have twenty investors. Also, if the broad-based fund had an institutional investor who held more than forty-nine percent of the shares or units in the fund, then the institutional investor was required to satisfy the broad-based criteria.

As a matter of practice, under the FII Regulations, SEBI was willing to grant conditional registration to a fund which did not satisfy the broad-based criteria at the time of seeking registration provided (i) the fund satisfied the broad-based criteria within a period specified by SEBI (usually 6 months), and (ii) the fund was either an India dedicated fund or undertook to invest at least 5 percent of its corpus in Indian securities. We understand that where a fund was unable to meet the broad-based criteria within the period specified by SEBI, it would need to unwind its transactions in Indian securities and surrender its sub-account license.

Under the new FPI Regulations, the broad-based criteria continues to apply to funds seeking registration as Category-II FPIs. Where the fund does not satisfy the broad-based criteria within 180 days of being granted conditional registration as a Category-II FPI, the fund is not required to surrender its registration (unlike under the prior FII Regulations); instead the fund is required to re-characterize as a Category-III FPI and can continue to invest in Indian securities. The fund then, however, becomes subject to stringent KYC requirements and is not able to invest in Offshore Derivative Instruments.

We understand that the broad-based criteria applied by SEBI for granting FII and FPI registrations was introduced with the intent of allowing only genuine and committed institutional investors to access the Indian markets. However, the requirement of investing 5 percent of the corpus of a fund in Indian securities, pending the fund satisfying the broad-based criteria, is not a workable solution for all Regulated Funds.

A Regulated Funds, such as a US mutual fund or UCITS, that is intended for broad distribution to retail and/or institutional investors may not meet the broad-based criteria at the time it seeks FPI registration. This is because the fund may be seeking FPI registration shortly after its formation, at a

time when only seed money has been invested in the fund and the fund has not yet begun distributing its shares to investors.

A Regulated Fund that does not yet meet the broad-based criteria and is required to seek conditional registration as a Category-II FPI may be unable or unwilling to commit 5 percent of its corpus towards investment in Indian securities because this does not align with the fund's investment objective and strategy. Many Regulated Funds that seek to invest in India have a global outlook and intend to allocate a smaller portion of their corpus towards investment in Indian securities. Importantly, the intended allocation towards investment in Indian securities may be lower than 5 percent of the corpus of the fund. These funds may not have the flexibility to commit to investing at least 5 percent in Indian securities.

Similar to Indian mutual funds, a Regulated Fund, such as a US mutual fund or UCITS, is launched with a specific investment objective (e.g., providing a high level of total return, providing long term growth on investment, etc.) and the fund implements an investment strategy to achieve its investment objective. The fund's investment objective and principal investment strategy is disclosed to investors in the fund's prospectus. For US mutual funds, for example, a change to or deviation from the investment objective or investment strategy of the fund requires the prior approval of the board of directors/trustees of the fund and, in some cases, the prior approval of the investors in the fund. Seeking such approvals can be time consuming and in some cases, the approval may not be received.

We submit that SEBI should not be focused on an investment commitment of 5 percent from Regulated Funds because, regardless of the percentage invested or intended to be invested, Regulated Funds are typically genuine and committed investors that provide a sizable and relatively stable source of foreign financing for emerging markets countries, including India.[3] In our view, Regulated Funds seeking to invest less than 5 percent of their corpus in Indian securities should not be treated in a manner that poses increased hardship and conditions in order to invest in Indian securities.

2. SUGGESTIONS

We request that SEBI permit DDPs to grant conditional registration to a Regulated Fund that agrees to invest in Indian securities a specified percent of its corpus that is less than 5 percent, based on the investment objective and strategy of the fund. SEBI could consider requiring such funds to furnish an appropriate declaration at the time of application for registration under the FPI Regulations. We have provided below a sample of the declaration for your consideration.

"We undertake as follows:

1. [•] is a fund formed under the laws of [•].

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[3] *See* Why Regulated Funds Are a Relatively Stable Source of Foreign Investment for Emerging Economies, by Chris Plantier (September 26, 2014), available at http://www.ici.org/viewpoints/view_14_sizing_funds_em_02.

2. [•] is committed to investing [•] % of its corpus in Indian securities which, as of date, translates into approximately US$ [•] million.

3. [•] further undertakes that it will satisfy the broad-based criteria within the specified period of 180 days."

Second, we request that SEBI consider providing a moratorium period of one year (rather than six months) for a new Regulated Fund to meet the broad-based criteria. For certain Regulated Funds, six months is not sufficient time to launch a fund and begin public distribution.

ISSUE 2
The pre-approval requirement for issuing additional classes of shares.

1. THE GENESIS OF THE ISSUE

Under the new FPI Regulations a Regulated Fund is treated like a Protected Cell Company ("PCC") or a Multi Class Share Vehicle ("MCV") and is required to obtain prior approval of the DDP prior to launching a new share class, which is granted only after obtaining prescribed documents and declarations from the FPI.

We understand that SEBI had introduced the requirement for PCCs and MCVs to seek prior approval of SEBI / DDPs as it had noticed that in some cases, segregated portfolios were being maintained across separate cells / shares classes of the PCC or MCV, respectively. Further, each cell or share class was not technically meeting the broad-based criteria though at an entity level, the PCC or MCV was satisfying the broad-based criteria.

We believe that Regulated Funds that maintain common portfolios of assets for all share classes are not akin to PCCs or MCVs and hence, imposing requirements applicable to PCCs and MCVs on these Regulated Funds creates an unnecessary hardship for these funds.

PCCs are typically permitted to segregate their assets and liabilities into different cells; a creditor of one cell can only proceed against the assets of that particular cell. Each cell is completely independent and separate from the other cells in the PCC. A cell may have several investors or may be restricted to even a single investor.

In an MCV, it is possible to have different investment strategies (by way of different share classes) designed in accordance with the individual investor needs. It is also possible to structure a separate share class even for a single investor. The investors could also choose a share class in accordance with their respective investment horizon. Similar to PCCs, MCVs can have class wise segregation of assets and liabilities; however there can be no segregation of liabilities vis-à-vis third parties and to that extent MCVs are different from PCCs, as creditors of one class can proceed against assets of the other classes of the MCV at the entity level.

Many Regulated Funds, such as US mutual funds and UCITS, are able to issue multiple classes of shares in accordance with their home jurisdiction's regulations. Different share classes are created for business reasons – such as targeting retail or institutional investors, or targeting investors who purchase shares without the help of a financial professional. While such share classes are permitted to charge different

fees for certain categories of expenses, the fund maintains a common portfolio of securities for all of the share classes.[4]

A Regulated Funds may determine to launch a new share class subsequent to the initial launch of the fund because there is a demand for such a share class from potential investors. The requirement to seek prior approval from a DDP in order to launch a new share class can negatively impact a Regulated Fund, its investors, and its investment firm sponsor. A delay in approval can result in missed opportunities for business growth (e.g., prospective investors go elsewhere because the desired shares class is not offered). It can also impact the ability of the fund and its investors to reap the benefits of economies of scale. Further, a Regulated Fund incurs regulatory and administrative costs in connection with seeking approval for the issuance of a new share class.

2. SUGGESTIONS

We believe that it is not necessary for SEBI to require pre-approval of a new share class for Regulated Funds that maintain a common portfolio of securities for all of the share classes. Rather, SEBI can address its concerns by allowing Regulated Funds to make a declaration – either as part of the FPI application process or subsequently – stating that a common portfolio of securities, including any Indian securities, is maintained across any and all classes of shares issued by the Regulated Fund (e.g., they do not operate segregated pools of capital). SEBI may, thereafter, require such funds to provide notice to SEBI, or a DDP, upon the launch of a new share class.

In this regard, we have provided below a sample declaration that SEBI could consider taking from the Regulated Fund:

1. [•] is a fund formed under the laws of [•] as a [•].

2. Under the regulations' of its home jurisdiction, [•] is permitted to issue multiple classes of shares to its investors.

3. The fund maintains a common portfolio of securities across any and all of its share classes. It does not and will not maintain segregated portfolios in Indian securities across its share classes.

[4] For a description of mutual fund fee structures and classes of securities, see the 2014 ICI Factbook at 94-99, available at http://www.ici.org/pdf/2014_factbook.pdf.

ISSUE 3
Reorganizations of Regulated Funds May Require a Fresh Registration with SEBI

1. THE GENESIS OF THE ISSUE

Reorganizations of Regulated Funds occur for many different business and regulatory reasons. Under US law, for example, reorganizations of Regulated Funds may involve multiple Regulated Funds or a single Regulated Fund. When two Regulated Funds are merged, the assets of the Regulated Funds (which have comparable investment objectives) are combined; the investors in the remaining (successor) Regulated Fund have a proportionate interest in each asset that previously was held by each of the predecessor Regulated Funds. When a single Regulated Fund is reorganized, there is no change in the assets, ultimate investors, fund manager, or (in some instances) the directors/trustees of the predecessor Regulated Fund and the successor Regulated Fund. All such reorganizations, whether involving one or multiple funds, are treated as "tax neutral" in the US and in many/most other jurisdictions.

The reorganization of Regulated Funds can in some cases lead to a situation in which SEBI treats the resulting Regulated Fund as a new fund and requires it to procure a fresh FPI registration with SEBI. There is a lack of clarity regarding which reorganizations require a new FPI registration and which reorganizations do not.

In addition, Regulated Funds seeking to reorganize are subject to potential tax consequences if Indian securities are held in any of the affected portfolios. Specifically, the possibility of owing Indian tax, to the extent the portfolio consists of Indian securities, can prevent a Regulated Fund from reorganizing or cause the Regulated Fund to sell its entire Indian securities before it reorganizes and perhaps not reacquire them after the reorganization. This in turn creates hardship for the Regulated Fund and its shareholders. The Indian markets also can be impacted negatively.

2. WHY DO FUNDS MERGE?

Regulated Fund managers merge Regulated Funds to increase economies of scale and enhance investor returns. After one fund manager acquires another manager, the fund offerings will be reviewed and comparable Regulated Funds will be merged. A single fund manager sometimes will merge two of its own Regulated Funds; this typically will occur when one Regulated Fund with a narrow investment objective, that has not generated sufficient investor interest, is merged into a Regulated Fund with a comparable but broader investment objective.

3. WHY DO US REGULATED FUNDS REORGANIZE THEMSELVES FROM A CORPORATE STRUCTURE TO A TRUST STRUCTURE?

Reorganizations in the US of a single Regulated Fund may occur either to effect a change in form (such as from corporate to trust form), a change of jurisdiction (such as from Maryland to Delaware), or to change the trust under which the Regulated Fund is constituted, or a combination of these. These single-fund reorganizations typically occur because of state law innovations that improve fund governance and make a particular form or jurisdiction more attractive than it previously had been.

Some states in the US, such as Delaware, have codified the common law principles regarding the existence and structure of statutory trusts. Once created, the statutory trust is recognized as a separate legal entity. Hence, a Delaware Statutory Trust (DST) is a statutory legal entity that is created by the execution of a governing instrument and the filing of a Certificate of Trust with the Delaware Secretary of State. The governing instrument is an agreement entered into between one or more trustees and one or more persons who are to own equity interests in the DST. Only one trustee is required in order to create a statutory trust. The trustee (or, if there is more than one trustee, at least one of the trustees) must be either: (i) a natural person who is a resident of Delaware; or (ii) an entity that has Delaware trust powers. There are a number of banks in Delaware that can provide the requisite Delaware trustee services.

A DST is similar to a corporation in that the beneficial owners of the trust have no greater liability than that of a stockholder in a corporation. That is, if the governing instrument does not provide to the contrary and if the beneficial owners comply with the formalities of the governing instruments, with few exceptions, their liability is limited to the amount of their required investment. The law of a DST is drafted into the trust instrument, and provides full flexibility to eliminate governance procedures that are obligated under the corporate form; this has been one of the great attractions of the trust form. The trust instrument can be drafted, for example, to dispense with routine shareholder meetings. Similar to a corporation, the law provides that, once formed, a DST has perpetual existence and is not terminated by the death, incapacity, dissolution, termination, or bankruptcy of a beneficial owner, or the transfer of a beneficial interest. All of the foregoing may be altered, however, by the terms of the governing instrument.

4. WHY DO US REGULATED FUNDS SHIFT THE PLACE OF THEIR TRUST?

US Regulated Funds initially were formed as Massachusetts business trusts ("MBTs"). Over the years, a number of developments led these funds to consider other forms of organization. There was some uncertainty, particularly in states other than the one in which a Regulated Fund was organized, regarding the legal rights and responsibilities of a Regulated Fund's investors vis-à-vis the Regulated Fund and its trustees.

Statutory business trust statutes address certain potential difficulties with operating a Regulated Fund as an MBT. In addition, these statutes can eliminate many of the uncertainties associated with common law trusts. The Delaware Statutory Trust Act ("Delaware Act"), which was enacted in 1988, provides, among other things, that the business trust is a separate legal entity and that the personal

liability of the beneficial owners is limited to the same extent as it is for stockholders in a Delaware Corporation. Under the Delaware Act, the rights, obligations, and liabilities of the trustees and the beneficial owners of the trust can be varied to suit investors' needs. The Delaware Act contains specific provisions, including the authorization of separate portfolios, that make it attractive for use by Regulated Funds.

Given the above, some Regulated Funds that initially were organized as MBTs, for example, reorganized themselves into DSTs. This essentially entailed migrating the Regulated Fund from its existing state to the State of Delaware and setting up as a DST under the Delaware Statutory Trust Act. In each of these instances, there was no change in the assets, ultimate investors, or fund manager; there also was no change, in some instances, to the directors/trustees of the predecessor fund and the successor fund. Such reorganizations are treated as "tax neutral" in the US and in many/most other jurisdictions.

5. HOW ARE SUCH REORGANIZATIONS TREATED IN THE US?

Under US Federal income-tax law (the Internal Revenue Code or IRC), a Regulated Fund organized as a trust (be it an MBT or a DST) is treated as a RIC and taxed as a corporation for US tax purposes under the IRC subchapter M rules. Hence, any Regulated Fund reorganization that involves a trust is treated as tax neutral in the US (so long as it meets the requirements under the IRC for a tax-free reorganization), as it enjoys the same tax neutrality that is afforded to corporations.

6. THE VARIATION WITH THE INDIAN LAW

A US Regulated Fund holding Indian securities in its investment portfolio that undergoes such a reorganization in the US encounters several significant regulatory issues in India. We have listed these below:

- First, India treats the reorganization of the Regulated Fund from one jurisdiction to another as a newly incorporated entity and as a taxable transfer of all Indian assets from the predecessor Regulated Fund to the successor Regulated Fund. This results in the predecessor Regulated Fund unnecessarily suffering a capital gains tax leakage. In addition, the Regulated Fund may need to surrender the existing registrations it has obtained in India and obtain a new FPI license.
- Second, from an Indian tax perspective, securities that are held by the predecessor Regulated Fund may instead be sold. If the same securities are re-acquired after the re-structuring and then sold within one year, the gain will be short-term rather than long-term (as would be the case had the restructuring not triggered tax).
- Third, the new Regulated Fund may be required to obtain fresh registrations in India prior to investing. This will involve a substantial amount of time, effort, and costs in terms of administrative and legal processes that need to be complied with prior to implementing investments in India. Further, any accumulated capital losses on Indian securities of the

predecessor Regulated Fund are "lost" upon the reorganization and cannot be used by the successor Regulated Fund.

- Fourth, reinvestment of the India portfolio may not be economically viable. The time involved in the restructuring exercise may entail the allocation of the India portfolio to other emerging markets in the interim and the cost of reinvestment in India may not be attractive.
- Fifth, under the Income-tax Act, 1961 (IT Act): (i) the successor Regulated Fund cannot file tax returns on behalf of the predecessor Regulated Fund; and (ii) practical challenges arise in having the predecessor Regulated Fund file its tax return in India and represent its case before the Indian Revenue authorities after the Regulated Fund has shut down. This latter difficulty arises because there is no one available to sign the last tax return of the predecessor Regulated Fund or represent the predecessor Regulated Fund's case, as and when it comes up for hearing before the Indian Revenue authorities.

7. THE INDIAN MUTUAL FUND EXPERIENCE

In India, all SEBI registered mutual funds operate under the trust structure as is mandated under the SEBI (Mutual Fund) Regulations, 1996. Unlike in the US, mutual funds in India do not have the option of being set up as corporate entities. Hence, the foregoing issue of reorganizations of mutual funds in India from one legal form to another does not exist in an Indian context, as the Indian regulations do not allow for it.

Having said that, it is pertinent to note that mutual funds in India nevertheless can reorganize. Their reorganizations, however, typically are of the following kinds:

- Mergers of two or more mutual fund schemes when one mutual fund house is acquired by another mutual fund house.
- Consolidation of two or more mutual fund schemes that have similar attributes, as has been stipulated by SEBI in the past.[5]

In both these instances, the mutual fund houses combine their schemes (which are managed by a trust set up in India) by transferring the assets and liabilities of the predecessor fund to the successor fund; the unit holders in the predecessor fund are given units in the successor fund in exchange for their units in the predecessor fund. Such combinations or mergers involving Indian mutual fund schemes that use the trust structure do not trigger any Indian income-tax implications for the mutual fund schemes because, under the IT Act, any income of a SEBI registered mutual fund is exempt from tax in India as per section 10(23D) of the IT Act. The unit holders in the predecessor fund suffer tax consequences as the exchange of units of one fund for another is regarded as a taxable 'transfer' under the IT Act and such unit holders become liable to pay capital gains tax on such transfer depending on the nature of the units they hold and the period for which they held the units. More recently, SEBI, in its Board meeting

[5] SEBI/MFD/CIR No. 05/12031/03 dated June 23, 2003; SEBI/Cir/IMD/DF/15/2010 dated October 22, 2010.

held on February 13, 2014, approved a Long Term Policy for Mutual Funds in India. One of the tax incentives related proposals that SEBI has recommended to the Indian Government is to not regard the merger/consolidation of equity mutual funds schemes as taxable 'transfers', thereby exempting them from capital gains taxation, as is the case with merger / consolidation of Indian companies[6].

Hence, our request is for a level playing field to be provided for US Regulated Funds that undergo reorganizations under the home country, based on the home country law, and which are treated as tax neutral in the US and other countries worldwide. Our request is based on the tenet that even when Indian mutual funds undergo mergers in India, they do not suffer any Indian tax consequences.

Principle of reciprocity

The US does not tax a foreign Regulated Fund that conducts only portfolio investments in the US capital markets as a US taxpayer. Because the foreign Regulated Fund is not treated as having a permanent establishment in the US, its only US tax liability, like that of any other non-US portfolio investor in US securities, is the withholding tax on dividends paid by US companies.

A non-US Regulated Fund making portfolio investments is not required to file a US tax return. Consequently, were an Indian mutual fund to reorganize its operations in India, such a reorganization would not trigger US tax implications. No tax would be due even if, as part of the reorganization, US securities held by one fund were transferred to another fund.

India is one of the few countries that taxes foreign portfolio investors on their Indian-sourced income and mandates that such investors file annual tax returns in India. We are not asking the Indian Government to stop taxing foreign portfolio investors. All we are seeking is a level playing field for US funds that are organized as trusts, treated as RICs, and therefore taxed as corporations, or that wish to reorganize themselves as trusts, to be exempted from their Indian tax liability arising on account of such one-off reorganizations. This same treatment is provided when an Indian mutual fund reorganizes itself in India; it neither triggers income-tax implications for itself in India (because all of its income is exempt from tax in India under section 10(23D) of the IT Act), nor does it trigger income-tax implications for itself in the US as the US does not tax Indian mutual funds on the gains from their U.S portfolio investments.

8. TAX NEUTRALITY AFFORDED UNDER THE IT ACT

We wish to submit that the IT Act does contain certain provisions that treat as "tax neutral" mergers involving two or more entities, subject to certain conditions. Comparable exemptions that already exist in the IT Act include mergers between Indian companies,[7] mergers between foreign companies wherein

[6] PR No. 12/2014.

[7] Sections 47(vi) and 47(vii) of the IT Act.

shares of an Indian company are transferred,[8] demergers of Indian companies,[9] demergers of foreign companies wherein shares of an Indian company are transferred,[10] conversions of sole proprietorship concerns or firms into companies,[11] and conversions of companies into LLPs.[12]

The IT Act should be amended to exempt reorganizations of Regulated Funds from capital gains tax if the reorganizations are treated as "tax neutral" in the home country. The exemption should be agnostic to the legal form of the Regulated Fund. For example, if a US Regulated Fund were to reorganize itself from one corporate form to another, it could claim exemption under the current provisions of section 47(via) of the IT Act. However, if the US Regulated Fund uses a trust structure, it will not be able to claim exemption under the IT Act, just because it is not a corporation; hence, our request for a change to be brought about in the Indian domestic tax law to set right this anomaly, which causes such unintended consequences.

9. HARDSHIP THAT IS FOLLOWED BY THE US REGULATED FUNDS

US Regulated Funds that are organized as trusts, treated as RICs, and taxed as corporations, and that hold Indian securities have three options in regards to reorganization. Any such reorganization in the US today requires the restructured Regulated Fund to seek a new license in India and to cause the registration for the old Regulated Fund to be cancelled. The two reorganization options (1 and 3) both may entail seeking a new license for the restructured fund and cancelling the registration of the old fund.

- Option 1 (Which is the least preferred): Regulated Funds can reorganize while holding Indian securities. This is the least preferred option as it will entail treating all of the existing Indian investments as sold (in a deemed sale) by the old fund and re-acquired by the new fund. In addition to possible tax liability from the deemed sale, there also are costly and complicated reporting and filing requirements.

- Option 2 (Which also is undesirable for Regulated Funds and consequently to their shareholders): Regulated funds choose not to reorganize due to the undue hardship, from an Indian tax and regulatory perspective.

- Option 3 (Which also is undesirable for Regulated Funds and could harm the Indian capital markets): Regulated Funds sell all of their Indian holdings prior to reorganization. After reorganization, Regulated Funds determine if India still is an appropriate investment. Some Regulated Funds will invest their proceeds from the liquidation of their Indian holdings in other

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[8] Section 47(via) of the IT Act.
[9] Sections 47(vib) and 47(vid) of the IT Act.
[10] Section 47(vic) of the IT Act.
[11] Sections 47(xiii) and 47(xiv) of the IT Act.
[12] Section 47(xiiib) of the IT Act.

countries or will not reinvest fully in India for reasons such as time constraints and market fluctuation.

Hence, we need a mid-path solution that addresses the Regulated Funds' concerns and is not inconvenient to them. If such a solution were to be provided, through tax neutral treatment to Regulated Funds that reorganize themselves, more reorganizations would take place with no loss of fresh investment into the Indian capital markets.

10. SUGGESTIONS

To address these concerns, we recommend that SEBI consider the following:

- First, in the case of reorganizations that are treated as a simple name change in the home country, the FPI Regulations could provide for an intimation to be submitted for change of name of the entity along with appropriate proof that the change has become legally effective in the home country. The Regulated Fund would not be required to cancel its existing registration and seek a new license to invest in India.
- Second, in the case of some reorganizations from one state to another, there is no change in the assets, ultimate investors, fund manager, or (in some instances) the directors/trustees of the predecessor Regulated Fund and the successor Regulated Fund. In such circumstances, the FPI regulations could treat the reorganization on the same lines as a "name change."
- Third, in the case of a change in the Regulated Fund's legal form of organization (i.e., from corporation to trust), and there is no change in the assets, ultimate investors, fund manager, or in some instances the directors/trustees of the predecessor Regulated Fund and the successor Regulated Fund, there should not be a requirement for the cancellation of the predecessor's registrations obtained in India with regulatory authorities. The successor Regulated Fund could provide an undertaking confirming the change in nature of the entity and with no change in the assets, ultimate investors, fund manager, or directors/trustees along with appropriate proof that the change has become legally effective in its home jurisdiction.

Separately, for your information, we have requested that the Indian Government and the Central Board of Direct Taxes consider the following changes:

- First, the IT Act should be amended to exempt reorganizations of Regulated Funds from capital gains tax if the reorganizations are treated as "tax neutral" in the home country. Comparable exemptions already exist in the IT Act for numerous types of reorganizations; these exemptions, however, do not currently apply to trust structures.
- Second, in case of a reorganization that is treated as "tax neutral" in the home country, the IT Act should allow a successor Regulated Fund to take into consideration: (i) the cost of acquisition of the shares acquired by it from the predecessor Regulated Fund; and (ii) the period of holding of the shares of the predecessor Regulated Fund, while computing the successor Regulated Fund's capital

gains tax liability. Similar provisions exist in the IT Act in case of mergers and demergers of Indian companies, conversions etc.[13]

- Third, the IT Act should be amended to allow capital losses incurred by a predecessor Regulated Fund to carry over to a successor Regulated Fund that acquires the predecessor Regulated Fund's assets in a reorganization that is "tax neutral" in its home country. This treatment is consistent with international norms.
- Fourth, the provisions of the IT Act[14] that allow a successor entity that earns "business income" to address tax filings and other obligations of its predecessor entity should be extended to investment funds and tax filings associated with capital gains of a predecessor Regulated Fund.

[13] Sections 2(42A) and 49 of the IT Act.

[14] Section 170 of the IT Act.

ISSUE 4
The margin requirements for investments in Government Securities

1. THE BACKGROUND OF THE ISSUE

Regulated Funds based outside Asia that invest in Indian securities face operational hurdles and complexities with respect to the timing and requirements of Indian margin rules, as well as increased and unnecessary foreign exchange exposure, especially on G-Secs.

Local custodians require Regulated Funds investing in G-Secs to provide for margin requirements on trade date minus 1 day, if the Regulated Fund does not have settlement operations in Asia. This usually entails a Regulated Fund purchasing more INR than is required to account for foreign exchange fluctuation and to provide additional flexibility in determining what G-Secs to purchase on trade date. This causes additional complexities and exposure for the Regulated Fund due to foreign exchange fluctuations.

2. IRREVOCABLE PAYMENT COMMITMENT (IPC) RULE

Under the current Indian exchange control regulations,[15] custodian banks in India are permitted to extend an irrevocable confirmation in favour of a stock exchange/clearing corporation of a stock exchange on behalf of its FII/FPI clients for purchase of shares and convertible debentures. This effectively reduces the requirement of a Regulated Fund to provide funds for meeting the Indian margin requirements on shares and convertible debentures.

The RBI has already put in place risk mitigation mechanisms[16] to protect banks from adverse movements in the price of equities and the possibility of default by FII/FPI clients. Some of the risk mitigants put in place by the RBI under the IPC are as under:

- Only those custodian banks, who have a clause in the agreement with their clients which gives them an inalienable right over the securities to be received as pay out in any settlement, would be permitted to issue IPCs. However, in cases where transactions are pre-funded (i.e. there are clear INR funds in the customer's account and, in case of foreign exchange deals, the bank's nostro account has been credited before the issuance of the IPC by the custodian bank), the requirement of the clause of inalienable right over the security to be received as pay out in the agreement with the clients is not required; and
- The maximum risk to the custodian banks issuing IPCs would be reckoned at 50 percent on the assumption of downward price movement of the equities bought by FIIs/FPIs on the two

[15] FEMA (Guarantees) Regulations, 2000 – FEMA 8/2000-RB dated May 3, 2000.
[16] DBOD.Dir.BC. 68 /13.03.00/2011-12.

successive days from the trade date (T) (i.e., on T+1 and T+2), of 20 percent each with an additional margin of 10 percent for further downward movement.

3. SUGGESTIONS

We request that SEBI consider extending the IPC rule to FII/FPI investments in G-Secs.

ISSUE 5
Re-investment of proceeds received on sale or maturity of Government Securities

1. THE GENESIS OF THE ISSUE

We are pleased that the Government of India has announced an option for T+2 settlement for secondary market OTC trades in G-Secs. This eases the operational burden for foreign investors, including Regulated Funds, that do not have trade operations in Asia. In addition, the increased timeframe will lead to fewer trade fails, resulting in more efficient market operations. We also understand that the Government is in discussions with International Central Securities Depositories (e.g., Euroclear) to make G-Secs available for settlement offshore. These positive steps are very encouraging and will make the market more attractive for foreign investors.

We appreciate that SEBI has gradually relaxed the requirements pertaining to investment in G-Secs. However, in practice, the reinvestment rules pose challenges and have significant consequences for foreign investors, including Regulated Funds.

At present, FPIs (other than long-term FPIs) are permitted to invest in Indian G-Secs up to US$ 25 billion. This may be done either without acquiring a G-Sec debt limit, or it may be done through the acquisition of a limit at an auction. Under current rules, foreign investors that purchase G-Secs using limits that they obtained at auction are generally permitted to reinvest the proceeds of the bonds, provided that they do so within five days. However, if the overall debt utilization falls below 85% (at which point G-Secs can be purchased and sold freely without limit) and then subsequently increases to greater than 90%, limit auctions are reinstated and a foreign investor needs to acquire a new limit in an auction in order to reinvest the proceeds from the sale of bonds purchased with limit that was previously purchased in an auction (prior to the new reinstatement of auctions).

These auction restrictions are problematic for Regulated Funds and other foreign investors that purchase G-Secs using limits because they increase investment risk by introducing unpredictability in any reinvestment strategy, based on fluctuation in foreign investor holdings and/or changes in the aggregate investment limit. Regulated Funds may suddenly be unable to effectively manage portfolio duration as they will not be able to invest in G-Secs within a specified period of time. In this situation, they may be required to sell their existing positions and repurchase at a later date once limits are obtained.

We recognize that aggregate foreign investor caps and limits are in place to recue portfolio flow volatility. However, the reinvestment rules applicable to foreign investors in the situation we describe do not seem necessary to achieve these goals, but rather to seem to be at odds with the spirit of what the restrictions are trying to achieve.

2. SUGGESTIONS

We request that SEBI revise the current reinvestment guidelines, in order to allow FPIs that have purchased G-Secs using limit to freely reinvest proceeds from the sale or maturity of those securities without having to go through the auction process should the debt utilization rate change, provided that they do so within a specified period of time.