

Master-class  
**Structuring an Alternative  
Investment Fund**

Session 1: Key Regulatory Considerations

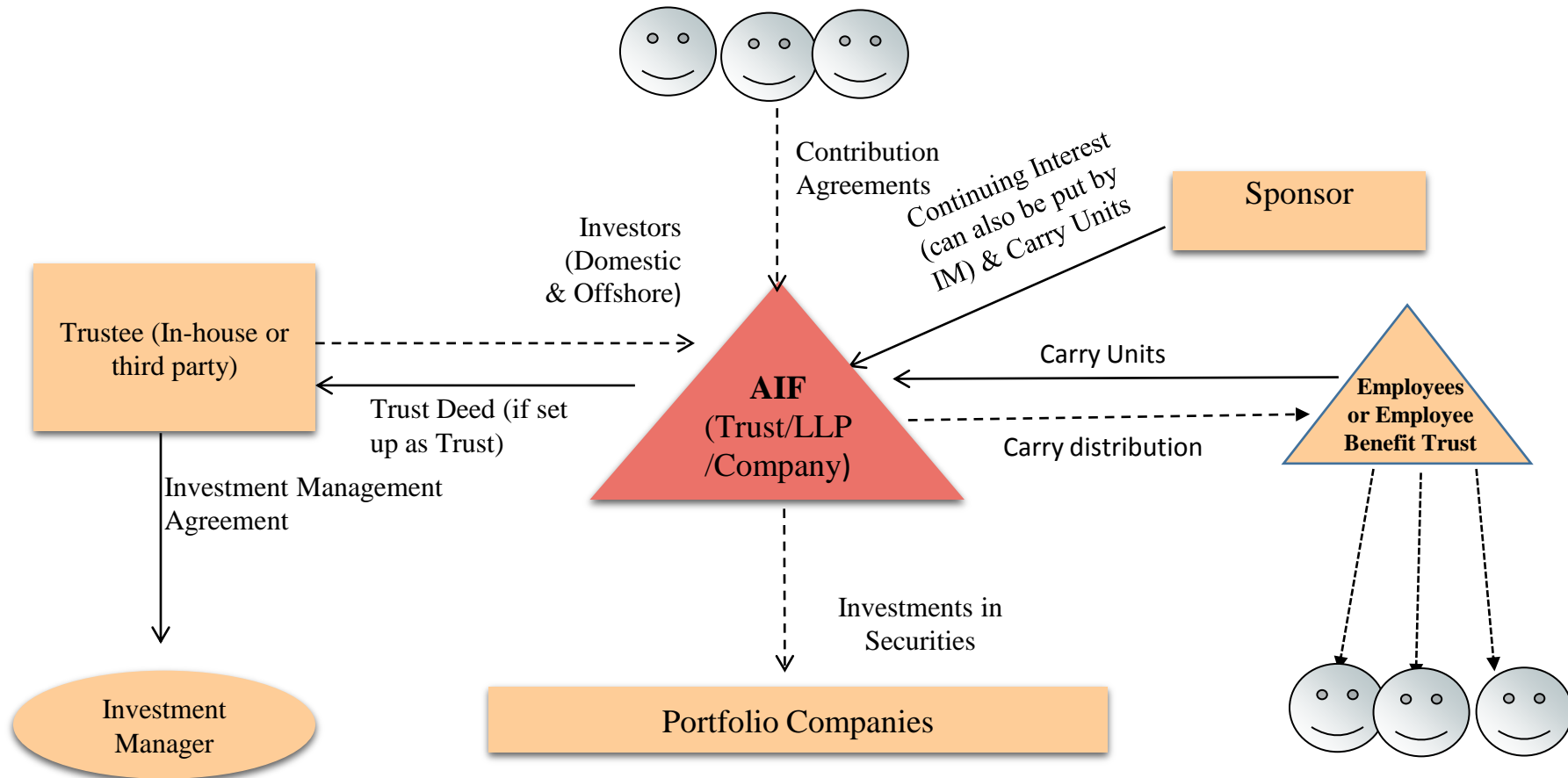
Tejesh Chitlangi, Partner, IC Universal Legal

---

## Table of Contents

<b>Sr. No.</b>	<b>Content</b>
1.	Typical AIF Structure
2.	Choice of AIF Structures
3.	Categories of AIF – Which one to Select ?
4.	AIF Business - Key Regulatory Aspects
5.	Material Contractual Provisions in AIF Documents
6.	Foreign Investments in AIF – Key Considerations & Recent Trends
7.	Phenomenal Growth of AIF Industry - Key Statistics
8.	Regulatory Push behind the AIF Growth
9.	Glossary & Notes

# Typical AIF Structure



## Choice of AIF Structure

Criteria	Trust	Company	LLP
Compliance	Low	High	Moderate
Client Confidentiality	High	Moderate	Low
Market Practice	More than 95% of the AIFs are set up as Trusts	Minimal	Less than 5% AIFs are set up as LLP
Acceptability with Investors and Distributors	High	Low	Moderate
Ease of Operations	High	Low	Moderate
Mitigation of GST on Management Fee	No	No	Yes

## Categories of AIF – Which one to Select ? (1/2)

Criteria	Category I AIF	Category II AIF	Category III AIF
Categorization	<ul style="list-style-type: none"> <li>- Angel Fund</li> <li>- Venture Capital Funds;</li> <li>- SME Funds;</li> <li>- Social Venture Funds; and</li> <li>- Infrastructure Funds.</li> </ul>	<ul style="list-style-type: none"> <li>- Private Equity Funds;</li> <li>- Structured Credit Funds;</li> <li>- Debt Funds;</li> <li>- Real Estate Funds.</li> </ul>	<ul style="list-style-type: none"> <li>- Long only Funds;</li> <li>- Long-short Funds;</li> <li>- Hedge Funds and any other Funds with diverse and complex trading strategies.</li> </ul>
SEBI Registration Fees	Rs.5,00,000	Rs.10,00,000	Rs.15,00,000
Continuing Interest	Lower of the following amounts: <ul style="list-style-type: none"> <li>- 2.5% of corpus; or</li> <li>- Rs.5 crores</li> </ul>	Lower of the following amounts: <ul style="list-style-type: none"> <li>- 2.5% of corpus; or</li> <li>- Rs.5 crores</li> </ul>	Lower of the following amounts: <ul style="list-style-type: none"> <li>- 5% of corpus; or</li> <li>- Rs.10 crores</li> </ul>
Ability to invest in Listed Securities	Limited ability for listed investments. Different norms across sub-categories.	Upto 49.99% investments can technically be done in listed securities.	Investments upto 100% can be made in listed securities.
Overall restrictions/Compliances	Moderate	Low	High

## Categories of AIF – Which one to Select ? (2/2)

Criteria	Category I AIF	Category II AIF	Category III AIF
QIB Status	Yes [Also, no lock in for investment made prior to IPO if held for at least one year]	Yes [Also, no lock in for investment made prior to IPO if held for at least one year and the DRHP is registered with ROC on or after July 31, 2017]	Yes
Leverage	No	No	Yes (upto 2X leverage / 100% additional exposure permitted)
Investment by DFIs, Insurance Companies, Banks	Yes, subject to compliance with prescribed norms	Yes, subject to compliance with prescribed norms	No
Diversification	Not more than 25% of the Investible Funds can be invested in a single Portfolio Entity.		Not more than 10% of the Investible Funds can be invested in a single Portfolio Entity.
Close Ended/Open Ended	Close Ended	Close Ended	Open and/or Close Ended

## AIF Business – Key Regulatory Aspects

- One Trust / One Scheme V/s One Trust / Multiple Scheme Issue – Ring Fencing and Bankruptcy Remoteness Concerns.
  - Key Issues under Category III AIF (Long Only Funds, Long Short Funds and Hedge Funds)
    - *Can a CAT III AIF have both open ended and closed ended scheme?*
    - *Permissibility of Redemption / Exit Option to Investor in a Close Ended Fund?*
    - *Grey areas with respect to investments by Cat III AIFs with foreign money?*
  - Category II AIF – (Real Estate Fund, Structured Credit Fund, Debt Fund, Pre-DRHP/Post DRHP Investment Funds)
    - *How to ensure compliance with unlisted v. listed securities ratio in the portfolio (SEBI requires portfolio to be more in unlisted securities).*
  - Key Issues Considered under the “SREI” order:
    - *Whether an AIF is allowed to give loans to the portfolio companies instead of investing the same as per definition of ‘Alternative investment Fund’ prescribed under regulation 2(1) (b) of AIF Regulations?*
    - *Whether the Investment Manager shall maintain the limit on the investments in one Investee Company (25% or 10% as applicable) of the total investible funds as per regulation 15 (1) (c) of AIF Regulations throughout the life of the Fund or at the time of Investment by the Fund?*
    - *Whether the Sponsor or Investment Manager contributing sponsor commitment/continuing interest as per Regulation 10(d) of AIF Regulations may seek distribution of its pro-rata share during the term of the Fund alongside distributions to other Contributors?*
-

## Material Contractual Provisions in AIF Documents(1/2)

*Negotiating the Fund Documents with Institutional Investors (including DFIs like IFC, CDC, DEG and Family Offices, Insurance Companies, Banks etc.)*

- Contributor Giveback;
  - Indemnity;
  - Removal of the Investment Manager for “Cause” or “without Cause”;
  - “Most Favoured Nation” Rights;
  - Information Rights for the Contributors;
  - Right to appoint member on IC/Advisory Board
  - Distribution Waterfall, Clawback mechanisms;
  - List of matters requiring “Super Majority/Two Third Majority” Investor Approvals;
  - Quantum of Fees/Expenses and manner of charging the same.
  - Key Man Clause
  - Co-Investment Rights
-



## Material Contractual Provisions in AIF Documents(2/2)

- Investment Guidelines: ESG, Anti-Corruption, Conflict Mitigation and Co-Investment
  - Valuation Methodology
  - Follow-on investment
  - Drawdown Notice Format
  - Legal Opinion on Enforceability
  - Compensatory Contribution or Premium v. NAV based subscriptions
  - Whether Warehoused Investments to be transferred to Fund at Cost or FMV – Whether issuance of units in lieu of warehoused Investments possible
  - Investments in Associate Entities – Approval to be taken at the time of each Investment ? Whether deemed or specific ?
  - Changes in Contribution Agreements – Can all Contribution Agreements be amended by obtaining super majority approval ?
  - ESG Policy (Environmental, Social and Governance);
  - Anti-Corruption Provisions
-

## Foreign Investments in AIF – Key Considerations & Recent Trends (1/2)

- 100% FDI is permitted under Automatic route in all the Categories of AIFs.
- If the Sponsor and Manager (both) are Indian “Owned and Controlled” as defined in FEMA20 Regulations, then the AIF does not need to follow FDI downstream investment norms.
- The extent of foreign investment in the corpus of the AIF will not be a factor to determine as to whether downstream investment by the AIF is foreign investment or not.\*
- Downstream investment by an AIF that is reckoned as foreign investment shall have to conform to the sectoral caps and conditions / restrictions, if any, as applicable to the company in which the downstream investment is made.

*\*As a special condition, a Category III AIF with any foreign investment shall make portfolio investment in only those securities or instruments in which a FPI is allowed to invest under the FEMA20 Regulations.*

---

## Foreign Investments in AIF – Key Considerations & Recent Trends (2/2)

### *AIF Route – New Alternative to FDI, FPI & ECB?*

- AIF Regime alternative to FDI regime – Since offshore investors can invest in an AIF under automatic route and AIF with an Indian owned and controlled manager and sponsor is not required to follow FDI norms (regardless of quantum of foreign investment which can be upto 100%), hence it's becoming a viable option for facilitation foreign investments which may otherwise not be permissible/viable under FDI route.
  - AIF Regime alternative to FPI regime for debt investments & ECB - With the corporate debt limits insufficient for FPIs and future uncertainty on availability of limits, the AIF as a vehicle has alternatively been used to route such money in Indian entities. An overseas pooling structure can be set up which can invest in AIF under an automatic route and in turn AIF can take exposure in listed as well as unlisted debt securities without any restrictions on limits or end use requirements. Also the coupons and principal amounts received from the investee entities is fully repatriable to overseas investors. AIF regime has also become an alternative for ECB regime which has too many restrictions pertaining to class of lenders, end use restrictions, limit on coupon payout etc.
  - AIF Regime alternative to FPI regime in listed securities – If for some regulatory reason, FPI registration may not be obtained or is not feasible, then foreign investors can invest under automatic route in an AIF (under appropriate category) which in turn can invest in listed securities on stock markets as well as in IPOs.
-

## Phenomenal Growth of AIF Industry - Key Statistics

Category of AIF	AIFs registered with SEBI as on January 2017	AIFs registered with SEBI as on February 2018
Category I	92	111
Category II	151	202
Category III	43	61
Total	286	374

Fund raising by AIFs as on **December 31, 2016** (In Crores)

Category of AIF	Commitments Raised	Funds Raised	Investments made
Category I	19121.76	5529.01	3867.04
Category II	41065.95	20162.86	17185.69
Category III	10078.81	7691.99	7433.36
Total	70266.52	33383.86	28486.09

Fund raising by AIFs as on **December 31, 2017** (In Crores)

Category of AIF	Commitments Raised	Funds Raised	Investments made
Category I	25220.13	8893.80	6796.99
Category II	87063.47	41339.29	29493.20
Category III	28835.99	22025.42	21718.66
Total	141119.59	72258.51	58008.85

During the one year period between December 31, 2016 to December 31, 2017 there has been an exponential growth of 101%, 116% and 104% in Commitments raised, Funds raised and Investments made by AIFs, respectively. The number of AIF registrations also increased by a massive 31% between January 2017 and February 2018.

## Regulatory Push behind the AIF Growth

- Liberalisation in Exchange Control Laws resulting in greater inflow of foreign capital in AIFs. Large overseas investors taking direct exposure in Indian AIFs.
  - A massive increase in the Domestic Institutional Investor participation in AIFs. Over the past few years RBI and IRDA have liberalised the investment norms for Banks and Insurance Companies to invest in Category II AIFs which was earlier restricted to Category I AIFs. Government has massively increased allocations to AIFs through institutions like SIDBI. Significant steps taken by SEBI to promote more AIF set-ups, like extending post IPO lock-in exemptions to Category II AIFs. Diversion of ultra HNI money in alternate asset classes post demonetisation.
-

## Glossary & Notes

<b>TERM</b>	<b>DESCRIPTION</b>
AIF	Alternative Investment Fund
LLP	Limited Liability Partnership
FDI	Foreign Direct Investment
DFI	Development Finance Institution
DRHP	Draft Red Herring Prospectus
IPO	Initial Public Offering
FPI	Foreign Portfolio Investor
FEMA 20	Foreign Exchange Management (Transfer or Issue of Securities by a Person Resident Outside India) Regulations, 2017
ECB	External Commercial Borrowings

## Glossary & Notes

<b>TERM</b>	<b>DESCRIPTION</b>
QIB	Qualified Institutional Buyer
IRDA	Insurance Regulatory and Development Authority of India
RBI	Reserve Bank of India
ROC	Registrar of Companies
SME	Micro, Small and Medium Enterprises
SEBI	Securities and Exchange Board of India
AIF Regulations	Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 as amended from time to time

## ***Disclaimer***

- ***This Presentation is not exhaustive and deals with specific areas and provides our views on the matters discussed herein and is not to be read as an opinion with respect to any factual or legal matters. The analysis provided herein is limited to the laws of India in force as of date and no opinion is expressed or should be implied as to the laws notified hereinafter or of any other jurisdiction/s.***
  - ***The Presentation is prepared by us on the basis of our interpretation of the applicable legal provisions. Any person relying on this Presentation shall be fully responsible / liable for any decision taken on the basis of this Presentation and we would not be held responsible under any circumstances.***
  - ***Our views/observations/conclusions stated in this Presentation are not binding on any authority or court, and so, no assurance is given that a position contrary to that expressed herein will not be asserted by any statutory/regulatory authority and ultimately sustained by a relevant authority and/or a court of law. The data provided in this Presentation has been procured from the SEBI website and other authentic media sources.***
-



**Thank You**

---