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New Indian alternative investment rules compel closure of unregulated structures, say lawyers

May 29 2012 Ajay Shamdasani in Hong Kong

India's proposed new alternative investment fund (AIF) rules will force the closure of previously used but unregulated legal structures, said several Indian lawyers. Their comments came after the country's capital markets regulator announced draft rules requiring AIFs to register with it.

Murali Neelakantan, a partner with law firm Khaitan & Co. in Mumbai, told Thomson Reuters the new rules had implications for compliance and legal personnel at firms using certain investment vehicles. "The new regulations mean compliance officers and in-house counsel that have established or otherwise used, either for themselves or their clients, investment pools using unregulated trusts and investment companies will need to shut them down or register them," he said.

Last week, the Securities Exchange Board of India (SEBI) announced theSEBI (Alternative Investment Funds) Regulations (2012). They followed its issuance in August 2011 of a concept paper on comprehensive regulation for alternative investment funds. The proposal to create a separate regime was approved by SEBI at its board meeting last month. The new regulations affect venture capital, private equity and other investment firms by introducing a registration requirement with SEBI.

Under the draft regulations, registered funds will be subject to comprehensive disclosure requirements including with respect to their investment strategy, risk management tools and disciplinary history.

There currently exist three categories of registration, depending on the nature of a fund and the risk to investors — based on leverage and trading strategy complexity. Limitations also exist on the manner in which the AIFs are operated. AIFs are defined quite broadly in regulations to mean any "fund established or incorporated in India" which 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". Several investment funds such as mutual funds, collective investment schemes, family trusts and employee stock option plans are explicitly excluded.

From a compliance and legal perspective, the rules mark a shift from a lightly to a more heavily regulated alternative investment sector, said Siddharth Shah, a partner with international law firm Nishith Desai Associates in Mumbai.

"The internal compliance and administrative cost and [manpower] burden of compliance officers will rise under the [new] regulations," he said. "Compliance officers will be more responsible than under current regulations, which merely require them to file quarterly reports with SEBI."

Shah said current duties for AIF compliance officers were more based on what their fund's documents said than any statutory obligations.

The new regulations prescribe certain obligations on financial institutions for reporting and governance standards, Shah said. "This will affect quarterly reports and annual reports, valuation disclosures and related party transactions," he said.

Specifically, the AIF regulations state that some funds shall provide reports containing financial information of the investee companies and material risks regarding their management to their investors on an annual basis, said Shardul Shroff, managing partner of law firm Amarchand, Mangaldas & Shroff in New Delhi.

Other funds provide similar reports to investors on a quarterly basis.

"Compliance officers and in-house counsels of a financial institution which intends to raise capital in different categories under the AIF Regulations need to be cautious of this," Shroff said.

Mandatory registration

Umakanth Varottil, an assistant professor of law at the National University of Singapore (NUS), said the new regulations were relevant for financial institutions keen on establishing investment funds. "They will now almost necessarily have to register with SEBI if such funds are to be established in India," he said. He added that the various restrictions on the operation of such funds depended on their nature.

For example, hedge funds and similar capital pools would be subject to greater restrictions if they executed complex strategies and took on leverage. Other 'plain vanilla' funds may be subject to less stringent regulation, he said.

"The regulatory regime for alternative investment vehicles and private pools of capital in India has altered from being one that is voluntary in nature to a more mandatory one," Varottil said.

In future, every privately pooled investment vehicle not covered by any other SEBI regulation will have to compulsorily register under the AIF regulations.

"Compliance officers and in-house counsel will have to be careful of where the fund's investment is headed," said Chanda Sheemar, a senior associate with law firm Lex Counsel in New Delhi. Once registered, the fund will be bound by the conditions stated in SEBI's AIF regulations, she said. "AIFs are currently granted approval under different categories … based on the destination of their investment and transitioning between different categories is not permitted without SEBI's approval."

But Saionton Basu, head of the India practice group at Penningtons Solicitors in London, said that while unregulated funds must register with the SEBI, the proposed rules were not overly prescriptive and took a mature regulatory approach.

Timing

NUS' Varottil said that given the securities regulator's white paper last year, alternative investment regulations had been on SEBI's agenda for some time. "The new regulations are the culmination of SEBI's efforts to regulate private pools of capital. Previously, only capital raised publicly by funds such as mutual funds and collective investment schemes were regulated by SEBI," he said.

He said the current proposal by SEBI aimed to bring private pools of capital such as private equity funds and hedge funds under the purview of SEBI.

Private pools are not subject to mandatory regulation. Varottil said only venture capital funds are regulated, albeit on a non-mandatory basis and only if a fund seeks to register itself with SEBI for various tax benefits. "These became available upon submission to SEBI's regulatory authority," he added.

SEBI is also planning to ask the central government to extend the tax "pass through" status to AIFs and not just to venture capital funds, said Pennington's Basu, adding that this was discussed in a March budget proposal.

Khaitan's Neelakantan said that the regulations were also aimed at countering the perception the SEBI was lax on regulating collective investment schemes and other investment pools.

"The existing collective investment scheme regulations were meant to regulate ‘plantation schemes' and there was no prohibition on unregulated investment pools irrespective of the nature of the entity," he said. He added that the categorisation of funds on the basis of government incentives was extremely difficult to understand. "These incentives have been known to change over time which makes the categorisation very uncertain," he said.

Amarchand's Shroff said SEBI was trying to make fund managers deal with investors more transparently. "It is likely that a lot of this information is any how provided pursuant to contractual obligations between the parties, but now there is greater clarity on this," he said.

The regulator seemed to be following global best practices to address financial difficulties faced by international markets, as well as to limit systemic risks, said Lex Counsel's Sheemar.

"The SEBI regulations seek to regulate erstwhile unregulated funds such as private equity, real estate, private investment in public equity, and ensure a level playing field for registered and unregistered funds," she said.

SEBI did not return calls for comment.

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