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DOING BUSINESS IN INDIA: CHANGE & CHALLENGE AHEAD

Investors See Changes – and Opportunities

Big reforms in India have the economy humming

*American lawyer **John Holton** advises clients on emerging markets in Asia from the London office of **Akin Gump Strauss Hauer & Feld LLP.** He has much to say about the current pro-business government in India, why registration with the U.S. Securities and Exchange Commission under the U.S. Investment Advisers Act doesn't always apply to non-U.S. fund managers, and how in-country experience plays a vital role in advising clients. The interview has been edited for length and style.*

What are the most daunting challenges that emerging market funds face, and what strategies do you advise clients to employ to overcome them?

John Holton: The first issue that sponsors of emerging market funds wrestle with is getting prospective investors comfortable with the additional risks that apply to emerging markets beyond the normal ones that you take when you invest in U.S. equities. The risks include, for example, political instability or unrest and exchange rate moves that reduce the U.S. dollar value of investments that are denominated in another currency.

Some U.S. investors will say, "The stock market has been soaring in the United States. There's no currency risk when I invest in the United States. There's no risk of civil insurrection. The infrastructure and the economy generally function quite fine. Equity investments are risky. Why should I venture overseas and take additional risks?" Emerging market fund managers need to successfully make the counter-argument that the U.S. economy and stock markets have had a good run recently, but many emerging economies offer the prospect of strong and steady growth over the next 20 or 30 years. For investors who have a long time horizon, growth over that extended period of time is extremely valuable.

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Some emerging markets are more developed than others. In Vietnam, for example, there are a lot of natural resources and a well-educated and young work force – there's a lot of potential. But securities markets in Vietnam are less well developed than in some other emerging economies. Vietnam has fewer of the professionals that you need to run a successful market economy, such as accountants, bankers, lawyers and securities brokers. Its rules governing investment are less well-developed. As a result, the risk profile for Vietnam is probably greater than in a more developed emerging economy, such as India, where the Bombay Stock Exchange is the oldest stock exchange in Asia. India has established the government agencies, rules and systems that you need to have efficiently functioning capital and private equity markets. Still, many less developed markets, such as Vietnam, understand the steps they need to take to move ahead, and they are coming up fast.

Homegrown teams – groups of people who are based in the emerging market economies – face the issue that many large international fund managers have funds focusing on the emerging economies. North American and European investors often have a certain degree of comfort in dealing with brands that they know. If a private equity manager has delivered solid returns on their U.S. investments and says, "We've decided to open an emerging markets fund," some investors may decide that, if we are going to dip our toe in emerging markets, let's invest with the well-established firms that we already know, like and trust.

The argument that managers in the emerging markets need to make is that private equity, venture capital and real estate investing are very much localized businesses, particularly real estate. The conditions in different countries are very different, and the way you go about making investments is very different. The legal systems are different. A person who has done a good job investing in Europe or the United States may not be the right person to help you with emerging market investments.

It's been some years since Congress extended the registration requirements under the Investment Advisers Act to include advisers of private investment funds, including non-U.S. funds marketing to U.S. institutional investors. How have these changes played out, and what have they meant for your clients?

Holton: Many fund managers based in emerging markets are able to avoid full investment adviser registration with the SEC

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because they typically do not have a presence in the United States. They conduct their business only from offices outside the United States. As a result, they rely on what's known as the private fund adviser exemption. They file a partially completed Form ADV with the SEC on a notification basis. They don't have to wait for the SEC to register them.

If a fund manager is able to rely on the private fund adviser exemption, its reporting burden under the U.S. Investment Advisers Act is reduced. Also, firms that rely on this exemption are not required under SEC rules to establish a compliance program that meets the requirements of the U.S. Investment Advisers Act. Those compliance programs are a significant undertaking because you've got to really think through how you're going to go about complying with each rule. That's quite a bit of work, particularly for a non-U.S. firm, because many of the rules under the U.S. Investment Advisers Act are designed for U.S. markets and may not work so well in markets outside of the United States.

Some of our clients in emerging markets that could rely on the private fund adviser exemption have chosen to go for full SEC registration, typically because they want to take money from U.S. pension plans, which are generally more comfortable investing with SEC-registered managers. Those firms are required to file a fully completed Form ADV report. In addition, they are required to establish and implement compliance programs that set forth how they're going to comply with all of the various rules. Many of these rules are tailored for the way the investment management and brokerage business is done in the United States. You need to think fairly carefully about the best way of complying with a U.S.-focused rule in a country where the systems, procedures and structure that U.S. money managers take for granted don't exist.

Fueled by a strong manufacturing sector and low oil prices, India has enjoyed robust economic growth. Some are concerned, however, that growth will lag without additional reform, such as last year's currency experiment and the new nationwide sales tax. What's your take on the state of India's economic expansion and the regulatory changes, such as bankruptcy reform, that some believe are needed to sustain or even accelerate it?

Holton: In general, India's economy is growing very rapidly. Since Prime Minister Narendra Modi took office, there's been a high degree of confidence that his government would tackle some of the entrenched problems that have made it difficult to invest in India. In the first year or so, people were disappointed that he didn't move as aggressively as he might have, but in the last year, he has begun to address some of those problems.

I think that reflects his party's recent wins in a number of important state elections. India is a federal republic, like the United States, so it has both national federal elections and state elections. Mr. Modi's party has done well in recent state elections, in particular in the large state of Uttar Pradesh. That win convinced international investors that the Modi government is going to win a second term. That reassured investors that Mr. Modi wasn't just going to be a one-term prime minister. International investors are much more confident that the pro-growth policies in India will continue for many more years.

The wins in state-level elections also seem to have invigorated the Modi government to pursue the reform path that it believes necessary. As you mentioned, three important steps have been taken recently: the reform of the bankruptcy laws, the currency reform and the sales tax. Regarding new bankruptcy laws, for a long time it was difficult for Indian companies to go bankrupt and for creditors to enforce their claims on a timely basis. As a result, India had too many zombie companies that weren't really functioning. The new Indian bankruptcy laws go a long way toward providing a better bankruptcy framework that enables creditors to quickly move against a company that's failing, prevent further losses and wind the company up so that the creditors can get paid as much as possible and resources can be re-allocated to more productive enterprises.

The currency reform was at first very controversial and painful for Indians, but in the longer term it seems to have worked out well. When it first came out, there was a huge outcry because the Indian government canceled two of the most commonly used rupee banknotes: the 500 rupee note and the 1,000 rupee note. It was as if the U.S. government had abolished, without any prior notice, the $20 and $50 bills. That created a lot of disruption. People didn't have enough of the small denomination notes, and the time that it took to replace the canceled rupee notes was slow, so there was, for several months, a shortage of cash in the Indian economy. Some families had to raid their children's piggy banks in order to buy groceries. For a while, the cash shortage slowed the Indian economy down.

Two positive things came out from the currency reform. It sent a clear signal that this government is serious about tackling corruption, because corruption in India very much worked through cash. Bribes were paid in cash. Cash transactions took place without taxes being paid. Improper campaign contributions were made in cash. Everyone knew that was the way the world worked, including poorer people, who didn't benefit from these cash payments. It was very politically popular when suddenly poorer Indians saw that corrupt politicians and corrupt businessmen were largely put out of business because they were hoarding stacks of cash that suddenly became worthless. Indians saw that as a sign that the government was serious about tackling tax evasion and other corrupt practices.

The currency reform forced people in India to increase their use of electronic payment systems, such as credit cards, debit cards, iPay or other electronic means of payment. That's important for the long term, because electronic payment can be done much faster than fumbling around for cash in your pocket. It speeds up the economy to the extent that you can move people from a largely cash-based system to an electronic payment system. Collecting taxes on electronic payments is more efficient than collecting taxes on cash transactions. That's important because the Indian government was losing a lot of tax revenue to people who were evading tax with the use of cash. That revenue is needed for important projects, such as alleviating poverty and improving health, education and infrastructure.

Last, there's the nationwide sales tax. Because of different taxes in different Indian states, the situation had been that you didn't have free border crossings for goods and services, as in the United States. Trucks loaded with goods often had to get in line at the border between states, wait and pay taxes because the tax rules were different in one state or another. This created road blocks and backups in shipping goods and services across state lines. As a result, India lost much of the benefit of being a united country, because it was easier to just do business in your own home state and avoid the costs and headaches of different state tax assessments. Adopting a single national sales tax should improve the smooth flow of goods and services across state boundaries.

Investors recently received some good news about the government's move to cut the Foreign Investment Promotion Board (FIPB). How important is that, and will foreign direct investment grow as a result?

Holton: Decades ago, the Foreign Investment Promotion Board was very important because most non-Indian investments into

India required prior approval by the Indian government. Over time, as the Indian government has liberalized the rules on non-Indian investment into India, more sectors of the economy have moved to what's known as the automatic route. Subject to meeting certain well-defined conditions, non-Indian investment into those sectors is automatically approved. There are now only about 11 sectors of the Indian economy that are not subject to the automatic route.

The abolition of the FIPB means that for these non-automatic sectors, this particular agency, which had a bit of a reputation of holding up foreign investment, is gone. You still need approvals in these sectors, but those will be given principally by the agency that regulates the industry sector in which you are investing, and it will all be under the review of the Indian Department of Industrial Policy and Promotion, which is generally viewed as much more pro-investment. The expectation is that this will speed up the approval process in those sectors that are not subject to the automatic route. Abolishing the FIPB is important because of the message it sends. Shutting down cold an agency that had been around for 25 years tells people they're ready to do radical things to promote international investment into India.

The Indian government has acknowledged the need for massive infrastructure investment and committed to a large-scale program. What's the likely impact on the fund clients you represent?

Holton: India's new infrastructure initiative offers many investment opportunities, and the Indian government has made it very clear that they want to take advantage of public-private partnerships to finance some of these important and expensive projects. For example, there's a plan to build more highways using both public and private money, and then tolls on the roads will help pay off the private investors.

Infrastructure projects are attractive for many international investors with long-term time horizons because if, say, you build a road between two important Indian cities, you can be fairly sure that there'll be a steady level of traffic on that road over the next several decades, and that will mean a steady level of tolls being collected to pay returns to investors.

Improving India's infrastructure is one of the key things to get the Indian economy to start galloping ahead. Electrical power is a good example. For a long time, there were regular power outages in India. Just think how difficult it would be to conduct business if the power went down for several hours every few days, and you couldn't use the computer, couldn't send emails and the phone didn't work. That was a real challenge for many Indian businesses.

Some years ago, there was a huge blackout across northern India. Whole cities were blacked out for a long stretch of time. The blackout helped to catalyze the Indian government to focus on building new electric generating and distribution facilities, and they've largely succeeded. They've managed to improve the quality of the electricity grid and increase the sources of electrical power. As a result, in much of India, blackouts are much less common than they once were. Many offices and factories had their own generators, with tanks of gasoline or other fuels to power the generators, so that when the power grid went down, the on-site generator would kick in. Building, maintaining and operating those generators wasn't cheap. To the extent that businesses can rely on the electrical grid, that makes it easier and cheaper to conduct business.

In short, the infrastructure initiatives appear to offer a win-win for investors into India because there will be opportunities to invest in infrastructure and, when you invest in companies, they're going to have plenty of electricity so they can conduct business more effectively.