news flash

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Alternative Investment Funds

The Securities and Exchange Board of India ("**SEBI**") has notified the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") on 21 May, 2012, thus bringing various funds investing in Indian securities under a unified regulatory umbrella.

Intent

SEBI had earlier framed the SEBI (Venture Capital Funds) Regulations, 1996 ("**VCF Regulations**") to encourage investments into start-ups and mid-size companies. Since the introduction of the VCF Regulations, it was observed that the venture capital route was being used by several other categories of funds such as private equity funds, real estate funds etc. Further since registration as a venture capital fund ("**VCF**") was not mandatory under the VCF Regulations, not all private equity or other categories of funds were registering with the SEBI. While these funds did not enjoy certain exemptions that were available to VCFs, they were not subjected to any investment restrictions either.

Currently, while retail investors such as mutual funds and collective investment schemes are well regulated, SEBI noted the need for comprehensive regulations to deal with investments that are sourced from diverse parts of the private pool of capital.

The AIF Regulations aim to regulate funds involved in the pooling or raising of private capital from institutional investors or high net worth investors ("**HNI**") with a view to invest such funds in accordance with a defined investment policy for benefit of the investors and the manager of such fund, irrespective of their legal domicile. These regulations provide that an entity, seeking to pool and manage such private pool of capital for investing in securities or acting as an Alternative Investment Fund ("**AIF**"), should be registered with the SEBI under these regulations.

Accordingly, SEBI notified the AIF Regulations to govern unregulated entities and create a level playing ground for existing venture capital investors.

Applicability

AIF Regulations are applicable to all privately pooled investment vehicles (other than mutual funds, collective investment schemes, family trusts, ESOP Trusts, employee welfare trusts, holding companies, funds managed by securitization companies or asset reconstruction companies, other special purpose vehicles not established by fund managers including securitization trusts or any such pool of funds which is directly regulated by any other regulator in India).

The different categories of AIFs based on investment philosophy are as follows:

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(a) Venture Capital Funds: These funds will primarily invest in unlisted securities of start ups, emerging or early stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property rights based activities or a new business model.

(b) Hedge Funds: Hedge Funds will employ diverse or complex trading strategies and invests and trades in securities having diverse risks or complex products, including listed and unlisted derivatives.

(c) Private Equity ("PE") Funds: PE funds will invest primarily in equity or equity linked instruments or partnership interests of investee companies.

(d) Infrastructure Funds: These funds will primarily invest in unlisted securities or partnership interest or listed debt or securitized debt instruments of investee companies or special purpose vehicles engaged in or formed for, the purpose of operating or holding infrastructure projects.

(e) Debt Funds: These funds will primarily make investments in debt or debt securities of listed or unlisted investee companies.

(f) Small and medium enterprises ("SME") Funds: These funds will invest primarily in unlisted securities of investee companies which are SMEs or securities of those SMEs which are listed or proposed to be listed on a SME exchange or SME segment of an exchange.

(g) Social Venture Funds: These funds will invest primarily in securities or units of social ventures and which satisfy social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns.

Categories

AIFs are broadly categorised as follows, for the purposes of its registration with SEBI:

- Category I - Funds which invest in start-up or early stage ventures/ social ventures/ SMEs/ infrastructure/ other sectors or areas which the government or regulators consider as socially or economically desirable and shall include Venture Capital Funds, SME Funds, Social Venture Funds and Infrastructure Funds and such other AIF as may be specified. This category is for those finds which have a positive spill over on the economy and which may be entitled to incentive or concessions from SEBI or other regulators. Such funds formed as a trust or a company will be construed as a '*venture capital company*' or '*venture capital fund*', as specified under Section 10 (23FB) of the Income Tax Act, 1961.

- Category II – This is the residual category and is for those funds which cannot be classified either as Category I or III and which do not undertake leverage or borrowing, other than to meet day to day operational requirements and as permitted under these regulations. This category will include PE Funds or Debt Funds for which no specific incentives or concessions are given by the government or any other regulators.

- Category III - Funds in this category would adopt diverse or complex trading strategies and may employ leverage (including through investment in listed/ unlisted derivatives). This category will include Hedge Funds or funds which trade with a view to make short term returns or such other funds which are open-ended and for which no specific incentives or concessions are given by the government or any other regulators.

AIFs shall seek registration in one of the categories mentioned above and in case of Category I AIF, in one of the subcategories thereof. An AIF which has been granted registration under a particular category cannot change its category subsequent to registration, except with the approval of SEBI.

Other features

- The fund may raise funds from any investor whether Indian, foreign or non-resident Indians by way of issue of units.
- Each scheme of the fund should have a minimum corpus of Rs. 20 crores and each investor should make a minimum investment of Rs. 1 crore. Provided that if the investor is either a director or employee of the fund or an employee or director of the manager of the fund, the minimum investment will be Rs. 25 lakhs.
- No scheme of the fund is permitted to have more than 1000 investors.
- The sponsor/manager of the fund should continue to have a minimum interest of the lower of 2.5% of the corpus or Rs. 5 crore other than through the waiver of his management fees. For category III funds, the sponsor/manager's interest should continue to be the lower of 5% of the corpus or Rs. 10 crores.
- These funds are not permitted to raise funds through the stock exchange mechanism but may be listed on stock exchange, subject to a minimum tradable lot of Rs. 1 crore. Listing of AIF is permitted only after final close of the fund or the scheme.
- Category I and II funds cannot invest more than 25% of the investible funds in any one investee company whereas category III cannot invest more than 10% of the investible funds in any one investee company. Co-investment in an investee company by a Manager or Sponsor shall not be on terms more favourable than those offered to the AIF.
- AIFs will have Qualified Institutional Buyer ("**QIB**") status as per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.
- While a Category III AIF may be either close-ended or open-ended, the other two categories of AIFs will have to be close-ended funds with a minimum tenure of 3 years. Tenure for the close-ended funds can be extended for a maximum tenure of up to 2 years subject to the approval of two-thirds of its unit holders by value.

Existing Funds

Existing VCFs will be permitted to continue and shall be governed by the VCF Regulations till such fund or scheme managed by the fund is wound up. VCFs will not be permitted to raise any fresh funds after notification of these regulations, as aforesaid, except for commitments already made by investors as on the date of the notification. These VCFs may seek re-registration under AIF Regulations, subject to approval of two-thirds of their investors by value.

Existing funds (falling within the definition of an AIF) not registered with SEBI may continue to operate for 6 months from the date of commencement of the AIF Regulations or if it has already made an application for registration under these regulations within those 6 months then till the disposal of its application (extendable up to 12 months in special cases with the permission of the Board). These funds will not be allowed to float any new scheme without registration under the AIF Regulations. Schemes floated by such funds before coming into force of AIF Regulations, shall only be allowed to continue till maturity. Further existing funds that are currently not registered with SEBI but wish to seek registration under the AIF Regulations may apply to SEBI for exemption from the strict compliance with the AIF Regulations if they are not able to comply with all provisions of these regulations.

Conclusion

SEBI appears to have taken into consideration the inputs received from various stakeholders on the concept paper & the draft regulations and has re-classified the categories of the AIFs based on exposure to risk. It remains to be seen whether the AIF regulations with the broad based classification will be effective to meet SEBI's objectives and increase investor protection or only lead to a labyrinth of new compliances, increased costs and uncertainty.

Disclaimer

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