The Year That Was ... Investment Funds

The Alternative Investment Fund ("**AIF**") industry has seen tremendous growth in India with more than INR 12 trillion worth of commitments raised as of September 30, 2024,[1] signifying a surge of 30% on year-on-year basis.[2] At present, there are 1466 registered AIFs with multiple schemes operating under them. Of the total investments of Rs. 4.5 trillion made by AIFs, the real estate sector has received the highest investments followed by IT/ITes and financial services.[3]

About 67% of the investments were made in equity / equity linked securities, 26% of the investments were made in debt securities (including securitized / listed / to be listed / unlisted), whereas the remaining investments were made towards other investment vehicles such as AIFs/real estate investment trusts/infrastructure investment trusts and security receipts.

A larger part (about 60%) of the total commitments was raised domestically, and about 40% was raised from foreign investors. AIFs are becoming a vehicle of choice for HNIs in addition to institutional investors and it is expected that the industry is likely to surpass Rs. 100 trillion mark by 2030.[4]

Given the increasing popularity of the investment vehicle, the securities market regulator Securities and Exchange Board of India ("**SEBI**") has taken several regulatory measures to revise and update the framework governing AIFs. SEBI introduced some changes for ease of doing business, whereas others were in the nature of strengthening governance by tightening compliances. Set out below is a year-end wrap up of some of the most critical legal / regulatory changes in 2024 that are likely to impact formation of AIFs going forward.

Key amendments for AIFs in the calendar year 2024 have been depicted below.

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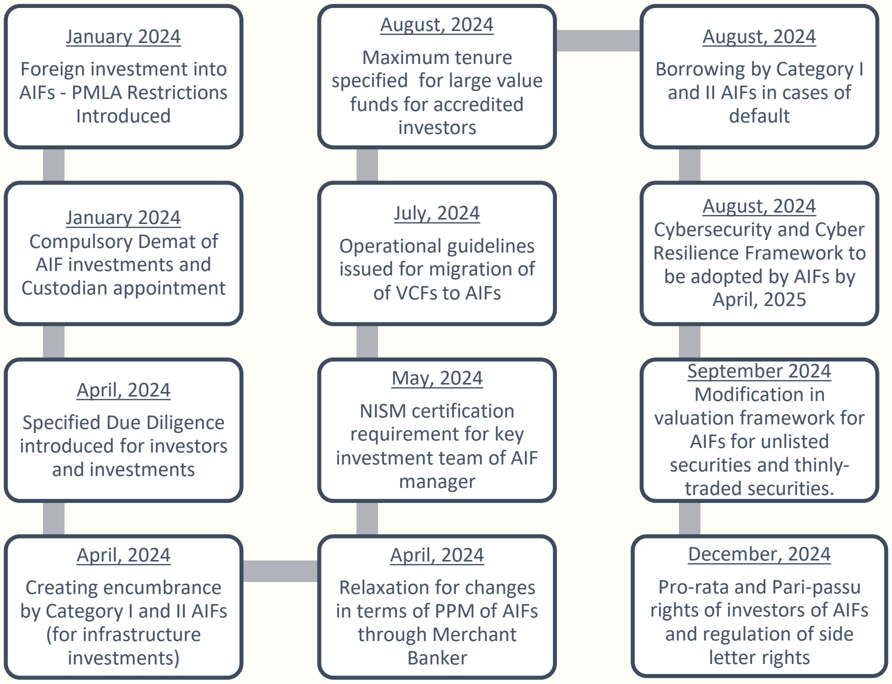
[1] https://www.sebi.gov.in/statistics/1392982252002.html

[2] https://www.business-standard.com/markets/news/alternative-investment-funds-gain-currency-as-fund-raise-tops-rs-5-trillion-124112601117_1.html

[3] *Id.*

[4] https://www.businesstoday.in/personal-finance/investment/story/pms-aif-assets-to-surpass-rs-100-lakh-crore-mark-by-2030-pms-bazaar-456882-2024-12-10.



With these amendments, the industry is currently facing the following challenges:

1) Lack of certainty around whether foreign investments into AIFs are limited by Press Note 3 of 2020, or are the hit only by a mandatory disclosure requirement for now5;

2) Foreign LPs continue to struggle with opening demat accounts to hold their AIF units;

3) While PAS Rules6 under the Companies Act, 2013 exempt small companies from the requirement to dematerialize their securities, AIFs are required to hold all investments in dematerialized form only.7 The timelines involved for companies to dematerialize its securities is impacting deal efficiencies;

4) Considerable push back by LPs to the additional declarations and representations now required from them in relation to due diligence requirements pertaining to circumvention of laws by AIFs;

5) While there is demand for large value funds for accredited investors, operational inefficiency for LPs to maintain their accredited status is a concern;

6) Valuation requirements for unlisted investments by Category III AIFs is unclear;

[5] https://dpiit.gov.in/sites/default/files/pn3_2020.pdf
[6] Rule 9B of the Companies (Prospectus and Allotment of Securities) Rules, 2014, available at https://www.mca.gov.in/content/mca/global/en/acts-rules/ebooks/rules.html
[7] Regulation 15(1)(i), available at https://www.sebi.gov.in/legal/regulations/nov-2024/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-november-18-2024-_88648.html

7) Despite multiple changes adopted for dealing with unliquidated investments by AIFs, operational challenges remain for implementing in-specie distributions, especially to foreign investors;

8) It is not clear whether it is mandatory for an AIF manager to demonstrate track record of previous funds even if such track record is irrelevant to the new AIF / scheme (e.g. a Category III AIF having to demonstrate its Category II AIF's track record);

9) Many LPs are not comfortable with drawdowns and distributions being made in the ratio of capital commitments, as is now mandated by SEBI. This has also lead to operational issues, such as dealing with investors admitted after the first close and distributions to them for existing investments (including those already exited);

10) While detailed list of rights is awaited, LPs are also uncomfortable with SEBI's move towards regulating side letter rights.

Conclusion

SEBI has been mindful of operational issues which arise due to changes in law governing AIFs and we are hopeful that the trend continues. Formation of the pilot Standard Setting Forum for AIFs (SSF) is a commendable step for operational guidelines to be issued on AIF related amendments from time to time. Moreover, SEBI has been regularly engaging with industry participants and has been issuing consultation papers before introducing changes to the law to consider practicability concerns of the industry. All these steps should go a long way to harbour the AIF regime in India, which to some extent is still in its nascent years.

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