Corpsec Hotline

April 05, 2012

ALTERNATE INVESTMENT FUNDS REGIME - ALMOST HERE

The Securities and Exchange Board of India (''**SEBI**'') has approved the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"). A press release of its board meeting held on April 2, 2012 ("**Press Release**"), purported to summarized some of the features of the soon to be released AIF Regulations. Earlier SEBI had on August 1, 2011, issued a concept paper along with the draft AIF Regulations.

The roadmap for the Indian fund industry laid out by the AIF Regulations has a clear departure from the existing regulatory platform. Though it may appear to be overwhelming for the industry, it is commendable that several aspects, on which the industry has been lobbying, seem to have been addressed. While the final set of regulations are still awaited, this hotline summarizes the features of the AIF Regulations as indicated in the Press Release and also highlight few issues that existing funds at different stages of their life cycle may face owing to the regime rollover. Needless to say, the devil lies in the details and we would study the AIF Regulations once notified by SEBI and shall provide a more in-depth analysis through a follow on update, but at the same time the press release provides some degree of details on what we could expect to see in the AIF Regulations which is summarized herein.

SEBI'S PROPOSAL

Categorisation of funds. Adhering to fundamental objective of effectively channelize incentives, the Press Release indicates that the AIF Regulations shall identify 3 categories of AIFs (funds). **Category I AIF** encompasses AIFs with a defined investment strategy focusing on Venture Capital Funds, SME Funds, Social Venture Funds and Infrastructure Funds, which in SEBI's view, lead to "… positive spillover effects on the economy". AIFs falling in this category be entitled to certain incentives and concessions. This category shall be refrained from engaging into leverage. **Category II** AIF is intended to encompass AIFs that may not need any focused incentives. These would include private equity funds, debt funds and fund of funds. **Category III AIF** could be used to set up an open-ended onshore hedge fund structure with prescribed levels of leverage. SEBI perceives AIFs encompassed in this category as those that "… exacerbating systemic risk" and may prescribe prudential norms and operational standards to such AIFs.

This is clearly a welcome move. The originally proposed 9 categories of AIFs worried the industry. The 'straight jacketed' approach of forcing the funds to categorize themselves based on their strategy into one of these proposed 9 categories attracted severe push back. The current proposal appear to offer the industry a choice as to depending on the flexibility and incentives that they seek to avail, they could choose whether to go under any of the 3 proposed categories. While the detailed regulations will demonstrate as to whether any sub-categorization has been made within the Categories in terms of investment conditions and restrictions for different strategies or the regulators have left it to the discretion of the sponsor to define their strategy under the Category 2 and Category 3.

Minimum ticket size. Taking cognizance of the industry's call for dropping the percentage criteria to a fixed minimum size of investors' commitment, the Press Release confirms that the AIF Regulations shall seek a minimum contribution of INR 10 million in an AIF. The industry had been clamoring for a smaller ticket size such that it would have allowed an opportunity to provide risk diversification to participating investors, the same does not seem to have been taken up by SEBI.

This proposal is likely to cause challenges for the fund houses which were focused on the retail segment for fund raising. Also, there was an expectation that SEBI could consider a limit to be reduced possibly in line with what they have done in case of portfolio manager which is Rs. 2.5 million or may be Rs. 5 million. However, clearly SEBI appears to have perceived this asset class as relatively riskier and retained the higher limit of Rs. 10 million. Also, the alternate proposal of defining an 'accredited' or a 'sophisticated' investor on the basis of his asset size, net worth or such other parameters and thereafter leaving the amount of contribution by such investor into an AIF at his discretion, also doesn't seem to have found any favor with SEBI. However, it also appears that somewhere the industry had recognized the discomfort of SEBI in reducing the minimum investment size and in a sense, willingly or otherwise, had reconciled to this.

Sponsor commitment. As a relief to non-institutional sponsors, SEBI has reduced the percentage criteria to 2.5% as one of the dual test of minimum sponsor commitment. Accordingly, lower of either 2.5% of the intial corpus or INR 50 million, will have to be brought in as sponsor commitment. Despite the relaxation, the two fundamental departures from industry practice remains – (1) such contribution cannot be made by way of adjustment to management fee; and (2) such contribution is to be a 'continuing interest' in the AIF which seems to indicate that there shall be a lock-in on the sponsor's commitment till the end of the AIF's term and hence not participate in the distribution waterfall. This would lead to a misalignment of sponsor's interest with that of the investors in the AIFs.

Though the industry had represented that the sponsor commitment should be left to be negotiated by the LPs and GPs, if a prescribed amount is insisted by the regulator, this should be in the range of 1 to 2% of the fund size. However, a 2.5% seems to be a compromise that the industry may live with but the added condition of locking in the sponsor commitment till the end of the life of the fund does appear out of the standard international practice. Thankfully, the original proposal of forcing the sponsor to purchase any un-liquidated investments at the end of the life of the fund appears to have been done away with.

IMPACT ON EXISITNG INDUSTRY PARTICIPANTS AND TRANSITION

While a detailed review of the AIF Regulations will provide more clarity, the plain reading of the Press Release appears to deals with several possible situations. Following is a tabulated analysis of the same:

Phase / Situation	Impact
Existing 'scheme' / 'fund' that are post their final close operating under the existing SEBI (Venture Capital Fund) Regulations, 1996 ("VCF Regulations").	Would continue to be regulated by the VCF Regulations until the fund/ scheme is wound up except that no rollover/ extension or raising of any fresh funds shall be allowed.
Existing 'scheme' / 'fund' of a VCF that may not have achieved any closings.	Will be required to re-register as a AIF and raise funds in accordance with the new framework.
Existing 'scheme' / 'fund' of a VCF that may have achieved initial commitments but in the process of raising further commitments closings.	While one reading suggest that the commitments already raised/Contribution received will be governed by the VCF Regulations, and all fresh commitments following AIF Regulations will be governed by new regulations. This clearly could cause absurd situation wherein one could end up with two sets of investors governed by two separate set of regulations. This is not desirable. Alternatively, SEBI should possibly consider that those funds/schemes which have already been launched and have raised commitments, they be allowed to complete their targeted fund raising under the VCF Regulations which should avoid the complexity.
Existing funds not registered under VCF Regulations and may come within the ambit of AIF Regulations (private trusts not otherwise exempted, investment LLPs, discretionary portfolio management schemes, etc.).	Scheme' / 'Fund' floated by such VCFs before coming into force of AIF Regulations, shall be allowed to continue to be governed till maturity by the contractual terms, except that no rollover/ extension or raising of any fresh funds shall be allowed unless registered under the AIF Regulations. Thus, all unregistered structures to the extent they have raised the commitments shall be grand fathered.
New application for setting up a private pool of capital.	Will be considered under the AIF Regulations only unless exempted from such registration.

CONCLUSION

Clearly, jurisdictions globally are engaged in a fight for capital. In such situations, it is imperative that a vibrant onshore fund platform be created that promotes forming domestic pools of capital to sustain the growth. The AIF Regulations reflect a nearly complete overhaul of how the onshore funds platform is to operate. The rewriting of the rules of the game on the positive side should create a conducive platform for alternative investment strategies, thereby increasing the suite of specialized offerings in this asset class for discerning investors. However, any regulations which tend impede and complicate the partnerships between the capital providers and capital managers may put paid to such endeavors of the regulator. This would specially be true as the higher than global standard of sponsor commitment could tend to discourage non-institution fund managers and may limit the industry to a chosen few.

Sleepless Nights?
June 01, 2017

Audio

Seminar: Possible Last Window for the Start-Up Community's Say on Proposed Privacy Law
February 19, 2020

Webinar: India Budget 2020: Implications for the International Community
February 05, 2020

Webinar: A New Dawn for Privacy in India: the Personal Data Protection Bill, 2019
December 17, 2019

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

NDA cCep - Client Continuing Education Program

Big Deal: Experts discuss how Facebook-Jio deal could impact FDI inflows into India (May 01, 2020)

CNBC TV18 Startup Street

– Shashank Singh, Richie Sancheti & Siddharth Shah
You can direct your queries or comments to the authors