Alternative Investment Funds Regulation in India: A Changed Regulatory Landscape

By Vineetha MG, Divaspati Singh and Aditya Jhaveri

The notification of the SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations") on May 21, 2012, marked a watershed moment for the Indian private capital industry. A story that began in the mid 1980's by Indian financial institutions like ICICI and IFCI has now culminated into a 200–300 fund-strong industry. The provision of a comprehensive, robust regulatory framework is a natural consequence for an industry that has grown admirably, and has played a significant part in the India growth story.

The AIF Regulations seek to regulate funds established in India for the purpose of pooling monies from investors, Indian or foreign, on a private placement basis. Foreign funds investing directly into India are outside the ambit of the AIF Regulations. Though an effort to finally bring alternative investment funds ("AIFs") under a regulatory umbrella is certainly laudable, the bigger question remains as to how much will these new regulations contribute to creating an environment that is conducive to the sustained growth of the Indian private capital industry?

The size and contribution of private equity has been steadily rising—over a ten year period (1998–2007), the size of the PE market grew 72 percent, far outstripping traditional economic rivals such as China (43 percent), South Korea (24 percent) and Japan (10 percent) in Asia. The obvious question to be asked in this context is whether the present regulatory system will augment this growth or will it lead to a slow down as fund managers get accustomed to a new ecosystem? With a lack of regulations and strong regulatory support having been the biggest barrier to the private capital industry fulfilling its potential till now, perhaps these guidelines may now usher in a new era of close co-operation between the regulatory authorities and the private capital industry (as has already been evidenced in the consultative process leading to the final AIF Regulations itself).

Regulatory Gap

The previously unregulated space of private equity and venture capital funds all came under the SEBI (Venture Capital Funds) Regulations, 1996 ("VCF Regulations"). This effectively resulted in a situation wherein regulations put into place for a particular subset of private equity were made applicable to all private capital funds. The patent incongruities and incompatibility of this one-size-fits-all solution created a significant regulatory gap which required redress.

On August 1, 2011, the Securities and Exchange Board of India ("SEBI"), the Indian securities market regulator, published a concept paper on its proposed AIF Regulations. These initial draft regulations contained a number of debatable provisions—including 9 different categories of AIFs based on restrictive investment strategies, a 5 percent sponsor commitment with a lock-in clause till other investors had been redeemed, obligation on the sponsor to buy out the portfolio investments in the event of lack of liquidity, and a time commitment on key persons. Following a long consultation and deliberation process in which a great deal of industry feedback was solicited and acknowledged, a significantly improved version of these regulations was notified by SEBI.

Salient features of the AIF Regulations

The AIF Regulations stipulate that every AIF established or incorporated in India for the purpose of pooling capital from domestic or foreign investors (certain types of AIFs are excluded from registration such as ESOP trusts, family trusts, holding companies, securitization trusts, etc.) is to be compulsorily registered with SEBI. An AIF can only collect funds on a private placement basis.

Present unregulated pools of capital are required to register themselves with SEBI under the AIF Regulations within six months. Existing SEBI registered funds will continue to be governed under the old VCF Regulations and may continue till the fund or scheme is wound up but will not be allowed to launch new schemes or increase their targeted corpus (to do so would require re-registration under the new AIF Regulations).

Three categories of alternative investment funds have been defined by SEBI, as opposed to the nine categories originally proposed in August 2011, distinguished on the basis of the investment strategy, fund purpose, leverage and complexity/risk of trading strategies. The purpose is to ensure that benefits or concessions to any type of funds accrue to their targeted beneficiaries, in addition to managing and regulating systemic financial risk.

Category I AIFs include funds that "have a positive spillover effect on the economy." These include venture capital funds, social venture funds, small and medium enterprise funds, infrastructure funds and other funds as may be specified by SEBI. The Government will consider providing incentives and concessions for this class of funds. These funds will be closed-ended.

Category II AIFs are funds that do not fall under Category I AIFs or Category III AIFs and include private equity funds, real estate funds and debt funds. Funds in this category will not be able to employ leverage, other than to meet their day-to-day operations and as permitted by the AIF Regulations. These funds will be closed-ended funds.

Category III AIFs are funds that employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives. This category includes hedge funds, funds which trade with a view to make short term returns and funds which are open-ended.

Permissible investments by each category of AIFs have been provided in the AIF Regulations. Some significant general investment and fundraising conditions are: AIFs are to have a minimum fund size of INR 200 million (approximately US$3.6 million). There is a maximum limit of 1000 investors in an AIF, and a minimum contribution of INR 10 million (approx. US$180,000) per investor. A continuing sponsor commitment of the lesser of 2.5 percent of the corpus or INR 50 million (approx. US$900,000) for Category I AIFs and Category II AIFs and the lesser of 5 percent of the corpus or INR 100 million (approx. US$1.8 million) for Category III AIFs has been provided. Such continuing sponsor commitment cannot be held through the waiver of management fee.

AIFs have been permitted to invest in securities of companies incorporated outside India, subject to applicable Reserve Bank of India and SEBI guidelines. SEBI has laid sufficient emphasis on disclosures and it has been provided that a sponsor or manager is required to disclose their investment in the AIF to investors and a sponsor or manager cannot be offered more favorable terms than the AIF if they co-invest in investee companies. An AIF is also required to disclose valuation procedures and methodologies to investors for valuing assets. Significant emphasis has also been placed on the detection, mitigation and resolution of conflicts of interest by the sponsor and manager.

Additionally, SEBI has provided that a sponsor or manager of a category I or II AIF may appoint a custodian registered with SEBI for safekeeping of securities if the corpus of the AIF is more than INR 5 billion (approx US$90 million). However, a Category III AIF must appoint a custodian irrespective of its corpus. In terms of reporting requirements, AIFs are required to provide specified disclosures and reports to investors on an annual basis and are also required to maintain certain records for a period of five years after winding up of the fund.

SEBI has also provided that units of a closed-ended AIF may be listed on a stock exchange after the final closing, subject to a minimum tradable lot of INR 10 million (approx. US$180,000). However, the AIF Regulations are silent on the process and mechanism for listing. It is expected that SEBI may provide further guidance in this regard.

Conclusion

The AIF Regulations put in place a regulatory framework which is expected to sufficiently regulate the alternative investment fund asset class in India. Globally, in the private capital industry, different types of funds play a different role in the growth of an investee company at different stages of its development. Prior to the AIF Regulations, all private funds functioned in India under the framework of the VCF Regulations. The greater regulatory clarity and specificity provided by the AIF Regulations for different pools of capital will go a long way in helping India's private equity industry to become more mature. India offers a unique combination of size, fast-growing businesses and reasonably robust public markets for exits. Although the impact of the AIF Regulations remains to be seen, there can be no doubt about their necessity.

In the Indian context, the ability to create instruments that enable greater financial inclusion may well reach beyond the government and commercial banks to include enterprises such as private equity firms, which can commit timely financial assistance to varied sectors including small and medium industries, social ventures such as microfinance and the infrastructure sector. However the rapid growth and globalization of alternative investment funds as an asset class demands a dedicated and transparent regulatory framework. The AIF Regulations provide a regulatory framework that will encourage the capital formation and investment capable of buffeting ongoing macroeconomic difficulties and go a long way towards meeting India's considerable requirements for investment, in infrastructure, manufacturing and finance, for example. A streamlined, well-regulated industry will not only strengthen the foundation of private capital in India but also boost investee confidence and eventually increase deal-making opportunities across the board.

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Alternative Investment Fund Categories under the SEBI Regulations 2012 (effective 21 May 2012)

	Description	Examples	Investment Restrictions
Category I AIFs	Invest in start-up or early stage ventures, social ventures, small and medium enterprises, infrastructure or other areas deemed socially or economically desirable. Determined to have "positive spillover effects" for the economy.	Venture capital funds, social venture funds, SME funds, infrastructure funds, and other funds as specified by SEBI.	Cannot invest more than 25% of corpus in one investee company. Can invest in unites of other Cat. I AIFs but not in units of other funds of funds. Cannot borrow funds directly or indirectly or leverage except for meeting temporary funding requirements on not more than 4 occasions per year, not more than 10% of corpus.
Category II AIFs	Funds not otherwise captured in Category I or III.	Private equity funds and debt funds for which no incentives or concessions are given by the government or any other regulator.	Cannot invest more than 25% of corpus in one investee company. Can invest in units of other Cat. I or II AIFs but not in units of other funds of funds. Cannot borrow funds directly or indirectly or leverage except for meeting temporary funding requirements on not more than 4 occasions per year, not more than 10% of corpus. Can engage in hedging subject to SEB guidelines.
Category III AIFs	Funds employing diverse or complex trading strategies, including the use of leverage through investment in listed or unlisted derivatives.	Hedge funds, open-ended funds for which no incentives or concessions are given by the government or any other regulator.	Cannot invest more than 10% of corpus in one investee company. Can invest in units of other Cat. I or II AIFs but not in units of other funds of funds. Can leverage or borrow subject to consent from investors in the fund and subject to a maximum limit as specified by SEBI, provided appropriate disclosures made as specified under AIF Regulations.