

ALTERNATIVE INVESTMENT FUNDS IN INDIA – REGULATORY FRAMEWORK



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Enterslice is Award Winning Legal Technology Company that helps entrepreneurs start and manage their business in India.

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1. On May 21, 2012 SEBI (Alternative Investment Funds) Regulations, 2012 were implemented with a view to regularize all the pooled investment funds collected from sophisticated investors with a view to invest as per pre determined investment policy. In India All the Alternative Investment Funds are covered under these regulations.
2. Before the introduction of the SEBI (Alternative Investment Funds) Regulations, 2012 there were various funds which were operating unregulated. Such funds were not covered under any of the regulations specified by Securities and Exchange Board of India like SEBI (Mutual Funds) Regulations, 1996; SEBI (Custodian Of Securities) Regulations, 1996 etc.
3. As of January of this year, 374 AIFs are registered with the SEBI.
 - Total funds raised by all the registered AIFs amount to Rs. 61797.19 Crore and investments made by such AIFs amount to 43489.05 Crore.

As per the Regulation 3(4) of AIF Regulations, AIF are categorized into 3 categories depending upon their investment plans and impact;

AIF Categories

Category I

They invest in socially or economically desirable sectors, and attract certain incentives or concessions from the Govt. & SEBI itself. 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

They are the ones not covered in Category I & III and can only undertake leverage or borrowing for operational requirements.

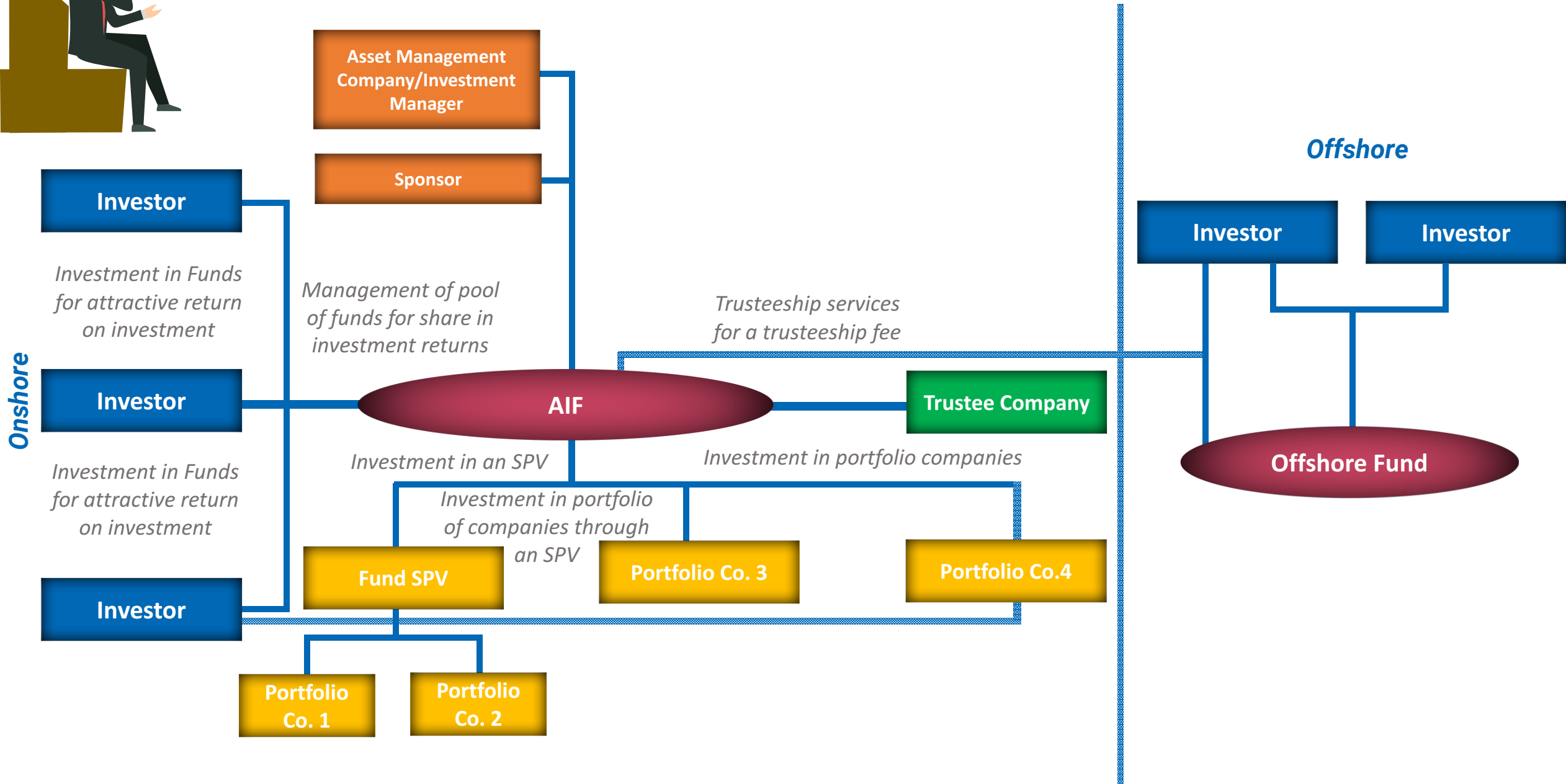
These include:

- Private equity funds
- Debt funds



Constitution of Alternative Investment Funds in India

TYPICAL STRUCTURE



AIF can be established either in the form of a trust, company (private or public), LLP or a body corporate.

Following are the key parties in the establishment of an AIF:

- Fund
- Trustee
- Sponsor
- Asset Management Company/Investment Manager

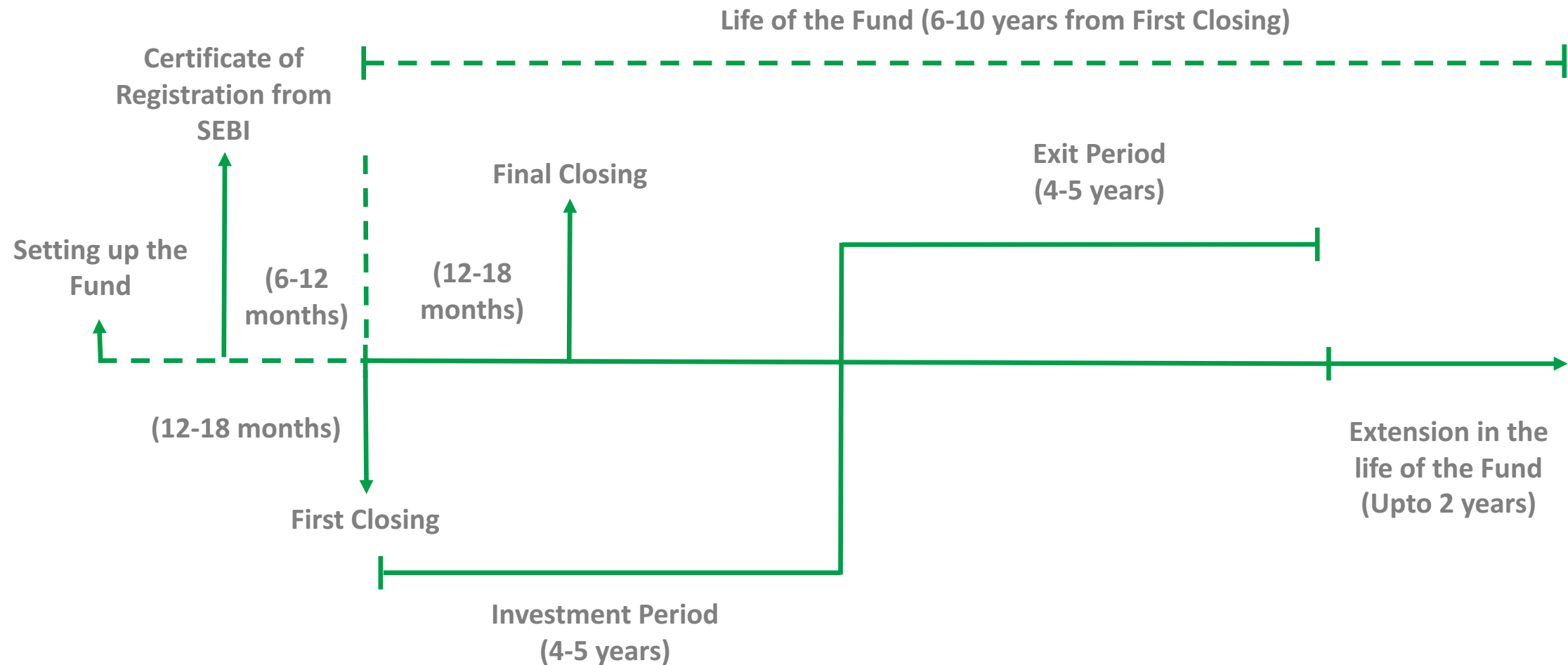
An Indenture of Trust for the settlement of the Trust by the Settlor;

1. Fund is the AIF itself. A Private Placement Memorandum is drafted detailing the key features of the AIF like investment focus ,strategy and fund management team information.
2. Sponsor is responsible for setting up the fund and is required to have knowledge and insight of the market as they have ultimately responsibility.
3. Trustees could either be a broad of trustees or a trustee company. They look after the entire working of the Fund.
4. AMC/Investment Manager are delegated the authority to manage the funds and take all investment decisions. They are paid a management fee for the same.





**Costing, Operation &
Management of an AIF**





Fee Structure for AIF Registration

1. Non-Refundable Fee

The applicant is required to remit a non-refundable application fee of Rs. 1,00,000

2. Registration Fee

Other than the non-refundable fee the applicant is required to remit registration fee, its amount will depend upon the category of AIF

- | | |
|--------------------|---------------|
| - For Category I | Rs. 5,00,000 |
| - For Category II | Rs. 10,00,000 |
| - For Category III | Rs. 15,00,000 |
| - For Angel Fund | Rs. 2,00,000 |
| - For any Scheme | Rs. 1,00,000 |



Costs incurred by the Fund

1. **Set up Costs :** They include registrations, legal documentation, taxation advisory and consultation fee etc.
2. **Marketing Fee:** Incurred to promote the AIF
3. **Administration Costs:** all the day to day costing like committees meetings expenses, report formation , audit fees etc. are included
4. **Management Fee :** This is paid to the AMC in return for their management services
5. **Investment & Transaction Costs :** Here, cost of due diligence and documentation is included

Costs incurred by Asset Management Company

1. **Salary payment to employees working on the scheme .**
2. **Administration Costs –** Every cost incurred while dispensing their duty other than the ones borne by the AIF.



Returns

1. Entry Charge/Set-up Fee:

- Payable at the time of investment in AIF

2. Management Fee

- During the Period of Investment, management fee is to be paid either quarterly, half yearly or yearly. This will be a percentage of the capital commitments.

3. Performance Linked Fee:

- This is also termed as profit sharing. And as the name suggests it's amount is dependent on the performance of the funds.

WATERFALL MECHANISM

Waterfall Mechanism is basically a formula for equitable distribution of returns among all the investors. This involves following steps:

1. **Return of Capital** – Firstly, 100% of the capital contributed by the investors is returned in proportion to their respective investment.
2. **Hurdle Rate** – It is the minimum expected rate of return the firm expects from the investments. The distributed amount will be the x% of the invested amount in proportion to their respective investment.
3. **Catch-up** It is the manner in which Investment Manager is compensated. It will be 25% of the distribution made towards hurdle.
4. **Carried Interest** – It represents the interest of investors and Investment Manager in the remaining profits. Here, 80% of the profit is distributed to the investors in proportion to their respective investment. And remaining 20% is remitted to the Investment Manager.

DISTRIBUTION WATERFALL

| Particulars | Case 1 | Case 2 | Case 3 | Case 4 |
|--|--|---|---|---|
| <i>Assume that the amount invested by the Fund is Rs. 2,000 and the hurdle rate is 10%</i> | | | | |
| Particulars | If the performance of the Fund is not as per expectations and it has Rs. 1800 after disposition | If the performance of the Fund is moderate and it is Rs. 2,200 after disposition | The Fund has Rs. 2,250 disposition | The Fund does well and has Rs. 2,450 after disposition |
| Capital | Rs. 1800 | Rs. 2,000 | Rs. 2,000 | Rs. 2,000 |
| Hurdle | NA | Rs. 200 | Rs. 200 | Rs. 200 |
| Catch-up | NA | NA | Rs. 50 | Rs. 50 |
| Carried Interest | NA | NA | NA | Rs. 40 (Rs 160 to the investor) |
| Total | Rs. 1800 | Rs. 2,200 | Rs. 2,250 | Rs. 2,450 |

Key Provisions of AIF Regulations, 2012 – Categories and different Provisions

AIF REGULATIONS – KEY PROVISIONS



| Sr. No. | Particulars | Category I* | Category II | Category III |
|---------|---|---|-------------|---|
| 1. | Investor requirements | Investor can either be Indian or foreign | | |
| 2. | Minimum Corpus | Rs. 20 Crore (Except for Angel Funds, for then it is Rs. 10 Crore) | | |
| 3. | Minimum Subscription | Rs. 1 Crore (angel investors and employees of the fund are allowed to make minimum investment of 25 lakh rupees) | | |
| 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 (In case of Angel funds the no is 200 only) | | |
| 6. | Tenure | <i>Close ended-Minimum 3 years</i> <i>Note: The tenure can be extended by 2 years, only after the approval from the unit holders by 2/3rd majority based on the value of their investment in the AIF.</i> | | Optional-Open or Close ended |
| 7. | Maximum investment in a single investee company | 25% of the investible funds | | 10% of the investible funds |

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 Category I & II AIFs as specified in the placement memorandum | Invest in securities of listed or unlisted investee companies or derivatives or complex or structured products. They can also invest in units of other AIFs |
| 10. | Leverage | <p>Conditions Precedent:</p> <ul style="list-style-type: none"> -Only for meeting temporary funding requirements - For maximum 30 days -Only 4 times in a year and -Amount shall not exceed 10% of the investible funds | <p>Conditions Precedent:</p> <ul style="list-style-type: none"> -Only for meeting temporary funding requirements - For maximum 30 days -Only 4 times in a year and -Amount shall not exceed 10% of the investible funds <p>However Category II funds may engage in hedging subject to guidelines specified by the SEBI</p> | 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



| 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. |



FDI IN AIFs



FDI in an AIF


1. Earlier government approval was required for FDI in AIF set up as trusts. However, this requirement is let go of. Now, FDI through automatic route is allowed under every category of AIF.
2. If the sponsor or investment manager of the firm is not owned and controlled by an Indian, then even if the AIF is registered under SEBI the Downstream investments by such AIF will be treated as foreign investments.
3. The above stated fact that downstream investment is considered as a foreign investment is not affected by any percentage of FDI in corpus.
4. If any category III AIF has foreign investment , then it is allowed to invest in such securities/instruments in which Registered Foreign Portfolio Investor are allowed to.

TAXATION





1. Category I and II AIFs have Tax pass-through status for all income excluding income from business or profession.
 - AIFs to withhold tax on distribution/accrual of income
 - (a) at the rate of 10% for Indian investors;
 - (b) as per 'rates in force' (i.e. lower of tax treaty rates or domestic tax law) for foreign investors.
2. Category III AIFs do not have Tax pass-through status. Tax is required to be paid at the fund level.
3. Income from business or profession is taxable in the hands of AIF.
4. AIF are not allowed to pass on Unutilized losses to investors, they are required to be carried forward and set-off in successive years.
5. Income from portfolio companies is exempted from withholding tax.
6. In case of Category I and Category II AIFs No dividend distribution tax is payable when distributing such income to investors.

A large blue circle is centered on a white background. Inside the circle, the text "RECOMMENDATIONS OF THE AIPAC" is written in white, bold, uppercase letters.

RECOMMENDATIONS OF THE AIPAC

In March 2015 SEBI constituted the Alternative Investment Policy Advisory Committee (AIPAC) under the chairmanship of Mr. Narayana Murthy. This committee was constituted with a view to solicit the comments/views from public and make recommendations regarding the reforms required to develop the market for alternative investments.

Since AIPAC establishment, the committee has submitted three reports till date. The latest one was submitted in November 2017.

Major recommendations made by AIPAC relate to :

- Taxation provisions of AIFs, including Category III AIFs. This was discussed in all the three reports.
- The GST incorporation in AIF. As GST was introduced last year, it was a major point of discussion in the latest committee meeting.
- Corporate Social Responsibility provisions.
- Disclosures and governance provisions for AIFs
- Public Trust Recommendations, as most of the AIF are registered in trust form

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