# Alternative Investment Funds in India – Regulatory Framework

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# PRESENTATION STRUCTURE

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I) Introduction

II) Typical structure of Alternative Investment Funds in India

III) Life-cycle of an AIF

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# INTRODUCTION

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1. The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") were issued with effect from May 21, 2012 by the Securities and Exchange Board of India ("**SEBI**") to regulate all types of private pools of capital in India.

2. The AIF Regulations replaced the Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996 ("**VCF Regulations**").

   - Under the VCF Regulations, a total of 208 venture capital funds had obtained registration from the SEBI over a period of 16 years. As of June 30, 2016, the total investments made by such VCFs amounts to approximately Rs. 335 Billion.

3. As of January 2018, there are 372 AIFs registered with the SEBI.

   - Total capital commitments raised by such AIFs amount to Rs. 1160.85 Billion and investments made by such AIFs amount to 434.89 Billion.

# CATEGORIES OF AIFS

The AIF Regulations categorise funds into 3 categories, based on their investment focus and impact on the economy :

**AIF Categories**

**Category I**

Those AIFs with positive spillover effects on the economy, for which certain incentives / concessions are given by the SEBI / Government. These include:

- Venture Capital Funds (including Angel Funds)
- SME Funds
- Social Venture Funds
- Infrastructure Funds

**Category III**

Those AIFs which employ diverse or complex trading strategies and undertake leverage to a great extent.

**Category II**

Residuary category - those AIFs which do not fall within Category I & III and do not undertake leverage or borrowing other than to meet operational requirements

# TYPICAL STRUCTURE - ALTERNATIVE INVESTMENT FUNDS IN INDIA

# TYPICAL STRUCTURE

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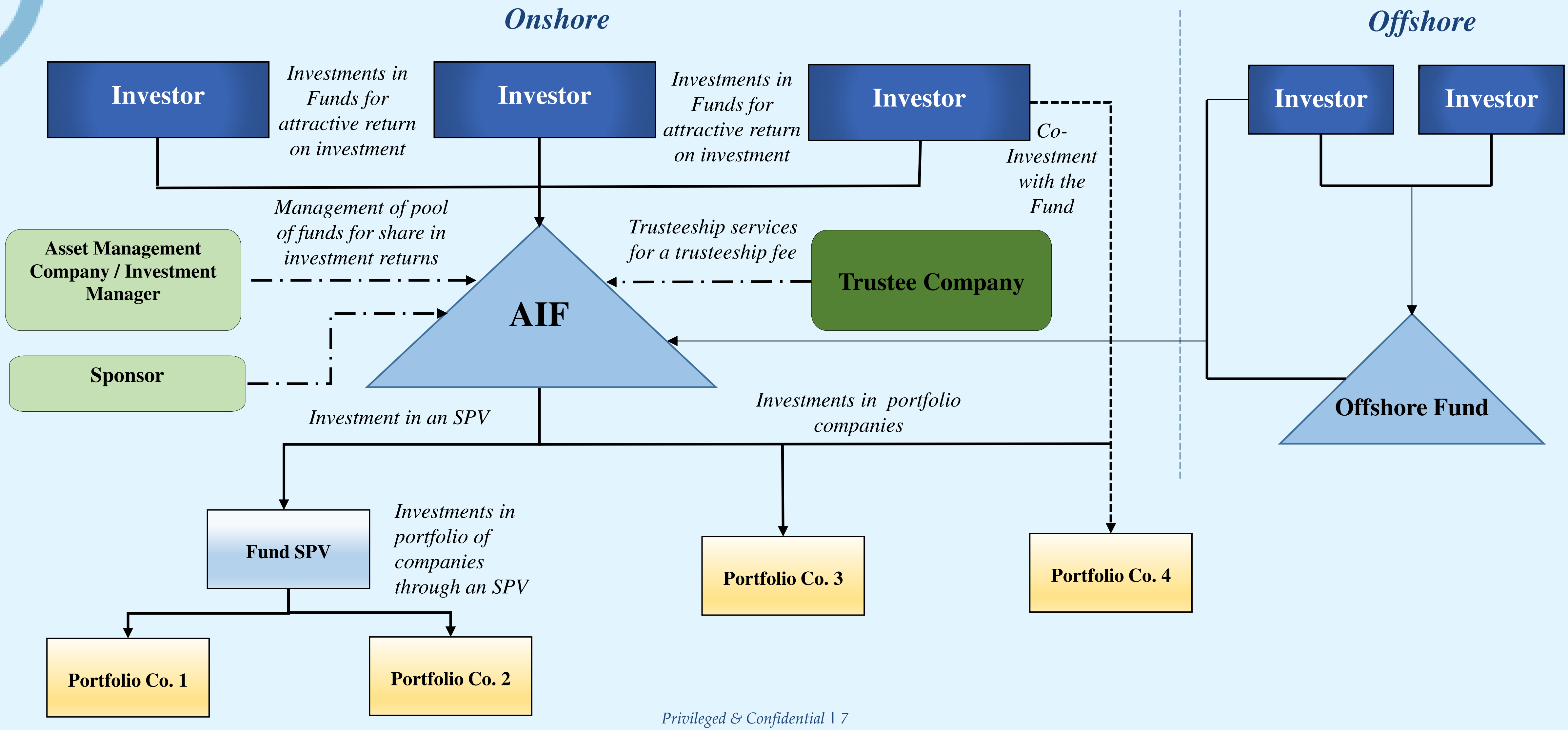

# PARTIES TO THE AIF

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1. A Fund can take the form of (a) a trust under the Indian Trusts Act; (b) a company under the Companies Act; (c) a limited liability partnership; or (d) a body corporate – **Trust is preferred**.

2. Typically, the parties involved are the Fund, the Sponsor, the Trustee, the AMC / Investment Manager. The documents executed are –

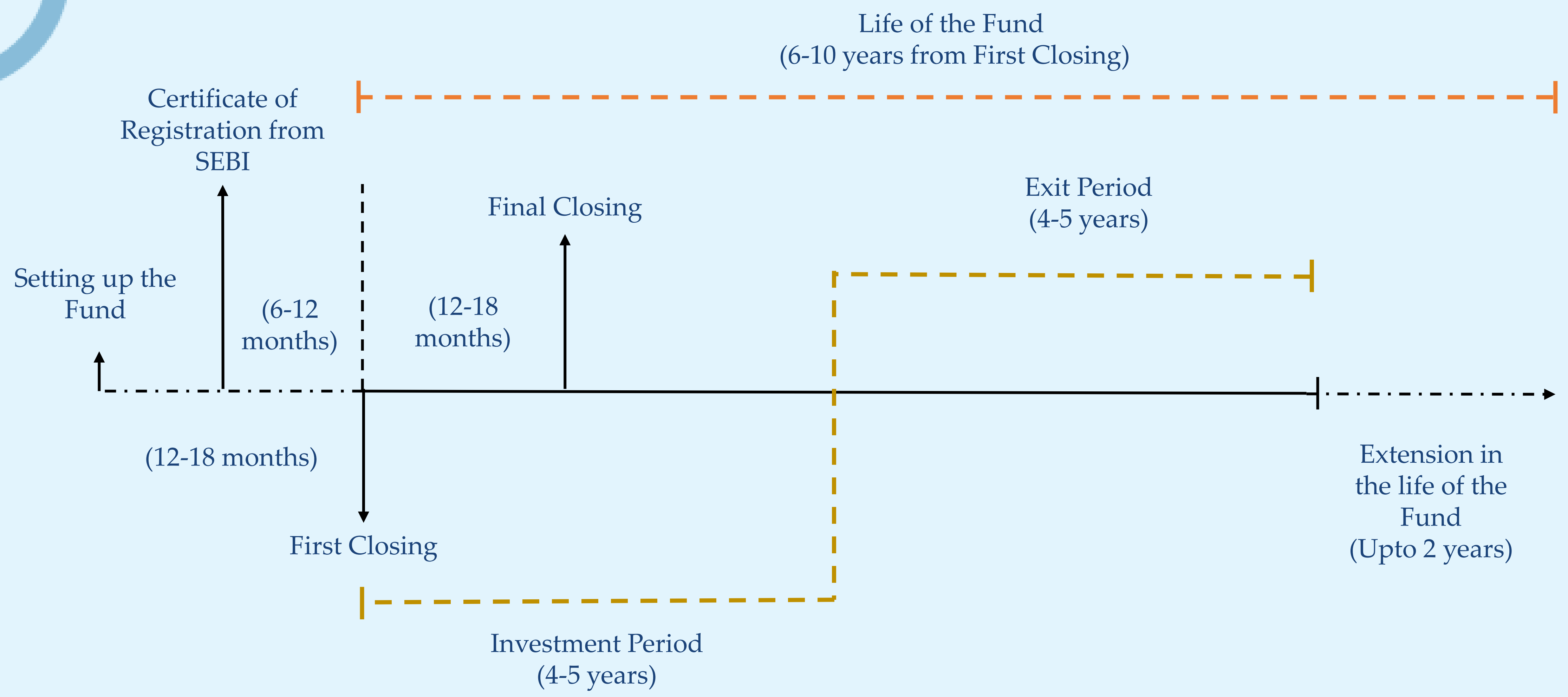
   - An Indenture of Trust for the settlement of the Trust by the Settlor;
   - The Investment Management Agreement for delegation of authority to manage the fund and the payment of Management Fee to the AMC / Investment Manger;
   - The Private Placement Memorandum setting out the key terms of the AIF, investment focus and strategy and details of the fund management team.

3. Sponsor sets up the Fund – required to have 'skin in the game'. Ultimately responsible for the activities of the AIF.

4. Trustees could be a board of trustees or a trustee company – independent professional trustees also permissible.

# LIFECYCLE, OPERATION AND MANAGEMENT OF AIFS

# TYPICAL LIFE OF A CLOSE-ENDED AIF



# FUNDING BY INVESTORS

1. Upfront Contribution:
   - Paid at the time of execution of the contribution agreement.

2. Drawdown during the Investment Period:
   - To invest the money into identified portfolio companies;
   - Capital commitments to be drawndown in tranches;
   - Default on capital contribution could lead to (a) levy of interest by the AIF; or (b) cancellation or forfeiture of all or part of the units held by the defaulting Investor.

3. Drawdown after the Investment Period:
   - Only under limited / specified circumstances which are set out in the fund documents.

# COSTS

***Costs borne by the Fund***

1. Set up Costs – initial documentation, registrations, legal, taxation and advisory fee etc.
2. Marketing Fee – fee paid to distributors?
3. Administration Costs – meetings of the fund committees, the investors, reports, audit fees etc.
4. Management Fee – paid to the AMC for providing investment advice to the AIF.
5. Investment & Transaction Costs - due diligence and documentation costs.

***Costs borne by the AMC***

1. AMC employee costs.
2. Administration Costs – all costs other than those costs that are specifically borne by the Fund.

# ECONOMIC RETURNS

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***Returns (2 / 20 Model)***

1. Management Fee

   a) During the Investment Period, management fee is paid as a percentage of the capital commitments. After the Investment Period, management fee is paid as a percentage of the cost of investments made by the AIF.

   b) Paid to offset the costs of running the Fund and the AMC Team.

2. Carried Interest / Performance Fee

   a) The AMC is paid a percentage of the profits made by the Fund, over and above the hurdle rate – typically shared between the employees and the sponsors of the AMC.
      - Special class of units issued to persons entitled to earn carried interest.

   b) The entire carried interest is back-ended and paid after the initial capital is distributed to the investors – also known as the waterfall mechanism.

# WATERFALL MECHANISM

1. Return of Capital – First, 100% to Investors in proportion to their respective investment until the entire capital contributed by them is returned.

2. Hurdle Rate – Second, 100% to all Investors in proportion to their respective investments until distributed amount is equal to **X%** of the invested amount.

3. Catch-up – Third, 100% to the Investment Manager until the amount distributed equals 25% of the distribution made under point 2 above, i.e. the payments made towards the hurdle.

4. Carried Interest – Fourth, of the balance amount, 80% to the Investors in proportion to their capital contribution and the balance 20% to the Investment Manager.

# DISTRIBUTION WATERFALL

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| Particulars | Case 1 | Case 2 | Case 3 | Case 4 |
|---|---|---|---|---|
| *Assume that the amount invested by the Fund is Rs. 1,000 and the hurdle rate is 10%* | | | | |
| **Particulars** | The Fund's investments do not perform as expected and it has **Rs. 900** after disposition | The Fund's investments perform moderately and it is **Rs. 1,100** after disposition | The Fund has **Rs.1,125** after disposition | The Fund does well and has **Rs. 1,225** after disposition |
| Capital | Rs. 900 | Rs. 1,000 | Rs. 1,000 | Rs. 1,000 |
| Hurdle | NA | Rs. 100 | Rs. 100 | Rs. 100 |
| Catch-up | NA | NA | Rs. 25 | Rs. 25 |
| Carried Interest | NA | NA | NA | ***Rs. 20 (Rs 80 to the investor)*** |
| **Total** | **Rs. 900** | **Rs. 1,100** | **Rs. 1,125** | **Rs. 1225** |

# AIF REGULATIONS – KEY PROVISIONS

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| Sr. No. | Particulars | Category I* | Category II | Category III |
|---|---|---|---|---|
| 1. | **Investor requirements** | Any investor – Indian, NR or NRI | | |
| 2. | **Minimum Corpus** | Rs. 20 Crore | | |
| 3. | **Minimum Subscription** | Rs. 1 Crore** | | |
| 4. | **Minimum continuing interest of the sponsor or the manager** | 2.5% of the corpus or Rs. 5 Crore whichever is lower | | 5% of the corpus or Rs. 10 Crore whichever is lower |
| 5. | **Maximum no. of investors for each scheme** | One Thousand | | |
| 6. | **Tenure** | Close ended – Minimum 3 years<br><br>*Note: Extension of tenure is permitted up to 2 years, subject to the approval of 2/3rds of the unit holders by value of their investment in the AIF. In the absence of the consent of the unit holders, the AIF shall fully liquidate within 1 year following expiration of the fund tenure or extended tenure.* | | Optional - Open or Close ended |
| 7. | **Maximum investment in a single investee company** | 25% of the investible funds | | 10% of the investible funds |

**Note*: Separate terms and conditions apply for Category I – VCF (Angel Funds).*

*** **Note**: Employees of the AMC are exempt from making this contribution.*

# AIF REGULATIONS – KEY PROVISIONS

| Sr. No. | Particulars | Category I | Category II | Category III |
|---|---|---|---|---|
| 8. | **Investment in Associates*** | Requires approval of 75% of the investors | | |
| 9. | **Other specific investment conditions** | Investment in venture capital undertakings, social ventures, SMEs or entities operating, developing or holding infrastructure projects** | Primarily invest in unlisted investee companies or in units of other AIFs as specified in the placement memorandum | Invest in securities of listed or unlisted investee companies or derivatives or complex or structured products. |
| 10. | **Leverage** | Only for meeting temporary funding requirements for not more than 30 days, on not more than 4 occasions in a year and not more than 10% of the investible funds | Only for meeting temporary funding requirements for not more than 30 days, on not more than 4 occasions in a year and not more than 10% of the investible funds<br><br>However Category II funds may engage in hedging subject to guidelines specified by the SEBI. | May engage in leverage or borrow, subject to consent from the investors in the fund and subject to a maximum limit, as may be specified by the SEBI. |

**Note*: *Associate means an entity in which a director, trustee, sponsor, manager of the AIF or a director or partner of the sponsor or manager, hold more than 15% of its equity share capital or partnership interest.*

***Note**: *Separate terms and conditions apply for each sub-category of Category I AIFs.*

# AIF REGULATIONS – KEY PROVISIONS

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| Sr. No. | Particulars | Category I | Category II | Category III |
|---|---|---|---|---|
| 11. | **Valuation** | Once every 6 months by an independent valuer appointed by the AIF | | Calculation of the net asset value should be independent of the fund management function of the AIF and such net asset value shall be disclosed to the investor at intervals of not longer than a quarter for close ended funds and not longer than a month for open ended funds. |

# FOREIGN INVESTMENT IN AIFs

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## FDI in the Investment Manager

1. Prior to October, 2016 Foreign Direct Investment **("FDI")** in the financial services sector for fund based NBFCs was subject to the following minimum capitalization norms:

   - USD 0.5 million for FDI upto 51% to be brought up front;
   - USD 5 million for FDI more than 51% and up to 75% to be brought up front; and
   - USD 50 million for FDI more than 75% of which USD 7.5 million to be brought up front and the balance in 24 months.

   Non-fund based NBFCs had a flat USD 0.5 million minimum capitalization requirement.

2. In October, 2016 these minimum capitalization norms were done away with.

   - Now, 100% FDI is permitted under the automatic route, subject to the requirement of such financial service being regulated by a financial service regulator.

   - FDI under the automatic route in a manager which is an LLP is unclear.

# FOREIGN INVESTMENTS IN AIFs

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## FDI in an AIF

1. Prior to November, 2015 FDI in funds set up as trusts required government approval.

2. FDI is now permitted in AIFs under the automatic route (i.e. without the approval of the concerned ministry or the Reserve Bank of India).

3. Downstream investments by an AIF will be regarded as foreign investments if either the sponsor or the investment manager is not Indian owned and controlled.

   - *'Downstream investment' means indirect foreign investment, by an eligible Indian entity, into another Indian company / LLP, by way of subscription or acquisition.*

4. The extent of foreign investment in the corpus is not a factor to determine whether the downstream investment by the AIF is to be considered a foreign investment.

5. A Category III AIF with foreign investment can make portfolio investment in only those securities or instruments in which a Registered Foreign Portfolio Investor is allowed to invest.

# TAXATION OF AIFs

# TAXATION

1. Tax pass-through status for Category I and Category II AIFs (excluding income from business or profession).

   - AIFs to withhold tax on distribution/accrual of income (a) at the rate of 10% for resident investors; (b) as per ‘rates in force’ (i.e. lower of tax treaty rates or domestic tax law) for non-resident investors.

   - No tax pass through for Category III AIFs. Tax paid at the fund level or determinate trust structure used for availing pass through benefits.

2. Business income taxable at the AIF level and correspondingly distribution of such income will be exempt in the hands of the investors.

3. Unutilised losses cannot be passed on to the investors - AIF to carry forward and set-off such losses in subsequent years.

4. Income received by the AIF from portfolio companies is exempt from withholding tax.

5. No dividend distribution tax is payable by Category I and Category II AIFs when distributing income to investors.

# RECOMMENDATIONS OF THE AIPAC

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1. The SEBI had constituted the Alternative Investment Policy Advisory Committee (AIPAC) under the chairmanship of Mr. Narayana Murthy in March 2015.

   - AIPAC was established to make recommendations on the reforms required for the development of the alternative investment eco-system in India.

   - Till date, the AIPAC has submitted 3 reports – in December 2015 (1st report), November 2016 (2nd report) and November 2017 (3rd report).

2. Major recommendations relate to :

   - Taxation of AIFs, including Category III AIFs (1st, 2nd & 3rd report)
   - The GST regime relating to AIFs (3rd report);
   - Unlocking domestic pools of capital (1st & 2nd report);
   - Promoting Onshore Fund Management (1st report);
   - Enhanced disclosures and superior governance of AIFs (2nd report);
   - Corporate Social Responsibility & Public Trust Recommendations (1st & 3rd report).

# THANK YOU