

# The AIF framework in 2022

## Recent amendments and their impact



### Background

The recovery of the Indian economy in the backdrop of the global pandemic has seen significant growth in the alternative investment fund (AIF) industry. The rise in the assets under management (AUM) is an indicator of the fast pace of growth of the industry, which saw the number of AIFs registered with the Securities and Exchange Board of India (SEBI) crossing 800.

One of the key factors contributing to the rapid pace of AIFs is SEBI's approach, with recent amendments to the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations) aimed at easing the operating flexibility for AIFs and bringing the regime at par with the global regulatory framework.

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**Some of the recent key amendments to the AIF Regulations have been discussed as follows:**

### Recent key amendments in the AIF Regulations and their implications

#### 1 Introducing new sub-category of category I AIF

Recently in its board meeting held on 28 December 2021, SEBI decided to introduce Special Situation Funds (SSFs), as a new sub-category under Category I AIF, which shall invest only in stressed assets. Stressed assets have been defined to inter-alia include stressed loans available for acquisition, security receipts issued by asset reconstruction companies, securities of companies in distress, etc. It has been decided that SSFs will be exempted from the investment concentration norm in a single investee company and there will be no restriction on investing their investible funds in unlisted or listed securities of the investee company.

This amendment assumes significance against the backdrop of continued efforts to address the issue of monetising stressed assets in the economic system and provides an added avenue for redressal of stressed companies.



## 2 Expansion of definition of Venture Capital Undertaking (VCU)

Category I AIFs with sub-category Venture Capital Funds (VCFs) are required to invest at least two-thirds of their investible funds in VCUs.

The earlier definition of VCU in the AIF Regulations included a negative list of activities which shall not fall within the ambit of VCUs. This restrictive definition of VCU narrowed down the investment avenues available for category I AIFs (VCF).

Few months back, the definition of VCU has been widened by SEBI to include within its ambit any company which is not listed on a stock exchange at the time of making the investment. This change in the definition of VCU thus removes the requirement of an entity to be engaged in the business of providing services, production or manufacture of article or things in order to qualify as a VCU and also removes restriction imposed for investment in NBFCs.

With the removal of the restricted activities and sectors for qualifying as VCUs, the investment universe for category I AIFs (VCF) is proliferating, thereby augmenting investment opportunities in VCFs.

## 3 Introduction of definition of start-up in the AIF Regulations

Chapter III-A of the AIF Regulations lays down provisions with respect to Angel Funds – a Category I AIF, registered with the objective of raising funds from angel investors and invest the same in start-ups, i.e., ventures that encourage entrepreneurship in the country, by financing them at a stage where it would otherwise be difficult for such entities to raise funds from mainstream sources (banks, other financial institutions, etc.).

The AIF Regulations did not define the term start-up, thereby leaving significant room for ambiguity with respect to investments by angel funds.

The AIF Regulations have now explicitly defined the term start-up as a private limited company or limited liability partnership which fulfils the criteria of being a start-up, as specified by the Department of Promotion of Industry and Internal Trade (DPIIT), Ministry of Commerce and Industry.

Since the definition of start-up introduced in the AIF Regulations is now aligned with the definition prescribed by DPIIT, going forward there shall be no ambiguity with respect to eligible investments by AIF in start-ups.

## 4 Standardisation of format for Private Placement Memorandum (PPM)

The PPM is a disclosure document critical for marketing of a proposed AIF to potential investors. It contains the details (viz. the commercial terms, investment strategy of the AIF, composition of management team, the risk factors, potential conflict of interest situations, tax and regulatory considerations, etc.) based on which an investor makes decision with respect to investment in an AIF.

SEBI has now mandated a standard template for the PPM of an AIF to ensure disclosure of essential information to the investors. Broadly, the PPM template encapsulates various disclosures including the fund structure, governance policy, principal terms, risk factors, distribution waterfall, etc.

Standardisation of the PPM shall now help in making available sufficient information to the investors and is likely to bring about higher disclosure and transparency in the AIF space, especially for existing as well as potential investors thereby enabling them to take informed decisions regarding the AIF investments. This will also eliminate any variance from the manner of disclosures made by various AIFs and would also facilitate ease for investor to compare and evaluate investment opportunities available in different AIFs. It would also help in streamlining the approval process and could help in bringing down the time taken by SEBI to provide approval for registration of AIF.

Also, to ensure compliance by the AIF with the terms mentioned in the PPM, mandatory annual audit has been prescribed by SEBI. The audit is to be carried out by an internal or external auditor or a legal professional. This will also give greater assurance to the investors about the fund manager managing the AIF in accordance with the PPM.

## 5 Introduction of Investor Charter section in PPM

SEBI has mandated to have a section in the PPM on Investor Charter. An Investor Charter is a brief document containing details of services provided to investors, grievance redressal mechanism, responsibilities of the investors, etc. at one single place for ease of reference. This was introduced with a view to keep the investors informed about various activities pertaining to AIFs and aimed at bringing further transparency about investor grievance redressal mechanism.

## 6 Amendments for AIFs in IFSC

After SEBI's decision to permit AIFs to operate from the International Finance Services Centre (IFSC), active discussions have been underway to provide regulatory headroom for local AIFs to explore and innovate fund structures and make India a competent jurisdiction as compared to traditional offshore jurisdictions such as Singapore and Mauritius.

The following benefits have been extended by the tax and regulatory authorities to incentivise offshore fund managers to migrate to IFSC: (i) Non-applicability of Investment concentration norms prescribed under the AIF Regulations to AIFs in IFSC; (ii) AIFs in IFSC are permitted to borrow money or engage in leveraging activities with appropriate disclosures and post investor approval; (iii) Indian entities permitted to be sponsor of AIFs in IFSC without obtaining prior RBI approval; (iv) No restriction on overseas investment for IFSC AIFs unlike domestic AIFs (which are subject to conditions such as maximum limit, need for Indian connection, etc.); (v) AIF in IFSC now permitted to co-invest in portfolio company through a segregated portfolio by issuing a separate class of units subject to disclosures and conditions; and (vi) Exemption to non-resident investors from obtaining PAN and filing tax returns, etc.

These exemptions/ benefits will go a long way in making India a preferred jurisdiction for pooling and management of funds as compared to other offshore jurisdictions.

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## Conclusion

The aforesaid amendments are an indication of SEBI's twin intention of upscaling the growth of the AIF industry and maintaining an appropriate regulatory oversight. These amendments will act as a catalyst for the investment activities, with more capital flowing to various sectors of the economy. Some amendments intended to safeguard investor interest and appropriate oversight from the regulator have added to the compliance to be undertaken by AIFs.

The industry is looking forward to the forthcoming Union Budget for fulfilment of certain unfinished asks like clarity to put to rest litigations on GST on carried interest, tax pass through for category III AIFs, clarifications in co-investment conditions to remove unintended consequence of wide applicability of co-investment guidelines, etc. which shall go a long way to add to the growth story of AIF industry in India.

