

7. HEDGE YOUR BETS: UNLOCKING LIQUIDITY AND REFORMING REGULATION IN INDIA'S BOOMING AIF MARKET

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Abstract

To regulate Alternative Investment Funds (AIFs) in India, SEBI adopted the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012. The assets under management in the AIF sector have increased drastically, leaping from ₹3.6 lakh crores in 2020 to ₹8.5 lakh crores in 2023. This rapid growth results from SEBI and the Indian government's aggressive efforts to foster an investment-friendly environment. However, key sectors remain underserved, necessitating further regulatory improvements to sustain this expansion.

Major industry demands are -

- (a) granting Category III AIFs pass-through status to resolve tax discrepancies, particularly for hedge funds, which currently face unfavourable tax treatment;*
- (b) Excluding GST on carried interest, as it is not guaranteed and has historically been treated as capital gains, necessitating full GST exemption to boost investor confidence and fund managers' incentives; and*
- (c) Granting India-based AIFs with foreign investors "zero-rated or export status" to promote onshoring, strengthening domestic fund management, creating jobs, and increasing tax revenues.*

The article explores the impact of SEBI's AIF Regulations since 2012, followed by an in-depth analysis of the tax and regulatory challenges confronting AIFs. The proposed reforms in the third section aim to facilitate money pooling, enhance liquidity, and position India as a global investment hub. The article also incorporates insights from Budget 2024, which introduced significant changes to the AIF industry. The author

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examines the budget's alignment with industry demands, including onshoring incentives and clearer tax regulations for Category III AIFs. By addressing these issues, the article seeks to provide policymakers with a strategic roadmap to sustain AIF sector growth, furthering India's economic development.

INTRODUCTION

AIFs, or alternative investment funds, are private investment entities that pool the capital of different local and foreign investors.¹ These investments are very different from more conventional ones like stock trading and mutual funds, because of their unusual character and special chances, they are mainly attractive to wealthy investors. AIFs are divided into three different groups in India. The first group consists of start-ups and early-stage businesses that support innovation and entrepreneurship by giving start-ups the necessary funding.² The second group consists of debt or private equity funds, which are essential for funding established companies seeking chances for restructuring or expansion, but do not receive special treatment from the government.³ The third group consists of funds similar to hedge funds, which trade using tactics like arbitrage, leverage, and derivatives trading in an attempt to generate short-term profits.⁴ These broad, suggestive categories are intended to cover all AIF types and offer an organised method for approaching alternative investments.⁵ Ever since the SEBI (Venture Capital Funds) Regulations, 1996, were superseded by the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (AIF Regulations), AIFs have continuously shown themselves to be indispensable in augmenting market liquidity. AIF

¹ CFA Institute, 'Introduction to Alternative Investments' (*CFA Institute Program Level I*, 2023) <<https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/introduction-alternative-investments>> accessed 8 August 2024

² Sugata Ghosh, 'SEBI moots higher threshold for investment in AIFS' *Economics Times* (11 May 2023) <<https://economictimes.indiatimes.com/epaper/delhicapital/2023/may/11/et-front/sebi-moots-higher-threshold-for-investment-in-aifs/articleshow/100144009.cms>> 7 August 2024

³ Business Standard Team, 'What Are Alternative Investment Funds?' *Business Standard* (1 December 2022) <https://www.business-standard.com/podcast/finance/what-are-alternative-investment-funds-122120100023_1.html> accessed 5 August 2024

⁴ Vikas Gupta, 'Need for Enactment of an Act on 'Investment Strategies in Securities' Regulated by SEBI in the Light of Hedge Fund Strategies - Part III' (*Taxmann*, 2010) accessed 3 August 2024

⁵ Aashika Jain, 'India Stock Market Outlook June' *Forbes Advisor* (2023), <<https://www.forbes.com/advisor/in/investing/stock-market-outlook-2023/>> accessed 8 August 2024

commitments increased by 42% in the fiscal year 2022, with a sizeable amount going into debt and private equity funds.⁶

From 23 AIFs in December 2012 to 1,131 AIFs registered with SEBI by June 2023, this is a significant increase.⁷ As of March 2023, AIFs have raised a total of INR 8.33 lakh crores in capital commitments, of which these pooling vehicles had already disbursed INR 3.65 lakh crores⁸. The upward trajectory of AIFs highlights their growing significance and influence. This trend has been emphasised in the sector by recent developments. For example, the Finance Minister's budget for 2024 contained many initiatives meant to fortify the AIF regulatory environment even more.⁹ It is anticipated that these steps will improve openness, reduce the burden of compliance, and create an atmosphere that is more favourable for both domestic and foreign investors. The unveiling of more AIF regulatory simplifications is a noteworthy highlight.¹⁰

To reduce operational complexity for fund managers, these include the establishment of a more transparent reporting system and simplified compliance requirements.¹¹ Furthermore, in recognition of the critical role that foreign money plays in propelling the expansion of the AIF sector, the budget also included tax benefits that are expressly tailored to draw in overseas investors.¹² The growing emphasis on Environmental, Social,

⁶ Securities and Exchange Board of India (Alternative Investment Funds) Regulations 2012, (IND) Reg. 3(4)

⁷ Ahlawat & Associates, 'SEBI Makes Changes to Regulations for Alternative Investment Funds' (*The Legal 500*, 28 November 2022) <<https://www.legal500.com/developments/thought-leadership/sebi-makes-changes-to-regulations-for-alternative-investment-funds/>> accessed 3 February 2025

⁸ SEBI, 'Data Relating to Activities of Alternative Investment Funds (AIFs)' (*SEBI*) <<https://www.sebi.gov.in/statistics/1392982252002.html>> accessed 10 July 2024

⁹ TOI Business Desk, 'Finance Minister's Speech Highlights: Budget 2024' *The Times of India* (New Delhi, 1 February 2024) <<https://timesofindia.indiatimes.com/business/india-business/budget-2024-highlights-nirmala-sitharaman-presents-modi-3-o-budget/articleshow/111943482.cms>> accessed 8 August 2024

¹⁰ SEBI, 'Registered Alternative Investment Funds' (*SEBI*) <<https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=16>> accessed 8 August 2024

¹¹ Rikshit Narang, 'Foreign Funds in The Stressed Assets Market of India : Special Situation Funds' (*Taxmann*, 2023) accessed 23 July 2024

¹² The Financial Express, 'Tax Benefits in Budget 2024 for Foreign Investors' *The Financial Express* (Mumbai, 2 February 2024) <<https://www.financialexpress.com/budget-2024/tax-benefits-in-budget-2024-for-foreign-investors/2978484/>> accessed 8 August 2024

and Governance (ESG) requirements is another noteworthy development.¹³ Putting a strong emphasis on incorporating ESG considerations into investment plans draws in socially conscious investors and is consistent with worldwide investing trends.¹⁴ It is anticipated that this action will motivate AIFs to implement sustainable investing strategies, supporting more general economic and social objectives.¹⁵ The Minister also touched on the long-standing request that Category III AIFs be given pass-through status.¹⁶

By aligning these funds' tax treatment in line with other investment vehicles and eliminating tax inconsistencies and ambiguities, this reform would make hedge funds and other funds more appealing to investors.¹⁷ Another important element was the GST exemption on carried interest. Because carried interest is not guaranteed, it has historically been classified as capital gains and has presented tax issues.¹⁸ Fund managers would greatly profit from the proposed GST exemption, which would also increase investor trust by guaranteeing more consistent and advantageous tax treatment. It was also suggested to give India-based AIFs with foreign investors "zero-rated or export status." The goal of this policy is to promote the onshoring of funds, which would support the regional money management sector and result in higher tax revenues and employment opportunities.¹⁹

¹³ Amit Kedia and Raghav Aggarwal, 'Budget 2023 – Expectations of Alternative Investment Funds' (*Taxmann*, 2023) accessed 14 July 2024

¹⁴ Nandini Pathak and others, 'Term, Termination and Liquidation of AIF' (*Nishith Desai Associates*, October 15, 2020) <<https://www.nishithdesai.com/SectionCategory/33/Investment-Funds/12/29/InvestmentFundsMonthlyDigest/4238/1.html>> accessed 10 July 2024

¹⁵ Vineet Sukumar, 'Transparency and Transferability: New Age of Alternative Investment Funds (AIFs)' (*LiveMint*, February 21, 2023) <<https://www.livemint.com/money/personal-finance/transparency-and-transferability-new-age-of-alternative-investment-funds-aifs-11676971823320.html>> accessed 12 July 2024

¹⁶ Budget 2024: Key Highlights and Announcements (n 9)

¹⁷ ZeeBiz WebTeam, 'CAT III Alternative Fund: What Are They? Are They Risky?' (*Zee Business*, September 4, 2023) <<https://www.zeebiz.com/personal-finance/news-cat-iii-alternative-fund-what-are-they-are-they-risky-features-investment-stst-251989>> accessed 13 July 2024

¹⁸ Pratyush Miglani, 'Budget 2023: Why Carried Interest for Alternative Investment Funds Must Be Kept Outside GST Purview' *Times of India* (16 December 2022) <<https://timesofindia.indiatimes.com/business/budget/budget-2023-why-carried-interest-for-alternative-investment-funds-must-be-kept-outside-gst-purview/articleshow/96259114.cms>> accessed 5 August 2024

¹⁹ Pranay Bhatia, Nidhi Goyal, 'Parity on CAT III AIF With Respect to Tax Carve Outs' (*Taxsutra*, January 23, 2023) <<https://www.taxsutra.com/gst/experts-corner/parity-cat-iii-aif-respect-tax-carve-outs>> accessed 13 July 2024

Hence, while covering these subjects, the author intends to provide a thorough grasp of how AIFs are changing and what regulatory adjustments are required to make India's investment ecosystem more resilient and dynamic.

CURRENT REGIME ON LIQUIDATION OF AIFS

Liquidity management was a major issue in the world of unregulated investment methods before the establishment of the Alternative Investment Funds (AIFs) laws. There were many obstacles for investors to overcome, especially during hard times when having the ability to turn assets into cash rapidly became essential. The absence of a well-defined regulatory system frequently led to uncertainty and ineffectiveness, intensifying the risks related to liquidity in these transactions. In times of financial strain, the question of liquidity became especially urgent. Realising how important it is for AIFs to have a dependable and effective liquidation process, SEBI implemented several measures to improve transparency by requiring open-end funds to provide more information and to closely monitor their liquidity management procedures.

Recognising the importance of a systematic approach to liquidity, the Securities and Exchange Board of India (SEBI) established extensive restrictions for AIFs. These steps were taken to make sure that open-end fund operations were more transparent and that liquidity management procedures were well observed. SEBI sought to reduce the risks related to liquidity and create a steadier and predictable investment environment by enacting these policies. When an AIF is wound up or terminated, Indian investors frequently worry about the procedure for liquidating their assets. This procedure might have major financial ramifications, which makes it a crucial concern for stakeholders.

The inability to rapidly and effectively sell their assets upon the winding up or termination of an AIF is one of the main worries of investors.²⁰ This uncertainty is a crucial problem for stakeholders since it might have major financial repercussions. In order to allay this worry, SEBI's AIF regulations include a clear distinction between an AIF's winding up and

²⁰ Abhik Guha Roy and Soumitro Mazumdar, 'Dynamic Nature of Hedge Funds' (*Taxmann*, 2006) accessed 10 August 2024

liquidation.²¹ This distinction is important because it reduces the possibility of investor worry and financial instability by providing an organised timeframe and method for the distribution of assets. According to the AIF legislation, the liquidation process must begin no later than a year following the winding up or dissolution of the fund.²² This schedule makes sure investors don't have to endure a protracted period of uncertainty. The methodical distribution of assets in accordance with the distribution plan described in the fund documentation is known as liquidation.²³ This procedure only starts once the fund's debts have all been paid off. The regulations provide a clear and equitable liquidation procedure, safeguarding the interests of all parties concerned by following a predetermined distribution mechanism. SEBI has also increased security measures in an effort to increase investor confidence. Among them are the requirements that AIFs provide regular updates and disclosure of their liquidity management practices.

Investors are better able to make judgments and comprehend the possible risks involved with their investments when there is transparency. Furthermore, AIFs are required by SEBI laws to have a clearly defined exit strategy in place, which gives investors further confidence in the fund's capacity to manage liquidity efficiently.

A. Cross-Border AIFs

Through their deliberate alignment with the Indian government's aim of globalising the Indian economy, Alternative Investment Funds (AIFs) have successfully positioned themselves as intermediaries for cross-border capital flows. A major obstacle that had previously prevented cross-border investments from being made has been eliminated,

²¹ Jeffrey Rosenberg, 'Yields are back, and alternatives are here to stay' (*BlackRock*, 8 March 2023) <<https://www.blackrock.com/us/individual/insights/alternatives-yields-2023>> accessed 10 August 2024

²² Suresh P. Iyengar, 'Alternative equity funds outperform MF schemes' *Hindu BusinessLine* (Mumbai, 29 December 2022) <<https://www.thehindubusinessline.com/markets/alternative-equity-funds-outperform-mf-schemes/article66316862.ece>> accessed 5 August 2024

²³ Mike Wright, Andrew Burrows, Rod Ball, Louise Scholes, Miguel Meuleman, Kevin Amess, 'The implications of alternative investment vehicles for Corporate Governance' (2007) OECD < <https://www.oecd.org/corporate/ca/39005553.pdf>. > accessed 10 August 2024.

thanks in large part to the legislation and programmes that SEBI has helped to put into place.²⁴

For example, upon the liquidation of an AIF's investment in a foreign investee business, the proceeds of the liquidation are accessible for reinvestment by all AIFs. By enabling AIFs to access international capital flows, this legal provision not only reduces liquidity limitations but also improves their lending capabilities.²⁵ These foreign investments provide the money and risk-bearing capabilities required to increase AIFs' investment horizons, resulting in an improved stability and active investment environment. In this ecosystem, the International Financial Service Center Insurance Office (IIO) is essential because it monitors how exposed its investments are to different risks, such as credit risk, liquidity risk, interest rate risk, and market risk. The IIO stipulates that investments be made in foreign currencies that are easily convertible to reduce the risk of liquidity in all AIF-related transactions.²⁶ By compelling the investments to retain their liquidity, this condition lowers the risk of liquidity crises.

It has been noted over time that a reduction in fund liquidity may have "spillover effects" that span international borders in developed economies.²⁷ These developed economies have acknowledged how serious this problem is and are proactively addressing it. The encouragement of trading through central clearing houses has been one such strategy.²⁸ By serving as middlemen in financial transactions, central clearing houses reduce counterparty risk and facilitate effective trade settlement.

²⁴ James Chen, 'Undertakings for collective investment in transferable securities' (*Investopedia* August 2023)

<<https://www.investopedia.com/terms/u/ucits.asp>> accessed 2 August 2024

²⁵ Irish Funds, 'Fund Types & Legal Structures, International Investments' (Irish Funds) <<https://www.irishfunds.ie/set-up-distribution/fund-types-legal-structures/>> accessed 18 July 2024

²⁶ Rajesh H. Gandhi, 'Tax Parity Required in Treatment of AIF, PMS and Other Similar Modes of Investment' *The Financial Express* (19 January 2023) <<https://www.financialexpress.com/money/tax-parity-required-in-treatment-of-aif-pms-and-other-similar-modes-of-investment/2953640/>> accessed 19 July 2024

²⁷ Securities and Exchange Board of India, Guidelines on Disclosures, Reporting and Clarifications under AIF Regulations (*CIR/IMD/DF/14/2014, 2014*)

²⁸ Securities and Exchange Board of India, 'Consultation Paper on Direct Plan for Schemes of Alternative Investment Funds (AIFs) and Trail Model for Distribution Commission in AIFs' (*SEBI* 3 February 2023) <https://www.sebi.gov.in/reports-and-statistics/reports/feb-2023/consultation-paper-on-direct-plan-for-schemes-of-alternative-investment-funds-aifs-and-trail-model-for-distribution-commission-in-aifs_68093.html> accessed 21 July 2024

By substantially reducing the risks connected to liquidity mismatches in open-end funds, this method creates a steadier and predictable investing environment. Furthermore, the fact that industrialised economies have adopted these techniques emphasises how crucial strong liquidity management frameworks are.²⁹ These economies can avoid the kinds of market disruptions that can result from liquidity crises by making sure that liquidity risks are reduced through central clearing systems. This helps to improve the overall stability of the financial system while also protecting investors.³⁰ Additionally, since foreign investors are frequently more inclined to make investments in markets that uphold globally accepted norms of risk management and transparency, this alignment may increase the appeal of Indian AIFs to these investors.

B. Liquidity Boosters

Investment portfolios like AIFs, which concentrate mostly on illiquid assets, have traditionally raised concerns among stakeholders about how they may affect market liquidity as a whole.³¹ Investors who usually seek more liquid investment options that provide rapid access to their funds are generally hesitant to invest in illiquid assets due to their limited marketability and lengthier holding periods.³² This caution can be especially noticeable in erratic economic times when cash worries are more acute. The relationships between liquid and illiquid assets, however, are more complex than they might first seem, and this must be understood.³³ Comparing these asset classes, it is evident that frantic investors' desire to continue holding a greater proportion of their investments to liquid assets is frequently offset by their draw to illiquid assets, which, despite carrying a higher

²⁹ Satya Sontanam, 'What the sharpest growth in risky AIFs means' (*Livemint*, 12 December 2022) < <https://www.livemint.com/money/personal-finance/is-the-rise-of-aifs-the-barometer-of-growing-income-inequality-in-india-11670853617801.html> > accessed 18 July 2024

³⁰ Vivriti, 'Revolutionizing the AIF space' (*Vivriti Asset Management* 20 January 2023), < <https://vivritiamc.com/revolutionizing-the-aif-space/> > ; SEBI, 'Data Relating to Activities of Alternative Investment Funds (AIFs)' (*SEBI*) < <https://www.sebi.gov.in/statistics/1392982252002.html> > accessed 10 July 2024

³¹ Vikas Agarwal et al., 'Role of Managerial Incentives and Discretion in Hedge Fund Performance' (2009) 64 *Journal of Finance* 2221

³² Vivaik Sharma et al., 'Funds in GIFT City – FAQs & Structuring Insights' (*Cyril Amarchand Mangaldas*, 09 August 2021), < <https://corporate.cyrilamarchandblogs.com/2021/08/funds-in-gift-city-faqs-structuring-insights/> > accessed 10 July 2024

³³ Abdourahmane Sarr & Tony Lybek, 'Measuring Liquidity in Financial Markets' (2002) IMF Working Paper No. WP/02/232, < <https://www.imf.org/en/Publications/WP/Issues/2016/12/30/Measuring-Liquidity-in-Financial-Markets-16211> > accessed 18 July 2024

risk, may also offer potentially greater returns.³⁴ This is because liquid assets are seen as less risky.³⁵ The way that risk and return interact has a significant impact on investor behaviour and portfolio allocation techniques. When building their portfolios, investors must carefully consider their level of risk tolerance and liquidity requirements.³⁶

For example, investors who are risk-averse could prefer liquid assets, which offer the convenience of instant access to cash, like stocks or bonds that are easily exchanged on the market. Conversely, investors who are prepared to take on more risk can choose illiquid assets like real estate or private equity, which often offer higher long-term returns but call for a longer investment horizon.³⁷ An important aspect of the decision-making process for investors is striking a balance between possible rewards and liquidity. Furthermore, the landscape of investing choices is changing due to the increasingly sophisticated investor base. High net-worth individuals, family offices, and institutional investors are realising how important it is to diversify their portfolios with illiquid assets to improve total returns.³⁸ In this situation, AIFs can be quite helpful because they give access to a variety of investment opportunities that conventional investment vehicles might not offer.

Fund managers are employing a range of tactics to augment liquidity inside their AIFs in order to mitigate the liquidity issues that are linked to illiquid assets. For example, they are using strategies like creating secondary markets or using structured finance options that can help with liquidity events more frequently.³⁹ Furthermore, the implementation of liquidity enhancers, including options for investor redemption or recurring liquidity

³⁴ Reserve Bank of India, *Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio (LCR)* (RBI/2019-20/217, 2020)

³⁵ Lisa Lillioth Rydin, 'Private Equity, Venture Capital and Hedge Funds' (*Harvard Law School*, 12 June 2023) <https://guides.library.harvard.edu/law/private_equity> accessed 6 August 2024.

³⁶ Jamie Sklar, 'Schulte Partner Stephanie Breslow Discusses Hedge Fund Liquidity Management Tools In Practising Law Institute Seminar' (2012) 5 (43) *The Hedge Fund Law Report*

³⁷ Jarrod Quigley, 'Looking Beyond Private Equity Secondary Markets' (*Morgan Stanley Investment Management*, 7 June 2023), <<https://www.morganstanley.com/im/en-us/individual-investor/insights/articles/undiscovered-secondary-markets.html>> accessed 8 August 2024

³⁸ Setter Capital, *Volume Report FY 2022*, 18 (February, 2023), <https://settercapital.com/media/reports/Setter_Capital_Volume_Report_FY_2022.pdf> accessed 8 August 2024

³⁹ K Ram Kumar, 'ARC/AIF for banks to resolve bad loans faces roadblocks' *Hindu BusinessLine* (Mumbai, 16 October 2018), <<https://www.thehindubusinessline.com/money-and-banking/arcaif-for-banks-to-resolve-bad-loans-faces-roadblocks/article25239854.ece>> accessed 8 August 2024

events, might assist in easing investor apprehension regarding their capacity to obtain money when required.⁴⁰

As a result, the development of technology and financial innovation is essential to improving AIF liquidity. Investors' interactions with illiquid assets are changing as a result of the emergence of FinTech platforms that offer trading options and secondary market opportunities. These platforms expedite transactions and allow for more effective price discovery, which eventually improves liquidity and boosts investor trust.⁴¹

C. Unliquidated Investments

In the Indian financial environment, the operation of selling and allocating unliquidated investments during the winding-up phase of an Alternative financial Fund (AIF) has long been a cause of worry.⁴² During these crucial periods, investors frequently experience uncertainty about the future of their investments, which breeds doubt about the overall liquidity and effectiveness of AIFs. To address these issues, SEBI unveiled in March 2023 a novel and adaptable system designed to simplify the handling of non-liquidated assets. With agreement from at least 75% of investors by value, this recently approved method permits AIFs to move unsold investments that are not liquidated during the winding-up process to a new scheme under the same AIF.⁴³ By providing investors with a say in the decisions made about their investments, this clause gives them more authority and increases their sense of security and involvement in the upkeep of their assets.⁴⁴

⁴⁰ Vipul Das, 'Would AIFs (Alternative Investment Funds) gain favour as debt funds lose long-term tax benefits' (*Livemint*, 29 March 2023), < <https://www.livemint.com/money/personal-finance/does-alternative-investment-funds-aifs-are-attractive-after-removal-of-long-term-tax-benefits-of-debt-mutual-funds-11680089271382.html>.> accessed 6 August 2024

⁴¹ Valarie Revest, Sandro Sapio, 'An essay on the emergence, organization and performance of financial markets: the case of the Alternative Investment Market' (2011) Laboratory of Economics and Management Working Paper Series (2011), <<https://www.lem.sssup.it/WPLem/files/2011-15.pdf>> accessed 10 August 2024

⁴² Ashok Banerjee ; Bobbur Abhilash Chowdary, 'Performance of Hedge Funds in India' Indian Finance Association <<http://indiafa.org/performance-hedge-funds-india/>.> accessed 12 August 2024

⁴³ Securities and Exchange Board of India, *Circular on Schemes of AIFs which has adopted priority in distribution among investors* (SEBI/HO/AFD-1/PoD/P/CIR/2022/157 2022)

⁴⁴ K.S. Badri Narayanan, 'SEBI's contention on AIF is noteworthy' *Hindu Business Line* (26 May 2023), < <https://www.thehindubusinessline.com/markets/sebis-contention-on-aif-is-noteworthy/article66897164.ece>> accessed 10 August 2024

If the required majority of investors decide against approving this transfer mechanism, investors will be required to receive the unliquidated investments in specie. This implies that the actual assets will be distributed to the investors directly, as opposed to being auctioned off.⁴⁵ The sad result is that the investment will be written off if the investor is unable to accept the in-specie dividend. This part of the rule emphasises the significance of investor permission and the necessity of active communication between investors and fund managers during the winding-down procedure.⁴⁶

The purpose of introducing this strategy is to offer an investor-approved, transparent, and organised way to handle non-liquidated assets. Allowing unsold investments to be transferred to a new plan helps AIFs prevent potential fire sales, which can have a negative impact on asset prices and cause investors to suffer large losses. Rather, this mechanism creates an atmosphere in which investors' interests as a group are given precedence, and choices are made in a way that takes their risk tolerance and preferences into account.⁴⁷ The regulations prioritise investor participation and offer structured choices for asset management during the winding-up process. This will create a more resilient and robust AIF ecosystem that can successfully handle the challenges associated with investment liquidation.

D. Secondary Market Transactions

Building a strong secondary market is essential to improving liquidity and making sure that the financial markets' liquidation procedures run smoothly. Realising this, SEBI has made a concerted effort to create an atmosphere that encourages secondary market expansion and makes transactions easier and more transparent. Through a demand-

⁴⁵ Pavan Burugula ; Sneha Seth, 'AIFs jittery over Sebi move to ban priority distribution' (*Livemint*, 15 June 2023), < <https://www.livemint.com/market/stock-market-news/aifs-jittery-over-sebi-move-to-ban-priority-distribution-11686849444190.html>> accessed 23 July 2024.

⁴⁶ Securities and Exchange Board of India, 'Consultation Paper on the proposal to review Qualified Institutional Buyer status of Alternative Investment Funds, Venture Capital Funds and Foreign Venture Capital Investors' (SEBI, 19 May 2023) <https://www.sebi.gov.in/reports-and-statistics/reports/may-2023/consultation-paper-on-the-proposal-to-review-qualified-institutional-buyer-status-of-alternative-investment-funds-venture-capital-funds-and-foreign-venture-capital-investors_71435.html> accessed 18 July 2024

⁴⁷ Matthias Lehmann, 'Volcker Rule, Ring-Fencing or Separation of Bank Activities: Comparison of Structural Reform Acts Around the World' (2014) LSE Law, Society and Economy Working Papers 25/2014 6 – 8 <http://eprints.lse.ac.uk/60570/1/WPS2014-25_Lehmann.pdf> accessed 21 July 2024

supply mechanism, the regulatory framework that SEBI has developed attempts to facilitate accurate price discovery while giving investors better exit possibilities.⁴⁸

The improvement of stock exchange's Request for Quote (RFQ) platforms is one of the major initiatives in this area. By enabling users to obtain quotes for securities, this platform aims to improve market depth and facilitate more effective trading by increasing liquidity. Furthermore, SEBI has put laws into place to improve disclosure standards and openness in relation to corporate bond trading in the secondary market. These efforts aim to improve the efficiency and integrity of secondary market transactions and are in line with the Alternative Investment Policy Advisory Committee's recommendations.⁴⁹

Given that they facilitate leveraged buyouts and a range of investment techniques that might affect market liquidity, AIFs play a crucial role in this situation. Consider, for instance, the following situation: an investor, called "A," owns equity capital in compliance with the Overseas Investment Regulations, 2022 (IO Rules). Following the IO Rules, "A" may transfer this investment, returning any outstanding funds to their home country before disinvestment. By fostering chances for secondary market interactions and enhancing the general market infrastructure, these transactions can help to increase liquidity.⁵⁰ FinTech has had a revolutionary effect on secondary market transactions both internationally and in India. Innovative FinTech solutions are being aggressively explored by Indian investment businesses, including Edelweiss, to alleviate liquidity concerns and improve their operational effectiveness. The emergence of modern trading platforms, automated trading systems, and data analytics tools is an example of these developments, which help to improve price discovery and liquidity management.⁵¹

⁴⁸ The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 2(u)

⁴⁹ Debbie Kane, 'What the UK's Carried Interest Announcement Means for Fund Managers and Investors' (*IQ-EQ*, 27 March 2023) ; <<https://iqeq.com/insights/what-uks-carried-interest-announcement-means-fund-managers-and-investors/>> accessed 23 July 2024

⁵⁰ Paul Mulholland, 'Biden Budget Proposes End to Carried Interest, Higher Tax on Buybacks' (*Chief Investment Officer*, 9 March 2023) <<https://www.ai-cio.com/news/biden-budget-proposes-end-to-carried-interest-higher-tax-on-buybacks/>> accessed 24 July 2024

⁵¹ Securities and Exchange Board of India, '*Guidelines on Disclosures, Reporting and Clarifications under AIF Regulations* (CIR/IMD/DF/14/2014, 2014)

Moreover, the integration of FinTech into secondary market operations is not limited to trading alone. It extends to various aspects of market participation, including the issuance and management of corporate bonds. By leveraging technology, investment firms can streamline processes, reduce transaction costs, and improve market access for investors. This technological evolution supports the growth of investment businesses and enhances their fixed-income advisory services.⁵²

RECOMMENDATIONS & SUGGESTIONS TO THE REGULATORY FRAMEWORK OF AIFS

Even though the government has taken action to boost AIF growth and the Indian economy, there are still some aspects of the regulatory framework that need to be further addressed to foster fund pooling and improve liquidity in the Indian market. For AIFs to fulfil all of their potential as important sources of capital and liquidity, these challenges must be remedied.⁵³

A. Providing pass-through status to Category III AIFs.

The "pass-through" principle governs the present tax structure for investment entities like Mutual Funds (MFs), Portfolio Management Services (PMS), Real Estate Investment Trusts (REITs), and Infrastructure Investment Trusts (InvITs). According to this theory, investors immediately pay income taxes at the appropriate rates.⁵⁴ Nevertheless, Alternative Investment Funds (AIFs), especially those involved in public market investments, are not subject to the same uniform tax treatment.⁵⁵ For Category III AIFs,

⁵² Ernst & Young, 'Tax and Regulatory Updates, in PE/VC Agenda: India Trend Book' (2024) EY 37 <https://assets.ey.com/content/dam/ey-sites/ey-com/en_in/topics/private-equity/pe-vc-monthly-roundup/2023/03/ey-pe-vc-trend-book.pdf> accessed 23 July 2024

⁵³ Shrimi Choudhary, 'Govt Evaluating Measures to Bring down Tax Burden on PE/VCs in India' *BusinessStandard*; (New Delhi, 21 March 2023) <https://www.business-standard.com/article/economy-policy/govt-moots-framework-to-reduce-tax-burden-on-pe-funds-venture-capitals-123032101150_1.html> accessed 22 July 2024

⁵⁴ TaxGuru, 'Taxation of AIFs in India' (*Taxguru*, 1 August 2024) <<https://taxguru.in/income-tax/taxation-alternative-investment-funds-aif.html>> accessed 8 August 2024

⁵⁵ *ibid*

which are mainly hedge funds engaged in high-risk, speculative investments motivated by value trading positions, this discrepancy presents serious difficulties.⁵⁶

Specifically in derivatives and risk-hedging products, hedge funds enhance market liquidity and efficiency by taking on risks and serving as counterparties to risk-averse organisations. Hedge fund trading might be significantly reduced if all market players were required to reveal these funds' positions. This could result in the funds leaving the market or in a large loss of market liquidity. Alternatively, a more equitable strategy would entail sending the regulator an overall report on all hedge funds in order to reduce risks without adversely affecting any particular funds. This approach would support the expansion of hedge funds in emerging nations such as India and assist in preserving market equilibrium.⁵⁷

For fiscal reasons, Category I and II AIFs currently have pass-through status, much like other investment vehicles. Nonetheless, because Category III AIFs do not fall under a particular tax system, their taxes are determined by applying general trust taxation principles. Investors are faced with uncertainty and complexity as a result of this scenario, which increases the possibility of double taxation as well as challenges with tax reporting and computation. Under the lack of tax pass-through status, investors in Category III AIFs suffer significant setbacks in comparison to investors in Mutual Funds, PMS, and Category I and II AIFs, where income is taxed directly in the hands of investors. Additionally, it is not expressly stated in the Income Tax Act, 1961, that revenue generated at the AIF or trust level cannot be reassessed in the hands of the beneficiaries (investors) once it has been evaluated and taxed by the trustee. Foreign investors in Category III AIFs are particularly impacted by this lack of clarity because they frequently aren't able to claim tax credits for taxes paid by the AIF in their home country, which prevents them from taking advantage of the beneficial tax treaty terms.⁵⁸

⁵⁶ Divyesh Lapsiwala and Amit Bothra, 'Alternative Investment Funds and Venture Capital Funds - Indirect Tax –Key Provisions' (2018) 7 The Chamber's Journal 40

⁵⁷ P Kannan, 'AIF Taxation: Challenges Faced by Category III Funds' (The Economic Times, 2022) <<https://economictimes.indiatimes.com/markets/stocks/news/challenges-faced-by-category-iii-aifs-on-taxation/articleshow/90004251.cms>> accessed 8 August 2024.

⁵⁸ Vinod Joseph, Rabia Rahim, Anurag Prasad and Aishwarya Manjooran, 'Tax Treatment of Alternative Investment Funds and Their Investors – An Analysis' (*Argus Partners*, 22 March 2022)

By giving Category III AIFs tax pass-through status, the tax system would be more equitable for all AIF categories, which would help to address these problems. Furthermore, reducing complexities and the risk of additional tax liabilities would be achieved by clearly defining the income characterisation requirements for Category III AIFs, especially those that use long-short strategies or frequently churn their portfolios. The hedge fund industry would develop and become more stable if such policies helped create a more open and predictable tax regime.

B. Exemption from Goods and Services Tax on carried interest.

The percentage of a fund's earnings that is allotted to the fund manager—carried interest—is proportionate to the manager's investment amount but not to the fund's performance or profitability. Carried interest is typically seen as a "capital gain" from investing in securities for income tax purposes. It was treated as income from securities under the GST and the previous service tax scheme, meaning it was free from both taxes. Because of this classification, fund managers were able to take advantage of a lower capital gains tax rate, and investors were shielded from paying any GST on carried interest that was provided to fund managers.⁵⁹

Following a decision in the ICICI Econet Internet and Technology Fund case, the Custom, Excise, and Service Tax Appellate Tribunal Bangalore (CESTAT) adopted a different position, classifying carried interest as a performance fee and applying it to service tax.⁶⁰ Contrary to the stated distribution waterfall arrangements permitted under the VCF/AIF Regulations, where carried interest is allocated to the investment manager, this approach implies that funds retain certain sums as payment for management assistance.

The means by which carried interest is treated by the tax authorities differ between the United States and the United Kingdom. Investments maintained for fewer than three years are subject to higher tax rates. In the US, the length of an investment influences

<<https://www.argus-p.com/papers-publications/thought-paper/tax-treatment-of-alternative-investment-funds-and-their-investors-an-analysis/>> accessed 3 February 2025

⁵⁹ M Smith, 'Hedge Funds: Regulation and the Future' *Financial Times* (2022) <<https://www.ft.com/content/hedge-funds-regulation>> accessed 8 August 2024

⁶⁰ 'ICICI Econet Internet and Technology Fund: CESTAT Bangalore Decision' (Taxmann, 2023) <<https://www.taxmann.com/post/ce-stat-bangalore-on-icici-fund-case>> accessed 8 August 2024.

whether it qualifies for capital gains treatment or is deemed ordinary income.⁶¹ The elimination of the carried interest tax reduction is the main goal of the planned budget for the fiscal year 2024. Carry interest is liable to capital gains tax in the UK, where a sliding scale approach based on the average holding duration of investments is employed. In order to reconcile tax responsibilities and provide relief from double taxation, the UK's Spring Budget of 2023 permitted taxable individuals to declare chargeable gains early.

Regulatory explanations are urgently needed because of the CESTAT ruling's added complexity and uncertainty. Carry-borne interest is not a promised payment or remuneration for delivered services, which is a prerequisite for an activity to be taxable as a service, hence, it makes no sense to define it as such under the GST system. This justification suggests that carried interest should be free from GST. Since potential investors may become unclear about the tax treatment of fund managers due to ambiguity surrounding the verdict, fund managers may become discouraged, and ecosystem liquidity may be impacted.

C. Addressing New Industry Demands and Enhancing Liquidity

The government's ongoing commitment to enhancing the investment environment is clear in the wake of Budget 2024. The budget has a strong emphasis on improving infrastructure, accelerating economic growth, and creating an atmosphere that welcomes international investment. Consideration should be directed to a few significant enhancements and highlights from Budget 2024:

1. *Increased Allocation for Infrastructure:* To improve connectivity and logistics, the Budget 2024 has allotted ₹10 lakh crore, a major increase in financing, for infrastructure development. It is anticipated that this investment will both boost economic expansion and offer alluring opportunities for AIFs concentrating on infrastructure projects.⁶²

⁶¹ M Johnson, 'Carried Interest in the US and UK: A Comparative Analysis' (2022) *Journal of International Taxation*)

⁶² Ministry of Finance, 'Union Budget 2024' (*Ministry of finance*, 2024)<<https://www.indiabudget.gov.in>> accessed 10 August 2024

2. *Support for Startups and Innovation:* The government has launched several programs to assist new businesses, including funding programs and tax breaks, which are in line with the goals of Category I AIFs. The focus on technology and innovation can improve these funds' growth prospects and draw in further investment.⁶³
3. *Tax Incentives for Green Investments:* In keeping with the current budget's emphasis on sustainability, tax breaks for investments in green technologies and renewable energy have been included. This is going to open up a new market for environmental sustainability-focused AIFs and encourage investors to put money toward responsibly managed projects.⁶⁴
4. *Digitalisation Initiatives:* The government's dedication to digitisation, which includes making tax collection and compliance procedures more efficient, will generally boost investor sentiment. Process simplification will facilitate AIF operations and reporting, boosting investor confidence. The government's dedication to digitisation, which includes making tax collection and compliance procedures more efficient, will boost investor sentiment generally. Process simplification will facilitate AIF operations and reporting, boosting trust among investors.⁶⁵
5. *Strengthening the Regulatory Framework:* The proposed budget suggests bolstering the AIF regulatory framework to provide more robust oversight and increased transparency. A promise to improve SEBI regulations is part of this, as it will help allay worries about investor protection and market integrity.⁶⁶
6. *Focus on Foreign Direct Investment (FDI):* India will become a more alluring destination for foreign investment because of the steps outlined in Budget 2024 to

⁶³ Department for Promotion of Industry and Internal Trade, 'Startup India' (DPIIT, 2024) <<https://www.startupindia.gov.in>> accessed 10 August 2024

⁶⁴ Ministry of New and Renewable Energy, 'Incentives for Green Investments' (*Ministry of new and renewable energy*, 2024) <<https://mnre.gov.in>> accessed 10 August 2024

⁶⁵ NITI Aayog, 'Digital India: Transforming Governance' (2024) <<https://niti.gov.in/digital-india-transforming-governance>> accessed 10 August 2024

⁶⁶ Securities and Exchange Board of India, *Alternative Investment Funds Regulations, 2024* (LAD-NRO/GN/2012-13/04/11262, 2024)

relax FDI restrictions in many sectors. The government hopes to improve domestic market liquidity by encouraging foreign investment, which will directly help AIFs that depend on foreign funding.⁶⁷

D. Enhancing Investor Education and Awareness

Improving investor education and understanding of AIFs is another crucial area that needs focus. Since AIFs are a relatively new idea in the Indian market, there is doubt about the potential success and advantages of these funds among potential investors as well as the government. In order to solve this, the government might start extensive investor education initiatives in coordination with industry players. These initiatives ought to clarify the intricacies of AIF investments while emphasising both their advantages and disadvantages. Workshops, seminars, and internet resources that describe the different kinds of AIFs, their investing strategies, and the regulatory environment could be included in investor education programs. Potential investors would be more inclined to view AIFs as a feasible investment choice if knowledge and comprehension were raised.

Additionally, more knowledgeable investors can make better investment choices, which lowers the chance of market volatility and improves overall market stability.

E. Introducing Incentives for Long-Term Investments

Government rebates for long-term investments might be implemented to further improve the appeal of AIFs, particularly in those categories where they make a substantial contribution to economic development. These incentives might take the form of tax cuts or reduced capital gains tax rates for long-term investments. As long-term investments offer a steady flow of cash into projects that take a long time to mature, including infrastructure and renewable energy projects, they are essential for the security and growth of the country's economy.

The government can encourage investors to commit their resources for extended durations by offering incentives for long-term investments. This would give essential

⁶⁷ Department for Promotion of Industry and Internal Trade, 'FDI Policy in India' (2024) <<https://dipp.gov.in/policies-rules-and-acts/fdi-policies>> accessed 10 August 2024

growth initiatives a reliable source of finance. This strategy would help the nation's economy grow and stabilise overall in addition to the sectors that would immediately benefit from these investments. These steps will increase liquidity, promote long-term economic expansion, and guarantee that AIFs make a major economic contribution to India. In order to build a strong and dynamic investment ecosystem in India, prompt action on these fronts would be essential.

The establishment of a panel of experts entrusted with investigating tax and regulatory reforms targeted at improving the allure of venture capital (VC) and private equity (PE) investments in India was announced by the Hon'ble Finance Minister in the Budget 2022. In December 2022, this committee, headed by former SEBI director M. Damodaran, sent the government its conclusions. Giving "zero-rated or export status" to Alternative Investment Funds (AIFs) domiciled in India that work with overseas investors is one of the report's key suggestions.

The primary goal of the proposal is to classify fund management services under Section 147 of the Central Goods and Services Tax (CGST) Act, 2017, as considered exports.⁶⁸ If these services were classified as exports, even if they were rendered in India, it would be especially unfair to fund managers who serve AIFs that receive foreign investments. There is now a discrepancy for domestic AIFs managed by Indian asset managers, who pay a comparatively high GST rate of 18% on management fees, as PE/VC funds operating in offshore jurisdictions enjoy GST exemptions. This tax burden, even in cases when capital contributors are situated globally and qualify for export incentives, adds to an inefficient framework that hinders the onshoring of money. The current tax regime in India presents formidable obstacles to the development of a competitive and appealing onshore fund management sector. In order to strengthen the Indian investment ecosystem, this structure needs to be reevaluated. Prioritising the treatment of fund management services as "deemed exports" under the GST law and designating them as "zero-rated" for contributions from foreign investors is something the government must do. This tactical step would promote the establishment of high-value job opportunities domestically by facilitating the onshoring of funds and fund managers. Furthermore, it might increase

⁶⁸ Central Goods and Services Tax Act 2017, s. 147

local taxes on related services like banking, consulting, and due diligence, which would increase tax collections.⁶⁹

In addition, the Indian government ought to consider granting GST exemptions to foreign investors doing business with AIFs registered in India outside of the GIFT City. Through the provision of incentives and the attraction of foreign capital to anchor funds in India, this strategy will facilitate the growth of the local investment environment. The liquidity picture is made more difficult by the persistent problems with Non-Performing Assets (NPAs) in the Indian financial system. Nowadays, security receipts, which are illiquid, are created from the remaining fifteen percent of the sold non-performing assets (NPAs). NPAs cause instability in capital markets' liquidity by acting like a virus.⁷⁰

The findings of the Sunil Mehta Committee, which were summed up in "Project Sashakt," called for a system with three stages that would act as a comprehensive plan for resolving the NPA crisis. ⁷¹It would consist of a new Asset Management Company (AMC), an Asset Reconstruction Company (ARC), and an alternative investment fund. ⁷² India does not currently have a structured securitisation industry that would allow bad banks to effectively sell their non-performing assets. An active auction system for asset disposal can improve liquidity and guarantee fair pricing in distressed asset transactions. A system like this would reduce some of the pressures brought on by the financial system's illiquidity, speed up the sale process, and make it easier to determine fair market prices.

Despite the potential to greatly improve India's investment climate, each observation is vital in the context of Budget 2024. Investment is encouraged by a more efficient financial ecosystem since it makes the market more open and easier for stakeholders to interact

⁶⁹HM Revenue & Customs, 'UK Carried Interest and Capital Gains Tax' (*Gov.uk*, 30 October 2024) <<https://www.gov.uk/government/publications/carried-interest-and-capital-gains-tax>> accessed 8 August 2024.

⁷⁰ Miheer Jain and Uddeshya Goel, 'Analysis of Bad Banks As An Alternative Tool of Recovery' (Taxmann, 2021) accessed 27 July, 2024.

⁷¹bankingfinance, 'Project Sashakt' (*bankingfinance*, 10 October 2018) <<https://www.bankingfinance.in/project-sashakt-2.html>> accessed 3 February 2025

⁷² Press Information Bureau, 'Frequently Asked Questions Regarding Central Government Guarantee to Back Security Receipts Issued by National Asset Reconstruction Company Limited for Acquiring of Stressed Loan Assets' (16 September 2021) <<https://pib.gov.in/PressReleasePage.aspx?PRID=1755466>> accessed 28 July 2024

with. A further essential consideration is that strengthening the regulatory framework for AIFs is vital since both investor protection and market integrity depend on a strong regulatory environment. The government responds to worries about possible market abuses and inefficiency by improving SEBI regulations. This improved environment encourages investor trust, drawing in both local and foreign capital and guaranteeing a steady investment environment that supports expansion. This strategy should help AIFs that rely on foreign investments by boosting liquidity in home markets. In addition to promoting innovation and infrastructure development, the flood of FDI can also boost economic growth and sustainability.

Therefore, taken as a whole, the observations made in Budget 2024 represent an all-encompassing strategy by the Indian government to improve the investment ecosystem. The administration is creating a strong basis for long-term economic growth by tackling important issues, including digitisation, infrastructure, support for entrepreneurs, sustainability, regulation, and foreign direct investment. Together, these projects have a positive impact that can draw in a wide spectrum of investors, boost market confidence, and promote long-term economic growth.

CONCLUSION

Alternative Investment Funds (AIFs) are essential sources of financing for investee firms in India and have a substantial impact on the liquidity of the Indian economy as a whole. Regulatory bodies in India have been gradually increasing the number of investors and the investment horizon for AIFs as a way of recognising their significance. Proactive steps taken to address the many obstacles that AIFs have faced along the road show that stakeholders have realised these funds can improve liquidity in the Indian market. Nonetheless, there are still a few gaps in the regulatory framework that must be filled in order to properly take advantage of the benefits that AIFs offer.

Considering AIFs are still a relatively new idea and not all market players in India are aware of them, there is some governmental and regulatory agencies' scepticism about the potential benefits and success of these funds. As this article has already covered, ensuring and improving liquidity will be very difficult in the near future. It is relevant to state that

AIFs will probably have a significant effect on increasing liquidity in the Indian market, but the final result will mostly depend on concentrated efforts meant to get past current roadblocks and improve regulatory frameworks.

Although the Indian government has done a commendable job of creating a climate that is conducive to investment, there are still important requests from businesses that need an immediate response. The proposals to designate AIFs as "zero-rated or export statuses," exclude Goods and Services Tax (GST) on carried interest, and confer Category III AIFs pass-through status are crucial among them. By attending to these essential demands, we may be able to unleash tremendous potential for increasing investment inflows and act as a powerful catalyst for the expansion and sustainability of the AIF ecosystem. The government would add to the general strength and vibrancy of the nation's financial situation by putting these reforms into effect, which would also increase India's appeal as a capital target.