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SEASON'S GREETINGS FROM GIFT CITY: AIF WISH-LIST IN IFSC FULFILLED?

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The International Financial Services Centre Authority, vide its circular dated 9 December 2020, titled "*Alternative Investment Funds (AIFs) in International Financial Services Centres (IFSC)*" (Circular) seems to have uplifted the spirits of fund managers and investors, both in India and globally. The Circular has introduced some far-reaching amendments to SEBI (International Financial Services Centres) Guidelines 2015 and the operating guidelines for alternative investment funds (AIF) operating in an International Financial Services Centre (IFSC). Notably, these amendments are being welcomed as a panacea to some of the long-term issues that were being faced by the fund management industry in India. In order to ensure that the IFSC regime compares well with its peer global financial services regimes, the following amendments have been introduced by the Circular, in relation to the AIF regime in IFSCs:

i. *Leeway on leverage: IFSC AIFs permitted to undertake leverage*

An AIF in IFSC (IFSC AIF) is permitted to borrow funds or engage in leveraging activities, subject to the following conditions:

a. *Disclosure in the PPM*: Maximum leverage by an IFSC AIF, along with the methodology for calculation of leverage must be disclosed in the private placement memorandum (PPM) of such IFSC AIF;

b. *Consent of investors:* The IFSC AIF must exercise leverage subject to consent of its investors;

c. *Risk management*: The IFSC AIF employing leverage is required to have a comprehensive risk management framework in place, which is appropriate to the size, complexity, and risk profile of such IFSC AIF.

It is notable that under the SEBI (Alternative Investment Funds) Regulations 2012 (AIF Regulations), Category I AIFs and Category II AIFs are not permitted to borrow funds directly or indirectly. Further, such AIFs are also not permitted to engage in leverage except for meeting temporary funding requirements for not more than 30 days, on not more than 4 occasions in a year and to the extent of maximum 10% percent of investible funds.

Moreover, leverage undertaken by Category III AIFs cannot exceed 2 times of the net asset value of such AIF, under the AIF Regulations.

ii. *Segregation sanctified: Co-investments by segregated portfolio and investments along-side AIFs permitted*

The Circular now also permits an IFSC AIF to:

a. co-invest in a portfolio company through a segregated portfolio by issuing a separate class of units. However, in relation to such co-investment, such IFSC AIF must ensure that:

- investments by such segregated portfolios must, in no circumstance, be on terms more favourable than those offered to the common portfolio of the IFSC AIF; and

- appropriate disclosures regarding creation of segregated portfolio are made in the PPM of such IFSC AIF; and

b. invest in an AIF registered with the Securities and Exchange Board of India (SEBI) in India, alongside other permissible investments.

Bound by the spirit of the AIF Regulations, AIFs are considered to be 'blind-pool' vehicles, wherein segregation of portfolio for co-investors within an AIF has not been looked upon favourably by SEBI in the recent past. Permitting (a) co-investments by way of a segregated portfolio alongside blind pool investments; and (b) co-investments by IFSC AIFs with AIFs, will lead to evolution of innovative co-investment structures by way of AIF-IFSC AIF combinations and fund-of-fund co-investment structures, both at domestic and offshore levels.

iii. *Diminishing diversification: Investment diversification norms not applicable to IFSC AIFs*

Under the AIF Regulations, Category I and II AIFs cannot invest more than 25% of the investible funds in one investee company, and Category III AIFs cannot invest more than 10% of the investible funds in one investee company. The Circular exempts IFSC AIFs from the application of the aforementioned investment diversification requirements for AIFs, as laid down under regulation 15(1)(c) and 15(1)(d) of the AIF Regulations. However, such exemption is subject to the conditions that (a) IFSC AIFs must make appropriate disclosures in the PPM; and (b) investments by IFSC AIFs must be in line with the risk appetite of investors.

IFSC: "Promised Land" for AIFs in India?

It is notable that the above proposals are based on the fundamental premise that most of the other international financial services centres do not impose such investment conditions and restrictions on collective investment vehicles organized in their respective jurisdictions. Hence, exempting the IFSC AIF from such requirements that are otherwise applicable to onshore AIFs will greatly help in creating a better level playing field for IFSC, in the global fund space.

Pursuant to the Circular and other ameliorating regulatory and tax incentives offered by the IFSC regime, the IFSC in Gujarat International Finance Tec-City (GIFT City) seems to be emerging as the "promised land" for alternative investment management space in India. While exemption from investment diversification norms for IFSC AIFs will accord increased flexibility to fund managers in terms of investment strategies, such relaxation will also contribute to the growth of GIFT City as a regional fund destination that competes favourably with other popular fund jurisdictions such as Dubai, Singapore, Mauritius, and the Cayman Islands. Further, relaxation from the leverage restrictions will permit AIFs to explore wider avenues of funding and investment, providing a fillip to distressed asset platforms and debt oriented investment structures that may take roots in IFSCs.

The ability of IFSC AIFs to co-invest, by segregation of portfolio alongside blind-pool investments and with AIFs, will permit fund managers to co-invest along with co-investors or AIFs in portfolio companies and fund-of-fund structures. Further, a co-investment class structure would also be useful for master-feeder fund structures, to track returns for investments in which a co-investing feeder fund would participate. Emergence of bespoke co-investment structures between IFSC AIFs-AIFs would attract fund managers to employ inventive investment strategies and fund structures, through IFSCs. Co-investment structures employing investment vehicles such as infrastructure investment trusts and real estate investment trusts with IFSC AIFs would also be in the offing, with this Circular in effect.

While the Circular brings IFSCs one step closer to its aim of "*onshoring the offshore*", an IFSC is still inherently restrictive towards participation of Indian residents. Seamless migration of fund managers and funds in GIFT City without any adverse tax consequences would go a long way in encouraging stakeholders to migrate existing structures to GIFT City. Further, increased certainty around some issues in relation to the IFSC regime may still be on the wish-list of the alternative asset management industry looking to establish in GIFT City. These would include continuity of tax incentives for funds and fund managers in IFSCs and streamlining of relevant regulatory approvals required for participation of domestic players in IFSCs (for example, approval of the Reserve Bank of India for domestic investment in IFSCs). Nonetheless, it is certain that the Circular has fundamentally eased investment norms for the AIF regime in IFSCs to a large extent, and hence, has paved way for GIFT City to become a playground for fund managers to explore, innovate, and re-invent existing fund structures, in and through IFSCs.

- *Siddharth Shah (Partner), Vivek Mimani (Partner) and Ishita Khare (Associate)*

For any queries please contact: editors@khaitanco.com

Mumbai
One Indiabulls Centre, 13th Floor
Tower 1 841, Senapati Bapat Marg
Mumbai 400 013, India

T: +91 22 6636 5000
E: mumbai@khaitanco.com

New Delhi
Ashoka Estate, 12th Floor
24 Barakhamba Road
New Delhi 110 001, India

T: +91 11 4151 5454
E: delhi@khaitanco.com

Bengaluru
Simal, 2nd Floor
7/1, Ulsoor Road
Bengaluru 560 042, India

T: +91 80 4339 7000
E: bengaluru@khaitanco.com

Kolkata
Emerald House
1 B Old Post Office Street
Kolkata 700 001, India

T: +91 33 2248 7000
E: kolkata@khaitanco.com