Funds Hotline

December 18, 2020

RELAXATIONS FOR AIFS IN GIFT CITY

- AIFs in GIFT City permitted to undertake leverage, subject to satisfaction of prescribed conditions.
- Co-investment in portfolio companies permitted by AIFs in GIFT City through segregated portfolio, provided the investment terms are not favourable than those offered to the common portfolio and appropriate disclosures are made in the placement memorandum.
- AIFs in GIFT City permitted to invest in domestic AIFs, alongside other permissible investments.
- Diversification limits under the AIF Regulations not applicable to AIFs in GIFT City, subject to appropriate disclosures in the placement memorandum

The International Financial Services Centre ("**IFSC**") in the Gujarat International Finance-Tec ("**GIFT**") City at Gandhinagar, Gujarat is all set to offer a competitive and collaborative environment to the fund management industry in India. The establishment of the IFSC Authority ("**IFSCA**") to act as a single window clearance is likely to boost investor confidence in the GIFT City.

The Securities Exchange Board of India (IFSC) Guidelines read with the Operating Guidelines for alternative investment funds ("**AIFs**") in IFSC provide the regulatory framework for AIFs operating in IFSC ("**IFSC AIFs**"). Recently, the IFSCA issued a circular[1] announcing certain relaxations for IFSC AIFs (Category-I/ II/ III) to align the regulatory framework with international best practises ("**Circular**").

· Leverage limits for IFSC AIFs

The SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") restricts Category-I / Category-II AIFs from borrowing directly or indirectly or engage in any leverage except for meeting temporary funding requirements for not more than 30 days, on not more than 4 occasions in a year and not more than 10% of the investible funds.[2] Category-III AIFs are permitted to engage in leverage subject to consent from investors of the fund and subject to maximum limit not exceeding 2 times of the Net Asset Value of the AIF.[3] However, there are no such restrictions on offshore funds which frequently undertake leverage to fund investment opportunities.

The Circular now permits IFSC AIFs to undertake leverage, subject to the following conditions:

a. The maximum leverage by the IFSC AIF, along with the methodology for calculation of leverage, shall be disclosed in the placement memorandum;
b. The leverage shall be exercised subject to consent of the investors;
c. The IFSC AIF employing leverage shall have a comprehensive risk management framework appropriate to the size, complexity and risk profile of the fund.

· Investment by IFSC AIFs

a. Co-investment through segregated portfolio: The regulatory framework for AIFs is such that monies from all investors is pooled in the AIF and all the investors generally participate in deals on basis of their pro-rata share in the AIF. The AIF is not permitted to allow investors to increase their allocation to a particular deal on a standalone basis.

   The Circular permits IFSC AIFs to co-invest in portfolio company through a segregated portfolio by issuing a separate class of units and such that the investments by such segregated portfolios shall, in no circumstance, be on terms more favourable than those offered to the common portfolio of the AIF; and appropriate disclosures have been made in the placement memorandum regarding creation of such segregated portfolio. This will simplify deal structuring and provide flexibility to AIFs and investors to allocate more capital to lucrative opportunities.

a. Permission to invest in domestic AIFs: While the AIF Regulations permit Category-I AIF to invest in units of other Category-I AIFs[4] and Category-II AIF to invest in units of other Category-I AIF / Category-II AIF,[5] the AIF Regulations provide that the AIF should only invest in such units and shall not invest in units of other Funds of Funds. In such a case, an issue arises as to whether an IFSC AIF investing in a domestic AIF can also invest in portfolio companies in India. The Circular clarifies this and permits IFSC AIFs to invest in domestic AIFs, alongside other permissible investments. For domestic AIFs, this position is not clear and there are views that an

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AIF can either operate as a fund-of-funds or make direct investments.

· Diversification limits

Under the AIF Regulations, Category I and II AIFs cannot invest more than 25% of the investable funds in one Investee Company.[6] Further, Category III AIFs cannot invest more than 10% of the investable funds in one Investee Company.[7] It is common for offshore funds to be set up for investment in a few targeted companies or sectors. Such conditions on diversification may not interact well with the investment strategy of offshore funds.

The Circular now provides that these diversification limits under the AIF Regulations should not apply to IFSC AIFs provided appropriate disclosures have been made in the placement memorandum and the investments by AIFs are in line with the risk appetite of the investors. In this regard, what is considered as risk appetite is subjective and accordingly, the investment managers should ensure appropriate disclosures in the placement memorandum. The exemption from diversification limits would also enable IFSC AIFs in co-investing in portfolio companies through a segregated portfolio by creation of separate class of units.

The Circular is indeed a very welcome move for the fund industry and it depicts the commitment of the IFSCA in onshoring the fund management industry to India. These relaxations offered to IFSC AIFs were long due industry asks and should encourage fund managers to explore setting up or migrating funds to the GIFT City. These relaxations seek to bring the GIFT City at par with the international offshore jurisdictions like Singapore, Netherlands, Luxembourg etc. wherein there are no restrictions on undertaking leverage, diversification requirements for offshore funds and create a level playing field for funds set up in IFSC. The relaxations provided by the Circular coupled with the other regulatory and tax incentives provided to units set up in IFSC should provide a conducive environment for operations of IFSC AIFs in the GIFT City.

NDA'S ASSOCIATION WITH GIFT CITY

Nishith Desai Associates (NDA) is proud to have been associated with GIFT City project right from its conceptualization in 2007 until today. After a long journey, it is on the verge of becoming a clean, transparent and FATF compliant offshore jurisdiction for international financial services. It also creates new and collaborative opportunities as mid-shore jurisdiction alongside other offshore jurisdictions. The relaxations under the Circular are a welcome move and are a result of several discussions which NDA had with the officials of the GIFT City along with other industry bodies and stakeholders. Please refer our publication "*Opportunities in GIFT City – Setting up Funds in India's New Offshore Financial Center*" for our detailed analysis of the regulatory and tax framework in relation to setting of AIFs in GIFT City.

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You can direct your queries or comments to the authors

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[1] F. No. 81/IFSCA/AIFs/2020-21 dated December 09, 2020

[2] Regulation 16(1)(c) and Regulation 17(1)(c) of AIF Regulations

[3] Regulation 18(1)(c) of AIF Regulations

[4] Regulation 16(1)(b) of AIF Regulations

[5] Regulation 17(1)(b) of AIF Regulations

[6] Regulation 15(1)(c) of AIF Regulations

[7] Regulation 15(1)(d) of AIF Regulations

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