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T&I ASIA: CALL FOR INPUT ON INDIA AIF REGULATIONS

By Bijal Ajinkya and Siddharth Shah,
Nishith Desai Associates

On August 1, 2011, The Securities and Exchange Board of India issued a Concept Paper along with draft SEBI Alternative Investment Funds Regulations, 2011, which proposes the introduction of a comprehensive regulatory framework for private pools of capital, i.e. Alternate Investment Funds (AIF). The Concept Paper also suggests the introduction of a separate Investment Advisor regime for all advisors, including managers of AIF. The Draft Regulations were open for public comments till August 30, 2011 following which SEBI is expected to come promulgate a final set of regulations. The Concept Paper is a significant development for India as the new regulations will regulate the alternate investment asset class, which is, to date, in many ways unregulated. However, the concept paper and draft regulations as proposed, appear onerous and are likely to be restrictive for fund managers. The most positive aspect of the proposed changes, are SEBI's definitions of asset classes, several of which have existed in an uncertain status to date, including: hedge funds, social venture funds and debt funds which face challenges in their formation and operation under the current regulatory framework. At the same time, SEBI's attempt to classify alternative investment funds will prove restrictive for funds with multiple strategies, discouraging innovation in this important class of investments.

ANALYSIS OF DRAFT REGULATION

The Draft Regulations propose a framework for all AIFs collecting funds from institutional or high net worth investors in India for investments in India. Further, the draft appears to regulate even offshore pools of capital investing in India and their offshore managers. SEBI's power to extend the AIF Regulations to such offshore pool of capital itself may be questioned under the SEBI Act and in light of the global legal precedent. Furthermore such an expansion of regulation is likely to have a chilling effect upon investment in India by foreign investors.

SEBI proposes increasing the threshold for a minimum investment from INR 500,000 to INR 2,500,000 and has specifically clarified that while portfolio management scheme (PMS) relationship with clients on a one-on-one basis may continue to be regulated by PMS Regulations, any pooling of capital under the PMS regime would fall within the aegis of the new AIF Regulations. This will impact several real estate funds and private equity funds operating under the PMS regime that would be regulated under the proposed AIF regulations. This potentially takes away the flexibility of investments that the PMS regime offered to such pooled structure in terms of investment limits or choice of instrument or the type of investors that they could raise funds from The existing schemes in the nature of AIF will now have to register with SEBI as AIFs and subject to any grandfathering that SEBI would offer, will be regulated by the proposed AIF Regulations and not by PMS Regulations.

The Draft Regulations propose that existing funds will be "grandfathered" and allowed to operate under current VCF regulations with their current amount of capital. However, all fresh pools of capital raised by these funds will have to be approved under the new regulations once notified. In addition the "grandfathered" firms will have to re-register with SEBI. The Draft Regulations, do not provide guidance timing, approvals procedures, or for implementation, under such re-registration.

The Draft Regulations create nine investment strategies and require funds to register and operate under a single asset strategy. Such delineation ignores, the current realities of investment funds in India, in which AIFs operate across multiple investment strategies. A possible outcome of requiring a single strategy will be to inhibit investments by managers who currently straddle venture capital, growth capital, buyouts, pre-IPO or hybrid strategies; most funds operating in India, currently have "carve-outs" in investor agreements allowing such hybrid strategies. SEBI's strict definitions significantly curtail firm's ability to act in a timely fashion in their own, and in their investors best interests. In a worst-case scenario, funds will have to re-negotiate their investment strategies with their investors and potential investors. The overall likely impact is a slowdown in the AIF industry; a possible impact is considerably less being invested by this important asset class.

The Draft Regulations will allow trust and limited liability partnerships (LLPs) to invest as AIFs. While LLPs promise more structural flexibility (especially from a tax transparency perspective) for fund structures, the use of LLPs as investment vehicles needs clarity from the Reserve Bank of India (RBI) which has currently limits the Registrar of Companies (the licensing authority for LLPs) approving LLPs with investment objectives on account of their concern that LLPs can be a work around for non-banking finance companies which are heavily regulated by the RBI.

The Draft Regulations impose a cap on the number of investors to 50 in case AIFs are constituted as company or an LLP. In case of a trust, up to 1000 investors could participate in the concerned AIF. While the idea here is to restrict wide retail participation in this asset class, AIFs which raise significant pools of capital through retail participation from high net-worth investors could find this cap restrictive.

The Draft Regulations proposes to increase the minimum size of the funds to INR 200 million from the current INR 50 million with a cap on the [final size of the fund] above the targeted size by 25%. While the increase in the minimum size may not find much resistance from the industry, the cap on final-size appears restrictive and the industry wants these caps to be left to be negotiated between the GP and the LPs.

The Draft Regulations restrict several aspects of funds operations for all of the proposed 9 strategies, which are at present left unregulated by other global regulatory bodies such as the US-SEC and the UK's FSA. Included are: minimum investment size life of fund, extensions of funds, sponsor commitments, lock up periods, wrap-up of funds, disclosures, governance and other aspects of fund operations. They are unnecessarily prescriptive, considerably more restrictive than in far more mature alternatives investments markets and well beyond the scope of regulation in any other market in the world, not-including communist nations. An even less favorable view is that this kind of comprehensive regulation creates controls that are antithetical to the very nature of the alternatives investment environment. In practice the draft regulations will conflict directly with a number of industry standard practices, such as waterfalls, while at the same time leaving un-regulated important aspects of fund operation such as portfolio valuations (among other quasi-standards used globally).

CONCLUSION

We commend SEBI for proposing the Draft Regulations that draw upon the experience of international regulations for alternate investment funds, especially in regard to their consideration of governance and investor protection. The creation of segregated strategies under a single regime allows benefits for each strategy, improving upon the generalized approach followed to date. Most importantly the Draft Regulations can encourage an environment conducive to alternate investments, attracting additional international investment to India, accruing additional benefit to the Indian economy, and improving the asset class for investors. However, the breadth of the regulations as proposed may overwhelm the still maturing alternative class of investments in India. In sum while the regulations introduce onerous requirements on AIF practitioners, we do not observe any commensurate regulatory concessions/ relaxations being offered to AIFs, the most important of which are tax pass through concessions, removal of sector investment limitations, or clarification on tax treaty investment stance by the government. Beyond these significant concerns, the proposed draft regulations add considerable administrative burden and costs.

RECOMMENDATIONS

We recommend a clarification on the scope of these regulations specifically relating to overseas pool of capital investing in India in order to reassure international fund managers.

We recommend clear written guidelines on the processes, timing, and requirements of "re-registrations" for existing funds, in order that the current industry has unequivocal guidance which will allow its continued operation, as the new regulatory scheme is enacted. This is important to avoid the existing pools of capital being exposed to any uncertainty about the applicability of the proposed regulations.

We recommend that SEBI lower its mandate for a minimum investment size of INR 10 million or 0.1% of the corpus for a single investor. This could severely restrict the ability of the investors to achieve risk diversification through investments in multiple AIF. Rather than defining an eligible investor in an AIF by the size of his investment, a more matured approach would be to come up with a comparable definition of an 'accredited investor' and then leave the minimum investment amount to the discretion of the sponsor.

We recommend that the differential treatment for the sponsors in terms of minimum commitment of 5% of the fund corpus and the back ending of their return of capital towards the end of the life of the fund and condition requiring them to buy un-liquidated investments at the end of the fund term, all with a view to ensure the 'skin in the game' are completely out of the fairly established international practices for such asset class. These conditions should be left entirely to be negotiated between a discerning sophisticated investor and the sponsor.

We recommend that SEBI remove its proscriptive limitations on fund operations (investment sizes, lockups, fund liquidations/realizations), that if put in place, will cause investors considerable concern, and put India at the forefront of breaking new regulatory ground in a field that has to date, remained unrestricted in even the most comprehensively regulated alternatives markets of the US and the UK. We recommend that SEBI consult with the published guidelines of the US and UK, and implement similar guidelines, to insure the development and continued growth of AIFs in India.

CALL FOR AIF TO PROVIDE INPUT

We call upon current and future practitioners in the investment class to provide their input to SEBI on this important topic during this consultative process adopted by SEBI. While the prescribed period for providing comments on the proposed regulation ended on August 30 SEBI should still be open to receiving comments on the Draft AIF Regulations. Comments may be sent to the authors (nda.aif@nishithdesai.com) who as a part of the consultative process on behalf of the Indian Venture Capital Association and various other bodies will endeavor to share any contributions to SEBI.