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## India
## Alternative Investment Funds

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This country-specific Q&A provides an overview of alternative investment funds laws and regulations applicable in India.

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# India: Alternative Investment Funds

## 1. What are the principal legal structures used for Alternative Investment Funds?

Alternative investment funds (**AIF**(s)) are privately pooled investment vehicles established or incorporated in India and are regulated by the Securities and Exchange Board of India (**SEBI**). AIFs collect funds from investors, which are then invested in accordance with the AIFs' investment policy.

Under the SEBI (Alternate Investment Funds) Regulations, 2012 (**AIF Regulations**), SEBI permits an AIF to be set up as a trust, limited liability partnership (**LLP**) or a company. However, a trust is the most widely used AIF structure owing to certain legal, regulatory, tax and commercial considerations. Under Indian law, a trust does not have a separate legal personality and is dependent on the personality of the trustee. Accordingly, trustee is the legal owner of the trust property and investors are beneficial interest holders in the trust. LLPs and companies, on the other hand, do have a separate legal personality, wherein the investors are partners or shareholders in LLPs and companies, respectively, registered as AIFs (which is uncommon, as noted above).

Certain vehicles such as family trusts, ESOP trusts, employee welfare trusts, gratuity trusts, and securitization trusts are excluded from the definition of an AIF.

## 2. Does a structure provide limited liability to the investors? If so, how is this achieved?

Under Indian law, most structures provide for limited liability of investors. Under Indian companies' law, a shareholder's liability is limited to the extent of its unpaid share capital. Similarly, under Indian LLP law, the liability of a partner is limited to its unpaid partnership interest unless otherwise provided for in the LLP agreement or in case of fraud. In case of a trust, while Indian trust law does not provide for statutory limitation of liability, the same could be achieved basis contractually agreed terms in the governing documents of the trust (typically the contribution agreement in the case of trusts registered as AIFs). This is also the market practice across AIFs in India that are set up as trusts.

## 3. Is there a market preference and/or most preferred structure? Does it depend on asset class or investment strategy?

While the Indian AIF Regulations permit an AIF to be established as a company, trust or an LLP, the most preferred structure for managers in India has been to establish AIFs as trusts. This is evidenced by the fact that out of of the 1382 AIFs registered with SEBI in India as of 28 August 2024, 1348 are registered as trusts, whereas the number of LLPs and companies are 31 and 3 respectively. Please also refer question 11 for further discussion on this.

The AIF Regulations provide for four categories for AIFs to seek registration, Category I, Category II, Category III and Corporate Debt Market Development Funds[1]. Noticeably most AIFs are registered under Category II, the residual category, as it provides greater flexibility to the manager to formulate investment objectives and strategy of the AIF. However, as further explained in 4 and 8 below, Category II AIFs are required to primarily invest in unlisted companies ("primarily" here means greater than 50% of the AIF's commitments). Resultantly, AIFs that have an investment strategy focussed on listed investments are registered as Category III AIFs.

Footnote(s):

[1] We have furnished limited information in relation to Corporate Debt Market Development Funds in this article, due to its specificity and purpose of such a fund acting as a backstop facility for purchase of corporate debt securities during times of market stress and to enhance secondary market liquidity.

## 4. Does the regulatory regime distinguish between open-ended and closed-ended Alternative Investment Funds (or otherwise differentiate between different types of funds or strategies (e.g. private equity vs. hedge)) and, if so, how?

Under the AIF Regulations, AIFs are categorised in the following four categories based on their investment strategies and with the intent of providing an appropriate regulatory framework:

 

- Category I AIF: This category invests in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and sub-categories include venture capital funds (including angel funds and migrated venture capital funds), small and medium-sized enterprise funds, social impact funds, infrastructure funds and special situation funds.
- Category II AIF: This category includes AIFs that do not specifically fall under Category I or Category III and that do not undertake leverage or borrowing other than for specific situations as provided under the AIF Regulations. Private equity funds and debt funds typically fall under this category.
- Category III AIF: This category includes funds that employ diverse or complex trading strategies and may employ leverage. Additionally, AIFs with an investment strategy focused on listed investments are required to be registered as Category III AIFs.
- Corporate Debt Market Development Fund: This category includes a fund, which in periods of market dislocation purchases corporate debt securities from specified debt-oriented schemes of mutual funds which meet a prescribed eligibility criteria.

Further, Category I AIFs, Category II AIFs and Corporate Debt Market Development Funds can only be set up as closed-ended funds, whereas Category III AIFs can be either closed-ended or open-ended.

Category I AIFs and Category II AIFs are required to have a pre-determined tenure, calculated from their first closing, with three years being the minimum prescribed term. The tenure of a closed-ended AIF can be extended only for a further period of up to two years with the approval of 66.67% of the investors by value of their investment in the AIF.

Separately in case of a large value fund for accredited investors, i.e., any AIF in which each investor (other than the manager, sponsor, employees, or directors of the AIF or the manager) are accredited investors and invest a minimum amount of approximately USD 8.35 million[2] (i.e., the USD equivalent of INR 700 million) (**LVF**), the term can be extended for up to a period of five years subject to the approval of two-thirds of the unit holders by value of their investment.

Please see below 31 for further details on accredited investors.

Footnote(s):

For the calculations herein, we have assumed 1 USD to be equal to INR 83.88.

## 5. Are there any limits on the manager's ability to restrict redemptions? What factors determine the degree of liquidity that a manager offers investor of an Alternative Investment Fund?

SEBI has prescribed certain redemption norms and restrictions for open-ended AIFs in India. It is the responsibility of the managers of such AIFs to ensure adequate and sufficient liquidity consistent with the overall liquidity profile of the AIF.

The offering documents of an open-ended AIF should clearly disclose the possibility of suspension of redemptions in exceptional circumstances to investors provided that such suspension is exclusively in the best interest of investors or is required under the AIF Regulations or by SEBI.

During the said suspension period for the redemptions, the managers are not allowed to accept new subscriptions.

Further, any decision to suspend redemptions in open-ended AIFs is required to be appropriately documented and intimated to SEBI and investors of such AIFs along with the reasons for such suspension and planned actions. The decision to revoke suspension is also required to be intimated to SEBI and investors.

The managers can also incorporate restrictions on transfers which are typically disclosed in the fund documents of the AIF. The degree of liquidity a manager offers is also dependent on the type of underlying securities held by the Fund and the overall strategy / thesis of the respective AIF.

The discussion above pertains to open-ended AIFs. For closed-ended AIFs, the manager has an unrestricted ability to determine the terms of the redemption, including in respect of restrictions.

## 6. What are potential tools that a manager may use to manage illiquidity risks regarding the portfolio of its Alternative Investment Fund?

For Category I and II AIFs (i.e. being closed ended in nature), managers often do not provide liquidity and a disclosure is appropriately made in the placement documents of such AIFs to that effect. For Category III AIFs certain tools employed by managers to facilitate redemptions are (i) providing for cut- off dates for every redemption request, (ii) controlled frequency of redemptions, (iii) introducing fund or investor level gates, (iv) lock-in period and high exit load(s), and (v) temporary suspensions.

In recent years, the exit environment for Category I and II AIFs has been improving and the following key exit avenues have become prominent with respect to unlocking value and providing liquidity to investors (i) listing on the secondaries markets i.e. stock exchanges; (ii) sale to strategic investors including through setting up of a continuation vehicle; (iii) sale of investments to other AIFs/funds (including offshore funds). In addition, there are also (albeit infrequent) events of negotiated sale of entire portfolio to other fund houses.

Recently, SEBI has also delineated a framework to provide flexibility to AIFs to deal with investments of their schemes which are not sold due to lack of liquidity during the winding up process, by either distributing such unliquidated investments in-specie during the liquidation period i.e. one year following the expiry of tenure or extended tenure of the scheme for fully liquidating the scheme of an AIF ("**Liquidation Period**") or entering into a "dissolution period", i.e. a period following the expiry of the Liquidation Period after obtaining approval of at least 75% of the investors by value of their investment in the scheme of the AIF, subject to certain conditions prescribed by SEBI. During the Liquidation Period, if the AIF fails to obtain requisite investor consent for entering into a "dissolution period" or in-specie distribution of unliquidated investments, then the unliquidated investments shall be mandatorily distributed to investors in-specie, without requirement of obtaining consent of 75% of investors by value of their investment in the scheme of the AIF. In case any investor is not willing to take in-specie distribution of unliquidated investments, such investments are required to be written off.

## 7. Are there any restrictions on transfers of investors' interests?

Managers can incorporate contractual restrictions on transfer of investors' interests which are typically disclosed in the fund documents of the AIF. There are no regulatory restrictions on transfers other than the requirement that each investor (other than an accredited investor) in the AIF should not make capital commitment of less than approximately USD 120,000 (i.e. the USD equivalent of INR 10 million) i.e., the transferee should hold a minimum commitment of such USD 120,000 in the AIF and, in case of part transfers, each of the transferor and transferee should hold a minimum commitment of USD 120,000 in the AIF. Also, with a view to facilitate operational ease of transfer, SEBI has mandated all AIFs to dematerialise their units.

Having said this, managers should ensure the eligibility of the potential transferees under applicable laws, including importantly satisfaction of know your client /anti-money laundering norms. In fact, these are typically provided, in the governing documents of AIFs, as essential requirements for the manager consenting to transfer of units of AIFs. To accommodate for specific requests from institutional investors, the manager may allow for free transferability in side letter(s) of such investors.

## 8. Are there any other limitations on a manager's ability to manage its funds (e.g., diversification requirements)?

Categories I and II AIFs cannot invest more than 25% (or 50% in case of LVFs) and Category III AIFs cannot invest more than 10% (or 20% in case of LVFs) of their investable funds in a single portfolio entity directly or through investment in the units of other AIFs. Notably this restriction applies at the time of each investment i.e., the aforesaid diversification limit is applicable at all times. SEBI allows Category III AIFs to calculate their 10% (or 20% in case of LVFs) investment concentration limit in one investee company either on their investable funds or the net asset value of the fund if such AIFs are investing in listed equity; provided that one of the two options are opted by such AIF at the time of its establishment and which option shall remain the same throughout the term of such AIF.

Category II AIFs are required to invest primarily in unlisted companies directly or through investment in units of other AIFs i.e., majority of the investments must be in unlisted securities.

Category III AIFs may invest in securities of listed or unlisted investee companies or derivatives, units of other AIFs or complex/structured products. They may also deal in goods received in delivery against physical settlement of commodity derivatives.

There are certain sub-categories of category I AIFs. Set out below are some further key investment restrictions based on the sub-category of Category I AIFs.

- Venture Capital Funds: At least 75% of their investable funds must be invested in unlisted equity shares or equity-linked instruments of a venture capital undertaking (**VCU**) or in companies listed or proposed to be listed on a small and medium-sized enterprise (**SME**) exchange or SME segment of an exchange.

- SME funds: At least 75% of their investable funds must be invested in unlisted securities or partnership interests of VCUs or investee companies which are SMEs, or in companies listed or proposed to be listed on an SME exchange or SME segment of an exchange or in units of Category II AIFs which invest primarily in such VCUs or investee companies.
- Social impact funds: At least 75% of their investable funds must be invested in unlisted securities or partnership interests of social ventures or in securities of social enterprises.
- Infrastructure funds: At least 75% of their investable funds must be invested in unlisted securities or partnership interests of VCU, or investee companies or special purpose vehicles which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects or in units of Category II AIFs which invest primarily in such venture capital undertakings or investee companies or special purpose vehicles.
- Special situation funds: 100% of their investable funds must be invested in stressed loans, security receipts or securities of such companies which are subject to insolvency process or whose loans are under default as prescribed further in AIF Regulations.

The AIF Regulations also restrict Category I / Category II AIFs from borrowing directly or indirectly or engaging in any leverage except 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 investable funds. These AIFs may borrow for the purpose of meeting shortfall in drawdown amount subject to (i) a disclosure regarding such borrowing ability in the PPM, and (ii) such borrowing being undertaken only in case of emergencies and as a last recourse when an investment opportunity is imminent to be closed and the AIF has not received the drawdown amounts from its investors in spite of the best efforts of the manager of such AIF. Such a borrowed amount shall not exceed the lower of 20% of the investment proposed to be made in the investee company, or 10% of the investible funds of the AIF, or the commitment pending to be drawn down from investors other than the investors who have failed to provide the draw down amounts. Category I and Category II AIFs shall maintain thirty days cooling off period between two periods of borrowing as permissible under AIF Regulations, where such period shall be calculated from the date of repayment of previous borrowing. Category I and Category II AIFs which transact in credit default swaps, shall maintain thirty days cooling off period between the two periods of borrowing or engaging in leverage. Category III AIFs are permitted to engage in leverage, subject to consent from investors of the fund and subject to a maximum limit as prescribed by SEBI. Category I and Category II may also create encumbrance on equity of investee companies in the business of development, operation, or management of certain infrastructure projects specified by the Indian government, only for borrowing by such investee companies for specific purposes, subject to certain conditions specified by SEBI. The duration of such encumbrances shall not be greater than the residual tenure of the Category I or Category II AIF.

Further, with respect to AIF's ability to invest outside India, AIFs are required to obtain prior approval from SEBI and their aggregate overseas investments should be limited to 25% of their investable funds. Overseas investments are also subject to the overall industry limits, which may change from time to time. Further, SEBI has also released guidelines for overseas investments by AIFs including requirements to the effect of (i) restricting investments in only those overseas companies, which are incorporated in a country whose securities market regulator is a signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding or a signatory to the bilateral Memorandum of Understanding with SEBI; (ii) prohibiting investments in those overseas companies which are incorporated in a country identified in the public statement of Financial Action Task Force.

It is pertinent to note that there is an increasing number of investment funds being launched in Gujarat International Finance Tec-City (**GIFT**), India's offshore financial services centre. On 19 April 2022, the International Financial Services Centre Authority (**IFSCA**) published the International Financial Services Centre Authority (Fund Management) Regulations, 2022 (**FM Regulations**), overhauling the fund regime in International Financial Services Centre (**IFSC**). IFSCA's entire fund framework is into one unified regulation, which regulates the fund management entities, while having prescribed guidelines for investment funds. The FM Regulations became effective from 19 May 2022. All entities that intend to undertake the business of fund management in the IFSCA are required to be registered under the terms of the FM Regulations.

 

Although similar in most substantive respects *vis-à-vis* AIFs registered with SEBI, certain key concessions provided by the IFSCA to funds established in GIFT are (i) the disapplication of diversification requirements described above; (ii) the disapplication of leverage norms described above, as long as appropriate disclosures and risk management frameworks are in place; and (iii) the ability to create co-investment pockets through a special purpose vehicle or through a segregated portfolio by issuing a separate class of units within the fund.

## 9. What is the local tax treatment of (a) resident, (b) non-resident, and (c) pension fund investors (or any other common investor type) in Alternative Investment Funds? Does the tax treatment of the target investment dictate the structure of the Alternative Investment Fund?

Indian income tax laws grant "tax pass-through" status to Category I and II AIFs incorporated or established in India i.e., income is taxable in the hands of the investors of such AIF, in the manner as if it were received by or accruing to, such investors had they invested the amount themselves. Category III AIFs do not enjoy such benefits; however, if Category III AIFs structure themselves as trusts, they could be granted tax transparency following the general principles of trust taxation and other provisions of Indian tax laws.

The tax pass-through status (for Category I and II AIFs) is with respect to all income, other than income under the head of "profits and gains of business or profession" earned by an AIF i.e. income that is in the nature of business income. Such business income will be taxable at the maximum marginal rate in the hands of the AIF prevailing in that financial year. Thereafter, this business income is exempt in the hands of the investors.

The taxation of offshore or non-resident investors is primarily governed by Section 90 of the Indian Income Tax Act, 1961 (**IT Act**), read with the double-taxation avoidance agreements (**DTAAs**) between the country of residence of an offshore investor and India. The provisions of the DTAAs would supersede the provisions of the IT Act if they are more beneficial than the provisions of the IT Act, subject to other requirements and customary substance requirements. In cases where investors are from countries with which India does not have a DTAA, then provisions of the IT Act will continue to apply.

## 10. What rights do investors typically have and what restrictions are investors typically subject to with respect to the management or operations of the Alternative Investment Fund?

Typically, investors have no rights with respect to the management or operations of the AIFs as AIFs are established as passive vehicles with management being delegated to a professional manager.

Generally, investors have limited voting rights on key governance matters of the AIFs (provided under the AIF Regulations or governing documents of the AIFs) such as extensions to the tenure of the AIFs or ability to enter into "dissolution period", change in investment strategy, *in specie* or in-kind distributions, investment in associates, approvals for conflicts of interest, termination of the AIFs or manager and change in diversification requirements. Certain anchor or strategic investors may also receive a seat on LPAC or investor advisory committee which would provide them with certain consultation or voting rights on governance decisions taken by the manager.

As an exception to the general position stated above, SEBI has identified certain 'material changes', which may be construed as changes in the fundamental attributes of an AIF and significantly influencing the decision of the investor to continue to be invested in the AIF such as change in sponsor/manager (not including an internal restructuring within the group), change in control of sponsor/manager, change in fee structure/hurdle rate resulting in higher fee being charged to the investor. In the case some of these 'material change', SEBI has prescribed that at least 75% investor (by value) consent should be sought, failing which an exit option is required to be provided to dissenting investors.

Finally, it may be noted that SEBI has increasingly sharpened its focus on the responsibility of managers *vis-à-vis* decisions taken in relation to AIFs. Through amendments to the AIF Regulations, SEBI has affixed responsibility on the manager for each decision of an AIF, including for compliance with applicable law and the fund documents. In addition, if an AIF provides for an investment committee to take binding investment decisions, the members of such investment committee are responsible for such decisions, including compliance with the policies and procedures of the AIF in respect thereof. Further, amendments to the AIF Regulations have been undertaken with the specific objective to strengthen governance mechanisms of AIFs by *inter alia* (i) standardising valuation methodology; (ii) formalising a mechanism to address liquidity issues during an AIFs winding up process; (iii) mandating dematerialisation of

 

AIF units; and (iv) setting an investor approval threshold for an AIF to buy or sell investments from or to (a) associates; (b) schemes of AIFs managed or sponsored by its manager, sponsor or associates of the manager or sponsor; or (c) an investor who has committed to invest at least fifty percent of the corpus of the scheme of an AIF.

## 11. Where customization of Alternative Investment Funds is required by investors, what types of legal structures are most commonly used?

The legal structure of a trust allows investors with the greatest flexibility to customize their contractual relationships, therefore, is most commonly used for the purpose of customization of AIFs.

Three primary reasons for trusts being a preferred structure for organizing AIFs are:

- structural flexibility – in comparison to an LLP or a company, parties generally have discretion to contractually design the structure and operation of the AIFs;
- compliance requirements – Indian trust law does not prescribe major compliances, reporting or disclosure requirements, whereas LLPs and companies are subject to oversight by the (Indian) Ministry of Corporate Affairs, which has established various reporting and disclosure requirements for such entities; and
- confidentiality of investor details – with respect to Indian trusts, investor details are not readily available in public domain, which is not the case with other structures. In the case of a trust, although the indenture of trust or the trust deed (i.e., its constitutive document) is required to be registered with the local governmental authority, substantial terms of investments are usually captured in the subscription/contribution agreement entered into with investors and the investment management agreement entered between the trustee and the investment manager, which are not required to be filed with the registrar. As opposed to this, the limited liability partnership agreement (in the case of LLPs) and the placement memorandum and articles of association (in the case of companies) often contain several commercial terms and are required to be filed with the relevant regulatory authorities in India.

## 12. Are managers or advisers to Alternative Investment Funds required to be licensed, authorised or regulated by a regulatory body?

Managers are not required to be registered or licensed by SEBI to carry out the activities as the managers of the AIFs. However, arguably, managers of AIFs are regulated by SEBI under the AIF Regulations as they are required to submit certain documents at the time of seeking registration of the AIFs and have certain ongoing regulatory compliances and duties under the AIF Regulations. Managers are required to follow certain compliances and transparency norms, such as periodic disclosure of key portfolio related information, periodic disclosure of fees charged to the AIF, disclosures around disciplinary and regulatory action, disclosure of breaches of fund documents, disclosure of changes to the key investment team and disclosure of conflicts of interest. Additionally, managers providing co-investment services must be licensed under the SEBI (Portfolio Managers) Regulations, 2020.

In the context of this query, it is pertinent to note that managers to funds set-up in GIFT are licensed or authorized by the IFSCA as a fund management entity (FME), depending on the type of fund and profile of investors targeted under the FM Regulations.

## 13. Are Alternative Investment Funds themselves required to be licensed, authorised or regulated by a regulatory body?

AIFs are licensed and regulated by SEBI under the AIF Regulations. SEBI has prescribed an application form which is required to be submitted along with the establishment documents of the AIF and the offering/placement memorandum. Certain declarations and undertakings are also submitted along with disciplinary history of the key parties to the AIF such as manager and sponsor.

The placement memorandum along with the declarations are vetted by a registered merchant banker, which is appointed by the manager. Furthermore, due diligence certificate is provided by the merchant banker if it believes that the disclosures are sufficient to be provided to SEBI along with the relevant documents. The merchant banker is also obliged to ensure that the comments provided by SEBI are duly incorporated into the placement memorandum. Exemption has been provided to LVFs, subject to certain conditions from the foregoing requirement.

 

The entire application process is online. As per the AIF Regulations, SEBI is required to approve or reject the application within 30 days. SEBI may ask for any additional information or document and typically completes the registration process in two to three months.

For investment funds set-up in GIFT, IFSCA has recently introduced a “green- channel” route which allows the FMEs to launch investment funds as soon as they file the memorandum with the IFSCA, subject to certain minimum disclosure requirements in the memorandum.

## 14. Does the Alternative Investment Fund require a manager or advisor to be domiciled in the same jurisdiction as the Alternative Investment Fund itself?

While not explicitly stated in the AIF Regulations, SEBI has an expectation that AIF managers are required to be domiciled in India. Under the AIF Regulations, other than the manager, AIFs are required to have a sponsor(s) who sets up the AIF. While the AIF manager should be an entity, the sponsor could be an entity or individual. Predominantly, sponsors of AIFs are also domiciled in India, however there are instances of foreign persons serving as sponsors to AIFs and SEBI has approved the same. The manager and sponsor could also be the same entity.

## 15. Are there local residence or other local qualification or substance requirements for the Alternative Investment Fund and/or the manager and/or the advisor to the fund?

If the manager and sponsor of an AIF are ultimately owned and controlled by Indian resident citizen(s) and the control of the AIF is in the hands of the sponsor and manager to the general exclusion of others, the investments by such AIF in capital instruments are treated as domestic investments i.e., exempt from the restrictions or conditionalities like impermissibility of certain instruments, sectoral restrictions and pricing guidelines.

‘Ownership’ is defined as holding of more than 50% of the beneficial interest of equity and equity-linked instruments and ‘control’ means the right to appoint the majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights or shareholders’ agreement or voting agreement or in any other manner.

The members of the key investment team of an investment manager are required to have adequate experience and qualification with at least one key personnel to have certification from the National Institute of Securities Market by passing the NISM Series-XIX-C: Alternative Investment Fund Managers Certification Examination and with professional qualification in finance, business management, commerce, economics and the like. Similarly, the appointment of a compliance officer by the manager is also subject to the criteria that SEBI may prescribe. The AIF Regulations prescribe certain codes of conduct to be followed by the AIF, manager, key personnel and members of the investment committee. While not laying down objective criteria for substance, the prescriptions therein imply certain minimum standards in the conduct of the activities of an AIF. These include, but are not limited to (i) the development of a risk management process, (ii) adoption of a written conflict resolution policy, (iii) affirmation of the fiduciary capacity towards investors, (iv) ensuring proper care, due diligence and independent professional judgment; (v) documentation of all relevant correspondence with relation to the AIF’s deals; and (vi) maintenance of a written record of investment, divestment and other key decisions.

Please see answer to 14 above on other local substance requirements.

## 16. What service providers are required by applicable law and regulation?

The AIF Regulations require multiple service providers to be engaged in the setting up and working of the AIF. Unless specifically exempted, to file the private placement memorandum, a merchant banker will need to be appointed. For the safekeeping of securities, the AIF Regulations also require the appointment of a SEBI-registered custodian for AIFs. For the annual audit by an auditor or a legal professional of the AIF’s books of account and to ensure compliance with the PPM, an AIF is required to appoint a qualified auditor. SEBI has also introduced mandatory performance benchmarking for AIFs other than Angel Funds, which will require the appointment of credit-rating agencies like CRISIL. For the valuation of the investments made by the AIFs, it requires the appointment of an independent valuer who shall meet the eligibility criteria specified by SEBI. For collection of stamp duty on sale, transfer and issue of units of an AIF, AIFs are required to appoint a registrar and transfer agent. In addition, apart from its role as a trustee under

 

Indian trust law and the governing documents of an AIF, a trustee is also required to exercise oversight over the operations of an AIF, including importantly reviewing and providing inputs on the annual compliance test report (**CTR**) prepared by the manager.

Notably, SEBI doesn't allow the AIF manager to delegate its core functions.

### 17. Are local resident directors / trustees required?

As per the Indian Law, the following additional conditions should be met by the AIFs which are set up as trusts, companies and LLPs:

- Trust must have a local trustee;
- companies must have a local director; and
- LLPs must have at least two designated partners (the corporate partners must nominate one individual each to act as a designated partner) of which one must be Indian resident.

### 18. What rules apply to foreign managers or advisers wishing to manage, advise, or otherwise operate funds domiciled in your jurisdiction?

Please see answer to question 14 above rules applicable to AIF managers. However, it is possible for non-resident persons to incorporate an entity in India for it to act as the manager of an AIF. Please see answer to question 15 for the rules applicable to managers who are controlled and owned by non-resident persons.

### 19. What are common enforcement risks that managers face with respect to the management of their Alternative Investment Funds?

As noted above, managers of AIFs are required to comply with certain norms relating to disclosure and transparency. The areas which present potential risks to investors, which are more likely to be the subject matter of enforcement, are in breach of reporting or disclosure norms applicable to AIFs and managers, failure to disclose conflicts of interest or ensure accurate valuations, improper allocation of fees and expenses and violation of private placement rules.

### 20. What is the typical level of management fee paid? Does it vary by asset type?

The typical level of management fee varies depending on the size and strategy of an AIF. For example, for equity funds it varies between 1-2% of the capital commitment. However, in case of open-ended funds, a lower rate of 0.5% – 1.5% is typically seen with the base being the net asset value (**NAV**) of the investment. For debt funds it varies between 0.5-1.5% of the capital commitment. Typically, for closed-ended funds, the management fee during the investment period is charged based on capital commitments, and there is usually a step down in management fee post the investment period, where it is calculated on the basis of actively invested capital.

### 21. Is a performance fee typical? If so, does it commonly include a "high water mark", "hurdle", "water-fall" or other condition? If so, please explain.

Performance fee/carried interest is typical and is charged as performance fee or distributed as carried interest due to different tax implications. Typically, Category I and II AIFs (which are closed-ended funds) operate with a hurdle/preferred return construct to calculate carried interest pursuant to a 'distribution waterfall' i.e., distributions are distributed to managers/sponsors according to a set priority. Category III AIFs, which are often open-ended, employ a performance fee model coupled with a high-water mark construct. The high-water mark principle ensures that an investor is not charged performance fee until any losses are recovered.

### 22. Are fee discounts / fee rebates or other economic benefits for initial investors typical in raising assets for new fund launches?

There are no regulatory restrictions for the grant of fee discounts or fee rebates or other economic benefits to the initial investors. However, unless such terms are provided and implemented through side letters, adequate disclosure of such benefits is required in the various fund documents, which are ideally implemented through separate share/unit classes. They are commercially negotiated terms which vary in each transaction and largely depend on the track record of the manager and the investment size of the investor. These are typical arrangements to enhance fund raising efforts.

### 23. Are management fee "break-points" offered

 

### based on investment size?

Management fee rebates are offered based on investment size, strategic relationships, stage of investments.

### 24. Are first loss programs used as a source of capital (i.e., a managed account into which the manager contributes approximately 10-20% of the account balance and the remainder is furnished by the investor)?

While not too common, first loss programs are seen in specific contexts in AIFs, such as AIFs which aim to meet certain environmental, social or governance (**ESG**) objectives. In such AIFs, investors with higher risk tolerance and/or more focused on the achievement of ESG goals, typically the manager/sponsor and development financial institutions (**DFIs**), participate in the first loss program through a separate class of units/shares which offers capital protection to the class of units/shares subscribed by the other investors i.e. those with lower risk tolerance and/or more focused on the commercial returns. This is done through measures such as occupying a junior position in the distribution waterfall (whereunder distributions are made to first loss investors only after capital contributions and preferred return are distributed to the other investors) and through acceptance of a lower preferred rate of return by first loss investors. However, SEBI has directed all schemes of AIFs which have adopted a priority distribution model to not accept any fresh commitment or make new investments.

From a regulatory perspective, social impact funds, a sub-category of Category I AIFs are permitted under the AIF Regulations to issue social units to investors who have agreed to receive only social returns or benefits and no financial returns against their contribution.

### 25. What is the typical terms of a seeding / acceleration program?

Typical terms of a seeding/acceleration program often include accepting long term seed investment in AIFs from seed investors in return of preferential economic terms such as lower fees, increased disclosures, share in carried interest/performance fee, 'most favoured nations' treatment and certain governance rights such as approval rights with respect to investment norms. In addition, a special area of focus for seed investors is the visibility and access to co-investment opportunities, and seed investors usually require the manager of AIFs to provide visibility over all term sheets being negotiated, an obligation to connect the investor with the founders and to ensure participation by the seed investor in investees and potential investees. Sometimes, an equity stake in the manager is also offered. Through these programs, managers ensure committed long-term capital helping them to build track record and raise further capital.

### 26. What industry trends have recently developed regarding management fees and incentive/performance fees or carried interest? In particular, are there industry norms between primary funds and secondary funds?

We have seen management fee and carried interest/performance fee coming under significant pressure in the last couple of years . Except in situations where the manager can demonstrate greater involvement with the portfolio, such as venture capital funds or stressed asset funds, investors tend to exert downward pressure on management fee and carried interest/performance fee. Given the maturing nature of the AIF regime in India, there are many franchises launching the successive generations of their funds. In such cases, investors, especially investors who were also investors in prior fund(s) from the franchise, seek better terms on management fee and performance fee/carried interest. Investors also seek step-down on management fee base in the event of launch of a successor fund. Institutional investors seek carry clawback protection through measures such as guarantees going up to ultimate carry recipients and provision of carry escrow.

### 27. What restrictions are there on marketing Alternative Investment Funds?

The AIF Regulations restrict the marketing of AIFs only on a private placement basis through the issue of the private placement memorandum. The Manager cannot issue a public advertisement for investment.

AIFs are marketed by way of private placement through issuance of a placement memorandum to any person or entity in or outside India, provided that no AIFs can have more than 1,000 investors. While there are no strict regulations on private placement, drawing an analogy from Indian company law, managers do follow certain private placement norms basis legal advice they must seek in this regard.

SEBI has, as of late, started distinguishing between smaller investors and investors that commit more than approximately USD 8.35 million (i.e. the USD equivalent of INR 700 million). AIFs where all investors (except the regulatorily required sponsor commitment and with respect to commitment by the AIF manager or its directors and employees) commit more than USD 8.35 million are permitted to follow their own format of private placement memorandum, whereas other AIFs are required to follow the format prescribed by SEBI. The SEBI prescribed format of the PPM focusses on disclosures to be made by managers and is hence aimed at being protective of the investors' interests.

## 28. Is the concept of "pre-marketing" (or equivalent) recognised in your jurisdiction? If so, how has it been defined (by law and/or practice)?

The concept of "pre-marketing" is strictly not recognised in India (unlike other jurisdictions); however, possible through obtaining an 'in-principle' approval for the AIF. The in-principle route permits AIFs to accept commitments from investors but does not permit AIFs to collect monies prior to conversion of the 'in-principle' approval into a final approval. The 'in-principle' route is generally not preferred given the timelines involved, being nearly the same as the timelines for a regular approval, which is thereafter required to be followed up with regular approval. Practically, 'pre-marketing' is carried out through adequate disclosures/disclaimers.

## 29. Can Alternative Investment Funds be marketed to retail investors?

The AIF Regulations were promulgated to cater the non-retail investors and accordingly the minimum investment limit was prescribed at approximately USD 120,000 (i.e. the USD equivalent of INR 10 million). Further, SEBI has amended the AIF Regulations to introduce the concept of 'accredited investor' in India, based primarily on net worth criteria coupled with accreditation by an accreditation agency. It is the expectation that accredited investors are those investors, who are considered to be well advised and informed about the subject of investment. Accordingly, various regulatory relaxations have been provided for participation by accredited investors and for large value funds pooling accredited investors.

For certain investor qualifications, please see our answer to 31.

## 30. Does your jurisdiction have a particular form of Alternative Investment Fund be that can be marketed to retail investors (e.g. a Long-Term Investment Fund or Non-UCITS Retail Scheme)?

There is no specific form of an AIF that may be marketed to retail investors, subject to the AIFs not marketing to more than 200 persons in the aggregate in a single financial year.

## 31. What are the minimum investor qualification requirements for an Alternative Investment Fund? Does this vary by asset class (e.g. hedge vs. private equity)?

As a general rule, the AIF Regulations do not contemplate any investor qualification, except for the minimum investment requirement of approximately USD 120,000 (i.e. the USD equivalent of INR 10 million). Two exceptions to this rule are angel fund investors and accredited investors.

Angel fund investors need to fulfil the following conditions prescribed by the AIF Regulations – in case of an individual investor, (i) they should have net tangible assets of a minimum of USD 240,000 (i.e. the USD equivalent of INR 20 million) excluding their principle residence, (ii) they should either have early stage investment experience or experience as a serial entrepreneur or should be a senior management professional with a minimum of ten years of experience; if the angel fund investor is a body corporate it should have a net worth of at least approximately USD 1.20 million (i.e. the USD equivalent of INR 100 million); alternatively, the angel fund investor could be an AIF or a venture capital fund registered under the SEBI (Venture Capital Funds) Regulations, 1996 to qualify as an investor for angel funds.

Finally, as discussed above, SEBI has also introduced an 'accredited investor' regime in India, with accredited investors being exempt from the minimum commitment requirements. Accredited investors are required to be accredited by an accreditation agency and need to fulfil one of the following conditions prescribed by the AIF Regulations – (a) in the case of an individual, Hindu undivided family, family trust or sole proprietorship, (i) annual income of at least approximately USD 240,000 (USD equivalent of INR 20 million) or (ii) net worth of at least approximately USD 895,000 (USD equivalent of INR 75 million) out of which with not less than approximately USD 0.5 million (USD equivalent of INR 37.5 million) is in the form of financial assets; or (iii) annual income of at least approximately USD 120,000 (USD equivalent of INR 10 million) and minimum net worth of at least approximately USD 596,000 (USD equivalent of INR 50 million) out of which not less than approximately USD 299,000 (USD equivalent of INR 25 million) is in the form of financial assets; (b) in the case of a body corporate or trust (other than family trust), net worth of at least approximately USD 5.96 million (USD equivalent of INR 500 million).

In the case of overseas investors, manager's while accepting commitments are also to ensure that certain conditions as mentioned below are met, and in case of the investors already on-boarded who subsequently don't meet such conditions, the manager is prohibited from making any further drawdowns from such investor until the said investor satisfies the following conditions:

(i) Foreign investors of the AIF must be residents of a country whose securities market regulator is a signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding or a signatory to the bilateral Memorandum of Understanding with SEBI, with the exception that such foreign investor is the government or a government related investor resident in a country as may be approved by the government of India in which case the foregoing condition is not applicable;

(ii) The investor, or its underlying investors contributing 10% or more in the corpus of the investor or identified on the basis of control, is not a person mentioned in the sanctions list notified from time to time by the United Nations Security Council and is not a resident in the country identified in the public statement of Financial Action Task Force as:

a. a jurisdiction having a strategic anti-money laundering or combating the financing of terrorism deficiencies to which counter measures apply; or
b. a jurisdiction that has not made sufficient progress in addressing deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address deficiencies.

## 32. Are there additional restrictions on marketing to government entities or similar investors (e.g. sovereign wealth funds) or pension funds or insurance company investors?

While there are no additional restrictions on marketing to these investors under the AIF Regulations, certain investors such as banks, insurance companies and pension funds are subject to the restrictions prescribed by their sectoral regulators with respect to investment in AIFs. For example, banks are not permitted to invest more than 10 per cent of the paid-up capital or unit capital of a Category I or II AIF unless otherwise approved by the Reserve Bank of India (the banking regulator). Further, the threshold for investments in Category I and II AIFs has been capped at 20 per cent of the bank's net worth permitted for direct investments in shares, convertible bonds and debentures, units of equity oriented mutual funds and AIFs. Banks are not allowed to invest in Category III AIFs. Moreover, the Reserve Bank of India has also recently put certain restrictions on banks and non-banking financial companies (including housing finance companies) from making investments in any AIFs which have downstream investments in instruments, other than equity shares, in a debtor company of such banks/ non-banking financial companies (including housing finance companies).

Insurance companies or pension funds are permitted to invest in Category I and II AIFs. However, in the case of Category II AIFs, a minimum of 51 per cent of the funds of these AIFs are required to be invested in the infrastructure entities, SME entities, VCUs or social impact entities. Insurance companies are also subject to certain exposure limits for their investors in all AIFs.

A pension fund can only invest in AIFs whose corpus is approximately USD 12 million (i.e. the USD equivalent of INR 1 billion) or more and have a minimum rating of AA and above, except for government-owned AIFs. The exposure to a single AIF shall not exceed 10 per cent of the AIF size.

Additionally, non-government provident funds, superannuation funds and gratuity funds can invest only up to 5% of their investible surplus in certain category of AIFs.

## 33. Are there any restrictions on the use of intermediaries to assist in the fundraising process?

While there are no legal or regulatory restrictions on the use of intermediaries in the fund-raising process, managers typically ensures that these intermediaries follow the private placement norms while distributing AIFs.

Any intermediaries involved in the distribution of AIFs should however ensure that they are not seen as providing investment advice in respect of the units of the AIFs so as to trigger the registration requirements under the SEBI (Investment Advisers) Regulations, 2013 (**IA Regulations**).

 

With regards to the services of a distributor, SEBI has provided a framework for a direct plan for AIFs and a trail model for distribution commission in AIFs, as per which, AIFs are required to have an option of a direct plan for investors, without routing the investment through any distributor. AIFs are also mandated to ensure that any investor approaching the AIF through a SEBI registered intermediary which is separately charging the investor any fee (for example, an advisory fee or portfolio management fee) is onboarded through the direct plan only.

### 34. Is the use of "side letters" restricted?

Side letters are letter agreements entered between the investment manager and individual investors, to provide such investors with certain rights with respect to commercial terms like that of transfer, co-investment, and so on. Such agreements are also entered into for the grant of rights pertaining to non-commercial terms like confidentiality obligations, inspection rights, reporting obligations and so on. The managers are required to ensure that side letters do not adversely affect the rights of the other investors.

Further certain differential rights on preferential exit from fund, contribution to indemnification, giveback and drawdown may not be possible to be offered to an investor through the side letter given the fiduciary obligations of the managers/sponsors.

### 35. Are there any disclosure requirements with respect to side letters?

Although the terms of the side letter need not be disclosed, AIF managers should disclose the possibility that an AIF may enter into side letters. The criteria for offering differential rights through side letters is also required to be disclosed. This is also a requirement under the SEBI prescribed format of the PPM.

### 36. What are the most common side letter terms? What industry trends have recently developed regarding side letter terms?

The most common side letter terms include terms on transfers, most favoured nation rights, enhanced disclosure and transparency rights, jurisdiction specific representations and warranties including matters on tax, co-investment rights, cash elections, and confidentiality.

As per AIF Regulations, an AIF may excuse its investor from participating if an investor, as part of its contribution agreement or any other agreement signed with the AIF has disclosed to the manager that, participation of the investor in a particular investment opportunity would be in contravention to the internal policy of the investor. Manager shall ensure that terms of such agreement with the investor include reporting of any change in the disclosed internal policy, to the AIF, within 15 days of such change. It is expected that such terms may be provided in side letters.

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