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Alternative Investment Funds in India: Unlocking Sophisticated Investment

Sai Krishna Bharathan and Ganesh Rao

Alternative Investment Funds are increasingly becoming fundamental to capital raising activities in the Indian economy by tapping into an asset class of high net worth individuals, financial institutions and other investors who are comfortable with understanding multifaceted investments. This paper examines the evolving regulatory framework around such pooling investment vehicles and concludes with important future considerations for the holistic development of Alternative Investment Funds in the Indian market.

I. Introduction

An enterprise requires access to an adequate amount of stable, long-term capital as well as to advisors who can assist it in improving governance processes and in expanding production and services. However, due to the limited risk appetite of traditional sources of finance such as banks, there is a requirement for alternative sources of ‘patient’ capital. Pooled investment

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vehicles, that is, vehicles that collect funds from investors and invest such monies in accordance with a specified investment policy (instead of the investor buying securities directly), step in to fulfil the capital need of enterprises. Such pooled investment vehicles include mutual funds, pension funds, employee gratuity trusts, and alternative investment funds.

Alternative investment funds (‘AIFs’) are vehicles set up in India for pooling of funds on a private placement basis. They are primarily regulated by the SEBI (Alternative Investment Funds) Regulations, 2012 (‘AIF Regulations’) issued by the Securities and Exchange Board of India (‘SEBI’), and accordingly AIFs do not include funds covered under the SEBI (Mutual Funds) Regulations, 1996, SEBI (Collective Investment Schemes) Regulations, 1999 or any other regulations issued by SEBI for regulating fund management activities. Further, AIFs do not cover (i) holding companies\(^2\), (ii) trusts set up for employee stock options, (iii) family trusts for relatives, (iv) employee welfare or gratuity trusts, (v) special purpose vehicles not established by fund managers (for instance, securitization trusts), (vi) funds managed by securitization or reconstruction companies, or (vii) pooled vehicles which are directly regulated by other Indian regulators, such as pension funds.

As of March 31, 2017, AIFs have invested in excess of INR 350 billion, which represents rapid growth of approximately 92.5% due to INR 168 billion invested during the previous year.\(^3\) Amounts committed for investment through AIFs, that is, the maximum potential amount for investment in India, is currently around INR 843 billion. These investments are not only being made across Indian industries, including sectors critical for the nation’s socio-economic development, but are also being received by start-ups to mature enterprises. AIFs are increasingly considered as an attractive investment vehicle for foreign and non-resident Indian investors, reflected in the fact that a substantial share of these investments originates as foreign direct investment (‘FDI’) from India-focused offshore funds or foreign investors.\(^4\) Given the increasingly important role played by AIFs in the Indian economy, this paper examines the legal framework in India around AIFs and notes key concerns for further consideration by various stakeholders.

\(^2\) As defined under Section 2(46) of the Companies Act, 2013.

\(^3\) Securities and Exchange Board of India, Data relating to activities of Alternative Investment Funds (AIFs), Securities and Exchange Board of India (2017), http://www.sebi.gov.in/statistics/1392982252002.html (last visited October 1, 2017).

A. Prior legal framework

Incremental steps towards the facilitation and regulation of AIFs were initiated over four decades ago. In 1973, the Committee on Development of Small and Medium Entrepreneurs, under the chairmanship of the late R.S. Bhatt, recommended the promotion of venture capital financing in India to meet the gap in funding requirements faced by start-up companies, especially those based on innovative technologies. This was followed by the Industrial Finance Corporation of India sponsoring the creation of the Risk Capital Foundation in 1975 to supplement promoters’ equity by encouraging professionals and technology advocates to promote new industries and the Industrial Credit and Investment Corporation of India allocating funds for providing assistance to emerging high-risk technologies in 1984. In 1987, the Indian government introduced a cess on all knowhow payments to create a venture capital fund (‘VCF’) administered by the Industrial Development Bank of India.

The first meaningful step towards encouraging venture capital financing, however, was taken by the Indian government in 1988 when it issued restrictive guidelines for the establishment and functioning of VCFs, which were to be implemented by the Ministry of Finance’s erstwhile Controller of Capital Issues (‘CoCI’). Among other things, these guidelines limited the setting up of VCFs to banks and financial institutions.

Upon the liberalization of the Indian economy in 1991, CoCI was abolished and the SEBI was created. In 1996, SEBI issued the SEBI (Venture Capital Funds) Regulations, 1996 (‘VCF Regulations’) for administering the activities of domestic venture capital funds. At this time, though regulatory approvals required for foreign investment in most sectors were gradually being relaxed, legal mechanisms for monitoring foreign venture capital and private equity investors were absent. Accordingly, when in 2000 SEBI was made the nodal regulator for venture capital funds, SEBI undertook significant reforms including the notification of the SEBI (Foreign Venture Capital Investors) Regulations, 2000, which was applicable to offshore funds.

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6 Id.
8 Chary, supra note 5.
9 Kartik Ganapathy & Rajesh Pathania, Legal and regulatory aspects for private equity and venture capital in India, 63 Financier Worldwide 9, 10-11 (2008).
10 Chary, supra note 5.
enabling foreign venture capital and private equity investors to register with SEBI.

The VCF Regulations defines a VCF as a fund established in the form of a trust or a company or a body corporate registered under the VCF Regulations having a dedicated pool of capital raised and invested in accordance with the VCF Regulations. The VCF Regulations specifies that VCFs must invest at least two-thirds of their investible funds in unlisted equity shares or equity linked investments of a ‘venture capital undertaking.’ A venture capital undertaking is defined as a domestic company whose shares are unlisted and which is not engaged in activities or sectors listed by SEBI after the approval of the Indian government. The remaining one-third of the VCF’s investible funds could also only be invested in one or more of five specific ways.\textsuperscript{11}

The Income-Tax Act, 1961 was amended to grant VCFs a statutory tax pass-through status. That is, the income of a VCF was exempted from tax, but the income distributed by it to its investors was chargeable to income-tax in the hands of the investors of the VCF as if the investments made by the VCF were made directly by such investors of the VCF.\textsuperscript{12} The single level of taxation provided simplicity and certainty in VCF taxation matters (though subsequent amendments did away with this pass-through status for VCFs).

\section*{B. Necessary reforms}

As VCFs were aimed towards well-informed and relatively experienced investors, SEBI had historically sought to facilitate, rather than dictate, the growth of a venture capital industry with a relatively ‘light touch’ approach. However, financial crises in western countries highlighted vulnerabilities in certain fund strategies and their ability to magnify risks through the financial system. Therefore, at the time the AIF Regulations were introduced, private pools of capital were being subjected to regulation across jurisdictions

\textsuperscript{11} Regulation 12(d)(ii) of the VCF Regulations states that 33.33\% of a VCF’s investible funds must be invested in: (a) subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed; (b) debt or debt instrument of a venture capital undertaking in which the VCF has already made an investment by way of equity; (c) preferential allotment of equity shares of a listed company subject to lock in period of one year; (d) the equity shares or equity linked instruments of a financially weak company (that is, a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50\% but less than 100\% of its net-worth as at the beginning of the previous financial year) or a sick industrial company whose shares are listed; and (e) special purpose vehicles which are created by a VCF for the purpose of facilitating or promoting investment in accordance with the VCF Regulations.

due to their increasing importance in the financial ecosystem, along with the belief among regulators that they needed to have a better picture of the overall risks posed by such funds.\textsuperscript{13}

In its \textit{Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments}\textsuperscript{14}, SEBI highlighted that while it had framed the VCF Regulations to encourage funding of entrepreneurs' early stage companies, the VCF Regulations were instead increasingly used for many other funds such as private equity and private investment in public equity and real estate funds, leading to investment restrictions originally contemplated for VCFs being applied to these funds. Further, as registration under the VCF Regulations was not mandatory, there was a lacunae in the regulation of pooling investment vehicles. Therefore, SEBI stated that the regulatory framework governing domestic pooling vehicles needed to be overhauled in order to, among other things, promote start-ups and early stage companies, permit investments in secondary markets, and utilize investment restrictions and concessions from such restrictions to incentivize beneficial economic behaviour. As this necessitated recognizing alternative investment funds as a distinct asset class, SEBI introduced the AIF Regulations which, among other things, made registration mandatory for VCFs and other domestic pooling investment vehicles which may have otherwise been covered by the VCF Regulations.

Importantly, SEBI adopted a practical grandfathering approach which provides that funds already registered under the VCF Regulations would continue to be governed by the VCF Regulations. However, new funds and existing unregistered funds would need to be registered under the AIF Regulations.

\textbf{C. Further steps}

In 2015, SEBI constituted the Alternative Investment Policy Advisory Committee (‘AIPAC’), a standing committee under the chairmanship of Mr. N.R. Narayana Murthy for advising SEBI on initiatives to strengthen the alternative investment ecosystem in India and to bring to attention obstacles in the development of the industry. AIPAC released two reports, one on January 20, 2016 and another on December 1, 2016. Certain recommendations from the first AIPAC report were adopted in the annual budget tabled


\textsuperscript{14} Securities and Exchange Board of India, \textit{supra} note 4.
by the Union Finance Minister for the financial year 2016-17. While the first AIPAC report concentrated on structural reforms and future practices for AIFs, the second AIPAC report concentrated on performance indicators, such as more detailed disclosures in the offer documents released by the AIF, stricter reporting norms, incentivizing domestic investment in AIFs, and standardization of industry benchmarks. As the AIPAC interacts with industry professionals, the AIPAC reports are a positive step towards discourse between the regulator and the practitioners. However, the recommendations in the AIPAC reports are yet to translate into widespread changes, some of which are discussed in further detail later on in this chapter.

II. STRUCTURAL OVERVIEW

An AIF is defined under the AIF Regulations to mean a fund established or incorporated in India as a trust, company, limited liability partnership (‘LLP’) or a body corporate which is a privately pooled investment vehicle with Indian or foreign investors. Given that applicable laws impose significantly lesser administrative, disclosure and other compliance requirements upon trusts, as against companies or LLPs, trusts are the preferred mode for setting up AIFs. It should be noted however that unlike a company or an LLP, a trust does not have a separate legal personality. It is the trustees who are the owners of the trust property which vests with them, and the beneficiaries of the trust have beneficial interest in the trust.

The AIF Regulations require that an AIF have a sponsor and a manager. A sponsor means any person or persons who set up the AIF and includes promoter in case of a company and designated partner in case of an LLP. A manager refers to any person or entity appointed by the AIF to manage its investments. The manager and the sponsor may be the same.

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17 SEBI (ALTERNATIVE INVESTMENT FUNDS) REGULATIONS, 2012, No. LAD-NRO/GN/2012-13/04/11262, Circular issued by Securities and Exchange Board of India, 2012 (India), regulation 2(1)(w).
18 *Id*, regulation 2(1)(q).
A. Categorisation

The AIF Regulations bucket AIFs into three specific categories in order to appropriately determine the different investment criteria, restrictions and regulatory concessions under the AIF Regulations. An AIF has to be registered under one of the three categories. Only AIFs that have not made any investments under the category in which they were originally registered, are permitted to apply to SEBI for a change in their categorisation.19 If an AIF applying to SEBI for a change in categorisation has received commitments prior to its application, such an AIF is under a duty to inform investors that it is seeking a change in its categorisation, and provide the investors with an option to withdraw from the AIF without any penalty.

**Category I AIFs:** Such AIFs invest in start–up or early stage ventures or sectors considered socially or economically more desirable. Therefore, they are subjected to greater regulation but enjoy greater benefits as well. The sub-categories of category I AIFs are venture capital funds, small and medium sized enterprise (‘SME’) funds, infrastructure funds, social venture funds and angel funds. Such AIFs are close ended, that is, they are required to have a limited tenure. They must have a minimum tenure of three years. Category I AIFs can invest a maximum of 25% of their investible funds in a single company.20

**Category II AIFs:** Such AIFs are effectively the miscellaneous category of AIFs. They are not permitted to employ any leverage or borrowing other than to meet day to day needs and as such do not get any special benefits. Like category I AIFs, category II AIFs are close ended and are required to have a minimum tenure of three years. Category II AIFs can invest a maximum of 25% of their investible funds in a single company.21 Various types of funds such as real estate funds, private equity funds, funds investing only in debt securities and funds for distressed assets are typically registered as category II AIFs.

**Category III AIFs:** Category III AIFs are interested in fetching short term returns, and therefore may make riskier investments (for instance, hedge funds). Such AIFs employ diverse or complex trading strategies, such as investments in listed and unlisted derivatives, and may employ leverage. This category of AIFs may be open ended or closed ended, that is, they are not

20 SEBI, supra note 17, regulation 15(1)(c).
21 SEBI, supra note 17, regulation 15(1)(c).
required to have a specified tenure.\textsuperscript{22} Category III AIFs can invest a maximum of 10\% of their investible funds in a single company.\textsuperscript{23}

**B. Investors**

Under the AIF Regulations, domestic as well as foreign investors can invest in AIFs by way of subscription to ‘units’ of AIFs. No scheme of an AIF may have more than 1,000 investors,\textsuperscript{24} and for angel funds, the cap on investors is reduced to 200.\textsuperscript{25} The value of units of an AIF or the rights assigned to the holders of units of AIFs are primarily driven by contract, specifically the ‘contribution agreement’ (which in case of an LLP, includes the LLP Agreement, and in case of a company, includes a subscription and shareholders agreement) entered into by the AIF and the investor.

Under the AIF Regulations, the total amount of funds committed by investors to the AIF by way of a written contract, that is the contribution agreement, is termed as the corpus.\textsuperscript{26} The ‘investible funds’ of the AIF, that is, the funds which may be invested by the AIF’s investment manager, are calculated after subtracting the estimated expenditure for administration and management of the fund from the corpus of the AIF.\textsuperscript{27} In commercial parlance, and reflected without explanation in the AIF Regulations, the ‘commitment’ of an investor towards an AIF is distinct from its ‘contribution’. The ‘commitment’ is the amount pledged by the investor towards the corpus of the AIF under the terms of the contribution agreement. Typically, ‘contribution’ is the amount actually drawn down by the investment manager from the investor’s commitment towards the corpus of the AIF under the contribution agreement. The minimum commitment amount for an investor is INR 10 million;\textsuperscript{28} however, for employees or directors of either the AIF or its investment manager, or an investor in an angel fund, the minimum commitment amount is INR 2.5 million.\textsuperscript{29}

Notably, the investment manager or sponsor of the AIF is required to invest funds in the AIF by way of their ‘skin in the game’. For category I

\textsuperscript{22} The leverage of a category III AIF shall not exceed two times the net asset valuation of the fund. See: *Operational, Prudential and Reporting Norms for Alternative Investment Funds (AIFs)*, 2013, No. CIR/IMD/DF/10/2013, Circular issued by Securities and Exchange Board of India, 2013 (India).

\textsuperscript{23} SEBI, *supra* note 17, regulation 15(1)(d).

\textsuperscript{24} SEBI, *supra* note 17, regulation 10(f).

\textsuperscript{25} SEBI, *supra* note 17, regulation 19E(4).

\textsuperscript{26} SEBI, *supra* note 17, regulation 2(1)(h).

\textsuperscript{27} SEBI, *supra* note 17, regulation 2(1)(p).

\textsuperscript{28} SEBI, *supra* note 17, regulation 10(c).

\textsuperscript{29} SEBI, *supra* note 17, regulations 10(c) and 19D(3).
and II AIFs, the investment manager or sponsor is required to invest INR 50 million or 2.5% of the corpus of the AIF, whichever is lower. For category III AIFs, the required threshold is the lower of INR 100 million or 5% of the corpus of the AIF.\(^{30}\) For an angel fund, the threshold reduces to the lower of INR 5 million or 2.5% of the corpus of the angel fund.\(^{31}\) The interest of the investment manager or sponsor in the AIF must be disclosed upfront to investors of the AIFs. Pursuant to the ‘investment management agreement’, the investment manager would normally be entitled to an amount paid annually/quarterly from the contributions made to the AIF for meeting the operating and other expenses of managing the AIF borne by the manager. The minimum investment requirement of the manager in the AIF under the AIF Regulations cannot be set off against its management fees.\(^{32}\)

**Domestic Investors:** Certain domestic investors such as banks, insurance companies and pension companies are governed by restrictions imposed by their respective regulators. For instance, banks can invest in only Category I AIFs and cannot hold more than 10% of the unit capital of a category I AIF.\(^{33}\) Similarly, while pension funds and insurance companies can invest in category I and category II AIFs, the Pension Fund Regulatory and Development Authority and the Insurance Regulatory and Development Authority of India have prescribed detailed norms for such investments in AIFs.\(^{34}\)

**Foreign Investors:** Pursuant to amendments made by the Reserve Bank of India (“RBI”) to foreign investment regulations, a person resident outside India can now invest in units of AIFs without seeking any governmental or RBI approval.\(^{35}\) Investment by AIFs in domestic entities will however be considered as foreign investment if the sponsor and/or the investment manager of such AIFs are not Indian ‘owned and controlled’,\(^{36}\) irrespective of the

\(^{30}\) SEBI, *supra* note 17, regulation 10(d).

\(^{31}\) SEBI, *supra* note 17, regulation 19G(2).

\(^{32}\) SEBI, *supra* note 17, regulation 10(d).


\(^{34}\) *Investment in ‘Alternative Investment Funds (AIF)’,* 2016, No. PFRDA/2016/8/PFM/02, Circular issued by Pension Fund Regulatory and Development Authority, 2016 (India); *The Investments – Master Circular on IRDAI (Investment) Regulations, 2016* (updated as of May 2017).

\(^{35}\) *Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Eleventh Amendment) Regulations, 2015*, No. FEMA 355/ 2015-RB, Notification issued by Reserve Bank of India, 2015 (India).

\(^{36}\) A company is considered as owned by resident Indian citizens if more than 50% of the capital in it is beneficially owned by resident Indian citizens and/or Indian companies, which are ultimately owned and controlled by resident Indian citizens. *See: Consolidated FDI Policy, 2016*, No. S(1)/2016-FC-1, Notification issued by Department of Industrial Policy & Promotion, Ministry of Commerce & Industry, 2016 (India), clause 2.1.31.
amount of foreign investments in AIFs. Therefore, if an AIF is Indian owned and controlled, then investments made by such an AIF would not attract sectoral caps or other restrictions under Indian foreign investment norms. Further, investments by non-resident Indians are deemed to be domestic investments at par with investments made by resident Indians.\(^{37}\) A foreign venture capital investor can only invest in a category I AIF.\(^{38}\)

C. Administrative process

Key documents that are required in an AIF structure, whether under law or commercial practice, are as follows:

**Constitutive Document of the AIF:** This can be a trust deed (for a trust), LLP agreement (for a LLP) and memorandum of association, articles of association and shareholders agreement (for a company). The constitutive document(s) should specify the various functions and responsibilities to be discharged by the trustee, designated partners or board of directors, as the case may be. Certain other items should be kept in mind, for instance, the formula for computing the beneficial interest of the investors in an AIF, in some instances, may be required to establish whether the trust is determinate in nature, and whether it is entitled to a pass through for tax purposes. Therefore, from an income-tax perspective, such formula should be specified in the AIF’s constitutive document.

**Private Placement Memorandum:** As an AIF can only raise capital commitments through private placement, it is required to issue a private placement memorandum (or information memorandum). The AIF Regulations require that such private placement memorandum shall contain all material information about the AIF as may be necessary for the investor to take an informed decision on whether to invest in the AIF. By way of examples, the following are required to be included in the private placement memorandum: information about the investment manager and its key members, investment strategy, fees and expenses proposed to be charged, the distribution waterfall, tenure, terms of redemption, risk factors, conflict of interest and processes to identify and address them, manner of winding up of the

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\(^{37}\) *Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Second Amendment) Regulations, 2016, No. FEMA.362/2016-RB, Notification issued by Reserve Bank of India, 2016 (India).*

\(^{38}\) *Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Third Amendment) Regulations, 2016, No. FEMA.363/2016-RB, Notification issued by Reserve Bank of India, 2016 (India).*
AIF, and disciplinary history of the AIF, sponsor, investment manager and their key managerial personnel and affiliates.  

**Investment Management Agreement:** The powers and duties of the trustee, board of directors or designated partners, as the case may be, are delegated to the manager of the AIF through this agreement.

**Contribution Agreement:** This is a tri-partite agreement between the trustee (or board of directors for companies or designated partners for LLPs), investment manager of the AIF and the investor, setting out in detail, the commercial understanding regarding the investor’s investment in the AIF.

The AIF Regulations prescribe the process for registration of AIFs, the norms for disclosure and transparency as well as specify certain restrictions on investments. Therefore, the key documents detailed above should be drafted keeping in mind that AIFs are subject to such regulatory conditions or restrictions.

**Corpus:** The corpus of each scheme is required to be at least INR 200 million, except for angel funds where it is INR 100 million. While category III AIFs are required to appoint a SEBI registered custodian regardless of the size of the corpus of the AIF, category I and II AIFs are required to appoint a custodian only if the corpus exceeds INR 5 billion.

**Winding up:** The AIF Regulations provide that an AIF shall be wound up in the following cases: (a) when the tenure of the AIF or all schemes launched by the AIF, as mentioned in its ‘placement memorandum’ (discussed below) is over; (b) 75% of the investor by value of their investment in the AIF determine by way of a resolution at a meeting that the AIF be wound up; (c) if the AIF is a trust, if it is the opinion of the trustees of the AIF that the AIF be wound up; and (d) if SEBI so directs in the interests of investors. Within one year of the investors and SEBI being intimated by the trustees, board of directors, or designated partners, as the case may be, the AIF will be fully liquidated and the proceeds accruing to investors of the AIF have to be distributed to them after satisfying all liabilities.

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39 SEBI, supra note 17, regulation 11(2).
40 SEBI, supra note 17, regulation 10(b).
41 SEBI, supra note 17, regulation 19D(2).
42 SEBI, supra note 17, regulation 20(2).
43 SEBI, supra note 17, regulation 29(1).
44 SEBI, supra note 17, regulation 29(7).
Disclosure: In accordance with a SEBI circular, AIFs are required to submit regular reports to SEBI providing details of the investments of the AIFs. Category I and II AIFs and category III AIFs which do not undertake leverage are required to submit such reports on a quarterly basis. Category III AIFs which undertake leverage are required to submit reports to SEBI on a monthly basis. Further, at end of each financial year, the investment manager of an AIF is required to prepare a ‘compliance test report’ on the AIF’s compliance with the AIF Regulations and circulars issued thereunder in a specified format, and submit it to the trustee and sponsor of the AIF. In case the trustee or the sponsor observes any violation of the AIF Regulations or circulars issued thereunder by SEBI, the same shall be intimated to SEBI as soon as possible. Separately, an AIF is required to make specific disclosures to its investors including on conflict of interest, fees, risk management, investment valuations etc.

Valuation: Category I and II AIFs are required to appoint an independent valuer to carry out a valuation of their investments once every 6 months (extendable to 1 year with the approval of 75% of the AIF’s investors, by value of their investments). Category III AIFs are required to ensure that their net asset value is independently calculated and disclosed to their investor every 3 months (when the category III AIF has a fixed tenure) or every 1 month (when the category III AIF does not have a fixed tenure).

Alterations: The AIF Regulations provide that the fund strategy of an AIF cannot be materially modified without the approval of at least two-thirds of its investors, by value of their investments. Similarly, a change in the placement memorandum of an AIF, which would significantly influence the decision of an investor to continue being invested in the AIF, is required to be followed up by providing an exit option to investors along with a period of one month for indicating their dissent, unless such changes (with certain exceptions) have been approved by 75% of the AIF’s investors, by value of their investment.

45 Operational, Prudential and Reporting Norms for Alternative Investment Funds (AIFs), supra note 22.
47 SEBI, supra note 17, chapter IV.
48 SEBI, supra note 17, regulation 23(2).
49 SEBI, supra note 17, regulation 23(3).
50 SEBI, supra note 17, regulation 9(2).
51 Guidelines on disclosures, reporting and clarifications under AIF Regulations, supra note 46.
**Listing:** The units of an AIF may be listed on a SEBI recognized stock exchange, after the AIF has finalized its corpus and would not be conducting further draw down of contributions from investors, with a minimum tradable lot of INR 10 million. However, it is important to note that SEBI has yet to put in place a regulatory regime for listing and trading of AIF units.

Further, in order to receive registration as an AIF under the AIF Regulations, there are specific documentation requirements. While the documentation and information provided hereafter is from the perspective of an AIF established as a trust, the requirements would not significantly vary for LLPs or companies.

An application for registration has to be made in Form A prescribed under the AIF Regulations. It should be noted that in the event the constitutive document of the AIF, such as the trust deed, has not been registered, the AIF Regulations provide flexibility for an in-principle approval. If only an in-principle approval is sought, the unregistered document, such as the draft trust deed, is sufficient for SEBI filing. The registered trust deed would be required to be submitted within 6 months from the receipt of such in-principle approval from SEBI.

The AIF application is required to be accompanied by a cover letter specifying whether the AIF: (a) is registered with the SEBI as a venture capital fund; (b) has been undertaking the activities of an AIF prior to the application; and/or (c) is making the application for registration of a new fund and accordingly, the details of the AIF, the trustee, the sponsor, the manager, and proposed investments are to be provided.52

**D. Preferred structures**

As stated above, due to administrative ease, Indian AIFs are generally registered as trusts. Other factors to be accounted for when finalizing the AIF structure would be the cost of incorporation, tax implications, marketing and promotion restrictions and jurisdictions of target investors, the last of which has grown in importance with the liberalization of foreign investment regulations allowing offshore investors to invest in AIFs.

As of June 30, 2016, category II AIFs constituted around 55% of AIFs in India while category III AIFs constituted around 13% of AIFs in India. While India has accorded a tax pass-through status to category I and category II AIFs registered with SEBI - with a requirement to subject any income

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52 SEBI, *supra* note 17, first Schedule, Form A.
credited or paid by the AIFs to a withholding tax of 10% for resident investors and as per the applicable rates for non-resident investors\textsuperscript{53} - such tax pass-through status has still not been accorded to category III AIFs.

A schematic representation of a typical AIF structure, established as a trust is provided below:

![AIF Structure Diagram]

Indian resident investors prefer a domestic fund structure as they are not allowed to make investments in offshore vehicles which in turn invest in Indian entities.

For administrative ease and other factors, offshore investors are typically pooled in jurisdictions which have Bilateral Investment Promotion and Protection Agreements or other such agreements with India, which may provide investors access to an efficient dispute resolution framework and other rights and reliefs.\textsuperscript{54} Consequently, foreign investment into AIFs follows either of two approaches:

**Unified Investment Structure**: Commitments from both domestic and offshore investors are pooled into a domestic AIF. Usually, the foreign investor will pool their investment in a fund set up in an appropriate jurisdiction abroad (‘offshore fund’), which in turn invests in the domestic AIF. As foreign investment in an AIF does not require governmental approval, this structure has received a boost in recent years and is a preferred structure where the substantive management and control of the fund rests in India.

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\textsuperscript{54} Mauritius is the primary source for overseas investment into Indian corporates, accounting for about 35% of total foreign inflows into India. Further, India saw about USD 52.99 billion of inflows from Singapore from April 2000 to December 2016, making it the second largest investor in India after Mauritius, accounting for 16% of total FDI received by India. See: Nishith Desai Associates, \textit{supra} note 13.
Co-investment/Parallel Investment Structure: As the name suggests, in this structure, separate pools of capital are raised for domestic and offshore investors, by establishing a domestic AIF and an offshore fund both of which simultaneously make investments in Indian entities. The domestic AIF and the offshore fund usually have separate management structures.

E. Risk management

The parameters laid down by the AIF Regulations for effective management of an AIF are not exhaustive, and concentrate on investor protection. For
instance, mandating a minimum commitment and restricting the number of investors to ensure that only a certain class of investors with assumed experience in wealth creation can invest in AIFs, and requiring that the investment manager or sponsor provide a minimum commitment to the AIF so that those accountable for the investments of the AIF have alignment of interests with investors and have an incentive to perform.

As incentive structures for effective management of the fund and protection of investor interests have evolved through commercial practice, the extent of Indian regulatory oversight under the AIF Regulations is not exhaustive.

Investment Committee and Advisory Board: To allay investor concerns, it is becoming increasingly common for AIFs to set up an investment committee authorized to ratify or reject the decision of the investment manager in respect of the various investment and/or divestment proposals of the AIF, and monitor the performance of the AIF on a continuing basis. Such investment committee is usually comprised of senior representatives of the investment manager and may also include independent experts. Separately, sophisticated investors have often insisted upon the formation of an advisory board to the AIF comprised of members not associated with the investment manager or sponsor, who examine and have the power to approve, or reject, a number of matters, including transactions that could involve a potential conflict of interest.

Management Fee and Carried Interest: As stated in part B above, pursuant to the investment management agreement, the investment manager would be entitled to a management fee which is meant to cover the expenses borne by the investment manager in managing the AIF. Such management fee usually bears no correlation to the performance of the investments made by the AIF. The management fee is usually calculated as a percentage of the commitments or contribution of investors to the AIF, but the specific formula varies from AIF to AIF. Similarly, as the expenses of the AIF are usually borne from the contributions made by the investors, investors may express apprehension about the kind of expenses charged to the AIF. Certain investors may insist on placing a cap on expenses, taking into account the investment strategy of the AIF. In addition to the fees, sponsors or managers are usually entitled to performance fees which are based on the performance of the AIF. Commercially, the concept of such performance fees or ‘carried interest’, has evolved significantly. ‘Carried interest’, or ‘carry’, is simply a share of the profits of the investors in an AIF that are paid to the sponsor or the manager, as an incentive for good performance and as a method to align their interests with that of the investors. However, carried interest is usually
not paid until investors have received a specified percentage of return – usually expressed in internal rate of return or ‘IRR’ terms - on their investments, also known as ‘hurdle’ or ‘preferred return’, thereby providing a further incentive to ensure prudent risk taking behaviour.

### III. Issues for Consideration

The data in the table below is captured from the figure released by SEBI on the basis of disclosures made by AIFs registered with SEBI. The data shows that as of June 30, 2017, AIFs regulated by SEBI have invested nearly INR 393 billion. Over half of this amount is in the form of investments by category II AIFs. As of date, over 300 AIFs have been established under the AIF Regulations.

(All figures in INR billion)

<table>
<thead>
<tr>
<th>Category</th>
<th>Commitments raised</th>
<th>Funds raised</th>
<th>Investments made</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure Fund</td>
<td>68.2959</td>
<td>42.6038</td>
<td>35.7822</td>
</tr>
<tr>
<td>Social Venture Fund</td>
<td>10.3512</td>
<td>5.8951</td>
<td>4.9651</td>
</tr>
<tr>
<td>Venture Capital Fund</td>
<td>142.4042</td>
<td>32.9848</td>
<td>22.1924</td>
</tr>
<tr>
<td>SME Fund</td>
<td>2.0783</td>
<td>1.7512</td>
<td>0.2847</td>
</tr>
<tr>
<td>Category I Total</td>
<td>223.1296</td>
<td>83.2349</td>
<td>63.2244</td>
</tr>
<tr>
<td>Category II</td>
<td>580.6349</td>
<td>275.0792</td>
<td>221.7745</td>
</tr>
<tr>
<td>Category III</td>
<td>156.4453</td>
<td>122.9796</td>
<td>108.0834</td>
</tr>
<tr>
<td>Grand Total</td>
<td>960.2098</td>
<td>481.2937</td>
<td>393.0823</td>
</tr>
</tbody>
</table>

On the basis of the data available and the observations made so far in this article, a few issues are raised for further consideration.

**Unlocking category III AIFs:** Tax pass-through status should be accorded to Category III AIFs to ensure that the potential of such AIFs is harnessed. As AIFs are pooling vehicles established to enable investors to diversify their investments by investing across different asset classes and using different investment strategies, the income that ought to be taxed is the income of the investors and not that of the AIF. The basis for identifying the taxpayer in an AIF should not be different for different categories of AIFs. Category III AIFs can bring about certain economic benefits which should be strongly considered by policy makers.

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55 Securities and Exchange Board of India, *supra* note 2.
First, category III AIFs are attractive to large institutional investors with a capacity for absorbing risk. However, as category III AIFs typically start their corpus with the proprietary capital of the investment manager or sponsor, there is an alignment of interest between them and the investors. Globally, hedge funds attract sovereign wealth funds, pension funds, endowments and others institutions who are generally considered to be prudent investors.56

Second, as category III AIFs are interested in short term returns, and high-risk high-reward investments, it is in their interest that the quality of governance in their portfolio companies is efficient and effective. Therefore, their strategies include activist investment strategies which aim to improve the quality of corporate governance and improvements in the operational performance of their portfolio companies.57

Introduction of accredited investor test: Currently, there is no scientific mechanism to identify investors who are sophisticated enough to understand and accept complex investment products. SEBI mandates a minimum commitment size to identify such sophisticated investors. However, this may be insufficient. SEBI has already laid down a test for determining an angel investor under the AIF Regulations; using the same concept, an accredited investor test could be formulated and made applicable to other categories of AIFs. This is a concept adopted in several mature jurisdictions with clear-cut criteria on the basis of which an investor will qualify as an accredited investor. The determination of an accredited investor may be based on past tax assessments to gain an idea of the person’s net worth and annual cash flows. If such a test is introduced, SEBI may consider reducing the minimum ticket size for investing in AIFs to promote diversification of assets and attract a larger pool of investors.

Strengthening fiduciary principles: The second report of the AIPAC has mentioned the United States Employee Retirement Income Security Act of 1974 (‘ERISA’) as providing an effective five pronged test for determining the duties of a fiduciary. SEBI may consider incorporating a specific set of guidelines for the fiduciary duties of investment managers based on this test to provide greater clarity to all stakeholders. Each investment should be judged on its own merit and the test should be applied separately to each investment. The test under the ERISA is as follows:

(a) fiduciaries must avoid conflicts of interest when managing assets;

56 Alternative Investment Policy Advisory Committee, supra note 16.
57 Alternative Investment Policy Advisory Committee, supra note 16.
(b) fiduciaries must discharge their duties for the exclusive purpose of providing benefits or fulfilling reasonable expenses, and must not receive excessive compensation;

(c) fiduciaries must discharge their duties like a prudent expert, that is with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like chapter with like aims;

(d) fiduciaries must diversify investments to minimize risk of losses, unless it is prudent to not do so; and

(e) fiduciaries must behave in accordance with law.

IV. CONCLUSION

AIFs are significant sources of capital for Indian investee entities and therefore, play a major role in our economy. Recognising this, Indian regulatory authorities are gradually expanding the investor pool for investments in AIFs and expanding the investment universe of AIFs, in terms of the tools that AIFs can invest in. Commercial practices should continually be strengthened to manage risks inherent in AIF investments while ensuring the capital allocation and capital raising in the Indian economy can meet its full potential. Regulations on AIFs interact with the numerous other continually shifting and dynamic regulations in the Indian legal landscape and greater coordination is required among the different regulators to not just ensure clarity in the legal framework, but that the intent of one regulator is not defeated by the other regulator’s policies. At the same time, the international regulatory and tax environment is also undergoing changes. A greater number of AIFs tailored to meet the demands of specific investors will continue to be set up. It will be up to business practices determined by investment managers and investors, and the legal framework created by regulators to define whether AIFs can be a force for unlocking Indian economic growth.