

Funds Hotline

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ALTERNATIVE INVESTMENT FUNDS: SEBI SCORES HALF CENTURY ON DEBUT

Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") have breezed through one full year since its notification on May 21, 2012. The AIF Regulations were introduced after considerable interaction by the Securities and Exchange Board of India ("**SEBI**") with various stakeholders in the fund industry since the move was to completely overhaul the then existing regulatory framework for the onshore fund industry, being the SEBI (Venture Capital Funds) Regulations, 1996 ("**VCF Regulations**"). Further, considering that the Indian private equity / venture capital fund industry had started evolving over the last decade, a need was felt by SEBI to formulate an all-encompassing regulation which would bring within its ambit all pooled structures that were not regulated under the earlier regulations.

In a move to effectively channelize the incentives and imply separate obligations for different types of funds, SEBI identified three categories of Alternative Investment Funds ("**AIF**") under the AIF Regulations wherein SEBI, in a commendable move, also allowed the setting up of onshore hedge funds for the first time, a move that marked the beginning of onshore hedge fund industry in India. In the last one year, the fund managers and the investors have gracefully accepted the AIF Regulations and have shown great interest across all the three categories of AIFs as is apparent from the fact that, till April 22, 2013¹, 47 AIFs, have been registered with SEBI, out of which 13 are registered as Category I AIF, 24 are registered as Category II AIF and 10 are registered as Category III AIF. Further, till April 30, 2013², another 22 AIFs were pending with SEBI for registration. On its first birthday on May 21, 2013, SEBI had already crossed half century mark of granting registrations to more than 50 AIFs.

As mostly is the case with a number of legislations in India, certain ambiguities surface only after they are notified or made effective. Based on our experience in setting up number of AIFs in the last one year, we aim to share our experience on the ambiguities faced by the fund managers in setting up of AIFs and structuring of investments into AIFs.

AMBIGUITIES

The following are some of the ambiguities:

1. In majority of the jurisdictions across the world, investment funds are provided 'tax pass-through status' wherein the income of the investment fund is taxed directly in the hands of its investors, and not at the level of the fund itself. This provides fiscal neutrality to the funds as it eliminates taxation at the fund level by shifting it at the investor level. However, under the Indian regime, apart from Category I AIFs (being venture capital funds), no tax pass through has been provided to other Category I AIFs, Category II AIFs and Category III AIFs. Further, since specific tax pass through is not available at the fund level for these AIFs, issues may arise for the investors to bear additional taxes / get a tax credit for the taxes paid by AIFs in a situation where the investors are either tax exempt or are subject to lower rate of tax as compared to the rate of tax paid by AIF.
2. Despite the fact that the Consolidated FDI Policy (Circular 1 of 2013), that became effective from April 5, 2013 ("**FDI Policy**"), was issued much after the notification of the AIF Regulations, the FDI Policy yet has made no reference to foreign investments in the AIFs. This has resulted in ambiguity with respect to whether foreign investment in AIFs is permitted or not since as per the FDI Policy any foreign investment in trusts, other than Venture Capital Fund ("**VCF**") registered under the VCF Regulations, is not permitted. Further, the AIF Regulations allow for an AIF to be setup as a limited liability partnership ("**LLP**"); however, the FDI Policy has not yet allowed downstream investments by LLPs having foreign investments, thereby effectively ruling out the flexibility of raising foreign monies, with AIFs setup as LLP, as allowed under the AIF Regulations.
3. Under Regulation 2(1)(b) of the AIF Regulations, the term 'Alternative Investment Fund' is defined to mean a pooling vehicle created for investing in accordance with a defined investment policy for the benefit of its investors. While certain pooling vehicles like family trusts, employee welfare trusts, holding companies, etc. are excluded from the definition of 'AIF' (and thus fall outside the ambit of the AIF Regulations), there is no exemption available to investment vehicles set up for investments by entities belonging to the same group. This exposes the private structures floated by a group to the risk of categorization as an AIF since such structures may not be regulated under any specified regulatory framework and the investments in such structures are made by entities within the same group and not by third party investors. Similar concerns also arise for special purpose vehicles not regulated under any specific regulatory framework into which more than one investor invests especially in infrastructure space and which proposes to further invest into downstream companies which may not necessarily be subsidiaries of the special purpose vehicles.
4. The term 'Sponsor' is defined under the AIF Regulations to mean any person or persons who set up the AIF. This definition creates an ambiguity in a situation where the AIF is setup as a trust. If SEBI takes a view that the

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sponsor should also be the settlor of AIF, it could create lot of concerns for foreign sponsors since even for setting up an AIF, FIPB approval will be required which could significantly delay the fund raising process. The intent behind introducing the concept of 'Sponsor' under the AIF Regulations was to give comfort to the investors about the credibility of the people behind the AIF and not for casting an obligation on the Sponsor to set up the trust which is more of an administrative issue.

5. The term 'corpus' as defined under the AIF Regulations means the total amount of funds committed by investors to the AIF. As per Regulation 10(d) of the AIF Regulations, the manager or sponsor of an AIF is required to have a continuing interest in such AIF in the form of minimum capital commitment. Since the quantum of funds committed by investors doesn't reduce even at the stage of the AIF divesting its interest and returning capital and profits to the investors, the plain reading of the language leads to an interpretation that the manager or sponsor may be required to maintain the continuing interest in the AIF until such time that all the monies of the fund are paid out to the investors. Such an ambiguity is detrimental to the sponsor as opposed to the fair position of requiring the sponsor or the manager to maintain its sponsor commitment pro rata to the outstanding capital of the investors in the fund so as to maintain his / its skin in the game for the comfort of the investors.
6. The AIF Regulations require that a Category I AIF should invest at least 'two third of the corpus of the fund' in unlisted equity shares or equity linked instruments of a venture capital undertaking or in companies listed or proposed to be listed on a Small and Medium Enterprises ("SME") exchange or SME segment of an exchange; and not more than 'one-third of the corpus of the fund' in, inter alia, initial public offerings, debt or debt instruments, preferential allotments and equity linked instruments of financially weak companies. The phrases 'two third of corpus' and 'one third of corpus', makes it onerous for the AIFs, as they fail to factor in the expenditure required to be made for administration and management of the AIF which leads to a decrease in the available corpus for the AIF to invest. The above issue can be resolved if the aforesaid restrictions are linked to 'investible funds' (which term has been defined under the AIF Regulations but surprisingly not used anywhere in the AIF Regulations) which is defined to mean the corpus of the AIF net of estimated expenditure for administration and management of the AIF.
7. Category III AIFs are permitted to engage in leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit, as may be specified by SEBI. Also, it is provided that Category III AIFs shall be regulated through issuance of directions regarding areas such as operational standards, conduct of business rules, prudential requirements, restrictions on redemption and conflict of interest, as may be specified by the SEBI. Such maximum limit for leverage and other directions are yet to be officially prescribed by SEBI and the industry participants are eager to determine their future working path. Recent news report suggest that, before granting registrations to such Category III AIFs, SEBI has sought an undertaking that Category III AIFs cannot deal in currency as well as commodity derivatives and has also imposed the restriction that they can leverage only up to one-time the corpus. The fund industry awaits such guidelines from SEBI which provide adequate formula for calculation of the leverage that a Category III AIF can undertake at a given point of time and also provide an adequate reporting mechanism for such AIFs such that the leverage can be measured, tracked and reported in a manner that protects investor interests, prevents systemic risk, presents an accurate representation of the portfolio's risks and does not burden either fund managers or SEBI.

CONCLUSION

With AIF Regulations completing one year and SEBI hitting a half century of AIF registrations, it would be helpful if SEBI can make available FAQs on AIF Regulations covering issues that it has dealt with while granting approval to various categories of AIFs or amend the AIF Regulations, as required. This will bring the much needed certainty on some of the above issues which the fund managers are grappling with and will also help the Indian alternative funds industry mature to the next level.

- Mukul Aggarwal, Sahil Shah, Sambhav Ranka and Nishchal Joshipura
You can direct your queries or comments to the authors

¹ http://www.sebi.gov.in/cms/sebi_data/attachdocs/1366614548493.pdf
² http://www.sebi.gov.in/cms/sebi_data/attachdocs/1366614548493.pdf

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