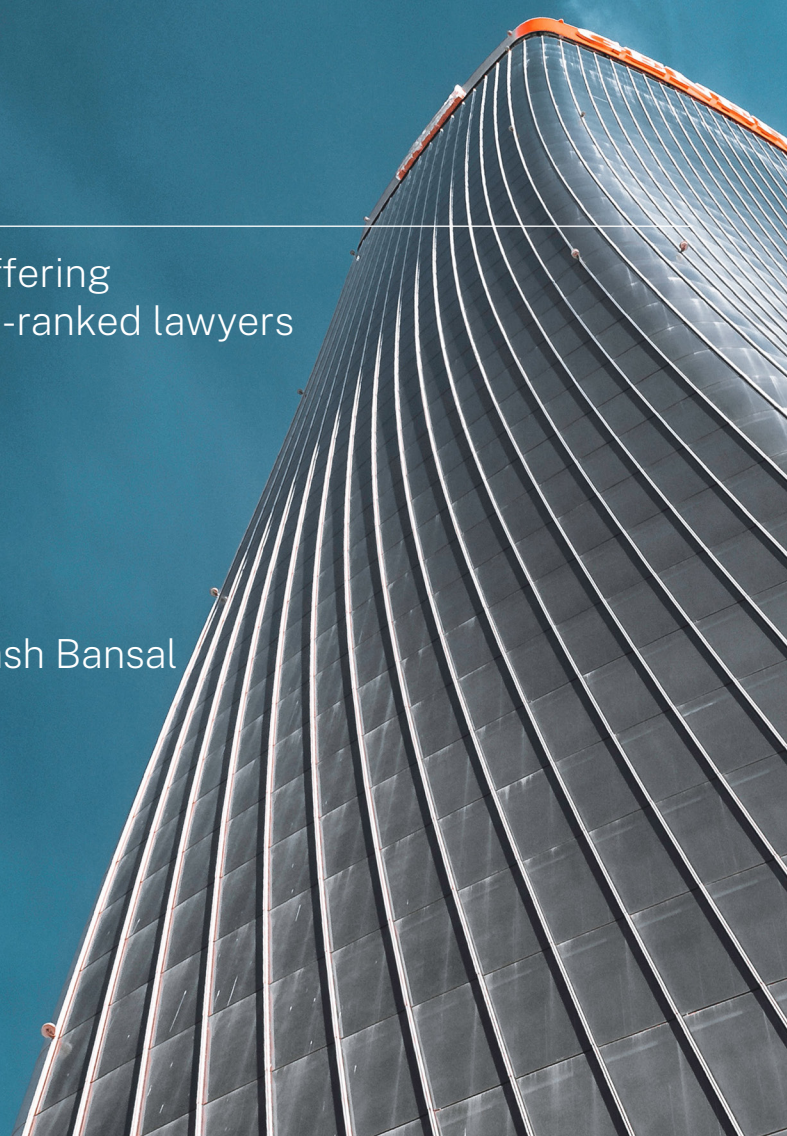

CHAMBERS GLOBAL PRACTICE GUIDES

Alternative Funds 2023

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**India: Law & Practice
and Trends & Developments**

Ganesh Rao, Aditya Jha and Yash Bansal
Trilegal



INDIA

Law and Practice

Contributed by:

Ganesh Rao, Aditya Jha and Yash Bansal
Trilegal



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The firm would like to thank Tahhira Somal, an associate at Trilegal, for her contribution to this chapter.

Authors



Ganesh Rao is a partner at Trilegal, specialising in asset management and funds. In addition to his core practice advising general partners, he regularly acts as counsel to

limited partners (including development financial institutions, pension funds, corporations and family offices) on their investments in private funds and other investment programmes. In just three years at Trilegal, he has built up a niche market-leading asset management and funds practice, putting together a team of two fellow partners, and over 20 lawyers. Ganesh and his team at this dedicated asset management and funds practice, the largest in India, have advised on over USD20 billion worth of commitments (either as GP or LP counsels) to funds investing in and around India. Additionally, Ganesh and his team advise a number of clients on special situations relating to funds, including on fund disputes, end of life situations, fund secondaries, key person events, LPAC special counsel and manager removals. He was previously a partner at Cyril Amarchand Mangaldas and AZB & Partners.



Aditya Jha is a partner at Trilegal, specialising in asset management and funds. Aditya has an impeccable track record of advising fund sponsors as well as investors. He advises a

wide range of fund sponsors across sectors and strategies. His investor representation includes extensively advising development financial institutions, family businesses and fund of funds. His practice expertise includes financial services, financial regulatory and securities laws, and inbound/outbound investment structures and strategies. He previously practised at Legacy SJ Berwin (London office) and Cyril Amarchand Mangaldas, and was a partner at AZB & Partners.



Yash Bansal is a partner at Trilegal where he specialises in asset management and funds. Yash's expertise, aside from investment funds, includes advising on securities laws and exchange control laws. In addition to advising GPs on structuring and formation of investment funds and other asset management platforms, he has represented institutional limited partners, development financial institutions, fund of funds and family offices on their commitments to investment funds in India as well as offshore. Yash regularly advises clients on in-bound and out-bound investment structuring. Yash previously practised at Cyril Amarchand Mangaldas and AZB & Partners, and served as a partner at IC Universal Legal.

Trilegal

One World Centre
10th Floor, Tower 2A and 2B
Senapati Bapat Marg
Lower Parel (West)
Mumbai 400 013
India

Tel: +91 22 4079 1000
Fax: +91 22 4079 1000
Email: ganesh.rao@trilegal.com
Web: www.trilegal.com



1. General

1.1 General Overview of Jurisdiction

Over the last few years, alternative investment has grown to be an attractive source of funding for Indian businesses. The increasing flow of alternative funds feeds start-ups, private companies, entrepreneurs and others, who may not always qualify for traditional capital sourcing. Whereas traditional sources of finance, such as banks, have a limited risk appetite, alternative investment provides enterprises with stable, long-term “patient” capital.

While India previously regulated venture capital funds (VCFs), it has now cast a much broader net seeking to cover other types of alternative funds, including private equity, infrastructure, debt, social venture and hedge funds. Alternative investment funds (AIFs) in India are governed by the Indian securities regulator, the Securities and Exchange Board of India (SEBI), under the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations).

AIF Regulations

In brief, the AIF Regulations define an AIF as a privately pooled investment vehicle set up in India, which raises funds from investors and invests in accordance with a defined investment policy for the benefit of its investors. The AIF Regulations mandate that an AIF should have a sponsor and a manager, although the manager of an AIF may also act as the sponsor. The AIF Regulations also mandate that the manager or sponsor of the AIF should make a sponsor investment, ie, have “skin in the game” (which cannot be set off against the management fee).

The AIF Regulations exclude funds regulated under the SEBI (Collective Investment Schemes) Regulations, 1999; the SEBI (Mutual Funds) Reg-

ulations, 1996; and any other regulations issued by Indian regulators that regulate activities to do with pooling of capital or fund management.

The scope of AIFs, under the AIF Regulations, excludes:

- holding companies;
- family trusts;
- employee welfare/gratuity trusts;
- special purpose vehicles (SPVs) that have not been established by fund managers;
- funds managed by securitisation or reconstruction companies;
- any such pool of funds which is directly regulated by any other regulator in India; and
- ESOP trusts.

While investors in an AIF could be domestic or foreign, each investor is required to commit (ie, undertake to contribute to the fund by way of a legally binding document) a minimum amount of capital, and an AIF is required to raise a minimum amount of commitment from its investors prior to commencing operations (for further details, see **2.3 Regulatory Regime for Funds**).

As per the data available from SEBI on 30 June 2023, in the eleven years since the promulgation of the AIF Regulations, AIFs in India have raised commitments worth approximately INR8,44,926.48 crore, of which, approximately INR3,50,306.17 crore has been invested. AIF commitments have seen a 42% rise between March 2021 and March 2022 as per the CRISIL Report dated 9 June 2022. With the growing appetite of sophisticated investors in India, these numbers are only expected to increase.

2. Funds

2.1 Types of Alternative Funds

AIFs can either be structured as single-scheme vehicles or have multiple schemes running under a single AIF license. In the case of multiple-scheme AIFs, most conditions of the AIF Regulations are applied at scheme level.

Further, AIFs have been classified under four categories with the intention of distinguishing the investment criteria and providing a framework for regulatory concessions under other laws, depending on the category.

After registration of an AIF, a change in category is only permitted with approval of SEBI, if an AIF has not made any investments and if the AIF has accepted commitments it will permit investors to withdraw with a fee refund, if applicable.

The following are the four categories of AIFs. Most AIFs are registered under Category II, which is the residual category, as greater flexibility is provided to the manager to formulate the investment objectives and strategy of the AIF. However, Category II AIFs are required to primarily invest in unlisted companies.

Category I AIFs

This category includes funds which invest in start-ups, early-stage ventures, social ventures, small and medium enterprises (SMEs), infrastructure or other sectors which the government or regulators consider socially or economically desirable. Sub-categories include VCFs (including angel funds), SME funds, social impact funds, special situation funds, and infrastructure funds. This sub-category faces stricter regulations, but also, arguably, enjoy certain benefits. These AIFs are closed-end and have a minimum tenure of three years.

Category II AIFs

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 to meet their day-to-day operational requirements. Hence, Category II is the residual category of AIFs (see Category III AIFs, below).

Private equity funds (ie, funds investing primarily in equity or equity-linked instruments or partnership interests) and debt funds (ie, funds investing primarily in debt securities) for which, typically, no specific incentives or concessions are given by the government/any regulator, fall in this category. Similar to Category I AIFs, Category II AIFs are also closed-end and have a minimum tenure of three years.

Category III AIFs

This category includes funds which employ diverse or complex trading strategies and may employ leverage. Hedge funds, funds which trade with a view to making short-term returns, and other funds which are open-end and for which no specific incentives or concessions are given by the government or any other regulator, fall in this category. This category is perceived to be for high-risk, high-reward investments. AIFs seeking to invest primarily in listed markets are also bundled in this category, even if their strategy is long hold. Category III AIFs can be open-end or closed-end and have no minimum tenure.

Corporate Debt Market Development Fund

This is a newly introduced category of an AIF which aims to resolve and support financial concerns of the corporate debt market in India. “Corporate Debt Market Development Fund” (CDMDFs) are required to, during periods of market dislocation, purchase corporate debt securities from specified debt-oriented schemes of mutual funds which meet the prescribed eli-

gibility criteria. Other than market dislocation periods, CDMDFs are required to invest in liquid and low-risk debt instruments and undertake any other activity related to the corporate debt market as may be specified by SEBI. These are closed-ended AIFs and have a tenure of fifteen years from the date of its first closing. CDMDFs offer units only to asset management companies and specified debt-oriented schemes of mutual funds, and therefore, not to typical investors of AIFs.

Accredited Investor Regime

SEBI introduced an “Accredited Investor” (see **4.1 Types of Investors in Alternative Funds**) regime and correspondingly a construct of “Large Value Fund for Accredited Investors” or “LVF for Accredited Investors” (with each such AIF still falling within Category I, Category II and Category III AIFs described above). An LVF for Accredited Investors may be formed subject to the condition that each of its investors (except the manager, sponsor, employees/directors of the AIF, and employees/directors of the manager) are accredited investors and each of them commits a minimum of INR700 million. An LVF for Accredited Investors enjoys certain regulatory relaxations, with key relaxations being described in **2.3 Funds: Regulatory Regime for Funds**.

2.2 Fund Structures

The AIF Regulations permit an AIF to be set up as a trust, a company or a limited liability partnership (LLP) in India. Out of these three structures, there is stark preference among Indian managers to structure AIFs as trusts. As of 20 July 2023, of the 1148 AIFs registered with SEBI, only 31 were formed as LLPs and three as a company, with the remainder being registered as trusts.

The clear preference for trusts as a viable AIF structure stems primarily from the reasons listed below:

- **Structural flexibility** – the parties involved enjoy discretion to contractually decide the finer details of the AIF. While the Indian Trusts Act, 1882 does place certain obligations on parties operating under a trust structure, parties mostly have a free hand to contractually design the structure of the AIF (far more than they would have with a company or an LLP).
- **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** – investor details are not readily available in the public domain, which is not the case with other structures. Indian trust law permits parties to maintain confidentiality, which is very useful when it pertains to the sensitive information of an AIF and its investors. While the instrument of trust, ie, a trust deed or an indenture, must be registered with the local government authority, the substantive terms of investment are usually captured in:
 - (a) the contribution/subscription agreement entered into by and among the investment manager, trustee and each investor; and
 - (b) the investment management agreement entered into between the investment manager and the trustee.

Such contribution agreement and investment management agreement are not required to be made public.

It is important to note that under Indian law, a trust does not have a separate legal personality. The legal ownership of the trust lies with the trustee(s), and the investors are beneficiaries who have a beneficial interest in the trust.

Key Parties

An AIF formed as a trust requires a trustee. Typically, third-party professional trusteeship service providers are appointed as the trustees of AIFs. An AIF formed as a trust also requires a “settlor” to settle the trust. This can be the investment manager/sponsor or any Indian-resident individual. Generally, there are no ongoing liabilities on a settlor.

Governing Documents

AIFs in India require the following documents:

Constitutional documents

A trust deed is required for the settlement of the AIF as a trust (and for related matters, such as appointment of the trustee and granting the trust requisite powers). In the case of an LLP, the constitutional document is an LLP agreement, and in the case of a company it is the memorandum of association, articles of association and any shareholders’ agreement. Constitutional documents are required to be filed with SEBI.

Marketing documents

SEBI requires an AIF to raise funds through a private placement memorandum/offering memorandum (privately placed) or PPM. This is required to be filed with SEBI. Schemes of an AIF are also required to file a PPM each in order to raise funds. PPMs of an AIF (including each scheme) are required to be filed with SEBI through a SEBI-registered merchant banker. However, LVFs for Accredited Investors, subject to certain conditions, have been exempted from the above requirements.

An AIF can raise funds only by way of issuing a PPM to the investors on a private- placement basis, ie, “units” of an AIF cannot be issued to the public at large. “Units” are the beneficial interest of the investor in the AIF/scheme of AIF and may be either fully or partly paid up. A PPM must disclose to the investors all the material information necessary for the investors to take an informed decision on their investment in the AIF. This would include information such as:

- the investment mandate of the AIF;
- tenure of the AIF;
- risk management tools and parameters employed by the AIF;
- fees and expenses;
- key service providers such as the manager/sponsor and key investment team;
- the process of distribution of the investment proceeds to the investors;
- the process of liquidation of the AIF;
- disciplinary history; and
- jurisdiction-specific legal and regulatory requirements.

See **2.4 Disclosure/Reporting Requirements**, for a discussion on the standard form for a PPM prescribed by SEBI.

Other agreements

An investment management agreement between the trustee/LLP/company and the investment manager governs delegation terms by the former to the investment manager for the management and administration of the AIF.

In the case of an AIF formed as a trust, a contribution/subscription agreement between each investor, the trustee (on behalf of the AIF) and the investment manager usually provide the substantive terms of the AIF. In the case of an LLP, this is drafted as an LLP agreement, and in the

case of a company, as a shareholders' agreement (and a subscription agreement).

2.3 Regulatory Regime for Funds

The AIF Regulations permit domestic and foreign investors to invest in AIFs by way of subscription to units of the AIF. An AIF cannot have more than 1,000 investors, and in the case of an angel fund, no more than 200 investors. Notably, no regulatory or government approvals are required for foreign investors to invest in AIFs.

The total commitment of all the investors in an AIF is termed its "corpus". The AIF's "investable funds", ie, funds which it could invest into portfolio entities, are arrived at after subtracting the estimated fund expenses for administration and management from the corpus estimated for the tenure of the fund. The "tenure" of the fund means the duration of the fund, ie, the period between the day of its launch and its last day. Each scheme of an AIF must have a minimum corpus of INR200 million (with angel funds being allowed to have a minimum corpus of INR50 million). Uninvested portions of investable funds and divestment proceeds pending distribution to investors may be invested in specified temporary investments until utilisation or distribution, in accordance with the AIF's fund documents.

An investor, other than an accredited investor, must commit a minimum of INR10 million to an AIF, as per the AIF Regulations. This limit has been reduced to INR2.5 million for employees/directors of the AIF or the investment manager, and for investors investing in angel funds. However, if the units of AIF are issued to the employees of the manager of the AIF for the purposes of profit-sharing then the minimum investment of INR2.5 million will also not be required. There are also relaxations that may be availed with regards

to the minimum commitment accepted by social impact funds and special situation funds.

The manager/sponsor is mandated to invest to provide some "skin in the game". For Category I and II AIFs, this is set at the lesser of INR50 million or 2.5% of the corpus of the AIF, and for Category III AIFs, this is set at the lesser of INR100 million or 5% of the corpus of the AIF. This is a continuing interest in the AIF and cannot be set off against management fees.

Key Diversification/Investment Limits

Category I and II AIFs cannot invest more than 25%, and Category III AIFs cannot invest more than 10%, of their investable funds in a single portfolio entity.

Importantly, AIFs are required to adhere to the aforesaid investment diversification limit at all times, ie, at the time of each investment. However, by way of exception to the above-mentioned limits, a Category I and II LVF for Accredited Investors may invest up to 50%, and a Category III LVF for Accredited Investors may invest up to 20%, of its investable funds in a single portfolio entity. Furthermore, SEBI has allowed Category III AIFs to calculate their 10% or 20% investment concentration limit in one investee company either on their investable funds or the net asset value if such AIFs are investing in listed equity; provided that one of the two options is chosen by such AIF at the time of its establishment and the option will remain the same throughout the term of such AIF. Furthermore, the aforesaid diversification conditions do not apply to an AIF established in GIFT City.

Category I and II AIFs are required to invest primarily in unlisted portfolio entities. "Primarily", in this context, means that the majority of the investments of a Category I or II AIF must be in

unlisted securities. Subcategories of Category I AIFs also have to comply with certain further investment restrictions.

Category I AIFs registered as VCFs must invest at least 75% of their investable funds in unlisted equity shares/equity-linked instruments of a venture capital undertaking; or companies listed/proposed to be listed on an SME exchange/SME segment of an exchange. For this purpose, a venture capital undertaking is defined as a domestic company, which is not listed on a recognised Indian stock exchange at the time of making the investment.

Category I AIFs registered as SME funds must invest at least 75% of their investable funds in unlisted securities/partnership interests of venture capital undertakings or investee companies, which are SMEs/companies listed or proposed to be listed on an SME exchange or the SME segment of an exchange or in the units of a Category II AIF that primarily invests in such venture capital undertakings or investee companies.

Category I AIFs registered as social impact funds must invest at least 75% of their investable funds in unlisted securities/partnership interests of social ventures or in units of social ventures or in securities of social enterprises. Social impact funds may accept grants of a minimum of INR 1 million for the same, provided that such minimum amount requirements do not apply to accredited investors.

Category I AIFs registered as infrastructure funds must invest at least 75% of their investable funds in unlisted securities/partnership interests of venture capital undertakings or investee companies, or SPVs, that are engaged in/formed for the purpose of operating, developing or holding infrastructure projects or in the

units of a Category II AIF that primarily invests in such venture capital undertakings or investee companies or SPVs.

Category III AIFs may invest in securities of listed or unlisted investee companies, derivatives, units of other AIFs or complex/structured products.

Category I AIFs are permitted to invest in the units of Category I AIFs of the same subcategory and Category II AIFs; Category II AIFs are permitted to invest in Category I and Category II AIFs; and Category III AIFs are permitted to invest in the units of other AIFs. However, in each case, an AIF cannot invest in the units of a fund of funds.

Without approval of 75% of investors by value in the AIF, an AIF may not:

- invest in associates; or
- invest in units of AIFs managed or sponsored by its manager, sponsor or associates of its manager or sponsor; or
- buy or sell investments to (a) associates, (b) schemes of AIFs managed or sponsored by its manager, sponsor or associates of its manager or sponsor, or (c) an investor who has committed to invest at least 50% of the corpus of the scheme of the AIF.

Overseas investments

There are certain restrictions on AIFs making overseas investments. In addition to prior approval from SEBI, the aggregate overseas investments of an AIF are limited to 25% of its investable funds. Overseas investments are also subject to the overall industry limits, jointly administered by SEBI and the Reserve Bank of India (RBI) which is currently at USD1.5 billion.

According to the recent circular issued on 17 August 2022, the requirement of the overseas investee company to have an Indian connection has been done away with and an AIF which is applying to SEBI is not required to demonstrate that its overseas investment has an Indian connection. Furthermore, investment by AIFs/VCFs have now been limited to:

- an investee company that is incorporated in a country where the securities market regulator is a signatory to the International Organisation of Securities Commission's Multilateral Memorandum of Understanding (IOSCO MMoU); or
- a signatory to the bilateral Memorandum of Understanding with SEBI (SEBI MoU).

Additionally, an AIF/VCF is prohibited from investing in an overseas investee company which is incorporated in a country that has been identified by the Financial Action Task Force.

Stewardship Responsibilities

SEBI has also prescribed "stewardship responsibilities" for AIFs – to protect client wealth and to ensure greater responsibility towards clients by enhancing the monitoring of, and engagement with, their investee companies. To this effect, SEBI released a Stewardship Code that came into effect from 1 April 2020 – all categories of AIFs are required to follow the Stewardship Code in relation to their investments in listed equity investments. A similar stewardship code applies to mutual funds in the country.

Under the Stewardship Code, AIFs must engage with investee companies through discussions with management, or voting in shareholder/board meetings, on matters such as corporate governance, strategy, performance, and material

environmental, social and governance opportunities, etc.

The move towards such stewardship responsibilities and bench-marking activities (see **2.11 Rules Concerning Other Service Providers**) reflects SEBI's prioritisation of data collection, investor protection and transparency in the AIF industry.

Stamp Duty

As of June 2020, the collection of a nominal stamp duty (ie, a type of document tax) on the issue, sale and transfer of units of AIFs was also mandated. Issuance of AIF units would attract stamp duty of 0.005% of the market value of such units. Any transfer of AIF units would attract a stamp duty of 0.015% of the consideration amount.

Other Factors

AIFs also serve as an attractive mode of investment because there are no restrictions on the repatriation of cash to investors (including off-shore investors).

General Obligations

AIFs and their personnel have, furthermore, to abide by certain general obligations as provided under the AIF Regulations.

- The AIF, its manager and key managerial personnel, trustee, trustee company, directors of the trustee company, and designated partners/directors must abide by and ensure that the AIF abides by the Code of Conduct (see **3.3 Regulatory Regime for Managers**).
- An AIF must have detailed and approved policies and procedures to ensure that all decisions of the AIF are in compliance with its PPM, other fund documents and laws/regulations, and the manager must ensure

compliance with the decisions of the AIF in respect thereof. These policies/procedures and their implementation must be reviewed by the manager on a regular basis or upon business developments to ensure continued appropriateness.

- The manager may constitute an investment committee for the purpose of approving the decisions of the AIF, subject to the conditions laid down by SEBI from time to time. The members of the investment committee must ensure that its decisions comply with the policies and procedures approved by the manager and trustee in respect thereto, except where each investor of the AIF has invested no less than INR700 million in the AIF and has furnished a waiver of this compliance. The members of the investment committee must also comply with the Code of Conduct (see **3.3 Regulatory Regime for Managers**). Any external members of the investment committee, whose names have not been disclosed in the fund documents during the on-boarding of investors, may only be admitted to the investment committee with the consent of 75% of the investors by value.
- The sponsor/manager must appoint a custodian for the AIF (see **2.11 Rules Concerning Other Service Providers**).
- The book of accounts of the AIF must be audited annually by a qualified auditor (see **2.11 Rules Concerning Other Service Providers**).
- The manager must not provide advisory services to any investor other than the clients of the co-investment portfolio manager, for the purpose of investments in securities of investee companies where the AIF which is managed by it, makes an investment. A co-investment portfolio manager is a portfolio manager who is a manager of a Category I or Category II AIF, or both, and provides services only to

investors of such AIFs. Co-investment portfolio managers have been introduced to facilitate a co-investment framework in respect of AIFs and are granted certain relaxations in terms of compliances or prerequisites of a portfolio manager under the SEBI (Portfolio Managers) Regulations, 2020.

- The manager is required to appoint a compliance officer who shall be responsible for monitoring compliance with applicable laws.
- The manager shall ensure that the AIF appoints an independent valuer who satisfies the criteria specified by SEBI. The manager and the key management personnel of the manager shall ensure that the independent valuer computes and carries out valuation of the investments of the scheme of the AIF in the manner specified by SEBI (see **2.11 Rules Concerning Other Service Providers**).

2.4 Disclosure/Reporting Requirements

AIFs are required to provide SEBI with regular reports on their activities as an AIF. Category I and II AIFs are required to submit such reports on a quarterly basis in the format specified by SEBI, and Category III AIFs that undertake leverage are required to submit reports on a quarterly basis in a separate format.

Category I and II AIFs are required to provide annual reports to investors containing financial information about their investee companies and material risks to their investors within 180 days from the end of the relevant year. Category III AIFs are required to provide these reports to investors on a quarterly basis within 60 days of the end of the quarter. Additionally, AIFs, irrespective of category, are required to disclose certain information to their investors from a corporate governance and transparency standpoint, including conflicts of interest, risk management,

disciplinary history, valuations, and any significant change in the key investment team.

In case an AIF makes an overseas investment, AIFs are required to follow certain prescribed reporting requirements. For instance, the AIF is mandated to report its utilisation of the overseas limits within five working days of such utilisation to SEBI. Sale/divestment details are also required to be detailed in a format prescribed by SEBI within three working days of such divestment.

Notably, the manager of an AIF is required to prepare a compliance test report (CTR) (in compliance with the AIF Regulations) in a prescribed format and submit it to the trustee and/ or sponsor of the AIF within 30 days of the end of every financial year. Any violation detected is to be reported to SEBI by the trustee/sponsor as soon as possible.

To ensure that a minimum standard of disclosure is made to the investors, SEBI has mandated a standard form of the PPM for Category I and II AIFs and separately for Category III AIFs, which provides a certain minimum level of information. An AIF is exempt from following the SEBI format for its PPM only if:

- it is an angel fund; or
- each investor of the AIF commits a minimum capital contribution of INR700 million (USD10 million or an equivalent amount if capital commitments are made in non-INR currency) and provides a waiver, in a prescribed format, that the AIF is not required to provide a SEBI-format PPM.

Further, AIFs participating in credit default swaps (CDS) are to report CDS transactions to the

appointed custodian within the prescribed time frame.

Reports and documents in relation to an AIF are not made publicly available.

2.5 Tax Regime for Funds

Indian income tax laws accord “tax pass-through” status to SEBI-regulated Category I and II AIFs established or incorporated in India. Category III AIFs are not accorded such benefits; however, Category III AIFs set up as trusts may potentially follow the general principles of trust taxation and other provisions of Indian tax laws to achieve tax transparency.

The statutory “tax pass-through” status (for Category I and II AIFs) has been granted in respect of all income (other than income chargeable under the heading “profits and gains of business or profession” earned by such an AIF). If income earned by an AIF is not characterised as business income, it is taxable in the hands of the investors of that AIF, in the same manner as if it were the income accruing to, or received by, such investors had they invested the money themselves. The income received by such AIFs is deemed to be of the same type and in the same proportion as if it had been received by investors.

If the income of the AIF is characterised as “business income” received by or accruing or arising to the AIF, such income is taxable at the maximum marginal rate applicable to the AIF.

2.6 Loan Origination

AIFs cannot grant loans; however, they can subscribe to debt instruments such as non-convertible debentures and/or optionally convertible debentures.

Furthermore, Category I and II AIFs are also limited in their power to raise loans. Category I and II AIFs cannot leverage or borrow, except to meet day-to-day needs for a period no longer than 30 days, for not more than 10% of their investable funds (see **2.3 Regulatory Regime**) and not more than four times a year.

Category III AIFs, however, can leverage and borrow. Such leverage and borrowing can be undertaken with the consent of the investors and is also subject to a maximum cap as may be prescribed by SEBI, provided that such AIFs disclose information regarding:

- the overall level of leverage employed;
- the level of leverage arising from borrowing of cash;
- the level of leverage arising from a position held in derivatives or in any complex product; and
- the main source of leverage in the AIF to the investors and to SEBI periodically, as may be specified by SEBI.

The current leverage limit on Category III AIFs, as prescribed by SEBI, is twice the net asset value of the AIF. Category III AIFs may buy credit default swaps for the purpose of hedging or otherwise, within permissible leverage limits.

However, the aforesaid leverage conditions do not apply to an AIF established in GIFT City.

2.7 Non-traditional Assets

AIFs can make investments only by way of subscribing to securities. Cryptocurrencies are currently not considered as securities under Indian law and therefore AIFs cannot invest in cryptocurrencies. It is also not possible for an AIF to hold hard assets and therefore, necessarily,

investments are typically made in securities of companies or in LLPs.

2.8 Use of Subsidiaries for Investment Purposes

The use of subsidiaries for investment purposes is not usual, primarily due to potential tax leakage in cash extraction from the subsidiary. Therefore, AIFs using a subsidiary structure tend to have specific commercial considerations that override or offset such issues, for instance, infrastructure AIFs may use a subsidiary structure for value creation in a platform.

2.9 Requirement for Local Investment Managers

All AIFs are required to have a manager entity and a sponsor entity (often one and the same entity).

An investment manager provides investment management services to the AIF. SEBI requires that the manager should be an entity incorporated in India. An AIF is also required to have at least one sponsor (which needs to be disclosed as such to SEBI). The sponsor may be an Indian entity or an offshore entity. The sponsor could also be any person(s) that sets up the AIF. In the case of an AIF organised as a company, this includes a promoter, and for an LLP, it includes a designated partner.

2.10 Other Local Requirements

If the manager and sponsor of an AIF are ultimately owned and controlled by resident Indian citizens and such persons are in control of the AIF to the general exclusion of others (an “IOCC AIF”, as in an Indian-owned and controlled company AIF), then investments by the AIF are treated as domestic investments, ie, no restrictions or conditions related to foreign direct investment (FDI) will apply, such as sectoral restrictions,

impermissibility of certain instruments and pricing guidelines.

In brief:

- “ownership” is denoted by a holding of more than 50% of the beneficial interest of equity and equity-linked instruments (which is to be tested for the manager and sponsor, and not the AIF); 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 (this will need to be tested for the sponsor, manager and, for clarity, control will also need to be tested in respect of the AIF).

Furthermore, the members of the key investment team of an investment manager must have adequate experience and meet certain qualifications:

- at least one member of the key investment team must have the relevant certification as may be specified by SEBI from time to time; and
- at least one member of the key investment team must also have a professional qualification in any of the following – finance, accountancy, business management, commerce, economics, capital markets or banking from a university or recognised institution.

Both the aforementioned qualification requirements may be fulfilled by the same individual.

While not specific to AIFs, it is relevant to note that:

- trusts must have a local trustee;
- companies must have a local director; and
- LLPs must have at least two designated partners (corporate partners must nominate one individual to act as a designated partner), one of which must be resident in India.

2.11 Rules Concerning Other Service Providers

While SEBI does not permit AIF managers to delegate core functions, AIFs and their managers are permitted to appoint third-party service providers for certain functions, which includes, inter alia:

- Merchant Banker: unless specifically exempted for certain circumstances under the AIF Regulations, to file the private placement memorandum, a merchant banker will need to be appointed.
- Custodian: Category I and Category II AIFs are required to appoint a SEBI-registered custodian if the corpus of such AIF is more than INR5 billion. A Category III AIF must appoint a SEBI-registered custodian irrespective of its size.
- Valuer: an AIF is required to provide its investors with a valuation of its assets conducted by an independent valuer (with the eligibility criteria specified by SEBI) on a six-monthly basis (or annually, if 75% of the investors by value of their investment in the AIF agree to such annual valuation).
- Auditing: the books of accounts of AIFs are to be audited annually by a qualified auditor. SEBI has also mandated an annual audit by a qualified auditor or a legal professional to ensure the AIF’s compliance with the SEBI format PPM. However, AIFs that do not have

to follow the SEBI format PPM (see **2.2 Fund Structures**) are not required to provide audit sections in PPMs.

- **Benchmarking:** SEBI has also introduced the requirement for an industry benchmark for AIFs (except angel funds) to enable comparison of the AIF industry with other investment avenues and global investment opportunities, and to help investors assess the performance of the AIF industry. To this end, SEBI has made the benchmarking of an AIF's performance mandatory and has introduced a framework to facilitate the use of data collected by benchmarking agencies. Such benchmarking is to be undertaken by those AIFs that have completed a year from the date of their first closing. Annual benchmarking exercises are being undertaken by credit rating agencies like CRISIL.
- **Registrar and transfer agent:** for the collection of stamp duty on sale, transfers and issue of units of an AIF, AIFs are required to appoint a registrar and transfer agent.

2.12 Anticipated Changes

Over the past few years, a special committee set up to advise on matters relating to alternative investment, the Alternative Investment Policy Advisory Committee (AIPAC), has submitted reports on various policy reforms required to strengthen the alternative investment framework in the country.

The last AIPAC report, issued in July 2018, made certain key recommendations, including the following:

- AIFs with “100% foreign investment” and India-based management operations should be exempt from goods and services tax (GST), along with incentivising tax structuring;

- the tax treatment of carried interest paid to managers/sponsors should be treated as long-term capital gains and not as a fee (see **3.6 Taxation of Carried Interest**); and
- investment in AIFs should count towards corporate social responsibility spends (which are currently mandated under Indian company law).

SEBI is increasing its oversight on AIFs and consequently released a series of consultation papers in 2023. We anticipate further changes to the AIF regulatory regime basis the balance recommendations in the consultation papers as summarised below:

- **Guidelines on borrowing for Category I and II AIFs:** currently Category I and II AIFs are only permitted to borrow funds for meeting operational requirements of the AIF, and not for the purpose of making investments (See **2.6 Loan Origination**). While it is anticipated that the regulatory intent remains the same to not permit Category I and Category II AIFs to borrow funds directly or indirectly or engage in leverage for the purpose of making investments, however, Category I and II AIFs may be permitted to borrow for the purpose of meeting shortfall in drawdown while making investments in an investee company.
- **Appointment of custodians:** currently Category I and II AIFs are required to appoint a SEBI-registered custodian if the corpus of such AIF is more than INR5 billion (See **2.11 Rules Concerning Other Service Providers**). SEBI may require the appointment of a custodian for such AIFs with a corpus less than INR5 billion as well.
- **Tenure of LVFs:** currently, LVFs enjoy certain regulatory flexibilities and exemptions such as extension of tenure beyond two years. Such flexibility may be capped by SEBI wherein the

LVF will be allowed to extend their tenure up to four years.

3. Fund Managers

3.1 Origin of Promoters/Sponsors of Alternative Funds

While the sponsor of an AIF may be an Indian or offshore entity, Indian entities generally act as sponsors in AIFs. This is also partly because the manager of an AIF must be an Indian entity, and the manager and sponsor are often the same entity (see **2.9 Requirement for Local Investment Managers**).

3.2 Legal Structures Used by Managers

AIF Regulations do not impose any restrictions on the legal structure of managers. Fund managers are usually set up as companies or as LLPs, with the latter gaining more traction in the last few years, since LLPs are potentially more tax-efficient in certain cases. Each structure comes with its attendant considerations, for example, establishing and running a company in India has higher compliance requirements than establishing and running an LLP, but LLP law provides greater government investigative powers.

Accordingly, managers may choose either structure, and the reasons for doing so tend generally to be driven by commercial considerations, rather than legal or regulatory considerations.

3.3 Regulatory Regime for Managers

A fund manager is not required to be registered with SEBI to carry out its activities as the investment manager of an AIF. However, it could be argued that fund managers are regulated by SEBI under the AIF Regulations to the extent that they act as investment managers to an AIF, particularly given their participation in the

regulatory approval process, ongoing regulatory compliance requirements and duties under the regulations.

As part of the regulations, SEBI has prescribed some minimum standards of compliance and transparency, and also retains inspection rights over investment managers/sponsors (with attendant disciplinary powers). SEBI has also specifically imposed a fiduciary obligation on managers.

Code of Conduct

SEBI has prescribed a “Code of Conduct” with which an AIF, an AIF manager, the key management personnel of an AIF, the members of the investment committee of an AIF, the trustee company and the directors of the trustee must all comply. In order to strengthen the governance of an AIF, the Code of Conduct imposes obligations on the aforementioned parties, such as:

- abiding by applicable laws;
- maintaining the highest professional/ethical standards in their dealings, dealing fairly with investee companies, not offering/accepting any inducement in connection with the business of the AIF, ensuring that the units of the AIF are not transferred in concert/collusion or without an effective change in beneficial interest, maintaining confidentiality, abiding by the policies pertaining to the mitigation of a potential conflict of interest with respect to the scope of the business, and not making misleading/inaccurate statements;
- making decisions with proper care and diligence and ensuring that they are in the best interests of the investors, including decisions pertaining to investment/divestment and valuations; and
- document/record in writing key investment/divestment decisions (including justifications

for making the same) as well as all correspondence/understandings of a particular deal/transaction.

Additionally, managers providing co-investment services must be licensed under the SEBI (Portfolio Managers) Regulations, 2020. It is pertinent to note that managers to funds set-up in GIFT are licensed or authorised by the IFSCA as a fund management entity (FME), depending on the type of fund and profile of investors targeted under the FM Regulations.

3.4 Tax Regime for Managers

Other than direct taxes applicable to the management fee received by the managers of AIFs for providing investment and management services, GST at a rate of 18% is applicable on the management fee. There are no specific taxation principles, under direct or indirect tax laws, that apply to managers.

3.5 Rules Concerning Permanent Establishments

The IT Act provides that a foreign company is treated as tax resident in India if its place of effective management (POEM) is in India that year. POEM is defined as the place where the key management and commercial decisions, necessary for conducting the business of an entity as a whole, are made.

POEM focuses on “substance over form” and provides that the place where the management decisions are taken is more important than the place where the implementation of the decisions takes place. However, an exception to the POEM concept is carved out for companies having turnover or gross receipts equal to or less than INR500 million in a financial year.

While typical permanent establishment rules also apply, POEM is greater in scope and relevance.

3.6 Taxation of Carried Interest

In addition to the management fee paid to the manager for providing investment management services, “carried interest” is typically paid for the profit share. Under Indian tax laws, carried interest, if received as a performance fee, is taxable in a similar way to the management fee. However, the managers may potentially take recourse to certain tax-efficient structures to classify this income as their return on investment made in the AIF. The Customs Excise and Service Tax Appellate Tribunal, Bangalore Bench (July 2021) has opined that “carried interest” to the manager and other expenses incurred by the VCF in the course of its operations are in the character of service income of the trust or VCF and should accordingly be taxed under the service tax regime. Such recognition might have an impact under the GST regime (since provisions have largely been carried forward). This decision is being closely watched by the Indian PE/VC industry.

3.7 Outsourcing of Investment Functions/Business Operations

While there are no regulatory restrictions on managers outsourcing their functions or business operations, managers are not permitted to outsource their core business activities or functions, such as investment-related activities. However, it is important to note that the ultimate responsibility for compliance with the AIF Regulations and the fund documents lies with the manager.

3.8 Local Substance Requirements

There are no minimum capitalisation norms applicable to managers. However, it is mandatory that the key investment team of the man-

ager has relevant certification and qualifications prescribed by SEBI, as provided for under the AIF Regulations (see **2.10 Other Local Requirements**).

Further, the sponsor or manager of an AIF have to invest a minimum amount in the AIF (see **2.3 Regulatory Regime for Funds**).

Additionally, the manager and the sponsor of the fund (often one and the same entity) are required to have the necessary infrastructure and manpower to undertake their activities. The manager and sponsor must also qualify as “fit and proper persons” under SEBI (Intermediaries) Regulations 2008.

3.9 Change of Control

Change in the sponsor/manager or change in control of the AIF or the sponsor/manager is construed as a “material change” under the AIF Regulations. For such a “material change” an AIF must (i) obtain prior approval from SEBI, and (ii) provide an exit option for a period of one month to existing investors of close-ended schemes of an AIF who do not wish to continue post such a change, unless such change is approved by 75% of the investors by value of their investment in the AIF.

3.10 Anticipated Changes

See **2.12 Anticipated Changes**.

4. Investors

4.1 Types of Investors in Alternative Funds

Both domestic and foreign investors may invest in AIFs in India. Investors typically include high-net worth individuals, family offices, pension and insurance funds, institutional investors and

banks. The flow of capital from development finance and multilateral institutions seems to have been steady over the past few years. Sovereign or quasi-sovereign wealth funds have also been active investors.

Certain domestic investors, such as banks, insurance companies and pension companies, are governed by their respective regulations and the relevant regulator has prescribed certain limitations on investments by these domestic investors. For example, banks cannot invest more than 10% of the unit capital of a Category I or II AIF without the approval of the RBI, and cannot invest in a Category III AIF. However, the subsidiary of a bank may make an investment in a Category III AIF, subject to the limits prescribed by SEBI. Similarly, while pension companies and insurance companies may invest in Category I and II AIFs, certain prudential norms are prescribed by the relevant pension and insurance regulators on investments by these companies. 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.

Accredited Investors

SEBI has also introduced an “accredited investor” regime. An accredited investor is an investor who/which receives a certificate of accreditation from an accreditation agency and fulfils certain minimum prescribed net worth and/or income criteria. In order to be eligible for the certificate of accreditation, an accredited investor has to fulfil the following criteria:

- if the investor is an individual/HUF (Hindu undivided family)/sole proprietorship/family trust, then it has to:
 - (a) have an annual income of at least INR20 million; or

- (b) have a net worth of at least INR75 million, of which at least INR37.5 million is in the form of financial assets; or
- (c) have an annual income of INR10 million and a net worth of INR50 million, of which at least INR25 million is in the form of financial assets;
- if the investor is a body corporate or a trust other than a family trust, it has to have a net worth of at least INR500 million;
- if the investor is a partnership firm, then each of its partners must fulfil the criteria applicable to “accredited investor”.

The central and state government of India and any development agencies/funds set up by them, qualified institutional buyers, Category I Foreign Portfolio Investors, sovereign wealth funds, multilateral agencies and any other entities specified by SEBI, will automatically be deemed to be accredited investors and do not require a certificate of accreditation.

An LVF for Accredited Investors may be formed, subject to the condition that each of its investors (except the manager, sponsor, employees/directors of the AIF, and employees/directors of the manager) is an accredited investor and each of them commits a minimum of INR700 million.

4.2 Side Letters

Side letters can be established between managers and investors to confer specific rights regarding commercial aspects such as transfer and co-investment, as well as non-commercial aspects like confidentiality, inspection and reporting obligations. Managers have the responsibility to ensure that these side letters do not adversely affect the rights of the other investors.

Additionally, certain distinct rights like preferential exit from the fund, contribution to indem-

nification, giveback and drawdown may not be feasible to grant to an investor via a side letter due to the fiduciary duties of the sponsor or manager.

While it is not required to disclose the terms of the side letter, it is required that managers disclose that side letters may be entered into with certain select investors based on specified criteria. SEBI's prescribed format of the PPM also requires the criteria to be disclosed.

4.3 Marketing of Alternative Funds to Investors

AIFs can be marketed by way of private placement through issuance of a PPM, to any person or entity inside or outside India, subject to the limitation that they cannot have more than 1,000 investors. At present, there are no specific rules defining the scope of private placement. Managers must seek legal advice in this regard.

Under the (Indian) Companies Act, 2013, any offer or invitation extended to more than 200 persons to subscribe to the shares of an Indian company in an aggregate financial year is considered as a public offer. This applies to AIFs set up as companies.

Furthermore, as mentioned above, no scheme of an AIF can have more than 1,000 investors.

4.4 Rules Concerning Marketing of Alternative Funds

See 4.3 Marketing of Alternative Funds to Investors.

4.5 Compensation and Placement Agents

While it is common for investors to be placed in AIFs through placement agents or distributors, managers ensure that these placement agents

follow the private placement norms. Further, distributors take precautions to avoid being perceived as offering investment advice regarding AIF units, which might lead to the need for registration under the SEBI (Investment Advisers) Regulations of 2013.

Regarding distributor services, SEBI has recently introduced a framework for AIFs, which includes a direct plan and a commission distribution model. AIFs must now offer investors the choice of a direct plan, allowing them to invest without involving a distributor. Additionally, AIFs are obligated to ensure that investors who engage with a SEBI registered intermediary charging separate fees (eg, advisory or portfolio management fees) are enrolled in the direct plan exclusively.

AIFs are also required to disclose any distribution fee which they charge (if any) to the investors at the time of on-boarding.

4.6 Tax Regime for Investors

Investors in India are taxed based on their legal structures, and different tax rates are applicable to corporations, partnerships and individuals.

AIFs in India have been accorded a statutory tax pass-through status for all streams of income other than business income, ie, investors in an AIF are taxed as if they have invested directly in portfolio companies. See **2.5 Tax Regime for Funds**. The only requirement is that an AIF must withhold tax from distribution to its investors, as follows:

- for resident investors, a rate of 10% on all income payable (other than business income); and
- for non-resident investors, the rates in force (ie, the rates specified in the income tax law for the relevant year, or the rates specified in

the applicable DTAA entered into between India and the country of residence of such non-resident) are applicable on all income payable (other than business income).

4.7 Double Tax Treaties

The taxation of offshore investors is governed by the provisions of the Indian Income Tax Act, 1961 (IT Act), read with the provisions of the double-taxation avoidance agreements (DTAAs) between India and the country of residence of such offshore investor. The provisions of the IT Act would apply to the extent that they are more beneficial than the provisions of the DTAAs. Offshore investors in AIFs generally qualify for benefits under the DTAAs, subject to customary substance and other requirements.

4.8 Foreign Account Tax Compliance Act (FATCA)/Common Reporting Standard (CRS) Compliance Regime

As part of various ongoing tax and regulatory developments around the globe, such as information exchange laws like the Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS) Compliance Regime, there are now additional investor and counterparty account-related due diligence requirements for financial institutions. With the intention of increasing tax transparency and the automatic exchange of financial account information for tax purposes, the government of India recently signed the following agreements:

- the Intergovernmental Agreement with the government of the USA to implement FATCA; and
- the Multilateral Competent Authority Agreement to implement the CRS for automatic exchange of information, as laid down by the OECD.

To give effect to these agreements, the Indian tax authorities have instituted rules which require Indian financial institutions to seek additional personal, tax and beneficial owner information and certain certificates and documents from all investors. In relevant cases, information will have to be reported to the tax authorities/appointed agencies.

AIFs are considered to be financial institutions for these purposes and, therefore, investors in AIFs are required to comply with the request of AIFs to furnish such information, documentation and declarations as and when deemed necessary by the AIFs. FATCA and CRS provisions are relevant not only at the on-boarding stage for investors but also throughout the life cycle of investment with AIFs. Investors are therefore required to intimate to the AIFs/managers any change in their status with respect to any FATCA or CRS-related information/documentation provided by them previously, including any declarations provided in respect of the residency of the investors for tax purposes.

4.9 Anti-Money Laundering (AML) and Know Your Customer (KYC) Regime

Investors can only be on-boarded by managers on satisfaction of anti-money laundering and KYC norms in India.

In order to eliminate and prevent money laundering in India, the government of India enacted the Prevention of Money Laundering Act, 2002 (PMLA), together with other rules and regulations including KYC regulations (PML Regime). RBI and SEBI both regulate anti-money laundering laws in India and as such the PML Regime.

The PML Regime requires AIFs and managers to maintain records of transactions of a prescribed nature and above certain thresholds. The PML

Regime also requires AIFs to verify the identity of an investor and prescribes documents that must be submitted by such investor. The documentation includes proof of identity, proof of address and source of money depending on the structure and type of investor.

For overseas investors, managers must ensure that specific conditions outlined below are met. If investors who are already part of the AIF do not meet these conditions later on, the manager is not allowed to make further drawdowns until they fulfill the following criteria:

- Foreign investors in the AIF should be residents of a country whose securities market regulator is a signatory to either the International Organisation of Securities Commission's Multilateral Memorandum of Understanding or has a bilateral agreement with SEBI. However, this rule does not apply if the foreign investor is a government or government-related entity residing in a country approved by the Indian government.
- The investor, or those contributing 25% or more to the investor's funds or identified on the basis of control, must not be listed on the United Nations Security Council's sanctions list. Additionally, they should not reside in a country mentioned in the Financial Action Task Force's public statement as either having strategic anti-money laundering or counter-terrorism financing deficiencies with countermeasures in place or a country that has not made sufficient progress in addressing these deficiencies or has not committed to an action plan with the Financial Action Task Force.

4.10 Data Security and Privacy for Investors

While managers and funds are required to abide by data protection and privacy laws generally applicable to them in India, under the AIF Regulations, SEBI has particularly mandated that managers shall abide by confidentiality agreements with the investors and not make improper use of the details of personal investments and/or other information of investors.

4.11 Anticipated Changes

See 2.12 Anticipated Changes.

Trends and Developments

Contributed by:

Ganesh Rao, Aditya Jha and Yash Bansal
Trilegal

Trilegal is one of India's leading law firms, with expertise across the full spectrum of corporate legal services. Trilegal has offices in four key cities of India.

The firm would like to thank Tahhira Somal, an associate at Trilegal, for her contribution to this chapter.

Authors



Ganesh Rao is a partner at Trilegal, specialising in asset management and funds. In addition to his core practice advising general partners, he regularly acts as counsel to

limited partners (including development financial institutions, pension funds, corporations and family offices) on their investments in private funds and other investment programmes. In just three years at Trilegal, he has built up a niche market-leading asset management and funds practice, putting together a team of two fellow partners, and over 20 lawyers. Ganesh and his team at this dedicated asset management and funds practice, the largest in India, have advised on over USD20 billion worth of commitments (either as GP or LP counsels) to funds investing in and around India. Additionally, Ganesh and his team advise a number of clients on special situations relating to funds, including on fund disputes, end of life situations, fund secondaries, key person events, LPAC special counsel and manager removals. He was previously a partner at Cyril Amarchand Mangaldas and AZB & Partners.



Aditya Jha is a partner at Trilegal, specialising in asset management and funds. Aditya has an impeccable track record of advising fund sponsors as well as investors. He advises a

wide range of fund sponsors across sectors and strategies. His investor representation includes extensively advising development financial institutions, family businesses and fund of funds. His practice expertise includes financial services, financial regulatory and securities laws, and inbound/outbound investment structures and strategies. He previously practised at Legacy SJ Berwin (London office) and Cyril Amarchand Mangaldas, and was a partner at AZB & Partners.

Contributed by: Ganesh Rao, Aditya Jha and Yash Bansal, **Trilegal**



Yash Bansal is a partner at Trilegal where he specialises in asset management and funds. Yash's expertise, aside from investment funds, includes advising on securities laws and exchange control laws. In addition to advising GPs on structuring and formation of investment funds and other asset management platforms, he has represented institutional limited partners, development financial institutions, fund of funds and family offices on their commitments to investment funds in India as well as offshore. Yash regularly advises clients on in-bound and out-bound investment structuring. Yash previously practised at Cyril Amarchand Mangaldas and AZB & Partners, and served as a partner at IC Universal Legal.

Trilegal

One World Centre
10th Floor, Tower 2A and 2B
Senapati Bapat Marg
Lower Parel (West)
Mumbai 400 013
India

Tel: +91 22 4079 1000
Fax: +91 22 4079 1000
Email: ganesh.rao@trilegal.com
Web: www.trilegal.com



Regulatory Trends: Indian Funds

Alternative investment funds (AIF) are effectively non-traditional privately pooled investment vehicles that cater to the funding needs of relatively high-risk ventures across a broad spectrum of the investing universe. The Securities and Exchange Board of India (SEBI), under the SEBI (Alternative Investment Funds) Regulations, 2012 (the “AIF Regulations”) regulates all pooling structures in India, including AIFs.

AIFs are classified into four categories, as set out below:

- Category I – this category includes funds investing in start-ups, early-stage ventures, social ventures, small and medium enterprises (SMEs), infrastructure or other sectors which the government or regulators consider socially or economically desirable, as well as venture capital funds, angel funds, funds focused on medium and small enterprises, social impact funds, infrastructure funds and special situation funds.
- Category II – a bulk of the private equity and debt funds are in this category. Such funds are required to make a majority of their investments in unlisted securities.
- Category III – this category includes funds that employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.
- AIFs specified under Regulation 19 of the AIF Regulations – this is a recently introduced category and includes a “Corporate Debt Market Development Fund” that (i) invests in liquid and low-risk debt instruments and undertakes any other activity related to the corporate debt market; (ii) during periods of market dislocation, purchases corporate debt securities from specified debt-oriented

schemes of mutual funds which meet the eligibility criteria prescribed in the AIF Regulations.

As is quite clear from data published by SEBI, AIFs have seen exponential growth over the last few years, rapidly becoming a key capital provider in the domestic economy.

India has also created a special economic zone for financial services, popularly called the GIFT City (an acronym of Gujarat International Finance Tec-City). Interestingly, domestic laws have been changed to effectively treat this area as a foreign territory for exchange control purposes. Financial regulation in GIFT City is under the International Financial Services Centres Authority (IFSCA), which is a unified regulator (a mandated split between four regulators in the rest of India). The IFSCA has been quite active in the last few years, implementing an effective and attractive regulatory framework with a view to creating a substantive footprint as an international finance centre.

Recent Key Trends and Developments

The AIF framework in India has recently witnessed various regulatory developments under the aegis of SEBI. SEBI is increasing its oversight on AIFs given the pace of growth clocked by the industry, with an aim to lay emphasis on governance mechanisms and investor protection. In this note, we have set out (i) key aspects of the master circular dated 31 July 2023 (Master Circular) and the recent circulars issued by SEBI for AIFs; and (ii) amendments made to the AIF Regulations – see SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2023, SEBI (Alternative Dispute Resolution Mechanism) (Amendment) Regulations, 2023 and SEBI (Facilitation of Grievance Redressal Mechanism) (Amendment) Regulations, 2023.

Declaration of first close and tenure

The manner of calculating the tenure of a close-ended scheme of an AIF, including the manner of modification of the tenure, has been updated. The tenure of close-ended AIFs is required to be calculated from the date of first closing and the tenure may be changed before the first closing. If existing AIFs have not declared final closing, then such AIFs should declare final closing per the timeline provided in the PPM and the investment manager shall not have any discretion to extend the said timeline provided in the PPM. It may be noted that the AIF Regulations permit close-ended schemes of AIFs to extend their tenures with requisite investor consent; however, it has additionally been clarified that in case there is no requisite consent for extension or when the extended term expires, the AIF or the scheme is to be wound up.

The time period for declaring the first close has also been codified. SEBI requires the first close of a close-ended AIF shall be declared within 12 months from the date of SEBI communication of taking the private placement memorandum (PPM) of the AIF on record. Existing schemes of AIFs that have not declared first closing should declare first closing no later than 12 months from the date of the aforementioned circular. If such declarations are not undertaken within the prescribed timelines, the AIFs are required to file a fresh application for launch of the said AIF by paying the requisite fee to SEBI.

Foreign Investments in an AIF

While there are no regulatory or government approvals required for foreign investors to invest in AIFs, investment managers of AIFs are to ensure certain conditions are met by such foreign investors. The foreign investor of the AIF must be a resident of the country whose securities market regulator is a signatory to the

International Organisation of Securities Commission's multilateral memorandum of understanding or a signatory to the bilateral memorandum of understanding with SEBI. It may be noted that, investments may be accepted from governments or government related investors that do not meet the aforementioned criteria provided the investor is a resident of a country approved by the Indian government.

It should further be ensured that the investor, or its underlying investors contributing 25% or more in the corpus of the investor or identified on the basis of control, is not the person(s) mentioned in the sanctions list notified by the United Nations security council, or is not a resident in the country identified in the public statement of financial action task force (FATF) as (i) having a strategic anti-money laundering or combating the financing of terrorism deficiencies to which counter measures apply; or (ii) a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the FATF to address the deficiencies.

Change of control or change of Investment Manager or Sponsor

The AIF Regulations require prior approval of SEBI for any change in control of the investment manager, sponsor or AIF and now the same is required in case of change of the investment manager or sponsor of an AIF. By way of the SEBI (Change in Control in Intermediaries) (Amendment) Regulations, 2023 that came into effect on 1 January 2023, the definition of "change in control" has been amended. The latest definition provides that for a body corporate that does not have its shares listed on any recognised stock exchange, the meaning of control shall be construed with reference to the definition of control

as provided in section 2(27) of the Indian Companies Act, 2013.

Direct plan for AIFs and trail model for distribution commission

SEBI has introduced a framework for AIFs in relation to distributor services. AIFs are to have an option of a direct plan for investors, without routing the investment through any distributor, on which no distribution fee shall be applicable. AIFs are further required 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. AIFs are also required to disclose any distribution fee which they charge (if any) to the investors at the time of on-boarding. Category I and Category II AIFs may pay up to one-third of the total distribution fee to the distributor on an upfront basis, with the remaining fee paid on an equal trail basis over the tenure of the AIF. Category III AIFs are required to charge distribution fees, if any, to investors only on an equal trail basis, ie, to charge no upfront distribution fee by the Category III AIF to its investors. Any distribution fee shall be paid only from the management fee received by the manager of the Category III AIF.

Guidelines for excusing/excluding an investor

SEBI issued guidelines for excusing/excluding an investor from an investment of an AIF (Excuse Circular). The Excuse Circular allows investors of an AIF to excuse themselves from participating in a particular investment in any of the following circumstances: (i) if the investor, on the basis of an opinion of a legal professional/legal advisor, confirms that its participation in the investment opportunity would be in violation of an applicable law or regulation; and (ii) if the investor (in the contribution agreement or any other agree-

ment with the AIF) has disclosed to the investment manager that participation of the investor in a particular investment opportunity would contravene the investor's internal policy. In relation to excuse on account of internal policy, the investment manager is required to ensure that such internal policies are captured in the agreement between the investor and the AIF including reporting of any change in the disclosed internal policy of the investor to the AIF within 15 days of such change. We expect such terms to be provided in side letters.

Further, the Excuse Circular also allows the investment manager to exclude an investor from participating in a particular investment if the investment manager is satisfied that participation of an investor in a particular investment opportunity would cause the AIF to be in violation of an applicable law or regulation or have a material adverse effect on the AIF. Investment Managers are required to record the rationale for exclusion along with any supporting documents. It is further clarified that if the investor is itself an AIF or another investment vehicle, it may be partially excused or excluded from participation in a particular investment opportunity to the extent of its underlying investors who are excused or excluded from such investment opportunity.

Issuance of units of AIFs in dematerialised form

SEBI has amended the provisions of AIF Regulation by way of a notification dated 15 June 2023. As per the amended provisions, AIFs shall issue units in dematerialised form subject to the conditions specified by SEBI from time to time. This circular provides time frame for the dematerialisation of units issued by AIFs. This requirement of dematerialisation of units will not be applicable for schemes whose tenure (excluding permissible extensions in tenure) ends on or before

30 April 2024. Further, depositories are directed to make necessary amendments.

Standardised approach to valuation of investment portfolio of AIFs

SEBI has amended the provisions of the AIF Regulations to provide for a standard valuation methodology of the portfolio investments of an AIF. As per the amended regulations AIFs are, amongst other things, required to carry out valuation of their investments in the manner specified by SEBI from time to time.

As per the circular, valuation shall be carried out for (i) the securities for which valuation norms have already been prescribed under SEBI (Mutual Funds) Regulations, 1996 (MF Regulations), as per the norms prescribed under MF Regulations; and (ii) other securities as per valuation guidelines endorsed by any AIF industry association which, in terms of membership, represents at least 33% of the number of SEBI registered AIFs. The eligible AIF industry association shall endorse appropriate valuation guidelines after taking into account the recommendations of the Alternative Investment Policy Advisory Committee of SEBI.

The investment manager shall disclose in the PPM the details of the valuation methodology and approach adopted for each asset class of the scheme of the AIF.

Further, the investment manager is responsible for true and fair valuation of the investments of the scheme of the AIF. In case the established policies and procedures of valuation do not result in fair and appropriate valuation, the investment manager can deviate from the established policies and procedures in order to value the assets or securities at a fair value and document the rationale for such deviation. This circular also

provides the eligibility criteria for an independent valuer.

To ensure timely and appropriate reporting of valuations of investment portfolios to performance benchmarking agencies, the investment manager shall ensure that a specific timeframe for providing audited accounts by the investee company to the AIF is included as one of the terms in subscription agreement/investment agreement with the investee company, so as to enable AIFs to report valuation based on audited data of investee companies as on 31 March to performance benchmarking agencies within the specified timeline of six months.

Modalities for launching a liquidation scheme and for distributing the investments of an AIF in specie

SEBI has amended the AIF Regulations 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 selling such investments to a new scheme of the same AIF (Liquidation Scheme) or distributing such unliquidated investments in specie during the liquidation period, ie, one year following the expiry of tenure or extended tenure of the scheme for fully liquidating the scheme of an AIF.

If the AIF fails to obtain requisite investor consent for launching a Liquidation Scheme or for in-specie distributions of unliquidated investments, then the unliquidated investments shall be mandatorily distributed to investors in specie, without the requirement to obtain the consent of 75% of investors by value of their investment in the scheme of the AIF.

The investment manager of AIF shall report the value, as specified above, with regard to the sale of unliquidated investments to a Liquidation

Scheme or distribution of unliquidated investments in specie, to performance benchmarking agencies in a timely manner for the purpose of performance benchmarking. The manager shall also make suitable disclosure with regard to the same in the PPMs of subsequent schemes.

Dispute Resolution and grievance redressal

SEBI has amended the AIF Regulations to provide that claims, differences or disputes between investors and the AIFs or their managers that arise out of or in relation the activities of the AIFs, or their managers, in the securities market, are required to be submitted to a dispute resolution mechanism which includes mediation and/or conciliation and/or arbitration, in accordance with the procedure specified by SEBI. Further, SEBI has streamlined the existing dispute resolution mechanism in the Indian securities market by establishing a common online dispute resolution portal for online conciliation and arbitration of disputes arising in the Indian securities market.

While the investor charter delineated the mechanism of grievance redressal, recently the timeline for closure has also been provided. The AIF Regulations provide that the manager shall redress the investor grievances no later than 21 days from the receipt of the grievance.

Other Updates

- Without approval of 75% of investors by value in the AIF, an AIF may not buy or sell investments to (i) associates; or (ii) schemes of AIFs managed or sponsored by its manager, sponsor or associates of its manager or sponsor; or (iii) an investor who has committed to invest at least 50% of the corpus of the scheme of the AIF.
- Changes to the eligibility criteria of the key investment team and the compliance officer of an AIF.
- Revision of quarterly reporting formats in relation to the activities carried on by AIFs.
- Guidelines on transactions in corporate bonds and on participation of AIFs in credit default swaps.

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