Regulatory Barriers and Levers for Deploying Foreign Catalytic Capital in Impact-Focused Enterprises, Funds, & Facilities in India

Research Report

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PRIME

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ABOUT DESAI & ASSOCIATES

Desai & Associates (D&A) is a mission-based innovative finance advisory and market building firm. It provides advisory services to public, philanthropic, and private capital providers on intervention design, strategy and structuring of innovative finance solutions. It also provides market building services in knowledge & education, policy advocacy and capacity building to drive the allocation of capital towards sustainable development. D&A has been a pioneer in building the blended and outcomes financing market in India, advising leading foundations, impact funds, non-profits, social enterprises, government bodies, and international organizations in implementing innovative finance solutions such as impact bonds, outcome based funding and blended finance structures and facilities.

ABOUT PRIME COALITION

Prime Coalition is a non-profit organization on a mission to unlock catalytic capital and change the future of climate finance. By empowering philanthropists to invest charitable capital into market-based solutions to fight climate change, Prime has mobilized over $315MM+ in catalytic capital in partnership with over 256 individual investors and philanthropic organizations to back 27 early-stage ventures since 2015. Prime works to address gaps in funding for solutions which hold the promise to mitigate gigaton-scale CO2-equivalent emissions by 2050 when deployed at scale. Prime also offers a range of field-building programs and resources, including Project Frame, the open-source CRANE Tool, the Catalytic Capital Intermediation Resources Library, & Catalytic Capital courses.

ABOUT THE LEMELSON FOUNDATION

The Lemelson Foundation, established in 1992 by prolific inventor Jerome Lemelson and his wife Dorothy, promotes invention to tackle global challenges and improve lives. It supports inventors and innovators that foster invention-based businesses and technologies with social and environmental benefits. The foundation's initiatives include education programs to inspire future inventors, funding for invention-based enterprises, and partnerships to catalyze impactful innovations. By fostering a culture of invention and providing resources for idea development and commercialization, the foundation aims to create a sustainable impact, addressing significant issues like poverty, health, and environmental sustainability both in the US and globally.

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DISCLAIMER

Please note that while leading funders and legal and intermediation experts have been consulted and extensive secondary research conducted in the preparation of this study (the “Study”), appropriate and deliberate legal counsel must be sought before opting for and implementing any of the specific financial pathways or key recommendations of this Study. In addition, *the Study is provided for information purposes only and is not a recommendation as to which pathway is appropriate in any given circumstance, nor does the Study evaluate or express any views on the financial return associated with any of the options outlined in the Study*. Any of the financial pathways or recommendations set forth in the Study may result in a full loss of capital invested through a certain pathway. Implementation of any of the specific financial pathways or recommendations of the Study is done at the risk of the recipient of this Study.

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GLOSSARY OF KEY TERMS

Abbr	Term	Definition
DTAA	Double Taxation Avoidance Agreement	The Double Taxation Avoidance Agreement or DTAA is a tax treaty signed between India and another country (or any two/multiple countries) so that taxpayers can avoid paying double taxes on their income earned from the source country as well as the residence country.
FEMA	Foreign Exchange Management Act	An Act to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India.
VRR	Voluntary Retention Route	Voluntary Retention Route (VRR) refers to a channel brought about by the Reserve Bank of India (RBI) for FPIs to invest in India's debt markets.
SEBI	Securities Exchange Board of India	SEBI is the regulatory authority for the securities market in India, responsible for both protecting investors and fostering an orderly environment for trading and investment activities.
RBI	Reserve Bank of India	India's central bank, entrusted with the management of monetary policy, regulation of the banking sector, and oversight of foreign exchange markets.
KYC	Know Your Customer	KYC standards are critical compliance measures for financial institutions, intended to verify identities, assess client risk profiles, and uphold anti-money laundering laws.
PAN	Permanent Account Number	PAN is a ten-character alphanumeric identifier, issued in the form of a laminated card, by the Indian Income Tax Department to any "person" who applies for it.
NCD	Non-Convertible Debenture	NCDs are debt instruments issued by corporations to raise long-term capital, carrying a fixed interest rate and not convertible into shares or equities.

GLOSSARY OF KEY TERMS

Abbr.	Term	Definition
TDS	Tax Deducted at Source	TDS is a system in India where tax is automatically deducted from an individual's earnings or income during the payment process.
IFSC	International Financial Services Centre	IFSC refers to a jurisdiction that provides world-class financial services to non-resident and foreign entities, with minimal regulation.
GIFT	Gujarat International Financial Services Centre	GIFT City is a planned business district in Gujarat, India, aimed at providing high-quality infrastructure for finance and technology firms, and promoting India as a global financial hub.
AIF	Alternative Investment Fund	It refers to any privately pooled investment fund, (whether from Indian or foreign sources), in the form of a trust or a company or a body corporate or a Limited Liability Partnership. As per Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 Alternative Investment Funds shall seek registration in one of the three **Category I:** Mainly invests in start- ups, SME's or any other sector which Govt. considers economically and socially viable. **Category II:** These include Alternative Investment Funds such as private equity funds or debt funds for which no specific incentives or concessions are given by the government or any other Regulator **Category III:** Alternative Investment Funds such as hedge funds or funds which trade with a view to make short term returns or such other funds which are open ended and for which no specific incentives or concessions are given by the government or any other Regulator.

GLOSSARY OF KEY TERMS

Abbr.	Term	Definition
ECB	External Commercial Borrowing	• External commercial borrowing (ECBs) are loans in India made by non-resident lenders in foreign currency to Indian borrowers. • Transactions on ECB are governed by Foreign Exchange Management Act,1999. ECB can be raised through an Automatic Route or Approval Route. • Under Automatic Route, the cases are examined by the AD Category-I Banks. • Under the Approval Route, borrowers send their requests to the Reserve Bank of India through their AD banks for examination.
DAF	Donor Advised Fund	A donor-advised fund, abbreviated as DAF, is an account for charitable giving established within a public charity. It operates as a 501(c)(3) organization, acts as a "sponsoring organization" responsible for overseeing and managing individual DAF accounts. Through DAF accounts, donors can make charitable contributions, obtain an immediate tax deduction, and subsequently suggest grants from the fund over time.
CG	Credit Guarantee / Loan Guarantee	A credit guarantee is a commitment by a third party, to repay a loan partially or fully if the borrower defaults. This mechanism reduces the risk to lenders, enabling them to extend credit to less creditworthy borrowers and stimulate economic growth by broadening access to finance.
FDI	Foreign Direct Investment	Investment made by a firm or individual in a foreign country into business interests located in India
FPI	Foreign Portfolio Investment	Investments by individuals and companies in foreign countries, in equities listed on a stock exchange.

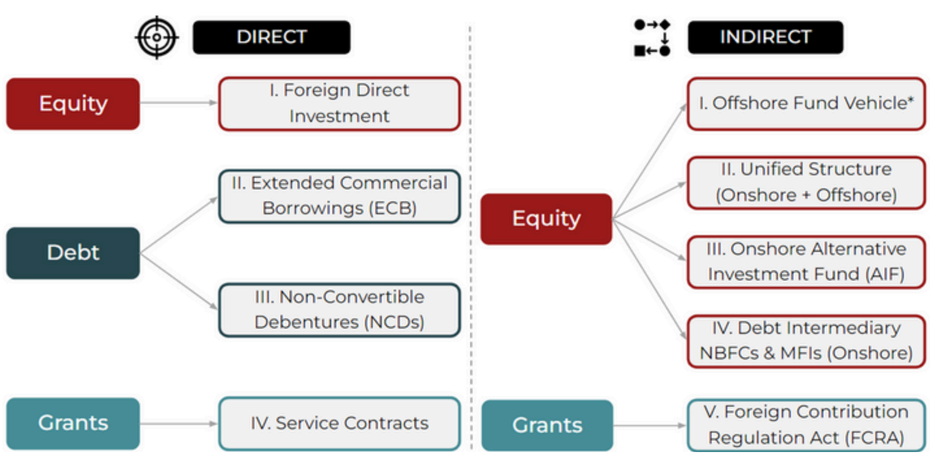
EXECUTIVE SUMMARY

This report is the result of a detailed study on '**Regulatory Barriers and Levers for Deploying Foreign Catalytic Capital in Impact-Focused Enterprises, Funds & Facilities in India**' conducted by Desai & Associates (D&A) in partnership with Prime Coalition and with the support of the Lemelson Foundation. Overall, the study has the following key objectives:

1. Map the different **financial pathways** for aggregating US and European catalytic capital in India to support Indian social enterprises, defined as both for-profit and non-profit enterprises with a social and/or environmental mission.
2. Assess the **legal, structural, financial, and operational challenges** of channeling capital via these pathways and identify **potential solutions, including recommendations for possible intermediation** to bring catalytic capital into India.
3. Develop a **shared taxonomy** for funders and recipients of catalytic capital, and create a public report useful to all stakeholders interested in bringing such capital into India.

It is important to note that while the report lays out the operational and regulatory challenges and opportunities presented by different pathways, it does not make specific strategic recommendations on the pipeline and absorptive capacity of the enterprises.

The study has mapped out ten direct and indirect pathways for deploying catalytic capital in India through consultations with over 35 stakeholders, including legal experts, capital providers, and fund managers. All options of capital aggregation in the US i.e. Donor Advised Funds (DAFs), Impact Funds set up by Public Charities, Family Offices, and Private Foundations, can participate in all direct and indirect pathways described below, and thereby make catalytic investments through equity, debt, and grant instruments. Direct deployment refers to pathways where the asset holder directly invests/ deploys capital to the social enterprise. Indirect deployment refers to pathways that deploy capital through an intermediary vehicle. Pathways have been compared based on regulatory and operational feasibility, sectoral focus, company type, and control for investors.



Direct Deployment: Direct deployment of foreign catalytic capital involves a significant allocation of resources in the time, cost, and effort from the capital provider. The three direct deployment pathways are (1) direct equity (via Foreign Direct Investment), (2) direct debt (via External Commercial Borrowing or Non-convertible Debentures) and (3) Service Contracts. Below are their key advantages and challenges:

- **Advantages of Direct Deployment**
  - ***Control**:* Provides the capital provider with a greater degree of control, enabling tailored interventions and direct engagement with recipients.
  - ***Impact**:* Ensures that the impact can be directly attributed to the funding and support provided by the capital provider.
- **Challenges with Direct Deployment**
  - ***Operational Costs:*** High operational costs and resource requirements can be a barrier, particularly for smaller capital providers.
  - ***Resource-Intensive*:** Continuous monitoring and management can drain resources and operational capacity.

Indirect Deployment: The report outlines four major indirect pathways beyond FCRA (Foreign Contribution Regulation Act) grants for foreign catalytic capital to support social enterprises via capital intermediation by offshore, onshore, or unified funds vehicles, or debt intermediaries (NBFCs & MFIs).

(**1) Offshore Capital Aggregation:** This pathway aggregates foreign catalytic capital offshore (i.e. outside India), facilitating deployment with lower tax burdens, affordable operations, and easier regulatory compliance.

- **Opportunities**
  - ***Streamlined Process**:* This can potentially reduce the administrative burden on the capital provider.
  - ***Effective Pairing**:* To pool both domestic and foreign capital, the pathway is especially effective when paired with Indian Alternative Investment Funds (AIFs) or equity investments in Non-Banking Financial Companies (NBFCs) and Microfinance Institutions (MFIs).
  - ***Catalytic Capital:*** More diverse options for blending capital and leveraging catalytic capital to bring additional financing. through innovative fund structuring.
- **Challenges**
  - ***Management Structure**:* Requires a robust offshore local management structure.
  - ***Regulatory Issues**:* Potential regulatory and compliance issues across different jurisdictions that are dependent on double taxation norms.

(2) Unified Structure: This pathway aggregates foreign catalytic capital offshore and domestic Indian capital onshore, facilitating deployment with lower tax burdens, affordable operations, and easier regulatory compliance.

- **Opportunities**
  - ***Dual Leverage:*** Domestic capital can be leveraged through the AIF, whilst parallelly utilizing the financial & regulatory benefits from pooling foreign capital offshore in jurisdictions such as Singapore, Delaware or Mauritius.
- **Challenges**
  - ***Complexity****:* High governance and regulatory oversight requirements as a result of multiple jurisdictions.
  - ***Resource-Intensive****:* Aligning the objectives and operations of onshore and offshore entities can be challenging and resource-intensive.

(3) Onshore Capital Aggregation via Investments in AIFs (including GIFT IFSC): Involves channeling catalytic capital into Indian AIFs that align with the capital provider's sectoral and investment theses.

- **Opportunities**
  - ***Diverse Sources of Capital:*** Can be used to pool and leverage both domestic and foreign capital.
  - ***Large-Scale Investments:*** Facilitates larger-scale investments and helps in pooling de-risked commercial capital.
- **Challenges**
  - ***Differential Returns:*** Lack of regulatory clarity on arranging differential returns and investment goals.

(4) Investments in NBFCs & MFIs: Deploying equity capital into Non-bank Finance Companies (NBFCs) and Microfinance Institutions (MFIs) can create a multiplier effect by reducing the cost of capital and enabling access to finance for the borrower.

- **Opportunities**
  - ***Amplified Impact:*** Investments can be paired with service contracts supporting interest subvention, results-linked payments, and capacity-building initiatives.
- **Challenges**
  - ***Framework Requirement:*** Requires a well-structured framework to ensure effective utilization and monitoring of deployed capital.
  - ***Regulatory Changes:*** Regulatory changes and market dynamics in India can affect NBFCs' and MFIs' performance.

Strategic Comparison of Deployment Pathways: The ten deployment pathways have been compared based on: a) operational and regulatory ease of deployment, and b) scale of deployment, at the enterprise level, sector level or ecosystem level. In terms of ease of deployment below is a ranking of the pathways from easiest to most challenging to use.

High Ease of Deployment

- ***Offshore Funds**:* Preferred by most fund managers due to the ease of implementing innovative financial structures and low compliance burden.
- ***Service Contracts**:* Direct means of compensating enterprises for certain projects/services with low operational and regulatory burdens.

Moderate Ease of Deployment

- ***Unified Structures**:* Suitable for pooling both foreign and domestic capital with minimal regulatory hurdles but with higher operational fees.
- ***Onshore AIF Funds**:* Moderate in operational and regulatory ease but may require high legal intermediation for innovative financing structures.

Potentially Difficult Deployment

- ***Direct Deployment**:* Potentially difficult for new capital deployers in the Indian regulatory landscape, requiring local legal advisors and operational teams.
- ***GIFT IFSC**:* Emerging option with higher legal intermediation costs and opportunities for creative structuring; but yet to see successful examples.
- ***FCRA Pathway**:* High compliance burden, but can develop the financing ecosystem through technical assistance, incubation, and handholding support.
- ***Indian Debt Intermediary**:* Requires FDI route with operational and regulatory knowledge of the Indian NBFC market.

The study also compares the various options for aggregating catalytic capital in the US, such as **Donor Advised Funds (DAFs), Public Charities, Private Foundations and Family Offices** based on available deployment options, financial returns, investment control, internal staff and experience required and tax implications. For such capital aggregation, we find that impact-first funds set up by public charities are a viable option for asset owners seeking high-impact, low tax burden, and a moderate level of control of their investments based on their impact investment theses.

This study is provided for information purposes only and is not a recommendation as to which pathway is appropriate in any given circumstance, nor does the Study evaluate or express any views on the financial return associated with any of the options outlined in the Study. Desai & Associates, Prime Coalition, and The Lemelson Foundation waive any responsibility for any repercussions stemming from applying any options enlisted in this report. *Please refer to the disclaimer on page 4 for more details.*

SECTION I. CONTEXT

Introduction

The widening gap in development capital to achieve the Sustainable Development Goals (SDGs), presents both a critical challenge and a substantial opportunity for investors. Recent studies highlight the current SDG financing gap has reached a staggering $4 trillion[1] in developing countries (UNCTAD). Sectors like Energy and WASH account for approximately 70% of this shortfall leading to 2030. Moreover, the Indian Government estimates that climate investments in India need to escalate from $18 billion to $170 billion[2] to meet ambitious net-zero targets effectively (IFC).

While a large share of attention and funding for reaching the SDGs typically goes to non-profit organizations, the role of impact-focused market-based solutions (social entrepreneurship) has gained significance across major global platforms such as COP (Conference of the Parties), WEF (World Economic Forum) and OECD (Organization of Economic Cooperation and Development). Given the untested nature of the innovative solutions offered through social entrepreneurship, this funding must often come in the form of high-risk, flexible, and patient capital for seeding, scaling and sustaining social enterprises.

Catalytic capital, i.e. debt, equity, guarantees, and other investments that accept disproportionate risk and/or concessionary returns relative to a conventional investment to generate positive impact and enable third-party investment that otherwise would not be possible. Catalytic capital aims to fill funding gaps that are not being met by public subsidy or private investment but are intended to leverage and bridge such resources. Catalytic capital thus seeks to accelerate progress and avoid stagnation in certain market segments (e.g., moderate and low-income housing) that are essential to achieve climate and social goals. Catalytic capital is critical for enterprises aimed at addressing the SDGs. While still at its nascent stage, the Indian catalytic/blended finance market is projected to reach $2.64 billion by 2027[3], providing an opportunity for capital providers to create impact while generating financial returns.

Despite the promise of catalytic capital to bridge commercial market gaps, deploying foreign catalytic capital into India is fraught with complexities. US- and EU-based stakeholders must navigate complex Indian regulations that impose stringent controls on foreign investments.

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[1] United Nations Conference on Trade and Development. (2023). SDG investment trends monitor (Issue 4). UNCTAD. https://unctad.org/publication/sdg-investment-trends-monitor-issue-4

[2] International Finance Corporation. (2023). Blended finance for climate investments in India. IFC. https://www.ifc.org/content/dam/ifc/doc/2023/Report-Blended-Finance-for-Climate-Investments-in-India.pdf

[3] Asha Impact Trust, & Impact Investors Council. (2023). The India Blended Finance Narrative: A Decade of Blended Finance in India and What Lies Ahead. Retrieved from https://blendedfinanceindia.org/wp-content/uploads/2023/05/The-India-Blended-Finance-Narrative-Report-1.pdf

These include sectoral caps, pricing guidelines, and compliance requirements, which can complicate the entry and operation of foreign catalytic capital.

Enabling the inflows of foreign catalytic capital into India is found to be complex in terms of regulations, operational viability, and legal resourcing for the structuring of financial instruments. Across the various thematic sectors of investment, the key challenges faced by the investors include:

1. **Taxation:** There are multiple layers of taxation, including corporate tax, capital gains tax, and Goods and Services Tax (GST), which can vary depending on the type of investment and the sector. Taxation norms also vary depending on India’s taxation treaties with the various foreign jurisdictions. Additionally, the lack of clarity and frequent changes in tax regulations can lead to uncertainties.
2. **Operating Cost:** These include costs associated with setting up and maintaining a local office, hiring skilled professionals, and compliance with local regulations. The overheads related to administration, management, and reporting requirements can also be substantial. For foreign investors, currency exchange risks and inflation rates add another layer of financial burden that must be managed.
3. **Legal fees:** The process of due diligence, compliance with local laws, and structuring deals often require the involvement of experienced legal professionals. These costs can escalate quickly, particularly when dealing with complex financial instruments or multiple/new jurisdictions. Legal intermediation is typically also more significant when attempting to develop innovative financial instruments that allow for the most efficient participation of catalytic capital.
4. **Regulatory permissions:** Acquiring the necessary regulatory permissions can be lengthy and bureaucratic, often requiring approvals from multiple government agencies. Certain sectors have specific restrictions and caps on foreign investment, further complicating the approval process. Delays in obtaining regulatory clearances can stall investment projects and lead to increased costs, making it challenging to maintain the momentum of capital inflows.
5. **Disclosure mechanisms:** Investors, both at the individual and fund level, are required to comply with disclosure mechanisms such as Know Your Customer (KYC) and Permanent Account Number (PAN), maintaining a Demat account and other requirements at the individual and fund level. These mechanisms are designed to prevent money laundering and ensure tax compliance but can be burdensome and time-consuming. They often require extensive documentation and periodic updates, which can be difficult for investors unfamiliar with the Indian regulatory landscape.

RESEARCH OBJECTIVES & METHODOLOGY

The study aims to enhance the strategic deployment of catalytic capital into Indian social enterprises by US and European investors through a detailed examination of the existing financial pathways and their associated challenges. The objectives are:

- **Developing a Shared Taxonomy:** Creating a unified framework for terms used by funders and recipients across the US, Europe, and India, facilitating clearer communication and understanding.
- **Mapping Financial Pathways:** Identifying and describing the various mechanisms through which catalytic capital can be directed from the US and Europe to Indian social enterprises.
- **Evaluating Challenges:** Assessing the legal, structural, financial, and operational hurdles within these financial pathways and determining their impact on capital flow.
- **Ideating Solutions:** Proposing actionable strategies to address identified challenges, potentially including the establishment of intermediary structures outside India.

It is important to note that while the study lays opportunities and challenges for different pathways, it does not make specific strategic recommendations on the pipeline and absorptive capacity of the enterprises. Additional demand-side analysis, tailored to align with a capital provider's mission and purpose, is necessary to determine the optimal deployment structures, sectors, strategies, and investment managers. The report analyzes data and insights collected through primary and secondary research methods including desk reviews and engagement with advisors, and primary research through consultations with key stakeholders in the US, EU, and India. The overall process and phases for the research have been highlighted below and in the following image:

- **Data Collection:** This study analyzed primary qualitative data from 36 consultations with identified critical stakeholders. These included US and India-based legal experts, US and EU-based capital providers (Private foundations, DAFs, family offices), and capital intermediaries (funds, facilities, and incubators). In-depth secondary research was also done to substantiate insights from the consultations.
- **Research Boundaries:**
  - The types of investments considered for the study are **Grants, Recoverable Grants, Program Related Investments (equity, debt, loan guarantee, etc.)**, and concessionary Mission Related Investments (equity, debt, loan guarantee, etc.) into **Indian Social Enterprises**. Social enterprises refer to for-profit entities in India that demonstrate their focus on eligible social objectives for the underserved or less privileged populations or regions and thus primacy of its objectives to serve social good. A framework for the eligibility of social enterprises

is provided under Section 5.2.2 (ii)a, b, c of the Framework for Social Stock Exchange by the Securities and Exchanges Board of India (SEBI).

- **Intended Outcome**: Consultations & secondary research was conducted to identify and analyze financial pathways based on financial feasibility, and operational & regulatory viability. Based on this, detailed investor-focused strategic recommendations have also been provided.

TAXONOMY

A shared cross-border taxonomy facilitates a common understanding of key concepts involved in international catalytic capital deployment. A standardized vocabulary aids stakeholders in aligning strategies and compliance across jurisdictions, enhancing the efficiency and impact of global philanthropic efforts. The table below highlights some of the key concepts that have been simplified as part of this study.

Concept	Definition	India Regulation	US Regulation
Catalytic Capital	Catalytic capital is debt, equity, guarantees, & other investments that accept disproportionate risk and/or concessionary returns relative to traditional investment instruments to generate positive impact & enable crowding additional commercial capital expecting market returns.	No specific regulation and guidelines that allow foundations to deploy catalytic capital.	PRIs (Program-Related Investments) & MRIs (Mission-Related Investments) allow foundations to invest debt or equity in social enterprises. Additionally, funds can structure differential returns to investors through catalytic sleeves.
Feeder Fund	An investment vehicle that pools capital in an offshore jurisdiction and then intentionally directs the pooled capital into enterprises or a primary fund in the target geography (onshore).		LP (Limited Partnership), LLC (Limited Liability Corporation) or Corporation (C-Corp or S-Corp) depending on state jurisdiction.

Concept	Definition	India Regulation	US Regulation
Foundation	An organization that provides funding towards charitable purposes through grants and catalytic capital.	CSR Donor, Trust, Society or Section-8 company.	501(c)(3) - Private Foundation
Fund	A capital intermediary i.e. a pool of capital aggregated from numerous investors that provides management expertise and deploys capital into investment opportunities. The investors retain ownership and some measure of control of their shares.	Alternative Investment Fund (AIF) Category I, Category I or Category III.	LP (Limited Partnership), LLC (Limited Liability Corporation) or Corporation (C-Corp or S-Corp) depending on state jurisdiction
Non-Profit Organization	An entity that is created and operated for charitable or socially beneficial purposes, prioritizing the public good over private benefit.	Trusts, Societies, and limited (Section 8) not-for-profit companies.	501(c)(3) - Tax-Exempt Organization/Public Charity or 501(c)(4) Social Welfare Organization
Social Enterprise	A for-profit Indian enterprise that demonstrates that social intent and impact are its primary goals, and that such intent is demonstrated through its focus on social objectives for the underserved or less privileged populations or regions. (As per SEBI framework on Social Stock Exchange).	Under the MCA (Ministry of Corporate Affairs) for-profits, can be registered as Pvt Ltd. (Private Limited), LLP (Limited Liability Corporation) or OPC (One-Person Company i.e. Sole Proprietorship) There is no specific registration for social enterprises.	B-Corp (Benefit Corporation), LLC, SPC (Social Purpose Corporation), C-Corp, S-Corp or L3C (Low-Profit Limited Liability Company) depending on state jurisdiction.

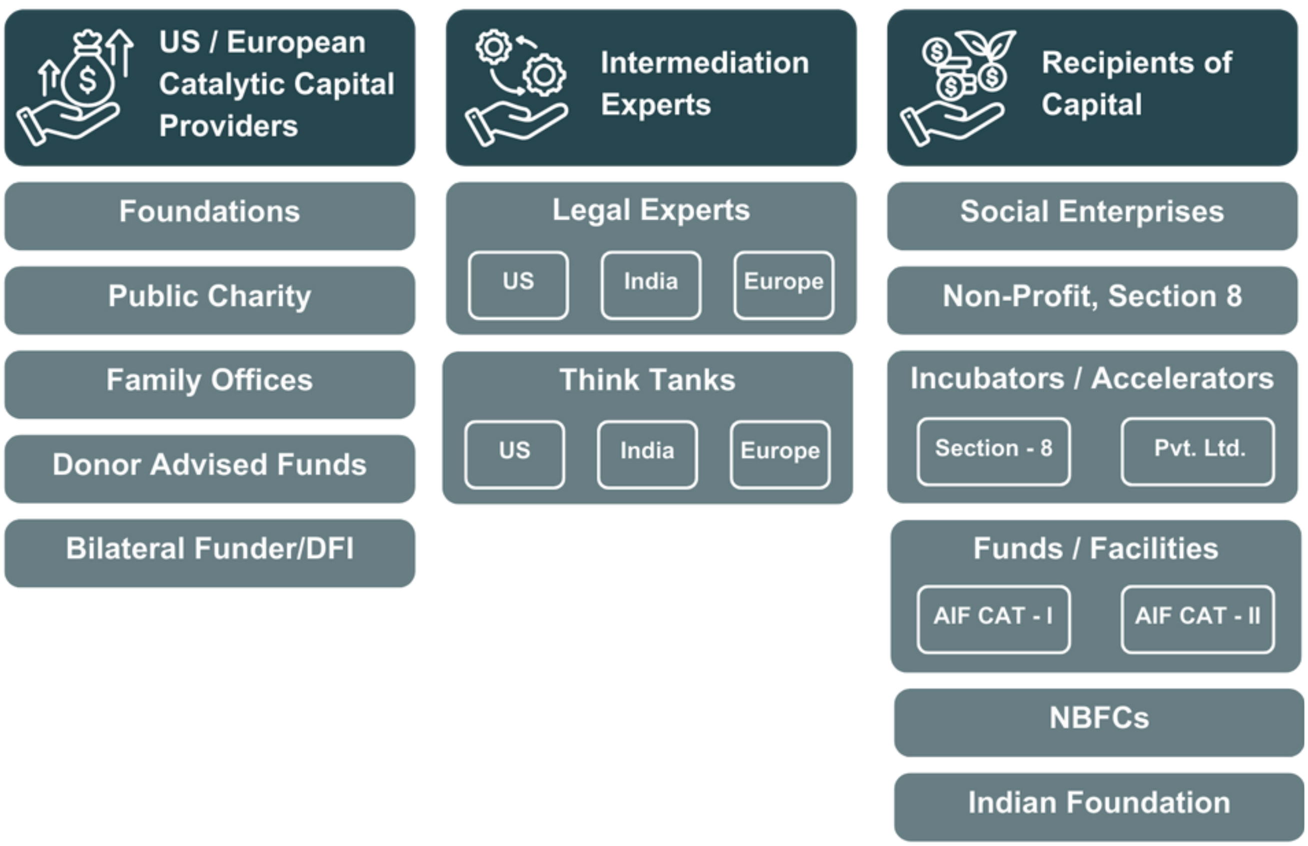
BOUNDARY CONDITIONS OF INVESTMENTS

- The study will focus on philanthropic capital directed toward investments in social enterprises i.e. for-profit companies (Private Ltd.) focused on social and environmental impact in India.
- These investments aim to increase impact & unlock other relevant sources of capital.
- Capital is provided by philanthropic organizations majorly domiciled in the USA, and some organizations in Europe. US philanthropic organizations include Private Foundations, DAFs, Private Charities, and other private funds.

- The final recipients of capital are social enterprises registered in India. Social Enterprises refer to businesses with specific social objectives that serve their primary purpose. (age, revenue, stage of investments)
- Types of Investment instruments being considered: Grants, Recoverable Grants, Program Related Investments (PRIs)(Equity, Debt, and Loan Guarantee).

STAKEHOLDER MAPPING

Consultations were conducted with key stakeholders in the US, Europe and India. These stakeholders include legal experts, capital providers (private foundations, DAFs, family offices), and capital intermediaries (funds, facilities, and incubators/accelerators). Questions were structured keeping the final recipients of capital in India (social enterprises, non-profits, NBFCs) at the center. The figure below represents the different kinds of stakeholders that were consulted along with their legal registration.



SECTION II: STRATEGIC & PRACTICAL CONSIDERATIONS

Within the boundary conditions defined, there are certain characteristics and considerations that investors must engage in and manage whilst designing investment strategies. Specific to US-based foundations seeking to participate in catalytic capital deployment, investments are legally required to align with the 'charitable purpose' of the organization. Additionally, several other contributing considerations will guide their investment decisions and strategy.

DEFINING CHARITABLE PURPOSE

Private foundations in the US making catalytic investments into enterprises directly or through capital intermediaries must prove their 'charitable purpose' for it to count towards its minimum requirement of 5% of assets disbursed for philanthropic activities. These investments are legally defined as a 'Program-Related Investment' (PRI) and need to be substantiated with a 'letter of intent' approved by the foundation's lawyers. If the investment is made through a capital intermediary e.g. a public charity, this documentation can be provided by the intermediary itself, working in tandem with the foundation's lawyers.

A proper argument on the need for catalytic capital to be deployed in the form of a PRI must be made for it to be considered a charitable purpose. This needs to fulfill the following criteria[1]:

1. **Primary Exempt Purpose Test:**
    - *Significantly Further Sub-Test:* The investment must further the foundation's exempt activities, consistent with IRC Section 501(c)(3) and the foundation's specific purposes.
    - *"But For" Sub-Test:* The investment would not have been made but for its contribution to the foundation's exempt purposes.
2. **No Significant Investment Purpose Test:**
    - The investment's primary purpose must not be income production or property appreciation. The indicators for this are:
        - Loans at below-market rates typically satisfy this test.
        - Investments producing significant income do not automatically disqualify as PRIs if other factors, like high risk, justify the investment.
        - Dual-purpose investments aiming for both return and charitable goals can qualify as PRIs.
3. **No Political Purpose Test:**
    - The PRI must not attempt to influence legislation or participate in political campaigns.

[1] Adler & Colvin. (n.d.). Legal explanation of program-related investments (PRI primer). Retrieved from https://www.adlercolvin.com/legal-explanation-of-program-related-investments-pri-primer/

- Exception: The recipient can engage in legislative activities if deductible under IRC Section 162, provided the foundation does not earmark PRI funds for this purpose.

CONTRIBUTING FACTORS TO CATALYTIC CAPITAL DEPLOYMENT

As per the Catalytic Capital Consortium[1], **Catalytic capital is debt, equity, guarantees, and their investments that accept disproportionate risk and/or concessionary returns relative to traditional investment instruments to generate positive impact & enable crowding of additional commercial capital expecting market returns.**

Catalytic capital deployment involves several critical considerations that guide capital providers in making strategic and impactful investments. While the first four considerations are specific to each pathway, the final consideration of ‘control’ is specific to the deployment vehicle selected at the source.Each pathway has been assessed based on the first four considerations in section III, and the aspect of control has been explored as part of the US deployment options in section IV.

1. **Sector:** Based on the investor organization’s mission and purpose, investments will most likely take place along a certain sectoral focus and impact metrics. Selecting the right sector is critical, with a focus on areas where there is limited availability of capital but significant potential for growth and impact. Investments should target sectors with a strong pipeline and the ability to generate high impact and social returns.
2. **Company Type:** Refers to the enterprise’s stage of growth and the expected ticket size of deployment. Investors must evaluate the expected internal rate of return and establish clear parameters for the duration and liquidity of investments, whether in short-term fixed-income assets or long-term equity investments.
3. **Catalytic Capital Potential:** Effective catalytic capital deployment utilizes structures that can enable the asset owner to take disproportionate risk and leverage the pooling of more commercial capital. The ratio of philanthropic to commercial capital is calibrated to enhance the financial sustainability and reach of the projects.
4. **Feasibility:**
    - **Regulatory and Legal Viability:** Investors must assess the tax implications and adhere to Foreign Exchange Management Act (FEMA) double taxation avoidance agreements (DTAA), and KYC (Know Your Customer) among other norms. Understanding these factors helps mitigate risks and facilitate smoother transactions.
    - **Operational Feasibility:** Investors must assess the resources needed for setting up and managing investments, including cost, personnel, and effort. This also

MacArthur Foundation. (n.d.). Catalytic Capital Consortium. Retrieved June 27, 2024, from https://www.macfound.org/programs/field-support/impact-investments/catalytic-capital-consortium/

- involves planning for expenditure reporting, financial structuring, and monitoring of impact to ensure operational efficiency and accountability.

5. **Control:** This refers to the degree of control that investors desire over their funds. Direct investment routes typically offer higher control, allowing investors to closely align capital deployment with their specific impact objectives. Investors may prioritize maintaining a high degree of control over their funds to ensure that the deployment aligns closely with their impact goals.

PHASES OF DECISION MAKING

The deployment of catalytic capital involves a structured decision-making process, divided into four distinct phases, each critical to the effective investment of resources in social enterprises and non-profit organizations:

Phase 1: Type of Capital

Selecting the type of capital to be deployed. Investors decide whether to use equity, debt, grants, or recoverable grants. Each option has its own set of characteristics and potential risks, and the choice depends on the investor's objectives and the specific requirements of the projects they intend to support.

Phase 2: Choice between Direct vs. Indirect

Investors' select between direct deployments, such as Program-Related Investments (PRI) to social enterprises, or indirect deployment through intermediary entities like foundations or Donor-Advised Funds (DAFs). This decision significantly influences how directly investors can control and monitor their investments.

Phase 3: Capital Aggregation in the US/EU

Aggregating capital, specifically in regions like the US and EU, where it can be funneled through various vehicles including private foundations, public charities, family offices, and DAFs. This stage is crucial for mobilizing substantial capital from developed markets to target regions.

Phase 4: Capital Intermediation

The final phase entails choosing the appropriate intermediary structure to channel the investment. This involves deciding to invest the aggregated funds into domestic Alternative Investment Funds (AIFs) or offshore funds. The choice made here will affect the overall investment features, such as expected returns, tax implications, and ease of operation and compliance.

SECTION III: MAPPING FINANCIAL PATHWAYS & FUND FLOW

Catalytic capital deployment from US or EU-based organizations to India is structured through multiple pathways, accommodating diverse donor preferences and compliance requirements. These pathways include:

1. **Direct Investments:** Direct flow of capital to India-based social enterprises.
2. **Indirect Investments:** Capital flows through capital intermediaries that may be based in India (onshore), US/EU or in other offshore regions

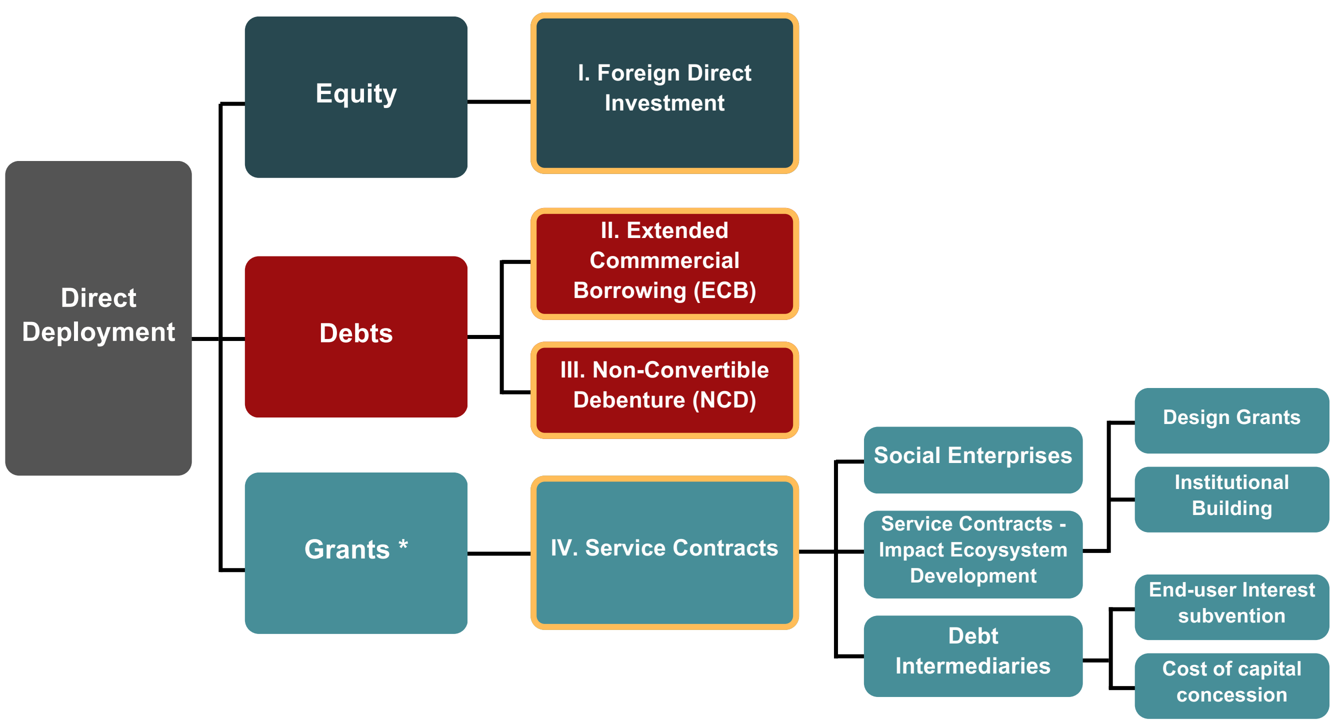
Each pathway is designed to align with strategic impact objectives, ensuring that the deployed capital achieves its intended social or environmental outcomes efficiently.

DIRECT INVESTMENTS

Direct investments refer to pathways where philanthropic capital is deployed directly into Indian social enterprises, either through equity, debt, or grants (structured as service contracts). These investments offer high control and require significant operational involvement.

Direct Deployment

Individual Investors, DAFs, Non-Profits, Funds and Family offices can deploy equity and grant capital in the following ways:



** Have not included recoverable grants as part of the detailed analysis as this was not the pathway that was recommended by legal experts*

I. Equity: Foreign Direct Investment (FDI)

Investors who invest equity directly in social enterprises, through the Foreign Direct Investment policy, can do so under the automatic route. Here, a foreign entity acquires ownership or controlling stake in the shares of an Indian company. It is different from foreign portfolio investment (FPI) where the foreign entity buys equity shares of a company. Based on the FDI policy in India, certain sectors fall under the "100% automatic route" and do not require government permission.

Opportunities: Equity through direct FDI is preferred for primarily moderate to big-ticket investments (USD 2 million to USD 4 million and above) in India. It allows for significant ownership and control and aligns with the strategic goals of the funder, typically large corporations. Additionally, large investments benefit from economies of scale, higher potential returns, and government incentives, making this route more suitable for investors seeking lower operational; burden compared to small or medium-sized investments.

Equity through FDI is attractive for its direct impact and strategic benefits in sectors such as livelihoods, clean energy, and affordable nutrition. Investors can optimize taxation and returns by structuring their investments through holding companies or special-purpose vehicles. However, they must carefully navigate the complexities of both Indian regulations and those of their home country and develop compliant and innovative financial structures.

Challenges: India's tax treaties can reduce withholding tax rates on dividends and interest, but frequent changes in tax laws create uncertainty and affect investment decisions. Retrospective amendments, such as indirect transfer provisions, increase tax risks by potentially imposing unforeseen taxes on foreign investors.

ON DEBT VERSUS EQUITY

"Equity is much more streamlined, both as part of direct investments and through funds. All debt pathways have become very expensive due to regulatory paperwork challenges."

- *An Indian equity fund manager who has also engaged in raising direct equity*

As with other forms of direct investments, making direct equity investments requires a deep understanding of the Indian sectoral markets, local context, business performance and regulatory landscape. This would require local teams and country-specific expertise, thereby increasing operating costs. As such, the pathway is highly dependent on the asset owners internal team capacity.

Further, several compliances are necessary at the end of the investor such as PAN (Permanent Account Number), and KYC (Know Your Customer) among others. However, it is found that several US and EU-based mid-sized foundations have been able to successfully navigate regulatory challenges. A strong internal team with experience navigating the Indian regulatory landscape is highly recommended when making direct equity investments.

Summary Table: FDI	
Sector	Sectors mentioned under 100% Automatic Route of FDI regulations (Ex: Renewable Energy, Roads & Highways, Single Brand Retail Trading, Textiles & Garments, Thermal Power). Potential for high-scale investments in tech, services, & manufacturing.
Company Type	**Company type:** Enterprises entering business growth stage, with robust product-market fit, with initial revenue generation. **Investment ticket size:** Typically moderate to large-scale investments (Series A onwards, USD 2 million to USD 4 million and above).
Catalytic Capital Potential	**Risk position:** This investment can take high risk as the enterprise may not have steady revenues, and a robust business model, that prevents the enterprise from raising capital through traditional investments. **Medium:** The enterprise uses the investment for business growth, and raises additional capital within 24-36 months through traditional investment instruments like new equity investments, affordable debt funding for working capital requirements or purchase of assets and infrastructure.
Feasibility	**Operational:** Requires deep understanding of the Indian sectoral markets, local context, business performance and regulatory landscape. This requires local teams and country-specific expertise, thereby increasing operating costs. **Regulatory:** Investors are required to be mindful of the constantly changing tax laws, and potential retrospective amendments related to investments in India. This pathway does not provide the avenue of concessionary returns according to India's regulatory framework unless the investment takes a minority stake in the enterprise on high valuations, or reducing the ticket size of the investment. **Legal:** Investors must navigate the complexities of both Indian and their home country regulations, ensuring compliance and utilizing innovative financial structures to optimize their investments.

Example	Strategic Investment Fund is the impact-first strategic investment arm of the Bill & Melinda Gates Foundation. They have done FDI investments in India across sectors like financial services and healthcare, with portfolio companies including 1mg, Avanti Finance, and Kaledofin.

II. Debt: External Commercial Borrowing (ECB)

ECBs are structured debt instruments that enable Indian social enterprises to access debt capital from international markets. Governed by Reserve Bank of India (RBI) guidelines, these borrowings offer flexible and scalable funding options for entities seeking debt capital.

ON CURRENCY EXCHANGE RISK

"International investors can come in through the FDI route or ECB route. There is a technicality here, concerning the hedging process of currency conversion. The rates have to be hedged, which is easier when it is a 3-5 year hedge but not a 7-10. If we do not get a 7-year hedge in India it's difficult. We have routed our money through Mauritius, where we got a 7-year hedge. ECB would only make sense if the transaction is 30+ crore, but would not make sense cost-wise otherwise."

- An Indian NBFC that has raised capital both domestically and internationally through NCDs

Opportunities: ECBs present an opportunity to engage in large-scale infrastructure and renewable energy projects through loan guarantees and other innovative financial instruments. However, the ticket sizes are typically large, and the investments require a rigorous assessment of risks associated with regulatory and operational challenges. ECBs are best suited for established enterprises capable of navigating the complex regulatory landscape and leveraging structured debt for significant development projects.

Challenges: ECB's operational framework imposes strict regulatory oversight, including stringent restrictions on the end-use of funds. There are high transactional costs, including currency exchange costs, limit its utility for small to medium-sized investments. Further, similar to FDI, ECB also have a high compliance burden on the investor/asset owner. While offering significant potential for facilitating large transactions of catalytic capital, this pathway necessitates a comprehensive understanding of the legal implications and tax scenarios, which can influence the overall cost of capital and the strategic alignment of investments.

ON NON-BANKING FINANCING COMPANIES (NBFCS) RAISING CAPITAL THROUGH ECBS

On Non-Banking Financing Companies (NBFCS) raising capital through ECBs: "We have considered raising capital through ECB. There are complications as an NBFC if we do not repay the ECB. A zero-interest arrangement may work. If the tenure of the ECB is less than 10 years, there is a limitation on end-use utilisation, which can only be used for capital expenditure or lend to specific sectors like housing, so the amount deployed is limited."

- An Indian NBFC that has raised capital through ECBs, FDIs and NCDs

Summary Table – ECB	
Sector	Under automatic, typically renewable energy, infrastructure, and healthcare.
Company Type	**Company type:** Suitable for mature enterprises with steady cashflows and high investment grade credit rating, raising large ticket-size capital at concessional rates. **Investment ticket size:** Typically, high due to the nature of projects funded via ECBs. Ticket sizes start from USD 12 million and above.
Catalytic Capital Potential	**Risk position:** This investment has low risk, as the due-diligence parameters for ECB are high, based on the RBI guidelines, and are only taken up by mature enterprises with high credit ratings and steady business metrics. **Medium:** The enterprise uses the investment for business growth, and raises additional capital within 24-36 months through traditional investment instruments like new equity investments, or additional and incremental debt funding.
Feasibility	**Operational**: Requires deep understanding of the Indian sectoral markets, local context, business performance and regulatory landscape. This requires local teams, country-specific expertise, high due diligence and transaction costs, forex hedging costs, etc. thereby increasing operating resources for investors. **Regulatory**: Investors require prior approval from the RBI, has strict regulatory oversight from the RBI, including stringent restrictions on the end-use of funds. **Legal:** The structure necessitates a comprehensive understanding of the legal implications and tax scenarios, thereby increasing legal costs and complexity.

Example	United States International Development Finance Corporation ("DFC") is setting up a loan facility (by way of an external commercial borrowing) of up to USD 6,700,000 to Leap Agri Logistics (Baroda) Private Limited ("Leap") for the construction of a grain silo storage complex in accordance with concession agreement executed by Leap with Food Corporation of India ("FCI"). The loan will enable Leap to construct modern grain silos able to feed people in India and helping FCI deliver on its food security mission and reducing food loss.

III. Debt: Non-Convertible Debenture (NCD) & Instruments through Foreign Portfolio Investment

NCDs are a fixed-income instrument that allows corporations to raise long-term funding without diluting equity ownership. Utilizing mechanisms such as the Voluntary Retention Route (VRR), NCDs offer Foreign Portfolio Investors (FPIs) a regulated and stable pathway for channeling foreign investment into Indian corporate debt, enhancing the financial robustness of the participating corporations.

Opportunities: NCDs can be a strategic investment choice for those interested in the Indian debt market, particularly for engagements that require secure and well-regulated investment avenues. They offer adaptability with flexible interest rates and repayment structures tailored to various investor preferences and risk tolerances. NCDs appeal to domestic and international investors seeking to invest significant funds into reliable, long-term debt instruments. The provision of secured NCDs, often supported by asset backing or credit guarantees, provides an added security layer, making these instruments particularly attractive in unpredictable markets. Nonetheless, potential investors must be prepared to manage the risks associated with market and interest rate fluctuations, which can significantly influence the liquidity and pricing of NCDs.

ON RAISING CAPITAL THROUGH DIRECT DEBT V/S DEBT DEBENTURES

"Domestically, most borrowing happens through direct loans. The only benefit of debentures is that it is traded through the market. People will typically go through the debenture route only when they do not have the permit to issue loans in India, so some international investors do it. When high-net-worth individuals (HNIs) want to invest in India, they do it through debentures, listed or unlisted. As far as the process goes, there was earlier a requirement that the debentures had to be rated, but for international investors, the rating does not matter much."

- An Indian NBFC that has raised domestic and international capital through NCDs

Challenges: NCDs carry inherent credit risks that reflect the issuing company's financial health; a higher yield can typically indicate a more significant risk. Compliance with the rigorous requirements set by the RBI and the Securities and Exchange Board of India (SEBI) including standards for minimum net worth and mandatory credit ratings, can further complicate any form of FPI investments.

The issuance of NCDs, while accessible to a diverse range of investors under regulations like FEMA 1999, requires adherence to stringent credit ratings, adding complexity to the issuance process. Additionally, FPIs (Foreign Portfolio Investors) must navigate through the regulatory maze of obtaining an FPI license and conforming to KYC and FEMA regulations, which can be daunting and resource intensive.

ON RAISING CAPITAL THROUGH DIRECT DEBT VERSUS DEBT DEBENTURES

"ECBs are often directly compared with Non-Convertible Debentures (NCDs). NCDs are described as more flexible and easier to label (e.g., green bonds), which makes them suitable for projects needing specific types of funding. NCDs allow for easier repatriation of interest and have fewer structural restrictions."

- An Indian debt fund manager that has raised capital through ECB (long-term debt), FDI and grants through an FCRA-certified entity

Summary Table – NCD	
Sector	Suitable for sectors that require stable, long-term investments like infrastructure & renewable energy.
Company Type	**Company type:** Suitable for mature enterprises having steady cash flows and good credit ratings. **Investment ticket size:** Large due to the nature of enterprises funded via NCDs. Typically, only high credit-rated entities will raise capital through NCDs.
Catalytic Capital Potential	**Risk position:** This investment has low risk, as the due-diligence parameters for NCDs are high, based on the RBI guidelines, and are only taken up by mature enterprises with high credit ratings and steady business metrics. **Leverage:** The enterprise uses the investment for business growth, and raises additional capital.

Feasibility	**Operational:** Requires deep understanding of the Indian sectoral markets, local context, business performance and regulatory landscape. **Regulatory:** Investors require an FPI license to participate which can be complex to acquire. **Legal:** Legal intermediation is expected to be low as investment process is straightforward.
Example	Samunnati has raised capital of INR 353.10 million for 48 months (2018 to 2022) at 12.3% coupon from FMO Entrepreneurial Development

IV. Grants: Service Contracts

Grants through service contracts are critical financial and operational tools to support for-profit social initiatives and projects. Grants provide non-repayable funds that allow organizations to pursue projects without the burden of economic returns. Service contracts, conversely, are agreements for compensated services that offer payment structures based on performance, bringing in specialized expertise for specific tasks.

Opportunities: Service contracts allow for the ability to finance projects that help build the innovative financing ecosystem in India.Service contracts provide the flexibility to leverage external expertise and scale operations based on project demands. However, a heavy reliance on grants may compromise the long-term sustainability of recipient organizations.

Challenges: Due to tax implications, service contracts might lead to additional financial burdens, such as Goods and Services Tax (GST) on local subcontracting in India. However, operationally these are found to be fairly easy to execute.

ON TAXATION ON SERVICE CONTRACTS

“The main challenge with service contracts is taxation. The foundation will have to take an 18% GST hit. This is fine for us as of now but can be different going orward as the regulatory landscape might also shift.”

- An Indian debt fund manager that has raised capital through ECB (long-term debt), FDI and grants through an FCRA-certified entity

Summary Table – Service Contracts	
Sector	Applicable across most impact sectors, based on the investor preference and the enterprise.

Company Type	**Company type:** All types of enterprises, mostly favoring early-stage enterprises with a nominal product-market fit. **Investment ticket size:** Typically low-ticket size, in the range of USD 150,000 to USD 2 million.
Catalytic Capital Potential	**Risk position:** This investment has medium to high risk, as the investment is for value creation for enterprises that may or may not generate high returns for the enterprise. **Leverage:** Through services that provide handholding support and technical assistance, the pathway can improve the capital absorptive capacity of the enterprises.
Feasibility	**Operational:** Very low operating costs and requires the least effort for investment. **Regulatory:** Very low regulatory issues, as long as the use-of-proceeds of the investment is strictly adhered to, based on the contractual agreement signed between the investor and the enterprise. **Legal:** Legal intermediation is low, as it requires drawing a service contract with defined scope of work and use of proceeds.
Example	Water.org provides technical assistance to microfinance entities in India to enable WASH financing in the microfinance sector.

Conclusion: Direct Pathways of foreign catalytic capital deployment

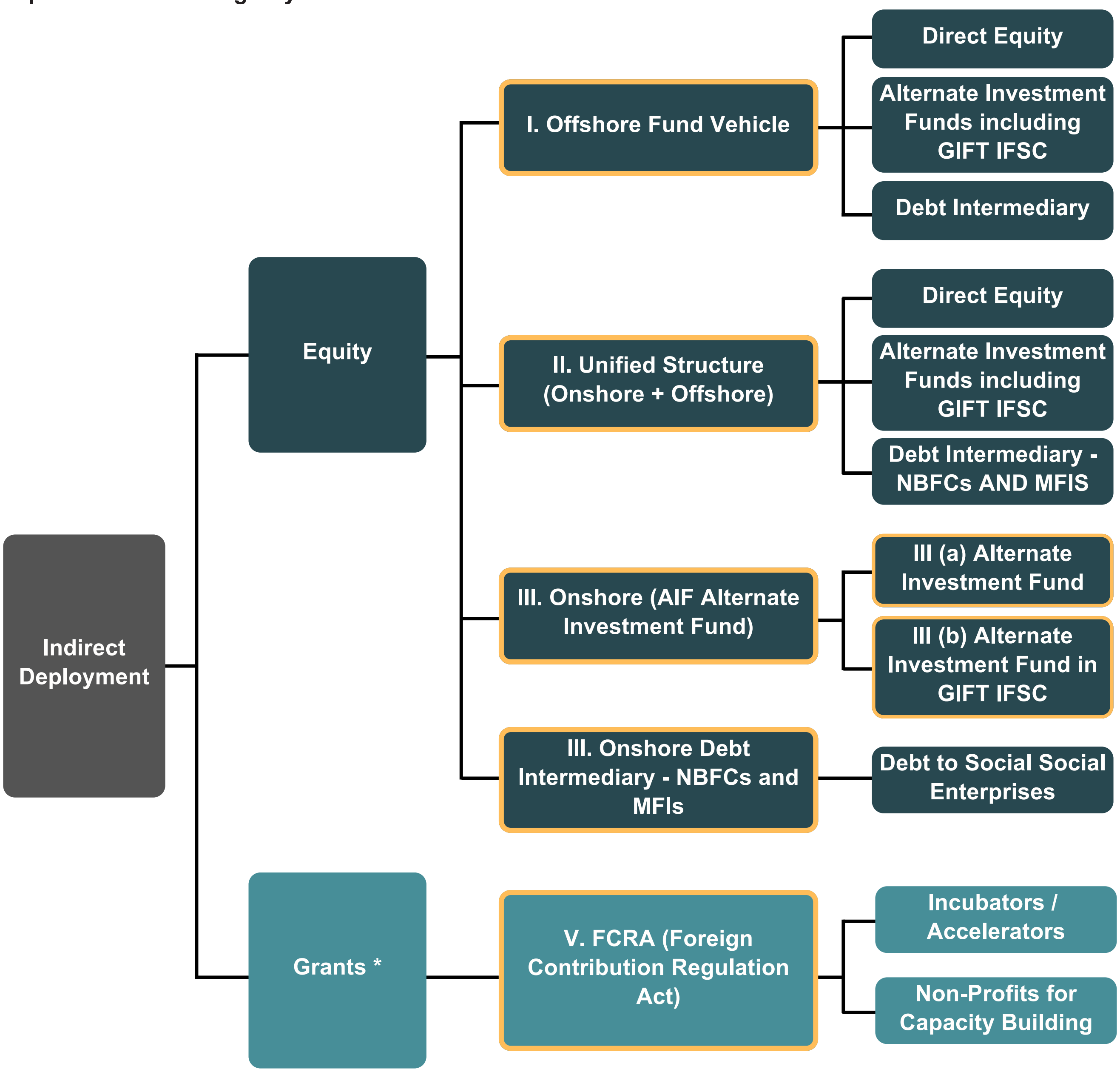
- **Overview:** Direct deployment of foreign catalytic capital involves significant resource allocation in terms of time, cost, and effort from the capital provider. These pathways typically demand a high level of involvement and oversight.
- **Advantages:** Provides the capital provider with a greater degree of control and direct attribution of impact, allowing for tailored interventions and direct engagement with the recipient entities.
- **Challenges:** High operational costs and resource requirements can be a barrier, especially for smaller capital providers. The need for continuous monitoring and management can also be resource-draining.

INDIRECT INVESTMENTS

Indirect investment involves channeling philanthropic capital through intermediaries such as funds or accelerators before reaching Indian social enterprises. This method enhances flexibility, reduces direct management complexities, and supports a broader range of projects with varying risk profiles and impact goals.

Indirect Deployment

Individual Investors, DAFs, Non-Profits, Funds, and Family offices can deploy equity, debt and grant capital in the following ways:



** Have not included recoverable grants as part of the detailed analysis as this was not the pathway that was recommended by legal experts*

I. Offshore: Fund Vehicle

An offshore fund vehicle (pure offshore structure) is used when there is no intention to pool capital within India. In this arrangement, a pooling vehicle, known as an Offshore Fund, is established in a foreign jurisdiction, e.g. Mauritius, Luxembourg or Singapore. Foreign investors will allocate capital to this Offshore Fund, which then invests in Indian social enterprises. These are generally structured as Trusts, LLPs, LLCs, and LPs etc.

Opportunities: Operational flexibility is the main contributing factor to the popularity of this structure. Offshore Funds can often be set up more quickly and with fewer upfront costs than onshore funds. Offshore funds don't need to register themselves with SEBI; only the offshore fund needs to have a valid PAN number associated in India. Foreign investors are therefore exempt from fulfilling these compliances.

The cost of operating the fund itself will depend on the country where the offshore vehicle is set up. While countries such as Singapore and Luxemburg are operationally expensive, countries like Mauritius and states within the US, like Delaware, might be comparatively lower cost. Offshore funds are also a great structure for investors seeking lower taxes on investments, such as minimal tax on investment gains and no capital gains taxes. Locations such as Mauritius, Luxembourg, and Delaware (within the US) have been popular for tax-related benefits. This can also be an attractive path for investors looking to invest in India without worrying about foreign exchange risks.

Challenges: Recent changes in the DTAA with countries such as Mauritius have reduced certain tax benefits. For example, India-Mauritius DTAA allows India to tax capital gains at the source, and these taxes may not be credited to the offshore investors' home countries.

Despite the benefits this pathway offers in terms of flexibility in structuring, and the ability to avoid taxation in certain geographies, the pathway presents a few operational challenges that investors must consider. Managing cross-border operations can be complex due to different business cultures, practices, and time zones. In terms of risk management, offshore funds investing in India may need local investment advisors for deal recommendations. There might be difficulties and costs associated with repatriating funds back to the US, which could affect the liquidity and attractiveness of these investments.

ON THE CHALLENGES OF SETTING-UP AND OPERATING AN OFFSHORE FUND

“We have set up a debt fund based in the Netherlands. Regulatory challenges caused it not to scale and narrow down the scope significantly. Withholding taxes were applied and we had to use the Dutch DTAA to route it through. We also have a Dutch company managed by the Foundation but are unable to invest much in India, so we are considering giving it through a Hong Kong entity of the Indian company.”

- *A Europe-based Foundation*

STRATEGIC OPTIONS TO BLEND CAPITAL IN OFFSHORE FUNDS

In terms of fund structuring, this pathway allows for the creation of blended capital stacks and differential returns to the investors based on their expected levels of returns. This can be done by combining catalytic capital with traditional private investment to leverage larger amounts towards impact investing in India. The offshore environment is conducive towards designing tailored financial instruments that can channel philanthropic funds into mezzanine debt, guarantees, or equity investments with specific impact-driven outcomes. Structuring options for this pathway include:

- **Facilitation of Multi-Tranche Investments:** The ability to create multi-tranche structures with different risk-return profiles can appeal to a wider range of investors. Philanthropic capital often takes first-loss positions, encouraging private investors to participate with reduced risk.
- **Co-investment structures** can be created where the offshore fund aggregates foreign investors and an onshore fund (AIF) with domestic investors which can both invest together or independently in enterprises in India at differential return rates.

Summary Table – Offshore Fund Vehicle	
Sector	Applicable across most impact sectors, based on the investor preference.
Company Type	**Company type:** All types of enterprises, mostly favoring early-stage enterprises with a nominal product-market fit. **Investment ticket size:** Typically in the range of USD 250,000 to USD 2 million, with up to 20-25% equity dilution for the enterprises. The investment is typically for 18-24 months, going up to 36 months.
Catalytic Capital Potential	**Risk position:** This investment has high risk, as this investment anchors the product-market fit of the enterprise and sets the enterprise on the trajectory of initial revenues. **Leverage:** High leverage, as the investment is pooled with other offshore investors.
Feasibility	**Operational:** Low operating costs for the investor. Low-to-medium operating costs for the fund manager, depending on the location of the offshore fund, e.g., Delaware-based offshore fund has low operating costs, vis-à-vis Singapore based offshore fund has higher operating costs.

Feasibility	**Regulatory:** The degree of regulatory challenges is based on the location of the offshore funds, especially on the taxation, reporting, and ease of participation (declarations, KYC norms, etc). **Legal:** Legal intermediation is low for the fund.
Example	A leading impact investor in early-stage Indian climate-tech enterprises is registered in Mauritius, providing investments of USD 150,000 to USD 500,000. The details can be provided on request.

II. Offshore: Unified Structure

Under this structure, two funds operate parallelly: a domestic Alternative Investment Fund (AIF) and an offshore fund. Domestic investors can directly contribute to an Onshore Fund, while overseas investors will pool their investments in an offshore vehicle ("Offshore Fund") which, in turn, invests (serves as a Limited Partner) in the Onshore Fund.

Opportunities: In comparison to the pure Offshore Structure, the Unified Structure is useful for investors who want to benefit from both the tax exemptions and operational flexibility of pooling foreign capital offshore as well as the efficiency of raising and pooling domestic capital through an AIF.

The unified structure enjoys certain specific financial benefits as compared to a pure offshore structure. Under the unified structure, investments made by the Indian AIF with the capital contributions received from the offshore fund shall also be deemed to be domestic investments if the manager and sponsor of the AIF are Indian owned and controlled. Therefore, this prevents restrictions placed on foreign investments that are specific to the FDI regulations.

ON THE NEED FOR A UNIFIED STRUCTURE V/S A PURE DOMESTIC AIF

"The AIF 'X' fund had no international investors. We were able to get international funds for another fund 'Y', but it was because the fund was domiciled in Mauritius. On the debt side, we tried raising a debt fund for close to a year, an AIF Cat 2 for climate-smart MSMEs.

In the last 1.5 years, many changes and credit-enhanced options have gone, so the possibility of catalytic funds goes away if domestic AIF is the pooling vehicle. Pooling has to happen outside. Even in GIFT City, SEBI regulations apply."

- An Indian Fund Manager

Challenges: The most significant challenge for this pathway is the high operational and management costs of setting up and operating two parallel funds. The integration of feeder funds into AIF structures must navigate both Indian and international regulations, which can vary significantly and impact the feasibility and efficiency of these arrangements. Further, in terms of taxes, depending on the jurisdiction and the structure of the investment, different withholding tax rates may apply to the income repatriated from the master fund back to the investors in the feeder fund. Proper structuring is crucial to minimize this tax burden.

Summary Table – Offshore - Unified Structure	
Sector	Applicable across most impact sectors, based on the investor preference.
Company Type	**Company type:** All types of enterprises, mostly favouring early-stage enterprises with a nominal product-market fit. **Investment ticket size:** Typically in the range of USD 250,000 to USD 2 million for early-stage, and USD 2 million to USD 10 million for seed-stage/Series-A investment. The investment is typically for 18-24 months, going up to 36 months.
Catalytic Capital Potential	**Risk position:** This investment has high risk, as this investment anchors the product-market fit of the enterprise and sets the enterprise on the trajectory of initial revenues. **Leverage:** High capital leverage, as it raises funds from both domestic and international investors.
Feasibility	**Operational:** Low operating costs for the investor. Very high operating costs for the fund manager, as it operates two funds in parallel, one on-shore and one off-shore. **Regulatory:** The degree of regulatory challenges is based on the location of the offshore fund and the on-shore fund, especially on the taxation, reporting, and ease of participation (declarations, KYC norms, etc.). In case of the Indian on-shore fund, the regulatory requirements are high. **Legal:** Legal intermediation is high for the fund, as it must operate two funds.
Example	The Northern Arc Impact Fund has a Mauritius-based feeder with a Domestic AIF (Category II) in India. In the first fund clocked USD 26mn in FY22.

III. (a) Onshore: Alternative Investment Fund (AIF)

An Alternate Investment Fund (AIF) is established or incorporated in India in the form of a trust, company, LLP, or body corporate. Foreign Investments can be made in an AIF under the Foreign Direct Investment ("FDI") Policy issued by the Department of Industrial Policy & Promotion ("DIPP"). In this pathway, the foreign investor would directly invest in the AIF that is domestically based. There are three categories of funds under an AIF set-up, two of which (Cat 1 and Cat 2) and relevant in making catalytic and impact-driven investments.

THE CHOICE BETWEEN CAT I AND CAT II

Cat-I AIFs are subject to specific regulatory benefits designed to support investments in startups, SMEs, social ventures, infrastructure, and other sectors deemed of vital national interest. These funds can include grants, which makes them particularly suitable for projects that combine social impact with financial returns. These AIFs are often used for projects that align with government incentives or objectives, benefiting from certain regulatory reliefs and supports. For example, social venture funds under Cat-I can utilise grants to mitigate investment risks or enhance potential impacts, which can be appealing to impact-driven investors.

Cat-II AIFs offer more operational flexibility and are subjected to fewer compliance burdens than Cat-I. These funds do not necessarily align with specific government incentives and do not receive the special benefits that Cat-I enjoys. Typically used for private equity, debt funds, and fund of funds, these AIFs can invest in a broader array of sectors without restrictions on the type of investments or the structure that might apply to Cat-I funds.

Fund managers need to consider their social and strategic objectives when selecting between the set-up of Cat-I and Cat-II. Cat-I might be the appropriate choice if the fund's strategy aligns closely with government-prioritized sectors and could benefit from grants or special status. However, for more generalist funds that value flexibility and a wider investment mandate, Cat-II might be more suitable.

Opportunities: Pooling capital directly into an onshore fund allows domestic and foreign funders to participate with lower operational expenses compared to a unified structure. This is a conducive option for fund managers seeking to arrange for equal returns for all investors who are predominantly Indian with a few foreign investors. As for the arrangement of differential returns, some options have been suggested by legal experts (refer to the box on 'Strategic Options for Indian Fund Managers Seeking to Blend Capital'). It must be noted that these options are still being explored and are yet to be validated through implementation.

ON ARRANGING DIFFERENTIAL RETURNS WITHIN AN AIF

"We have found it very challenging to arrange for differential or lower-class returns for foreign investors. Since SEBI changed regulations a few years back, participation in catalytic funds has become challenging. Although some options are being suggested by lawyers, the legal intermediation fees are typically very high and not something we are looking into till there is better clarity."

- An Indian Equity AIF Fund Manager

Challenges: In comparison to the offshore structure, domestic funds have a significantly higher tax burden on the fund manager. Fund managers will be taxed on Capital Gains, both Short-Term Capital Gains (STCG) and Long-Term Capital Gains (LTCG) and on dividend and interest income. Based on the investor tax slab, both dividends and interest from AIFs are taxable.

Summary Table – Onshore: Alternative Investment Fund (AIF)	
Sector	Applicable across most impact sectors, based on the investor preference.
Company Type	**Company type:** All types of enterprises, mostly favoring early-stage enterprises with a nominal product-market fit. **Investment ticket size:** Typically in the range of USD 250,000 to USD 2 million for early-stage, and USD 2 million to USD 10 million for seed-stage/Series-A investment. The investment is typically for 18-24 months, going up to 36 months.
Catalytic Capital Potential	**Risk position:** This investment has medium to high risk, depending on the investment strategy of the fund manager. In this context, the fund manager is from India, and has a deep understanding of the local context and markets, the investment is slightly less risky as compared to purely offshore fund. **Leverage:** The fund can raise additional capital from traditional other investors, providing high leverage.
Feasibility	**Operational:** Low operating costs for the investor. Low-to-medium operating costs for the fund manager. **Regulatory:** The degree of regulatory challenges and expectations is high, as there is strict adherence to SEBI norms for investor declarations and reporting

Feasibility	**Legal:** Legal intermediation is low for the fund.
Example	British International Investments has invested in Indian funds like Aavishkaar Emerging India Fund (USD 25 million), Insitor Impact Asia Fund 2 (USD 15 Million), India Agri Business Fund II Limited (USD 3 million), etc.

STRATEGIC OPTIONS FOR INDIAN FUND MANAGERS SEEKING TO BLEND CAPITAL

In terms of fund structuring, there are 3 potential ways an impact investor can hold a subordinate position within the fund. It must be noted that legal experts are still in the process of refining these pathways and are yet to be verified through implementation in the market:

Differential Hurdle Rates: Although differential returns are not possible as per SEBI, a waterfall of returns through different hurdle rate LP contracts can be arranged with investors. As an example, if a fund achieves a 30% return and the initial investment is 100 rupees (INR 50 each from two investors with return expectations of 10% and 5% respectively), the distribution of returns would first cover the higher hurdle rate for the financial investor before any distribution to the impact investor. This setup reflects a "waterfall" where returns flow down from the highest priority (or highest return expectation) to the lowest.

Fund Sponsor: Differential returns can also be arranged if the Offshore Entity (Private Foundation, DAF, Public Charity, Private Fund) acts as a sponsor to the fund. It must be noted that subordinating the sponsor introduces legal complexities and heightened disclosure requirements such as revealing ultimate beneficial ownership. This could deter potential participants like foundations that value privacy or have regulatory restrictions against such disclosures. The risks associated with this role include greater legal liabilities, making it a less attractive option unless offset by potentially higher returns from the fund's success.

Fund Sponsor: Differential returns can also be arranged if the Offshore Entity (Private Foundation, DAF, Public Charity, Private Fund) acts as a sponsor to the fund. It must be noted that subordinating the sponsor introduces legal complexities and heightened disclosure requirements such as revealing ultimate beneficial ownership. This could deter potential participants like foundations that value privacy or have regulatory restrictions against such disclosures. The risks associated with this role include greater legal liabilities, making it a less attractive option unless offset by potentially higher returns from the fund's success.

Differential Schemes: Previously, AIFs used class-based units to offer differentiated returns to different classes of investors. Recent regulatory changes by SEBI have restricted this, but different AIFs can be established with different schemes under a multi-scheme trust, each with unique investment strategies and return profiles and the same fund manager, effectively mimicking the old class-based system.

CHOICE OF JURISDICTIONS FOR OFFSHORE STRUCTURES (PURE OFFSHORE AND UNIFIED)

When setting up India-focused funds with offshore investors, the choice of jurisdiction is crucial due to varying tax and regulatory landscapes. Popular jurisdictions include:

- **Mauritius:** Historically favored for its tax benefits, notably the India-Mauritius Double Tax Avoidance Agreement (DTAA). This jurisdiction offers advantages like a low withholding tax rate on interest income and capital gains tax benefits on share sales. However, recent changes now allow India to tax capital gains, which could diminish some historical advantages. The need for economic substance in Mauritius also imposes operational requirements such as local management and sufficient business activities.

- **Singapore:** Known for its robust regulatory environment and attractive capital markets regime, Singapore offers exemption on capital gains. Yet, like Mauritius, it requires substantial economic presence, and recent amendments in the India-Singapore DTAA align it with the India-Mauritius DTAA changes, mandating source-based taxation of capital gains, thus requiring careful planning for tax benefits.

- **Ireland:** Ireland is favorable for debt funds, benefiting from lower withholding taxes on interest, royalties, and fees for technical services under the Ireland-India DTAA. It's particularly attractive for financing operations that generate royalties or similar income streams. However, the costs and operational complexities can be higher compared to Asian jurisdictions.
- **Netherlands:** Offers a strong treaty network and is advantageous for portfolio investments into India, especially when not exceeding 10% shareholding to avoid capital gains tax in certain scenarios. The jurisdiction provides relief against capital gains tax but demands that entities pay tax locally to avail treaty benefits, which may influence operational and structuring decisions.
- **Delaware, United States:** Delaware in the United States is another jurisdiction commonly used for setting up feeder entities. While it does not provide specific tax benefits in the bilateral context with India, it offers a flexible and well-understood corporate environment, which is favorable for setting up investment structures. Unlike Mauritius, Delaware's appeal doesn't stem from tax advantages but from its sophisticated legal framework for corporate governance, which is well-suited to managing complex international investments.

III. (b) Onshore: AIF in GIFT IFSC

In this pathway, the AIF is set up and operated domestically in the Gujarat International Finance Tech City. GIFT, like other international financial centers in Dubai and Singapore, encourages foreign market participation through tax exemptions, reduced compliance burden and a regulatory environment that is more supportive of innovative financing structures.

Opportunities: Tax exemptions remain the most significant benefit of AIFs set up in GIFT IFSC. Investors are exempted from a range of taxes they would otherwise be liable towards through AIFs not set up within the GIFT jurisdiction (Exemption from income tax, capital gains tax, dividend distribution tax, withholding tax). There is also an ability to transact in multiple currencies, reducing the foreign exchange burden on investors.

Regarding operational viability, the GIFT IFSC offers single window clearance for compliances, a strong legal system that supports investor protection/dispute resolution and a streamlined regulatory process to avoid transaction delays.

ON OPPORTUNITIES AND RISKS WITH GIFT IFSC

"GIFT City allows more flexibility in financial operations, including the ability to take on leverage, which is restricted for AIFs located in other parts of India. This arrangement is particularly appealing because it can potentially enhance the returns on investment by employing borrowed capital under favourable terms. But typically leveraging comes with increased risk, and the regulatory frameworks governing these activities are stringent, aimed at protecting investor interests while allowing funds the flexibility to maximize their potential returns."

- An Indian AIF Debt-Fund Manager on the potential of AIFs in GIFT CITY

Challenges: The most significant challenge with this pathway is the lack of existing catalytic funds that have showcased practical success, both operationally and legally. GIFT-based AIFs are relatively new in the ecosystem and are still being explored by legal experts. The risk of regulatory restrictions from SEBI is uncertain. Further, to navigate through a pathway that is still novel in the market, the legal expenditure is expected to be relatively higher.

Summary Table – Onshore: AIF in GIFT IFSC	
Sector	Applicable across most impact sectors, based on the investor preference.
Company Type	**Company type:** All types of enterprises, mostly favoring early-stage enterprises with a nominal product-market fit. **Investment ticket size:** Typically in the range of USD 250,000 to USD 2 million for early-stage, and USD 2 million to USD 10 million for seed-stage/Series-A investment. The investment is typically for 18-24 months, going up to 36 months.
Catalytic Capital Potential	**Risk position:** This investment has medium to high risk, depending on the investment strategy of the fund manager. In this context, the fund manager is from India, and has a deep understanding of the local context and markets, the investment is slightly less risky as compared to purely offshore fund. **Leverage:** The fund can raise additional capital from traditional other investors, providing high leverage.
Feasibility	**Operational:** Low operating costs for the investor and the fund manager.

Feasibility	**Regulatory:** The degree of regulatory challenges and expectations is medium, as the GIFT City IFSCA has a regulatory sandbox in which funds can be setup. **Legal:** Legal intermediation is high, as it is a new avenue of setting funds in India.
Example	Northern Arc Emerging Corporate Bond Fund is setup in the GIFT City IFSCA, with a total fund size of INR 1300 Crore.

IV. Onshore: Debt Intermediaries – NBFCs & MFIs

Non-Banking Financial Companies (NBFCs) and Microfinance Institutions (MFIs) serve as pivotal debt intermediaries under the regulatory framework of the RBI. As integral components of India’s financial landscape, these institutions extend a range of financial services to underserved segments, including social enterprises and individual entrepreneurs in sectors such as WASH (Water, Sanitation, and Hygiene) and agriculture. Registered under the Companies Act, NBFCs, and various acts (Societies Act, Trusts Act) for MFIs, these institutions primarily offer -smaller ticket size loans, which are crucial for promoting financial inclusion in rural and semi-urban areas.

Opportunities: Financially, NBFCs and MFIs are noted for their diverse financing channels, providing loans, equity, and grants, and are capable of listing Non-Convertible Debentures (NCDs) to attract foreign investments with a valid FPI license. This flexibility enables them to target different stages of business growth and offer substantial returns as they scale. An equity infusion in these institutions can act as a catalyst, unlocking significant amounts of debt, thereby multiplying their impact on the ground. Operationally, NBFCs and MFIs benefit from greater flexibility compared to traditional banks, which allows them to innovate and adapt quickly to market needs.

Innovative financing through NBFCs and MFIs includes mechanisms such as loan guarantees, interest subventions, and technical assistance grants, which aid in building their capacity to design financial products tailored to the needs of the underbanked. Notable cases, such as those involving the Grameen Foundation and Water.org, exemplify how NBFCs leverage innovative finance models to support sustainable development projects, thereby illustrating the effectiveness of NBFCs and MFIs as debt intermediaries in facilitating broad-based economic and social advancements.

Challenges: They are, however, subject to stringent regulatory oversight, which imposes operational burdens, particularly in areas like KYC and anti-money laundering norms. Despite these challenges, their ability to leverage concessional debt and grants enhances their capability to fund projects at a reduced cost, maximizing the potential for impact. They also face inherent risks, such as credit risk from serving high-risk segments, and interest rate fluctuations, which can affect both their operational costs and the sustainability of their returns.

Summary Table – Onshore: Debt Intermediaries – NBFCs & MFIs	
Sector	Applicable across most sectors, especially in climate, agriculture, education, etc.
Company Type	**Company type:** All types of enterprises, mostly favoring early-stage to growth-stage enterprises **Investment ticket size:** Typically in the range of USD 1 million to USD 10 million. The NBFC/MFIs leverage this equity investment and raise around 10x of debt capital from the market which is then used for lending.
Catalytic Capital Potential	**Risk position:** This investment has low risk, as the NBFCs and MFIs have a proven business models with defined net interest margins, with very strict regulatory oversight ensuring good business performance. **Leverage:** The NBFC/MFI raise around 10x the amount raised through equity investment at the minimum.
Feasibility	**Operational:** Low operating costs for the investor. NBFC/MFI operating costs vary depending on the business and sector. MFIs have large operating costs, NBFCs have lower operating costs. **Regulatory:** Strict adherence to RBI regulations and guidelines. **Legal:** Legal intermediation is moderate, as it is another type of FDI investment, in a RBI regulated entity that engages in lending operations.
Example	British International Investments has invested in orgs like Aye Finance Pvt Ltd, Indifi Technologies Private Ltd., Arohan Financial Services Limited, ASA International India Microfinance Limited, Asirvad Microfinance Limited, etc.

V. Onshore: Grants/Incubators via Foreign Contribution Regulation Act (FCRA)

The Foreign Contribution Regulation Act (FCRA) serves as a crucial framework for Section 8 organizations in India, enabling them to receive foreign grants aimed at fostering the growth of social enterprises. This regulation allows philanthropic organizations, particularly those registered under FCRA, to support incubators and accelerators that are instrumental in scaling early to medium-stage non-profits and social enterprises across various sectors. By providing such support, these organizations can help build the necessary capacity to attract additional commercial financing, thereby enhancing the ecosystem for catalytic finance in India.

Challenges: However, engaging under FCRA comes with significant compliance challenges. Organizations must undergo a stringent registration and continuous compliance process, which includes submission of detailed annual returns and quarterly updates on foreign contributions. This oversight mandates meticulous record-keeping and reporting, which can be cumbersome but ensures transparency and proper use of foreign funds.

Opportunities: Operationally, the process is straightforward as long as the funded organizations are FCRA compliant, facilitating a relatively simple way for foreign donors to contribute to India's social development goals. By enabling small ticket-size grants for ecosystem building, FCRA plays a pivotal role in catalyzing the development of innovative financial structures and blended finance models that can significantly impact under-served communities and foster sustainable development.

Summary Table – FCRA	
Sector	Applicable across most impact sectors, specially in climate, agriculture, education, etc.
Company Type	**Company type:** Investment will take place across the entire ecosystem rather than towards a specific enterprise. **Investment ticket size:** Variable and will depend on the scale and scope of the project
Catalytic Capital Potential	**Risk position:** Not applicable as it deployed in the form of grant **Leverage:** Can enable in building the catalytic capital ecosystem and the setting up successful blended finance instruments and facilities for social enterprises.
Feasibility	**Operational:** Low operating costs for the funder but high operating cost for the organization receiving the fund as FRCA required maintenance of detailed documentation. **Regulatory:** Grants can only be deployed to FCRA certified organisations and therefore the scope of grant making is limited. **Legal:** Legal intermediation is typically very low.

Example	Greenr Accelerator Initiative by Technoserve aims at building capacities of 450+ climate-based enterprises in India, providing them with technical assistance, increase in access to markets and access to finance. This is supported by the IKEA Foundation and Visa.

Conclusion: Indirect Pathways

I. **Offshore Capital Aggregation**

- **Overview: T**his pathway aggregates foreign catalytic capital offshore, allowing it to be deployed with a lower tax burden for the fund manager, affordable operations and easier regulatory compliances to navigate.
- **Advantages:** Streamlines the process and reduces the administrative burden on the capital provider. It is especially effective when paired with investments in Indian Alternative Investment Funds (AIFs) or equity investments in Non-Banking Financial Companies (NBFCs) and Microfinance Institutions (MFIs).
- **Challenges:** May require a robust offshore management structure and could face regulatory and compliance issues across different jurisdictions.

II. Unified Structure

- **Overview:** Involves a dual-level management structure with fundraising and fund management occurring both onshore (in India) and offshore. This model requires significant resources and sophisticated management.
- **Advantages:** Enables better alignment of sectoral and investment theses, leveraging both local expertise and international capital.
- **Challenges:** Increased complexity and higher governance and oversight requirements. Aligning the objectives and operations of onshore and offshore entities can be challenging and resource-intensive.

III. Investments in AIFs

- **Overview**: Involves channeling catalytic capital into Indian AIFs that align with the capital provider's sectoral and investment theses.
- **Advantages**: Can leverage existing AIF infrastructure and expertise, facilitating larger-scale investments. Helps in pooling de-risked commercial capital.
- **Challenges**: Differential returns and alignment of investment goals can be a challenge. The ability to pool large amounts of capital efficiently is often hindered by market and regulatory conditions.

IV. Investments in NBFCs/MFIs

- **Overview:** Deploying capital into NBFCs and MFIs can create a significant multiplier effect, supporting multiple Indian social enterprises over an extended period.

- **Advantages:** These investments can be paired with service contracts supporting interest subvention, results-linked payments, and capacity-building initiatives, amplifying the impact.
- **Challenges:** Requires a well-structured framework to ensure effective utilization and monitoring of the deployed capital. Regulatory changes and market dynamics can affect the performance of NBFCs and MFIs.

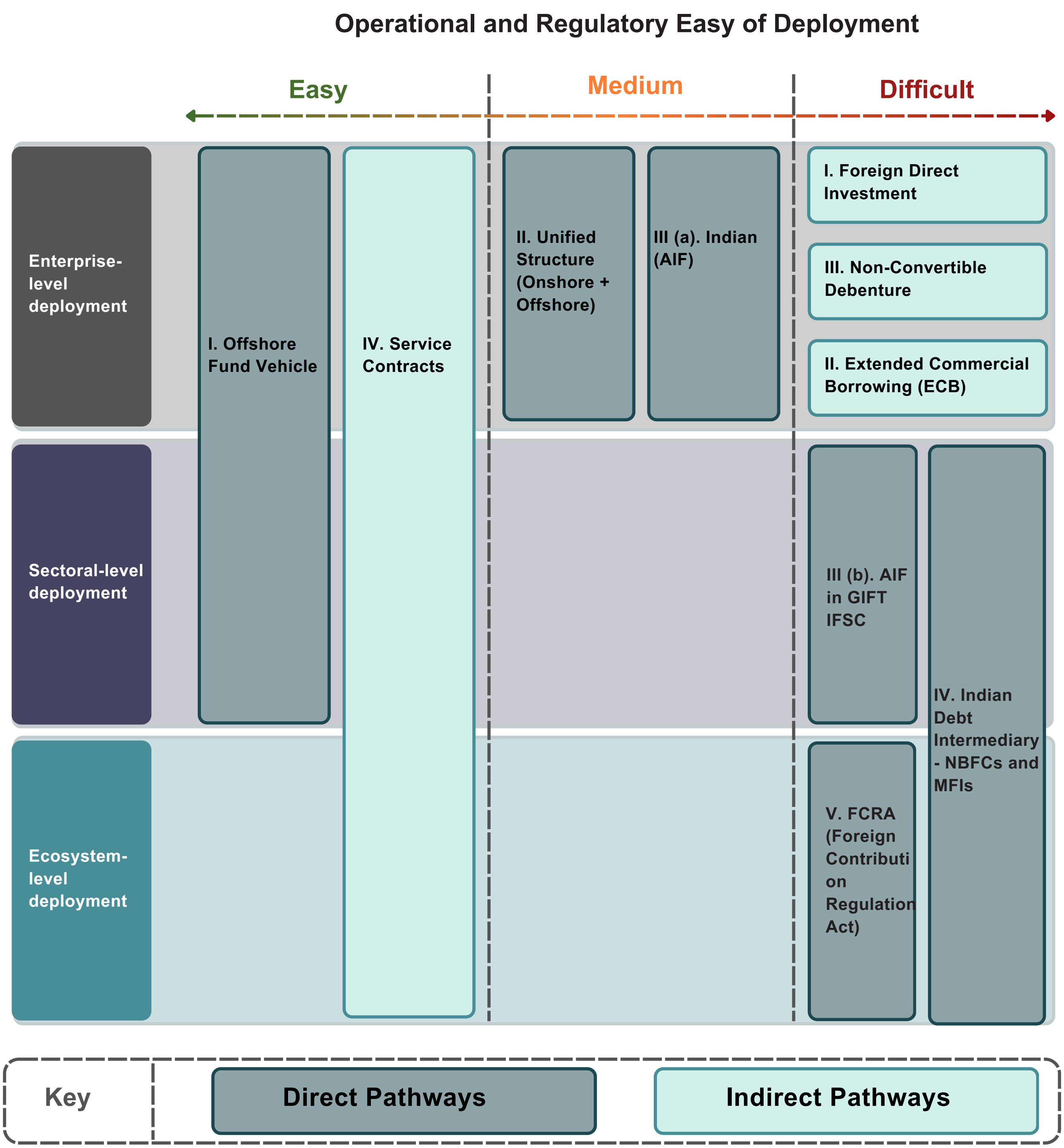
V. Building the Impact Investment Ecosystem

- **Overview:** Involves fostering collaboration and building the capacities of investors, entrepreneurs, and policymakers to strengthen the overall impact investment ecosystem.
- **Supply-Side:** Focuses on building the capacities of financing institutions through grants (Foreign Contribution Regulation Act (FCRA) deployment) and service contracts with both for-profit and non-profit entities in India.
- **Demand-Side:** Aims at building a quality pipeline of investments by ensuring a steady flow of capital and developing robust investment opportunities.
- **New Capital:** Unlocks new sources of capital for social enterprises, thereby expanding the scope of existing support systems.
- **Additional Enterprises:** Increases the number of social enterprises that can be supported by foreign catalytic capital in the future, ensuring long-term sustainability and impact.

SECTION IV: CONCLUSION & STRATEGIC LANDSCAPING

STRATEGIC COMPARISON OF DEPLOYMENT PATHWAYS

Deployment Pathways Compared based on Ease of Deployment



The figure above compares all direct and indirect deployment pathway options based on:

1. **Ease of Deployment:** This refers to the operational and regulatory considerations such as the need for an internal team that is experienced in managing the transaction, the level of regulatory compliances that need to be fulfilled, the degree of risk management expected, and the overall effort required to ensure a streamlined process and operational efficiency.
2. **Level of Deployment:** This refers to the scale at which the pathway will create an impact and is divided across 3 levels: enterprise, sector and ecosystem. Pathways along the enterprise level of financing can finance a single enterprise. For example, a direct equity or debt transaction will only finance the enterprises chosen by the fund deployer. At the sectoral level of deployment, the pathway is financing an entire sector. For example, a fund dedicated towards WASH micro-enterprises will pool and deploy capital towards social enterprises focused on water, sanitation, hygiene and health. At the ecosystem level, the impact is generated across all stakeholders engaged in catalytic capital transactions: enterprises, financial institutions, incubators/accelerators, capital providers and the government.

I. Offshore: Fund Vehicle

High Ease of Deployment:

- Offshore funds (I) are found to be the preferred pathway for most managers deploying foreign catalytic capital in India. In comparison to domestic funds, the offshore vehicle is ideal for creating innovative financial structures and arrangement of differential returns. Depending on the location of the offshore vehicle, operational costs and compliance burden can be low. As a result of pooling capital through a fund, the deployment can finance a chosen sector.

- Service contracts (IV) with social enterprises are a direct means of compensating an enterprise for certain projects/services. The operational and regulatory burden is very low, with most transactions facing almost no operational or legal costs. However, the impact can be broad as service contracts can be used to enable enterprises to conduct research and strategy projects that can create an impact across the entire catalytic capital ecosystem.

Moderate Ease of Deployment:

- Unified structures, i.e. parallel onshore and offshore funds, are found to be moderate in terms of regulatory and operational ease. This pathway is the most suitable for fund managers looking to pool both foreign and domestic capital with minimal regulatory hurdles. Offshore fund managers may be able to enjoy certain tax exemptions based on the location of the fund. The operational fees can be high due to the cost of running two parallel funds. In terms of deployment, as with any other fund, financing takes place at a sectoral level.

- An AIF fund is moderate in operational and regulatory ease as the taxation on the fund manager is higher compared to the other pathway options. There are also some limitations on arranging different classes of returns for investors. While some options have been suggested by legal experts, there are no confirmed fund examples of these yet. Arranging any form of innovative financing structure will most likely require a high amount of legal intermediation for success. As with other funds, the deployment can impact a selected sector.

Potentially Difficult Deployment

- Any form of direct deployment, other than service contracts, can be potentially difficult for capital deployers who are new to the Indian regulatory landscape. Several compliances need to be fulfilled before investments can be successfully made through the FDI, NCD or ECB route. US-based DAFs and family offices have indicated difficulties in being able to navigate the regulatory/compliance systems. It must be noted that with the right set of legal advisors and operational team, direct options are possible and have been done by several US and EU-based foundations. All three of these direct options will enable financing at the enterprise level.

- The novelty of the GIFT IFSC option might lend itself to a higher legal intermediation cost. Further, this study has also been unable to come across any successful examples of funds that have innovative financial arrangements. However, this is an emerging and promising option, and fund managers should be on the lookout for its success in the coming years. As with other funds, the financing occurs at the sector level.

- For the FCRA pathway, only certain non-profit organizations with relevant certifications and approvals can receive this financing. The compliance burden for the recipient is very high. Grants through the FCRA route can enable the development of the entire financing ecosystem, both at the supply and demand end. This can be done through supporting initiatives for incubation, pipeline development and technical assistance.

- For the Indian debt Intermediary pathway, the financing would have to take place through the FDI route. Similar to direct FDI, operational and regulatory knowledge of the Indian NBFC market would be needed to navigate the space. The impact generated could be across a sector and the ecosystem level. The reduced cost of capital for the NBFC would result in higher coverage and more affordable lending to high-impact social enterprises.

Summary Comparison of All Pathways				
Pathwys	**Type of Capital**	**Operational Feasibility [1]**	**Regulatory Viability [2]**	**Catalytic Capital Viability [3]**
Foreign Direct Investment (FDI)	Equity	Low	Moderate	Medium
External Commercial Borrowing	Debt	Low	High	Medium
Non-Convertible Debentures (NCD)	Debt Instruments	Low	Moderate	Medium
Service Contracts	Grant	High	High	Moderate
Offshore Fund	Equity or Debt through NCDs	High	High	High
Alternate Investment Fund	Equity or Debt through NCDs	Moderate	Moderate	Moderate
Unified Structure	Equity or Debt through NCDs	Moderate	High	High
AIF in IFSC GIFT	Equity or Debt through NCDs	Potentially High	Low at present	Moderate

[1] Operational Feasibility: The extent of resources needed for setting up and managing investments, including cost, taxes, personnel, and effort.
[2] Regulatory Viability: The degree of difficulty in navigating regulations for the pathway.
[3] Catalytic Capital Viability: The ability of investments to accept disproportionate risk and/or concessionary returns relative to traditional investment instruments to generate positive impact and attract further investment.

Debt Intermediaries	Deployed as Equity, received as Debt	Low	Low	Low
FCRA	Grant	Moderate	Low	High

COMPARISON OF DEPLOYMENT OPTIONS IN THE US

With a clear understanding of the type of capital aggregations options available to US and European-based investors, we now turn to the options that those investors have in structuring and deploying their capital. US Investors can differentially prioritize their capital deployment based on various financial, operational and impact-related considerations. The table below analyzes 4 deployment entities, each of which can participate in all the direct and indirect pathways described in the previous section, and thereby leverage catalytic investment options through equity, debt and grant instruments .

Donor Advised Fund (DAF)

Overview	A donor-advised fund, (DAF), is an account for charitable giving established within a public charity. This 501(c)(3), acts as a "sponsoring organization" responsible for overseeing and managing individual DAF accounts.
Capital Aggregation	DAFs can collect capital in the form of donations (grant) from individuals and Pvt Foundations.
Deployment Options	**The DAF, which will act as the principal investor, can make the following investments:** • **Equity** directly through Indian Social Enterprises or indirectly through a fund based offshore or in India. • **Debt** directly to Indian Social Enterprise or through an intermediary fund. ** It must be noted that the investor will not be the principal investor and will not withdraw returns from the capital.* DAFs may also make grants and/or recoverable grants through nonprofit intermediaries.
Financial Returns	**No returns to the DAF client, but recovery to the DAF account**. DAFs recycle returns generated through investments and recoverable grants at the DAF sponsor level.

Investment Control	**Investors will retain little control over the investments made by the DAF.**
Internal Staff & Experience	**None is required** by the investor (individual, Pvt Foundation, Family office). **Medium to High level** of internal staff experience for the DAF itself.
Tax	**Grants/Donations to a DAF by investors are Tax Exempt**

Private Foundation

Overview	A private foundation is an independent legal entity set up for solely charitable purposes. Private Foundations are **required to deploy at least 5% of their assets to charitable purposes** on an annual basis.
Capital Aggregation	Receives funding from a single individual, a family, or a corporation, which receives a tax deduction for donations.
Deployment Options	• **Grants or Recoverable Grants** to a registered US or Indian Non-Profit OR an Indian Incubator/Accelerator • **Grants (Service Contract)** to a social enterprise, debt intermediary or a non-profit for ecosystem building • **PRI (Equity, Debt, Loan Guarantee)** directly to social enterprise or through an intermediary fund. Pvt Foundations can make investments through PRI (debt or equity) as long as they further the charitable purpose of the Private Foundation. • **Mission Related Investments** • **UPMIFA:** Uniform Prudent Management of Institutional Funds Act that obligates large foundations with **Endowments** to responsibly make investments that are **low-risk, market rate-return seeking.**
Financial Returns	Financial return cannot be the primary purpose of a program-related investment.
Investment Control	• **High** control if the Pvt Foundation is making investments directly. • In the case of indirect investments, the intermediary type will define the degree of control.
Internal Staff & Experience	**Low** in the case of indirect investments and **High** in the case of direct investments.

Internal Staff & Experience	• Direct PRI Debt investment **may require a lower need for legal intermediation and support.** This is because for direct debt, the interest rates are contractually pre-determined and face very little risk of defaulting on PRI fulfilment. • Direct PRI equity is more complex and requires the support of an internal team that is experienced in working in Indian equity markets.
Tax	**Grants, recoverable grants and PRIs are tax-exempt**

Public Charities that set up Impact-first Funds

Overview	Public charities, structured as a 501(c)(3), receive contributions from many sources, and have the ability to build nonprofit programs that can deploy catalytic capital and coordinate nonprofit programmatic efforts.
Capital Aggregation	• Rely on public fundraising to support their activities. • Can set up funds to manage capital from **Pvt Foundations (grants, PRIs, MRIs, and endowments), from individuals, DAFs, family offices, trusts, and more.**
Deployment Options	• **Equity** directly through Indian Social Enterprises or indirectly through a fund based offshore or in India. • **Debt** directly to Indian Social Enterprise or through an intermediary fund. • **Grants (Donations) to Indian Non-Profit OR an Indian Incubator/Accelerator** • **Grants (Service Contract)** to a social enterprise, debt intermediary or a non-profit for ecosystem building • **Loan Guarantee** through Financial Intermediaries in US and India to enterprise.
Financial Returns	**Moderate to High.** In comparison to Pvt Foundations, Public Charities are not as restricted in the use of capital.
Investment Control	**Moderate Control**. Impact Funds have a more "active" model of fundraising as compared to DAFs and are more likely to address the investor's specific impact goals.
Internal Staff & Experience	**Low for investors** (individual, Pvt Foundation, Family office). **Medium to High** level of internal staff experience for the Pvt Foundation/Fund Managers.
Tax	Grants and Investments are tax exempt

Family Office

Overview	A private wealth management firm that serves ultra-high-net-worth individuals (HNWI). In addition to financial planning and investment management, they offer budgeting, insurance, charitable giving, wealth transfer planning, tax services, and more.
Capital Aggregation	Manage the funds and financial needs of an affluent individual or family.
Deployment Options	• **Equity** directly through Indian Social Enterprises or indirectly through a fund based offshore or in India. • **Debt** directly to Indian Social Enterprise or through an intermediary fund. • **Grants or Recoverable Grants** to Indian Non-Profit OR an Indian Incubator/Accelerator • **Grants (Service Contract)** to a social enterprise, debt intermediary or a non-profit for ecosystem building • **Loan Guarantee** through Financial Intermediaries in US and India to enterprise.
Financial Returns	**Moderate to High** as there are no restrictions on making any form of investments
Investment Control	• **High control** if the Family Office is making investments directly • In the case of indirect investments, the intermediary type will define the degree of control
Internal Staff & Experience	**Low** in case of indirect investments and High in case of direct investments.
Tax	**Depends on how investments are structured**

CONCLUSION

The direct deployment of foreign catalytic capital requires significant investments of time, cost, and effort from the capital provider, demanding high involvement and oversight of the transaction. The direct capital deployment pathway also involves high operational costs and resource requirements, which can be a significant barrier for smaller capital providers.The investment requires continuous monitoring and management. However, this pathway also offers greater control on the use of investment and has direct impact attribution to the investor. This allows for tailored interventions, and direct engagement with recipient entities.

Indirect pathways, such as offshore capital aggregation, can reduce tax burdens for fund managers, lower operational costs, and simplify regulatory compliance, though they may require robust offshore management and face regulatory issues across jurisdictions. A unified structure, involving dual-level onshore and offshore management, aligns sectoral and investment theses effectively but increases complexity and oversight demands. Investments in Indian Alternative Investment Funds (AIFs) leverage existing infrastructure and expertise for larger-scale investments, while investments in Non-Banking Financial Companies (NBFCs) and Microfinance Institutions (MFIs) amplify impact through service contracts and capacity-building initiatives. Additionally, strategic grant-making can also facilitate building the impact investment ecosystem that focuses on enhancing the capacities of financing institutions, ensuring steady capital flow, developing robust investment opportunities, unlocking new capital sources, and supporting more social enterprises for sustained impact.

Ultimately, the choice of pathway should align with the asset owner's strategic objectives, operational capabilities, and desired level of impact. Each pathway has been mapped based on relative ease of deployment and the scale of impact expected. Such an analysis can direct an asset owner to assess the most suitable options given existing internal capacity and organization’s mission. It must be noted that the mapping and analysis of pathways have only been done at the supply end, i.e. on the capital deployer and intermediary. Beyond this, further demand-side analysis on the potential pipeline, sectors, etc. will need to be done by the asset owner and should align with the asset owner’s investment thesis and mission. Nonetheless, the range of pathways and opportunities for US- and EU-based capital providers has been clarified, providing a direction for those seeking to direct capital into India. This study should also enable a preliminary investment thesis and shortlist of the most viable investment opportunities for high impact in critical social and environmental sectors.

APPENDIX A: LIST OF STAKEHOLDER CONSULTATIONS

Geography	Capital Aggregators	Intermediation Experts	Catalytic Capital Providers	Social Enterprises	Total
India	11	6		2	19
US	3	2	8		13
Europe	-	1	4		5
All	**14**	**9**	**12**	**2**	**37**

STAKEHOLDERS

INDIA

- 3i Partners
- Ankur Capital
- Ashu Sikri (Independent Advisor)
- Avaana Capital
- Caspian Debt
- Climate Collective
- Climate Policy Initiative
- Elevar Equity
- Green Artha
- Hari Rajagopal (Independent Advisor)
- Minus CO2
- Nishith Desai Associates (NDA)
- Samunnati*
- Second Nature Sustainable Solutions
- The Blended Finance Company (TBFC)
- Trilegal
- Unitus Capital
- Villgro
- Yunus Social Business

US

- Acumen
- Autodesk Foundation
- AWE Funds
- Blue Haven Initiative
- Breakthrough Energy Fellows
- CapShift
- Encourage Capital
- Lemelson Foundation
- MacArthur Foundation
- Morgan Lewis
- Prime Coalition
- RPCK | Rastegar Panchal
- US International Development Finance Corporation (DFC)

EUROPE

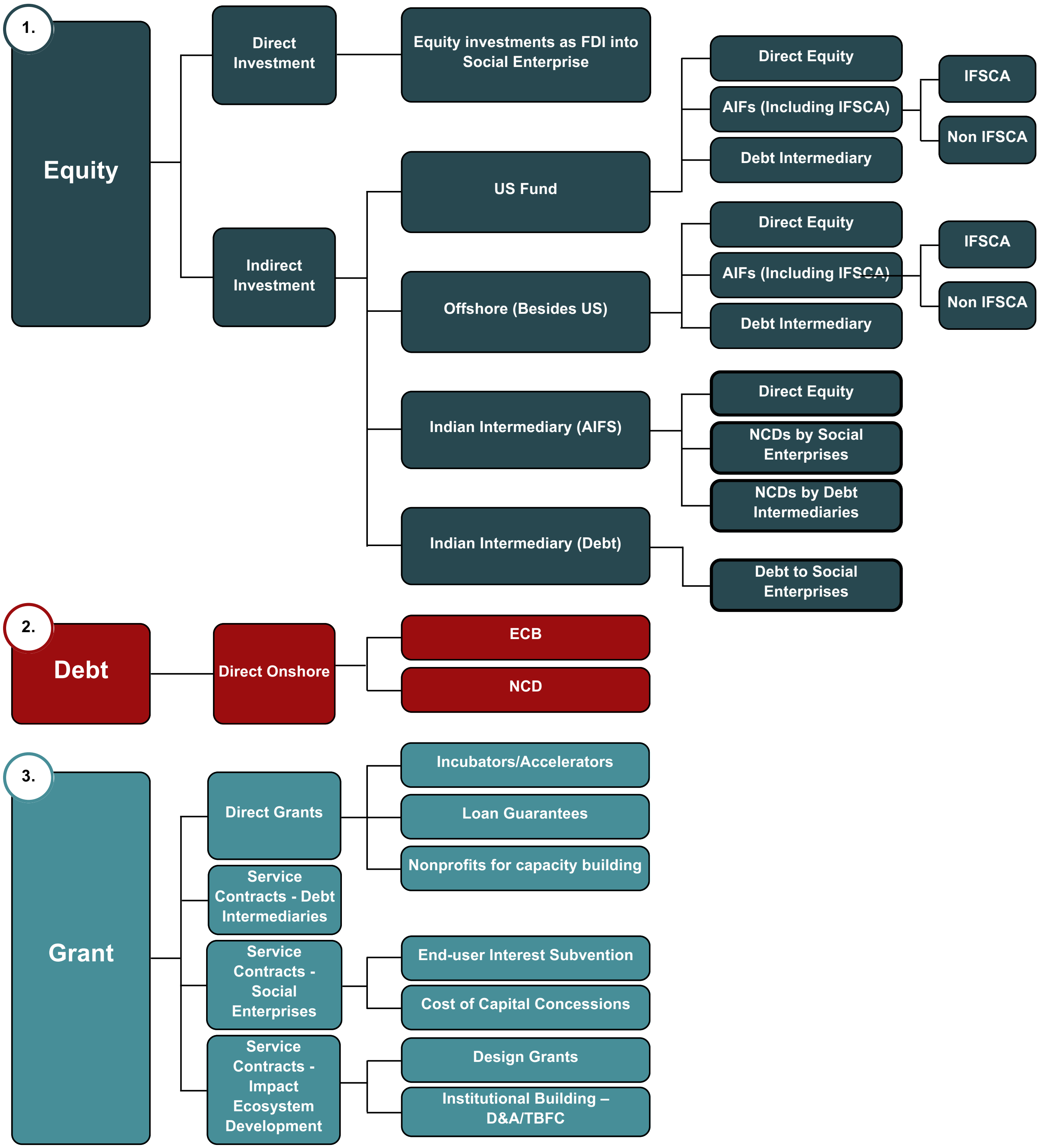
- Friedrich-Ebert-Stiftung (FES), India Office*
- IKEA Foundation
- Laudes Foundation
- Rabo Foundation*
- Voluntary Carbon Markets Integrity Initiative (VCMI)

**Includes consultations with Consultants/Advisors/Partners/Collaborators associated with the organization mentioned above. Any views expressed are not necessarily those of the organization.*

APPENDIX B: OPTIONS FOR TYPE AND PATH OF DEPLOYMENT

Options for Type and Path of Deployment

Individual Investors, DAFs, Non-Profits, Funds and Family offices can deploy equity, debt and grant capital in the following ways.



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APPENDIX D: SOCIAL ENTERPRISE ELIGIBILITY CRITERIA

Provided below is the eligibility criteria provided by the Social Stock Exchange for Social Enterprises.

- (a)15 broad eligible activities based on Schedule VII of the Companies Act, 2013, Sustainable Development Goals and priority areas identified by Niti Aayog. The list of eligible activities is as follows:
  - i. Eradicating hunger, poverty malnutrition and inequality; promoting health care (including mental health) and sanitation; and making available safe drinking water
  - ii. Promoting education, employability and livelihoods
  - iii. Promoting gender equality, empowerment of women and LGBTQIA+ communities iv. Ensuring environmental sustainability, addressing climate change (mitigation and adaptation), forest and wildlife conservation
  - v. Protection of national heritage, art and culture
  - vi. Training to promote rural sports, nationally recognised sports, Paralympic sports and Olympic sports vii. Supporting incubators of social enterprises Page 12 of 38
  - viii. Supporting other platforms that strengthen the non-profit ecosystem in fundraising and capacity building
  - ix. Promoting livelihoods for rural and urban poor, including enhancing income of small and marginal farmers and workers in the non-farm sector
  - x. Slum area development, affordable housing, and other interventions to build sustainable and resilient cities
  - xi. Disaster management, including relief, rehabilitation and reconstruction activities xii. Promotion of financial inclusion
  - xiii. Facilitating access to land and property assets for disadvantaged communities
  - xiv. Bridging the digital divide in internet and mobile phone access, addressing issues of misinformation and data protection
  - xv. Promoting welfare of migrants and displaced persons
- (b) SEs shall target underserved or less privileged population segments or regions recording lower performance in the development priorities of national/state governments
- (c) SEs shall have at least 67% of its activities qualifying as eligible activities to the target population, to be established through one or more of a. Revenue, b. Expenditure, c. Customer base