*Quest Journals*
*Journal of Research in Humanities and Social Science*
*Volume 11 ~ Issue 4 (2023) pp: 114-117*
*ISSN(Online):2321-9467*
www.questjournals.org

**Research Paper**

# All you need to know about AIFs in India

Naemish J Redhu

*Received 01 Apr., 2023; Revised 09 Apr., 2023; Accepted 11 Apr., 2023* 

Alternative Investment Fund (AIF) is a type of investment vehicle that is distinct from traditional investment options such as stocks, bonds, and mutual funds. AIFs are designed to provide investors with accessto alternative asset classes such as real estate, private equity, hedge funds, and commodities. These funds offer unique investment opportunities with potentially higher returns, but also entail higher risks. The term ‘alternative investment fund’ refers to the collection of pooled investment funds that infuse in hedge funds, private equity, venture capital, and other investment types. These investment vehicles are required to adhere to the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (hereinafter referred to as “**SEBIAIF Regulations**”). Section 2(1)(b) of the SEBI AIF Regulations provides for the definition of an “alternative investment fund” *i.e.* “*any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefits of its investors; and is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.*”

AIFs are typically managed by professional fund managers and require a higher minimum investment commitment compared to traditional investments. AIFs offer investors diversification and the potential for higher returns (subject to risks associated with these returns, including illiquidity, lack of transparency, and potentially higher fees). Additionally, AIFs are not suitable for all investors and investors should carefully consider their investment objectives, risk tolerance, and financial situation before investing in pooled vehicles.

Few examples of alternative investment funds include:

- Private equity funds, which invest in private companies and often seek to acquire a controlling interest in those companies.
- Hedge funds, which use a variety of strategies to try to generate returns, such as long/short equity, global macro, and event-driven strategies.
- Real estate funds, which invest in real estate assets such as office buildings, shopping centres, and apartment complexes.
- Commodities funds.
- Venture capital funds, which invest in early-stage companies/startups with high growth potential.

An AIF can be set up as a trust, company, limited liability partnership, or body corporate. AIFs must raise funds through private placement by the issue of private memorandum/information memorandum.

Fund managers typically have more flexibility in their investment strategies that can pursue investment opportunities that are not available to traditional investment funds. AIFs are generally only available to accredited or institutional investors who have the knowledge and experience to evaluate the risks and benefits of these investments. Funds administered by a securitization or reconstruction firm, as well as family trusts, ESOP trusts, employee welfare trusts, holding companies, and special purpose vehicles not formed by fund managers, do not qualify as AIFs under SEBI AIF regulations.

* Corresponding Author: Naemish J Redhu

**Categories of AIFs**
As per the SEBI AIF Regulations, there are 3 categories of alternative investment funds:

| # | Description | Category I AIF | Category II AIF | Category III AIF |
|---|---|---|---|---|
| 1. | *Nature* | These funds invest in start-up or early-stage ventures, social ventures or in sectors/areas which are considered to be economically and socially desirable by the government or regulators of financial market. | These funds do not generally undertake leverage or borrowing other than to meet day-to-day operational requirements (as permitted under the SEBI AIF Regulations). | These funds employ complex and diverse trading strategies and employ leverage including investment in listed or unlisted derivatives and units of other AIFs. These funds trade to make short-term returns or such other funds which are open-ended in nature. |
| 2. | *Incentives/ Concessions* | Government of India, SEBI and other regulators consider granting incentives and concessions to funds which invest in Category I AIFs as these are perceived to have a positive effect in the growth of economy. | These funds are usually private equity or debt funds for which no specific incentive or concession is given by the Government of India, SEBI or any other regulator. | The investment made in Category III AIFs is made for generating quick profit returns, and no specific incentive or concession is provided by the Government of India, SEBI or other regulator. |
| 3. | *Examples* | Venture Capital Funds, Angel Funds, Social Impact Funds, Small and Medium Enterprise Funds, and Special Situation Funds, are few examples of Category I AIFs. | Private Equity Funds, Debt Funds, and Structured Credit Funds are few examples of Category II AIFs. | Private Investment in Public Equity Funds, Long-Only Funds, and Hedge Funds are few examples of Category III AIFs. |
| 4. | *Registration Fees* | As per the SEBI AIF Regulations, registration fees for these types of funds is INR 5 Lakhs (INR 2 Lakhs in case of Angel Funds). | As per SEBI AIF Regulations, registration fees for these types of funds is INR 10 lakhs. | As per SEBI AIF Regulations, registration fees for these types of funds is INR 15 lakhs. |
| 5. | *Continuing Interest Requirement* | The continuing interest by the Sponsor/Manager in Category I AIF must be lower of 2.5% of the corpus of the fund or INR 5 crore (INR 50 lakhs in case of Angel Funds) and interest must not be earned through waiver of management fees. | The continuing interest by the Sponsor/Manager in Category II AIFs must be lower of 2.5% of the corpus of the fund or INR 5 crore and interest must not be earned through waiver of management fees. | The continuing interest by Sponsor/Manager in Category III AIFs must be lower of 5% of the corpus of the fund or INR 10 crore and interest must not be earned through waiver of management fees. |
| 6. | *Borrowing/ leverage capacity* | The ability of these funds to invest in listed securities is limited. Category I AIFs can borrow funds directly or indirectly or engage in leverage, i.e. using borrowed capital to increase the potential return of investment, for not more than: 30 days, 4 times in a year and; not more than 10% of the investible funds. | Similar to Category I AIFs, Category II AIFs can borrow funds directly or indirectly or engage in leverage for not more than: 30 days; 4 times in a year and; not more than 10% of the investible funds. | Category III AIFs can engage in leverage, subject to consent from investors in the fund and the maximum limit specified (*i.e.*not more than 2X of net asset value, excluding the value of investment in units of other AIFs). |
| 7. | *Credit Default Swaps* | Category I AIF can engage in hedging, including in credit default swap, subject to terms and conditions imposed by SEBI. | Category II AIFs can buy or sell credit default swaps, subject to terms and conditions imposed by SEBI. | Category III AIFs can buy or sell credit default swaps, subject to terms and conditions imposed by SEBI. |
| 8. | *Investible Funds* | Category I AIF cannot invest more than 25% of the investible funds in a single investee company.<br>Large value funds for Category I AIFs can invest up to 50% of the investible funds in a single investee company. | Category II AIFs cannot invest more than 25% of investible funds in a single portfolio entity.<br>Large value funds for Category II AIFs can invest up to 50% of the investible funds in a single investee company. | Category III AIFs cannot invest more than 10% of the investible funds in a single portfolio entity.<br>Large value funds for Category III AIFs can invest up to 20% of investible funds in a single investee company.<br>Investment Limit of investments made in listed equity will be calculated, either out of, investible funds or net asset value of scheme. |
| 9. | *Open and/or Close* | For an AIF scheme launched | For a scheme launched under | Category III AIFs can be open |

* Corresponding Author: Naemish J Redhu

| | | | | |
|---|---|---|---|---|
| | *Ended* | under Category I AIFs, it will be close ended, the tenure for which must be determined at the time of application and will be for a minimum of 3 years. | Category II AIFs, it will be close ended, the tenure for which will be decided at the time of application and will not be less than 3 years. | ended or close ended. |
| 10. | *Primary Investment* | Category I AIFs will invest in investee companies, venture capital undertakings, limited liability partnerships, special purpose vehicles, and in units of Category I and Category II AIFs. | Category II AIFs will invest primarily in unlisted companies directly or through investment units in other AIFs and in investee companies or in the units of Category I or Category II AIFs. | Category III AIFs will invest in securities of listed or unlisted investee companies, derivatives, units of other AIFs or complex and structured products. Such funds will deal in goods delivery against physical settlement of commodity derivatives. |

**Key Provisions under the SEBI AIF Regulations**

- *Eligibility Criteria* – Resident Indians, NRIs, foreign nationals can invest in these funds; The minimum investment limit is INR 1 crore for investors, whereas the minimum investment amount for directors, employees, and fund managers is INR 25 lakhs; the number of investors in every scheme is restricted to 1000, except angel funds; each scheme will have a corpus of atleast INR 20 crore; AIFs are prohibited from making invitation to public to subscribe to its securities; Sponsor/Manager shall have the necessary infrastructure and manpower. Additionally, at the time of registration, an AIF must declare the scheme’s investment strategy, objectives, methodology and the targeted investors, corpus and tenure.

- *Application*– An applicant must apply in Form A of SEBI AIF Regulations, along with necessary fund documents for registration of an AIF. Once satisfied with the application, SEBI will grant the registration certificate after having paid the requisite registration fees.However, SEBI may reject an application for registration of an AIF, after providing reasonable opportunity of being heard. In case of rejection, SEBI will communicate such rejection within 30 days. Subsequently, the applicant will cease to carry all AIF related activities, but this does not absolve the applicant’s liability towards existing investors.

Prior to the launch of any scheme, AIF shall submit a duly filled private placement memorandum (PPM) along with ancillary fund documents to SEBI through a merchant banker 30 days in advance. SEBI can communicate its comments through merchant banker prior to the said launch of the scheme and the merchant banker will ensure that SEBI’s comments are appropriately incorporated.

- *Listing of an AIF* - Listing of units of close ended AIFs on recognised stock exchange is allowed, subject to minimum tradeable lot of INR 1 crore. Listing of units of close ended funds is only allowed after the final closing of the fund is consummated.

- *Uninvested investible funds* - Uninvested portion of investible funds can be invested in liquid mutual funds or liquid assets of higher quality till the deployment of funds as per investment objective or distribution of funds to investors as per the terms of funds documents. AIFs can act as nominated investors.

- *Duties of Managers and Sponsors* - Manager, along with trustee or trustee company must ensure compliance of AIF with code of conduct, SEBI AIF regulations, PPM, and fund documents. They must ensure that the assets and liabilities of an AIF are segregated and ring – fenced, in order to prevent the AIF from using the funds or assets of a scheme to settle their debts and offset them against their losses in corresponding scheme. Managers may constitute an investment committee to approve the decisions of AIF and ensure compliance. However, the managers of an AIF will not provide advisory services to any investor other than the clients of co-investment portfolio manager. Sponsor/Manager will act in fiduciary capacity towards its investor, abide by high level principles on avoidance of conflicts of interests, maintain records regarding assets, valuation policies, investment strategies, particulars of investor and their contribution, rationale for investment trade.

- *Transparency* - AIFs should ensure transparency and disclosure of information regarding financial, management and operational risks and provide the same to theirrespective investors periodically. Fees ascribed to Manager or Sponsor or any fees charged to AIF by associated must be disclosed. Any inquiry, legal action, material liability, breach of provision should also be disclosed.

* Corresponding Author: Naemish J Redhu

- *Reports and Valuation* - Category I and Category II AIFs will provide reports to investors about financial information of investee companies, material risks and how they are managed, on an annual basis, within 180 days from the year end. Category III AIFs will provide quarterly reports to investors within 60 days from the end of the quarter. Category I and Category II AIFs will undertake valuation of the investments atleast once in 6 months, which can be extended to 12 months only after consent from atleast 75% of the investors by value of their investment. Category III AIFs will ensure calculation of net asset value and disclose to investors within a timeline that is: no longer than a quarter for close ended funds; and no longer than a month for open ended funds.

- *Winding Up* – An AIF will be wound up when the tenure of the fund ends, or trustee or trustee company decides to wind up interest of investors (in case of an AIF set up as a trust), or 75% of the investors by value of their investments decide to pass a resolution to this effect, or when SEBI directs winding up of an AIF which is considered to be in best interests of investors. An AIF set up in form of a company or a body corporate would be wound up in accordance with relevant statues under which it was constituted. A manager or sponsor of an AIF must maintain all records up to 5 years after the fund is liquidated.

- *Inspecting Authority* – SEBI can appoint one or more inspecting authority to inspect books, accounts and records of an AIF: to ensure they are maintained; to inspect complaints received against an AIF and; to ascertain whether compliances are being are followed or not. Before ordering such inspection, SEBI must give 10 days or more notice prior to the date of inspection. After inspection, such inspecting authority must submit their findings/reports to SEBI. After the inspection report has been submitted, SEBI can restrict launch of a new scheme, prohibit person concerned from disposing any fund assets or property, require the person concerned to dispose off concerned property in certain manner or, prohibit person/(s) from operating or even accessing the capital market. Furthermore, the powers exercisable by SEBI can also be exercised by any person of SEBI to whom these powers have been delegated by SEBI.

- *Code of Conduct* – An AIF should be operated and managed taking into consideration the interest of all investors and not only of the sponsor, manager, and directors. AIF must ensure that effective risk management process is in place and any unethical activity to sell, market or induce any investor to buy the units of any respective AIF, is prohibited. The managers and key management personnel must abide by the rules, regulations and guidelines, not make any misleading or inaccurate statement, not enter into any arrangements for the sale or purchase of securities. The manager of an AIF must not offer or accept any inducement in connection with the affairs of or business of managing funds of investors. AIF, Managers, key management personnel, members of investment committee, trustee, trustee company, directors of the trustee company, directors or designated partners will not indulge in any unethical practice or professional misconduct or any acts which tantamount to gross negligence or fraud.

While alternative investment funds offer investors access to a wider range of investment opportunities and can provide higher returns than traditional investment funds, one of the potential disadvantages of investing in an AIF is that they are typically less liquid than traditional investment funds. This means that investors may not be able to sell their shares as easily as they could with a traditional investment fund. AIFs also tend to have higher fees than traditional investment funds, which can reduce the overall returns.Investing in AIFs requires careful consideration of the risks and benefits. Investors should carefully evaluate the investment strategy, track record, and fees of the fund before investing. Investors should also consider the liquidity of the investment, the level of diversification, and the potential risks associated with the asset class that the fund invests in.As with any investment, it is important to carefully evaluate the risks and benefits before investing.