
SETTING UP OF AN ALTERNATIVE INVESTMENT FUND IN INDIA

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The Securities and Exchange Board of India (“SEBI”) issued the SEBI (Alternative Investment Fund) Regulations, 2012 (“AIF Regulations”) which repealed the SEBI (Venture Capital Fund) Regulations, 1996 (“VCF Regulations”). By the AIF Regulations, SEBI intends to regulate all privately pooled investment vehicles. The VCF Regulations was the sole regulation that regulated such private pooling vehicles. However, the VCF Regulations did not mandate such vehicles to be registered with SEBI and registration was made optional. This led to several private equity funds being floated, without having to comply with any investment restrictions prescribed under the VCF Regulations. True that registration with SEBI under VCF Regulations came with certain merits, but flexibility in operation of a fund seemed to have an edge and fund houses also choose a less merited unregulated fund over a merited regulated fund.

Further, the intention behind VCF Regulations was to promote investments into start-ups and mid-size companies. However, most VCFs made operated as real estate funds, infrastructure funds, etc. Thus, a need was felt to frame a more exhaustive set of regulations to govern all such kinds of private funds, viz. venture capital funds, real estate funds, social ventures funds, SME funds, etc. and also open up market for more complex structures such as hedge funds. Accordingly, SEBI notified the AIF Regulations to govern unregulated entities and create a level playing ground for existing venture capital investors.

I. Implication of AIF Regulations on venture capital funds

- 1.1 As stated above, the VCF Regulations did not require venture capital funds (“VCF”) to be registered with SEBI. The AIF Regulations required the unregistered VCFs which qualify as an AIF shall register with SEBI under an appropriate category of AIF within 6 months from the date of operation. These funds were permitted to raise capital up to an amount of commitment received by them as on date of registration as AIF.
- 1.2 So far as the registered VCFs are concerned, they shall continue to be regulated by the VCF Regulations until the existing VCF or scheme is wound up. No new scheme shall be launched by the VCFs and no the targeted corpus size shall not be increased.
- 1.3 A VCF is permitted to seek registration as an AIF upon obtention of approval of two-thirds of their investors by value of their investment.

II. What constitutes an AIF

2.1 Definition

Regulation 2(b) of the AIF Regulations defines an AIF as following:

- (a) A fund established in India either as a trust, company, limited liability partnership (“LLP”) or a body corporate;
- (b) A privately pooled investment vehicle that collects money from investors for investment in accordance with a defined investment policy;
- (c) All investments are made for the benefit of the investors;
- (d) The investors may be Indian or foreign (subject to the extant foreign direct investment policy of India);
- (e) A fund which is not covered under the SEBI (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other SEBI regulations to regulate fund management activities
- (f) Does not comprise any of the following:
 - (i) Family trusts;
 - (ii) ESOP trusts;
 - (iii) Employee welfare trusts or gratuity trusts;
 - (iv) Holding companies;
 - (v) other special purpose vehicles not established by fund managers, including securitization trusts, regulated under a specific regulatory framework;
 - (vi) funds managed by securitisation company or reconstruction company which is registered with the Reserve Bank of India; and
 - (vii) any such pool of funds which is directly regulated by any other regulator in India.

2.2 ***Forms in which AIF may be constituted***

The AIF Regulations permit setting up of an AIF either as a trust, a company, an LLP or a body corporate. However, for many reasons, primarily being the operational flexibility, taxation benefits and practically no compliances, trust has been a consistent practice and a unanimous choice in India for establishing an AIF.

A comparative chart, which also forms a basis for selection of a trust structure, is briefly set out below:

Trust	Company	LLP
No ongoing compliance. Governed by provisions of the trust deed.	Several ongoing compliances prescribed under the Companies Act, 1956 (amended by the Companies Bill, 2012), such as regular filings with the Registrar of Companies on change of directors, shareholders, officers, etc.; filing of annual	Though operation of the LLP is governed by provisions of the LLP Deed, the LLP Act, 2008 prescribes ongoing compliances.

Trust	Company	LLP
	returns, governance as per the statute, etc.	
No regulatory compliance for winding up. Simple process governed by trust deed.	Extremely tedious and a long-drawn process.	Simpler as compared to a company, but the rules for winding up a LLP have not been made effective as yet.
No regulation pertaining to distributions to investors, which shall be proportionate to their investments, except as set out in trust deed.	Dividends are the only way for making distribution, which is proportionate to capital.	Not required to make proportional distribution.
Amendment to trust deed can be easily done in the manner set out in the trust deed.	A special resolution is required to amend the articles and memorandum of a company. This is an elaborate process and not easy to take through.	The partners may amend the LLP Deed in accordance with the provisions of the LLP Deed.

2.3 **Registration of an AIF and the Schemes**

An AIF shall be registered with SEBI under the AIF Regulations in one of the categories set out under the AIF Regulations.

- (a) The AIF may launch multiple schemes. No separate registration is needed for each scheme and a scheme can be launched by filing a placement memorandum with SEBI 30 days prior to launch of the Scheme. Appropriate changes in the placement memorandum as required by SEBI shall be made for launch of a scheme.
- (b) The applicable fee payable to SEBI is as follows:
 - (i) Application fee for AIF Registration: Rs. 100,000.
 - (ii) Registration Fee for AIF: Rs. 500,000
 - (iii) Scheme Registration Fee: Rs. 100,000.

III. **Categories of AIF and Compliances**

There are 3 categories of AIF as set out under the AIF Regulations. The requisites of each category, conditions and compliances therein are set out below:

Basis	Category I	Category II	Category III
Meaning and basic features	<ul style="list-style-type: none"> ▪ AIF under Category I are generally perceived as those funds which have a spillover effect on economy. ▪ Invests in (a) start-up; (b) early stage ventures; (c) social ventures; (d) SMEs; (e) infrastructure; or (f) other sectors or areas which the government or regulators consider as socially or economically desirable. ▪ Includes venture capital funds, SME Funds, social venture funds, infrastructure funds and such other AIFs as may be specified. ▪ Angel fund, focusing on investment in start-ups, is being considered by Regulators to be included in Category I. 	<ul style="list-style-type: none"> ▪ Funds which do not fall under Category I and Category III. ▪ Does not undertake leverage or borrowing other than to meet day-to-day operational requirements as permitted under AIF Regulations. ▪ Includes private equity funds or debt funds for which no specific incentives or concessions are given by the government or any other Regulator. ▪ Can undertake hedging. 	<ul style="list-style-type: none"> ▪ A Category III AIF employs diverse or complex trading strategies. ▪ May employ leverage including through investment in listed or unlisted derivatives. ▪ Includes (a) hedge funds; (b) funds which trade with a view to make short term returns; (c) such other funds which are open ended and for which no specific incentives or concessions are given by the government or any other Regulator.
Permissible Investments	<ul style="list-style-type: none"> ▪ May invest in (a) investee companies; (b) venture capital undertaking; (c) special purpose vehicles; (d) limited liability partnerships; or (e) in units of Category I AIF of the same sub-category. ▪ Shall not invest in fund of funds. 	<ul style="list-style-type: none"> ▪ Shall invest primarily in (a) unlisted investee companies; or (b) in units of Category I or Category II AIF. ▪ Shall not invest in fund of funds. 	<ul style="list-style-type: none"> ▪ May invest in (a) securities of listed or unlisted investee companies or derivatives or complex or structured products; or (b) units of Category I or Category II AIF. ▪ Shall not invest in fund of funds.
Minimum Sponsor Continuing	2.5% of the corpus or Rs. 5,00,00,000 (Rupees Five Crore), whichever is lower.		5% of the corpus or Rs. 10,00,00,000 (Rupees Ten Crore), whichever is lower.

Basis	Category I	Category II	Category III
Interest			
Minimum Tenure	Minimum tenure of 3 years.		No minimum tenure prescribed.
Open-ended / close-ended	Shall be close-ended funds.		May be open-ended or close-ended.
Investment limits per Investee Company	Not more than 25% of the corpus in one investee company.		Not more than 10% of the corpus in one investee company.
Leverage	Not to borrow funds directly or indirectly or engage 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 corpus.		May engage in leverage or borrow subject to consent from the investors in the AIF and subject to a maximum limit of 2 times the NAV of the AIF.
Appointment of Custodian	Custodian shall be appointed if the corpus of the AIF is more than 500,00,00,000 (Rupees Five Hundred Crores).		Custodian shall be appointed irrespective of the size of the AIF.
Reporting to Investors	AIF to provide at least on an annual basis, within 180 days from the year end, reports to investors setting out (a) financial information of investee companies; and (b) material risks and how they are managed as required by AIF Regulations.		Quarterly reports, within 60 days of end of the quarter, to be provided to investors in respect of (a) financial information of investee companies; and (b) material risks and how they are managed as required by AIF Regulations.
Reporting to SEBI	Category I and II AIFs shall submit report to SEBI on a quarterly basis.		<ul style="list-style-type: none"> ▪ Category III AIF that do not undertake leverage shall submit report to SEBI on a quarterly basis. ▪ Category III which undertake leverage shall submit report to SEBI on a monthly basis.

Basis	Category I	Category II	Category III
Valuation of investments	Shall undertake valuation of their investments, at least once in every 6 months, by an independent valuer appointed by the AIF. The period may be enhanced to 1 year on approval of at least 75% of the investors by value of their investment in the AIF.		<p>Shall ensure that calculation of the net asset value is independent from the fund management function of the AIF.</p> <p>Such NAV shall be disclosed to the investors at intervals not longer than a quarter for close ended funds and at intervals not longer than a month for open ended funds.</p>
Foreign Investment	<p>Permitted only in a SEBI registered venture capital fund, which is a sub-category of Category I.</p> <p>However, where AIF is set up as a company, FDI rules to apply, and investment through automatic route may be done subject to sector limits.</p> <p>In case of LLP and trust structures, approval from the Foreign Investment Promotion Board will be required.</p>	<p>Not permitted.</p> <p>However, where AIF is set up as a company, FDI rules to apply, and investment through automatic route may be done subject to sector limits.</p>	
Taxation	The AIF Regulations provide a pass-through status to Category I AIF under section 10(23)FB of the Income Tax Act, 1961 (" IT Act "). The IT Act however, as the provision stands today, has not extended any parallel pass-through benefits to Category I AIF, except a venture capital fund which is a sub-category of Category I AIF.	No statutory pass through status. Taxation will depend upon whether the AIF has been set up as a trust, company or LLP.	

IV. Raising capital from investors by AIF

An AIF shall not solicit or collect funds except by way of private placement. As required under the AIF Regulations, a private placement memorandum is issued to the investors, which shall mandatorily contain the following details:

- (a) all material information about the AIF and the fund manager;
- (b) background of key investment team of the fund manager;
- (c) targeted investors;
- (d) fees and all other expenses proposed to be charged;
- (e) tenure of the AIF or scheme;
- (f) conditions or limits on redemption;
- (g) investment strategy;
- (h) risk management tools and parameters employed;
- (i) key service providers;
- (j) conflict of interest and procedures to identify and address them;
- (k) disciplinary history;
- (l) the terms and conditions on which the fund manager offers investment services, its affiliations with other intermediaries;
- (m) manner of winding up of the AIF or the scheme; and
- (n) such other information as may be necessary for the investor to take an informed decision on whether to invest in the AIF.

Typically, a placement memorandum will also contain detailed information on:

- (a) The sector in which the AIF is targeting to invest is also set out in the placement memorandum. For example, where the AIF seeks to make investment in infrastructure sector, a background of the infrastructure sector – scope, investment opportunity, past performance, shortcomings, legal and regulatory restrictions, etc. – is also set out for the investors to understand the nature of investments the AIF will make.
- (b) A brief of the key terms on which the investors would invest into the AIF. This helps the investors to review the key terms before proceeding with detailed documentations.
- (c) Legal, regulatory and tax provisions applicable to the AIF as well as the investors, to help them understand the implications of making an investment into the AIF. However, needless to say, an investor shall seek independent legal and tax advice as well.

V. Winding up an AIF

5.1 *When can AIF be wound up?*

An AIF may be wound up:

Where set up as a trust	Where set up as a company	Where set up as an LLP
If the trustee is of the opinion that the AIF be wound up in the interests of investors in	May be wound up in accordance with the provisions of the Companies	May be wound up in accordance with the Limited Liability Partnership Act,

Where set up as a trust	Where set up as a company	Where set up as an LLP
the units. OR	Act, 1956.	2008. AND
Upon completion of the tenure of the AIF or all schemes launched by the AIF. OR		Upon completion of the tenure of the AIF or all schemes launched by the AIF. OR
If 75% of the investors by value of their investment in the AIF pass a resolution at a meeting of unitholders that the AIF be wound up. OR		If 75% of the investors by value of their investment in the AIF pass a resolution at a meeting of unitholders that the AIF be wound up. OR
Where directed by SEBI in the interests of investors.		Where directed by SEBI in the interests of investors.

The AIF shall intimate SEBI and the investors when the AIF is to be wound up and the circumstances, being any of the aforesaid as may be applicable, leading to winding up of the AIF.

5.2 ***Cessation of Investments by AIF upon winding up***

No further investments shall be made by the AIF on and from the date of intimation of winding up.

5.3 ***Distribution to investors upon winding up***

- (a) The assets of the AIF shall be liquidated and distributions of the proceeds thereof shall be distributed to the investors, after satisfying all liabilities, within 1 year from the date of intimation of winding up to SEBI and the investors.
- (b) Any in-specie distribution of assets of the AIF shall be made as per the preference of investors, after obtaining approval of at least 75% of the investors by value of their investment in the AIF. This shall be applicable to any distribution being made by the AIF, whether or not made at the time of winding up.

VI. **Other salient features of an AIF**

6.1 ***Change in category of AIF***

An AIF registered in any particular category can change its category of registration subject to the following:

- (a) The AIF shall not have made any investments under the category in which they were registered earlier. Where any investment has been made, change of category will not be permitted.
- (b) Until the approval for change in category has been obtained from SEBI, the AIF shall not make any investments other than in liquid funds/ banks deposits.

- (c) If the AIF has received commitments/ raised funds prior to application for change in category, the AIF shall send letters/emails to all its investors providing them with an option to withdraw their commitments/ funds raised without any penalties/charges. Any fees collected from investors seeking to withdraw commitments/ funds shall be returned to them. Partial withdrawal may be allowed subject to compliance with the minimum investment amount required under the AIF Regulations.

The applicable fee for making an application for change of category is Rs. 1,00,000 (Rupees One Lakh) and no separate registration charges shall be applicable. Along with the application, the rationale for the proposed change shall be explained.

6.2 Key Management Team

The fund manager shall constitute a key investment team that has adequate experience in managing a fund. This team shall comprise at least 1 key personnel having not less than 5 years experience in advising or managing pools of capital or in fund or asset or wealth or portfolio management or in the business of buying, selling and dealing of securities or other financial assets and has relevant professional qualification.

6.3 Alteration in fund strategy

Any material alteration to the fund strategy shall be made with the consent of at least two-thirds of unit holders by value of their investment in the AIF.

6.4 Fund raising

- (a) An AIF may raise funds from any Indian as well as a foreign investor, subject to the extant regulations governing foreign direct investments.
- (b) Each scheme of the AIF shall have corpus of at least 20,00,00,000 (Rupees Twenty Crore).
- (c) An AIF shall have maximum 1,000 investors per scheme.
- (d) An investment of a minimum of Rs. 1,00,00,000 (Rupees One Crore) from shall be obtained from each investor by an AIF. Where the investors are employees or directors of the AIF or of the fund manager, minimum investment of Rs. 25,00,000 (Rupees Twenty Five Lakhs) shall be obtained.

6.5 Listing of Units of AIF

Units of a close-ended AIF (i.e. units of Category I, Category II and close-ended Category III AIFs) may be listed on stock exchange subject to a minimum tradable lot of Rs. 1,00,00,000 (Rupees One Crore). However, units are permitted to be listed only after final close of the AIF or scheme, as the case may be.

6.6 Investment by Sponsor / Fund Manager

Co-investment in an investee company by a fund manager or sponsor shall not be on terms more favourable than those offered to the AIF.

6.7 *Investment by AIF*

- (a) An AIF shall not invest in associates¹ except with the approval of 75% of investors by value of their investment in the AIF.
- (b) Un-invested portion of the fund corpus may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality such as treasury bills, CBLOs, commercial papers, certificates of deposits, etc. till deployment of funds as per the investment objective.

6.8 *Fiduciary duty of Sponsor / Fund Manager and management of Conflict of Interest*

- (a) The Sponsor and fund manager of the AIF shall act in a fiduciary capacity towards its investors and shall disclose to the investors, all conflicts of interests as and when they arise or seem likely to arise. They shall abide by high level principles on avoidance of conflicts of interest with associated persons, as may be specified by SEBI from time to time.
- (b) The fund manager shall establish and implement written policies and procedures to identify, monitor and appropriately mitigate conflicts of interest throughout the scope of business.

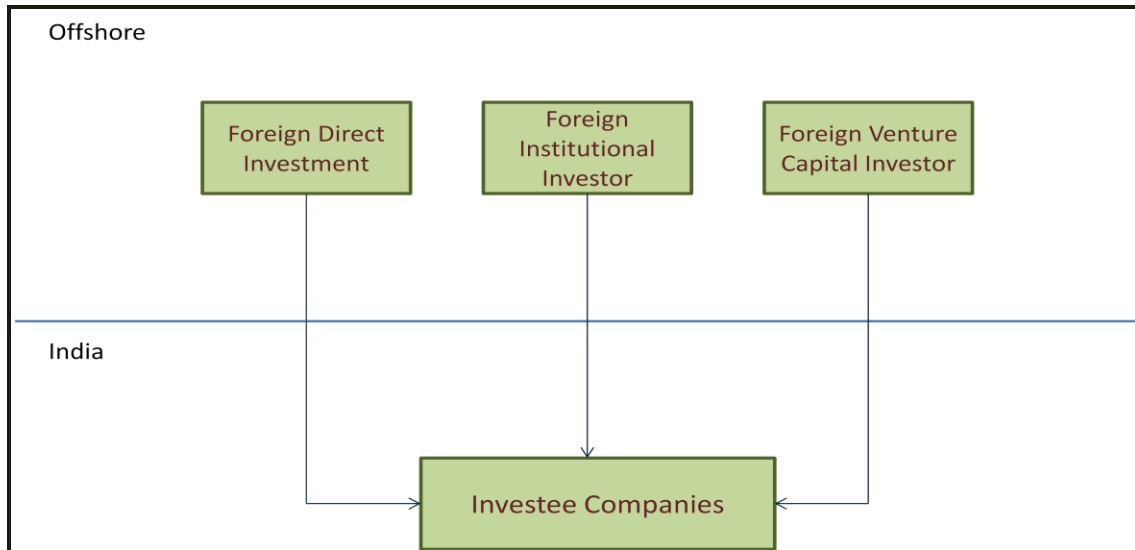
VII. Foreign investment in AIF

Investments may be made in an AIF in accordance with the extant Foreign Direct Investment (“FDI”) Policy issued by the Department of Industrial Policy & Promotion (“DIPP”) from time to time.

As can be seen from the diagram below, investments in India may be made in India by either of the following ways (a) through FDI route (automatic route or government route)²; (b) as a foreign institutional investor (“FII”); or (c) as a foreign venture capital investor (“FVCI”).

¹ An associate is defined under the AIF Regulations to mean a company or a LLP or a body corporate in which a director or trustee or partner or sponsor or fund manager of the AIF or a director or partner of the fund manager or sponsor holds, either individually or collectively, more than 15% of its paid-up equity share capital or partnership interest, as the case may be.

² Where no approval from FIPB is required to be obtained, it is said to be automatic route, else it is referred to as government route.



For making investments in an AIF, any of the aforesaid 3 routes may be selected, subject to the nature of the AIF and extant Regulations. For example, where a venture capital fund is set up as a trust, investment may be brought in through a FVCI under automatic route rather than FDI route which would require FIPB approval, and so on.

As the position stands today:

- (a) FVCIs are allowed to invest in VCFs. It may be noted that even after the VCF Regulations have been repealed by the AIF Regulations, the current FDI Policy limits the definition of a VCFs as those registered under the VCF Regulations. No FDI has been expressly permitted to any category of AIF.
- (b) If a VCF is set up as a trust, then a person resident outside India (non-resident entity/individual including an NRI) can invest in such domestic VCF subject to approval of the FIPB.
- (c) If a VCF is set-up as a company, then a non-resident can invest in such VCF under the automatic route of FDI Scheme, subject to the pricing guidelines, reporting requirements, mode of payment, minimum capitalization norms, etc.
- (d) Though no provision in the FDI Policy sets out investment conditions where VCF is set up as a LLP, however, general provision for FDI in LLP states that FDI in LLP will be allowed through the government approval route, only in LLPs operating in sectors/activities where 100% FDI is allowed, through the automatic route and there are no FDI-linked performance conditions.

VIII. Conclusion

Even though SEBI has notified the AIF Regulations as a fresh set of regulations to govern and monitor private funds, a lot needs to be done by other government departments, such as the

DIPP, FIPB and the Finance Ministry, to align the provisions and intent of the AIF Regulations with other provisions of law.

It is expected that FDI will be permitted in Category I and Category II AIFs and clarity on taxation of these categories will also be provided.

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