

Funds Hotline

October 03, 2013

SEBI UPDATES AIF REGULATIONS: ANGEL FUNDS NOTIFIED

- Notify the framework for setting up Angel Funds.
- Cut lead time for fund managers for seeking commitments.
- Linking the investment allocation for different categories of AIFs to their 'investible funds' (previously the linkage was to the 'corpus' of the fund).
- Now permit a lower threshold (of Rs. 2.5 million) in case a Social Venture Fund accepts grants (as opposed to the prescribed minimum ticket size of Rs. 10 million for capital commitments).

The Indian securities regulator, Securities and Exchange Board of India ("SEBI") recently notified the first amendment to the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") ("**AIF Amendments**"). The AIF Regulations regulate all forms of vehicles set up in India for pooling of funds from investors, Indian or foreign, on a private placement basis. The amendments provide certain operational flexibility to fund managers, remove certain ambiguities in investment allocations and formalize the framework for setting up of Angel Funds.

AMENDMENTS

(1) *Permission to market a fund prior to registration with SEBI*

The amendments now provide that subject to certain eligibility criteria being met, SEBI may grant in-principle approval to applicant funds even if draft constituent documents (for example, the trust deed in case of trust applicants) have been submitted. On the basis of the 'in-principle' approval, the fund manager is now permitted to seek commitments for a period of 6 months, post which, duly executed constituent documents need to be submitted.

While the fund needs to obtain formal registration with SEBI in order to issue calls and accept contributions, the amendments are a welcome move as it cuts the lead time for fund managers for seeking commitments. Further, based on marketing efforts, the manager can now fine tune the product offering description in the constituent document at the time of approaching the regulator.

(2) *'Investible Funds' instead of 'Corpus' to be used as the benchmark*

The AIF Regulations have defined several categories of funds with the intent to distinguish the investment criteria and relevant regulatory concessions that may be allowed to them. The regulations also provide floor and cap of investment allocations as prescribed proportions of the 'corpus' of the concerned fund, *i.e.* the fund's committed capital. This linkage to a fund's 'corpus' led to an anomaly.

Illustration: There is a requirement that a venture capital fund (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 (VCU) and not more than 'one-third of the corpus' of the fund' in initial public offerings of VCUs.

Issue: Considering that the above fund has a corpus of Rs. 3 billion with an expense allocation of Rs. 300 million during the term of the fund. Then under the AIF Regulations, in the situation highlighted in the illustration above, the fund has to mandatorily invest at least Rs. 2 billion (*i.e.* two third of the fund corpus) into unlisted equity shares or equity linked instruments of a VCU. Whereas, despite the permissible allocation of up to Rs. 1 billion (*i.e.* one third of the fund corpus), the fund would only be able to invest Rs. 700 million (*i.e.* Rs. 1 billion minus Rs. 300 million) into listed opportunities.

The above issue has been resolved by linking the calculation of the investment limits to the term 'investible funds' (*i.e.* corpus of the AIF net of estimated expenses). Hence, it now means that fund would only be required to invest Rs. 1.8 billion (*i.e.* two third of the amount left after factoring the expenditure *i.e.* Rs. 2.7 billion) and Rs. 900 would be available with the fund for investment into listed opportunities as compared to Rs. 700 million that was left earlier.

The above amendment has been reflected across regulation 15 (General Investment Conditions), 16 (Conditions for Category I AIFs) and 17 (Conditions for Category II AIFs) of the AIF Regulations.

(3) *Social Venture Funds raising funds through grants*

Social Venture Funds (a category I AIF with focus on investments into social ventures) are allowed to raise capital by way of grants. The AIF Amendments now prescribes that the minimum ticket size of a grant that a Social Venture Fund can accept, is to be Rs. 2.5 million and no profits or gains of the fund are to be allocated to such grantor. This is a welcome move as it clarifies that while the minimum ticket size for commitment to a fund remains Rs. 10 million (as in case of all categories of AIFs except 'Angel Funds' discussed below), grants can be raised for a smaller amount (*i.e.* Rs. 2.5 million).

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A recommendation from the industry has also been that funds contributed or grants made to Social Venture Funds will be sufficient for corporates to meet the obligation towards Corporate Social Responsibility prescribed under the Companies Act, 2013.

(4) Framework for Angel Funds introduced

The AIF Amendments notified the broad framework for setting up funds focused on investments in start-ups ("**Angel Funds**"). We had previously analyzed (in our hotline titled **Angel Funds: A new product offering on the Alternative Investment funds Platform**) the minutes of SEBI's earlier meeting where the broader contours of the platform were approved. To summarize:

Investor ticket size and corpus of the fund: The minimum ticket size for investors has been kept at Rs. 2.5 million (approx. USD 41,667) as against Rs. 10 million (approx. USD 166,667) for other AIF categories. The committed capital has to be drawn down within 3 years.

Investor qualification: Individual angel investors are required to have an experience of at least 10 years for early stage investments / as serial entrepreneur / as a senior management professional and also have net tangible assets of at least Rs. 20 million (approx. USD 333,333).

Continuing Interest: The level of sponsor commitment as 'continuing interest' should be the lower of 2.5% of fund's corpus or Rs. 5 million (approx. USD 83,333).

Investee companies: Conditions have been imposed that to be eligible to receive 'angel funding', the investee company has to be within 3 years of its incorporation, not listed on the floor of a stock exchange, have a turnover of less than Rs. 250 million (approx. USD 4,166,667) and not be promoted by or related to an industrial group (with group turnover exceeding Rs. 3 billion (approx. USD 50,000,000)).

Deal ticket size / holding period of investments: The deal ticket size is required to be between Rs. 5 million (approx. USD 83,333) and Rs. 50 million (approx. USD 833,333). Separately, it is required that an investment shall be held for a period of at least 3 years.

Inclusion within the fold of VCF: Angel Funds are included within the fold of VCFs hence, providing the benefit of tax 'pass-through' wherein the income of the investment fund is taxed directly in the hands of its investors, but not at the level of the fund itself.

LP consent: Affirmative approval from all the investors need be obtained by the manager for each opportunity that the fund invests in. Considering the risk profile of angel investments, SEBI seems to be of a view that investor consensus is obtained before each investment. However, this may lead to a deal-by-deal participation structure in case certain investor(s) opt out while the manager and other investors agree to consummate an investment.

ANALYSIS

The clarifications made by SEBI in the AIF Amendments resolve issues that the industry has been facing and accordingly underline SEBI's receptiveness to industry feedback. Recognition of Angel Funds as a distinct assets class is also a commendable move from SEBI and highlights the regulator's confidence that the Indian startup ecosystem is maturing as an asset class.

– **Mukul Aggarwal & Richie Sancheti**
You can direct your queries or comments to the authors

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