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*Research*

# Fund Formation: The Beginning of the Fund Lifecycle for India Focussed Funds

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## About Resolüt Partners

We are a transactional law firm built on four main foundations:

- *Mathematically sharp commercial lawyers*
- *Integrated Legal and Tax advice*
- *Multi-jurisdictional understanding*
- *Eliminating choices*

Simply, we believe that for us to be effective at what we do, we cannot confine ourselves to the theoretical exploration of the law and have to lean into the practical implementation.

Our emphasis on simplicity is deep-rooted. Our clients rely on us to guide them through some of their more challenging and novel situations, where convention and precedent are of little assistance, and they require a trusted advisor, one who can eliminate the chaff and can take those high stakes calls without seeking comfort in ambiguity.

We have been closely associated with the investment funds industry and have advised some of the largest global sponsors and sovereign wealth funds. Our core specialism, therefore, is to advise on every aspect across the lifecycle of a fund – from formation, investments, structured transactions, governance issues (fund and portfolio level), to exits and commercial disputes. In addition to legal expertise, our key standout ability is to understand deal-specific tax and accounting issues and engage with principals in devising deal commercials including mathematical formulations.

We have been involved in prominent public equity, private equity, M&A and private credit transactions across different industry verticals. Underlying our experience and expertise is the team's unflinching commitment towards research and advocacy efforts. Our research-based approach to advising transactions has allowed us to develop innovative structures and anticipate critical roadblocks in high-stakes transactions.

The heart of our practice is a common vision we share – to function as a firm driven by purpose and not merely by profit. We like to be identified by our values and organizational philosophy. We work with a select family of clients where we function with utmost professionalism yet remain emotionally invested with our clients' purpose. Success for us is a measure of happiness, innovation, and professional excellence.

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FINANCIAL TIMES

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# About Our Private Funds and Asset Management Practice

Our core practice is centred around funds and asset management, and we have extensive expertise in advising on the various aspects in the lifecycle of an investment fund. We view fundraising as the foundation of the lifecycle of an investment fund and as a critical piece that informs various aspects of its operations and investment programme. We apply a rigorous process to our fund formation projects, which involves a study of the outcome of prior investor negotiations and approaches adopted by peer funds in the market, a thorough deliberation of the commercials, and ultimately, the structuring and Marketing Analysis exercise.

Our funds practice benefits from our team's first-hand experience with fundraising on behalf of some of the largest fund houses in India, Europe and the United States. Internationally, members of our team have represented some of the largest sponsors such as EQT and CVC on their flagship buyout funds. Our team has acted on product offerings across various asset classes, ranging from vanilla venture capital and private equity funds to more bespoke products in the real estate, infrastructure, debt, fintech and impact investment space. We take pride in being thought leaders, unafraid of innovation and have been at the forefront of developing innovative structures during challenging fundraising cycles.

On the research side, we closely follow judicial developments and market trends on governance issues and fiduciary responsibilities. As these continue to assume greater importance in LP-GP negotiations during the course of fund operations, we are committed to identifying and defending the most efficient protections in terms of key person obligations, change of control, GP removal triggers and indemnification provisions.

As lawyers, we believe it is important to shape conversations relating to legal reform. With this in mind, our team has been actively involved with the rollout of the Foreign Portfolio Investors (FPI) Regulations (which replaced the erstwhile FII Regulations) and the introduction of the regulatory framework for Real Estate Investment Trusts, to take a few examples. Whilst the mainstay of our practice is focused on representation of sponsors, our team has, from time to time, been retained to act for LPs in special situations (such as where the LP is the cornerstone investor or where the LP is participating in a managed account arrangement or investing in a single-asset fund). We have been engaged repeatedly by some of the world's largest sovereign wealth funds, pension funds and large institutional investors.

### Our team offers the following scope of services in relation to fund formation:

- **Pre-Structuring Review and Analysis**

  As a first step, our team will sit down with the sponsor and hold a detailed discussion on proposed commercials and fund terms. As a part of this process, we will review Marketing Analysis in relation to prior funds to study the positions previously negotiated with investors and suggest improvements.

- **Structuring**

  Our team will evaluate various jurisdictions and types of legal entities to identify the most efficient structure for the proposed fund / investment platform from a legal, tax and regulatory perspective. As a part of this process, we will also advise on a suitable structure for the management of the fund / investment platform (including with respect to extraction of fee / carry).

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- **Marketing Analysis**

  Depending on the existing investor base of the fund as well as the sponsor's target investors, our team will coordinate with local counsel in relevant jurisdictions and compile a set of rules and restrictions that must be adhered to when marketing interests of the fund / vehicle in various jurisdictions.

- **Documentation**

  Our team will be responsible for generating drafts of the various documents that are required for the fund / investment platform including the private placement memorandum, indenture of trust, management agreement, subscription agreement, shareholders agreement, inter se agreement, parallel investment agreement etc.

- **Interface with Regulators**

  Wherever necessary, our team will prepare communication and liaise with the Indian regulators including for the purposes of registering a fund or seeking a licence.

- **Investor Negotiations**

  We will run the process of investor negotiations in consultation with the sponsor. Our team will liaise with investors to address their questions and comments and requests for side letter comfort.

- **Post-Closing Formalities**

  Our team will be responsible for running the MFN process, documenting any post-closing amendments, preparing compliance checklists and calendars, etc.. Where the structure includes a SEBI-registered AIF, our team will also be available to conduct a legal audit.

- **Coordination**

  The process of setting up a fund involves liaising with regulators and service providers in a number of jurisdictions. We understand the importance of coordinating the various parts of the fundraising process in a timely manner and strive to be a single point of contact for our clients.

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## Glossary

| Term | Definition |
|---|---|
| 40 Act | The Investment Company Act of 1940 (United States) |
| Advisers Act | The U.S. Investment Advisers Act of 1940 |
| AIFMD | Alternative Investment Fund Managers Directive |
| AIF Regulations | SEBI (Alternative Investment Funds) Regulations, 2012 |
| AOP | Association of Persons |
| ARC | Asset Reconstruction Company |
| Blended Carry | Refer to section G – Distribution Waterfall |
| Capital Commitments | Refer to section C – Key concepts of a closed-ended fund |
| Capital Contributions | Refer to section C – Key concepts of a closed-ended fund |
| Carried Interest | Refer to section C – Key concepts of a closed-ended fund |
| Carry Haircut | Refer to section G – No Fault Divorce |
| CBDT | Central Board of Direct Taxes |
| CCD | Compulsory Convertible Debenture |
| CCI | Competition Commission of India |
| CCPS | Cumulative Convertible Preference Share |
| Closing | Refer to section C – Key concepts of a closed-ended fund |
| Commitment Period/ Investment Period | Refer to section C – Key concepts of a closed-ended fund |
| Competition Act | The Competition Act, 2002 |
| Corpus | The sum total of capital commitments in an alternative investment fund |
| 'Deal-by-Deal' Sleeve | Refer to section G – Distribution Waterfall |
| Disclosure Circular | Refer to section D – Analysis of certain regulatory concepts |
| Distribution Waterfall | Refer to section C – Key concepts of a closed-ended fund |
| DTAA | Double Taxation Avoidance Agreement |
| ECI | Effectively Connected Income |
| ERISA | Employee Retirement Income Security Act |
| Escrow Reserve | Refer to section G – Types of Clawback Protection |
| EU | European Union |
| EU COGC | European Union Code of Conduct Group |
| FATF | Financial Action Task Force |
| FDI | Foreign Direct Investment |
| FEMA | Foreign Exchange Management Act, 1999 |
| FIPB | Foreign Investment Promotion Board |
| FPI Regulations | SEBI (Foreign Portfolio Investor) Regulations, 2019 |
| FVCI Regulations | SEBI (Foreign Venture Capital Investors) Regulations, 2000 |

| | |
|---|---|
| GAAR | General Anti-Avoidance Rules |
| GDPR | Global Data Protection Regulations |
| GIFT | Gujarat International Finance Technology City |
| Graded Carry | Refer to section G – Distribution Waterfall |
| Haircut | Refer to section G – No Fault Divorce |
| HNWI | High Net Worth Individual |
| Honeymoon Period | Refer to section G – No Fault Divorce |
| ICDR Regulations | SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 |
| IFSC Guidelines | SEBI (International Financial Services Centre) Guidelines, 2015 |
| Interim Clawback | Refer to section G – Types of Clawback Protection |
| InvITs | Infrastructure Investment Trusts |
| Investee Companies | The companies in which the fund invests |
| Investable Funds | The fund Corpus net of estimated expenditure for administration and management of the fund |
| Investment Manager | Provides investment management services to the fund in consideration of an annual management fee |
| IRR | Internal Rate of Return |
| IPO | Initial Public Offering |
| IRDA | Insurance Regulatory and Development Authority |
| LPAC | Limited Partner Advisory Committee |
| Management Fees | Refer to section C – Key concepts of a closed end fund |
| MCA | Ministry of Corporate Affairs |
| MFI | Multilateral Financial Institutions |
| MFN | Most Favoured Nations |
| Minimum Fund Corpus | Refer to section D – Analysis of certain regulatory concepts |
| Minimum Investor Commitment | Refer to section D – Analysis of certain regulatory concepts |
| Minimum Residual Maturity | Refer to section E – FPI investment into debt instruments |
| Minimum Sponsor Commitment | Refer to section D – Analysis of certain regulatory concepts |
| MLI | Multilateral Instrument |
| MoM | Multiple of Money Invested |
| NCD | Non-convertible debentures |
| NDI Rules | Non-Debt Instruments Rules, 2019 |
| NPS | National Pension System |
| LLP | Limited Liability Partnership |
| OCD | Optionally Convertible Debentures |

| | |
|---|---|
| OCRPS | Optionally Convertible Redeemable Preference Shares |
| OECD | Organisation for Economic Co-operation and Development |
| PE | Permanent Establishment |
| PFRDA | Pension Fund Regulatory and Development Authority |
| PN3 | Press Note 3 of 2020 |
| PPM | Private Placement Memorandum |
| PTC | Pass Through Certificate |
| QIB | Qualified Institutional Buyer |
| REITs | Real Estate Investment Trusts |
| RBI | Reserve Bank of India |
| SEBI | Securities Exchange Board of India |
| Securities Act | The U.S. Securities Act of 1933 |
| Settlor | Person who settles the trust and appoints the trustee |
| SMEs | Small and medium-sized enterprises |
| Sponsor | Sponsor of the fund who sponsors or seeds the fund, as more properly defined in the AIF Regulations |
| Sponsor Commitment | Refer to section G – No Fault Divorce |
| Staggered Catch-up | Refer to section G – Distribution Waterfall |
| SWF | Sovereign Wealth Funds |
| Target Exemption | Any transaction where the target has assets not exceeding INR 350 crore in India or has a turnover not exceeding INR 1,000 crore in India, and therefore, exempt from the mandatory pre-approval merger filing |
| Takeover Code | SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 |
| Tax Act | Income Tax Act, 1961 |
| Term | Refer to section C – Key concepts of a closed-ended fund |
| Trustee | Person appointed by the Settlor responsible for the overall supervision and management of the fund for which it is usually entitled to receive a trusteeship fee |
| UBTI | Unrelated business taxable income |
| USD | United States Dollar |
| VCC | Variable Class Company |
| VCOC | Venture Capital Operating Company |
| VCF Regulations | SEBI (Venture Capital Funds) Regulations, 1996 |
| VRR | Voluntary Retention Route |
| LP | Limited Partner |
| GP | General Partner |
| FPI | Foreign Portfolio Investment |

| | |
|---|---|
| NPA | Non-Performing Asset |
| AIF | Alternative Investment Fund |
| FVCI | Foreign Venture Capital Investor |
| SSF | Special Situation Fund |
| ART | Asset Reconstruction Trust |
| FME | Fund Management Entities |
| IFSCA | International Financial Services Centre Authority |
| RFQ | Request for Quote |

## A. Background: The Private Funds Market in India

The alternative investment funds (AIFs) market has increased consistently over the years in terms of both commitments raised and investments made. Commitments raised by AIFs increased by 18.87% in March 2025 with an increase of INR 2.14 lakh crores from March 2024. Investments made by Category I, II, and III AIFs increased by 10 thousand crores, 56 thousand crores, and 64 thousand crores with combined investment of around 5.4 lakh crores. Reports suggest that India saw private equity investments aggregating to all time high of USD 77 billion in 2021 spread across 1,226 deals in 2021 alone. 2020 was, however, relatively dampened from a fundraising perspective owing to COVID 19, which had a major impact on global economies. AIFs are on a rise in India and raised about 3.7 trillion INR by June, 2023, with the investments of the three different types of AIFs, viz., Category I, II and III, growing at CAGRs of 25 per cent, 49 per cent and 30 per cent, respectively from 2012. Notably, significant portion of investment in AIFs is made by domestic investors.[1]

The stock market dip in early 2020 was coupled with LP-GP relationships coming under severe stress. Denominator effect had its share of contribution as LPs pulled the plug on fresh investments and 'requested' GPs not to draw down capital.

While most public markets managed some form of recovery on the back of stimulus offered by governments, LPs have remained cautious and have in fact renewed their focus on portfolio valuations, fund governance and reporting at both the fund and portfolio levels. LPs are now increasingly requiring GPs to focus on their core strengths and identify their niche.

Guided by global experiences, some large institutional LPs appear to be moving away from the blind pool model towards direct investment. A number of seasoned institutional LPs increased their direct exposures to India with bolstered on-the-ground presence enhancing their deal sourcing and asset management capabilities. Considering their successful track record, LPs like GIC, CPPIB, CDPQ were seen engaging in, and exploring, more direct partnerships, minimising the role of financial sponsors and attendant costs. Not just institutional LPs, but even financial sponsors were keenly looking at setting up investment platforms with reputed operating partners, particularly in asset heavy asset classes.

Buyouts were on the rise, until Covid-19 disturbed the 'normative' financial benchmarks forming the very basis of deal making. The bid-ask gap became huge, making exits difficult, which in turn impacted fresh fundraising. Offshore leverage for fund investments in India was also subdued. Growth, credit and special opportunity deals therefore appeared more conducive. The high-yield Indian debt market attracted an unprecedented amount of global interest, even though deal completion was somewhat muted. Other than primary structured debt deals, global credit and special funds were keenly looking at acquiring standard credit portfolios, both retail and corporate, at substantial discounts through securitisation trusts. Offshore funds, restricted until recently, were recently permitted to acquire an interest in such loans portfolio by subscribing to pass through certificates (PTCs) under the FPI Route.

[1] RBI Bulletin- December 24, 2024; SEBI's Data relating to activities of Alternative Investment Funds (AIFs).

Distress funds also showed interest in the Indian NPA story and some of them looked to acquire interests in sub-standard debt through security receipts issued by asset reconstruction companies (ARCs), though the interest in standard assets outstripped interest in sub-standard assets. This was largely due to the overstated role of ARCs and regulations requiring a form of forced and rather unnecessary partnership between foreign investors (or PTC holders) and the ARC.

Another interesting development that impacted global investment funds was the introduction of Press Note 3 of 2020 (PN3). PN3 required that any foreign investment with Chinese beneficial ownership should require prior approval of the government of India, without actually clarifying what the term 'beneficial ownership' meant. This restriction seemed to apply irrespective of the fund being a listed or an unlisted vehicle. PN3 caused a flurry as large global fund investors could also be caught within its reach and be subjected to the approval process due to the presence of Chinese investors. PN3 galvanized financial sponsors to think of creating India focused vehicles without any Chinese investors to preclude the need of seeking regulatory approval.

While a majority of the global financial sponsors still choose to invest in India out of their global funds with limited or no specific allocation for India, there has been an increasing trend in the past few years to raise India focused funds. These India focused funds can either be in the nature of funds or quasi-fund structures such as investment platforms or managed accounts with financial sponsors (or increasingly with developers) investing in private equity, private debt, public equity and public debt.

On the home front, the Government of India gave a shot in the arm to its offshore financial services centre, the IFSC (or GIFT City), by rejigging its management structure. Tax exemptions, regulatory rationalising and single window clearance have driven some sponsors to set base in the IFSC.

Fundraising activity in India generally falls into one of the following broad categories:

1. Domestic financial sponsors raising funds from domestic investors.

2. Domestic financial sponsors raising funds from global investors.

3. Global financial sponsors raising funds from global investors for global investments, with or without an allocation for India.

4. Global financial sponsors raising funds from global investors for investments primarily in India.

5. Managed accounts or separate accounts, where institutional LPs require the financial sponsor to invest in India on a deal-by-deal basis, or which are created for targeted assets.

6. Investment platforms with Indian operating partners, where financial sponsors or institutional LPs directly partner with an operating partner.

7. Quasi-fund structures such as Infrastructure Investment Trust in (InvITs) and Real Estate Investment Trusts (REITs).

Categories 2, 4, 5, 6 and 7 have shown a stable increase, and these trends are likely to continue.

The legal, tax and regulatory framework for investment funds is being driven not just by the letter of the law, but also by unwritten and commonly understood regulatory and tax customs. SEBI's approach continues to move away from laissez faire to one that is distinctively hands-on. Amongst other things, this is manifest in the prescriptive nature of rules and regulations laid down by SEBI in recent times. For instance, SEBI prescribed the form of private placement memorandum to be used by alternative investment funds in early 2020. More recently, SEBI has prescribed minimum experience standards for key personnel. The tax authorities, on the other hand, are becoming more aware of complex fund structures and armed with tools of MLI, GAAR and indirect transfer tax, are looking at 'innovative' fund structures more carefully.

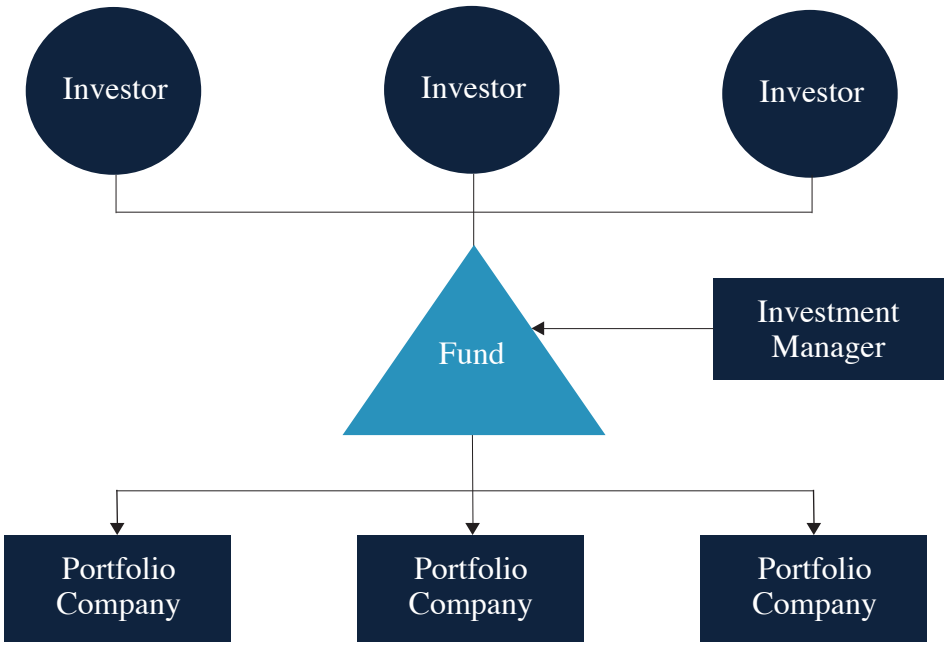
This paper aims to assist global fund counsel and fund managers on India focused fund formation from a legal, tax, regulatory, commercial, and strategic perspective.

## B. Key Features of a Fund

A fund is a vehicle that pools capital from investors with a view to invest such capital in accordance with a defined investment policy. Historically, investment funds were set up as limited partnerships under which the liability of investors (or limited partners) was structurally limited to the extent of their capital contribution to the fund vehicle whereas the fund manager (or the general partner) was responsible for the management of the fund and assumed unlimited liability for the debts and obligations of the fund.

### How does a fund work?

A fund is raised with the object of deploying capital in investment opportunities over a period of time, nurturing these investments and ultimately exiting the investments. The diagram below shows a simplified fund structure with investors, the manager and the portfolio companies that the fund invests in.




Some of the key concepts associated with a private close-ended fund structure may be illustrated with the help of the above diagram.

## Key concepts of a close-ended fund

**Capital Commitments**: The fund raises capital commitments from investors. As the name suggests, a capital commitment is a commitment by the investor to contribute (or invest) capital when called by the Investment Manager.

**Capital Contributions**: The portion of an investor's capital commitment that is actually contributed by the investor when called by the Investment Manager is known as such investor's capital contribution.

**Closing**: A closing occurs when an investor's offer to make a capital commitment to the fund is formally accepted by the Investment Manager. First closing of the fund shall be declared not later than 12 months from the date of SEBI communication for taking on record the private placement memorandum. Fund may declare its first closing upon meeting minimum corpus requirements. Further, the last date on which such offers are accepted is known as the final closing date.

**Commitment Period / Investment Period**: The commitment period / investment period of a fund is the period during which the Investment Manager can draw down capital commitment for the purpose of making investments in portfolio companies. Following the end of the commitment period, the purposes for which capital can be called are restricted.

**Term**: A close-ended private fund has a defined term (which is determined on the basis of a number of factors including the target asset class) during which investors will remain invested (i.e., they cannot exit except in extremely rare circumstances). The fund is expected to make investments and dispose of them prior to the end of the term. The term of the fund may be extended but such extensions usually require investor approval.

**Management Fees**: The Investment Manager is responsible for management of the affairs and investment programme of the fund. In consideration of its services, the Investment Manager is entitled to receive a periodic management fee. This fee is generally calculated with reference to capital commitments during the commitment period and subsequently with reference to capital invested.

**Distribution Waterfall**: Proceeds arising from the disposal of investments are distributed in accordance with a distribution waterfall. The waterfall sets out the sequence, extent and proportions in which distributions are to be made.

**Carried Interest**: In addition to the management fee, the Investment Manager will be entitled to a percentage share in the profits accrued upon realisation of the fund's investments. This share in profits is known as carried interest and is typically paid out only after investors have been returned their capital contributions, together with a preferred return.

## Tax Neutrality and Pass-Through Status

From a structuring perspective, the foremost consideration when choosing a fund vehicle is tax neutrality. What this means is that investors in a fund should be taxed no differently than they would have been taxed had such investors participated directly in the same investments that are made by the fund. To achieve this, funds are established as 'pass-through' or 'tax transparent' vehicles. In very simple terms, this means that money passes through the fund and is taxed at the level of the investor i.e., the fund itself does not pay tax. This makes sense since funds are merely pooling vehicles that collect capital from investors with a view to deploy it in accordance with an investment policy. However, the taxation mechanics tend to be more complex in practice.

Some vehicles are inherently tax transparent (e.g., partnerships, trusts, etc.) whereas others (such as corporations and Indian limited liability partnerships) are not. In the ultimate analysis, the tax treatment of fund vehicles will depend on the tax regimes in force. For instance, under Indian domestic tax law, venture capital funds and private equity funds are accorded pass-through status irrespective of whether they are set up as trusts, limited liability partnerships or companies.

## C. Domestic Funds

The private fund regime in India was formally introduced with the rollout of the Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996 (the "VCF Regulations"). The VCF Regulations permitted sponsors to set up venture capital funds, which were defined primarily in terms of a specific investment criteria. As the private funds ecosystem matured, it became apparent that capital pools had deepened and investor appetite for more bespoke investment strategies had grown. In response to these trends, SEBI introduced the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (the "AIF Regulations").

The regulatory framework applicable to domestic funds (and the AIF Regulations in particular) are discussed in detail in the sections below.

### Choice of Vehicle

Under the AIF Regulations, alternative investment funds may be set up as trusts, Limited Liability Partnerships ("LLPs") or companies. However, as mentioned in previous sections, the overwhelming majority of AIFs are set up as trusts.

Whilst the top consideration when choosing a fund vehicle is tax transparency, various other factors also come into play. One such factor is 'familiarity' – the trust structure has been around for decades and both investors and sponsors are familiar with the structure. Another key factor is operational flexibility – it should be possible to extract fee / carried interest and / or admit new investors without elaborate, time-consuming procedures.

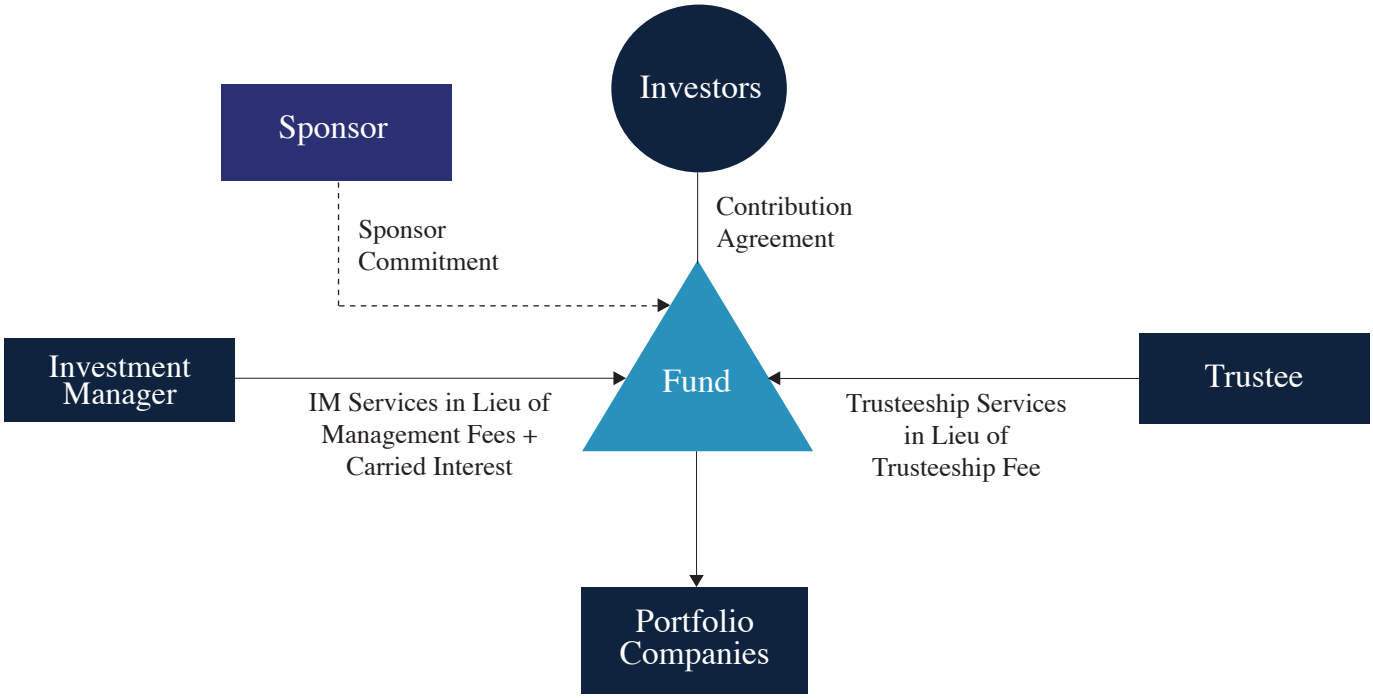
The chart below provides a rudimentary comparison between trusts, LLPs and companies from an investment funds perspective.

| | Trusts | LLPs | Companies |
|---|---|---|---|
| **Relevant Parties** | A trust consists of a Settlor, a Trustee and one or more beneficiaries. A trust is formed when the Settlor transfers property to the Trustee to be held and managed for the benefit of the beneficiaries. | A LLPs consists of two or more partners (with at least two designated partners). The relationship between partners is typically governed by the terms of a LLP agreement. | A company is constituted by shareholders and is managed by a board of directors. The relationship between the company, the directors and the shareholders is set out in the articles of association and may be more specifically described in a shareholders agreement. |

| | | | |
|---|---|---|---|
| **Management** | General management powers are conferred upon the Trustee under the instrument of trust. In practice, the trustee delegates management powers and responsibilities to an Investment Manager (to be discharged under the overall supervision of the trustee). | The designated partners are responsible for the overall management and compliance obligations of the LLP. In practice, management powers may be delegated to an independent Investment Manager. | A company is managed by its board of directors. However, management powers may be delegated to an Investment Manager (to be discharged under the overall supervision of the board of the company). |
| **Product Familiarity** | Trusts are the predominant vehicle through which AIFs are established in India. | Few funds are established as LLPs (although the Ministry of Corporate Affairs ("MCA") has historically not been enthusiastic about approving investment LLPs). | Companies are not used to establish AIFs. |
| **Operational Flexibility** | Wide operational flexibility in terms of extraction of economics and running the day-to-day affairs of the fund. | Wide operational flexibility in terms of extraction of economics and running the day-to-day affairs of the fund. | Low flexibility with respect to extraction of economics. Mechanisms to cater to day-to-day operational requirements remain subject to the Companies Act, 2013 and related delegated legislation. |
| **Confidentiality** | Limited disclosures. | Extensive disclosures with online access. | Extensive disclosures with online access. |
| **Compliance** | Limited compliances. | Extensive regulatory compliances and reporting to MCA in addition to AIF Regulations.<br><br>However, the LLP (Significant Beneficial Owners) Rules, 2023 exempt LLPs to the extent of AIF's contribution but not LLPs which are themselves established as AIFs. | Extensive regulatory compliances and reporting to MCA in addition to AIF Regulations. |

## Anatomy of a domestic fund

The following diagram illustrates a simplified domestic fund structure, where the fund is set up as a trust.




For tax reasons, the trust is settled by an independent settlor, who appoints the trustee and who makes an irrevocable settlement into the trust.

The trustee is responsible for the overall supervision and management of the fund for which it is usually entitled to receive a trusteeship fee. In practice, the primary management powers in relation to the fund are delegated to an investment manager under the terms of an investment management agreement.

The investment manager provides investment management services to the fund in consideration of an annual management fee.

The investment manager also doubles up as the sponsor. To demonstrate skin-in-the-game, investors usually require the management team (i.e., the sponsor) to make, and maintain, a minimum sponsor commitment to the fund.

The fund raises capital commitments from investors. During the life of the fund, the investment manager will draw down such capital commitments for the purposes of making portfolio investments (as well as for other purposes e.g., paying management fees and other expenses).

In almost all respects, the sponsor commitment is treated at par with capital commitments made by other investors. However, there may be some differences: for example, the investment manager will not charge a management fee on the sponsor commitment.

The sum total of capital commitments in an AIF is known as the corpus of the fund. The fund corpus net of estimated expenditure for administration and management of the fund is referred to as investable funds.

The investment manager will make portfolio investments in portfolio companies (which are also referred to as investee companies).

Proceeds arising on the sale / realisation of portfolio investments are available to pay any outstanding expenses following which, such proceeds will be available for distribution in accordance with the distribution waterfall.

For the purposes of the waterfall, the sponsor commitment is placed on the same footing as other capital commitments. However, the investment manager will usually be entitled to a percentage share in the post-capital profits earned by the fund – this profit share is called carried interest.

## Source of Capital

Generally, as a general comment, the sources of capital for domestic funds are not different from the sources of capital for funds in general albeit the relative concentration of different kinds of investors may differ from global standards. There are a number of factors that affect the investor profile of a fund – these include fund size, asset class, investment strategy, quality of existing investors, prudential norms, etc. A brief summary of the principal sources of capital for a domestic fund is set out below.

### High Net Worth Individuals (HNWIs)

Depending on the size of the fund, HNWIs could constitute a sizeable chunk of the fund corpus. It is not uncommon for top executives at large financial institutions to allocate a portion of their personal wealth to AIFs.

### Family Offices

The rollout of the AIF Regulations in 2012 heralded greater participation by family offices in AIFs. Management of family office wealth has become increasingly specialised and most Indian family offices make routine allocations to alternative investments.

### Corporations

Some corporations may find it useful for business and / or strategic reasons to invest in AIFs. However, such investments are largely made on a discretionary basis and tend to form a small portion of the overall corpus.

## Accredited Investors

SEBI introduced the concept of an "accredited investor" pursuant to amendments to the AIF Regulations in August 2021. An accredited investor is any person who is granted a certificate of accreditation by an accreditation agency. In the case of an individual, an accredited investor must have: (i) an annual income of at least INR 2 crores; or (ii) a net worth of at least INR 7.5 crores (of which not less than INR 3.75 crores is in financial assets); or (iii) an annual income of INR 1 crore and minimum net worth of INR 5 crores (of which not less than INR 2.5 crores is in financial assets). A body corporate may qualify for accreditation if it has a net worth of at least INR 50 crores.

As a part of the same set of amendments, SEBI has also introduced the concept of a "large value fund for accredited investors" i.e. an AIF in which each investor (other than the Manager, Sponsor, employees or directors of the AIF or employees or directors of the Manager) is an accredited investor and makes a commitment of not less than INR 70 crores. Such funds are likely to be populated by sophisticated investors who are well-aware of investment risks and are capable of taking a financial hit. Therefore, SEBI has relaxed some requirements for such funds (including crucially the diversification requirement).

## Banks

Participation by banks in alternative investments has been fairly brisk. However, given their critical importance to the economy, the Reserve Bank of India (the "RBI") has introduced prudential norms applicable to investments made by banks.[2] Pursuant to these prudential norms, no bank is permitted to invest more than 10% of the paid-up capital in a Category I or Category II AIF without prior RBI approval. Further, the total direct investment that can be made by a bank in REITs, InvITs, shares, convertible bonds, debentures, mutual funds and AIFs is subject to an overall ceiling of 20% of its net worth. Banks, financial institutions, and NBFCs (REs) were barred from investing in schemes of AIFs which have downstream investment in a debtor company to which the entity had loan or investment exposure (excluding equity shares, CCPS, and CCD) anytime during the preceding 12 months.

RBI, through the Investment in AIF Directions, 2025, has recently granted relaxations to REs regarding investments in AIFs.[3] Under the revised norms, a single RE is now permitted to contribute upto 10% of the corpus of an AIF scheme. However, the aggregate contribution from all REs in a single AIF scheme is capped at 20% of the corpus.

Importantly, if an RE's investment in an AIF scheme exceeds 5% of the scheme's corpus, it must make a 100% provision proportionate to the exposure in debtor company. The provisioning requirement is, however, limited to RE's exposure in debtor company.

Please refer to our paper in Annexure D for a detailed analysis on RBI restrictions on Bank Investments into AIFs.

[2] Reserve Bank of India (Financial Services provided by Banks) Directions, 2016. RBI/DBR/2015-16/25. Updated as on 10.08.2021.
[3] Reserve Bank of India (Investment in AIF) Directions, 2025 dated 29, July 2025.

## Insurance Companies

Insurance companies were among the earliest institutional investors in domestic funds. The Insurance Regulatory and Development Authority ("IRDA") issued a circular permitting insurers to invest in Category I AIFs and those Category II AIFs that have a mandate to invest at least 51% of their investable funds in entities that are venture capital undertakings, SMEs or which are engaged in the social venture or infrastructure sectors.[4] As per the IRDA circular, the individual exposure limit applicable to insurance companies is the lower of 10% of the fund corpus (20% for infrastructure fund) and 20% of the overall exposure cap. The overall exposure cap for life insurance companies is 3% of the fund value whereas the same for general insurance companies is 5% of investment assets. Insurance Companies should ensure that the AIFs do not invest in securities of companies incorporated outside India. In April 2021, the IRDA issued a fresh circular permitting insurance companies to take exposure to an AIF that operates a 'fund of funds' strategy provided that such AIF does not indirectly invest in overseas companies / funds. Further, an insurance company is restricted from investing in an AIF which has exposure in a fund of funds in which such insurance company has already taken exposure. Insurance companies are restricted from investing in AIFs that have a priority distribution model.[5] Insurance companies should ensure that the sponsors of AIFs should not be from the promoter group of the insurance company. The AIF should not be managed by a manager who is controlled or managed by the insurance company or promoter.

## Pension Funds

Subject to certain exposure limits, pension funds falling under the National Pension System (NPS) Schemes are permitted to invest in Category I AIFs and Category II AIFs that have a mandate to invest at least 51% of their investable funds in entities that are venture capital undertakings, SMEs or which are engaged in the social welfare or infrastructure sectors.[6] The Pension Fund Regulatory and Development Authority ("PFRDA") has set out the following principal safeguards in respect of pension fund investments in AIFs: (i) an overall investment ceiling of 2% of the pension fund corpus; (ii) investments permitted only in funds with a corpus of INR 100 crores or more; and (iii) exposure to a single fund to not exceed 10% of the corpus. Through a notification in March 2021, the Ministry of Finance permitted private pension funds (i.e Non-Government Provident Funds) to invest up to 5% of their assets in the units of Category I and Category II AIFs. However, the conditions applicable to funds falling under the National Pension System relating to investment exposure for Category II AIFs, the fund corpus and the individual fund exposure limits have been made applicable to private pension funds as well. The sponsor of the AIF should not be the promoter in pension fund or the promoter group of the pension fund.[7] Additionally, the AIF should not be managed by investment manager, who is directly or indirectly controlled or managed by the pension fund or the promoter group of the pension fund.

[4] Investments Master Circular – IRDAI (Investment) Regulations, 2016 dated 27/10/2022.
[5] Master Circular 2022 and Circular 2023 by IRDA.
[6] PFRDA Circular No. PFRDA/2016/8/PFM/02 dated 08.04.2016.
[7] PFRDA October, 2023 Master Circular.

### Sovereign Wealth Funds (SWFs)

SWFs are investment entities that are owned and controlled by a national, state or local government. Given their size and backing, they tend to make large capital commitments (and are often the cornerstone investor in AIFs) in exchange for preferred terms.

## An overview of the regulatory framework

As mentioned earlier on, SEBI rolled out the AIF Regulations to cater to the evolving risk appetite among investors. The AIF Regulations subsumed the concept of venture capital funds within its scope and significantly downgraded the status of the VCF Regulations.[8] SEBI has allowed flexibility to venture capital funds registered under VCF Regulations to migrate to AIF regulations and avail the facility of dealing with unliquidated investments of their schemes upon expiry of tenure.

The most important development was the introduction of different categories of alternative investment funds. A number of theories have been suggested as to the basis for the categorisation of alternative investment funds but from a perusal of the AIF Regulations, it would appear that SEBI saw fit to create three broad categories to cover a broad range of asset classes and investment strategies.

The table below summarises the three different categories of alternative investment funds under the AIF Regulations.

| Category I AIFs | Category II AIFs | Category III AIFss |
|---|---|---|
| Investments in start – up, early stage ventures, SMEs and infrastructure. Also includes social impact funds, and special situation funds. | AIFs that are not covered by Category I or Category III AIFs. | Employs diverse trading strategies and includes hedge funds and funds that trade to make short term returns. |
| Investments in sectors having positive spillover effects on the economy and for which the sector might receive benefits or concessions from the Government. | Does not employ debt at the Fund level (debt taken for day-to-day operations allowed under the Regulations). | Can undertake leverage at the Fund levels. |
| Includes funds which invest in other sectors or areas then the above mentioned which the government or regulator consider as socially or economically desirable. | Includes private equity funds and debt funds for which the fund does not receive any specific benefits or concessions from the Government. | Includes funds which do not receive any specific benefits or concessions from the Government. |

[8] See Regulation 39 ('Repeal and Saving') of the AIF Regulation.

The AIF Regulations prescribe specific investment conditions and restrictions to AIFs depending on their categorisation. Below is a snapshot of these conditions and restrictions.

| Category I AIFs | |
|---|---|
| | • No more than 25% of investable funds may be invested in a single investee company (except in the case of large value funds for accredited investors which can invest up to 50% of investable funds in a single investee company).<br><br>• Category I AIFs must invest in investee companies or venture capital undertakings or special purpose vehicles or LLPs or units of other AIFs in accordance with the AIF Regulations.Category I AIFs of a given sub-category may invest in units of a Category I AIF belonging to the same sub-category or in units of Category II AIF as specified.<br><br>• Borrowing not permitted to engage in any leverage for the purpose of making investments or otherwise, except to meet temporary funding requirements for no more than 30 days and not more than 4 occasions annually. Borrowing should not exceed 10% of investable funds.<br><br>May create encumbrance on equity of investee company, which is in the business of development, operation or management of projects in any of the infrastructure sub-sectors listed in Harmonised Masters List of Infrastructure by the Central Government, only for the purpose of borrowing by such investee company and subject to conditions specified.<br><br>Each sub-category of Category I AIFs are subject to further conditions and restrictions.<br><br>**Special Situation Funds (SSF)**<br><br>SSFs were introduced by SEBI as a Category I AIF via SEBI (AIF Amendment Regulations), 2012. The SSF under the framework have the ability to buy loans directly and are not just restricted to 'securities.' This will essentially help the offshore funds to invest / buy off bad loans in India without involvement of an Asset Reconstruction Company ("ARC") which had its own demerits. Please refer our paper in Annexure E for a detailed analysis on Special Situation Funds vis-à-vis ARC. |

| | |
|---|---|
| **Category II AIFs** | • No more than 25% of investable funds may be invested in a single investee company (except in the case of large value funds for accredited investors which can invest up to 50% of investable funds in a single investee company).<br>• Category II AIFs must invest primarily in unlisted investee companies and/or listed debt securities (including securitised debt instruments) which are rated 'A' or below by a credit rating agency registered with SEBI, directly or in units of other AIFs.<br>• Category II AIFs may invest in the units of Category I and other Category II AIFs as may be disclosed in the placement memorandum.<br>• Borrowing not permitted for the purpose of making investments or otherwise, except to meet temporary funding requirements, or as permitted by the AIF Regulations for no more than 30 days and at not more than 4 occasions annually. Borrowing should not exceed 10% of investable funds.<br>• Category II AIFs may engage in hedging subject to guidelines specified by SEBI from time to time.<br>• Category II AIFs may buy or sell credit default swaps subject to conditions specified by SEBI from time to time.<br>• Category II AIFs may enter into an agreement with a merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making under Chapter IX of the ICDR Regulations.<br>• Category II AIFs shall be exempt from regulation 3(1), 3(2) and 4(1) of Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992 in respect of investment in companies listed on the SME exchange or the SME segment of an exchange pursuant to due diligence of such companies.<br>However, to be eligible for this exemption, a Category II AIF must disclose to the stock exchange in which the relevant investee company is listed any acquisition or dealing in securities pursuant to such due diligence within two trading days. Moreover, the investment must be locked in for a period of 1 year from the date of investment.<br>• May create encumbrance on equity of investee company, which is in the business of development, operation or management of projects in any of the infrastructure sub-sectors listed in Harmonised Masters List of Infrastructure by the Central Government, only for the purpose of borrowing by such investee company and subject to conditions specified. |

| | |
|---|---|
| **Category III AIFs** | • No more than 10% of investable funds may be invested in a single investee company (except in the case of large value funds for accredited investors which can invest up to 20% of investable funds in a single investee company) directly or through units of other AIFs.<br>• Category III AIFs may invest in securities of listed or unlisted investee companies, derivatives, units of other AIFs or complex or structured products.<br>• Category III AIFs may deal in goods received in delivery against physical settlement of commodity derivatives.<br>• Category III AIFs may buy or sell credit default swaps in accordance with conditions as specified by SEBI from time to time.<br>• Category III AIFs may engage in leverage or borrow subject to investor approval and it has been specified that the leverage of a Category III AIF shall not exceed 2 times of the NAV of the fund.<br>• Custodian shall keep custody of the securities and goods received in delivery against the physical settlement of commodity derivative. |

For foreign investments in AIF, please refer to Section E of this paper.

## Analysis of certain regulatory concepts

Whilst most jurisdictions have been reluctant to lay down specific rules and standards for private funds (taking the view, perhaps, that such matters are best left to negotiations between investors and fund manager), the AIF Regulations legislate for various operational and governance aspects. Some of these are described below.

### Participation Threshold – Minimum Investor Commitment

No person making a capital commitment of less than INR 1 crore may be admitted as an investor in an AIF.[9] This threshold is relaxed to INR 25 lakhs for employees or directors of the fund and/ or the fund manager.[10] This threshold is enhanced to INR 70 crores in the case of a large value fund for accredited investors.

### Alignment of Interests – Minimum Sponsor Commitment

With a view of facilitating better alignment of interests between investors and the sponsor, the AIF Regulations require sponsors to maintain a minimum 'continuing interest' in alternative investment funds. For Category I and Category II AIFs (which together cover the entire spectrum of venture capital, private equity and debt funds), the minimum continuing interest is the lower of: (i) 2.5% of the fund corpus; and (ii) INR 5 crores.[11] For Category III AIFs, the minimum continuing interest is the lower of: (i) 5% of the fund corpus; and (ii) INR 10 crores. Whilst this is the bare minimum, investors may contractually negotiate a larger sponsor commitment.

[9] Regulation 10(c) of the AIF Regulations.
[10] Provision to Regulation 10(c) of the AIF Regulations.
[11] Regulation 10(d) of the AIF Regulations. As per the provision to Regulation 10(d), the minimum continuing interest for Category III AIFs (which would include hedge funds) is the lower of 5% and INR 10 crores.

## Minimum Fund Corpus

The AIF Regulations prescribe a minimum fund size of INR 20 crores.[12] For close-ended funds, it is generally accepted that the minimum corpus requirement needs to be satisfied at first closing. A fund with a corpus smaller than INR 20 crores would be in breach of law and although the AIF Regulations do not clearly specify the consequence of such a breach in the case of a close-ended fund[13], SEBI may well exercise its power under Regulation 29(1)(d) and direct the fund to wind up.

Whilst the AIF Regulations set a minimum corpus requirement, investors frequently request a cap on the total commitments that can be raised by a fund – this is popularly known as a hard cap.

## First Close

The first close of a scheme should be declared before 12 months from the date of SEBI communication for taking the PPM of the scheme on record. The first close for open ended schemes is the close of their initial offer period. While for large value fund for accredited investors, first close should be declared before 12 months from the date of grant of registration of the AIF or date of filing of PPM of scheme with SEBI, whichever is later. SEBI has also specified that the AIF need to have the minimum corpus prescribed in AIF Regulations at the end of the first close.

## Appointment of Custodian

A custodian is appointed by the AIF for safekeeping of the securities prior to the date of first investment of the scheme. An associate of the sponsor or manager can act as custodian, if:

a. Sponsor / manager has a net worth of at least INR 20,000 crores at all times.

b. 50% or more of the directors of the Custodians do not represent the interest of the sponsor / manager or their associates.

c. Custodians and sponsor / manager of the AIF are not subsidiaries of each other.

d. Custodians and sponsor / manager do not have common directors.

e. Custodian and manager sign an undertaking that they shall act independently of each other in their dealings of the schemes.

[12] Regulation 10(b) of the AIF Regulations.
[13] The consequences of such a breach for open-ended schemes is set out in paragraph 3 of SEBI Circular CIR/IMD/DF/14/2014 dated 19.06.2014. As per this circular, the AIF has a period of 3 months to restore the minimum corpus, failing which it is required to redeem the units of all investors.

## Tenure

The AIF Regulations have legislated extensively as to the tenure of close-ended alternative investment funds. Category I and II AIFs are required to have a minimum term of 3 years.[14] This is a fairly low threshold for most illiquid fund strategies. The tenure of close ended schemes shall be calculated from the date of declaration of first close, prior to which, the AIF may modify the tenure of its schemes. The term of an alternative investment fund may be extended by up to 2 years with the approval of investors representing at least two-thirds of the total investment in the fund. Where investor approval is not obtained, the fund is required to liquidate within 1 year following expiry of the fund's term (or extended term as the case may be).

Whilst the voting threshold under the AIF Regulations is not per se unreasonable, it does foreclose an element of operational flexibility. However, it is worth noting that the AIF Regulations were amended in August 2024 to provide that large value funds for accredited investors would be permitted to extend their terms by up to 5 years subject to compliance with the provisions of the fund documents and any conditions specified by SEBI.

Owing to the challenges faced by AIFs to liquidate their investments, SEBI introduced the dissolution period framework to provide flexibility to investors to deal with unliquidated investments. The dissolution period allows for additional time to deal with unliquidated investments within the same scheme. Conditions such as arrangement of bid for 25% of the value of its unliquidated investments and consent of 75% of the investors by the value of their investment in the scheme, need to be fulfilled to enter the dissolution period. However, if the bid fails but consent of 75% investors is received, then dissolution period may still be launched. If consent is not received for either entering dissolution period or in-specie distribution or if the AIF fails to sell unliquidated investments, then unliquidated investments shall be mandatorily distributed to investors in-specie.

## Overseas Investment

Alternative investment funds are permitted to invest in equity and equity linked instruments only of offshore venture capital undertakings, subject to the overall limit of USD 1,500 million (which applies on an aggregate basis to AIFs and VCFs registered under the VCF Regulations, and which is allocated on a 'first come first serve' basis depending on availability). An "offshore venture capital undertaking" is a foreign company whose shares are not listed on any recognised stock exchange in India or abroad. VCFs and AIFs have a time limit of 4 months from SEBI's approval for making the allocated investments in offshore venture capital undertaking, if the same is not done in 4 months, the unutilized limit will be allocated to other AIFs / VCFs.

AIFs / VCFs can transfer / sell the investment in overseas investee company only to the entities eligible to make overseas investments. Such transaction details should be intimated SEBI within 3 working days, for updating the overall limit available for overseas investment by AIFs/VCFs. No more than 25% of the investable funds of an alternative investment fund may be deployed in overseas

[14] Regulation 13(2) of the AIF Regulations.

investments. Further, it should be ensured that the securities market regulator of the investee company is a signatory to the IOSC's Multilateral MoU or the bilateral MoU with SEBI.[15] AIFs are restricted from investing in a company incorporated in a country identified in the public statement of Financial Action Task Force (the "FATF") as:

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

Capital contribution cannot be drawn from an investor who does not meet the above conditions, until the defect is rectified.

### Direct Plan

Schemes of AIFs now have an option of direct plan for investors, under which there would be no distribution fee / placement fee. The same is mandatory for investors who approach through a SEBI registered intermediary. This has been done with an intention to provide flexibility to investors for investing in AIFs, bring transparency in expenses and curb mis-selling.

Category I and II AIFs may pay 1/3rd of the distribution fee / placement fee upfront and remaining is to be paid on equal trail basis over the tenure of the fund. Category III AIFs are barred from charging upfront distribution fee / placement fee and can charge only on equal trail basis.

### Dematerialised Form

The AIF Regulations have been amended to mandate investments made by an AIF on or after July 01, 2025 to be held in dematerialised form only. If (i) the investee company has been mandated to facilitate dematerialisation of its securities; or (ii) AIF, on its own, or along with other SEBI registered intermediaries which are mandated to hold their investment in dematerialised form, exercises control over the investee company, then they are mandated to hold investments prior to October 01, 2024 in dematerialised form.

### Transaction in Corporate Bonds

AIFs are mandated to undertake at least 10% of their total secondary market trades in Corporate Bonds by value in a month by placing / seeking quotes on RFQ Platform. All transactions in Corporate Bonds between two AIFs should be executed through RFQ platform in one-to-one mode.

[15] SEBI August, 2022 Circular.

### Credit Default Swaps

Category I and Category II AIFs can buy CDS only for the purpose of hedging. However, Category III AIFs may additionally buy CDS for purposes of hedging and otherwise. Concentration norms should be kept in mind for such transactions. Category II and III AIFs can sell CDS by earmarking unencumbered government bonds / treasury bills equal to the amount of the CDS exposure, such that the CDS exposure does not amount to leverage. If the earmarked securities fall below CDS exposure:

i. It should be reported to the custodian on the same day.
ii. Rectification details to be sent to the custodian by the end of the next trading day.
iii. If the AIF fails to rectify, the custodian shall report details of the breach to SEBI on the next working day.

### Governance Considerations

The AIF Regulations have adopted a fairly proactive stance in terms of governance. One example of this has been cited above in the discussion around term extensions. In addition, the AIF Regulations have empowered investors by requiring their consent to be taken before performing certain actions (e.g. making material alterations to the fund strategy, making investments in associates, etc.) and authorising them to initiate certain actions (e.g. passing a resolution to wind up the alternative investment fund).

Moreover, the AIF Regulations specifically provide that the sponsor and manager (which may ultimately be the same entity) are required to act in a fiduciary capacity towards their investors and that they must disclose all conflicts of interests as and when they arise or are likely to arise.

SEBI has introduced responsibilities for members of the investment committee of an AIF and set out specific codes of conduct to be followed by various stakeholders such as the Trustee, the Manager, the Sponsor, the members of the investment committee and the key management personnel of the AIF. SEBI has mandated that the manager designate an employee or director as the Compliance Officer to monitoring compliance with various laws and regulations.

An AIF may excuse an investor from participating in an investment for reasons such as if it would be against any law. If the investor of an AIF is also an AIF or any other investment vehicle, such investor may be partially excused and the rationale for the same must be recorded. The manager may additionally exclude an investor if it would be against any law or would result in a material adverse effect.

### Disclosure Obligations

In light of developments in the financial sector in India and across the world, SEBI has begun to place significant emphasis on disclosure and transparency. The AIF Regulations set out a non-exhaustive list of items that must be included in a fund's private placement memorandum (PPM) during the fundraising process. This includes information such as targeted investors, fees and all other expenses proposed to be charged, risk management tools, disciplinary history, conflicts of interests

other expenses proposed to be charged, risk management tools, disciplinary history, conflicts of interests and procedures to identify and address these, etc. Separately, the AIF Regulations also contain a list of items to be disclosed to investors on an ongoing basis.

In June 2014, SEBI issued a circular setting out a number of disclosure guidelines (the "2014 Disclosure Circular").[16] Pursuant to this circular, sponsors were required to annex a tabular example of the distribution waterfall as well as the manner in which fees and expenses would be charged.

Subsequently, with a view to streamlining disclosure standards for alternative investment funds, SEBI released a circular in February 2020 (which was followed by a clarificatory circular in June, 2020) containing a template of a private placement memorandum with a section for minimum disclosures. Pursuant to the same circular, SEBI also made it mandatory for AIFs to conduct an annual audit to ensure compliance with the terms of the PPM.

As per Regulation 23 of the AIF Regulations, an AIF need to inform its investors, a description of its valuation procedure and the methodology for valuing assets. Category I and Category II AIF should undertake valuation of their investments, at least once every 6 months, by and independent valuer appointed by the AIF. SEBI released a circular regarding this in June 2023, as per which, valuation of securities which are not covered under SEBI (Mutual Funds) Regulations, 1996 shall be carried out 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.

Via the same circular SEBI has also clarified that, at each asset level, in case of a deviation of more than 20% between two consecutive valuations or a deviation of more than 33% in a financial year, the manager shall inform reasons for the same to the investors.

### Exit Rights

As a reflection of the seriousness with which SEBI views disclosure issues, the 2014 Disclosure Circular also provided that where material changes significantly influencing the decision of investors to remain invested in an alternative investment fund are made to the PPM, investors who do not wish to remain invested would be provided with the option to exit. For close-ended funds, such exit would be given effect by buying out, or facilitating the purchase of, units held by the dissenting investor(s) at a value that is greater than or equal to the average of the valuations determined by two independent valuers.

The most common scenario in which such an exit facility would be triggered is upon the replacement of the existing sponsor / manager. It is critical that the larger investor body is taken into confidence when such decisions are taken since the exit option would allow dissenting investors to withdraw themselves from the fund and leave a smaller corpus for new management. The exit option would also be implicated in circumstances in which fund management businesses are acquired. Such acquisitions typically result in a change of control at the level of the manager and sponsor.

[16] SEBI Circular CIR/IMD/DF/14/2014 dated 19.06.2014.

SEBI has prescribed that certain changes such as (a) change in sponsor/ manager (not including an internal restructuring within the group); (b) change in control of sponsor/manager; or (c) change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders; are to be construed as 'material' changes. These are only indicative in nature and other changes that impact the fundamental attributes of the fund/scheme should also be seen as 'material' changes. For such material changes, approval of 75% of unit holders by value of their investment in the AIF should be sought. If not, then dissenting existing unit holders who do not wish to continue post the change shall be provided an exit option at fair value, and such exit should be consummated in 3 months' time. For other matters, intimation to the SEBI should be fine.

## AIFs in the International Financial Services Centre (IFSC)

Following the rollout of the Securities and Exchange Board of India (International Financial Services Centre) Guidelines, 2015 (the "IFSC Guidelines"), SEBI issued a set of operating guidelines providing for the formation of alternative investment funds in the International Financial Services Centre (the "SEBI IFSC Guidelines").

Under the IFSC Guidelines, alternative investment funds may only accept money in foreign currency. The SEBI IFSC Guidelines therefore set USD thresholds for items such as minimum corpus, minimum commitment, interest, etc. – these thresholds roughly correspond to their INR equivalents under the AIF Regulations. In addition, the SEBI IFSC Guidelines clarify that an alternative investment fund set up in IFSC is permitted to invest in units of other AIFs set up in IFSC.

Investors in alternative investment funds set up in IFSC must be one of the following: (i) a person resident outside India; (ii) a non-resident Indian; (iii) an institutional investor resident in India who is eligible under the Foreign Exchange continuing Management Act, 1999 ("FEMA") and the rules and regulations made thereunder to invest funds offshore; or (iv) a person resident in India having a minimum net worth of USD 1 million and who is eligible to invest offshore in accordance with the RBI's Liberalised Remittance Scheme.

Aside from investments in securities listed in IFSC or in companies that are incorporated in IFSC or in companies set up in foreign jurisdictions, alternative investment funds are also permitted to invest in India. SEBI recently clarified that with a view to harmonize the provisions governing investments by alternative investment funds set up in IFSC with those applicable to domestic funds, AIFs set up in IFSC are permitted to make investments as per the provisions of the AIF Regulations and the guidelines and circulars issued thereunder.

IFSCA, the unified regulator for GIFT City, has notified the IFSCA (Fund Management) Regulations, 2025, introducing several investor and manager-friendly reforms aimed at increasing flexibility and competitiveness. Notable changes from the previous framework include:

1. **Reduced Minimum Corpus Requirement**

   The minimum corpus for funds has been reduced from USD 5 million to USD 3 million, making fund launches more accessible.

2. **Relaxations for Open-Ended Schemes**

   Open-ended schemes may now commence investment activity upon raising USD 1 million, with the full minimum corpus to be raised within 12 months.

3. **Inter-Scheme Transfers**

   Transfers between schemes are permitted but will now require prior approval from 75% of the investors by value.

4. **FME/Associate Contribution**

   The permissible contribution by the Fund Management Entity (FME) or its associates has been significantly increased from 10% to 100%.

5. **Joint Investments**

   FMEs may now accept investments from joint investors, provided each individual investor meets the minimum investment threshold of USD 150,000.

6. **Portfolio Management Services (PMS)**

   The minimum investment amount for PMS clients has been reduced to USD 75,000, enhancing accessibility for a broader investor base.

7. **Overseas Presence**

   FMEs are now permitted to open branches or representative offices in other jurisdictions, supporting international expansion and investor outreach.

A brief snapshot of Present Fund Framework in SEBI vis-a-vis IFSCA (Fund Management) Regulations, 2025 has been enumerated in the below table:

| S. No. | Factors | Existing Regime | New Regime | | |
|---|---|---|---|---|---|
| 1. | Categorization | Funds can be of 3 categories viz.<br>• Category I AIFs<br>• Category II AIFs<br>• Category III AIFs | Introduced 3 types of schemes, which may be launched through a fund as a pooling vehicle viz: | | |
| | | | **Venture Capital Scheme** | **Restricted Scheme (Non- retail)** | **Retail Scheme** |
| 2. | Meaning | **Category I**<br>AIFs which invest in start-up or early-stage ventures or social ventures or SMEs or infrastructure.<br>**Category II**<br>AIFs which do not fall in Category I and III.<br>**Category III**<br>AIFs which employ diverse or complex trading strategies. | Schemes that invest primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings etc. | Can invest in:<br>a. Start-ups, Social ventures, SMEs or infrastructure etc.<br>b. For undertaking diverse or complex trading strategies including investment in listed or unlisted derivatives.<br>c. Investment which does not fall under the clause (a) and (b) above can only be filed as Category II of AIFs. | Can invest in Social Ventures, Infrastructure, ESG sector, specific sectors certain themes such as infrastructure certain asset class (equity/ debt scheme) or towards certain solution (retirement, schemes for children education, etc.)<br>These schemes can invite funds from public investors as well. |

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| 3. | Managing Body | Investment Manager specifically designated for each fund. | Authorized FME. | Registered FME (Non-Retail). | Registered FME (Retail). |
| 4. | Open/Close Ended | Cat I and II are close ended.<br><br>Cat III can be open ended or close ended. | Close ended. | Can be open ended or close ended. | Can be open ended or close ended. |
| 5. | Corpus for each fund/ scheme | < 2.4 million USD. | < 3 million USD upto a maximum of USD 200 million. | < 3 million USD. | < 3 million USD |
| 6. | Minimum Investment by investor | 120, 000 USD (approx.) | 250,000 USD | 150,000 USD | At least 20 investors with no single investor investing more than 25% in a scheme. |
| 7. | Approval Process | Approval Required<br><br>(usually takes 8-9 months to secure all approvals). | Green Channel<br><br>– scheme starts immediately on filing placement memorandum. | Green Channel<br><br>– scheme starts immediately on filing placement memorandum. | Draft offer document to be placed for at least 21 working days before launch. |
| 8. | Borrowing/ Leverage | Permitted | Permitted | Permitted | Cannot borrow except to meet temporary liquidity requirements. |

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| 9. | Portfolio Management services | Separate approvals and registrations required.<br><br>Restrictions apply on an Investment Manager performing Portfolio Management services. | Registered FMEs (both non-retail and retail) can carry out Portfolio Management services as well. | | |
| 10. | Special Situation Funds | Can be launched as Category I AIFs, but no special exemptions or provisions available in GIFT City | Not Applicable | A sub-category of non-Retail schemes. The pooling vehicle is considered as a Category I AIF for tax purposes. | Not Applicable |
| 11. | Exchange Traded Fund (ETF) | Governed separately under SEBI Mutual Fund Regulations, 1996. | Not Applicable | Recognized as a specific sub-category for retail schemes with specific regulations for commodity ETFs, debt ETFs, equity ETFs, gold ETFs, silver ETFs and actively managed ETFs. | |
| 12. | InvIT & REIT | Governed under separate regulations (InvIT Guidelines, REIT Guidelines, the Trusts Act, the Registration Act, FEMA). | Not Applicable | Can be launched as a retail or non-retail scheme. Units of non-retail schemes may be unlisted or privately listed, similar to the regime in rest of India. This permits investment in yield-based schemes like infrastructure and real estate through GIFT City.<br><br>At least 20 investors with no single investor investing more than 25% in a scheme. | |

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| 13. | Tax Treatment | Category I and II AIFs are pass through – all investments are charged at the hands of the investor. No preferential rate applies for foreign investors. | Treated as Category I AIFs in the existing regime for tax purposes.<br><br>Exemptions available to VCFs set up under SEBI have been extended to VCFs set under the Regulations. | Depending upon the nature of investment, may be treated as Category I/II/III AIFs as in the existing regime, for tax purposes.<br><br>Various tax exemptions granted to specified funds (registered as Cat I,II, II AIF) such as no tax on income of fund's investors, capital gains exemption on transfer of non-equity security, etc. have been extended to Retails schemes and ETFs via Budget 2024. |

## Operational challenges relating to the AIF Regulations

The AIF Regulations have incorporated various measures to protect investors. Few mature jurisdictions (if any) have legislated so proactively to safeguard the interest of investors in private funds. In taking such a stance, SEBI may have limited the ability of the relevant parties to negotiate innovative structures and solutions in the larger interest of the fund and the investors as a whole.

Below are a few examples of operational challenges that arise on account of the framework of the AIF Regulations.

### Rigid Investment Limits

As discussed earlier on, Category I and II AIFs (that are not large value funds for accredited investors) are not permitted to invest more than 25% of investable funds in a single investee company. As a starting point, this is not an unfair threshold. However, there is no mechanism under the AIF Regulations by which this ceiling can be increased even if such an increase is in the larger interest of investors. Even a large value fund for accredited investors cannot, in any circumstances, invest more than 50% of investable funds in a single investee company. Usually, fund documents set concentration limits but permit such limits to be exceeded with investor approval. This is a reasonable approach but one that cannot be implemented under the scheme of the AIF Regulations. However, as a relief SEBI has provided flexibility to Category III AIFs, including large value funds for accredited investors, to calculate investment concentration norm based either on investable funds or net asset value of the scheme investing in listed equity of an investee company. The basis of calculation of investment concentration norm cannot be changed during the term of the scheme.

### Restriction on Co-Investment Vehicles

It is increasingly common for sponsors to invite certain investors (as well as strategic third parties) to participate in a portion of the underlying portfolio investment on a no-fee / no-carry basis by setting up a co-investment vehicle to invest alongside the main fund. Although SEBI has amended the AIF Regulations and the Portfolio Managers Regulations to introduce a legal framework for co-investments alongside an AIF, a number of operating challenges remain. The most important among these challenges from an administrative perspective is the restriction on setting up a dedicated co-investment vehicle, which would mean that the cap table of an investee company may be crowded by individual investors to whom co-investment opportunities have been offered.

SEBI has recently released a consultation paper on Co-Investment Vehicles (CIVs) and approved the proposed changes in its 210th Board Meeting. The CIV model is designed to streamline co-investments by enabling pooled investment structures within the AIF framework, effectively addressing long-standing challenges such as cap table fragmentation and duplicative regulatory requirements. By allowing LPs to invest through a single vehicle rather than holding assets directly, the CIV structure reduces compliance burdens and simplifies internal approval processes. While it removes the need for a separate Portfolio Manager license and introduces streamlined onboarding via a Shelf Placement Memorandum, concerns remain regarding mandatory co-terminus exits and possible delays due to the requirement for registration prior to deployment. For a detailed analysis of these developments, please refer to our paper on the consultation paper.[17]

For a deeper understanding, please refer our paper on Co-investment in Annexure G.

### Rigid Borrowing Restrictions

For Category I and Category II AIFs, fund-level borrowing is restricted to 10% of investable funds and to a period not exceeding 30 days, for not more than 4 times in a year. Category I and II AIFs shall also maintain a 30-day cooling off period between two periods of borrowings, from the date of repayment of the previous borrowing, Alternative investment funds in India are therefore unable to follow the popular international practice of using credit facilities to fund investments. Whilst the current cost of credit in India is commercially unattractive, this issue may resurface in the future should interest rates fall.

Category I and II AIFs are allowed to borrow for the purpose of meeting temporary shortfall in amount called from investors for making investments in investee companies, subject to certain conditions such as PPM disclosures, etc. It has been specified that the amount borrowed shall not exceed 20% of the investment proposed to be made in the investee company, or 10% of the investable funds, or the commitment pending to be drawn down from investors other than investors who failed to meet the call on amounts, whichever is lower. Such borrowings should only be made as a last recourse.

[17] SEBI's Consultation on AIF Co-Investments: Implications for LPs.

### Restriction on Tracking Interests

Under the AIF Regulations, it is not open for a sponsor to exclusively offer tracking interests to certain investors. Therefore, a bespoke arrangement where a specific investor only tracks a specific investment may not be possible under the scheme of the AIF Regulations.

## Taxation of Alternative Investment Funds

As mentioned in the section on 'Key Features of a Fund', the foremost consideration when choosing a fund vehicle is tax transparency or pass-through status.

Venture capital funds had been in operation even before the AIF Regulations and their pass- through status had historically been recognised under section 10(23F) of the Income Tax Act, 1961 (the "Tax Act").

The Finance Act that followed immediately after the coming into force of the AIF Regulations amended the Tax Act to include section 10(23FB), which made clear that pass- through status would extend to venture capital funds registered under the AIF Regulations.

Some fund managers tried to register private equity funds as Category I AIFs under the venture capital fund sub-category. Such funds should have properly been registered as Category II AIFs and such attempts encountered stiff resistance from SEBI's Investment Management Division. There was a reason that the AIF Regulations had created separate categories for venture capital funds and private equity funds and the regulator correctly took the view that fund managers could not overlook the categorisation under securities law to avail of a benefit under tax law.

There were a couple of more scrupulous options available, and most fund managers combined these with a view to minimise the risk of litigation:

- First, managers could make the case that the contributions made by investors to the fund were essentially "revocable transfers" under section 61 of the Tax Act and that any returns on investment should be taxed in the hands of the investors. This analysis is inherently supported by the very purpose of a fund, which is to deliver returns to investors on the capital that they invest.

- Second, managers would ensure that funds were established as determinate trusts. This required two conditions to be fulfilled: (i) the beneficiaries of income (i.e. the investors) arising to the trust needed to be identifiable on the date of the trust instrument; and (ii) the beneficial interests of the investors needed to be ascertainable on the date of trust instrument. If both conditions were satisfied, then a trustee would be taxed as a 'representative assessee' in like manner and to the same extent as the investors represented by it.

The 'determinate trust' analysis is not as unambiguous as the pass-through status afforded by section 10(23FB) but it at least clarifies the extent to which a trustee could be taxed on behalf of investors in a fund.

In July 2014, the Central Board of Direct Taxes (CBDT) issued a circular to clarify the principles of taxation of domestic funds. The circular said nothing about the applicability of section 61 but caused a fair amount of disquiet because it shifted the goalpost for what would constitute a determinate trust. The most controversial aspect was the requirement under the circular for the precise names of the beneficiaries to be written into the trust deed on the date of its execution (whereas it was previously sufficient for the beneficiaries to merely be capable of identification).

The circular could have seriously upended the still nascent domestic private funds industry if relief had not been forthcoming in the following budget. Among other things, the circular could have jeopardised the ability of a fund to hold multiple closings, which would have materially impaired fundraising efforts. Also, the circular would have undermined the ability of investors to transfer their interests in the fund and thereby impacted an investor's liquidity matrix.

The Finance Act, 2015 solved a part of the problem by introducing section 10(23FBA) in the Tax Act together with a number of associated provisions. Under the amended Tax Act, any income of a Category I or Category II AIF other than income in the nature of 'profits and gains of business or profession' would not be taxed at the level of the fund i.e. such income would pass through and be taxed in the hands of the investor.[18] Income chargeable under the head 'Profits and gains of business and profession' will be taxed at the fund level and the CBDT has also clarified that income received by investment funds would be exempted from TDS by portfolio companies. This would be particularly helpful with respect to coupon payments made by portfolio companies to investment funds as it was previously burdensome from an administrative perspective for investors to avail of credit of TDS withheld by portfolio companies.

One of the key features of the new pass-through regime is the requirement to deduct tax at 10% (or in accordance with the provisions of an applicable tax treaty) on income payable to an investor of an alternative investment fund in the manner set out in section 194LBB of the Tax Act. In view of the rule mandating the deemed credit of income to the accounts of unit-holders, the Finance Act, 2015 extended the requirement to deduct tax to scenarios where income is not actually paid or credited but only deemed to be credited.

With respect to the losses incurred by alternative investment funds, whether in the nature of business losses or otherwise, section 115UB had originally provided that the same could only be set off or carried forward by the fund and not by its investors. Accordingly, losses (other than business losses) arising to an alternative investment fund could not be passed through to its investors. The Finance Act, 2019 amended section 115UB to permit losses (other than business losses) to be passed through to investors. In order to avail of pass-through treatment in respect of non-business losses, investors should have been invested in the fund for at least 12 months. Business losses would be retained at the fund level and can only be set off against business income.

[18] See section 10(23FBA) of the Tax Act together with Explanation 1(a) to section 115UB of the Tax Act.

As per section 10(23FE) of the Tax Act (which was introduced by the Finance Act, 2015), income in the nature of dividend, interest or long-term capital gains arising from an investment made in a Category I or Category II AIF by: (i) a wholly owned subsidiary of ADIA that is resident in the UAE; (ii) a foreign sovereign wealth fund; or (iii) a foreign pension fund, is exempt from tax in India provided such investment is made on or after 1 April 2020 but before 31 March 2024 and is held for at least 3 years.

## D. An Overview of Foreign Investment Regimes

Foreign investment transactions are primarily governed by the Foreign Exchange Management Act, 1999 ("FEMA"), and the rules and regulations issued thereunder. Specifically, inbound equity investments are regulated by the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ("NDI Rules").

Foreign equity investment primarily flows through the following investment routes/regimes:

I. Foreign Direct Investment
II. Foreign Venture Capital Investment
III. Foreign Portfolio Investment
IV. Non-Resident Investment in an Investment Vehicle

These particular investment regimes have been discussed in this section.

### Foreign Direct Investment

The Foreign Direct Investment ("FDI") route is the most common entry-route used by non- residents to invest in equity and equity-like instruments of an Indian company. At the threshold, under the FDI route, a non-resident is permitted to invest in all categories of companies – viz. private, public unlisted and public listed companies. However, FDI investors are not permitted to buy and sell shares on the stock exchanges, unless such investors are already in control of the underlying target company.

#### Entry Approvals and Negative List of Sectors

From a sector specific perspective, foreign investment can be categorized as falling in one of 3 categories, which are as follows: (i) prohibited sectors; (ii) permitted sectors (government approval route); and (iii) permitted sectors (automatic route).

| Prohibited sectors – negative list of sectors | Permitted sector (Government approval route) | Permitted sectors (automatic route) |
|---|---|---|
| FDI is prohibited in companies operating in the following sectors:<br>a. Lottery business including Government or private lottery, online lotteries, etc.<br>b. Gambling and betting including casinos, etc.<br>c. Chit funds,<br>d. Nidhi company,<br>e. Trading in Transferable Development Rights | Some sectors are sensitive (given India's overall economic position), and foreign investment in excess of a certain percentage into these sectors is regulated either through government approval requirements or attached conditionalities. For instance, foreign investment into defence in excess of 74% | Unless a sector is specifically regulated under the two categories given above, foreign investment into all other sectors is permitted up to 100% without a requirement of approval from either the RBI or the Central Government. |

| | | |
|---|---|---|
| f. Real estate business (not inclusive of development of townships, construction of residential or commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships, real estate broking services, and REITs) and earning of rent or income on lease of the property, not amounting to transfer or construction of farmhouses,<br>g. Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes, and<br>h. Atomic energy and railway operations (other than permitted activities given in Schedule I of the NDI Rules).<br>i. Foreign technology collaborations in any form including licensing for franchise, trademark, brand name, management contract is also prohibited for lottery business and gambling and betting activities. | requires government approval, and also requires adherence to certain conditions. Similarly, investment into a private bank in excess of 49% and up to 74% requires government approval. | |

**PN3 and China Perspective**

Apart from the sector specific entry route to be followed by non-neighbouring countries, the Government vide Press Note 3 of 2020 dated 17.04.2020 has made it mandatory for an entity of a country sharing land border with India to take prior Government approval for investing in any of the permitted sectors. This requirement is also applicable where the beneficial owner of an investment into India is situated in or is a citizen of any such countries.

### Instruments

FDI investors are permitted to invest only in equity or equity-like instruments – i.e. equity shares, compulsorily convertible preference shares, compulsorily convertible debentures and compulsorily convertible share warrants. In other words, under the FDI route, investors are expected to assume the equity risk fully, and not acquire hybrid-equity or debt like instruments which provide price protection. An analytical comparison of these instruments has been given in the table below.

| Particulars | Shares | CCPS | CCD |
|---|---|---|---|
| **Character** | High risk – high returns | Fixed rate of dividend only in case of profits | Assured interest payments irrespective of profits |
| **Voting Rights** | Allowed | Available post conversion to equity. CCPS holders can also vote on an 'as if converted' basis, if given in the SHA. | Available post conversion to equity |
| **Convertibility** | – | Converted to equity on maturity (mandatory) | Available post conversion to equity |
| **Dividend / Interest Payments** | Discretionary dividend only in case of profits | Fixed dividend (in preference to equity dividend) only in case of profits | Fixed interest payment irrespective of profit/loss |
| **Deductibility** | Dividend not deductible | Dividend not deductible | Interest paid is deductible in the books of the target |
| **Taxation** | Dividend taxable in the hands of the dividend holder as per individual tax slabs | Withholding tax, ranging between 10% – 40%, depending on the jurisdiction of the investor | |
| **Liquidation Preference** | Last (i.e. after debt and preference shares | Before equity but after debt | Before equity and preference shares |
| **Pricing** | Investments permitted only above fair value, to be determined at the stage of issuance as per the NDI Rules | | |

The NDI Rules specify certain pricing guidelines for acquiring and transferring equity instruments of an Indian investee company (except where the pricing is already regulated by SEBI).

Accordingly, the price of an equity instrument issued/transferred by an unlisted Indian company to a Non-Resident cannot be lower than the price of such instruments valued as per an internationally accepted pricing methodology.

Likewise, at the exit stage, a Non-Resident is not permitted to transfer an equity instrument to a Resident at a value exceeding the price of such instrument calculated as per an internationally accepted pricing methodology.

These pricing norms are based on the guiding principle that a Non-Resident cannot be guaranteed a predetermined exit price at the time of making an investment and can only exit the investment at the prevailing market price.

### Other Considerations

At the time of on-boarding the investors, it should be ensured that the foreign investor of the AIF is a resident of a country whose securities market regulator is a signatory to the IOSC's Multilateral MoU or a signatory to the bilateral MoU with SEBI. Government or government related investors can be exempted from this condition by an approval by the Government of India.

Foreign investment is barred if the investor or its underlying investor is mentioned in the Sanctions List by UNSC. Additionally, the investor should not be a resident of a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply or a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with FATF to address the deficiencies, as recognized by FATF in its public statement.

For an existing investor, subsequently not meeting the conditions specified above, the manager shall not drawdown any further capital contribution from such investor for making investment, until the investor meets the said conditions.

The Indian investee company needs to ensure compliance of the sectoral/statutory caps and attendant con- ditions for receiving any foreign investment.

The recently introduced Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 set out the reporting requirements that need to be complied with for any investment to be made in India by a person resident outside India.

## Foreign Venture Capital Investment

A Foreign Venture Capital Investor ("FVCI") is an investor incorporated and established outside India and registered with SEBI under the Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000 ("FVCI Regulations"). In addition to the NDI Rules, every FVCI will have to comply with the provisions of the FVCI Regulations for its investments.

Even though foreign investment is generally regulated from an entry and exit perspective, the government identified certain sectors which are capital intensive or require risk capital. In order to attract investment into these sectors, the government came up with a special route called the FVCI route. Under this route, investment is permitted only in select sectors such as infrastructure, information technology, biotechnology etc. (Detailed list of sectors given in Annexure A).

Investing through the FVCI route has some benefits in comparison to the FDI route, such as:

### Flexibility around hybrid instruments

While FDI investors are usually permitted to invest in the equity and equity linked instruments (as explained above), FVCI investors are given full discretion to structure their investment instruments in any manner, including hybrid instruments such as OCDs, OCRPS, NCPS, etc.

However, this is subject to the FVCI Regulations that mandates a minimum investment of 2/3rds of the investable funds in unlisted equity shares or equity linked instruments of a venture capital undertaking/ investee companies, and a maximum investment of 1/3rds of the investable funds in the debt instruments of a venture capital undertaking/investee company (where the FVCI has already invested in the equity of such an entity) or shares offered at an IPO of the venture capital undertaking/ investee company. Under the FVCI regime, OCDs, OCRPS qualify as equity linked instruments, and not debt.

### Pricing Freedom

The pricing guidelines in the NDI Rules do not apply to any transaction undertaken by an FVCI, thereby allowing the FVCI to enter and exit (put option/buyback) an investment at a mutually agreed price between the FVCI and the investee company. This is beneficial for an FVCI while negotiating default consequences such as put options and buy backs, which under the FDI regime can only be effected at fair value (and not agreed value).

### QIB Status

FVCIs registered with SEBI have been accorded the status of a Qualified Institutional Buyer ("QIB") that makes them eligible to subscribe to securities at an initial public offer ("IPO") or a Qualified Institutional Placement, a short form fund-raising route for listed companies to raise money from institutional investors.

### Lock-in Exemption

The SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ("ICDR Regulations") exempt an FVCI from being locked in the pre-issued capital for a period of 6 months (from the date of allotment from the IPO), in case the equity shares held by an FVCI are locked in for a period of at least 6 monthsr from the date of purchase of such shares. This allows the FVCI to exit the investment immediately post the listing of the investee company.

Also, the promoters are exempted from complying with the open offer provisions as given in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("Takeover Code") in case of a transfer of shares by the FVCIs to the promoters based on an agreement between the FVCI and the promoter.

## Foreign Portfolio Investment

Foreign Portfolio Investors ("FPIs") are a special class of investors that are governed by the Securities and Exchange Board of India (Foreign Portfolio Investor) Regulations, 2019 ("FPI Regulations"). Pursuant to the FPI Regulations, an FPI is required to register with SEBI and each registered FPI is deemed to be an intermediary. In addition to equity instruments of a listed Indian company, FPIs may invest in equity linked instruments or debt instruments of Indian companies as per the terms and conditions given in Schedule II to the NDI Rules.

The erstwhile 2014 FPI Regulations provided for three categories of FPIs that have been now consolidated into two categories under the updated FPI Regulations. The principle guiding the division of categories is that well-regulated entities such as Government and government-related investors such as central banks, sovereign wealth funds, international or multilateral organizations, pension funds, university funds fall under Category I FPIs. The rest not being in the earlier category (majorly endowments and foundations, charitable organisations, corporate bodies, family offices and individuals) are Category II FPIs.

Under the FPI route, investment is divided into 2 broad spheres: (1) equity; and (2) debt. These spheres and the conditions to be considered in respect of each are discussed below.

| FPI investment into equity instruments Shares | |
|---|---|
| **Instruments** | FPI's are mainly permitted to trade in equity of listed stock under the FPI route. This means that FPIs are not permitted to undertake off-market transactions (with the exception of private placement transactions) like FDI investors. In addition, FPIs are permitted to invest in other instruments such as units of a REIT and an InvIT, though a foreign investor can invest in REITs and InvITs without being an FPI as well under Schedule VIII. |

| | |
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| **Instruments Investment limits and conditions** | The total holding by each FPI, or an investor group must be less than 10 percent of the total paid-up equity capital on a fully diluted basis or less than 10 percent (individual limit) of the paid-up value of each series of debentures or preference shares or share warrants issued by an Indian company. Further, the total holdings of all FPIs put together (including any other direct and indirect foreign investments in the Indian company permitted under the NDI rules) must not exceed 24 per cent (aggregate limit) of paid-up equity capital on a fully di- luted basis or paid up value of each series of debentures or preference shares or share warrants.<br><br>With effect from 01.04.2020, the aggregate limit has been brought in line with the FDI sectoral caps applicable to Indian companies with respect to their paid-up equity capital on a fully diluted basis (or such same sectoral cap percentage of paid up value of each series of debentures or preference shares or share warrants). This aggregate limit may be decreased to lower threshold limits of 24% or 49% or 74% or may be increased to 49% or 74% or the sectoral cap ceiling, by passing the relevant corporate resolutions.<br><br>However, the Indian company cannot decrease the aggregate limit to a lower threshold once the same has been increased to a higher limit. Further, the aggregate limit for investing in a prohibited sector shall be 24 per cent.<br><br>Lastly, in case the prescribed investment limit is breached, the FPI will have the option of divesting their holdings within 5 trading days from the date of settlement of the trades causing the breach. If the FPI chooses not to divest, then the entire investment in the company by such FPI and its investor group shall be considered as FDI and the FPI and its investor group shall not be allowed to further invest in the company through the FPI route. |

| FPI investment into debt instruments | |
|---|---|
| **General** | Investment by an FPI in debt instruments is regulated by the Debt Regulations pursuant to which FPIs have been permitted to invest in various debt instruments such as government securities, treasury bills, state development loans and corporate bonds/non-convertible debentures (“NCDs”) subject to certain limits and restrictions imposed by the RBI. FPIs may also invest into debt securities issued by InvITs and REITs. However, the most commonly used instrument in the offshore structured debt space is a corporate bond or an NCD. For investing in a corporate bond/NCD, the FPI has to adhere to certain conditions, which are summarised below. |

| | |
|---|---|
| **Investment Limits** | Investment by any FPI (together with investments by related FPIs) shall not exceed 50% of any issue of a corporate bond unless investment is made under the FPI – VRR route. In case an FPI (together with related FPIs) has invested in more than 50% of a single issue, it shall not make further investments in such issue. However, this requirement is not applicable to investments by Multilateral Financial Institutions ("MFI") and investments by FPIs in certain exempted securities (which includes security receipts and debt instruments issued by ARCs and debt instruments issued by an entity pursuant to an approved resolution plan under the Insolvency and Bankruptcy Code, 2016). |
| **Minimum residual maturity** | FPIs are permitted to invest in corporate bonds with minimum residual maturity of above one year, subject to the condition that short-term investments in corporate bonds by an FPI shall not exceed 30% of the total investment made by such FPI in corporate bonds. These stipulations would not apply to investments in exempted securities. |
| **End-use restrictions** | FPIs are restricted to invest in unlisted corporate bonds in the real estate business (as defined under the NDI Rules), capital market and for the purchase of land. However, FPI investment in listed NCDs are not hit by these end-use restrictions. |

To attract long-term and stable FPI investments into the debt markets, the RBI proposed a separate channel called the 'Voluntary Retention Route' ("VRR") besides providing FPIs with operational flexibility to manage their investments.

FPI-VRR provides freedom from macro-prudential and other regulatory prescriptions such as minimum residual maturity requirement or single/group investor-wise limits applicable to FPI investments in debt markets, provided FPIs voluntarily commit to retain 75% of their investments (committed portfolio size) in India for a minimum period of 3 years. FPIs therefore have the option to redeem 25% of their investment prior to the completion of the minimum retention period under the VRR.

An FPI participating under VRR is given the option to either remain invested under this route for an identical retention period or, at the end of the retention period, to either liquidate its portfolio and exit or shift its investment to the general investment limits permitted under the FPI route. Further, if the FPI wishes to exit its investments prior to the end of the retention period, it can only do so by selling its investments to one or more other FPIs.

## Non-Resident Investment in an Investment Vehicle

Schedule VIII to the NDI Rules allows a Non-Resident, or an entity incorporated outside India to invest in units of an Investment Vehicle. A foreign investor may take the following advantages by participating through this investment route.

### No Pricing Restriction

Normally, foreign investors (other than FVCIs) are subject to certain pricing guidelines while purchasing securities or selling/transferring such securities. However, a Non-Resident who has purchased units of Investment Vehicles in accordance with Schedule VIII is not bound by such guidelines and is allowed to sell or transfer the units to any Resident or Non- Resident at a price that is mutually agreed between the parties . It should however be noted that redemption of units in Investment Vehicles needs to be in accordance with the regulations framed by SEBI and directions issued by the RBI.

### Deemed Domestic Investment

Investment made by an Investment Vehicle into an Indian entity shall be reckoned as domestic investment and not downstream investment for the investee Indian company if the Sponsor or Investment Manager is owned and controlled by resident Indian citizens or is owned and controlled by an Indian Resident.

As a result, the Indian company receiving investment from such a Vehicle shall not be required to comply with the entry routes, sectoral caps, pricing guidelines and other attendant conditions applicable to foreign investment (including downstream investments).

As a corollary, therefore, if a non-resident, either owns or controls the Sponsor or the Investment Manager, the investments made by the AIF will qualify as downstream investments and be subject to thresholds applicable for foreign investments.

### Registration

As otherwise required under the FVCI and FPI investment regimes, registration of an FVCI or an FPI is not required when investing in the units of an Investment Vehicle, thereby freeing the foreign investor of regulatory conditions imposed by SEBI and RBI.

### Foreign Investment in AIF

AIFs may raise funds from non-residents by way of issue of units. At the time of on-boarding such investors, the manager of the AIF shall ensure that:

a. Foreign investor is a resident of a 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. AIFs may accept commitments from an investor being Government or Government related investor, who does not meet this condition, if the investor is a resident in the country as may be approved by the Government of India.

b. The investor, or its beneficial owner, is not mentioned in the Sanctions List of the United Nations Security Council and is not a resident in the country identified in the public statement of FATF as:

    a. a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or

    b. a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the FATF to address the deficiencies.

If an investor who has been on-boarded to the scheme of an AIF, does not meet the conditions later, then, the manager of the AIF shall not drawdown any further capital contribution from such investor for making investments, until the investor meets the above conditions.

## E. Offshore Pooling Vehicles

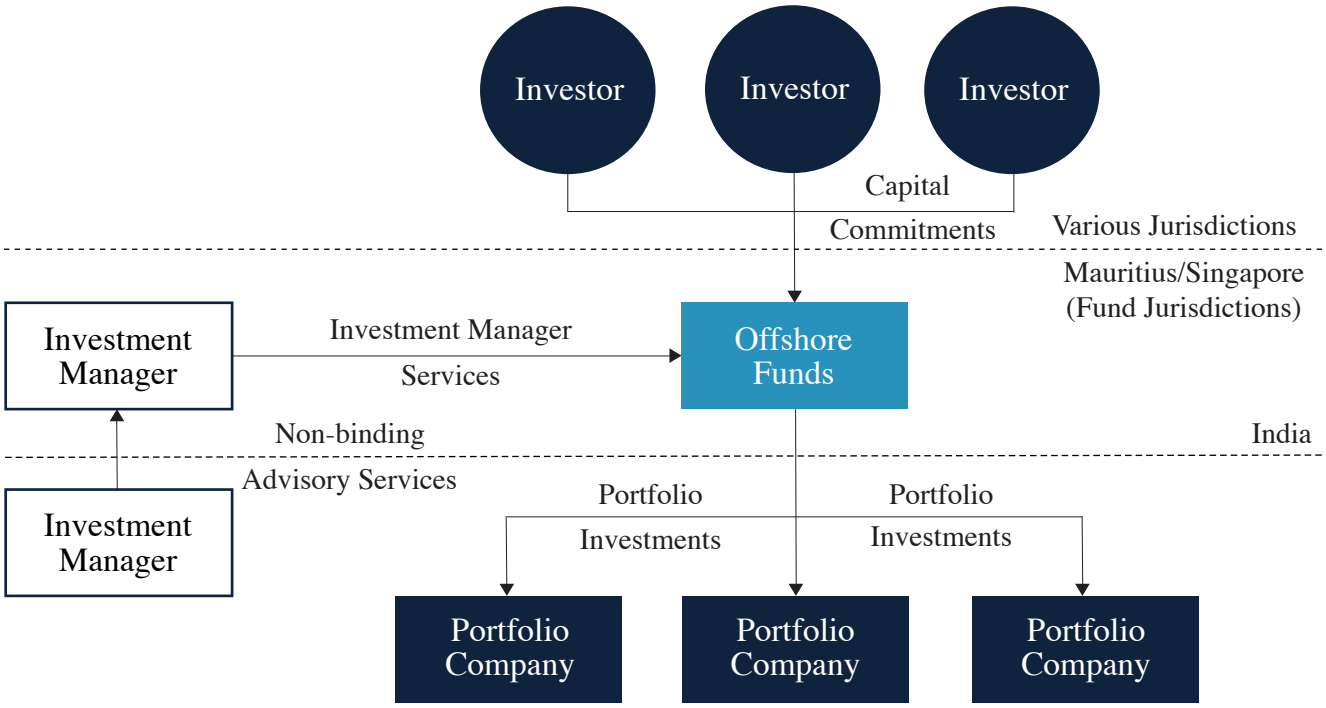
The liberalisation of the Indian economy in the early 90s helped generate momentum among foreign investors looking to allocate capital in India. India continues to be an attractive investment geography and capital allocations have remained largely stable. Further, the investment funds industry (which was still nascent in the early 90s) has experienced a few cycles of fundraising, investing and exits and has matured over the years.

As in the case of domestic funds, tax transparency is a key structural driver for offshore funds particularly in light of the fact that India follows source-based taxation. Credit for taxes suffered in India may not be easily available in the various jurisdictions in which investors are resident for tax purposes. Another important factor from a choice of jurisdiction perspective is investment protection – investors are increasingly focused on protection against expropriation, dispute resolution mechanisms, etc.

These and certain other aspects in relation to offshore pooling structures focused on investments in India are discussed below.

### Anatomy of a simplified offshore fund

The following diagram illustrates a simplified offshore fund structure.




To avail itself of benefits under a tax treaty, an offshore fund focused on investments in India is ordinarily established as a corporation.

An offshore fund may be externally managed by an independent investment manager (as show in the diagram above) or self-managed, in which case the investment decisions will be taken by the board of directors of the fund.

Most offshore funds retain an India-based investment advisor. The role of the investment advisor is to provide non-binding advice / investment recommendations to the investment manager (in the case of an externally managed fund) or to the board of directors (where the fund is self-managed).

The investment decision-making process is designed in this manner is to avoid any inference that the decision-making in relation to the fund is taken in India (which in turn may result in the fund being taxed in India).

Investors in an offshore fund may be spread across various jurisdictions. Depending on where investors are based, the sponsor will need to comply with applicable private placement / marketing rules.

Investors make capital commitments to the fund, which are deployed in accordance with the stated investment policy. As the offshore fund would be a 'foreign investor', it will need to comply with the foreign investment regimes applicable to it.

## Choice of Jurisdiction

Choice of jurisdiction is a central question to be considered when setting up India focussed funds. From a tax perspective, the choice should be made keeping in mind the following considerations:

### Commercial Substance and GAAR

With the introduction of a statutory general anti-avoidance rule (GAAR) regime in India, the focus of structuring exercises has shifted to ensuring that the various entities in the structure (including the fund vehicle) have 'commercial substance'. The question of what constitutes commercial substance has always been tricky with evolving case law and arguments. The consequences of the application of GAAR can be severe. Simply put, the provisions of a tax treaty may be overridden if it can be established that the choice of jurisdiction was driven purely (or even primarily) by tax considerations rather than by non-tax commercial reasons.

As a corollary, a strong case for why GAAR should not apply can be made if there are adequate non-tax reasons to choose a jurisdiction. In this regard, the following three principal factors are relevant:

**Purpose**: what is the real purpose of setting up an entity in a certain jurisdiction. While tax may be one of the considerations, there may be other non-tax reasons why investments into India are made from a certain jurisdiction. These could range from close cultural ties with India, a better and more flexible corporate law law regime, existence of a bilateral investment treaty which protects investments, etc. The purpose test should be applied not just with respect to jurisdiction but also for each entity in the structure.

**Pooling**: The risk of GAAR applying is higher for mere investment holding companies as against pooled investment vehicles. Since investors may pool funds from multiple jurisdictions, pooling of funds in a certain jurisdiction can sometimes be a good defence against the application of GAAR.

**People**: The presence of people in the jurisdiction to actually manage, and engage in, the business of the entity being set up lends significant legitimacy to the structure and corroborates the commercial substance argument. These people should be actual employees and not merely professional administrators acting for hundreds of similar companies. Singapore sometimes scores over Mauritius on this count as it is viewed as a more attractive business destination by people.

### Taxation under a Double Taxation Avoidance Agreement (DTAA)

The table below sets out the tax treatment for certain heads of income under the double taxation avoidance agreements ("DTAAs") with Mauritius, Singapore and the Netherlands. Care must be taken to consider the provisions of such DTAAs in the whole. For instance, the concept of 'beneficial owner' is relevant for the purposes of claiming treaty exemptions (largely for interest but also for dividends in Mauritius).

Beneficial ownership has been a rather obscure subject in the Indian context. Most recently, in M/s Golden Bella Holdings Ltd v Deputy Commissioner of Income Tax (International Taxation) the term 'beneficial ownership' was broadly defined by the following key determinants (i) exclusive possession and control over the interest income received; (ii) no requirement for the recipient to seek approval or obtain consent from another person for making investments; and (iii) absolute freedom for the recipient to utilize interest income received, unconstrained by any contractual, legal, or economic arrangements with any other third party.[19] Leaving a spread while making further distributions can also help allay the risk of beneficial ownership.

| Parameter | Mauritius | Singapore | The Netherlands |
|---|---|---|---|
| Dividends | • 5% tax withholding if the Mauritian entity is a 10% or more shareholder, and beneficial owner;<br>• 15% tax withholding otherwise.<br>• Locally: Mauritius will tax dividends at effective rate of 3%, subject to credits / tax exemptions. | • 10% tax withholding if Singaporean resident holds more than 25% shares;<br>• 15% tax withholding otherwise.<br>• Locally: Singapore does not tax dividends received from jurisdictions like India, where the headline tax is more than 15%. | • 10% under India – Netherlands DTAA.<br>• MFN – reduces rate to as low as 5% basis India – Slovenia DTAA. |

[19] M/s Golden Bella Holdings Ltd v Deputy Commissioner of Income Tax (International Taxation), Income tax appeal number: 6958/MUM/2017.

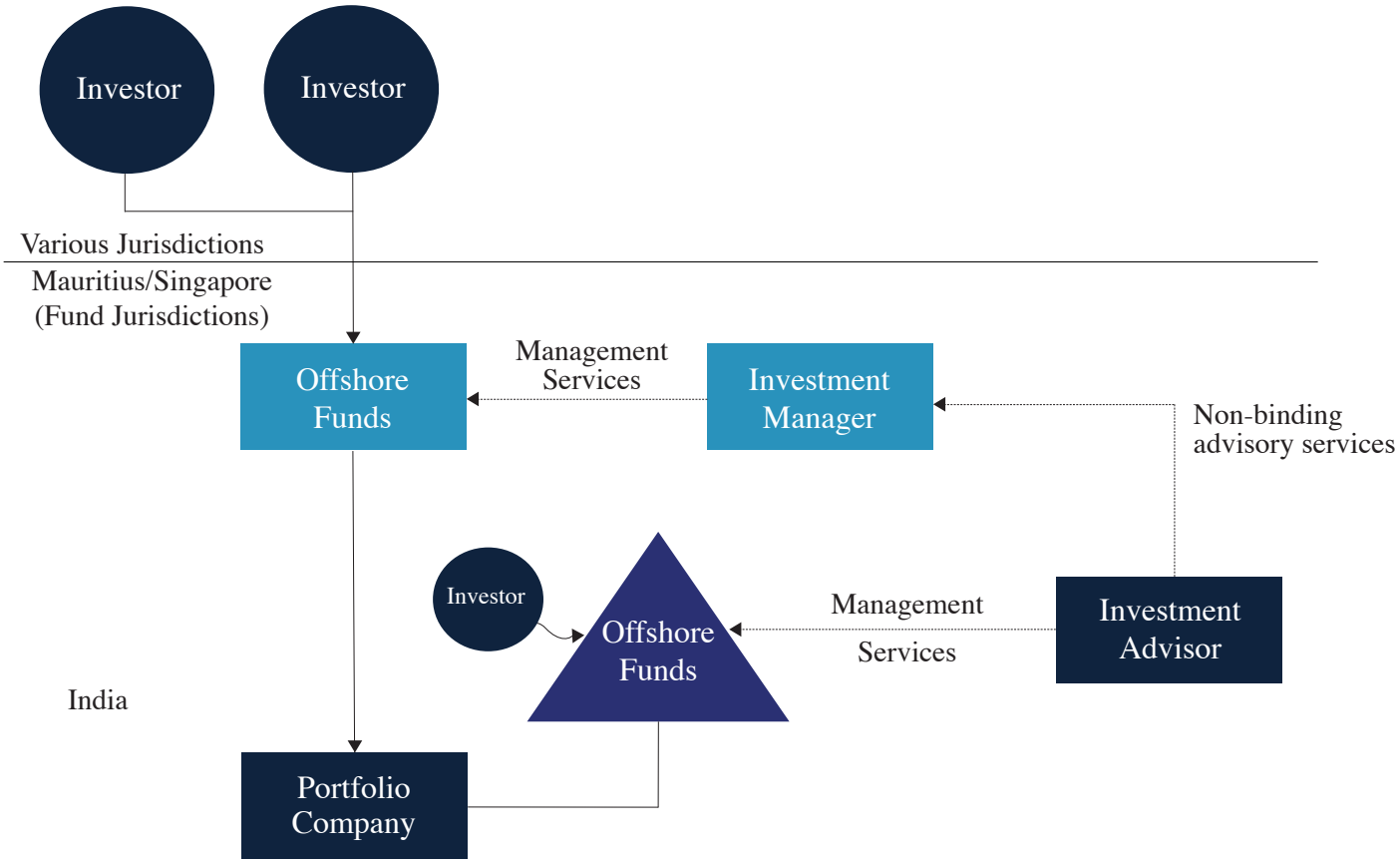
| | | | |
|---|---|---|---|
| Capital Gains | • Effective, April 1, 2017, India has the right to tax capital gains only on transfer of 'shares'<br>• Capital gains on instruments other than 'shares' not subjected to Indian tax (For instance, debentures etc.)<br>• Locally: Mauritius does not tax capital gains. | • Effective, April 1, 2017, India has the right to tax capital gains only on transfer of 'shares'<br>• Capital gains on instruments other than 'shares' not subjected to Indian tax (For instance, debentures etc.)<br>• Locally: Singapore does not tax capital gains. | • India can tax capital gains on alienation of shares (other than shares quoted on approved stock exchange) if such gains arise on a sale of 10% or more securities to an Indian resident, and if if such sale does not qualify as 'restructuring'.<br>• All other cases, capital gains to be taxed in Netherlands.<br>• Locally: Netherlands does not tax capital gains, subject to participation exemption.[20] |
| Interest | • Subject to a withholding tax of 7.5%<br>• Locally: Interest income effectively taxed at 15% with 80% tax exemption for foreign sourced dividends under the Partial Exemption Regime.[21] | • Subject to a withholding tax of 10% if such interest is paid on loan granted by a bonafide banking business or by a similar financial institution or 15% in other cases.<br>• Locally: Interest income taxed at 17%, though credit for 15% tax paid in India reduces the effective tax rate to only a further 2% in Singapore. | • Subject to a withholding tax of 10%<br>• Locally: Interest income taxed at 25% though credit for 10% tax paid in India reduces the effective tax rate to only a further 15% in the Netherlands.[22] |

[20] Participation exemption requires that the parent company holds a participation of at least 5% of, generally, the nominal paid-up share capital (or, in certain circumstances, 5% of the voting rights) of a company, AND satisfies one of the following three tests (a) the parent company's objective with respect to its participation is to obtain a return that is higher than a return that may be expected from portfolio asset management (the ' Motive Test'); (b) the direct and indirect assets of the subsidiary generally consist of less than 50% of 'low-taxed free passive assets' (the 'Asset Test'); or (c) the subsidiary is subject to an adequate levy according to Dutch tax standards (the ' Subject-to-Tax Test); and the payment received from the subsidiary is not tax deductible for the subsidiary.

| | | | |
|---|---|---|---|
| Local Tax Exemptions | Partial exemption regime | Full tax exemptions under 13X and 13R of Singapore Income tax for investment funds and SPVs held by qualifying funds. | Participation Exemption |
| FATF | White List | White List | White List |

## Parallel Investment Structure

Below is a diagram that illustrates a parallel investment structure.




[21] Mauritius abolished the global business license regimes in 2018, the concept of deemed foreign tax credits and introduced the Partial Exemption Regime, which is similar to the erstwhile regime and provides for an 80% tax exemption. OECD has now declared the Mauritian Partial Exemption Regime as not harmful as the regime complies with the OECD's standards. The conditions to be satisfied to avail of the Partial Exemption Regime include the following: (1) a GBC must, at all times, carry out its core income generating activities in, or from Mauritius by employing (either directly or indirectly) a reasonable number of suitably qualified persons to carry out the core activities; and (2) a GBC is expected to have a minimum level of expenditure proportio- nate to its level of activities. However, despite the positive reviews of the OECD, the European Union Code of Conduct Group (EU COCG) had flagged the Mauritian Partial Exemption Regime as harmful in February 2019. According to the EU COCG, the Mauritian Partial Exemption Regime does not have adequate substance requirements in terms of treatment of outsourcing activities. In response to the EU, the Mauritian Prime Minister recently announced that the Mauritian tax laws would be amended to stipulate conditions that must be satisfied where a company seeking to enjoy the Partial Exemption Regime outsources its core income generating activities. These conditions include the following: (i) the company must demonstrate adequate monitoring of outsourced activities; (ii) the outsourced activities must be conducted in Mauritius; and (iii) the economic substance of service providers must not be counted multiple times by different companies when evidencing their own substance in Mauritius. However, these changes have not been passed into law yet.

[22] The standard rate will decrease from 25% in 2020 to 21.7% in 2021. The lower rate will further decrease from 16.5% in 2020 to 15% in 2021.

In a parallel investment structure, the onshore fund (i.e. the domestic fund) and the offshore fund are raised in parallel. The offshore fund raises capital from investors outside India whereas the onshore fund raises capital from domestic investors.

The onshore fund is managed by the investment advisor, which also provides non-binding investment advice / recommendations to the external investment manager or the board of the offshore fund.

Once the separate pools of capital have been raised, the onshore fund and offshore fund will invest in parallel with each other i.e., the intention is that both funds will invest in the same portfolio companies.

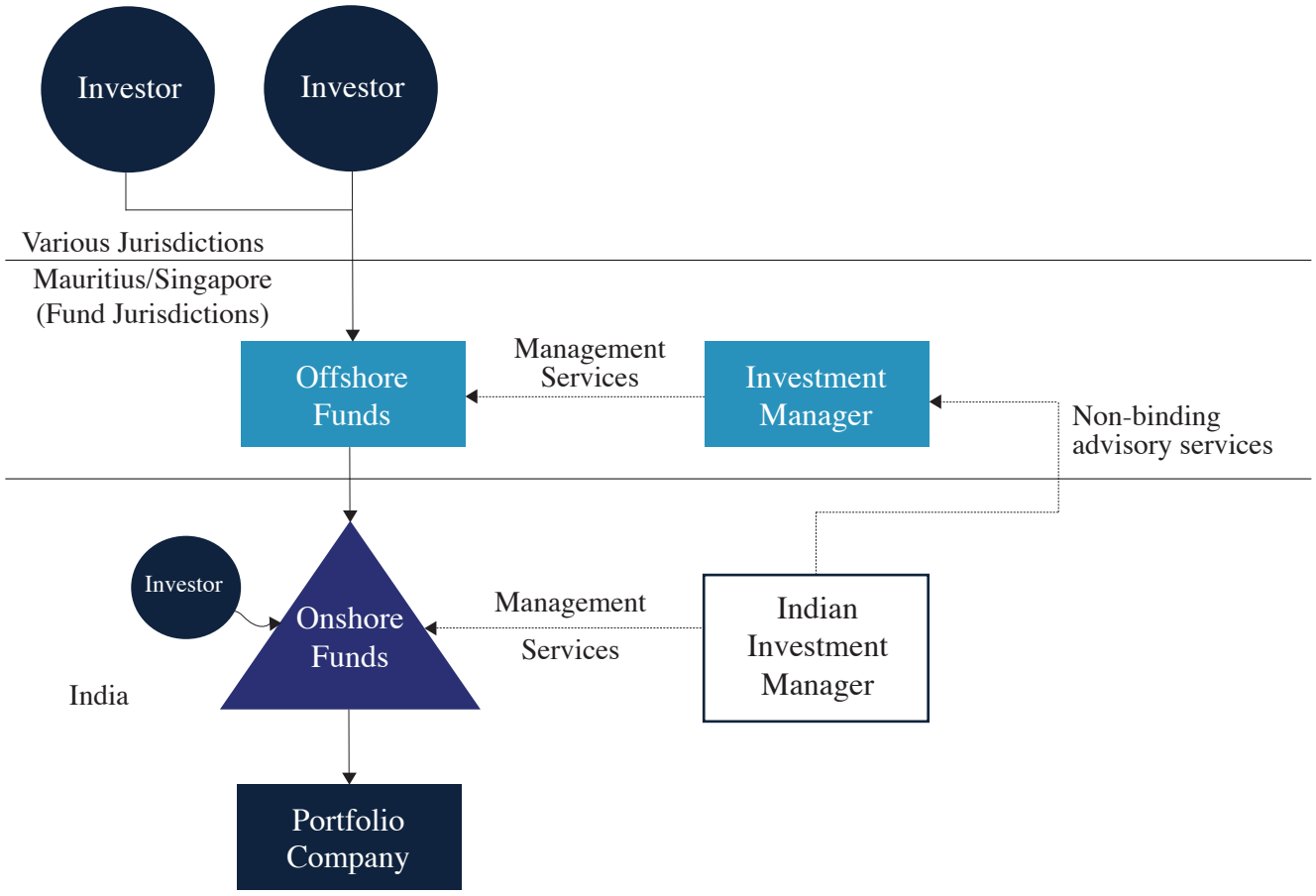
The terms on which the two funds will participate together will typically be set out in a separate parallel investment agreement. Among other things, this agreement will set out the basis on which costs are to be apportioned between the funds as well as the ratio in which the two funds will take up investment allocations.

From a management and administration perspective, it is also important to note that the onshore fund will be treated as standard domestic investor whereas the offshore fund will be treated as a foreign investor (and may be subject to additional conditions if it has obtained an FVCI / FPI licence).

Historically, investment by a foreign investor into a domestic trust required approval from the FIPB. There was no defined timeline for this, and the approval process would often take several months. It was in this context that many sponsors turned to the parallel investment structure as a way to kickstart their investment operations.

## Master-Feeder Investment Structure

Below is a diagram that illustrates a master-feeder structure.




In a master-feeder investment structure, the offshore fund pools capital from investors outside India and then makes a capital commitment to the onshore fund. The onshore fund separately also pools capital from domestic investors and forms a combined pool of capital.

The offshore fund may be externally managed or self-managed. In either event, an Indian investment manager may be retained to provide non-binding investment advice. In practice, the offshore fund is only required to take one investment decision i.e., to make a capital commitment to the onshore fund.

The onshore fund will be managed by the Indian investment manager under a standard investment management agreement.

In the last few cycles of fundraising, offshore investors have requested (and have generally been given) a preferred return calculated in foreign currency terms. Owing to currency fluctuations, this may mean that the sponsor is in the carry with respect to domestic commitments but not with respect to the offshore piece. This and various other currency- related issues need to be carefully addressed.

The master-feeder structure is the preferred structure for a number of reasons.

From a fundraising perspective, it provides a single, enlarged pool of assets. A number of domestic institutions cap their commitments at a percentage of the fund corpus. The inclusion of offshore commitments within the onshore fund corpus means that domestic institutions can make larger commitments.

From an investment perspective, the master-feeder structure offers the following advantages:

- Downstream investment by the onshore fund is considered domestic (notwithstanding participation by the offshore fund) as long as the investment manager is owned and controlled by Indians.
- The onshore fund is free to choose from a much wider universe of instruments.
- Sectoral caps are not applicable to investment made by the onshore fund (which can be contrasted with the parallel investment structure under which sectoral caps would apply to the offshore fund).
- The sponsor will be free to leverage the underlying portfolio investment (which would be restricted in respect of the offshore pool in a parallel investment structure).

## Bespoke Investment Platforms

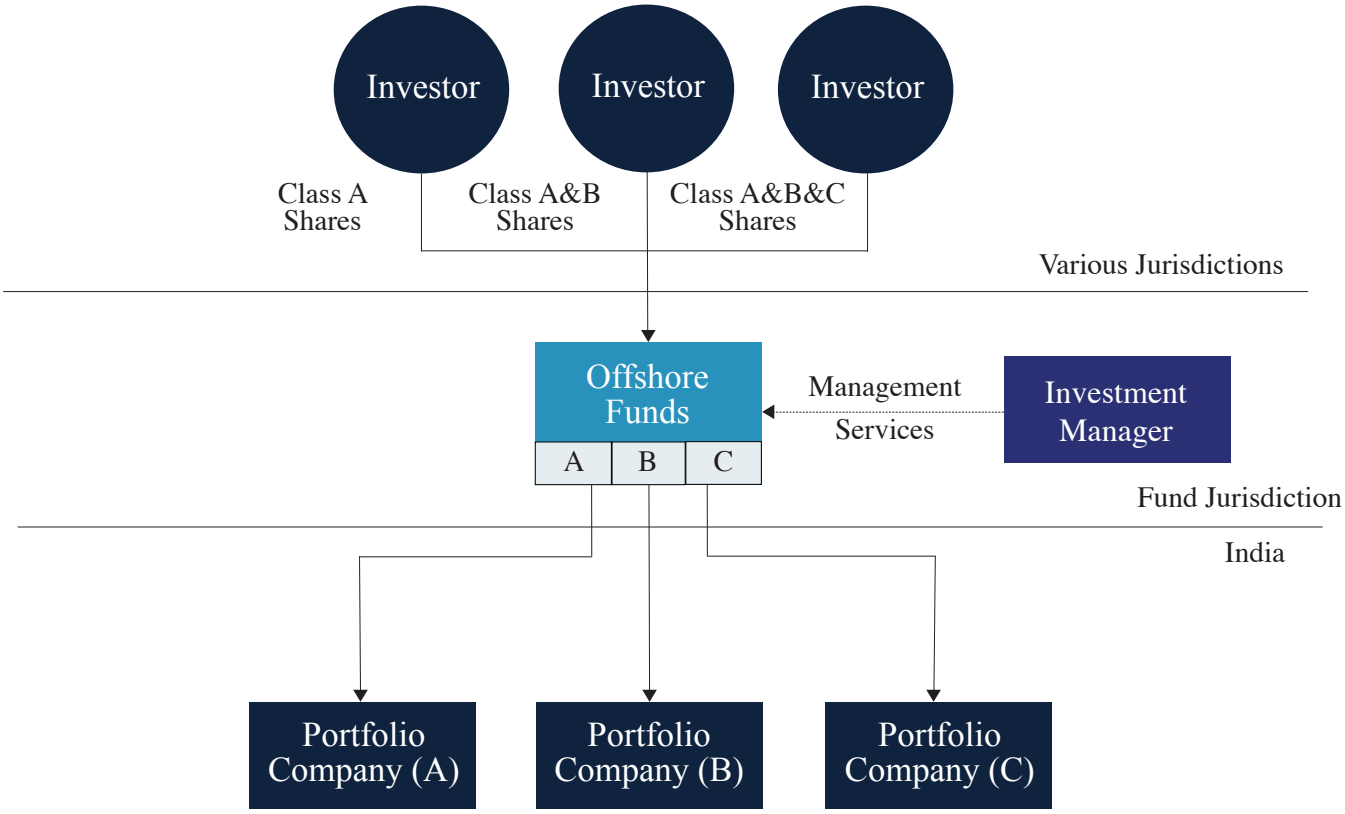
There has been a steady increase in the formation of bespoke investment platforms in connection with investments in India. Such platforms may be established to cater to a number of scenarios. These include: (i) pooling structures for the purposes of investing in a single company / project; (ii) managed accounts with enhanced rights tailored for a specific investor; and (iii) pooling structures to track economics with respect to one or more specific deals. Whilst investment platforms are now common across the board, they appear to feature most frequently in the real estate sector.

Whilst investment platforms cannot be painted with the same brush (and they are, after all, bespoke to the specific facts and circumstances in which they are used), there are some features that are common to platforms in general. One, the traditional blind pool format is abandoned in varying degrees. Two, the shift away from the blind pool means that LPs are more focused on individual deals and expect to receive more information from a diligence and monitoring perspective. Three, in light of the sponsor's relatively more hands-off role, LPs are better placed to demand fee and carry breaks.

## Multi-class Structures

Sponsors use structures with multiple classes for various purposes. Sponsors may embed different economic terms in different classes (e.g. Class A Shares may carry a 2% management fee and 20% carried interest; Class B Shares may carry a 1% management fee and 15% carried interest, etc.) and offer the various classes for subscription by potential investors.

Another popular use of class structures is to track different investments. This can be illustrated with the help of the diagram below.




In this structure, when an investment opportunity arises, the sponsor will gauge investor interest and issue interests (i.e. shares) to those investors that wish to take exposure to the investment opportunity.

In this structure, Class A Shares Track Portfolio Company (A), Class B Shares track Portfolio Company (B) and Class C Shares track Portfolio Company (C).

Any profits and losses arising in respect of a portfolio company are shared only amongst investors who hold shares that track such portfolio company.

The above diagram shows that Class A Shares are issued to all investors that wish to track economics in Portfolio Company (A) viz. Investors 1, 2 and 3. Class B Shares are issued to Investors 2 and 3 and Class C Shares are issued solely to Investor 3.

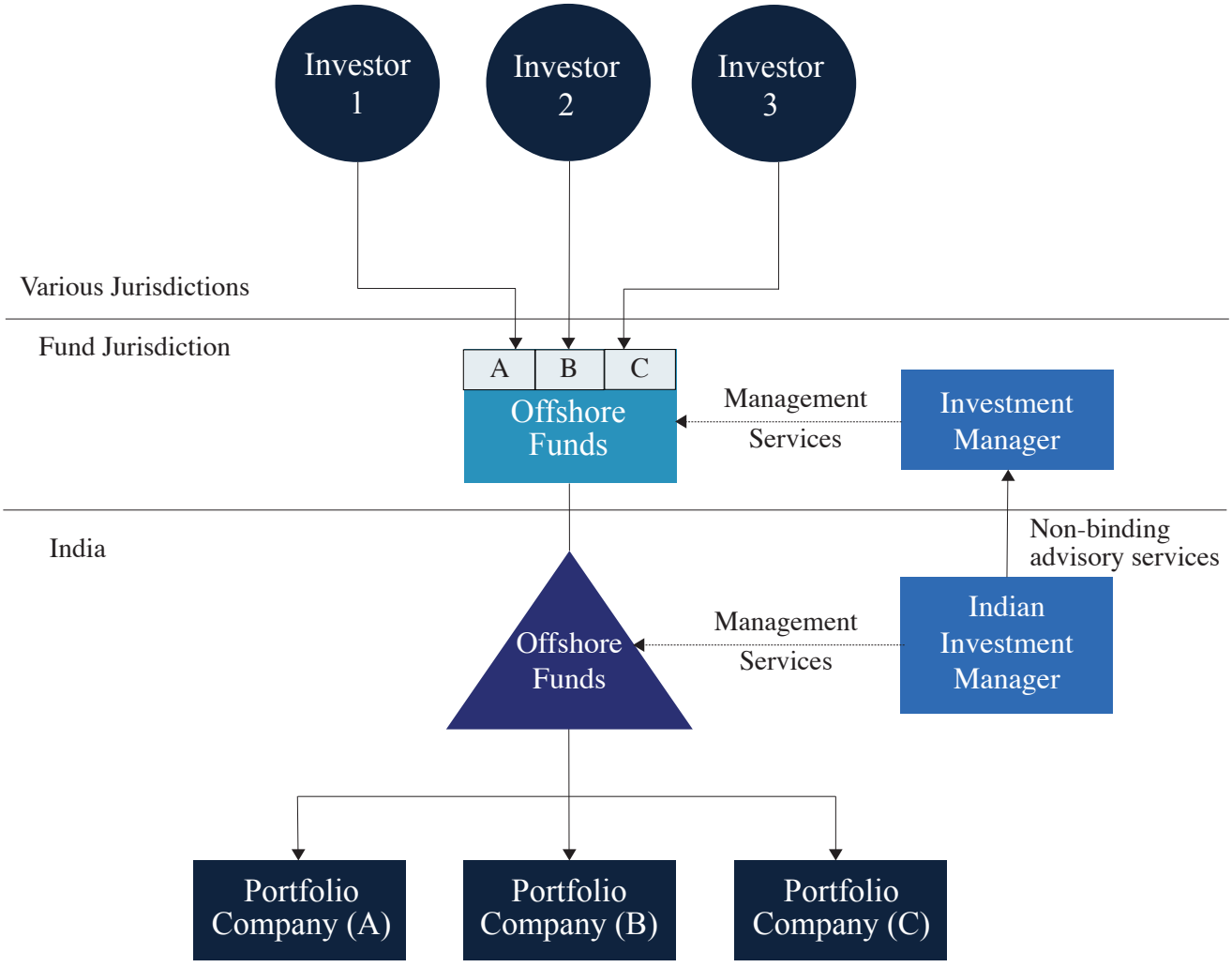
In other words, only Investor 3 will participate in the profits and losses of Portfolio Company (C) whereas Investors 2 and 3 will participate in the profits and losses of Portfolio Company (B) and Investors 1, 2 and 3 will participate in the profits and losses of Portfolio Company (A).

One thing to note with multi-class structures is that the various classes are established by contract i.e. the different classes do not flow naturally from the structure of the vehicle.

As a result, the losses from one class can only be contractually ring-fenced from other classes and therefore investors holding a class which has earned profits may be called upon to make good losses arising to another class.

## Variable Cell Companies

An alternative to the multi-class structure is the variable class company (VCC) structure. Below is an illustration of the VCC structure.



A variable cell company (which is referred to in some jurisdictions as a protected cell company or a segregated portfolio company) is a vehicle with multiple cells, each of which is bankruptcy remote from the other. In other words, the losses and liabilities of a given cell are structurally segregated from the profits and assets of other cells.

In a VCC structure, an investor would subscribe to interests issued with respect to a given cell. This structure can be used in the same manner as a multi-class structure such that each cell could be used to track a specific investment. The advantage of the VCC structure in comparison to the multi-class structure is that assets and liabilities of each investment are structurally ring-fenced from one another.

The VCC structure is often used where offshore investors want to take exposure to specific investments in India. Whilst the onshore fund could theoretically issue different classes of units to track each investment, the Indian securities regulator tends to frown upon the practice of using tracking interests.

In such cases, investors subscribe to shares of a VCC, which in turn invests into a domestic alternative investment fund, which ultimately deploys capital into various portfolio companies. Proceeds arising from each investment are up-streamed to the offshore fund and apportioned between the various cells.

## Key Tax Risks

Offshore pooling structures are likely to be on the taxman's radar on account of their size and complexity. Moreover, tax authorities may think of offshore funds as soft targets given that most LPs are sensitive to having their capital locked into a long-drawn tax litigation. Below are some of the broad categories of tax risks applicable to offshore funds.

### Association of Persons (AOP) Risk

Although the Tax Act does not specifically define the term 'association of persons', the Indian courts have held that the critical determining factor of an AOP is whether persons have joined in a common purpose or common action with the object of producing income. This is a principle that needs to be tested in the facts and circumstances of each case. Where AOP treatment is applied, then the individual vehicles in the structure are not taxed separately and ultimately, the tax authorities may rely on such treatment to deny treaty benefits and undermine tax transparency.

In an investment funds context, the AOP risk is implicated in two scenarios: (i) in a parallel investment structure where tax authorities may look to characterise the onshore fund and the offshore fund as an AOP; and (ii) in a master-feeder structure where again the tax authorities may characterise the onshore fund and the offshore fund as an AOP on the basis that they are effectively controlled by the domestic fund manager.

### Indirect Transfer of Capital Asset Risk

Under the Tax Act, capital gains tax may be levied on income arising from the transfer of shares or interests in a company or entity registered or incorporated outside India if such shares or interests

directly or indirectly derive their value substantially from assets located in India.[23] This came to be informally known as the 'indirect transfer tax'.

The indirect transfer tax risk had serious implications in an investment funds context since, at least in theory, its reach could inter alia extend to secondaries transactions (i.e. where an LP transfers its interest in an offshore fund invested in India), investor redemptions and distributions that are given effect to by way of a buyback of shares.

However, a number of clarifications were issued over the years by tax authorities and the legislature, which have had the effect of paring back the enormity of this risk.

1. In 2015, the CBDT clarified that a declaration of dividends by a foreign company in respect of shares or interests that derive value substantially from assets in India would not attract the indirect transfer tax.[24]
2. In 2017, the Finance Act, 2017 amended the Tax Act to carve out interests held by non-residents on account of their investments in Category I or Category II FPIs thereby eliminating the principal tax risk attached to investor redemptions.[25]
3. In 2017, the CBDT clarified that the indirect transfer tax would not apply to income accruing or arising to a non-resident on account of redemption or buyback of its shares or interest held indirectly in Category I or Category II AIFs (if such income accrues or arises from or in consequence of transfer of shares or securities held in India by such funds and such income is chargeable to tax in India).[26] This clarification provided relief to a vast number of fund platforms set up as master-feeder investment structures.

### General Anti-Avoidance Rule (GAAR) Risk

Chapter X-A of the Tax Act sets out the statutory scheme for the General Anti-Avoidance Rule. GAAR had been introduced into the Tax Act in 2013 but first started to apply with respect to the financial year 2017-2018. GAAR empowers tax authorities to declare an arrangement whose main purpose is to obtain a tax benefit and which additionally: (i) creates rights or obligations not ordinarily created between persons dealing at arm's length; (ii) directly or indirectly results in the misuse or abuse of provisions of the Tax Act; (iii) lacks commercial substance (or is deemed to lack commercial substance); or (iv) is entered into for non bona fide purposes, as an impermissible avoidance arrangement and apply tax consequences accordingly.[27] Such consequences could include the denial of benefits under a tax treaty.[28]

Whilst GAAR remains a largely untested regime, the statutory scheme does reflect the thinking and intention of tax authorities to clamp down on innovative tax structuring. It is therefore important to ensure that the various transactions contemplated as part of the investment structure have sufficient commercial justification. In particular, the fund vehicles in the structure should be able to demonstrate adequate commercial substance.

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[23] Explanation 5 to Section 9(1)(i) of the Tax Act read with section 45 of the Tax Act.
[24] CBDT Circular No. 4 / 2015 dated 26.03.2015.
[25] Second proviso to Explanation 5 to Section 9(1)(i) of the Tax Act. See also the third proviso to Explanation 5 to section 9(1)(i) of the Tax Act which was inserted by the Finance Act, 2020 following the introduction of the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019.
[26] CBDT Circular No. 28 / 2017 dated 07.11.2017.
[27] Sections 95 and 96 of the Tax Act.
[28] Section 98 of the Tax Act.

### Permanent Establishment (PE) Risk

In cases where the management of an offshore fund investing into India appears to be situated or controlled in India, tax authorities may declare an Indian entity (usually the domestic investment manager / advisor) to be a permanent establishment (PE) of the offshore fund and apply Indian tax to the offshore fund. To mitigate this risk, the offshore vehicle should be able to demonstrate independent decision-making and any Indian inputs to the offshore fund (or the external investment manager of the offshore fund) should be advisory and non-binding in nature.

# F. Discussion on Select Fund Terms

LPs investing into India-focused funds have heightened their scrutiny of the terms on which they participate in such funds. This comes in the backdrop of the general global shift towards greater scrutiny of fund terms over the last decade as well as the increasing organisation of institutional investors. These trends are likely to continue and the general legal interface between LPs and GPs could well witness some disruption.

Whilst a detailed discussion of various fund terms is outside the scope of this paper, a summary of the most negotiated and discussed fund terms in the Indian context is set out below.

## Management Fees

Management fee is the consideration paid to sponsors for providing management services to investors in connection with their investment in the fund. Management fee was historically charged at 2% in line with the famous "2 and 20" fee structure. However, following the financial crisis in 2008, managers have come under significant LP pressure to lower the headline fee percentage and offer various other fee concessions.

### LP Expectations

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|---|---|
| **Headline Fee Rate** | LPs have become resistant to a blanket 2% headline fee rate. Depending on fund strategy (and certain other factors), investors have, for the most part, managed to push down the headline fee rate to the 1-2% range. |
| **Discounts** | Most investors expect to see a volume discount tied to the size of their commitments as well as an early bird discount if they invest at the first closing. |
| **Fee Base** | At present, fee negotiations are focused on the base on which fee is calculated – LPs expect to see a number of adjustments to the base (including subtractions for investments written off and written down). |
| **Step-down** | LPs expect sponsors to 'step-down' the management fee when they repeatedly extend the term of the fund or when they activate a successor fund. Sponsors tend not to put up a strong resistance to this. |
| **Governance** | LPs have also negotiated a slew of governance-related adjustments to fees e.g. fee waivers on occurrence of a key person event. |

### GP Considerations

| | |
|---|---|
| **Utilising Fee Discounts** | Most LPs now expect to see some variety of discount. Sponsors are increasingly viewing discounts as tools they can capitalise on to differentiate themselves from peer funds and hasten the fundraising process. |
| **Resisting Value-linked Decreases** | Seasoned GPs resist adjustments for investments written off / written down on the basis that the fee base does not increase to reflect the value of investments that have appreciated and therefore should not be revised to reflect investments that have decreased in value. |
| **Preserving Fee on Term Extensions** | Managing investments at the end of the term still involves effort for which managers ought to be compensated. While a step-down of fee may be reasonable, a steep reduction or waiver may incentivise a fire sale, which would not be in the best interests of the GP or the LPs. |
| **Actuals** | GPs may prefer to charge fees on actuals i.e. on expenses that are actually incurred rather than as a percentage. While LPs are open to such an arrangement, they will ordinarily insist on some form of fee cap and/or the ability to audit expenses incurred. |

## Recycling Capital

It is common for sponsors to retain the ability to reinvest (or recycle) proceeds arising from an investment that has been realised prior to the end of the investment period. Over the years, LPs have become alert to potential hazards of allowing sponsors unfettered recycling powers. Some of these risks along with the key points of negotiation between LPs and GPs as regards recycling capital are set out below.

### Principal risks of recycling

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|---|---|
| **Style Drift** | The possibility of recycling may tempt managers to seek out 'quick wins' by deploying capital in shorter-term investments, thereby leaving less capital for deployment in opportunities more suited to the mana- ger's investment style. |
| **Management Capacity** | LPs invest in a fund with an eye on the hard cap. The ability to recycle capital would mean that sponsors will have effective access to investable funds over and above the hard cap, which may trigger concerns about whether management has the capacity to manage an enlarged pool of capital. |
| **Liquidity Concerns** | The recycling of capital may impact the liquidity management programme of LPs since it would mean that LPs are required to recontribute amounts that have been distributed i.e. amounts which would otherwise not be available for investment purposes. |
| **Loss Aversion** | Some LPs are in principle averse to re-deploying capital that has already been subjected to the investment cycle into fresh investments as they run the risk of incurring losses. |

### Safeguards expected by LPs

| | |
|---|---|
| **Restricted Amounts** | LPs often insist that only certain amounts up to a certain extent will be available for recycling e.g. only amounts up to the acquisition cost of an investment that has been realised will be available for draw down. |
| **Time Limits** | It is common for LPs to negotiate the timeline during which capital can be recycled e.g. recycling limited only to proceeds arising within 12 – 18 months from the acquisition of an investment. |
| **Special Situations** | LPs may seek to restrict recycling to specific circumstances e.g. in a "flip" transaction, where proceeds are distributed as part of a restructuring exercise with the intention of being reinvested. |
| **Aggregate Cap** | LPs may look to regulate recycling by imposing one of two kinds of caps: (1) a cap on the aggregate amounts that can be recycled (e.g. 25% of Total Commitments); or (2) a cap on the total amounts that can be invested by the fund (e.g. 125% of Total Commitments). |

### Presenting the case for recycling

| | |
|---|---|
| **Defending the Principle** | The purpose behind recycling capital is to ensure that as much of the capital raised by the fund as possible is actually deployed in investments (i.e. without leakages on account of fees and other charges). Moreover, recycling provides flexibility for the fund to participate in investment opportunities that it might otherwise have to forgo. |
| **Cash Management** | Most LPs have a well-defined cash management strategy that anticipates distribution timelines. Recycling capital helps harmonise the actual distribution timeline with the timelines projected by LPs. Restrictions on recycling may disturb an LP's cash management strategy. |
| **Performance Indicators** | A number of LPs evaluate their fund investments using the 'multiple of money invested' (MoM) parameter rather than on an IRR basis. Whilst a restriction on recycling may help protect IRR, it may discourage GPs from making longer-term investments that will boost the MoM. |

## Distribution Waterfall

The distribution waterfall sets out the sequence and proportions in which monies are distributed between the investors and the sponsor. The overwhelming majority of sponsors investing in India have adopted a European-style waterfall where carried interest distributions are triggered only after investors have received a full return of their capital together with a preferred return. Whilst a pure US-style waterfall is unlikely to find favour with LPs investing into India-focused funds, sponsors are testing a number of ideas within the European-style template.

### Innovations in Waterfall Structures

| | |
|---|---|
| **Staggered Catch-up** | Staggered Catch-up Once the preferred return is distributed to the investor, amounts are distributed to both the sponsor and the investor in an agreed proportion (e.g. 50%) until the amounts received by the sponsor and the investor are in the agreed profit-sharing ratio. This gives comfort to LPs as they receive distributions at each stage of the waterfall. |
| **Investor Choice** | Under this structure, LPs are permitted to choose between a deal-by-deal waterfall and a whole-of-fund waterfall. The different waterfalls are usually tracked through different classes of units / interests. Sponsors may try to incentivise the deal-by-deal option by offering it with lower management fees. |
| **'Deal-by-Deal' Sleeve** | As LPs are likely to balk at a wholesale shift to a US-style waterfall, some sponsors have adopted a 'deal-by-deal' sleeve under which say 10% of investor commitments and distribution proceeds are tracked though a deal-by-deal waterfall. |
| **Blended Carry** | Investors have the option of dividing their commitment between different classes, each of which will have a separate carried interest rate. Ultimately, the carry percentage for each investor is calculated on a weighted average basis. |
| **Graded Carry** | Under this structure, the carried interest percentage is linked to the investor's IRR and rises as the investor's IRR crosses certain thresholds. This structure is finding increasing favour among LPs as it reflects true alignment of interests between LPs and the sponsor. |

## Clawbacks

From the very inception of the private equity fund model, LPs have been sensitive to sponsors benefitting disproportionately to investors. The idea behind a clawback is to ensure that sponsors have not been overpaid beyond the remit of the waterfall. In the event of overpayment, a sponsor is under an obligation to return distributions until the amounts distributed to the investors and the sponsor are in the agreed profit-sharing ratio.

A clawback is designed to satisfy two conditions: (1) the GP should not receive any distributions until the LPs have received a return of their capital together with a preferred return; and (2) the GP should receive no more than the agreed percentage of the post-capital profits. In the event that either of the foregoing conditions is breached, the GP must repay amounts to the fund, which in turn will be re-distributed to the LPs to the extent necessary to satisfy both conditions.

### Types of Clawback Protection

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| **Interim Clawback** | A clawback test is undertaken at one or more regular intervals during the life of the fund. To the extent that the test reveals that the GP has received carry distributions in excess of its entitlement, it will be under an obligation to repay the fund at each such interval. |
| **Escrow Reserve** | A percentage of all carried interest distribution that the sponsor would ordinarily be entitled to receive is reserved in an escrow account. Such amounts will either be used to meet any shortfall in the event of a clawback being triggered or will be paid out to the sponsor at the end of the life of the fund. |
| **Guarantees** | The ultimate carry recipients enter into a guarantee to repay carried interest distributions to the extent necessary to meet any shortfall. LPs tend to require carry recipients (particularly the more senior members in the team) to provide a guarantee on a joint and several basis for all members of the team. |
| **Aggregate Cap** | LPs may look to regulate recycling by imposing one of two kinds of caps: (1) a cap on the aggregate amounts that can be recycled (e.g. 25% of Total Commitments); or (2) a cap on the total amounts that can be invested by the fund (e.g. 125% of Total Commitments). |

## Givebacks

There may be circumstances in which the fund is required to return monies to meet a liability or an obligation. For example, a counterparty may claim against the fund for a breach of representation. If such a claim is successful and the fund has exhausted all other methods to satisfy the liability (e.g. reserves, insurance, etc.), the investors (and the sponsor) will be required to "give back" a portion of the amounts distributed to them to satisfy the liability.

### LP Protections

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| **Cap on Amounts** | LPs would expect to see a cap on the amount that they are liable to return to the fund to satisfy a giveback obligation. Depending on the outcome of negotiations, the cap may be set at a percentage of total distributions or commitments or a formula that combines both. |
| **Time Limit** | LPs will generally seek to exclude amounts distributed to them from the ambit of the giveback obligation a few years after the relevant amounts have been distributed. Internationally, the time limit tends to be 2 years; for most Indian funds, the time limit is set at 3 years. |
| **Scope** | LPs will expect giveback amounts to be utilised solely in connection with liabilities and obligations in respect of the fund as a whole (and not to address liabilities / obligations that have arisen on account of the facts and circumstances applicable to a specific investor). |
| **Reverse Order of Waterfall** | Notwithstanding the comfort of the clawback, investors will insist that the giveback is satisfied in accordance with the reverse order of waterfall, which would mean that a sponsor that is in the carry will typically have to return amounts in parallel with the investors. |

### Negotiating the giveback provision – GP Considerations

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| **Rate of Distribution** | Giveback should be viewed as a halfway house offered by the GP to balance the interests of its LPs on the one hand and those of its investment counterparties on the other hand. The giveback provision allows the GP to return investment proceeds to its LPs (rather than retain them in a reserve to meet any liabilities / obligations that may arise to the fund), thereby improving investor IRR. |
| **Alternative to using reserves** | Whilst investors will expect some cap on amounts that are subject to giveback, the GP can negotiate more headroom by demonstrating that the alternative scenario would mean that proceeds that could be distributed to investors would be held up in a reserve, which would not be in the interests of either the LPs or the GP. |
| **Segregation of Liabilities** | Not all liabilities are created equal and not all liabilities come with a short limitation period. Therefore, whilst negotiating the cap on amounts or the time limit for the giveback, the GP should carve out extraordinary liabilities such as tax liabilities. |
| **Overlapping Caps** | GPs should ensure that the giveback obligation does not overlap with any other cap agreed with investors in respect of any of the other fund terms. For example, amounts that are returned under the giveback should not be treated as fund expenses and should therefore not be included when determining whether the expense cap has been hit. |

## Key Person Protections

A Key Person Event is a critical event in the life of the fund as it usually means that the team responsible for managing the investments and operations of the fund has become materially different. An investor that makes a commitment to a fund does so in large measure on the strength and quality of the fund's management team. Therefore, investors will be wary of, and will want to control, material changes to the composition of the management team.

### Consequences of a Key Person Event

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| **Suspension of Investments** | The first and most obvious consequence of a key person event is a suspension on new investments. When LPs commit to a fund, they do so on the strength of the management team. A material alteration in the composition of the team casts doubt over this premise. |
| **Search for replacements** | Following a Key Person Event, the sponsor will typically have a certain timeline (usually 2-3 months) during which it will have to identify suitable replacements for key persons who have departed. Once identified, the relevant candidates will need to be blessed by the LPs in some form. |

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| **Termination of Commitment Period** | In certain cases, LPs may have negotiated for themselves an automatic termination of the commitment period on the occurrence of a key person event or the ability to vote to terminate the commitment period. |
| **Fee Reduction** | Some LPs negotiate a step-down / waiver in the management fee rate for the duration of the period in which the key person event subsists. |
| **'Cause' Trigger** | On account of the LPs' relatively stronger bargaining power, some sponsors have had to accept the occurrence of a key person event as a trigger of 'Cause', which in turn would make it easier for LPs to remove the sponsor. |

### Negotiating the Key Person Provision – LP Considerations

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| **Scope of Commitment** | LPs should look to ensure that the key person clause covers the relevant people in the investment / management team i.e. such persons are under an obligation to devote their attention to the affairs of the fund. Where an LP is invested in more than one fund managed by the same persons, the key person provision should cover all of such engagements. |
| **Devotion of Time** | A key issue during negotiations is the manner in which the occurrence of a key person event is determined (particularly where the trigger lies in imprecise events such as not devoting sufficient time to the affairs of the fund). |
| **Fee Reduction** | If the investment programme of a fund is suspended following the occurrence of a key person event, then there are strong reasons for a step-down or even a waiver of management fee, at least for such time as the key person event subsists. |
| **Long-term Consequences** | LPs should think through the whole range of consequences that may arise on the occurrence of a key person event (including where suitable replacements are not identified) and plan accordingly. This would mean that thought should be given to various provisions including liquidation, transfer, carried interest, etc. |

### Negotiating the Key Person Provision – GP Considerations

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| **Multiple funds** | Often a sponsor will be managing more than one fund. These funds may spread across a number of investment strategies. A sponsor should therefore consider its specific facts and circumstances and ensure that its key person obligations across its various funds are not inconsistent with one another. |
| **Consistency of obligations** | As a general principle, sponsors should steer clear of agreeing bespoke key person arrangements with specific investors since a consistent key person obligation will make the obligation easier to manage. |

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| **Controlling the process** | To the extent possible, the sponsor should look to retain control over the key person process including by retaining the right to initiate the process by notifying the occurrence of a key person event. Permitting investors to unilaterally call a key person event may have rollover implications across the funds managed by the sponsor. |
| **Avoiding shutdowns** | The process for replacing key persons must be drafted in a manner that prevents investors from using the key person provision to force a shutdown of the fund (by arbitrarily rejecting any replacement put forward by the sponsor). |
| **Fee Reduction** | A sponsor should strongly resist fee waivers / reductions for a couple of reasons: (i) the occurrence of a key person event does not release the sponsor from paying its periodic overheads; and (ii) the management team is not completely dormant in that it would still be empowered to complete follow-on investments and other binding engagements, that are carved out from the general suspension. |

## No-Fault Divorce

A no-fault divorce right is a standard provision incorporated in fund documents which allows a certain percentage of investors to vote to remove the sponsor / GP without offering any reason or explanation. In practice, however, this right will only be invoked in the event of poor performance on the part of the sponsor or in pursuance of a managed restructuring exercise.

### LP Considerations

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| **Investor Vote** | As the no-fault divorce process is kickstarted by the investors, the structure of the vote becomes important. While the voting threshold is between 66.67 – 75%, a cornerstone LPs may wish to negotiate a lower threshold or retain a unilateral right to trigger a divorce. Naturally, the vote should also exclude commitments associated with the sponsor. |
| **Replacement / Liquidation** | Where a no-fault divorce is exercised, LPs will either need to appoint a replacement sponsor or put the fund into liquidation. Where a replacement is brought in, the investor base may expect the incoming sponsor to take some skin in the game by investing in the fund. These issues point to the planning that is required prior to triggering the divorce. |
| **Haircut** | Where a sponsor is removed before the end of the life of the fund, it will have to forego a portion of carried interest. The extent and structure of carried interest haircut is hotly contested at the time of fundraising. Another point to bear in mind is that the haircut structure must leave sufficient incentive for a replacement sponsor. Negotiations have yielded a number of creative solutions. |

### GP Considerations

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| **Reputational Damage** | Although a no-fault divorce may be triggered without any reason, it implicitly points to the poor performance of a sponsor. Moreover, a no-fault divorce triggered on one fund managed by a sponsor will have spillover effects on other funds managed by the sponsor. It is therefore in the GP's interest to deter the exercise of the no-fault divorce. |
| **Honeymoon Period** | A sponsor (particularly a relatively new sponsor) should look to embargo the exercise of no-fault divorce for at least the initial few years of the fund's life so as to allow itself a sufficient period of time to establish itself. However, a relatively more seasoned sponsor managing multiple funds will find it more difficult to negotiate a honeymoon period. |
| **Management Fee** | A sponsor that is removed without cause will still need to pay its periodic overheads. In light of this, it is common for GPs to negotiate a termination fee equivalent to anything between 1-2 years' management fee. |
| **Sponsor Commitment** | A sponsor that is removed may not wish to have its capital managed by a replacement sponsor. Therefore, a GP should look to negotiate a mechanism by which it can sell its investment in the fund. |
| **Carry Haircut** | In a no-fault removal scenario, a GP is well within its rights to protect its carry entitlement. While most LPs insist on some form of haircut, it is not unusual for sponsors to resist these efforts. As the fund will come under new management post-removal, an outgoing sponsor should consider negotiating a first charge to secure payment of its carried interest entitlement. |

## Fiduciary Duties

Across the Commonwealth, a fiduciary relationship is understood as one in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship. In an investment funds context, the sponsor stands in a fiduciary relationship with the investors as a whole and is therefore under a duty to act with the highest standard of care and in the best interests of the investors as a whole.

### Implication of fiduciary duties in an investment funds context

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| **Preferential Terms** | The most common claim for a breach of fiduciary duties is a scenario in which investors are placed on different pedestals. While it is open to a GP to offer different terms to different investors, the same requires to be effectively disclosed before the fact. |
| **Most Favoured Nations** | Most sponsors will agree to afford the same treatment to investors that are similarly placed. This is normally incorporated by way of a Most Favoured Nations (MFN) clause in a side letter or, more frequently, in the governing document of the fund. A failure to provide equal treatment may trigger a claim for breach of fiduciary duties. |

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| **Alignment of Interests** | The duty of loyalty is a key fiduciary duty and therefore, an egregious misalignment of interests between LPs and the GP could trigger a claim for breach of fiduciary duties. There are various examples of misalignment including notably 'cherry-picking' of investments. |
| **Multiple Funds** | A seasoned institutional sponsor will typically manage a number of funds across various investment strategies. Managing multiple funds present the risk that a sponsor may act in the interests of one fund at the cost of other funds. This may be unintentional or intentional (where, for example, the sponsor stands to gain more carried interest by prioritising a specific fund). |

### How can a sponsor discharge its fiduciary duties?

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| **Prior Disclosure** | The best response to claims for breach of fiduciary duties is that the sponsor has made prior disclosure of the facts leading to such claim. For example, a disclosure that investors may be eligible for certain preferential terms may ward off a breach of fiduciary duties challenge. |
| **Duty to investors 'as a whole'** | The fiduciary duty of the sponsor is to act in the best interests of the investors as a whole. Given the diversity of the investor base, it may not be possible (or desirable) to satisfy the interests of each investor. However, the sponsor should prepare a record of how its actions and decisions are intended to benefit the investor class as a whole. |
| **Pre-empting Conflicts** | To address claims founded on disloyalty, a sponsor must identify potential conflicts of interest and describe the manner in which it proposes to address such conflicts (e.g. the issue of a sponsor managing multiple funds may be addressed through an allocation of investment policy that investors have had the opportunity to review prior to being onboarded). |
| **Take investors into confidence** | Potential conflicts may be referred to the investors (or more commonly to an investor body like the LPAC) for review and approval. Whilst this is a fairly foolproof solution, it may not be in the fund's best interests for certain issues to be referred to investors (or the LPAC) particularly where these issues relate to time-sensitive events. |

# G. Antitrust Issues in the Investment Funds Context

## Antitrust Approval

The Competition Act, 2002 (the "Competition Act") and the Competition Commission of India (Procedure in regard to the transaction of business relating to combinations) Regulations, 2011 (the "Combination Regulations") require mandatory pre-notification to, and prior approval of, the Competition Commission of India ("CCI") for all domestic and international mergers, acquisitions and other types of 'combinations' which exceed the asset or turnover thresholds prescribed under the Competition Act (Refer Annexure B for these thresholds). These thresholds apply to the acquirer and the target jointly, and to the group to which the target will belong after the combination in question.

The definitions of "enterprise" and "person" under the Competition Act (which regulates, inter alia, acquisitions of shares, assets, voting rights and / or control) are wide enough to include AIFs within their ambit in view of the nature of their economic activity and since an AIF can be established as a trust, company, LLP or a body corporate. In this regard, the various instances involving AIFs which may require a merger control analysis are as follows:

a. **Setting up an AIF**: A notifiability analysis may need to be conducted at the time of setting up an AIF by a sponsor. However, this is likely to be covered under the de-minimis exemption (explained below) as the newly established AIF is unlikely to have substantial assets or turnover.

b. **Capital commitment, and subsequent acquisition of units, by investors and sponsors**: Provided that the jurisdictional thresholds are met and the proposed transaction cannot avail of any exemption, an acquisition of the units of an AIF (either primary or secondary) could trigger a merger control filing with the CCI. Whilst an investor or the sponsor may not receive any units or voting rights or controlling rights as such at the time of making the capital commitment, it may be prudent to assess notifiability from a holistic perspective at the capital commitment stage itself considering that the actual acquisition of units and / or rights in the AIF will inevitably follow. The two steps (viz. making of a capital commitment and the subsequent acquisition of the units) are likely to be treated as inter-connected transactions under regulation 9(4) of the Combination Regulations, which requires parties to file a composite notice (covering all transactions) where the ultimate intended effect of a business transaction is achieved by way of a series of steps or individual transactions that are inter-connected.

c. **Downstream acquisitions by the AIF**: A downstream acquisition by an AIF (either primary or secondary) could trigger a merger control filing if the jurisdictional thresholds are met and the transaction cannot avail of any exemption.

The notifiability events mentioned above are not exhaustive and the merger control analysis would vary from case to case. For instance, the analysis could vary in the event an investor makes an investment in the manager / sponsor (or the trustee) and in such case, the transaction would have to be analysed in conjunction with the instances described at (b) and (c) above. Moreover, a buyout

of the sponsor is also likely to require a merger control analysis as a new sponsor would acquire control over the AIF.

## Exemptions

There are certain standard exemptions provided by the CCI under Schedule to the Competition (Criteria for Exemption of Combinations) Rules, 2024 (refer Annexure C) and other notifications. Notably, the Government through a notification has prescribed that any transaction where the target has assets not exceeding INR 450 crore (approx. USD 54 million) in India or has a turnover not exceeding INR 1,250 crore (approx. USD 150 million) in India, is exempt from the mandatory pre-approval merger filing ("Target Exemption").

In addition, if the Target Exemption cannot be availed of, investors can explore the possibility of availing other exemptions mentioned under Annexure B. One such exemption is for minority acquisitions below 25% made "solely as an investment" or "in the ordinary course of business", which do not lead to any acquisition of control. Accordingly, if a potential AIF unit holder does not get controlling rights in an AIF or in the manager / sponsor (or the trustee), then it is likely that the acquisition of less than 25% of units of an AIF could be considered to be a simple investment and, therefore, eligible for the item 1 exemption under Schedule I to the Combination Regulations mentioned at Annexure B. However, in the event it becomes possible for an investor (i.e. a unitholder) to negotiate and obtain rights that are not available to "ordinary" unit holders, or an investor proposes to acquire "control" over the AIF or the manager / sponsor (or the trustee), then such an acquisition might trigger a merger filing regardless of the number of units proposed to be acquired.

It must be noted that the notifiability of such acquisitions still needs to be tested and further developed. Accordingly, the transaction has to be viewed holistically and several factors have to be examined closely before arriving at a conclusion, including investments into the AIF by the investors (even at the capital commitment stage), the nature of special / veto rights being obtained by the investors, and the nature of control exercised by the investors in the AIF.

# H. Key International Regulatory and Tax Considerations

Fundraising is a global activity that implicates rules and regulations in various jurisdictions. Some of these come into play in connection with the marketing of interests in a fund to investors resident or domiciled in various jurisdictions whilst others become relevant in connection with the operations of the fund (but which need to be anticipated at the time of the fundraise). A detailed discussion of foreign laws and regulations applicable to private funds is beyond the scope of this paper. However, a summary of some of the key regulatory and tax considerations in the context of India focussed funds is set out below.

## Private Placement in the United States

To avoid triggering the onerous registration requirement under the U.S. Securities Act of 1933 (the "Securities Act"), interests in a private fund need to be offered and sold on a private placement basis. For India-focused funds, this is ordinarily accomplished by relying on the exemption from registration in Rule 506(b) of Regulation D of the Securities Act (and in some recent cases, under section 4(a)(2) of the Securities Act). Rule 506(b), which is most commonly relied on, permits an offering of interests to an unlimited number of "accredited investors" (as defined in Rule 501(a) of Regulation D) and up to 35 non-accredited sophisticated investors but prohibits the use of general solicitation. Where a fund relies on Rule 506 to make its offering, it is required to make a Form D filing no later than 15 days following the first sale of interests.

## Exemption from Registration of the Fund in the United States

A fund may be required to register itself with the regulator in the jurisdiction in which it has been established. Depending on the jurisdiction and the regime under which the fund is established, interaction with the regulator may not be frequent or extensive.

In the United States, an issuer of securities that is engaged, or which holds itself out as being engaged, in the business of investing or trading in securities will be required to register under the Investment Company Act of 1940 (the "40 Act") unless it can avail itself of an exemption. The most relevant exemptions for India- focused funds are the ones set out in sections 3(c)(7) and 3(c)(1) of the 40 Act. The section 3(c)(1) exemption is available where interests in the fund are not beneficially owned by more than 100 persons. The section 3(c)(7) exemption is available where interests in the fund are sold exclusively to "qualified purchasers". Both exemptions are available only when the fund is not making a public offering of securities. The '100 persons test' under section 3(c)(1) and the 'qualified purchasers' test under section 3(c)(7) are only applied to investors resident in the United States (and not more generally to the fund' investor base).

## Registration of Investment Managers in the United States

In the United States, investment advisers (i.e. persons providing investment advice for some form of compensation) must register with the Securities and Exchange Commission pursuant to the U.S. Investment Advisers Act of 1940 (the "Advisers Act"). Generally, non-U.S. investment managers are

not required to register under the Advisers Act. However, they may be required to make certain filings as 'exempt reporting advisers'. The most common exemptions available to non-U.S. investment managers are the "foreign private adviser exemption" and the "private fund adviser exemption".

The 'foreign private adviser exemption' applies to investment managers that do not have a place of business in the U.S. and that have fewer than 15 U.S. clients with less than USD 25 million of assets under management attributable to such U.S. clients.

The 'private fund adviser exemption' applies to both U.S. and non-U.S. managers. In the case of managers whose principal place of business is outside the United States, the exemption would apply if the manager has no advisory clients who are U.S. persons other than private funds and it manages less than USD 150 million in assets at a place of business in the United States.

## Certain U.S. Tax Issues

The principal fund vehicle is generally classified as a partnership for U.S. federal income tax purposes. U.S. tax exempt investors often constitute a major chunk of commitments raised from the United States. These include university endowments, charities, pension plans, etc. Although such entities are tax exempt, they remain subject to U.S. federal income tax on UBTI i.e. unrelated business taxable income. This could arise, for example, where management fee payable by investors is reduced by the amount of other fees (such as portfolio monitoring fees, director fees, etc.) received by the fund or the manager. Non-U.S. persons are subject to U.S. federal income tax on ECI i.e. income effectively connected with the conduct of a trade or business in the United States. Whilst some sponsors are able to deal with these issues by providing simple covenants to avoid UBTI / ECI, it is increasingly common for sponsors to offer investors the option to invest through a U.S. blocker (i.e., an entity that elects to be treated as a corporation for U.S. federal income tax purposes) as a protection from UBTI / ECI.

## ERISA

Unless an investment fund operates under an exemption from ERISA, the presence of ERISA investors could subject a fund and the sponsor to extensive regulation and compliance requirements. The most common exemptions from the perspective of India-focused funds are the 25% exemption and the VCOC exemption. The 25% exemption applies where ERISA investors in the fund constitute less than 25% of the total commitments in the fund. In order for the VCOC (venture capital operating company) exemption to apply, the fund will need to negotiate "management rights" with respect to a majority of its portfolio companies. Such rights would include the ability to appoint directors to the board of a portfolio company, the right to receive financial statements and inspect the books of a portfolio company, etc. As these rights have become customary in most deals, it is likely that most India focused funds would satisfy this requirement as a matter of course.

## GDPR

The European Union's Global Data Protection Regulation ("GDPR") becomes relevant whenever a fund seeks to raise capital from investors in the EU. Pursuant to GDPR, sponsors are only permitted to process personal information for limited purposes and are restricted from making unauthorised use of such information. The GDPR also governs the flow of information outside the EU. A number of other jurisdictions have also enacted data protection legislation along the lines of the GDPR. Sponsors will need to comply with such legislation to the extent they are engaged in fundraising in such jurisdictions.

## AIFMD

The European Union's Alternative Investment Fund Managers Directive ("AIFMD") lays down a standardised regulatory framework for fund managers in the EU. The AIFMD will come into play if the fund and / or the fund manager is established in the EU or even if a fund set up outside the EU is raising capital from investors in the EU. Most India-focused funds will be set up outside the EU (and their fund managers will similarly be set up outside the EU). Such funds will have to comply with the national private placement regime(s) in the jurisdiction(s) from which it intends to raise capital. This will ordinarily involve making a marketing notification or obtaining a marketing licence.

# Annexure A

## List of sectors in which an FVCI can invest

1. Biotechnology
2. IT related to hardware and software development
3. Nanotechnology
4. Seed research and development
5. Research and development of new chemical entities in pharmaceutical sector
6. Dairy industry
7. Poultry industry
8. Production of biofuels
9. Hotel-cum-convention centres with seating capacity of more than three thousand
10. Infrastructure sector (*The term "Infrastructure Sector" has the same meaning as given in the Harmonised Master List of Infrastructure sub-sectors approved by Government of India vide notification F. No. 13/06/2009- INF, dated the March 27, 2012 as amended or updated*.)

# Annexure B

## Competition Act – CCI Notification Thresholds

| Thresholds for Filing Notice | | | | |
|---|---|---|---|---|
| | | Assets | | Turnover |
| Enterprise Level | India | More than INR 2500 crore | Or | More than INR 7500 crore |
| | Worldwide with India nexus | More than USD 1.25 billion<br><br>With at least INR 1250 crore in India | | More than USD 3.75 billion<br><br>With at least INR 3750 crore in India |
| Or | | | | |
| Group Level | India | More than INR 10000 crore | Or | More than INR 30000 crore |
| | Worldwide with India nexus | More than USD 5 billion<br><br>With at least INR 1250 crore in India | | More than USD 15 billion<br><br>With at least INR 3750 crore in India |

| Thresholds for Availing of De Minimis Exemption | | | | |
|---|---|---|---|---|
| | | Assets | | Turnover |
| Target Enterprise | In India | ≤ 450 INR crore | Or | ≤ 1250 INR crore |

## Relevant Analysis

Part 1: CCI approval for minority PIPE deals – to file or not to file?

Part II: Deal Value Trigger and CCI Approval – How does it affect dealmaking?

Part III: Inter-Connected Transactions — CCI's Recent Penalty Order In Matrix Pharma's Case

Part IV: CCI's Recent Penalty Order Against Goldman Sachs: Are Any Minority Protection Rights Filing Immune?

Part V: CCI Filing in India – The De Minimis Check & Control Clarity

# Annexure C

## Schedule of the Competition (Criteria for Exemption of Combinations) Rule, 2024

1. An acquisition of shares of an enterprise in ordinary course of business where the said transaction is –

   a. an acquisition of unsubscribed shares upon devolvement as per covenant of an underwriting agreement by any person registered with the Securities and Exchange Board of India established under the Securities and Exchange Board of India Act, 1992 (15 of 1992) or other similar authority established under any law for the time being in force outside India, as an underwriter, in so far as the total shares or voting rights held by the acquirer, directly or indirectly, does not entitle the acquirer to hold more than twenty-five per cent. of the total shares or voting rights of the company, of which shares are being acquired; or

   b. an acquisition of shares as a stockbroker registered with the Securities and Exchange Board of India, or other similar authority established under any law for the time being in force outside India, in so far as the total shares or voting rights held by the acquirer, directly or indirectly, does not entitle the acquirer to hold more than twenty-five per cent. of the total shares or voting rights of the company, of which shares are being acquired; or

   c. an acquisition of shares as a mutual fund registered with the Securities and Exchange Board of India, or other similar authority established under any law for the time being in force outside India, in so far as the total shares or voting rights held by the acquirer, directly or indirectly, does not entitle the acquirer to hold more than ten per cent. of the total shares or voting rights of the company, of which shares are being acquired.

2. An acquisition of shares or voting rights solely as an investment in so far as the total shares or voting rights held by the acquirer, directly or indirectly, does not entitle the acquirer to hold more than twenty-five per cent. of the total shares or voting rights of the company, of which shares or voting rights are being acquired, not leading to acquisition of control of the enterprise whose shares or voting rights are being acquired.

   Explanation: - In Rule 2, the acquisition of shares or voting rights of an enterprise shall be treated as solely as an investment where —

   a. pursuant to the said acquisition, the acquirer does not gain a right or ability to have a representation on the board of directors of any enterprise either as a director or as an observer;

   b. pursuant to the said acquisition, the acquirer does not gain a right or ability to access commercially sensitive information of any enterprise;

   c. the acquirer or its group entities and their affiliates are not engaged in —

i. any activity relating to production of similar or identical or substitutable product or service as offered by the target or its downstream group entities and their affiliates;

ii. any activity relating to production, supply, distribution, storage, sale and service or trade in product or provision of service which are at different stages or level of production chain to the activities of the target or of its downstream group entities and their affiliates; or

iii. any activity relating to production, supply, distribution, storage, sale and service or trade in product or provision of service which are complementary to the activities of the target or any of its downstream group entities or their affiliates:

Provided, where the acquirer or its group entities or their affiliates are engaged in any of the aforesaid activities mentioned in this clause, the acquisition shall be considered to be solely as an investment if such acquisition does not result in the acquirer holding ten per cent. or more shares or voting rights after the acquisition.

3. An acquisition of additional shares or voting rights of an enterprise by the acquirer or its group entities, where the acquirer or its group entities, prior to acquisition, holds shares or voting rights of the enterprise, but does not hold more than twenty-five per cent. of the shares or voting rights of the enterprise, either prior to or after such acquisition:

Provided that –

i. such acquisition does not result in acquisition of control of such enterprise by the acquirer or its group;

ii. pursuant to the acquisition, the acquirer or its group entities do not gain a right or ability to have a representation on the board of directors of any enterprise either as a director or as an observer for the first time;

iii. pursuant to the acquisition, the acquirer or its group entities do not gain a right or ability to access commercially sensitive information of any enterprise for the first time except where the acquirer or its group entities already have right or ability to have a representation on the board of directors of any enterprise as a director;

iv. in case the activities of the acquirer or its group entities and their affiliates exhibit horizontal or vertical or complementary linkages with the activities of target or its downstream group entities and their affiliates, the incremental shareholding or voting rights acquired by a single acquisition or a series of smaller inter-connected acquisitions does not exceed five per cent. and such acquisition does not result in the shareholding or voting rights of the acquirer or its group entities increasing from less than ten per cent. to ten per cent. or more.

4. An acquisition of additional shares or voting rights of an enterprise by the acquirer or its group entities, where the acquirer or its group entities, prior to acquisition, holds more than twenty-five per cent. shares or voting rights of the enterprise, but does not hold more than fifty per cent. of the shares or voting rights of the enterprise, either prior to or after such acquisition:

   Provided that such acquisition does not result in change in control of such enterprise.

5. An acquisition of shares or voting rights, where the acquirer or its group entities, prior to acquisition, has more than fifty per cent. shares or voting rights in the enterprise whose shares or voting rights are being acquired, except in the cases where the transaction results in change in control of such enterprise.

6. An acquisition of assets of an enterprise in ordinary course of business.— The acquisition of assets of an enterprise shall be treated as in ordinary course of business provided that said acquisition involves acquisition of stock-in-trade, raw materials, stores and spares, trade receivables or other similar current assets that do not constitute business.

7. An acquisition of assets, not directly related to the business activity of the party acquiring the asset or made solely as an investment, not leading to control of the enterprise whose assets are being acquired except where the assets being acquired represent substantial business operations in a particular location or for a particular product or service of the enterprise, of which assets are being acquired, irrespective of whether such assets are organised as a separate legal entity or not.

8. An acquisition of shares pursuant to a bonus issue or stock splits or consolidation of face value of shares or buy back of shares or subscription to rights issue of shares, not leading to a change in control.

9. An acquisition of assets by one person or enterprise, of another person or enterprise within the same group, except in cases where there is change in control over assets being acquired.

10. A merger or amalgamation of enterprises within the same group provided that the transaction does not result in change in control.

11. Acquisition of shares, control, voting rights or assets by a purchaser approved by the Competition Commission of India pursuant to and in accordance with its order under section 31 of the Act.

12. Demerger of a company and issue of shares by resulting company, in consideration of demerger, either to the demerged company or to the shareholders of the demerged company in the proportion of their shareholding in the demerged company prior to the demerger, except for discharge of consideration for fractional shares.

13. For the purpose of this schedule,–

1. The acquirer and its group entities mean the ultimate controlling person of the acquirer and other entities forming part of the same group.

2. An entity is considered to be an affiliate of another enterprise if that another enterprise has–

i. ten per cent. or more of the shareholding or voting rights of the enterprise; or

ii. right or ability to have a representation on the board of directors of the enterprise either as a director or as an observer; or

iii. right or ability to access commercially sensitive information of the enterprise.

# Annexure D

## RBI eases restrictions on Bank investments into AIF – Why and what next?
**(***Analysis - 29 April, 2024***)**

### Key Takeaways

- 'Evergreening' of loans by banks, NBFCs, etc. through fund structures shut down through 2 circulars – Banking entities can no longer indefinitely extend loan tenures by transferring their loan exposures to AIFs
- In RBI's first circular, banks having indirect exposure to a borrower through an AIF required to either liquidate their entire AIF investment or make 100% provision against it (significantly reducing available capital) – Well intended, but likely a case of 'too much' in a haste
- RBI's second circular provides helpful clarifications (i.e., relaxed provisioning, and carve-outs for funds of funds and for AIF's holding equity), but still fall short – Banks who bona fide invest in AIFs remain at a loss (e.g., if an investee obtain loans from a bank only after the bank has invested in the AIF)
- Balancing commercial freedom against systemic risk is complex – where should the RBI draw the line?

RBI's latest restrictions on the practice of 'evergreening' appear well justified given the systemic risk the practice creates. But, despite two rounds of clarification and consultation, bona fide market players may remain restricted. As a result, the effect on the banking and the AIF industry has been quite unsettling – with large write offs across leading banks, NBFCs, financial institutions, etc.[29] ("Banks", for easy relatability).

The objective of the evergreening restrictions, introduced through two sets of circulars, was to ensure that Banks do not misuse AIF structures to avoid potentially stressed assets appearing on their balance sheets – millstones round the necks of Banks. Banks would first subscribe to subordinate units of alternative investment funds ("AIFs") which in turn invested debt into the Bank's borrower. The borrower then used the funds to retire the outstanding loan of the Banks. This effective 'evergreening' of loans could even continue beyond the AIF's lifecycle by employing similar practices – the AIF could down-sell their troubled assets to another similarly funded AIF.

### The December Circular[30] – A bull in a china shop

RBI's initial set of restrictions to tackle the misuse were arguably stricter than required, and did misfire in a few situations that were not initially thought of. Such restrictions included requiring Banks to:

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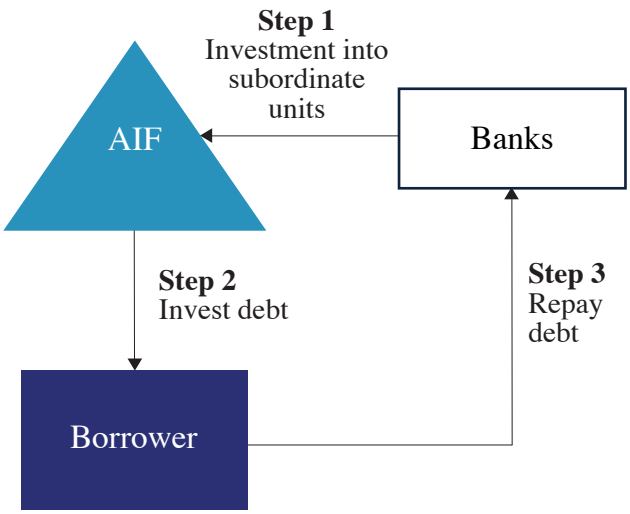
[29] Note. RBI's regulation regulates 'Regulated Entities', i.e., all Commercial Banks (including Small Finance Banks, Local Area Banks and Regional Rural Banks); all Primary (Urban) Co-operative Banks/State Co-operative Banks/Central Co-operative Banks; all All-India Financial Institutions; and all Non-Banking Financial Companies (including Housing Finance Companies).
[30] This refers to RBI's circular on investments into AIFs dated 19 December 2023 – accessible here.

a. not make any investments in schemes of AIFs having downstream investments either directly or indirectly in any borrower of the Banks;

b. liquidate their investments in any AIF having exposure in their borrower within 30 days of December Circular, or within 30 days of AIFs investment in such borrower;

c. make 100% provisions on investments in AIFs if Banks are not able to liquidate as per (b); and

d. deduct from the Banks' capital funds any investments made into subordinate units of any AIF scheme having a priority distribution model.




The circular was a clear and straightforward attempt to mitigate various systemic risks, notably: (i) concerns relating to substitution of direct loan exposures with indirect exposures; (ii) the growing interlinkages between AIFs and traditional debt segments; and (iii) the misuse of regulatory arbitrage.

The immediate effect, however, was that Banks were forced to sell/transfer their now contaminated AIF portfolios (mostly illiquid) at discounts, that is, if they were even able to find buyers ready to absorb such sizeable portfolios (take for example, HDFC Bank setting aside INR 1220 crores, ICICI setting aside INR 627 crores, or Piramal having to write down its entire investment in AIFs for a total loss of INR 2377.59 Crores)[31] though, a few AIF managers did make money by buying those fire sale assets.

The real impact was, however, felt by the AIF managers. Fundraising cycles of AIFs were disrupted as Banks did not honor their capital commitments in fear of breaching the December Circular. One such case was SBI refusing a capital call from the National Investment and Infrastructure Fund.

Compared globally, India's AIF industry is still in its nascent stages (and relatively, quite heavily regulated). Furthering that problem, and in sudden fashion, may not bode well for the industry's growth.

## The March Circular[32] – pulling back on regulation?

After significant complaints from the AIFs and banking industry representatives, RBI re-examined the restrictions imposed by the December Circular and issued the March Circular which relaxed and clarified positions. Key relaxations include:

[31] Note. News articles – accessible here and here.
[32] Note. RBI's circular on investments into AIFs dated 27 March 2024 – accessible here.

a. *Provisioning limited to AIF exposure in the borrower.* Limiting provisioning only to the extent of the AIFs exposure in the borrower, instead of provisioning for an amount equal to the entire investment in the AIF.

b. *Exemption of 'indirect investments' via mutual funds or fund of funds*. Exempting investments made through intermediaries such as funds of funds or mutual funds in AIF.

   This is naturally welcome, but, it also presents an internal disconnect on what the RBI's underlying principle is. If funds of funds and mutual funds are carved out because the Bank has no control over decision-making over where the mutual fund or downstream fund invests, then AIFs which are truly acting independently of Banks should also be carved out (say, if the AIF independently invests into a portfolio unaware that it in fact borrowing from a unitholder in the AIF). We believe a simpler solution could be to punish the intent, and not the act itself.

c. *Equity investments exempted*. Exempting equity investments, i.e., if AIFs are only investing into the equity shares of a borrower, then Banks are not required to divest or provision, though investments in hybrid instruments (like compulsorily convertible debentures and compulsorily convertible preference shares) remain prohibited. This is of course welcome since equity instruments were never being used to evergreen in the first place.

| Particulars | Shares |
|---|---|
| Restricted all downstream investments by AlF into the borrower | Investments in equity shares of the borrower are exempted |
| General embargo on direct and indirect investments by Banks into the borrower | Banks can invest in fund of funds or mutual funds which ultimately invest in the borrower |
| Provisioning for 100% of the investment by Banks into the AIF | Provisioning limited only to the exposure of the AIF in the borrower |
| Uncertainty on which capital had to be deducted from | Deduction from Tier-1 and Tier-2 capital equally |

## What about bona fide transactions?

Consider a 'Scenario A' where an AIF, which has received funding from a Bank, invests into debt instruments of an unrelated portfolio company in the natural course of its business. A few months later, the portfolio company raises money from that same Bank and thereby becomes a borrower. Will the Bank now be required to create provisions/ down-sell?

Consider another 'Scenario B', where the AIF buys the instrument of a borrower in the secondary market. Since there is no inherent interlinkage between the Bank, AIF and the borrower, should Banks still be required to make provisions/ down-sell?

Unfortunately, under the current scheme of the regulation, both Scenario A and B could entail the Bank creating minimum provisions or down-selling, i.e., they would be covered by the prohibition on 'direct or indirect on investment' in a borrower as per the December Circular.

## Conclusion

We think there is no perfect solution that cannot be misplayed. But as for all rule-making, the rules must be made such that bona fide players are not adversely impacted. While it's easy to give back-seat instructions and we do understand RBI's predicament, possibly an approach that addresses the intent (and not the act in isolation) could be the solution – inasmuch as Banks shouldn't be held liable if they couldn't have controlled or weren't aware of the portfolio companies conduct.

If RBI really does want to move towards a strict regime and regulate even bona fide players, then it should take that decision and inform the market well in advance to ensure that players have adequate time to absorb that change. The RBI should also be mindful of the effect its regulation would have on a nascent funds industry, which needs support – and also seek consultation from funds and the market regulator (SEBI) well in advance, and not subsequent to regulation.

# Annexure E

## SEBI Introduces Special Situation Funds: Opens doors for acquisition of stressed loans without ARC intermediation (*Analysis - 18 February, 2022*)

### Key Takeaways

- Special Situation Funds (SSF) have been launched Category – 1 AIF for sophisticated investors.
- Offshore investors no longer have to rely on an Asset Reconstruction Company / Asset Reconstruction Trust framework to invest in stressed assets.
- 25% diversification requirement not applicable to SSF.
- Ability to buy loans directly, not restricted to 'securities'.
- Edge over ARTs – allowed to act as resolution applicants in IBC, acquire uncapped equity

### Background

One of the biggest challenges faced by offshore funds wanting to invest in bad loans in India was necessary intermediation by a third party Asset Reconstruction Company (**ARC**). In most cases, the structure involved the ARC sponsoring and managing an asset reconstruction trust (**ART**), which acquired such bad loans from the funds received by the issue of security receipts. Setting up an in-house ARC wasn't feasible in most cases due to high regulatory requirements such as capital adequacy norms – most likely driven by the regulatory intent that ARCs should rather act as asset managers for ARTs than manage assets on their own books. ARCs and SR holders were also not always aligned on the governance and enforcement mechanics of the loans acquired. Offshore investors therefore pressed for a regime that allowed them to invest without the need for intermediation by an ARC.

A committee was formed to review the working of asset reconstruction companies (**Committee**), which recommended the creation of special situation funds (**SSF**) in the nature of AIFs as an alternative to ARTs. Premised on the recommendations of this Committee, the SEBI (Alternative Investment Funds) Regulations, 2012 have been amended and notified on January 24, 2022[33] (***Amendment Regulations***) to introduce special situation funds as a new sub-category under Category I AIF.

In September 2021, the Committee recommended as follows:

"*Given the limitation of traditional sources of financing for ARCs, the Committee recommends that, going forward, ARCs should be allowed to sponsor an AIF. All categories of AIFs have already been specified as QBs. Allowing an ARC to sponsor and set up an AIF, duly registered with SEBI with the objective of investing in stressed assets could address the above constraints and provide an additional investor base including HNIs and improve the ability of the ARC to effectively reconstruct the debt and also turn around the borrower. This would be in the interests of the SR investors and the economy. Further, there would be increased flexibility in restructuring options, given that investments to debt/ equity may be funded directly from the AIF. Using the AIF as a source can help ARCs in raising funds in a risk mitigated manner (in line with other AIFs) based on their performance track record and help*

[32] No. SEBI/LAD-NRO/GN/2022/68, dated January 24, 2022.

*in turning around many stuck cases. The objective is to use the AIF as an additional vehicle to advance the purpose of the ARCs to facilitate restructuring/ recovery of the acquired a debt. For revival of stressed companies, the ARCs may need flexibility to arrange the financial assistance from banks and FIs and additional capital for revival. Accordingly, an ARC should be allowed to set up an AIF which can subscribe to SRs issued by the trust set up by it and also invest in such companies for which debt has been acquired by the ARC for securitisation. As per Section 10(2) of Act, ARCs may undertake activities other than the permitted businesses, only with the prior approval of RBI. The Committee recommends that RBI should exercise the powers granted under Section 10(2) to allow ARCs to set up AIFs which should be registered with SEBI."*

Interestingly, SEBI has gone a step further and enabled a regime for SSFs which does not require an ARC to be a sponsor. In this article we analyse the SSF regime, its likely implications, and potential structures going-forward.

## The Change – Introduction of the SSF Regime

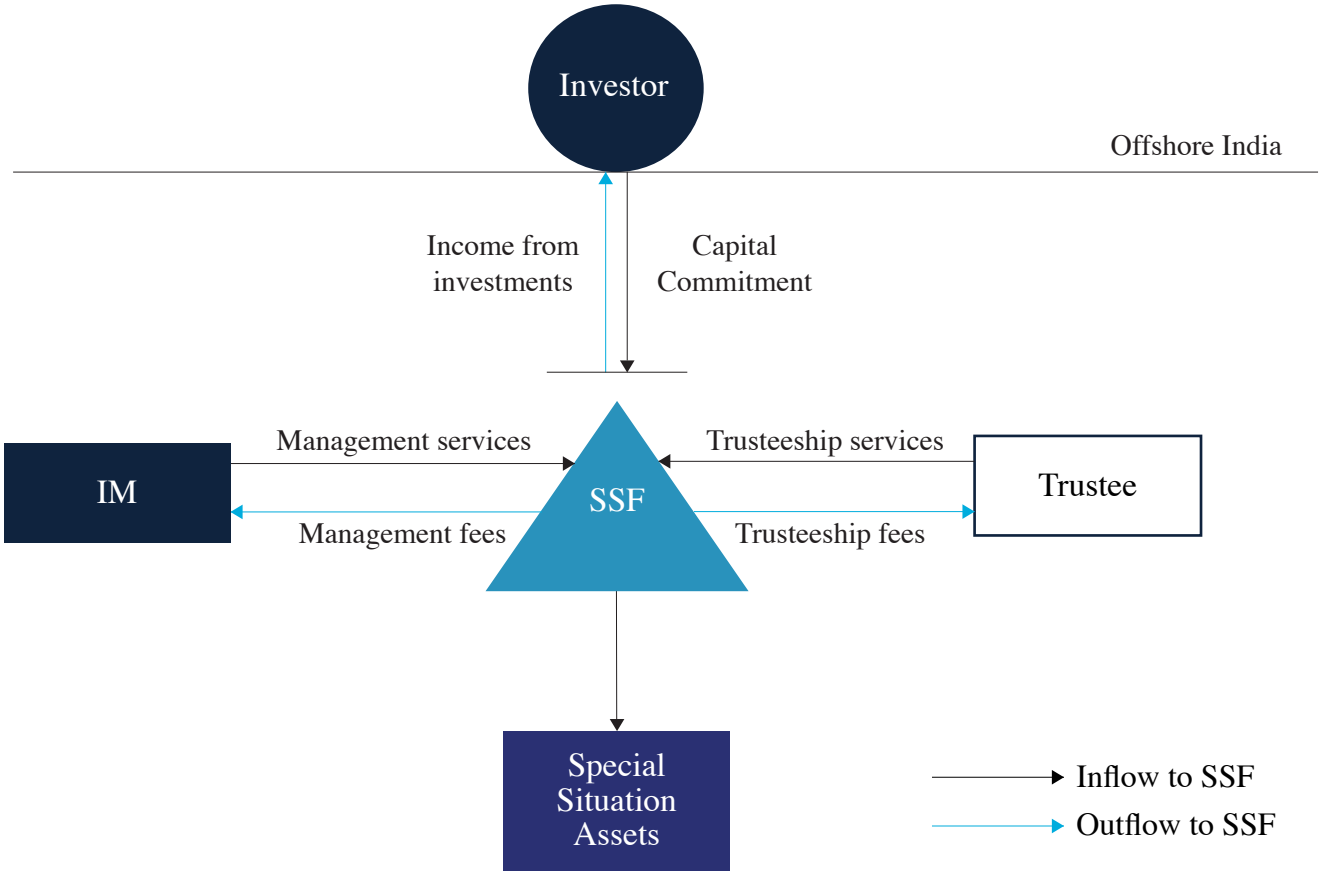
The SSF regime has sought to create a less cumbersome avenue for investors looking towards the stressed assets market in India. An SSF can conceptually do 2 main things: (a) invest in 'special situation assets', and / or (b) act as a 'resolution applicant' under the IBC.

Special situation assets have been defined vide the Amendment Regulations to include the following:

i. stressed loans[33] available for acquisition[34];
ii. SRs issued by an ARC;
iii. Securities of investee companies – either whose stressed loans are available for acquisition in accor- dance with (i), or against whose borrowings SRs have been issued by an ARC, or whose borrowings are subject to corporate insolvency resolution process under Chapter II of the IBC and the credit rating of the financial / credit instruments / borrowings have been downgraded to "D" or an equivalent ranking, or who have disclosed a default which is continuing for a period of at least 90 days after the event of default and credit rating of the financial / credit instruments / borrowings have been downgraded to "D" or an equivalent ranking.
iv. Any other assets as the Board may specify.

Structurally, the mechanism for investing in special situation assets via an SSF could be as follows:

[33] Loan exposures classified as Non-Performing Assets (NPAs) i.e., an asset which has ceased to generate income for the bank, or as Special Mention Accounts (SMAs) i.e., an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of her debt obligations (though the account has not yet been classified as NPA).
[34] As per (a) the terms of Clause 58 of the Master Direction – RBI (Transfer of Loan Exposure) Directions, 2021, or (b) as part of a resolution plan approved under the IBC, or (c) in terms of any policy issued by the RBI or the Government of India.




## The AIF Regime Thus Far

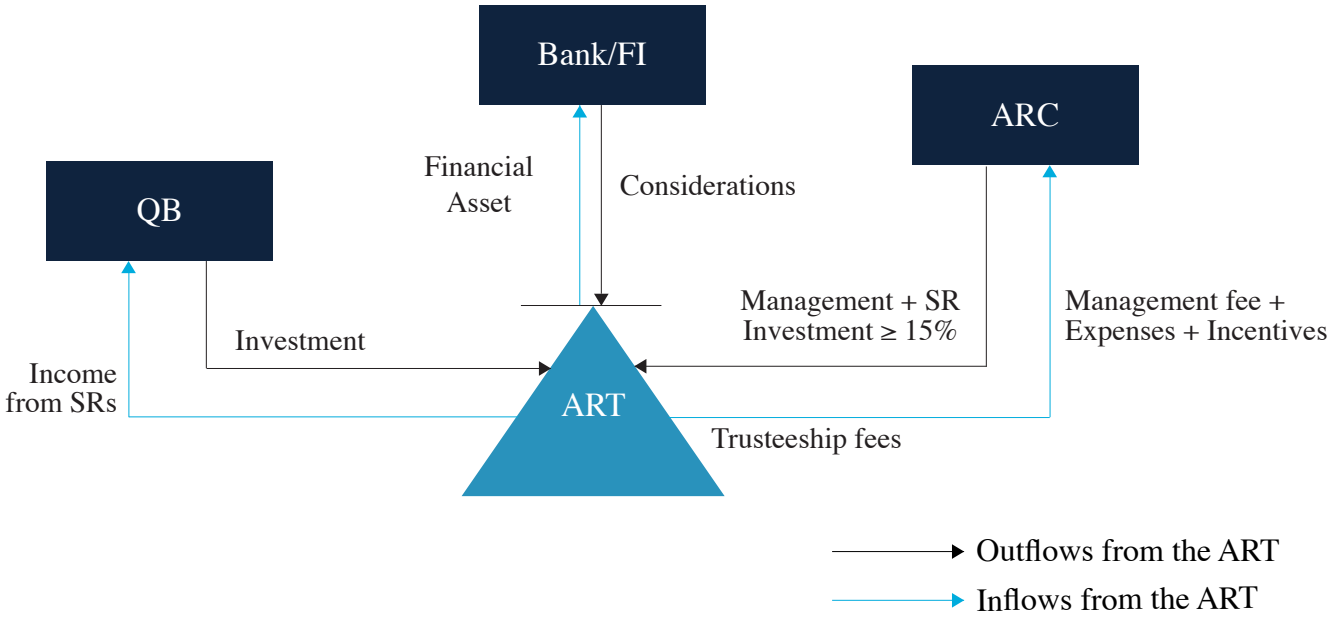
Earlier, AIFs could only invest in commodities and 'securities', as defined under the Securities Contracts (Regulation) Act, 1956, and not loans.[35] While a debt fund, which is a Category–II AIF, could invest in debt securities of listed or unlisted investee companies or in securitized debt instruments, this was as close as an AIF could get to acquiring debt. To that extent, the new regime wherein SSFs are allowed to directly acquire loans could be a gamechanger.

## The ARC Framework

Prior to the introduction of the SSF regime, only 'permitted transferees' were allowed to acquire stressed loans. As per the RBI (Transfer of Loan Exposures) Directions, 2021 – this category included scheduled commercial banks, all India financial institutions (NABARD, NHB, EXIM Bank, and SIDBI), small finance banks, all non-banking finance companies (including housing finance companies) and ARCs. Out of these, ARCs have historically occupied centre stage in the private market for loan acquisitions.

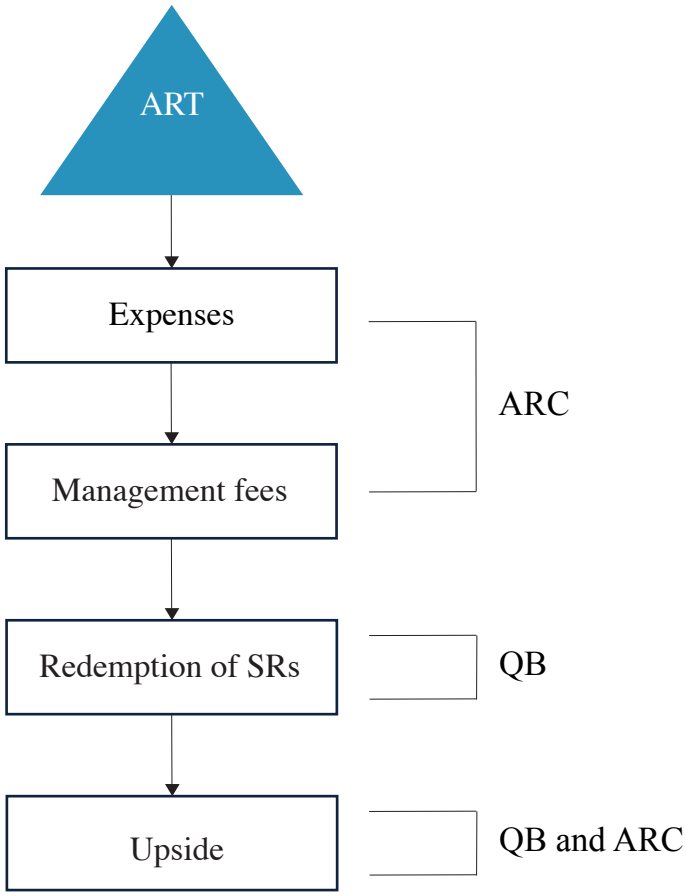
[35] SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021.

ARCs were introduced with the objective of helping banks and financial institutions manage their stressed assets by reducing the non-performing assets on their books. They did this either by acquiring financial assets on their own company books, or in the books of an ART set up for the purpose of securitisation / reconstruction. However, the SRs issued by these ARTs, which were backed by such loans, could only be acquired by financial institutions, insurance companies, banks, state financial corporations, state industrial development corporations, ARCs, and asset management companies investing on behalf of mutual funds or registered foreign institutional investors (Qualified Buyers or QB). In the context of offshore funds, the investing entities had to be registered as FPIs to invest in SRs. The structure was usually as follows:

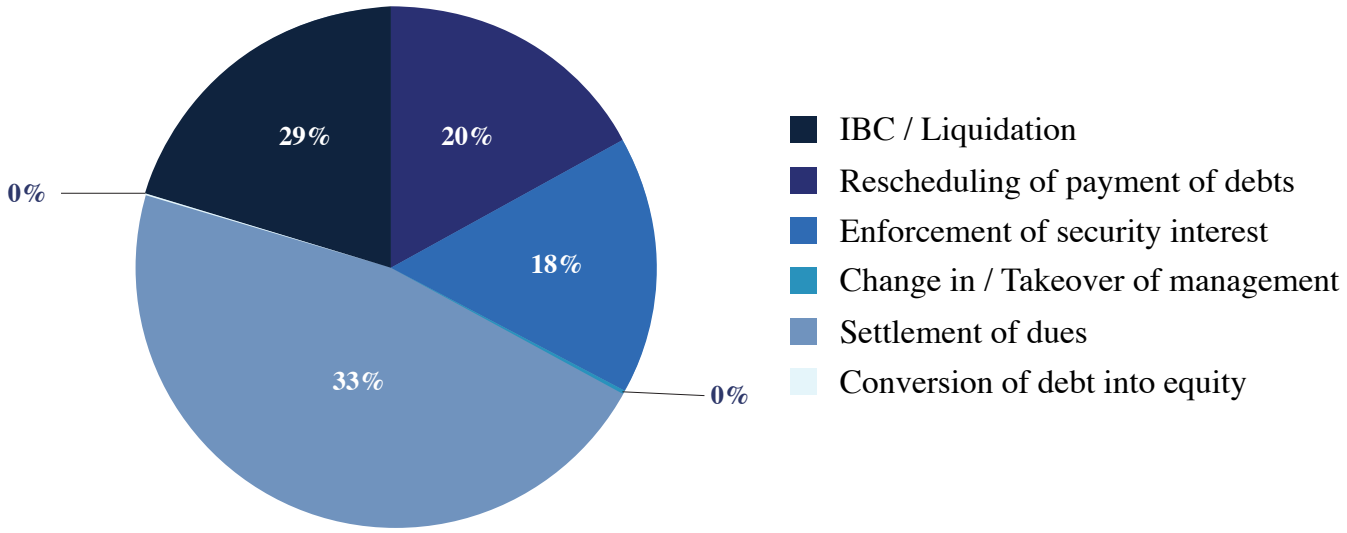



The amount of outflow from the ART is a function of the ARC's restructuring efforts. The first level of payments made by an ART is towards expenses, managements fees and incentives to the ARC itself, this is followed by redemption of the SRs held by the QBs (ARCs also qualify as QBs, since they are required to hold a minimum of 15% of SRs). The remaining funds are then allotted to the QBs and ARCs as per agreement between them.

The diagrammatic waterfall of the outflow is as follows:




However, data indicates that the performance of ARCs in revival of businesses has been unsatisfactory. The following chart indicates the methods of reconstruction deployed by ARCs during the financial years 2004-2021[36]:




[36] Data as per Report of the Committee to Review the Working of Asset Reconstruction Companies, Reserve Bank of India, dated September 2021.

While ARCs have managed to maintain some relevance by virtue of their unique position as private sector led institutional framework for handling / resolution of stressed assets, the commercial disincentives are underpinned by some foundational complications.

1. **No revivals**. ARCs seem to have lost the plot of ensuring revival of businesses. The effectiveness of asset reconstruction efforts is a function of the amount of SRs redeemed and upside earned. During a period of 9 years[37], the total redemption of SRs weighed against the total SRs issued, setting the overall recovery made by the sector at roughly 68.6%. However, if redemption is measured as a factor of the book value of the assets acquired, the figure drops to 14.29%. Data indicates that roughly 80% of recovery efforts in the sector have not resulted in revival of businesses.

2. **Limited funding flexibility**. Turnaround of stressed borrowers requires liquidity but raising and maintaining a steady flow of funds becomes difficult due to adverse asset classification of the defaulter accounts. Banks and institutional lenders are unlikely to lend funds given the stressed nature of the borrower, which unwillingness is only exacerbated by the unlikely assurance of return. Additionally, ARCs have restrictions on the amount of restructuring support finance they can provide (capped at 25% of funds raised under a scheme). An SSF will not be subject to any such restrictions – and as such, have a relatively higher potential to infuse the volume of funds required, at the frequency required.

3. Inability to acquire equity. A restructuring exercise involving a debt-to-equity conversion would result in the lenders acquiring equity in the borrower company, in addition to the debt. However, under the current regulatory and legal framework, the effectiveness of ARCs is sub-optimized due to their inability to acquire more than 26% of the post converted equity of the borrower company. Conversely, SSFs have been permitted to acquire both debt and equity of a stressed company without any restrictions.

4. **Can participate in IBC**. ARCs have been permitted to undertake those activities as Resolution Applicants (RA) under IBC which are not specifically allowed under the SARFAESI Act subject to certain conditions. The rationale being that the legal and regulatory design of ARCs is focused on recovery of debt from the borrower and not on resolution of the borrower's insolvency. In contrast, SSFs have been specifically permitted to act as RAs, which can be instrumental in investors' efforts to take the asset private, rather than be subject to the discretion of the committee of creditors (CoC) under the IBC.

5. **Restrictions on sale / lease of businesses**. While the SARFAESI Act provides for the sale or lease of a part or whole of the business of the borrower as a measure for asset reconstruction, RBI guidelines indicate that no ARC shall take this measure until the RBI issues necessary guidelines in this behalf (which have not yet been issued). No such restriction on sale or lease of business will apply to an SSF, thus opening up additional fund streams and giving the SSF an edge to reconstruct the asset in the most appropriate way it deems fit.

[37] Financial Year 2004 to Financial Year 2013.

6. **Value leakage**. ARCs are mandatorily required to hold a minimum of 15% of transferors' investment in the security receipts or 2.5% of the total SRs issued, whichever is higher. While this was done to ensure the ARC has 'skin in the game' and hence acts in the best interest of investors and investing lenders, this results in value leakage for investors, which inhibits sophisticated investors who have the risk appetite and willingness to access 100% of security receipts, from investing in ARTs.

7. **Dependence on ARC**. Enforcement and ability to control the assets is hinged on support from the ARC, which historically has not always been the most forthcoming. Only in the event of non-realisation of the assets for a period of 8 years, do the qualified buyers (holding at least 75% of the total value of security receipts) get to call a meeting of all the qualified buyers and pass a resolution binding on the ARC.

8. **Debt aggregation**. There are often situations where multiple ARCs acquire different parts of sub-standard assets of a single borrower – leading to multiple ARCs, and multiple ARTs, holding dispersed portions of the same borrower's assets for different QBs. It would be significantly more efficient to bring all the assets of a common borrower under the control of a single ARC/ART. However, if an attempt is made to consolidate the debt in one ARC, the ARC is required to mandatorily redeem the SRs from the sale proceeds. The ARC is not permitted to transfer the assets without redemption of the SRs. Such redemption requirement prevents the ARCs from having the flexibility to transfer the assets and achieve the benefits of aggregation. There is no corresponding requirement for an SSF aggregating debt, which allows SSFs the flexibility to transfer stressed assets if it is expedient to do so. SSFs, however, and importantly so are locked-in from transferring the stressed assets for a period of 6 months.

## Comparative analysis

At a practical level, a comparative analysis of both routes is as follows:

| Factor | ART | SSF | Implication |
|---|---|---|---|
| **Incorporation and registration** | Must be sponsored by an ARC. Hence, investors must find an ARC to collaborate with. | An offshore fund can itself be the sponsor. No need for an ARC or any other regulated entity. | Setting up an SSF is much easier than incorporating an ARC. There are no capital adequacy norms, and the regime has limited regulatory supervision and reporting requirements. |

| | | | |
|---|---|---|---|
| **Type of assets** | Financial assets[38], though enforcement entitlements are limited to NPAs. | Special Situation Assets | |
| **Investor** | Qualified Buyers | No restriction | Foreign investors had to take an FPI registration to invest in SRs, which won't be required to invest in an SSF. However, SSFs require a minimum investment of INR 10 cr or INR 5 cr if the investor is an accredited investor (as per AIF regulations). |
| **Corpus** | ≥ INR 300 crores (~USD 3,75,77,321). | ≥ INR 100 crores (~USD 1,19,25,774). | |
| **Manager/ sponsor's investment in the scheme** | ≥ 15% of SRs. | not less than 2.5% of the corpus or five crore rupees, whichever is lesser (~USD 596,000). | Minimal value leakage. |
| **SARFAESI Enforcement benefit** | Available. | No benefit available to an SSF. | SARFAESI regime for ARCs is not very efficient, as explained above. Besides, in most cases, SARFAESI is superseded by IBC, and SSFs may have an edge in the IBC process as they qualify as RAs. |

[38] "financial asset" means debt or receivables and includes— (i) a claim to any debt or receivables or part thereof, whether secured or unsecured; or (ii) any debt or receivables secured by, mortgage of, or charge on, immovable property; or (iii) a mortgage, charge, hypothecation or pledge of movable property; or (iv) any right or interest in the security, whether full or part underlying such debt or receivables; or (v) any beneficial interest in property, whether movable or immovable, or in such debt, receivables, whether such interest is existing, future, accruing, conditional or contingent; or [(va) any beneficial right, title or interest in any tangible asset given on hire or financial lease or conditional sale or under any other contract which secures the obligation to pay any unpaid portion of the purchase price of such asset or an obligation incurred or credit otherwise provided to enable the borrower to acquire such tangible asset; or (vb) any right, title or interest on any intangible asset or licence or assignment of such intangible asset, which secures the obligation to pay any unpaid portion of the purchase price of such intangible asset or an obligation incurred or credit otherwise extended to enable the borrower to acquire such intangible asset or obtain licence of the intangible asset; or] (vi) any financial assistance;.

| | | | |
|---|---|---|---|
| **Ability to convert debt into equity** | ARCs have the ability to convert debt into equity. However, the shareholding of the ARC / ART shall usually be ≤ 26% of the sectoral FDI limit. | No restriction on conversion of debt into equity, this allows the SSF a significant upside as they have the ability to take complete control of the company. This can translate into efficient restructuring, such as through IBC. | SSFs can act as alternate capital vehicles with the ability to own the entire asset (entire equity + debt), giving them greater flexibility to finance and turn around the stressed borrower. |
| **Resolution applicant** | Courts have accepted resolution plans submitted by ARCs in the past.[39] ARCs have been allowed to act as RAs subject to certain conditions as discussed above. | Specifically permitted to be RA. | |
| **ROFR** | Right of first refusal (ROFR) is available for an ARC – essentially, a bank offering stressed assets for sale shall offer the first right of refusal to the ARC which has already acquired the highest and significant share (~25-30%) of the asset. | No right of first refusal is available for an SSF. Therefore, ARCs have a relative advantage in undertaking debt aggregation. | SSF may lag in its ability to aggregate debt. Debt aggregation helps in having a greater say in the CoC at the resolution stage. |

[39] R. Velu v. Palm Lagoon Backwater Resorts Private Limited (MA/113/KOB/2020 in TIBA/9/KOB/2020) (CP.1312 of 2018 of Chennai Bench); Bank of India v. Aparant Iron and Steel Private Limited (MA 2960 of 2019 in CP No.2859/I&BC/MB/MAH/2018).

## Way forward

Covid-19 saw a slew of companies with good promoters fall into a cash trap and come under stress. There is significant interest in offshore funds to participate in the credit secondaries of such companies so as to provide them with high yield rescue financing. Strategies such as these have the ability to turn around stressed borrowers and bring them back to profitability. However, there is a need to allow for flexibility to structure tailor made solutions involving different avenues of capital infusion across debt, equity and mezzanine funding. The current ARC / ART framework did not offer such flexibility, and hence, despite interest from global sponsors of special situation funds / credit funds, the credit secondary market for bad debts could never take off.

The introduction of an SSF framework opens possibilities for companies which have good promoters, and revival potential, but are stuck in debt traps. The regime significantly deregulates a rather stringently regulated space and might appear inviting for a much larger pool of offshore investors. There may be a few tax concerns, which we will discuss separately in a follow up to this Analysis. However, the SSF regime seems to check most of the boxes that the investors wanted. Hopefully, a similar disintermediated regime could also be initiated to allow FPIs to directly buy stressed assets, and probably a similar regime to also allow for AIFs and FPIs to acquire standard assets.

# Annexure F

## GIFT City – Analysing new fund management regulations and why GIFT City still doesn't work (*Analysis - 26 February, 2022*)

### Key Takeaways

- IFSCA proposes significant shift in regulatory regime for investments funds – shift from investment vehicle towards fund management entity (FME)
- Replacement of Category I, II and III AIFs under present AIF Framework with investment schemes viz. Venture Capital Scheme, Restricted Scheme (Non-Retail) and Retail Schemes
- Streamlined approval process of investment schemes by introduction of 'Green Channel'
- Single point registration (as FME) as opposed to multiple registrations in different regulations
- Offers significant room for growth and innovation of new financial products in a sandbox environment

### Background

The International Financial Services Authority (IFSCA) – the unified regulator for GIFT City – released the IFSCA (Fund Management) regulations in 2022 (Regulations). The Regulations propose a wholesale overhaul of the investment funds regime in GIFT City in line with the regulatory model that has been adopted by major global jurisdictions such as the European Union. The most salient feature is the shift from a regime focused on the investment vehicle to one that is focused on the fund manager. The reforms set out in the Regulations follow several other tax and regulatory measures introduced by the IFSCA and the Government of India to facilitate the development of GIFT City as a highly reputable international funds jurisdiction.

Whilst the formal rollout of the Regulations is a landmark event, it is worth noting that GIFT City has not yet taken off as a preferred investment funds jurisdiction along the lines of traditional funds jurisdictions such as Mauritius, Singapore, Luxembourg and the Cayman Islands. This Analysis briefly examines the key features in the Regulations against the position under the existing regime and review some of the challenges that continue to plague the growth and development of GIFT City as an international investment funds jurisdiction.

### The Fund Management Framework

The proposed regulations outline significant departures from the current conception of the funds industry in India. Broadly, these are the changes on which draft regulations are based:

1. **Fund-Management Based Regime from Fund Based Regime**: The existing regulatory framework for investment funds in India is primarily focused on the investment vehicle i.e. AIFs of various categories. Consequently, there are rules that permit and restrict various activities and operations of funds. For instance, a Category I / II AIF is generally not permitted to invest more than 25% of investable funds in a single investee company. Managers and sponsors of an AIF are held to account if the AIF trips any of the rules and restrictions to which it is subject. Thus, the oversight on

it is subject. Thus, the oversight on managers is largely indirect. However, the Regulations focus on regulating the fund manager and provide a comprehensive framework for registration of Fund Management Entities ("FMEs"). Once an FME is registered, it will be permitted to launch different 'investment schemes' on a continuing basis (rather than having to apply for registration of a new AIF each time a new fund needs to be set up under the existing framework). For completeness, it should be noted that investment schemes under the proposed regime will receive the same tax treat- ment as AIFs registered with SEBI.

2. **Accelerated Approval Timelines**: A key area of concern for sponsors looking to set up private funds in India is the lengthy approval process. Depending on the investment strategy of the fund, approval from the domestic regulator tends to take up to 4 months on average. During this period, the sponsor is unable to carry out any meaningful operations on behalf of the fund. Against this backdrop, the Regulations propose two helpful measures. First, Restricted Schemes (Non-Retail Schemes) (which would cover almost the entire gamut of funds that are classified as AIFs under the existing framework) are permitted to commence operations 21 days after filing a placement memorandum with the IFSCA (subject to incorporating any comments provided by the IFSCA within the 21-day timeline). Second, a green channel has been introduced for: (i) Venture Capital Schemes; and (ii) Restricted Schemes (Non-Retail Schemes) that accept commitments only from accredited investors. Such schemes may be opened for subscription from investors immediately upon filing the placement memorandum with the IFSCA.

3. **Single Registration and Unified Regulatory Framework**: The proposed regulations create a singular registration for performing the role of traditional investment manager, provide portfolio management services, manage REITs, InvITs and family offices. This increases regulatory certainty in day to day functioning and simplifies compliance. Procedurally, FMEs can seek registration in the following three categories, linked to the kind of schemes they seek to pursue – viz., Authorized FMEs (primarily for venture capital schemes); Registered FMEs (Non-Retail) (for privately placed schemes in different asset classes and portfolio management services); and, Registered FMEs (Retail) (for schemes pooling money from retail and non-retail investors, portfolio managers, ETFs, etc.).

## Other Tax Benefits/Incentives in the Framework

The current draft policy builds upon the several other relaxations and tax measures provided in the past to incentivize activity in GIFT City. These include:

1. **Preferential Long Term Capital Gains (LTCG) Rate**. Any income of a Category III AIFs enjoys a preferential tax on capital gains at the fund level (long term at 12.5% and short term at 20%) and are exempt from other taxes in India. Interest income is also taxed at 10% in GIFT City. Under the Regulations, schemes focused on investments in securities primarily of listed entities (including for undertaking diverse or complex trading strategies) will be deemed to be Category III AIFs for income-tax purposes and will thus be eligible to avail of these preferential tax rates. This compares favorably to international jurisdictions with which India has tax treaties, such as Ireland, Mauritius, Singapore, etc.

2. **Business Tax Exemption**. Units set up in GIFT City are entitled to a 100% deduction of income generated from the business for which the unit was set up in GIFT City for 10 consecutive years. The income of an FME from investment and portfolio management services will qualify to receive this benefit.

3. **No PAN for Foreign Investors**. Non-resident investors do not need to obtain a PAN (Indian tax registration) when investing through an AIF. There is also no requirement for such investors to file Indian taxes. Global LPs have generally been wary of taking a PAN and have preferred to invest in offshore pooling vehicles which in turn procure the PAN. Removing the need to procure a PAN has therefore been a sig- nificant shot in the arm for GIFT City to attract global investors.

4. **Diversification and Leverage Relaxations**. Unlike funds incorporated in the rest of India, funds set up in GIFT City funds are not subject to borrowing restrictions and diversification requirements. This effectively permits a GIFT City fund to invest all its capital in a single investee company, which opens the doors for captive funds and activist investment strategies.

5. **Ancillary Tax Exemptions**. The Indian tax regime also provide a range of exemptions for ancillary taxes such as securities transaction taxes, stamp duty (through reimbursement), commodities transaction tax, etc.

6. **No Capital Gains for NR Transfers**. All inter-se transfers among non-resident Indians of securities traded on GIFT City exchanges are exempt from capital gains taxes.

## Challenges

Whilst the Regulations foretell a much needed reform, deeper issues plague the development of GIFT City as a funds jurisdiction that can truly rival the efficiencies provided by international financial services centres elsewhere in the world. Some of these are summarized below:

1. **Issue of Perspective**. At some level, the biggest challenge appears to be one of perspective. The various regulatory regimes introduced in GIFT City must be measured for efficiency and nimbleness against international financial jurisdictions such as the Cayman Islands, Mauritius, Singapore and Luxembourg among others. There is little sense or value in comparing regimes in GIFT City against their counterparts in the rest of India. In other words, the IFSCA's competition is the nimble, efficient regulator in other international financial services centres; not the domestic regulator (SEBI). GIFT City doesn't match up to those standards yet. It also lacks the infrastructure that Singapore or Luxembourg may offer to attract global talent pool.

2. **Challenges faced by Category III AIFs in availing of the LTCG**. The 12.5% LTCG benefit is only available to Category III AIFs that are registered in GIFT City. Category I and Category II AIFs are pass-through structures and are thus ineligible to receive this benefit. However, tax advisors have taken the view that a Category III AIF should be open-ended to minimize the scope of regulatory scrutiny. Open ended Category III AIFs are required to disclose monthly NAVs to investors alongside detailed quarterly reports on the fund's performance and risk assessment. Compared with annual disclosures for other funds, the frequency of disclosures is a costly and

for other funds, the frequency of disclosures is a costly and time-consuming exercise. As mentioned above, the Regulations provide that Restricted Schemes (Non-Retail Schemes) that invest in securities primarily of listed entities (including for undertaking diverse or complex trading strategies and for permitted investments under longevity finance) will be eligible for the same benefit as Category III AIFs. However, this may not solve for whether close-ended schemes that adopt such strategies will encounter heightened regulatory scrutiny.

3. **Additional SEZ Approvals**. The SEZ Act is applicable to GIFT City and therefore, a separate approval from the SEZ authority is required for setting up a fund in GIFT City. These approvals are separate from, and in addition to, the general approval required by the regulator (i.e the IFSCA). Whilst the Green Channel and the deemed approval provisions contemplated under the Regulations are welcome, they only resolve part of the challenge relating to timelines.

4. **FPI Registration**. While equity is taxed homogenously at 12.5%, GIFT City is substantially tax incentivizing for private debt funds looking to invest in the Indian high yield corporate bonds. GIFT City domiciled credit funds need to procure a foreign portfolio (FPI) registration for investing in corporate bonds, just as any other non-resident would require, removing the edge that GIFT City could have had over other offshore jurisdictions. From a practical standpoint, investing through GIFT City makes most sense for debt investors where the interest withholding could reduce from as much as 40% to 10%.

5. **Limitation of Trust Structures**. Fund investors (LPs) and GPs have often found the trust structure in India to be complex and cumbersome to manage due to intermediaries like trustees, settlors, etc. The expert committee recommended the introduction of Variable Cell Companies (VCCs) as an alternative pooling vehicle. VCCs allow for simpler infusion of funds (like a trust) with the flexibility of a company-like management structure, removing the need for intermediaries. The Regulations, however, have not incorporated the VCC concept. Introduction of VCCs in GIFT City (along the lines of the VCC structure in Singapore and equivalent structures in Mauritius and the Cayman Islands) would be helpful for the investment funds industry in India. Variable company structures are likely to be introduced for financing leasing of aircrafts and ships, and pooled funds of private equity through a variable company structure as per Budget 2024-25.

6. **Tax Incentive in GIFT v. Tax Treaties**. One of GIFT City's biggest support system could also be the most critical dissuading factor for offshore funds. GIFT City is currently enjoying tax exemptions which emanate from the Income-tax Act as against a diplomatic agreement like a tax treaty with Mauritius or Singapore. To that extent, diluting the tax inventive regime in GIFT City could be done with a mere parliamentary amendment as against a tax treaty which cannot be unilaterally amended.

While GIFT City continues to attract foreign investors looking to invest in India, the challenges set out above need to be addressed to fully optimize its presence as an international investment funds jurisdiction. Substance requirements have been eased, but further tax clarity and comfort from unnecessary tax scrutiny on substance may be helpful. For debt investors particularly, fund managers should be able to elect whether they want the pass through treatment or not. Importantly, the need for Category II AIFs to procure an FPI registration seems rather unnecessary since the fund (and now the fund manager) is anyway under robust regulation. Addressing such practical nuances is likely to make GIFT City the favored jurisdiction for investments into India paving the way for it to become the base for financial sponsors looking to invest in the region.

A BRIEF SNAPSHOT OF PRESENT AIF FRAMEWORK IN IFSC VIS-A-VIS PROPOSED IFSCA (FUND MANAGEMENT) REGULATIONS, 2022 HAS BEEN ENUMERATED IN THE BELOW TABLE:

| S. No. | Factors | Existing Regime | Proposed Regime | | |
|---|---|---|---|---|---|
| 1. | **Categorization** | Funds can be of 3 categories viz.<br>• Category I AIFs<br>• Category II AIFs<br>• Category III AIFs | Introduced 3 types of schemes, which may be launched through a fund as a pooling vehicle viz: | | |
| | | | **Venture Capital Scheme** | **Restricted Scheme (Non-retail)** | **Retail Scheme** |
| 2. | **Meaning** | **Category I**<br>AIFs which invest in start-up or early-stage ventures or social ventures or SMEs or infrastructure.<br>**Category II**<br>AIFs which do not fall in Category I and III.<br>**Category III**<br>AIFs which employ diverse or complex trading strategies. | Schemes that invest primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings etc. | Can invest in:<br>a. Start-ups, Social ventures, SMEs or infrastruc-ture etc..<br>b. For undertaking diverse or complex trading strategies including investment in listed or unlisted derivatives. | Can invest in Social Ventures, Infrastructure, ESG sector, specific sectors certain themes such as infrastructure certain asset class (equity/ debt scheme) or towards certain solution (retirement, schemes for children education, etc.) |

| | | | | | |
|---|---|---|---|---|---|
| 2. | **Meaning** | | | c. Investment which does not fall under the clause (a) and (b) above can only filed as Category II of AIFs. | These schemes can invite funds from public investors as well. |
| 3. | **Managing Body** | Investment Manager specifically designated for each fund. | Authorized FME. | Registered FME (Non-Retail). | Registered FME (Retail). |
| 4. | **Open/Close Ended** | Cat I and II are close ended.<br><br>Cat III can be open ended or close ended. | Close ended | Can be open ended or close ended. | Can be open ended or close ended. |
| 5. | **Corpus for each fund/ scheme** | < 3 million USD | < 5 million USD upto a maximum of USD 200 million | < 5 million USD | < 5 million USD |
| 6. | **Minimum Investment by investor** | 150,000 USD | 250,000 USD | 150,000 USD | Close ended schemes investing more than 15% in unlisted securities – 10,000 USD<br><br>Open-ended – None<br><br>No restriction to close-ended funds investing less than 15% in unlisted securities. |
| 7. | **Approval Process** | Approval Required (usually takes 8-9 months to secure all approvals). | Green Channel – scheme starts immediately on filing place-ment memo-randum. | Deemed Approval – Scheme starts if no comments on placement memorandum are received within 21 days. | Approval Required |

| | | | | | |
|---|---|---|---|---|---|
| 8. | **Borrowing/ Leverage** | Permitted | Permitted | Permitted | Cannot borrow except to meet temporary liquidity requirements. |
| 9. | **Portfolio Management services** | Separate approvals and registrations required.<br><br>Restrictions apply on an Investment Manager performing Portfolio Management services. | Registered FMEs (both non-retail and retail) can use the same license to carry out Portfolio Management services as well. | | |
| 10. | **Special Situation Funds** | Can be launched as Category I AIFs, but no special exemptions or provisions available in GIFT City. | Not Applicable | A sub-category of non-Retail schemes. The pooling vehicle is considered as a Category I AIF for tax purposes. | Not Applicable. |
| 11. | **Exchange Traded Fund (ETF)** | Governed separately under SEBI Mutual Fund Regulations, 1996. No GIFT City related exemptions provided. | Recognized as a specific sub-category for retail schemes with specific regulations for commodity ETFs, debt ETFs, equity ETFs, hybrid ETFs, and actively managed ETFs. Can be open ended or close ended. | | |
| 12. | **InvIT & REIT** | Governed under separate regulations (InvIT Guidelines, REIT Guidelines, the Trusts Act, the Registration Act, FEMA) | Not Applicable | Can be launched as a retail or non-retail scheme. Units of non-retail schemes may be unlisted or privately listed, similar to the regime in rest of India. This permits investment in yield-based schemes like infrastructure and real estate through GIFT City. | |
| 13. | **Tax Treatment** | Category I and II AIFs are pass through – all investments are charged at the hands of the investor. No preferential rate applies for foreign investors. | Treated as Category I AIFs in the existing regime for tax purposes. | Depending upon the nature of investment, may be treated as Category I/II/III AIFs as in the existing regime, for tax purposes. ETFs. Can be open ended or close ended. | |

| | | | | |
|---|---|---|---|---|
| 13. | Tax Treatment | Category III AIFs receive a preferential tax rate of 12.5% on long term capital gains.[40] | Exemptions available to VCFs set up under SEBI have been extended to VCFs set under the Regulations. | Various tax exemptions granted to specified funds such as no tax on income of fund's investors, capital gains exemption on transfer of non-equity security, etc. have been extended to Retails schemes and ETFs via Budget 2024. |

[40] Practically, advisors have taken the view that this can be only the case with open ended funds. Please see article below for details.

# Annexure G

## SEBI formalises the use of co-investments but leaves some question marks

(*Analysis - 9 February, 2022*)

### Key Takeaways

- SEBI introduces a new co-investment framework permitting AIF investors to co-invest alongside the AIF through portfolio managers
- The new framework provides that co-investments cannot be on more favourable terms than AIF investments
- Co-investments are not permitted in listed securities
- The global practice of using dedicated co-investment vehicles remains a challenge under the current framework
- There is a tax risk that the co-investors and the AIF will be regarded as an association of persons (AOP) and be taxed at the rate of approximately 30%

Through a series of amendments to the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (the "AIF Regulations") and the Securities and Exchange Board of India (Portfolio Managers) Regulations, 2020 (the "PM Regulations"), the Securities and Exchange Board of India ("SEBI") has formalised the use of co-investments alongside an alternative investment fund ("AIF"). Although there was no specific bar on co-investments under the AIF Regulations, fund sponsors quickly discovered that they likely needed to obtain an additional licence to advise / manage a co-investment. Further, there was little prospect of aggregating capital from various co-investors into a single vehicle since doing so may have tantamounted to "pooling" of funds and triggered a requirement to register as an AIF, which in turn would have meant being subject to the diversification restrictions.

Against this backdrop, the co-investment framework introduced by the amendments to the AIF Regulations and the PM Regulations removes some of the uncertainty around co-investments and creates a pathway for co-investments in the private funds space.

### Background

Co-investments are multi-purpose instruments that not only helps sponsors with capital management but also enables investors to invest a part of their capital on a low-cost basis. With the rollout of the "accredited investor" concept, it was hoped that SEBI might withdraw the diversification requirement for funds comprising accredited investors, thereby paving the way for the use of dedicated co-investment vehicles to invest alongside the primary fund. Whilst there was some movement in this regard (with the introduction of the concept of a "large value fund for accredited investors"), SEBI did not entirely lift the diversification limit. Consequently, it was left to SEBI to craft a special regime for co-investments.

## Summary of the Amendments

The new co-investment regime introduced by SEBI involves coordinated amendments to the AIF Regulations and the PM Regulations and as such, it is worth examining these together.

### 1. Investment Conditions

Amendments to both sets of regulations have laid down the following key aspects relating to the operation of co-investments:

a. the terms of Co-Investment in an investee company by a manager or sponsor or co-investor shall not be more favourable than the terms of investment of the AIF; and

b. the terms of exit from the Co-Investment in an investee company (including timing of exit) shall be identical to the terms on which the AIF exits its investment in the investee company.

It is also worth noting that SEBI has grandfathered the exit terms of co-investment arrangements entered into prior to the amendments.

## I. Co-Investment

The amendments have defined the term 'Co-Investment' as follows:

"*Co-investment means investment made by a Manager or Sponsor or investor of Category I and II Alternative Investment Fund(s) in investee companies where such Category I or Category II Alternative Investment Fund(s) make investments:*

*Provided that Co-investments by investors of Alternative Investment Fund shall be through a Co-investment Portfolio Manager as specified under the Securities and Exchange Board of India (Portfolio Managers) Regulation, 2020.*"

Two things emerge from this definition: (1) a co-investment can be made by the manager, the sponsor, or the investors of a Category I or II AIF; and (2) where a co-investment is proposed to be made by investors of an AIF, such co-investment must be made through a co-investment portfolio manager.

## II. Co-Investment Portfolio Manager

The manager of a Category I or II AIF may act as the CIPM to the investors of the AIF as long as the investments are made in unlisted securities of investee companies in which the AIF is invested. Further, the CIPM may also provide similar services to investors of other Category I or II AIFs which share a common manager and sponsor.

The definition of a CIPM is as follows:

*"Co-Investment Portfolio Manager means a Portfolio Manager who is a Manager of a Category I or II Alternative Investment Fund(s); and:*

*i. provides services only to the investors of such Category I or II Alternative Investment Fund(s); and*

*ii. makes investments only in unlisted securities of investee companies where such Category I or II Alternative Investment Fund(s) make investments:*

*Provided that the Co-investment Portfolio Manager may provide services to investors from any other Category I or Category II Alternative Investment Fund(s) which are managed by them and are also sponsored by the same Sponsor(s)."*

## III. Qualification Requirement for CIPM

An applicant for a portfolio manager licence is required to meet certain eligibility criteria including with respect to 'experience' and 'professional qualification'. Given that the manager of an AIF and the CIPM are the same entity and will operate in tandem, the amendments to the PM Regulations have streamlined the application process for CIPMs by effectively disapplying the 'experience' and 'professional qualification' requirements under the PM Regulations for CIPM applicants. In other words, as long as the key investment team of the manager of an AIF is fulfilling the 'experience' and 'professional qualification' requirements under the AIF Regulations, the CIPM applicant will not be required to separately fulfil the corresponding criteria under the PM Regulations.

## IV.No Net Worth Requirement

Similarly, the requirement for portfolio managers to have and maintain a minimum net worth of INR 5 crores does not apply to CIPMs (presumable because managers of AIFs are not under any obligation to maintain a minimum net worth).

## V. Restriction on advisory services by AIF Managers

Where an AIF manager proposes to offer co-investment opportunities, it will need to apply for registration as a CIPM. In such circumstances, the AIF manager is not permitted to provide advisory services to any person who is not a client of the CIPM with respect to any investment in an investee company in which the AIF makes investments.

## VI. Waiver from requirement to appoint a custodian

The general requirement for portfolio managers to appoint a custodian does not extend to CIPMs.

## Analysis of the Co-Investment Framework

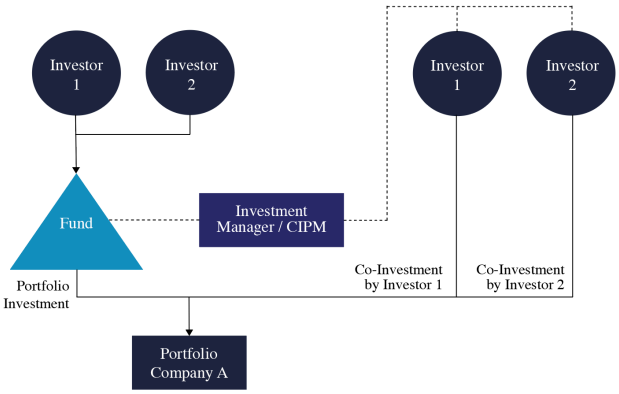
A few aspects of the new Co-Investment framework merit a closer examination as they point to certain structural and commercial issues that may crop up during the rollout of the framework. These are set out below.

### Structural Limitations

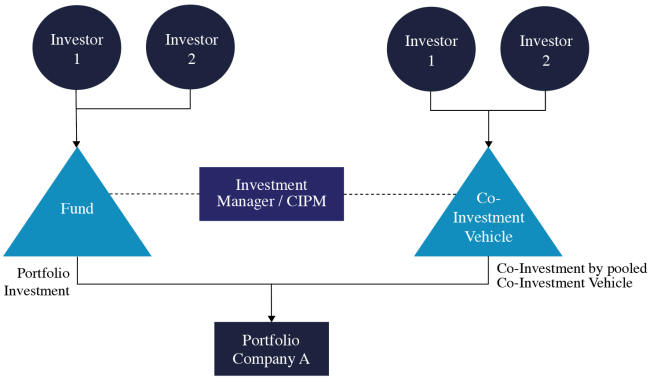
CIPMs are a class of 'portfolio managers' and fall within the purview of the PM Regulations. Under the scheme of the PM Regulations, it is the client that ultimately holds the investments and not the portfolio manager. This poses a few challenges from a commercial perspective. First, some investors may not actually want to take direct exposure to certain kinds of securities. Second, the scheme seems to preclude the use of aggregator or collect vehicles, which may result in the administration of portfolio holdings becoming scattered and unwieldy.

The diagram below illustrates the structural limitations under the new Co-Investment Framework.

**Permitted under new Co-Investment Framework**




**Not Permitted under new Co-Investment Framework**




As shown above, the Co-Investment Framework only permits co-investors to take direct exposure to the portfolio. A CIPM is not permitted to pool co-investment funds into a pooling vehicle, which in turn would make co-investments alongside the main fund. Further, as illustrated above, a CIPM is required to enter into seperate agreement with each co-investor to whom it offers co-investment apportunities.

## Limited Co-Investor Base

Whilst co-investment opportunities are generally offered to existing fund investors, sponsors may, on occasion, invite a third party to co-invest for strategic reasons. For instance, the sponsor may be looking to tap the third party as a lead investor in a future fundraising. Another common scenario is where the third party has been crucial to the deal becoming available to the sponsor. However, the newly introduced co-investment framework would seem to exclude such third parties from participating in co-investment opportunities.

Under the new co-investment framework, a CIPM may, in addition to the investors of the primary AIF, provide services to investors of other Category I or II AIFs that share a common manager and sponsor as the primary AIF. It is currently unclear whether this only means that a CIPM may provide co-investment opportunities in respect of multiple funds having a common manager and sponsor or whether it includes the possibility of an investor in one AIF participating in a co-investment opportunity offered in respect of another AIF in which it is not an investor. Either way, third party investors are shut off from the co-investor base.

The diagram below highlights the uncertainty around the scope of co-investor participation under the new framework.

**Figure 1**

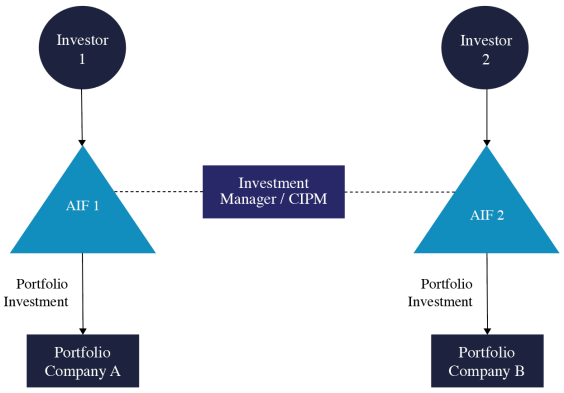
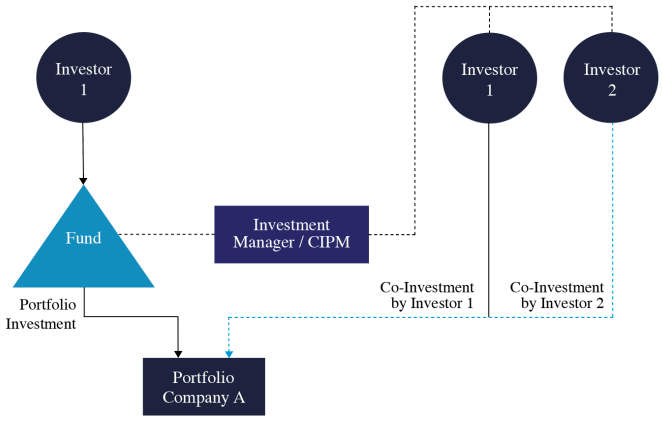



**Figure 2**




## Restricted Securities List

The Co-Investment framework permits a CIPM to invest exclusively in "unlisted securities",[41] whereas Category I and II AIFs are permitted to invest in a broader range of instruments. For example, Category II AIFs are permitted to take exposure to listed companies. It is not immediately clear why SEBI would draw a distinction between listed and unlisted securities as far as co-investments are concerned or whether there is in fact any reasonable basis to this distinction. Commercially, this is a significant restriction since it precludes the use of co-investments in listed debt, which is a popular investment structure for private funds. It also means that capital raised from co-investors cannot be used in 'take-private' transactions.

[41] As per SEBI FAQ dated 28.10.2020, "unlisted securities" for investment by portfolio managers includes units of Alternative Investment Funds (AIFs), Real Estate Investment Trusts (REITs), Infrastructure Invest- ment Trusts (InvITs), debt securities, shares, warrants, etc. which are not listed on any recognized stock exchanges in India. Available at *https://www.sebi.gov.in/sebi_data/faqfiles/oct-2020/1603946323909.pdf*.

## Issues relating to Syndication

As mentioned above, the amendments to the AIF Regulations and the PM Regulations crystallise two key operating principles of co-investments: (i) the terms of the co-investment in an investee company must not be more favourable than those of the AIF; and (ii) the co-investment in an investee company and the AIF's investment in the same investee company must operate in tandem (including with respect to the terms and timing of exit). These principles may come under pressure in some scenarios.

For instance, it is not always necessary that the AIF and the co-investors will deploy funds into the investee company at the same time. Often, the AIF will first complete the investment and then syndicate portions of the investment to co-investors over multiple rounds. At the second (or further) round of syndication, there is already a set of co-investors in play. It is unlikely to be the commercial intention for this initial set of co-investors to participate in the syndication process. However, not doing so may trip the requirement that the terms of exit (including timing) of a co-investment should be identical to that of the AIF.

To take another example, there may be a scenario in which the manager requires a co-investor to take up a larger chunk of the co-investment opportunity than the co-investor actually wishes to take exposure to on the understanding that a portion of the initial chunk will subsequently be sold down to other co-investors. Such an arrangement would also fall foul of the requirement that the terms and timing of the exit of the co-investment must be identical to that of the AIF.

## The AOP Tax Risk

Under the Income Tax Act, 1961 (the "Tax Act"), an 'association of persons' ("AOP") is a distinct taxable entity. Although the Tax Act does not specifically define an AOP, the Indian courts have held that the critical determining factor of an AOP is whether persons have joined in a common purpose or common action with the object of producing income. An AOP is taxed at the AOP level and the individual constituents of the AOP are not taxed separately.

The risk lies in the co-investors and the AIF being regarded as an AOP by the tax authorities on the basis that the co-investors and the AIF are both joined in a common purpose. If such a determination is made by the tax authorities, it would upend the current tax framework, which grants pass-through status to Category I and Category II AIFs. The likelihood of this risk may increase in circumstances where a co-investment agreement (or a parallel investment agreement) is put in place to coordinate the terms on which the AIF and the co-investors will interact with each other.

## Onerous Disclosure Requirements

Investors of an AIF are given the opportunity to read and review a Placement Memorandum, which contains extensive disclosures. The amended regulations provide an additional obligation on the CIPM to provide a copy of the 'Disclosure Document' to each client (i.e. the co-investor) before concluding a written agreement with such client. Given the disclosures already being provided in the Placement Memorandum, it seems redundant and cumbersome to provide these additional disclosures.

## Conclusion

The new Co-Investment Framework is a welcome development since it opens the doors for more capital deployment in India. The positive is that, theoretically, the rollout of a formal framework could encourage both sponsors and investors to use co-investments regularly. However, there may be some practical issues that could jeopardise the seamless integration of co-investments with AIF operations. These include the AOP tax risk, restrictions on third party co-investors, structuring limitations and syndication concerns. These aspects need to be ironed out before the many benefits of co-investments are unlocked.

The future of co-investments and their role in the private funds space more generally will depend on how the framework evolves in the near future. Whilst SEBI is unlikely to adopt a 'hands-off', 'light-touch' approach to co-investments after having crafted such a detailed framework, it might be helpful for the regulator to proactively offer clarifications on operational issues with a view to settling uncertainty and boosting confidence in the use of co-investments.

# Annexure H

**Private Funds: Six considerations when negotiating carry clawback provisions** (*Analysis - 4 May, 2022*)

## Key Takeaways

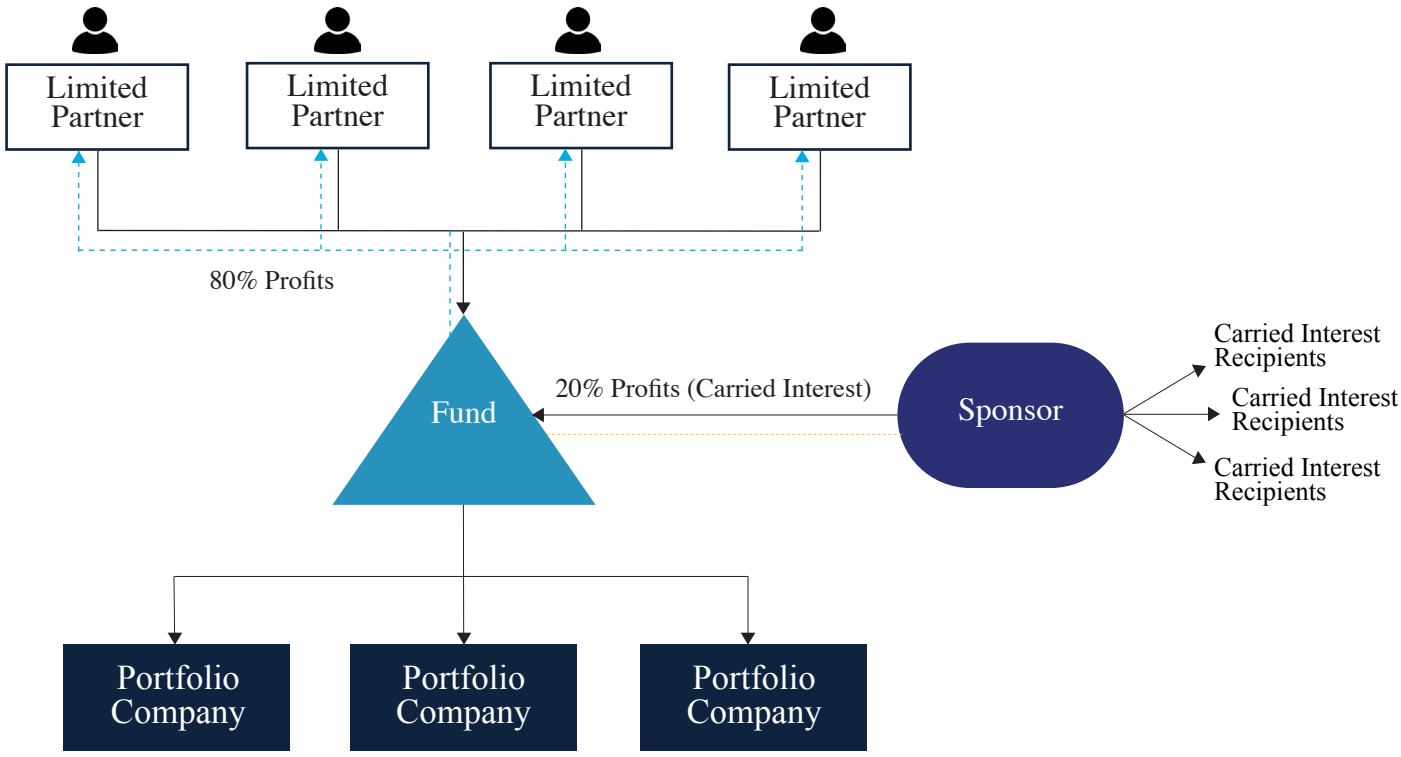
- Clawback liability must be ascertained with respect to each investor
- Standalone clawback obligations may not be sufficient
- The clawback provision should include a true-up mechanism for sponsors
- Tax leakages must be accounted for when determining clawback liability
- The waterfall sequence must be maintained when clawed back amounts are distributed to the LPs
- In a no-fault removal scenario, the original carry recipients must be released from future clawback liability

From the very inception of the private equity fund model, limited partners (LPs) have been sensitive to sponsors benefitting disproportionately to investors. This wariness resulted in the carried interest clawback. The idea behind a clawback is to ensure that sponsors have not been overpaid beyond the remit of the waterfall. In the event of overpayment, a sponsor is under an obligation to return distributions until the amounts distributed to the investors and the sponsor are in the agreed profit-sharing ratio.

In this piece, we review one of the most contentious fund terms – the carried interest clawback – and outline some considerations that stakeholders should keep in mind when negotiating clawback provisions. This is Part 1 of our two-part series on carried interest and clawback provisions.

## Carried Interest and Waterfalls

In the investment funds world, carried interest is the share in profits that a sponsor is entitled to after the investors have received an amount equal to their capital contributions. Carried interest is generally either computed on a deal-by-deal basis (US-style waterfall) or a whole-of-fund basis (European-style waterfall). Whilst funds with a US-style waterfall run a waterfall for each investment made by the fund, funds with a European-style waterfall use a single waterfall to track all capital flows from and to the investors.




## Stages of the Waterfall

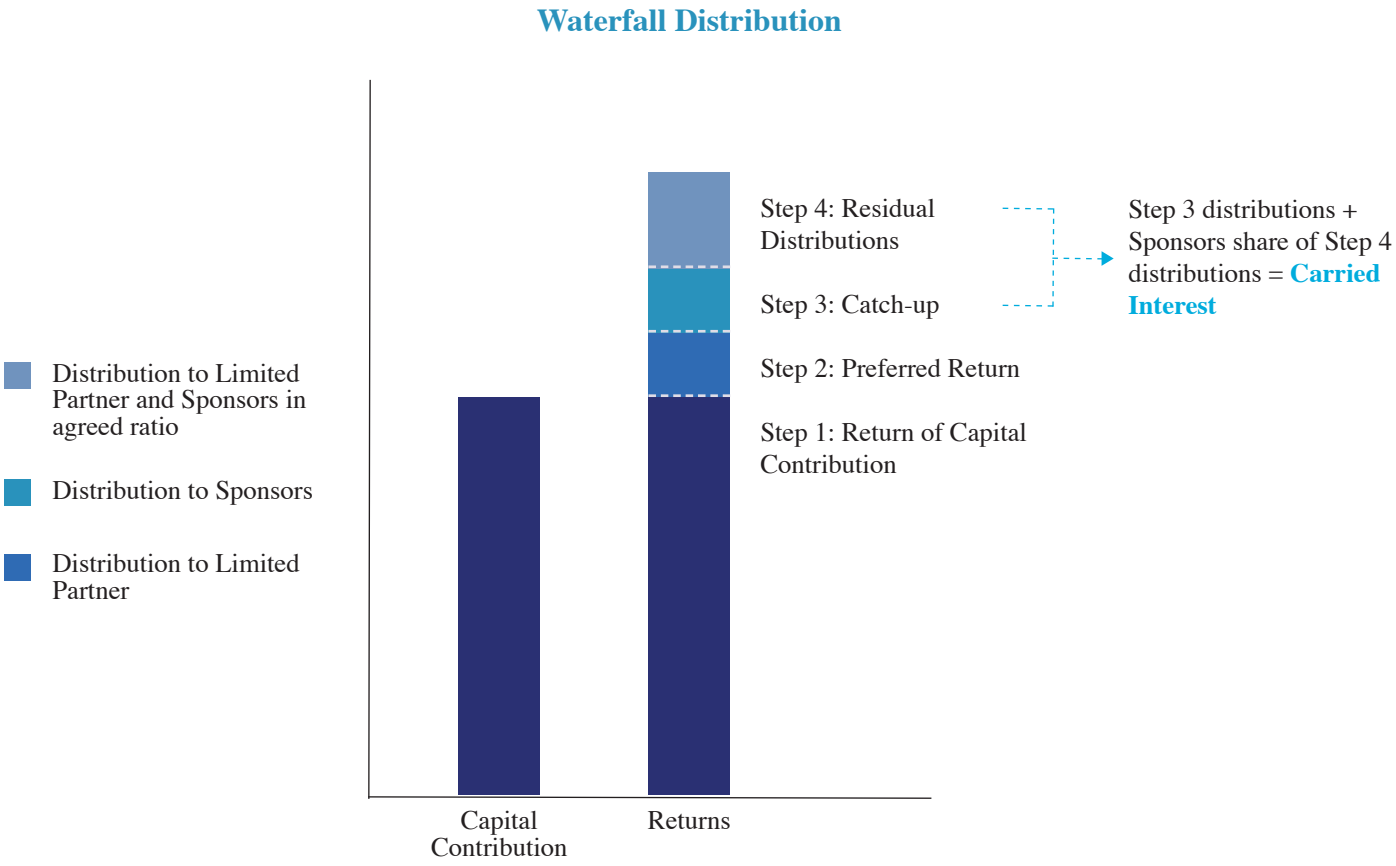
1. **Step 1**: The waterfall for a fund will provide that proceeds arising from the sale of an investment will first be applied towards returning the capital contributed by the investor. In a deal-by-deal waterfall, this step is completed after the investor has received an amount equal to the capital it had invested in the investment. In a whole-of-fund waterfall, this step will only be completed when the investor receives all amounts drawn down from it.

2. **Step 2**: The return of capital is followed by the distribution of a preferred return. In the case of a deal-by-deal waterfall, the preferred return is computed on the amount contributed to the investment. By contrast, in a whole-of-fund waterfall, the preferred return is computed on all amounts drawn down from the investor. These calculations are usually done on an IRR basis or some equivalent thereof.

3. **Step 3**: After the preferred return has been distributed, the sponsor is permitted to dip into the spoils of victory. The sponsor is entitled receive an amount of distributions that would put the post-capital distributions made to the investor and the distributions made to the sponsor in the agreed profit-sharing ratio. This stage is known as the 'catch up'. Although most India-based and India-focused funds have a 100% catch-up (i.e. the sponsor will receive 100% of the distributions made during this stage), some funds use a 50% or 75% catch-up.

4. **Step 4**: All remaining proceeds are then distributed between the investors and the sponsor in the agreed profit-sharing ratio.

   The total amount distributed to the sponsor in stages 3 and 4 is known as the carried interest.




## How does a clawback work?

The clawback provision works as a reconciliation mechanism that ensures that a sponsor has not been overpaid. The initial step in this process is to ascertain whether or not there has in fact been an excess distribution of carried interest to the sponsor. This will of course depend on the specific carried interest economics agreed between the LPs and sponsor. The clawback provision will scrutinize carried interest distributions by running two tests: (i) the preferred return test; and (ii) the post-capital profit share test.

## Preferred Return Test

This test checks whether the aggregate distributions received by an investor is equal to or greater than the sum of the investor's capital contributions and the preferred return calculated on such contributions. If the fund documents define the preferred return in terms of an IRR (say 8%), this test will simply check whether an investor has received sufficient distributions to produce an 8% IRR.

## Post-capital Profit Share Test

This test checks whether an investor has received sufficient distributions on top of its capital contributions such that its share in the total post-capital distributions is equal to or greater than the profit-sharing percentage agreed between the LPs and the sponsor. For instance, if the carried interest percentage is 20%, the investors' share in the post-capital distributions should be equal to at least 80%.

If either of these tests is not met, then the sponsor will be required to repay the fund such amounts as may be necessary to ensure that both tests are met. In substance, the clawback provision ensures that: (i) a sponsor is not "in the carry" unless the investors have received a full distribution of their preferred return entitlement; and (ii) a sponsor does not share in the post-capital distributions in excess of its carried interest percentage.

## Considerations when negotiating clawback provisions

Negotiating clawback provisions can be a challenging process for investors and sponsors alike. Both investors and sponsors should look to ensure accuracy of clawback calculations. In addition, investors are minded to secure some protection against the risk of non-payment by the sponsor. Sponsors, on the other hand, are keen to release their carried interest payouts from the risk of clawback as swiftly as possible.

We have set out below six considerations which we believe should guide clawback negotiations between LPs and sponsors.

### A. Clawback liability must be ascertained with respect to each investor

Calculations relating to both carried interest and clawback liability must be separately ascertained for each investor in the fund. Investors are differently situated from a legal, tax and regulatory perspective. During the life of the fund, some investors may have excused themselves from participating in some of the investments of the fund; others may have been excluded from fully participating in investments. Such events may materially impact the exposure that investors have in the fund. As a result, investors may not always stand on the same footing with one another for the purposes of carried interest and / or clawback liability calculations. To avoid inaccuracies, both sets of calculations (i.e. carried interest and clawback liability) must be separately run for each investor.

### B. Standalone clawback obligations may not be sufficient

A single, standalone clawback obligation at the end of the term of the fund may not offer sufficient protection to investors. At the end of the fund's tenure, it may be too late to recover overpaid carried interest distributions particularly where there have been changes in the fund's investment team. To solve for this problem, a clawback obligation is backed up with one or more of the following:

1. **Interim Clawbacks**: Rather than have a single clawback obligation at the end of the fund's tenure, the clawback mechanism is applied at periodic (or pre-agreed) intervals. This lends discipline to the clawback obligation and minimizes the risk of non-recovery of excess carried interest distributions;

2. **Escrow Mechanism**: The sponsor is required to deposit a certain percentage of its carried interest distributions in an escrow. The escrowed amounts will be applied to satisfy a clawback obligation. Typically, amounts will be released from the escrow to the carried interest recipients as per a pre-agreed timeline; and

3. **Guarantees**: The ultimate carried interest recipients enter into a guarantee to repay carried interest distributions to the extent necessary to meet any shortfall. LPs tend to require carry recipients (particularly the more senior members in the team) to provide a guarantee on a joint and several basis for all members of the team.

**C. The clawback provision should provide for a true-up mechanism for sponsors**

Whilst the purpose of the clawback obligation is to ensure that a sponsor does not receive excess carried interest distributions, it would be inequitable if the clawback resulted in a sponsor receiving less than its entitlement. Such a scenario may arise where the fund documents provide for interim clawbacks. To solve for this problem, the clawback provision should include some form of true-up mechanism that will allow the sponsor to receive its fair entitlement without comprising the entitlement of the investors.

**D. Tax leakages must be accounted for when determining clawback liability**

Carried interest distributions are likely to be the subject of taxes, duties, withholdings and / or deductions. Leakages suffered on these counts are unlikely to be recovered or easily recoverable. The clawback obligation must not result in the sponsor going out-of-pocket. Therefore, the clawback obligation must be capped at the actual amount of carried interest distributions received by the sponsor after accounting for taxes, duties, withholdings and deductions that are payable on such distributions. Further, when carried interest distributions are returned to the fund pursuant to the clawback obligation, the sponsor should be treated as never having received the grossed-up amount (i.e. the repaid carried interest plus taxes, duties, withholding and/or deductions payable thereon).

**E. The waterfall sequence must be maintained when clawed back amounts are distributed to LPs**

When carried interest distributions are clawed back by the fund and thereafter distributed to the LPs, such distributions should follow the sequence of the waterfall i.e. the clawed back amounts are first applied towards returning capital contributions (Step 1), followed by distributions towards the preferred return (Step 2) and finally towards residual distributions (Step 4). This preserves the integrity of the preferred return calculation.

**F. In a no-fault removal scenario, the original carried interest recipients should be released from future clawback liability**

In circumstances where the original sponsor is removed without cause and replaced by a new sponsor pursuant to an investor vote, the original sponsor will generally be entitled to receive carried interest (subject to a haircut) as if all the investments of the fund are realized on the date of removal. Such amounts will be distributed out of the proceeds arising from the actual realization of the investments. The carried interest distributions received by the original sponsor on or prior to the date of removal will typically be subject to a clawback test. However, the original sponsor should have no obligation to participate in clawback events that arise after its replacement. This makes sense intuitively since any fall in the value of the fund following the replacement of the original sponsor would have taken place under new management.

## Conclusion

As LPs continue to seek out greater alignment of interests in their private fund investments, the offer of a fair and equitable clawback provision would not only be a major boost for the sponsor from an investor relations perspective but also minimise the scope for disagreement between stakeholders besides reducing potential administrative inefficiencies.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