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# HEDGE FUNDS

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## Hedge Funds - An Indian Perspective

Siddharth Shah & Divaspati Singh  
Nishith Desai Associates

### Abstract

In this paper, Mr. Siddharth Shah and Mr. Divaspati Singh of Nishith Desai Associates present the legal and the regulatory environment for operating domestic as well as offshore hedge funds in India. This paper also encompasses the tax aspects associated with the Indian hedge funds industry.

### Introduction

Termed as rogue investors, blamed for global market anarchy, hedge funds have been a hot topic for debate amongst regulators and governments worldwide. There is no precise definition of hedge funds and even in the country of their conceptual birth, USA, hedge funds have remained undefined, unregulated and unregistered as per the federal and state laws. Amongst the various kinds of funds catering to different strata of the society, hedge funds are specifically designed to cater to high net-worth individuals or institutional clients.

Hedge funds, as the name suggest, use a wide variety of investment strategies to maximise their gains. Hedge funds target at achieving specific returns regardless of the underlying trends in the financial markets and therefore, use a plethora of investment strategies available to them ranging from equity, fixed income, commodity trading advisors, global macro, mathematical algorithms and so on, depending upon the way they trade, risk management and their involvement in the portfolio.

In relation to India, the term hedge fund was an enigma in the minds of the Indian regulators and other market investors until some time back. The Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI) were extremely apprehensive about such funds investing in India and as a policy measure SEBI was not according Foreign Institutional Investor (FII) registration to such funds. Hedge funds have been blamed continuously across the world for market turmoil and it is widely believed that such funds

were responsible for the phenomenal rise of Bombay Stock Exchange (BSE) in December 2003, as well as for Black Monday in January 2004 when the BSE fell by over 1,400 points in afternoon trading<sup>1</sup>. However, considering the requests from various fund managers and taking into account the fact that such hedge funds were continuing to invest in India through the Offshore Derivative Instruments (ODI) issued by various FIIs, which is a much less regulated and difficult to control regime, SEBI formally opened the floodgates for such hedge funds to get registered as FIIs in the second half of 2007. This was also partly with the regulators realising that there is some depth in the Indian markets and hedge funds at times can act as a very important counter balancing force in a unidirectional market and can play an important role in bringing stability into the market. This article is devoted to discuss the various structures and options available for structuring and setting up of such hedge funds outside and within India. This article is primarily divided into two parts - Offshore Funds and Domestic Funds.

### Offshore Funds

#### Structures

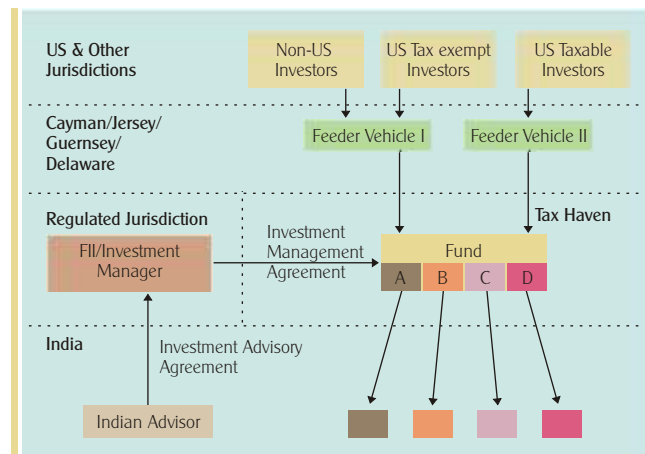
There are various alternatives available for structuring of hedge funds, to invest in India. Depending upon the investment strategies to be adopted by the fund manager, the comfort of the investors and the investment opportunities available to them, the fund managers structure their funds in a wide variety of ways. Some of the most commonly used structures are provided for below.

<sup>1</sup> On January 5, 2004, BSE fell by 316 points intraday.



**i. Plain Vanilla**

One of the simplest and the most widely used structure for hedge funds investing in India is the classic master-feeder structure, with an investment manager based in a regulated jurisdiction. The General Partner (GP) of the feeder funds are mostly setup in tax favorable and administration friendly jurisdictions like Cayman, Jersey, Guernsey, or Delaware (from a US perspective), and depending upon the nature of investors, they are structured in the form of a limited partnership or a company. These feeders then invest into the master fund which is set up in a tax favourable jurisdiction for India like Mauritius or Cyprus, and which primarily is setup for making investments in India. In the instant structure, the entity of the investment manager or the GP, which is regulated and registered will apply for a FII registration and will simultaneously procure a sub-account registration for the Mauritian master fund with SEBI. Most of these funds also setup an advisory entity in India to do the ground work and conduct research on the Indian markets. Such advisory entities render advice on a non-binding basis and are paid advisory fees on an arm's length basis by the investment manager.



**iii. Offshore Mutual Fund Route (OFO)**

Under this alternative, a mutual fund based in India floats a special scheme dedicated for the Fund. The special scheme could be structured as a multi-class scheme, which replicates the multi class share structure of the Fund. The Fund will subscribe to all the units of the dedicated scheme and this scheme will be managed by an India based manager. The Fund will execute a unit purchase agreement with the mutual fund, whereby it will exclusively subscribe to all the units of the scheme. The scheme, in turn, will invest in the Indian portfolio companies. SEBI has introduced the fund-of-fund regime w.e.f. May 29, 2003, whereby a mutual fund is permitted to invest in other schemes of the same mutual fund or other mutual funds without the inter-scheme restriction. As a result, the dedicated scheme can make investment in other schemes of the same or other mutual funds.

Under this arrangement, the scheme (including the entire arrangement with the Fund) will have to be approved by the SEBI. The Offshore Fund would have to file the following documents for registration with SEBI:

- Proposed offering memorandum
- Investment Management Agreement and
- Unit Purchase Agreement

As per a circular<sup>2</sup> issued by the SEBI, the requirement to obtain RBI's prior approval for issue of units, remittance of dividend and redemption of units to the overseas investors in the OFO has been done away with. A single window application process has been introduced, whereby, the Fund would need to obtain only SEBI's approval and SEBI in turn, would co-ordinate with the RBI for its approval.

Thus, once SEBI's approval is obtained for launching the Fund, the asset management company of the mutual fund can issue/redeem units, export unit certificates and repatriate distributions/dividends from the dedicated scheme, provided, the reporting<sup>3</sup> requirements specified by SEBI have been complied with.

Although the SEBI (Mutual Funds) Regulations, 1996 do not contain any specific provisions in regard to broad-basing of the OFO, SEBI at the time of granting its approval generally subjects the approval to the SEBI (FII) Regulations, 1995, which are explained later in this article.

**ii. Multimanager Structure for PE, MF, PMS Investments**

In this case, the Fund is established as a multi-class vehicle, and comprises of separate classes of shares, with each class of shares representing direct or indirect interests in a down line Indian product, such as, cash equities, listed derivatives, mutual funds, fixed income, structured products (bonds/equity-linked debentures listed on SEs), portfolio management schemes and so on. Each portfolio of the Fund shall comprise of a separate and distinct collection of investments from the investors, through separate class structures. As a result, the Fund will issue different classes of shares to the overseas investors, with each class of share representing a separate portfolio, which would further invest in different products in India.

<sup>2</sup> AP(DIR Series) Circular No.35, dated November 14, 2003.

<sup>3</sup> The SEBI has prescribed the following requirements to be reported on a fortnightly basis: (i) Date of launch of the offshore funds, (ii) No. & Date of SEBI Approval letter (iii) Amount authorised to be raised by SEBI (iv) No. of Units issued to the Off-shore fund (v) Amount of inflow in US Dollars (vi) Amount of Dividend remitted, if any, up to the current quarter (vii) No. of units redeemed (viii) Amount repatriated in US Dollars (ix) No. of Units Outstanding (x) Value of Fund in US Dollars & NAV per Unit and (xi) Management fees received/other out of pocket expenses reimbursed.



## Innovation: The growing importance of Venture Capital

– Knowledge dissemination & Networking at its best!

Dr. Martin Haemmig and Gil Forer

### Abstract

While the primary objective of an investor is to generate returns, venture capitalists expedite the process of value creation by assisting entrepreneurs in developing business models and generating innovation. In this paper, Dr. Martin Haemmig and Mr. Gil Forer illustrate the role of venture capitalists as catalysts of innovation.

The venture capital (VC) industry has been on a growth track since the end of 2004. Last year, venture capitalists put more than US\$ 40 billion to work in innovative companies, globally. The current cycle is characterised by substantial acceleration in Cleantech investing, the maturation of the venture capital ecosystem in China and growing venture capital investments in India. Increasing investment by corporations to become active participants in the innovation pipeline is another major driver of the global venture industry (see Figure 1).

Figure 1: Global venture capital investment



Source: Dow Jones Venture One

No one will argue that the primary objective of venture capital firms is anything other than to produce a high return on their limited partners' investments. However, the means that venture capitalists deploy to achieve this end is what distinguishes venture capital. By working with entrepreneurs to generate disruptive innovation and

business models, venture capitalists catalyse value creation and the emergence of new market-leading companies.

### Innovation: The Shifting Power Equation

The world is facing fundamental challenges. How will we deal with issues such as, the growing demand for energy and food in the face of limited supply, aging populations and the socioeconomic challenges and opportunities brought about by advances in information technology and biotechnology? More and more, the answer to this question is innovation. With the status quo no longer tenable, the world needs new ways to generate power, grow food and interact.

The good news is that global innovation is flourishing, not only in traditional hubs such as, Silicon Valley, but also in new centers that have recently arisen in China, India and other emerging economies. New innovation pathways are also being created; the business of innovation is changing as much as its location is.

Under pressure from global competition and challenged by the accelerated rise of emerging markets, corporations fully understand that to maintain or increase their competitive advantage, they must reach beyond the boundaries of their own payrolls to find the best brains and the smartest ideas, wherever they are in the world. Venture capitalists too have recognised these dramatic changes and are moving to where the talent is today: everywhere on this planet.

The most recent annual study by Booz Allen Hamilton of the world's largest corporate research and development (R&D) spenders finds two primary success factors: aligning the innovation model to corporate strategy and listening to customers every step of the way. However, it is also clear that today, corporate innovation models cannot rely only on internal R&D. They must implement a more collaborative, flexible and open model, with many innovation partners, including venture capital funds and their portfolio companies. Such a model can be described as an "innovation network."

Larry Huston at the Wharton School of the University of Pennsylvania has been building out and advocating the concept of innovation networks as an essential contributor to competitive advantage<sup>1</sup>. Innovation networks are individuals and organisations outside a company that can form an extended organisation and help it solve problems, as well as find new ideas for creating growth. The benefits of the innovation network include an ability to combine internal and external sources of innovative ideas, greater efficiency in converting innovation into products as well as services and better risk management through partnerships and collaboration.

Only a few organisations such as Procter & Gamble, Boeing, Microsoft and IBM currently have well-developed innovation networks. While these examples are all large companies, Huston also sees small companies benefiting from innovation networks. Indeed, with their resource constraints, small companies naturally look for outside help to address challenges. Increasingly, small companies are emerging as drivers of innovation. Huston points out that they now file 35% of all patents. Big companies need innovation; small companies need market access. Innovation networks provide a structure for them to work together successfully.

The entire innovation value chain is influenced by a number of factors, ranging from culture and education to fiscal policy, regulation, government and intellectual property rights. Today, governments, especially in emerging markets, have come to understand better, the competitive advantage of an innovation-based economy. Consequently, we have seen a growing number of national innovation initiatives; more focus on establishing and enforcing intellectual property rights; gradual improvement of technology transfer processes and the rise of entrepreneurship education, globally.

## Pre-Venture Capital Financing Sources for Innovation

With venture capital funds growing in size and the lengthening time between initial investment and exit, venture capital firms have placed new emphasis on expansion-stage and growth equity investments to put more money to work and realise returns sooner. Although there is no overall shortage of capital, the upstream movement of certain funds and the investment risk in emerging markets have reduced the capital available for seed investments in some regions.

In the United States, Europe and other mature markets, angel investors typically former successful corporate executives or entrepreneurs, help bridge the financing gap between start-up and venture capital financing, investing individually and in professional networks.

In emerging markets such as, India and China, the angel-investor base is still small, with very few professional networks. However, it is growing. Along with such investors, the financing gap in these

markets is being bridged by an increasing number of incubators, the launch of provincial or local government funds of funds for investments into local and foreign venture capital firms or even direct investments by science parks into entrepreneurial companies.

The incubation model has been adopted by many countries because it can be adapted to a variety of needs, from fostering commercialisation of university technologies to creating jobs in the community and providing seed capital. Incubators have proved to be most important in emerging markets because creating jobs and speeding up innovation are high on their national agendas. For example, at the end of 2007, the Chinese Ministry of Science and Technology tracked 548 incubators that have helped to incubate and grow almost 20,000 technology companies. In India, there are about 100 incubators, of which 40 are government sponsored and managed, about 50 are at universities and about 10 are privately owned. Corporations have become involved with many of these incubators to screen new technologies as part of their need to explore innovation beyond internal research and development.

## The Impact of the New Innovation Sources and Pathways on Venture Capital

To capture global innovation opportunities and to get them off the ground throughout the entire value chain, collaboration across traditional boundaries will have to continue and accelerate. As the importance of global innovation networks increases, corporations, venture capital funds and entrepreneurs will all have to scale up best practices and lessons learned in partnerships and collaborations around the world. Innovating better will provide competitive advantage not only to large multinationals, but also to leading companies in emerging markets and their investors.

Innovation networks encompassing collaboration between start-ups, venture capitalists and multinationals are even more important in emerging industries such as, Cleantech, which enable business response to climate change. This fast-evolving space presents vast opportunities for emerging, innovation-based companies to provide solutions for multinationals as they face the challenges of responding to climate change-related business opportunities, as well as the need to become more sustainable and comply with climate change regulations.

The need to leverage global innovation has encouraged many multinationals to set up core R&D centers in the technology hotbeds around the globe, whether Silicon Valley, Eastern Europe, Southeast Asia, China or India. These local R&D centers have allowed corporations to penetrate vast emerging markets and tap highly skilled but relatively low-cost talent. At the same time, they have supported the entrepreneurial spirit in their communities, attracted foreign venture capital funds and fostered the formation of local ones, all providing a foundation for a new generation of innovation-based start-ups and promoting the continuing globalisation of venture capital.

## Recent Venture Capital Developments and Trends

The current capital and exit environment in mature markets and increased global innovation have provided a couple of models for venture capital funds. They can expand vertically by raising a growth equity fund or a mega fund that will invest throughout the different stages of development from start-up to large growth company. Or they can expand horizontally to new geographic markets. Some funds have done both.

<sup>1</sup> "Innovation Networks: Looking for Ideas Outside the Company." Knowledge@Wharton, <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1837>, 14 November 2007.