With tighter AIF norms, fund managers mull offshore route

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Also spooked by questions on FDI policy for alternative investment funds

BY ASHLEY COUTINHO

The Reserve Bank of India has recommended that investments by persons resident outside India exceeding 50 per cent of AIF units be treated as indirect foreign investment.

A number of sponsors and investment managers – especially those wanting to raise predominantly foreign capital – are considering taking the offshore route to invest into India instead of setting up alternative investment funds (AIFs) in the country amid regulatory uncertainty and higher costs.

“Tighter regulations are impacting the operations of AIFs and has made managers circumspect about regulatory stability. Managers based in India and looking to raise significant offshore capital are now considering moving their base outside India to ensure that the adverse regulatory changes do not impact their funds," said Siddharth Shah, Senior Partner, Khaitan & Co.

A recent regulatory note denoting mistrust in the industry and questioning the FDI policy around AIFs has spooked investors, said experts. Foreign investors are setting up AIFs with domestic investment managers or sponsors to invest in sectors prohibited for foreign direct investment, or to invest beyond the allowed FDI sectoral limits, a January 19 consultation paper said. The Reserve Bank of India has recommended that investments by persons resident outside India exceeding 50 per cent of AIF units be treated as indirect foreign investment.

This signifies an about-face in regulatory stance. In 2015-16, regulations were amended to allow AIFs to take foreign capital through the automatic route. This meant the colour of capital – domestic or foreign – would be guided by whether the manager and sponsor were Indian-owned and controlled. The capital would be regarded at par with domestic investments irrespective of how much offshore money was raised. This was done to promote onshore management and encourage Indian fund managers to relocate to India.

"Regulatory provisions with increased subjectivity, especially ones at odds with settled rules of FEMA would not aid the growth of alternative asset management in India. The underlying intent of the FDI policy is to promote onshore pooling of foreign capital through domestically managed AIFs. Diluting the benefit for funds with substantial foreign capital could reduce benefits of onshore pooling and prompt managers to move to other jurisdictions with stable regimes," said Vivaik Sharma, Partner, Cyril Amarchand Mangaldas.

Challenges

The uncertainty with regard to taxation of carry, difficulty in administering co-investments, and the introduction of an online dispute resolution regime for global institutions has also put off investors.

"Increased compliance requirements for AIFs in India have impacted the return profile as costs are typically passed on to investors," said Ipsita Agarwalla, Leader - Fund Formation, Nishith Desai Associates.

While offshore funds benefit from a more stable regulatory regime, tax considerations need be borne in mind while setting up these structures given the recent changes in treaty benefits and substance requirements. GIFT City has emerged as a credible alternative for managers because of the regulatory stability, tax sops and the proximity to India.

"Entry barriers for jurisdictions like Singapore and US may be higher for smaller Indian firms. GIFT seems to be a promising alternative for the short to mid-term outlook," said Sharma.

To be sure, an AIF in India will still be needed if funds are being raised from Indian investors. Also, some Indian managers who are in their 40s or 50s may be reluctant to make the shift overseas.

The AIF industry has grown at a CAGR of 35 per cent per annum in the last five years. As of December 31, 2023, the cumulative commitments raised and investments made by AIFs amount to ₹10.8-lakh crore and ₹3.99-lakh crore, respectively.

Pointers: Issues to deal with

* Uncertainty around FDI policy

* Need for investor due diligence

*Rising cost of compliance and move away from light tough regime

*Taxation of carried interest under question

*ODR regime for dispute resolution for global institutions

*Exam requirement for managers

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