



Crystal Gazing into
**'THE FUTURE OF
ALTERNATIVE
INVESTMENTS
IN INDIA'**

Crystal Gazing into ‘The Future of Alternative Investments in India’

India being a high performance market, with a stable GDP, will see a quantum increase in capital inflows into the Capital Markets and AIFs are no exception. Alternative investments have grown rapidly in the past three years on account of proactive regulatory reforms, such as:

- ⊗ Foreign investments in AIFs under the automatic route
- ⊗ Tax pass-through structure implemented for category I and II funds
- ⊗ Permission to invest in commodity derivatives etc.

The Indian Alternative Investments Market still represents a miniscule share of the global market and is poised for unprecedented growth in the coming years. While we hope that regulatory reforms will continue to support the growth of this industry in India, we got together industry experts to debate and discuss the future of alternative investments in India.

The session held in June 2018 had Rajesh H. Gandhi – Partner, Tax at Deloitte; Tejesh Chitlangi – Partner, IC Universal Legal and Rakesh Rathod – Head, Domestic Institutions Client Group, Edelweiss Prime Brokerage in a discussion, moderated by Jyoti Rai – Head, Channels Partners & Alliances, Edelweiss Prime Brokerage.

Reproduced below are key excerpts (paraphrased) from the discussion.

On AIFs Being the Next Cutting-edge Option for Foreign Investors

Rajesh Gandhi:

I think the government’s intention whether it is in the form of AIFs, GIFT City or relaxation in the tax law on allowing fund managers to operate from India, is to create an ecosystem and in some sense replicate or move some of the fund management activity from Hong Kong, Singapore, and other jurisdictions. So I think the intent is to create that entire ecosystem in India. And AIF is a wonderful product to do that. So I think certainly it is the future in many ways. A lot of restrictions which have existed so far in the FPI space, particularly in debt investments such as the auction process or minimum maturity of 3 years have been relaxed for AIFs.

So we’ve seen a lot of debt investments being routed through AIF as the AIF route doesn’t have all those restrictions. Of course, SEBI has recently relaxed some of the debt norms but I still think there are certain nuances to that relaxation and so AIF continues to be a good route from a debt investment perspective. So all in all, I think both from a regulatory perspective and the government’s intention, AIFs have a good future and we should see more and more fund managers wanting to set up AIFs.

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Tejesh Chitlangi:

Obviously if you see the last 5 years, AIFs are becoming a big alternative to all the three regimes be it FPI, FDI or ECB. So to start with the FPI regime, even prior to the RBI notification of April 27, a lot of critical issues existed with the FPI regime such as minimum maturity period of 3 years for corporate debt instruments, investments allowed only in listed NCDs in India barring a few exceptions, non-availability of the corporate bond limits etc. With AIFs, there was no minimum maturity requirement for any instrument in which the AIF would have invested.

Secondly, there were no corporate debt limits or any auction processes which the AIF was to participate in. And also there was no requirement that the corporate debt instrument has to be listed. So the hiccups or stringent norms with FPIs do not exist with the AIF regime. ECB has been out of flavor for a long time now because of the end use restrictions as only a recognized lender could have given the money; the coupon you can pay outside is restricted etc. Now coming to FDI regime, if the AIF manager and sponsor are Indian owned and controlled there is no restriction as to the sectors, choice of instruments if the money is routed through the AIF.

There are no pricing norms which are applicable. This essentially means that the capital instruments which you could have invested in under the FDI regime would have been restricted to say equity and convertibles like CCPS and CCD. All these norms are not applicable at all if it is an AIF that is Indian owned with a controlled manager and sponsor. However, in cases where even the manager/sponsor is not Indian owned and controlled, AIFs allow you to freely invest in non-capital instruments which means you can very flexibly do non-convertibles, optionally convertibles or partially convertibles. This means that a lot of investments which the foreigners could not have done in the past can now easily be routed through the alternative investment fund route.

On Tax and Regulatory Matters, Specifically Tax Pass Through for Cat III Funds

Rajesh Gandhi:


I think the biggest reason is that unlike Category 1 and 2, Category 3 AIFs can invest not only in listed equity shares but also in more exotic instruments - derivatives or employing complex hedging strategies or multiple investment strategies by the investment manager. I would think the Government's view is that where there is a complex investment strategy or frequent trading or where leverage is used to make investments, they don't want to give up the flexibility or the freedom of deciding whether the income from such activity should be classified as business income or capital gains. The Government might fear loss of tax revenue in such circumstances. Also unlike Category 1 and Category 2, Category 3 AIF can be open ended; so investors can enter and exit during the fund life.



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So it might sometimes become difficult to track the investor and whether he has paid proper taxes on such income. Having said that, there is certainly a case for a tax exemption for AIFs because it is not just AIFs; today even mutual funds employ investment strategies involving frequent trading, multiple schemes, investment in derivatives etc. and enjoy a pass through status. One important way the Government can encourage the fund industry and attract fund managers to set up shop is by giving a tax pass through. I think it is a matter of time because as this industry grows, the pressure on the Government to give it tax neutrality will further increase.

On the Role of a Legal Firm for AIFs

Tejesh Chitlangi:

I think the law firm would play a very critical role because the regulatory policies will allow the foreign investments to come in an alternative investment fund under automatic route which means you are looking at a very big participation of the foreign LPs. Aspects like choice of offshore jurisdiction, regulatory structure and licenses, document drafting, knowledge of cross-border laws and pooling of funds therefore are critical. And to understand the objectives of the GPs or general partners is very critical as to which jurisdictions they are going to market their offering. There are no internal Governmental MOUs which freely allow Indian licensed entities to go and offer to anybody in the world.

There are safe harbours, reverse solicitation norms, exempt offerings etc. which the Indian lawyers will have to advise AIFs on when they raise overseas money. So lawyers have a key role to play because they have to tell the GPs that if you are soliciting money from a particular jurisdiction you obviously need to know what the laws are. Lawyers would also need to advise and facilitate obtaining regulatory approvals if an AIF wants to invest overseas and not only raise money from overseas. SEBI allows AIFs to invest up to 25% money overseas. And if you talk to AIFs, they are seeing a lot of opportunities overseas, right. So it becomes a critical issue that when you are investing money overseas or raising money from overseas.



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On Scalability of AIFs

Rakesh Rathod:

Rakesh Rathod: Based on multiple interactions with a number of fund managers and institutions on the alternative side, it is clear that it's not about a particular asset class. Alternatives can be defined by both the assets as well as strategy employed, and all assets need not necessarily go in one direction. Alternatives give you an edge in terms of having a window of being around in all seasons. AIFs have aided investments to be more organized.

Investors have access to investing in real estate and complex infra projects even now, but the investment process becomes much more simplified when routed through an AIF structure. Also, it is always a risk-return combination that ultra-high net worth investors look for. From this perspective, numerous attractive investment avenues are arising such as infusion of capital in SMEs, real estate projects and infrastructure through the AIF route. Investors now have access to distressed assets which otherwise would have been difficult in an individual capacity. So the pooling structure of AIFs and the options they provide are where the scale will come from.



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AIFs have helped investments move from being unorganized to organized. Investors now have access to investing in real estate and complex infra projects, but things are much more simplified when routed through an AIF structure.

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On the Shift from Core Investment Structures to Unified Structures

Rajesh Gandhi:

I think it's really fact driven and there are pros and cons to both; for example with a unified structure you get scale i.e. all the money is accumulated in the AIF as against investments being scattered in a co-investment structure. And secondly, the AIF would pay tax at its level so each investor doesn't have to pay taxes. And lastly, the risks around Place of Effective Management or PE i.e. Permanent Establishment are reduced because in a unified structure all the decision making happens at the AIF level. But, there are certain disadvantages of a unified structure from a tax perspective. For example, if you have a unified structure then the entire management fee becomes taxable at the 30% normal tax rate because everything is onshore.

Also, you would have a GST of 18% on the management fee. And lastly, I think there is also a question of losses, so let's say you have a unified structure and there is a loss in the AIF, the overseas investor does not get a benefit of that loss. In case of a co-investment structure, the losses will tag along to the overseas investor because he is an investor directly in the Indian entity.

Tejesh Chitlangi:

Unified obviously is the flavor of the season and it has gained prominence on account of regulatory approvals being done away with, because had it been a unified structure three years back, you would have needed an FIPB approval which was very stringent and meant that even if you were taking some small portion of money from overseas, it would have exposed an entire alternative investment fund vehicle in India to FDI norms. So it was all dependent on the FIPB what conditions they could have imposed in the regulatory approvals.

Key Impact Areas for Technology

Rajesh Gandhi:

Fund distribution. I think from a distribution side we still see lot of lacuna in the frame work, and I feel digitisation will impact this in the industry; that is the experience in matured markets.

Tejesh Chitlangi:

I will go with fund management. Just as AI and digitization are having a huge impact in the legal space, they will on fund management as well because of the manner in which algos are used. I am aware of a lot of portfolio managers and investment managers, who are not doing traditional fund management because they have set software that will digitize everything, giving them ready information on how to invest. This clearly means that a fund manager doesn't need a team of 10 or 15 people but can live with one of 2 or 3.

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Rakesh Rathod:

I second what Tejesh said about fund management. Fund Management space is increasingly getting digitized as scale can only come with digitization. Digitization eliminates any human or behavioral element from the equation, which is key when you are striving to achieve scale.

On their Wishes for the AIF Industry

Rakesh Rathod:

Appointment of an agency like DDP for issuing AIF licenses, similar to what we have for FPIs now.

Tejesh Chitlangi:

The one wish I have is that all the regulators are in sync because this is why policies are not implemented. So, the wish is that you have regulators who talk to each other, are not conflicted with each other and have no ego issue. This will make implementation excellent.

Rajesh Gandhi:

I think my wish would be tax transparency for Category 3 AIFs. The Government can collect its revenues by taxing at the investor level. So, whenever an investor exits or there is redemption, just like a mutual fund, the investor can be taxed and the AIF should be spared of taxation.

On Edelweiss Prime Broking's View on the AIF Ecosystem and Efforts to Boost it

Rakesh Rathod:

Any ecosystem needs all the pieces to be integrated. AIFs are no different and at Edelweiss, we are working on the building an ecosystem around AIFs. Edelweiss Prime Brokerage has created a robust platform where we help AIFs by handling the entire journey from setup to providing the custody environment, fund accounting platform, execution and advisory.

We provide that entire ecosystem on deal advisory on various asset classes, be it equity, real estate or infrastructure. You may find all these pieces scattered all over individually, but we have brought them together. More importantly, we have been at the forefront when it comes to influencing change. As there are a lot of concerns around AIFs being a new product, we have, as a platform, taken all the recommendations to regulators. So Edelweiss has taken the lead in collating views from all participants through its niche market advocacy efforts and with due consent, communicated it to regulators in a cohesive manner.

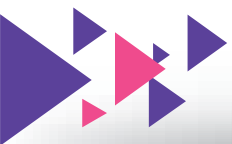
Also, before even being an enabler, we have taken a step back in educating the entire ecosystem on what this space holds for you. Our whole endeavor has been on letting the fund manager focus on his core which is investment ideas. Everything else is left to our platform. There is also an entire technology backbone driving it. The platform also helps with client engagement, communication and fund raising.



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