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The Securities And Exchange Board Of India's Proposals For A Comprehensive Regulatory Regime For Alternative Investment Funds

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The Securities and Exchange Board of India ("SEBI") on August 1, 2011, issued the Concept Paper along with the draft SEBI (Alternative Investment Funds) Regulations, 2011 ("Draft Regulations"), which seek to introduce a comprehensive regulatory framework for regulating private pools of capital, *i.e.*, Alternative Investment Funds ("AIFs"). The Draft Regulations were open for public comments until August 30, 2011.

Currently, SEBI regulates Mutual Funds, Collective Investment Schemes ("CISs"), Venture Capital Funds ("VCFs") and Portfolio Managers ("PMs"). Aside from Mutual Funds and CISs, which are more retail in nature, the only option available to an investment manager for managing a private pool of funds in a regulated environment is to set up a VCF or a portfolio management scheme. Given that VCFs were intended to encourage financing of early stage companies, these regulations are incompatible for fund managers having an investment strategy to invest in Private Investment in Public Equity ("PIPE"), debt, micro finance, and the like.

In SEBI's view, the wide variation in investment strategies desired by fund managers warranted the move to segregate various AIFs and create specific regimes for each of these strategies within an overarching umbrella regulation governing such private pools and also protecting investor interests.

The Concept Paper also indicates introduction of a separate Investment Advisor regime for all managers/advisors, including managers of AIFs. It is proposed that separate regulations shall be introduced in this regard.

What is SEBI Proposing?

Scope of the Draft Regulations

The Draft Regulations propose to create a regulatory framework which shall regulate:

- all AIFs (irrespective of their legal domicile) in the security market which collect funds from institutional or high net worth investors ("HNIs") in India, or
- managers of AIFs who manage AIFs for investments in India.

The Draft Regulations would subsume the existing SEBI (Venture Capital Fund) Regulations, 1996 ("VCF Regulations"), although existing VCFs would continue to be regulated by the VCF Regulations until the fund/scheme is wound up. However, all fresh pools of capital raised by existing VCFs would be regulated under the new framework. The Draft Regulations also pro-

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pose to regulate PMs who intend to "pool" assets for investments in unlisted securities.

Thus, no AIF can operate in India without registration. Additionally, all pooling vehicles (excluding VCFs which have an operating fund) already operating, including VCFs pending registration, would also have to register under these Draft Regulations within a period of six months from the commencement of the Draft Regulations.

Salient Features

- In addition to trusts and companies, limited liability partnerships ("LLPs") may be used as a pooling vehicle.
- The number of shareholders/partners is restricted to 50 in case an AIF is constituted as a company/LLP. In case of a trust, the Concept Paper indicates that up to 1,000 investors could participate in the concerned AIF.
- Minimum size of the funds: increased to INR200 million (U.S.$4.3 million) with an option for an upward revision of 25 percent.
- Minimum ticket size for investors: 0.1 percent of the fund's size, subject to a minimum amount of INR10 million (U.S.$217,040).
- Tenure of the fund: a minimum of five years, extendable by up to two years upon receiving approval of at least 75 percent of the investors in the fund.
- Sponsor commitment: a minimum of 5 percent of the fund's corpus by way of an actual contribution to the corpus and not through a waiver of management fees, and to be locked in until the last investor in the concerned fund has been given an exit.
- Each fund/scheme shall require a separate registration under the Draft Regulations.
- Investment in any single investee company shall not exceed 25 percent of the corpus of the AIF.
- The manager shall not invest directly in investee companies.
- Unlike the current VCF regime, the Draft Regulations permit AIFs (except Strategy Funds) to invest in certain categories of Non-Banking Financial Companies ("NBFCs"), such as Infrastructure Finance Companies, Asset Finance Companies, Core Investment Companies or companies engaged in microfinance activities.
- Investors are proposed to be locked in for a minimum period of three years.

Categories of AIFs proposed in Draft Regulations

The Draft Regulations seek to make clear distinctions among the various AIFs, with the intent to distinguish the investment criteria and relevant regulatory concessions that may be allowed to them. The following categories of AIFs have been identified:

Venture Capital Funds

Objective

To promote new ventures using technology with innovative business ideas or early or start-up stage companies, primarily through the acquisition of equity seed capital or minority stakes in companies that have not been publicly listed.

Investment Conditions

- Maximum size — INR250 crores (U.S.$54.3 million).
- Shall not invest in a company that is promoted by any of the top 500 listed companies by market capitalization or by their promoters.
- At least 66.66 percent of the investment shall be made in equity shares of unlisted companies.
- Shall not invest more than 33.33 percent of the fund in 1) unlisted debt or debt instruments where equity investment has been made; 2) preferential allotment of equity shares of a listed company subject to a lock-in period of one year; or 3) equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.
- Shall not subscribe to warrants.

Observations

- It is proposed that VCFs may invest by way of equity shares of eligible companies, and the flexibility to use any other "equity linked" instruments has been withdrawn. Such restriction will severely limit structural alternatives.
- The restriction that prevents a VCF from investing in any company promoted by promoters of the top 500 listed companies seems to be without merit.

PIPE Funds

Objective

PIPE Funds shall invest in shares of small sized listed companies which are not part of any market indices in exchanges having nationwide terminals.

Investment Conditions

- Shall invest at least 66.66 percent of the fund's corpus in equity shares of small sized listed companies.
- Shall not invest more than 33.33 percent of the fund in the debt or debt instruments of a company in which the fund has already made an equity investment.

Observations

- The Draft Regulations find a way to enable private equity investors to take informed decisions during PIPE transactions by exempting PIPE funds from SEBI (Insider Trading) Regulations, 1992.

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- It is proposed that PIPE Funds may invest only by way of equity shares of eligible companies, and there is no flexibility to use any other "equity linked" instruments. Such restriction will severely limit structural alternatives.
- SEBI (Prohibition of Insider Trading) Regulations, 1992 require that PIPE Funds do not sell or deal in securities of investee companies for five years to claim immunity. This period seems excessively long and impractical.
- Reference to "small sized" companies creates ambiguity as to whether all non-indices entities will be treated as such or whether there will be other parameters used to define such entities.

Private Equity Funds

Objective

A Private Equity Fund is a fund that may invest in unlisted equity and equity linked instruments of companies which require funding to develop and grow, with the primary focus on matching medium to long term capital of investee companies.

Investment Conditions

- Shall invest at least 50 percent of the fund in unlisted companies.
- Shall not invest more than 50 percent of the fund in companies proposed to be listed.
- Shall not invest more than 50 percent in unlisted debt of a company in which the fund has already made an equity investment.

Observations

- A Private Equity Fund has been restricted to invest only in unlisted companies and unlisted debt. This restriction seems to be in disregard of the fact that a private equity strategy would include investments in listed equities or listed debt.
- It is unclear as to what a "company proposed to be listed" would encompass. Would this relate to a pre-initial public offering ("IPO") investment or participation in an IPO or any other company which may have a plan to list? Suitable clarity in this regard would be required.

Debt Funds

Investment Conditions

- Shall invest at least 60 percent of the fund in unlisted debt, with not more than 25 percent of the fund invested in convertibles with minimum maturity of five years.
- May invest up to 40 percent in securitized debt instruments, debt securities of listed companies and equity shares of an unlisted company in which the fund has already made a debt investment.

Observations

- Investment in listed debt securities of unlisted entities should also be permissible.
- Recognition of this category of fund should facilitate the raising of a meaningful private pool of capital to provide necessary fillip to corporate bond markets in India, thereby achieving the SEBI objective of developing a vibrant debt market in India.

Infrastructure Equity Funds

Investment Conditions

- Shall invest at least 66.67 percent of the fund in equity or equity linked instruments of infrastructure projects/companies.
- May invest up to 33.33 percent in debt instruments of companies in which it has made an equity investment or in securitized debt instruments of an infrastructure company or a special purpose vehicle ("SPV") of an infrastructure project.

Observations

A specialised regime for infrastructure equity funds is a welcome step, as granting required concessions/ incentives to these funds could help encourage the establishment of such funds.

Real Estate Funds

Investment Conditions

- Shall invest at least 75 percent in real estate projects or fully built properties or in their SPVs.
- May invest up to 25 percent in allied sectors of real estate.
- Shall invest at least 66.67 percent in equity or equity linked instruments, and up to 33.33 percent in debt or debt instruments of real estate projects or SPVs engaged in real estate projects.

Observations

- While it appears that Real Estate Funds would be allowed to invest directly in real estate projects, as opposed to only in the holding SPVs for such projects, there seems to be a disconnect with the condition of an investment of at least 66.67 percent in equity or equity linked instruments.
- Flexibility to invest in developed properties could facilitate in some form the Real Estate Investment Trust ("REIT") regime, which has been lingering for a while.

Small and Medium Enterprise Funds

Objective

A Small and Medium Enterprise Fund ("SME Fund") shall invest primarily in the unlisted equity or equity linked instruments of SMEs in manufacturing or services, and also businesses providing infrastructure or other support to SMEs as defined by the Ministry of Small and Medium Enterprises.

Investment Conditions

May invest in equity or equity linked instruments of SME companies which are listed or proposed to be listed in the SME exchange or the SME segment of the Regional Stock Exchange.

Observations

SMEs are the mainstay of the Indian economy. A dedicated fund regime would help finance such entities. Regulatory concessions could be extended to such funds to incentivise the space.

Social Venture Funds

Objective

A Social Venture Fund shall be targeted to investors who are willing to accept muted returns, say 10 percent to 12 percent.

Investment Conditions

Shall invest in social enterprises such as Micro Finance Institutions ("MFIs") which satisfy social performance norms laid down by the fund.

Observations

- Social Venture Funds have been allowed to invest in spaces like micro finance that typically operate under an NBFC model. Under the current laws, a VCF could not effectively invest in such structure. Considering the turmoil faced by MFIs, this is a welcome move.

- This will also encourage other socially relevant investments where there is a growing interest with a philanthropic intent.

Strategy Funds (Residual Category, including Hedge Funds)

Objective

A Strategy Fund may specify any strategy in any class of financial instruments.

Investment Conditions

May invest in derivatives and complex structural products, subject to the requirements of suitability and disclosure to investors.

Observations

- Finally, a structure to facilitate the creation of domestic hedge funds would be welcomed by investors.

- It appears that Strategy Funds could be allowed to have an omnibus strategy. This would allow some flexibility for strategies that do not fit within the ones identified.

Key Proposals and Impact

Sponsor Commitment

The higher level of compulsory sponsor commitment to each concerned AIF makes it onerous for non-institutional sponsors to meet the eligibility criteria, and is in clear contrast to standard international practices, under which such sponsors' commitment would typically be in the range of 1 percent to 2 percent, and that not being mandatory, and allowing for such contribution by way of an adjustment to the management fee. Further, the lock-in on the sponsor's commitment until the end of the AIF's term is not in consonance with distribution waterfall either in India or internationally.

Minimum Commitments from Investors

Considering the higher risk weighting for alternative investments, SEBI's proposal to increase the minimum ticket size for investors to participate in an AIF is a welcome move. However, such increased limit could prove to be a barrier for HNIs from achieving risk diversification through investments in different asset classes. An alternative to this could have been to define the eligible investors who could participate in AIF structures in line with "accredited investors" as recognized in other jurisdictions on the basis of net worth criteria. Further, the ticket size could have been varied across the different strategies.

Offshore Fund Managers

The Draft Regulations seem to propose that managers of offshore fund vehicles that invest in India would need to be registered with SEBI. It is unclear whether such registration would be under the Draft Regulations or the "Investment Advisor" regulations (which are separately proposed). To that extent, these regulations seem to have extra-territorial reach, and the possibility of conflicts with regulations of other jurisdictions seems imminent, and could lead to complexities.

Strategy Specific Registrations

The Draft Regulations propose separate registrations for AIFs adopting different strategies (as have been identified above). The same could create complexities, including from a structural perspective for multi-strategy funds and those that invest across asset classes with no predetermined allocation for each class.

Change of Strategy or Investment Team

Such changes require that AIFs ask their investors to "positively reaffirm" their consent to continue being invested in the concerned fund. This could potentially prove to be extremely onerous, especially for institutionally backed fund managers when there is a churn within investment professionals. Further, the Draft Regulations expect that the key members of the management team devote "substantially all their business time" to each fund. This could prove difficult to satisfy, especially in the case of institutionally backed management teams, which comprise a significant portion of the domestic alternative funds industry.

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Unliquidated Investments to be Absorbed by Fund Manager/Sponsor

The Draft Regulations expect that the concerned fund should wind down within the indicated duration and buy out any unliquidated fund assets. This could be counterproductive, as it may pressurize fund managers to make an untimely exit, especially when the AIF is close to winding up. This could severely impact the returns that the fund could make to its investors.

Investment Instruments Available under Strategies

The Draft Regulations seem to indicate that all fund regimes can use equity linked instruments for transaction structuring, while VCFs and PIPE Funds have been restricted to only "equity shares". The same could significantly restrict the flexibility for structuring investments with downside protections like liquidation preference or pre-emptive rights or anti-dilution rights for the AIF.

Concessions/Exemptions

While the regulations have been in many senses made onerous, there does not seem to be commensurate regulatory concessions/relaxations being offered to AIFs. It would be interesting to see whether the government is willing to extend concessions/relaxations to AIFs from a taxation and exchange control perspective, for instance, tax pass-through for AIFs, removal of sectoral restrictions for Foreign Venture Capital Investors ("FVCIs") or participation by Non-Resident Indians ("NRIs") in AIFs.

Transparency and Disclosure Standards

By prescribing ongoing disclosure standards, SEBI has brought about consistency in the information flow to investors by AIFs. Though desirable from an investor protection and good governance perspective, such disclosure standards would increase the administrative burden and costs.

Conclusion

It is truly commendable that SEBI, in proposing the Draft Regulations, has drawn upon international regulatory developments in respect of Alternative Investment Funds with specific reference to governance and investor protection. Also, the motive here seems to be to create segregated strategies under an omnibus regime allowing directed benefits to be offered to each such strategy as against the generalized approach followed so far.

On the positive side, the Draft Regulations would create a conducive platform for alternative investment strategies, thereby increasing the suite of specialized offerings in this asset class for discerning investors.

However, the extent of the regulations proposed may be overwhelming for the industry, considering its yet maturing phase.

The text of SEBI's concept paper and draft regulations can be accessed on its website at http://www.sebi.gov.in/cms/sebi_data/commondocs/alternativeinvestment_p.pdf.

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