

Alt' investment funds: analysis within the Indian framework

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Recently, the Securities and Exchange Board of India (SEBI) created yet another stir with the introduction of SEBI (Alternative Investment Fund) Regulations, 2012 (the AIF Regulations) which seek to regulate investments made by private funds including private equity (PE) funds, real estate funds, hedge funds, etc. Hitherto, only mutual funds, collective investment schemes and venture capital (VC) funds were regulated by SEBI. However, the VC regulations have now been repealed and all new schemes of VC funds will be governed by the AIF Regulations while mutual funds and collective investment schemes continue to be exempt from the provisions of the AIF Regulations. An Alternative Investment Fund (AIF) maybe in the form of a trust, body corporate, company or limited liability partnership. The AIF Regulations essentially categorise funds into three categories on the basis of the investment objective on seeking registration with SEBI.

Category I AIF means any pooled fund, which invests in start-up or early ventures or social ventures or Small & Medium Enterprises or any other socially or economically desirable sector and includes venture capital funds, SME Funds, infrastructure funds, etc. Such funds are required to be closed ended and for a minimum tenure of three years and cannot borrow funds directly or indirectly or engage in any leverage except for meeting temporary funding requirements. This ensures that Category I Funds as well as their investors only utilise surplus funds available in the nature of proprietary investments. While these AIFs focus on unlisted companies or in units of other AIFs, they may, however, to limited extent, invest in initial public offers, preferential allotments, listed financially weak companies, etc. The AIF Regulations prescribe further conditions that are required to be complied with by social venture funds, infrastructure funds, etc.

Category II AIFs have been defined to mean any fund that is not a Category I AIF and/or Category III AIF and which does not undertake leverage or borrowing other than to meet its day-to-day operations.

Category I AIFs are essentially those AIFs which have a positive spill-over effect on the economy and for which SEBI and/or the Government of India may consider prescribing incentives, whereas

no specific incentives/ concessions are given by SEBI or the Government for Category II AIFs. However, both Category I and II AIFs primarily focus on unlisted companies or in units of other AIFs.

Category III AIFs are typically hedge funds which employ diverse and complex trading strategies and may employ leverage including investment in listed/ unlisted derivatives. However, given that the Securities (Contracts) Regulation Act, 1956 prohibits the issuance of derivatives other than those listed on a recognised stock exchange, it is not clear how such AIFs have been permitted to invest in unlisted derivatives. SEBI proposes to regulate the Category III AIFs by the issuance of directions regarding areas such as operational standards, conduct of business rules, prudential norms, conflict of interest, etc.

To the credit of SEBI, AIF Regulations bring much required clarity on the contentious point of due diligence by market players and specifically clarify that due diligence done by such funds for the purpose of investments will not be in breach of the SEBI Insider Trading Regulations. These concessions have however been restricted to the SME Sector for the time being. However, a rather onerous condition that the minimum corpus of an AIF must be Rupees 200 million has been prescribed. It appears that smaller funds would therefore have to seek specific exemption from SEBI for operation although there is no specific procedure laid down therefor under the AIF Regulations. This creates confusion for the operation of smaller funds and angel investors. Furthermore, each investor is required to contribute a minimum of Rupees 10 million thereby eliminating pooling of resources from individuals other than high net worth individuals.

It further appears that the controversial discussion of whether 'securities' as defined the Securities Contracts (Regulation) Act 1956 governs securities of unlisted private companies is now laid to rest, albeit to the discontent of the market players, to include all securities including those of private limited companies in which such AIFs propose to invest. Although the market players have not responded favorably to the introduction of the AIF Regulations, it remains to be seen whether they would have a long-term positive effect.

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