

Debt Funding in India Series

November 06, 2020

ONSHORE FUNDING MODELS: ALTERNATIVE INVESTMENT FUNDS

The Securities and Exchange Board of India ("SEBI") introduced the alternative investment funds ("AIF") regime in 2012 by way of the SEBI (Alternative Investment Fund) Regulations, 2012 ("AIF Regulations"). The AIF Regulations codifies the legislative framework for funds in India, replacing the earlier venture capital funds framework, which was restricted to venture capital funds. The AIF regime has ushered substantial investment into Indian securities, especially by non-resident investors, by way of setting up Indian AIFs. The various regulatory aspects of AIFs with respect to debt investments are provided in [Annexure A](#).

AIFs are primarily pooling vehicles or 'funds' incorporated in India under the AIF Regulations. Foreign investment into AIFs are governed by exchange control norms. The AIF is generally looked at par with resident investors, and accordingly, are debt investments through the AIF regime can benefit from substantial regulatory arbitrage.

We have listed down a few FAQs which will help understand the debt investments under the AIF route into India better.

1. *How does a foreign investor invest into the Indian debt market through the AIF route?*

A number of debt investors looking to invest into the Indian debt markets use the AIF route by investing into the AIF as limited partners or 'LPs'. The investors are generally passive investors, who do not control or drive the investments. In addition, investors have also set up their own AIFs, i.e. captive AIFs or unified structures, where a single non-resident contributor invests into the AIF and the AIF makes investments into Indian debt securities onwards. The second structure, i.e. the unified structure also provides room for pooling offshore into an offshore pooling vehicle, which can invest into the AIF as its contributor.

2. *How does one set up an AIF? Does one need to make any investments?*

To establish an AIF, generally an Indian company or a limited liability partnership is incorporated which shall act as the investment manager to the AIF. Separately a sponsor is also identified, which shall be one of the investors in the AIF, which may also be the investment manager. AIFs are generally set up in the form of a trust. Consequently, a trustee for the AIF is also identified, which is generally a regulated entity. Subsequently a trust is registered, which shall be registered as the AIF. Once the investment manager, i.e. the general partner or 'GP' entity and the trustee are identified, a private placement memorandum is drafted and investors / contributors to the AIF are solicited (if required) and finalized. The investors are required to execute contribution agreements, agreeing to invest into the fund from time to time (as per the terms agreed in the commitment letter), as and when investment opportunities arise. A registration application is filed with SEBI for registration of the trust as an AIF. Once the AIF is registered, the AIF can start raising funds and investing funds.

3. *Can a foreign player just set up the Indian entities mentioned in 2 above and start investing?*

Any Indian AIF needs to have a sponsor and an investment manager, and the sponsor or the investment manager is required to be one of the investors in the AIF. The AIF Regulations prescribe a minimum of 2.5% or INR 50 million, whichever is lower, to be the investment by the investment manager or the sponsor throughout the tenor of the AIF in case of a Category I AIF or Category II AIF (increased to 5% or INR 100 million in case of Category III AIF).

4. *How do investors offshore get the returns from the AIF's investments?*

Investments into the AIF are distributed on a basket basis, and not on an individual investment basis, i.e. an AIF cannot accept contribution by a single investor for making a specified investment. Accordingly, investment linked fund raising is not permitted, and all investments into an AIF must be subject to the risks and rewards of the entire portfolio of the AIF's investments. It is for this reason that general partners, or 'GPs' look at setting up debt focused AIFs to provide adequate comfort to their investors.

5. *Are all investments by the AIF considered domestic?*

Investments by AIF are considered as investments by residents under the exchange control norms, provided the manager and the sponsor of the AIF are both resident owned (more than 50%) and controlled. If either the manager or the sponsor are not resident owned or controlled, the investments by the AIF are considered as 'downstream investment' or 'indirect foreign investment' by the AIF.

6. *Are all investments by an AIF subject to exchange control restrictions if the conditions mentioned in 5 above apply? What happens if the investment is considered downstream investment?*

Investments by AIF into equity shares, compulsorily and mandatorily convertible preference shares and

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compulsorily and mandatorily convertible debentures are considered downstream investment. In such cases, compliances such as sectoral restrictions of the investee sectors and pricing norms for investments and exits apply.

Investments apart from the instruments mentioned above should not be impacted by exchange control norms, even if the manager or the sponsor are not domestically owned or controlled. Accordingly, investment by any AIF into non-convertible or optionally convertible debentures should not be impacted by exchange control norms.

7. *What distinguishes AIF from other onshore investment routes?*

AIF debt investments (unless into compulsorily convertible debentures), as mentioned above are considered domestic investments. However, there are certain factors which make AIFs more attractive to other domestic routes.

First, any income of an AIF (barring business income) is passed through at the Indian level, i.e. the AIF is not taxed at the India level, and it is deemed that the offshore unit holder of the AIF has directly made the investment, giving it the benefit of a reduced rate of tax as per the applicable double taxation avoidance agreement.

Secondly, an AIF can make debt investment or acquire both standard and sub-standard debt investments from other lenders.

Third, as opposed to the other onshore routes, i.e. NBFCs and ARCs, the AIF is not regulated by RBI, and does not have stringent provisioning and prudential norms that it is governed by, making investments and subsequent actions (such as restructurings) more flexible. Accordingly, any restructuring of investments by AIF in future does not require any regulatory consent, or does not result in additional provisioning / reporting requirements.

Fourth, considering AIFs are private parties, borrowers find AIFs much more flexible as compared to any of the other Indian lenders, i.e. banks, NBFCs and ARCs. While AIFs are regulated, the borrowers are more comfortable dealing with parties who are not subjected to stringent norms, which may make restructuring and any regular business operations (for instance, consent for negative covenants) cumbersome.

On the other hand, as a drawback for the AIF route, an AIF is only permitted to invest in securities, i.e. NCDs, CCDs, OCDs or other variants of debt securities. AIFs cannot extend facility or working capital loans. All funding must be in the form of investment into debt securities. While borrowers are generally indifferent when they are borrowing monies from AIFs, this restriction poses significant challenges in cases of secondary acquisition of debt from existing lenders.

8. *Can AIFs receive income from the investments or investee companies in any form? Are these freely repatriable from India to the offshore investor?*

AIFs can receive income from the investments in the form of interest or redemption premium. Such income is freely repatriable by the AIF offshore to the contributors of the AIF. Additionally, return of investment is also freely repatriable. The AIF may also receive income from the investee companies in the form of fees or charges. Such fees or charges may also be freely repatriable. However, such income may be subject to tax as business income in India.

9. *What security can be created in favor of the AIF by the investee company?*

A domestic borrower is permitted to create any security in favor of an AIF. Since the lending is in the form of debt instruments / debentures, the law requires the borrower to appoint a debenture trustee, and create security in favor of the debenture trustee. Security may be created in the form of mortgage over immovable property, pledge over securities, charge over the assets of the borrower, including the bank accounts.

The actions in relation to the borrowing is taken by the debenture trustee on behalf of the lender, i.e. the AIF. The manner of decisions being taken by the debenture trustee is guided by the documentation entered into in relation to the borrowing, generally being the trust deed, and all actions of the debenture trustee may, contractually, require the consent of the AIF. In this manner, the AIF can control the security.

10. *Since risks and rewards for AIFs are on a basket basis, and not an individual investment basis, is there any manner in which the GP can raise funds from different investors for individual investments?*

Not under Indian laws. However, such segregation / classification may be done offshore. AIFs may devise appropriate structures, including variable cell company / protected cell companies in offshore jurisdictions, and such offshore company can be the sole contributor into the AIF. The returns to the contributor can be earmarked and dealt with offshore in the manner deemed fit by the contributor.

11. *In what situations are AIF preferred by foreign investors?*

While AIFs are generally popular vehicles for investments, AIFs are particularly beneficial when investors are bullish at debt investments into India, and prefer the flexibility for restructuring. Further, investors who are open to restructure debt and take controlling interest of the investee companies are more likely to prefer AIFs, since it provides flexibility to undertake restructuring in a less regulated manner. Further, GPs setting up Indian AIFs, and using the AIF as their sole investment vehicle into Indian debt, with co-investments from offshore investors managed by the GPs are also becoming quite common. This also helps the offshore investors investing under the FPI route to comply with the 50% diversification norm.¹

With the flexibility in structuring the investments and the regulatory and tax benefits provided to the investors under this route, AIF route continues to be one of the popular routes for debt investments in India by both on-shore and off-shore investors.

¹ Explained in the '*Offshore Funding Route: Foreign Portfolio Investors*' paper in this series available [here](#).

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