ENHANCING FOREIGN INVESTMENT THROUGH AIFS IN TIMES OF COVID-19

Alternative Investment Funds (AIFs) have emerged as a major source of capital for social enterprises, start-up enterprises, infrastructure projects, real estate and other high risk and high reward sectors. AIFs are SEBI-registered investment entities that pool capital from foreign investors and domestic investors to deploy the same in accordance with their defined investment policy.

In an interview to MVIRDC World Trade Center Mumbai, **Ms. Nandini Pathak, Leader, Investment Funds Practice** at the international law firm **Nishith Desai Associates** shares her perspectives on the impact of COVID-19 on investment flows from AIFs. Ms. Pathak also suggests relief measures from government to promote foreign investment through the AIF route.

Excerpts of the Interview:

1) **What is an Alternative Investment Fund and how does it promote foreign investment in India?**

The legal definition of an 'Alternative Investment Fund '("**AIF**") in India is given under Regulation 2(1)(b) of the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (the "**AIF Regulations**").

In simple words, an AIF is a privately pooled investment vehicle, whose purpose is to make investments as per a defined investment policy for the benefit of its investors. A mutual fund (among others) is carved out from the definition of an AIF under the AIF Regulations. A mutual fund is entitled to invite the public to invest in its units; however, an AIF is entitled to raise monies only by way of private placement. Further, a minimum investment of INR 1 Crore is required for investors to participate in an AIF (which is far higher than what is required for a mutual fund, which as I understand can be as low as INR 100 for certain schemes of mutual funds in India now).

Foreign investors looking at India from a portfolio building perspective (as opposed to individual strategic investments) are likely to prefer (among other things) tax neutrality for their investments as well as ring-fencing from liabilities. An AIF structure tends to provide comfort on each of these touch points to foreign investors. AIFs received their long overdue tax transparent status under the Finance Act, 2015, which introduced four key sections to the Indian Income Tax Act, 1961 for taxation of AIFs – section(s) 10(23FBA), 10(23FBB), 115UB and 194LBB. Tax transparency allows the investment income of investors of an AIF (from such AIF) to be taxed in the same manner as if the investors had made those investments directly in the investee entities (and not through the AIF). Further, the introduction of an AIF as a structural intermediary, allows investors to limit and diversify their liabilities.

2) **How do you see COVID-19 crisis affecting foreign investment in India through AIF? What are the sectors you expect to be worst affected by reduction in inflows?**

An AIF continues to be an attractive structural alternative for foreign investments into India despite the unfortunate pandemic. Overall, foreign investments in India are likely to be impacted. However, foreign investors who have decided to invest in India despite the outbreak of the contagion and its effects on the world economy, may still look at an AIF structure to implement their investment decisions. Whether foreign investors are likely to look at India for some time is a different question – and it would be unfair to answer that without categorising different types of foreign investors and their investment thesis. Investors looking at (among others) social impact, stressed assets, healthcare and telecommunication may continue to be interested in India even during and immediately post the pandemic.

At the current stage, it is difficult to conclusively identify which sectors are likely to be most affected by reduction in inflows. My assessment instinct suggests that the outbreak is underreported (perhaps, for good reasons) and its impact on the world economy, including that of India's is likely to depend on how long we end up taking to fight this battle. If it takes later than sooner, we may be looking at a global recession which is not immediately reparable.

From what I have been reading, even traditional sectors such as the real estate sector are likely to see some damage due to the current situation. There are concerns for the information technology industry as well. However, industry players seem ready with solutions and vantage points (also basis the fiscal and policy measures being announced by the Government and the regulators) to get things rolling again. I would, however, like to emphasize on the uncertainty of the time and efforts required to tackle this worldwide concern.

3) **Do you foresee decline in foreign investors' angel funding and seed funding (that are routed through AIFs) to local startup enterprises?**

It depends on the sector we are talking about, however I will try and be agnostic. With angel and seed funding comes guidance, and to that extent, the existing start-ups (in some sectors) are being told by their investors to consider job cuts and layoffs, and make no assumptions while taking business decisions. Generally, with travel restrictions, it becomes all the more difficult for start-ups to raise funds. All of this suggests there could be a short term decline before angel investors start deploying capital in start-ups as effortlessly as they were in the second half of 2018 and most of 2019 in India. Having said that, one way to look at it is that angel / seed / venture funds may get on an early start on their 'follow-on investments' in their existing portfolio of start-ups.

4) **What are the measures you suggest to SEBI, RBI and other regulators and Government of India to promote foreign investment through AIF in this situation?**

We, at Nishith Desai Associates, have been interacting with the Government as well as the regulators continuously to assist them with measures which can be taken during these times. Suggestions include stretching timelines for compliances and submissions and availability of lending concessions to (among other things) enable bridge financing.

Given the stress on capital markets, it might be worthwhile for the Government to consider a complete tax pass through status for Category III AIFs (which are permitted to undertake complex strategies, and primarily invest in listed products). This could boost foreign participation in the capital markets. Another welcome structural move to boost foreign investment in AIFs at this stage would be to exempt management fees paid to AIF manager by the AIF for and on behalf of foreign investors to be exempted from GST.

Notifications

Press Information Bureau, Government of India

- Prime Minister discusses with President of Uganda
- Prime Minister discusses with President of Korea
- India-USA Partnership
- Commerce Minister meets industry associations
- MSMEs producing COVID-related items need to be supported
- Index of Industrial Production for February 2020
- Daily Bulletin on COVID-19

CBIC

- Exemption of customs duty on COVID-19 related materials
- Amendment in Notification

RBI

- Monetary Policy Report April 2020

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