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Regulations for Alternative Investment Funds – A Primer

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ABSTRACT

A strong financial system is considered as engine for economic growth. It facilitates formation of capital and effective allocation of funds. Venture Capital Funds are developed to assist early stage enterprises to encourage entrepreneurs to take up innovative projects. In the process of their development, VCFs have diversified their activities making way for some doubt in the minds of close watchers of the financial system that the VCFs are deviating from the intended objectives. To bring the VCFs on right track and carve out separate provisions for Alternative Investment Funds, SEBI has issued regulations. This paper gives a glimpse of important components of those regulations.

KEYWORDS: Financial System, VCF, AIF, Hedge Fund, Social Venture Fund

Regulations for Alternative Investment Funds – A Primer

Venture capital funds and mutual funds are a couple of financial institutions which play a major role in formation of capital and systematic channelization of funds. There are number of Developmental Financial Institutions (DFIs) which have done commendable work in industrial development in India. But they have been hesitant of extending funding assistance to the risky projects when particularly undertaken by new breed of entrepreneurs. Innovative projects deprived of funding assistance on account of traditional approach of DFIs. Realising the significance of innovative projects, various financial institutions designed new schemes like seed capital, risk capital, etc. These efforts were also inadequate to meet the demands of the risky projects. The challenging ventures just do not need an outsider's support but many a times necessitates partnering with new entrepreneurs. In the wake of these issues, Comptroller of Capital Issues (CCI) issued guidelines in November 1988 for development of venture capital funds. During the meantime, a number of investment avenues emerged in the financial system to meet the ends of both investors and entrepreneurs/enterprises. Securities and Exchange Board of India (SEBI) has been empowered with statutory powers in 1992 under the SEBI Act to develop and regulate market.

SEBI has been striving hard since its inception for the development and regulation of efficient and transparent capital market. It has issued well thought out regulations for mutual funds, collective investment schemes, venture capital funds (VCFs), portfolio managers, etc. Though there are regulations to regulate VCFs, they are not comprehensive in the light of increased activities of VCFs. Hence, SEBI has come out with comprehensive regulations to streamline the VCF activities and carve out separate set of funds called Alternative Investment Funds (AIF). This paper makes an attempt to throw light on the concept of AIF and a few important aspects of SEBI (Alternative Investment Funds) Regulations, 2012.

Reasons for Regulations

SEBI has identified the following reasons on the basis of working of VCFs in India, intended objectives, and world experience.

1. VCFs have gradually diversified their activities bypassing intended objectives. As a result of this, original aim of promoting early stage companies has been defeated.
2. The deviations have also resulted in directing the sops to non-intended spheres depriving the deserved entrepreneurs/enterprises.
3. SEBI believes that VCFs are being used as an omnibus investment fund which leaves most of the private investment funds dissatisfied.
4. Registration of VCFs is not mandatory under the prevailing VCF regulations.
5. A few of the funds like Private Equity (PE) and Private Investment in Public Equity (PIPE) require some concessions which are not appropriate to VCFs.
6. There is a need to recognize AIFs as distinct asset class apart from promoter holdings, creditors and public investors.

In the backdrop of the above reasons, SEBI has issued (on August 1, 2011) a Concept Paper comprising justification for promulgation of new regulations and its key components for public comments. After considering the public comments, SEBI has issued and published regulations on May 21, 2012 in the Gazette of India.

Alternative Investment Fund

Alternative Investment Fund means any fund established or incorporated in India in the form of trust or a company or a limited liability partnership or a body corporate which,

(i) is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and

(ii) is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.

Types of AIFs

There are different kinds of AIFs based on their primary investment objectives. They are as follows:

1. Debt Fund makes investment in debt or debt securities listed or unlisted investee companies.

2. Hedge Fund employs diverse or complex trading strategies and invests and trades in securities having diverse risks or complex products including listed and unlisted derivatives.

3. Infrastructure Fund invests 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, developing or holding infrastructure projects.

4. Private Equity (PE) fund makes investment in equity or equity linked instruments (i.e., instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity) or partnership interests of investee companies.

5. SME Fund invests in unlisted securities of investee companies which are SMEs (as defined under the Micro, Small and Medium Enterprises Development Act, 2006) or securities of those SMEs which are listed or proposed to be listed on a SME exchange or SME segment of an exchange.

6. Social Venture Fund makes investment in securities or units of social ventures (i.e., a trust, society or company or venture capital undertaking or limited liability partnership formed with the purpose of promoting social welfare or solving problems or providing social benefits including public charitable trusts registered with Charity Commissioner, societies registered for charitable purposes or for promotion of science, literature, or fine arts, company registered under Section 25 of the Companies Act, 1956, and micro

finance institutions) and which satisfies social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns.

7. Venture Capital Fund invests in unlisted securities of start-ups, emerging or early-stage venture capital undertakings (non-listed domestic company engaged in the business of providing services, production or manufacture of article or things) mainly involved in new products, new services, technology or intellectual property right based activities or a new business model.

Registration of AIFs

The registration is mandatory for all varieties of AIFs under SEBI (Alternative Investment Funds) Regulations, 2012. Existing funds shall get the registration within six months from the date of commencement of these regulations. Further, the registration is compulsory for each fund. It means that it is not an umbrella registration. However, existing funds registered under SEBI (Venture Capital Funds) Regulations, 1996 shall continue until completion of tenure of the existing fund/scheme. But, they are not allowed to launch new schemes.

SEBI has classified AIFs into three categories for registration. AIFs shall seek registration under any of the specified categories. Category I AIF shall include Venture Capital Fund, SME Fund, Social Venture Fund, Infrastructure Fund and any other funds specified from time to time. Category II AIF does not fall in Category I and Category III. It does not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in these regulations. Private Equity funds and Debt funds which are not getting any concessions or incentives either from the government or any other regulator shall get registration under this category. Category III AIF like Hedge Fund which employs diverse or complex trading strategies and employs leverage including through investment in listed or unlisted derivatives.

Eligibility Criteria

The following important aspects, among others, are taken into account by SEBI for the purpose of considering an entity for registration:

1. There should be permission from the Memorandum of Association in case of a Company; the Trust Deed in case of a Trust; the Partnership Deed in case of a Limited Liability Partnership (LLP) to carry on the activity of an AIF.

2. The applicant is prohibited by its Memorandum and Articles of Association, Trust Deed or Partnership Deed from making an invitation to the public to subscribe to its securities.

3. The applicant should have been registered under the applicable laws to it.

4. The Applicant, Sponsor and Manager are fit and proper persons based on the criteria specified in Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008.

5. The key investment team of the Manager of AIF has adequate experience, with at least one key personnel having not less than five years experience in advising or managing pools of capital or in fund or asset or wealth or portfolio management or in the business of buying, selling and dealing of securities or other financial assets and has relevant professional qualification.

6. The Manager or Sponsor has the necessary infrastructure and manpower to effectively discharge its activities.

7. The applicant has clearly described, at the time of registration, the investment objective, the targeted investors, proposed corpus, investment style or strategy and proposed tenure of the fund or scheme.

Investment in AIF

Investment in all categories of AIFs shall be subject to the following conditions:

1. The AIF may raise funds from any investor – Indian, foreign or Non-Resident Indians (NRI) – by way of issue of units.

2. Each scheme of the AIF shall have corpus of at least twenty crore rupees.

3. The AIF shall not accept an investment of less than one crore rupees from an investor. However, this minimum investment is reduced to Rs. 25,00,000 to the investors who are employees or directors of the AIF or employees or directors of the Manager.

4. The Manager or Sponsor shall have a continuing interest to the extent not less than two and half percent of the corpus or five crore rupees (whichever is lower) in the form of investment in the AIF. However, this criteria is extended to the extent not less than five percent of the corpus or ten crore rupees (whichever is lower) in case of Category-III AIFs. This information shall be disclosed to the investors in AIF.

5. No scheme of the AIF shall have more than one thousand investors. The AIF should mobilize funds by way of only private placement.

Tenure and Listing

Category I and II AIFs shall be close ended. The fund or scheme shall have a minimum tenure of three years. Category III AIFs may be open-ended or close-ended. Tenure of Close-ended funds under this category is not clear. Extension of tenure of close-ended funds may be permitted to two years subject to approval of two-thirds of unit-holders by value of their investment in AIF. Otherwise, the AIF shall liquidate within one year from the date of expiration or extended time horizon. The close-ended units may be listed, after the close of the fund/scheme, on the stock exchange subject to a minimum tradable lot of one crore rupees.

General Investment conditions

1. Category I and II AIFs shall invest not more than twenty five percent of the corpus in one Investee Company (Investee company means any company, SPV or LLP or body corporate in which AIF makes an investment).

2. Category III AIF shall invest not more than ten percent of the corpus in one investee-company.

3. AIF shall not invest in associates except with the approval of seventy five percent of investors by value of their investment in the AIF.

4. Un-invested portion of the corpus may be invested in liquid funds or bank deposits or other liquid assets of high quality like Treasury Bills, Commercial Papers (CPs), Certificate of Deposits (CDs), etc till the deployment of funds as per the investment objective.

Conclusion

In view of global experience and ongoing development in the world capital market, every possible effort to stabilize the financial system is a welcome move. Regulatory supervision and stringent accountability norms for AIFs are useful to the investors even though they are highly knowledgeable. It is a proactive approach in Indian context. Prevention is always better than cure.

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