Recommendations by Impact Investors on Alternate Investment Funds

for

Parliamentary Standing Committee meeting

The capital raised by AIFs in India has steadily increased over the last few years placing the industry at the forefront of inclusive growth. Debt AIFs in particular have done exemplary work in enabling access to capital for lower rated credits, in the process also deepening the corporate bond market. While much regulatory reform has been brought about to encourage investments in the AIF industry, we submit the following recommendations for review, which if implemented, would help in fostering a more vibrant and inclusive alternative investments industry –

1. Expand definition of Social Venture Funds:

A. The definition of social venture funds as elaborated under Clause 2 (1) (u) under SEBI (Alternative Investment Funds) Regulations, 2012

Given the tremendous role certain impact sectors play (currently not included explicitly in the definition of 'social venture'), we believe that it would be beneficial for the definition of 'social venture' to be expanded to include such sectors – such as small business loans / MSME finance, affordable housing finance, agri-business finance, certain segments of vehicle finance, and so on. While agriculture is the backbone of our economy, majority of financing in the sector arises from Priority Sector Lending (PSL) by banks. Agri-finance / Agri-allied enterprises help enable further development of the sector by providing specialized financing and services to the sector – in many cases, the end beneficiaries are mid-sized farmers with little formal access to capital and largely untapped by banks that prefer to do large ticket-size lending. Expanding the definition of 'social venture' will permit AIFs to tap into sophisticated and deeper pools of capital such as from insurance companies and pension funds.

B. Amendment to section 2 (h) of the Securities Contracts (Regulation) Act, 1956 to expand the definition of 'securities' to include units of AIFs

Currently, units of AIFs are covered under the defined 'securities' in section 2 (h) of the Securities Contracts (Regulation) Act, 1956. However, listing of AIF units is permissible under Regulation 14 of the AIF Regulations and accordingly stock exchanges have also begun initiatives to enable listing of AIF units. Accordingly, we submit that the definition under Section 2(h) of the SCRA be clarified and aligned with the AIF Regulations. Additionally, the SEBI (Depositories and Participants) Regulations, 2018 mentions that only specified 'securities' would be eligible for dematerialization. Here as well, it would be beneficial to include units of AIFs as permissible securities that may be dematerialized.

2. Expanding pool of investible capital in Alternate Investment Funds (AIFs)

A. A new Category IV AIF dedicated to Social Venture Funds could be considered.

Currently there are three separate categories of AIFs (Cat I, II & III) and SVFs (Social Venture Funds) are part of Category I AIF bucket.

- The new category IV AIF could be allowed to access domestic and overseas grants and be allowed to make grants in India without the need for any other regulatory approvals.

- Similarly, CSR allocations should also be opened up to such funds. Instead of having defined investment allocation strategy, the new category IV SVF could be designed ground up keeping best international practices in mind (e.g. ESG, SDG principles; expectation to identify gaps in portfolio companies and how such funds could be expected to engage with such portfolio companies to improve on parameters else such funds also being allowed to exit the investment on a contractual basis (as opposed to being subject to corporate laws).

In case any specific governmental agency needs to have an oversight over such AIFs or in case a different type of reporting framework needs to be implemented, it would be easier to legislate and manage over a dedicated code. From a tax perspective, while Cat I and II AIFs are currently covered, we will need the similar coverage for Cat IV if so mooted.

B. Changes to existing SVF regime:

Since institutional investors like Insurers and pension funds are allowed to invest in Cat I and II AIFs and there is a tax code covering such funds; there is some merit in working within the current framework. In that case, we will have to consider introducing changes across the length of the AIF Regulations which could be a disjointed effort.

- Investments in SVFs – to be added to list of permissible activities under CSR Section 135.

- Those AIFs that operate in the impact space stand to gain with enabling regulation permitting investments in impact AIFs as CSR. At the same time, organizations can benefit from the investment expertise of these AIFs and can save on resources and time spent on seeking out specific CSR opportunities on their own. While interest exists among some corporates for AIF-impact investments, their internal policies are often restrictive and do not permit investments in certain sectors through AIFs or other routes. The inclusion of social venture funds under permissible investments for CSR will create positive impact for sectors and enterprises in need of capital.

3. Accounting tax challenges for AIFs

A. Pass through for expenses is not allowed for AIFs:

- This is not global standard for passthrough entities resulting in serious impact on effective IRR to fund investors - including foreign investors
- The fund is a pass through entity for any income but not a pass through entity for expenses. It means that any income of the fund is added to investors personal income and investor has to pay taxes on it. But, the expenses are not passed on to the investors. Investors cannot net off these expenses against their business income and take tax benefit.
- At the same time there is no business income at the fund level to net these expenses. So the tax benefit on the netting off of expenses is lost.
- There is a difference between how domestic controlled AIFs are treated in India as compared to foreign managed AIFs on the basis of the ownership. This discourages foreign capital
- Ongoing issues (around benefits) on tax treatment for foreign investors are lower than private. Younger businesses are therefore discouraged to invest in India.
- Investment into SMEs should be highly encouraged and the idea to be mainstreamed.

B. GST charged on AIF management fees

- Not charged in any other major country; rather treated as firm income
- Lowers investor returns and/or reduces management fee
- Particularly an issue for smaller funds

C. Tax clarity for Category III funds to enable investment from sophisticated investors

As per the Income Tax Act, 1961, Cat I and Cat II AIFs are tax pass-through and are only required to withhold tax of 10%. Cat III AIFs however are not subject to the same exemption. We submit that the definition of ‘investment fund’ specified in clause (a) of Explanation 1 to section 115UB of the Income Tax Act, 1961 be expanded to include Cat III AIFs as well in order to extend the benefit of the tax pass-through status, in keeping with the need to create a more diversified base of investors and a vibrant investment climate.

4. Debt market AIFs

A. Type of investments in underlying investees for all categories of AIFs under SEBI (Alternative Investment Funds) Regulations, 2012

Regulations 15 to 18 of the AIF Regulations specify investment conditions for all three AIF categories. The investment conditions cover a wide range of instruments including securities (as defined in the Securities Contracts (Regulation) Act, 1956 (the "SCRA") but do not specifically include loans. It has been separately clarified by SEBI under the Frequency Asked Questions (FAQs) on the AIF Regulations, under 'debt fund' (FAQ #7) that "...since Alternative Investment Fund is a privately pooled vehicle, the amount contributed by the investors shall not be utilized for purpose of giving loans."

We recommend that the AIF Regulations be clarified for this aspect while also taking into consideration that many enterprises in impact sectors may lack the wherewithal to issue debentures (or similar securities), or may be too small in size to be able to garner the resources to comply with extant regulations and issuance compliances including listing compliances, and may benefit from loans being a permissible investment.

B. Investment restrictions with regard to-end use, rating, investment caps etc. be lifted for certain investor categories such as banks, insurance companies, and pension funds.

(i) Investment restrictions by the Insurance Regulatory and Development Authority (IRDA) on end-use (part 1): As per the 'Investment – Master Circular on IRDAI (Investment) Regulations, 2016' insurers are permitted to invest in Cat I & Cat II AIFs and specifically Cat I funds that are infrastructure funds, SME funds, venture capital funds, and social venture funds as defined in AIF Regulations. Additionally, for investments in Cat II AIFs, at least 51% of the funds of such AIFs need to be invested in either infrastructure entities or SME entities or venture capital undertakings or social venture entities. This is a restrictive position since investments into other categories of investments not covered above stand to lose over their counterparts.

(ii) Investment restrictions by the IRDA on end-use (part 2): As per the 'Investment – Master Circular on IRDAI (Investment) Regulations, 2016' life insurers and general insurers are permitted to invest up to 3% and 5% of their investment assets respectively in AIFs. The allocation of funds is even more constrained for a single AIF given prescribed limits. This permissible allocation for insurers constitutes a very small proportion of their book size. Additionally, the small ticket size of a potential investment compares unfavourably with the due diligence involved in making an investment for an insurer. If expanded, investments by insurers can result in wider outreach for AIFs in terms of investments and the sectors that may benefit from such investments. Private and confidential – not for circulation

(iii) Investment restrictions by the Pension Fund Regulatory and Development Authority (PFRDA) As Per Circular no. PFRDA/2016/8/PFM/02 clause 7 "..pension funds shall only invest in AIFs having a minimum rating of AA and above from atleast one rating agency except in case of Government owned AIFs..”. Since AIFs predominantly invest in those sectors not considered ‘mainstream’ and alternative investments including impact sectors, it may not be feasible for a portfolio of investments to achieve the minimum rating requirement prescribed by the PFRDA. Separately, since ratings awarded to AIFs are on the ‘structured obligation’ scale, it may be beneficial for the PFRDA guidelines to also clarify permissible rating scales.

High risk weight for AIF investments by banks As per the Master Circular on Basel III Capital Regulations, Clause 5.13.1, fund based and non-fund based claims on venture capital funds which are considered high risk exposures will attract a high risk weight of 150%. Such high risk weights allocated to investments in venture capital funds is a deterrent for banks to invest in the alternative investment space. Higher permissible allocation and greater flexibility in investment conditions will enable AIFs to tap into sophisticated and deep pools of capital available with the investor categories detailed above. This will enable much needed access to capital for all alternative investment sectors and especially those that operate in the broad impact space.

C. Limited domestic capital pool beyond SIDBI and HNIs

- How can banks and insurance companies be encouraged to consider investing into AIFs
- Make mainstream Wealth managers- equalize returns. To make relations easier for HNI community. AMCs and AIFs difference need to define better.
- There is no benefit out of investing into listed AIFs. As it requires bank investor to pay higher taxes. Mutual fund investors should be allowed to invest. There should be clear distinction between investor categories. Rules need to be redefined.
- Despite multiple years of lobbying, the HNIs don't feature under security. NSE has not put guidelines for AIFs. We need new regulations to allow wealth managers into impact investing.

We believe that the proposals laid out above will further encourage investments in the alternative investments space and will help the alternative investments sector emerge as an important growth engine for the economy.

Recommendations by Impact Investors Council (IIC) and its Members:

- *Aavishkaar*
- *Grameen Capital*
- *Kois Invest*
- *Nishith Desai Associates*
- *Northern Arc*
- *Unitus Ventures*
- *Vivriti Capital and*
- *Zephyr Peacock*