The Regulatory Regime Around Alternative Investment Funds

written by Apoorva Chandra | June 24, 2022

AIF Regulations 2012 Amendment

Securities and Exchange Board of India ("SEBI") recently amended the Alternative Investment Funds ("AIF") rules via notification in the official gazette on April 24th 2022 [1]. The said notification amends the SEBI (Alternative Investment Funds) Regulations, 2012. This move by SEBI is seen as a step towards making India a hub for Indian and foreign investments and the inclusion of private equity in its financial ecosystem.

What are Alternative Investment Funds?

AIFs[2] allow investors to invest in assets other than bonds, stocks, or cash. These are private investment funds, that can be invested in private equity, venture capital, etc. AIF collects the pool of funds from the investors and then invests it in different categories, as mentioned by SEBI.

SEBI also recently cut down the number of categories under AIF from nine to three and applicants who wish to register for AIFs can do so in the categories explained below:

1. Category I AIF: Investors who invest in early start-ups, joint ventures, small and medium enterprises, infrastructure sectors, or any other sectors are considered in Category I. This category is supposed to have a positive impact on the economy. SEBI and the Indian government have allowed for several relaxations/concessions for investments under this category.
2. Category II AIF: This category includes funds such as real estate and private equity funds, that are not included in Category I and III. These funds do not include any borrowing other than those to meet the operational costs. The government does not give any incentive or concession under this category.
3. Category III AIF: Complex and adverse levering in listed or unlisted derivatives fall under this category. This category includes AIFs like hedge funds, open-ended funds, etc. The government or SEBI does not give any concession or incentives under this category either.

AIF Regulations 2012

1. The AIF Regulations mention that every AIF incorporated in India, which collects funds for domestic or foreign investors, must register under SEBI within 6 months.
2. Permissible limits of investments are provided for each category in the regulations. These are as follows:

- Funds can only be raised in units.
- Each scheme must have a minimum corpus of INR 20 crores.
- The minimum investment by an investor must be INR 1 crore. If the investment is by an employee or manager, it must be INR 25 lakhs.
- A scheme must be limited to 1000 investors.
- All the funds have to be collected by way of private placement through the issue of a memorandum.

3. The placement memorandum shall contain all material information about the AIF and the manager. Further, it should include information about targeted investors, fees, expenditure, tenure and scheme of AIF, risk management, investment strategy, etc. All the memorandum must mention the investment strategy, purpose, and methodology used in the investment. The memorandum needs to be filed within 30 days before the scheme's launch to the SEBI [2].
4. All categories of AIF schemes have different tenures. For instance, categories I and II can be close-ended and tenure calculated from the date of application. They can have a minimum tenure of 3 years. The tenure can be extended for up to 2 years after the 2/3rd vote of the unitholders. The tenure of any scheme is calculated from the date of the final closing of the scheme.
5. AIFs can invest in companies incorporated outside India, subject to the guidelines given by SEBI.
6. SEBI has emphasized the importance of disclosure of all the information to the investors. The manager or sponsor must notify the investors about their investment in the investee company.
7. SEBI has also allowed closed-ended AIFs to get listed on a stock exchange after the final closing. However, the listing shall be subject to a minimum tradable lot of INR 1 crore. It is expected that SEBI will provide further information on this front.

More Recent Developments Regarding AIFs

- In December 2021, SEBI introduced a new sub-category under Category I AIFs through an amendment to the existing AIF Regulation Act. The amendment focuses on AIFs that will only invest in 'Special Situation Assets'. These Special Situation Funds or SSFs were introduced in clause (a) of Regulation 3. The SSF includes stressed loans available for acquisition, security receipts issued by an Asset Reconstruction Company registered with RBI and securities of investee companies or as a segment under a resolution plan approved by the Insolvency and Bankruptcy Code, 2016 ("IBC").
- The term, 'resolution applicant' will have the same meaning to it as assigned under the IBC, 2016. These funds can also invest in security receipts issued by Asset Reconstruction Companies (ARCs) or "any other asset/security as may be prescribed by the board from time to time [4]."
- Further, SEBI has amended the ownership regulations regarding the AIFs. The stock exchanges operating under the International Financial Services Center (IFSC) were restricted as only a few members were allowed to hold shares in such stock exchanges like insurance companies, public institutions, etc. This move will allow foreign investors to invest in various new categories of funds, although such investments are capped at 5% for each investor.

AIFS Around the World

AIFs are a common form of investment in developed places like the United States and the European Union (EU). A summary of the regulations around AIF in these places is given below:

- USA: There are restrictions on investing in AIF in the US market. The individual investors must have an income of more than USD 200,000 or USD 300,000 in the last two years and be consistent at that rate. Qualified investors must have a portfolio of USD 5 million.
- EU: The latest AIF regulations of the EU have opened various opportunities for investors. Amendments have been made to the Alternative Investment Fund Managers Directive (AIFMD). The managers and sponsors are subject to sustainable finance disclosures and several amendments have also been made to the environmental and social factors in AIFMD. The EU Commission has set up new investment structures to make it favourable investment location. As per the commission’s latest report for 2020, it is focusing on loan originating funds.

Remarks

Interest in AIFs is said to be on an exponential rise and it is reported that many investors are pivoting sharply towards them instead of more conventional investment products such as mutual funds, direct investments or unit-linked insurance plans. Investments in AIFs are expected to grow by 25% CAGR from 2022 to 2025 in Asian economies, making it a sector to watch.

The rise in popularity is said to be a result of investors seeking less conventional routes to grow their money and the increasing fragmentation of traditional insurance pools. AIFS offer a touch of novelty and innovation to a new class of investors who are seeking a new style of offerings and a different approach to the usual system of managing risks and rewards.

It also appears that the International Financial Services Centre (IFSC) at the Gujarat International Finance Tec-City (GIFT City) is poised to become a thriving ecosystem with more than 20 AIFs registered with the IFSC Authority of India, with proposals from another 30 or so AIFs pending clearance. This, along with more lenient taxation rates by the government, is expected to attract offshore investments from NRIs and foreign investors and build significant financial momentum for the country.

The amendments and developments discussed above ought to encourage investors further in the direction of AIFs and diversify their portfolios while furthering India’s path toward becoming an international financial hub.

- https://taxguru.in/sebi/sebi-alternative-investment-funds-amendment-regulations-2022.html
- Section 2(1)(b) of SEBI (Alternative Investment Funds) Regulations Act, 2012 .
- https://home.kpmg/uk/en/blogs/home/posts/2021/04/alternative-investment-funds-regulation-evolves.html
- https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1188

Contributed by Apoorva Chandra, Partner