



SECURITIES AND EXCHANGE BOARD OF INDIA (ALTERNATIVE INVESTMENT FUNDS) REGULATIONS, 2012

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INTRODUCTION

- ◎ The Securities Exchange Board of India (“SEBI”) vide its notification no. LAD-NRO/GN/2012-13/04/11262. dated May 21, 2012 issued regulations for Alternate Investment Funds in India- **SEBI (Alternate Investment Funds) Regulations, 2012 [AIF Regulations]**
- ◎ The need was felt after unregulated funds like private equity, PIPE and Real Estate flourished inspite of SEBI’s framing SEBI (Venture Capital Funds) Regulations, 1996.
- ◎ The aim behind enacting the Regulations still remains the same- *to encourage funding of entrepreneurs’ early-stage companies.*



BACKGROUND

- ◎ Concept paper released on August 01, 2011 along with Draft Regulations
- ◎ The draft regulations were open for comments of industry people
- ◎ Lot of changes in the notified Regulations as compared from the draft regulations in light of the comments received



POSSIBLE INVESTMENT REGIMES NOW

Typically, with the enactment of Regulations, the following are the various Investment vehicles:

Collective Investment Scheme

Mutual Funds

Alternative Investment Scheme



SCOPE OF AIF REGULATIONS

- ⊙ Extends to SMEs, social and economical ventures etc and therefore, the regulations prima facie seem to be very mild and liberal in approach
- ⊙ Seems that any property funds can come into India except the provisos as specified in case of Venture Capital Undertakings (VCUs)
- ⊙ **Territorial Scope**
 - ⊙ The definition of AIF clearly specifies “*fund established or incorporated in India*”

Thus two scenarios can be envisaged:

- ⊙ Company incorporated in India, carries business both in India and/or outside India
- ⊙ Company incorporated outside India, carries business outside India

In both these scenarios, AIF Regulations applicable and thus, certificate of registration for such entities mandatory.



ESSENTIAL FEATURE

◎ Fund management-

- essentially, the vehicles should pool in money from investors and the same should be managed. ***Simply, if not fund managed, then not an AIF.***
 - That is, the funds needs to be managed regularly

◎ Why do we say this?

- Proviso to clause (b) of sub-reg (1) of Reg 2 states-

“other special purpose vehicles ***not established by fund managers***, including securitization trusts, regulated under a specific regulatory framework”

SPVs not established by fund managers is not considered to be within the meaning of AIF as defined in the Regulations. Therefore, non-managed vehicles do not fall within the meaning of AIF



DEFINITIONS[REGULATION 2]

◎ **Alternative Investment Fund-**

Can be in the form of:

- ◎ Trust
- ◎ Company
- ◎ LLP
- ◎ Body corporate,

which is a:

- ✓ privately pooled investment vehicle which collects funds from investors, whether Indian or foreign
- ✓ Not covered by regulations governing CIS, mutual funds
- ✓ Invests Funds in a defined investment policy

Thus, essentially any other type of fund management vehicle would be “Alternative Investment Fund”.



CONTD....

◎ The existing VCF Regulations define Venture Capital Funds as:
“venture capital fund” means a fund established in the form of a trust or a company including a body corporate and registered under these regulation which—

- (i) has a dedicated pool of capital;
- (ii) raised in a manner specified in the regulations; and
- (iii) invests in accordance with the regulations;]

Therefore, prima facie the investment policy/utilisation of funds in case of AIF can be defined by the Fund itself keeping in mind the interest of its investors unlike in case of VCFs where it is to be as per the Regulations



WHO ALL CANNOT BE AN AIF?

**family trusts set up
for the benefit of
relatives**

**employee welfare
trusts or gratuity
trusts**

**Other SPVs not
established by Fund
managers,
securitization trust**

ESOP Trusts

**holding companies
within the meaning
of Section 4 of the
Companies Act, 1956**

**Funds managed by
securitisation
company or
reconstruction
company**

**Any such pool of funds which is directly regulated by any other
regulator in India**



DEFINITIONS CONTD....

◎ Associate

Means a company, LLP, body corporate in which a:

- Director, trustee, partner, sponsor, manager of AIF *or*
- Director, partner of Manager or Sponsor who holds
 - *More than 15% of paid-up equity share capital or partnership interest, individually or collectively*

The requirement for being called an associate is the same as under the VCF Regulations. Therefore, no disconnect



CONTD....

◎ **Corpus**

Total amount committed by investors to AIF by way of a written contract or any such document ***as on a particular date***

◎ **Hedge fund**

- ◎ an Alternative Investment Fund which employs diverse or complex trading strategies and invests and trades in securities having diverse risks or complex products including listed and unlisted derivatives;



CONTD....

◎ **Change in control**

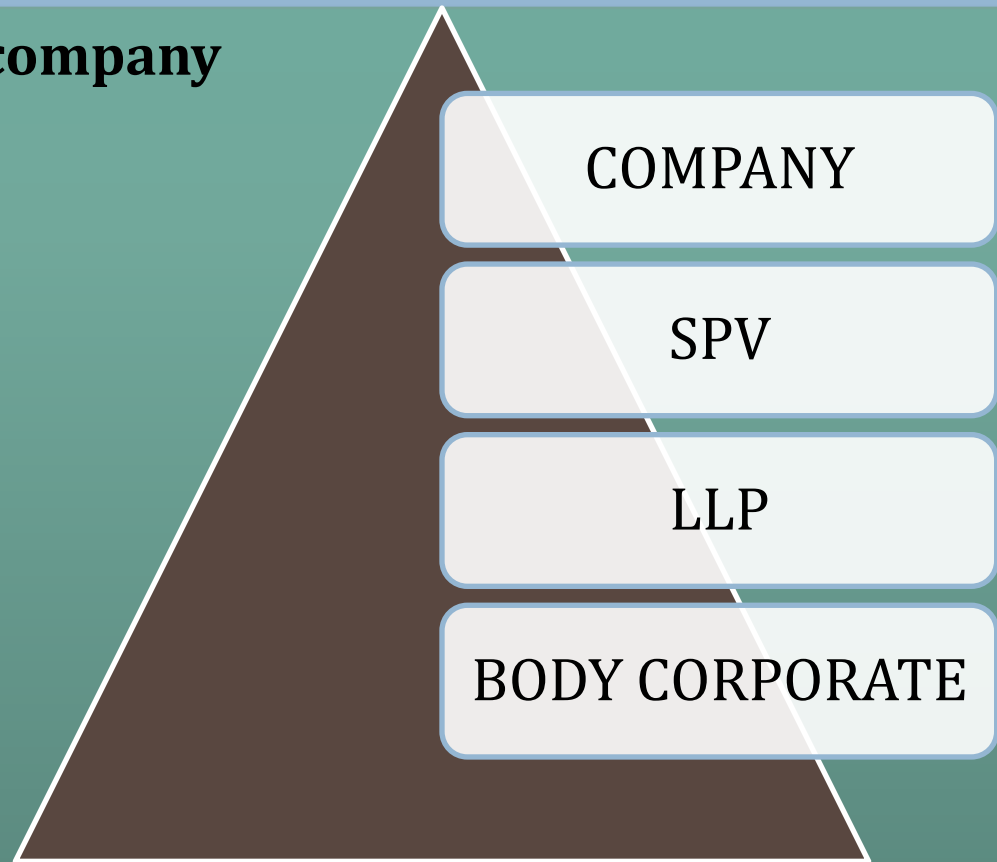
- ◎ change in control within the meaning of Reg 2 (1) (e) of SEBI (SAST) Regulations, 2011
 - control” includes the right to appoint majority of the directors or to control the management or policy decisions
- ◎ in any other case, change in the controlling interest or change in legal form
 - controlling interest means an interest, whether direct or indirect, to the extent of more than fifty percent of voting rights or interest

Therefore, the Regulations are very stringent not to allow controlling interest to be exercised unless 50% interest is there



CONTD....

② Investee company



Therefore, an AIF can invest even in LLP



REGISTRATION

- ◎ No entity or person to act as an AIF, unless holding a certificate of registration from the Board:

For already existent fund not registered with SEBI-

- ◎ May continue to operate for six months from commencement of Regulations or
- ◎ till the disposal of application if the application is made within these six months.
- ◎ Existing schemes can complete their agreed term and schemes however, restriction on raising fresh monies other than commitments already made.



PROCEDURE FOR REGISTRATION

apply

- Application in Form A
 - Accompanied by non-refundable application fee as specified in Part A
 - In the manner as in Part B

See
requirements

- Board to consider all the requirements laid down in AIF Regulations for the purpose of grant of certificate

validity

- Certificate of registration to be valid till the AIF is wound up.



WHAT HAPPENS TO EXISTING FUNDS?

What about the existing VCFs?

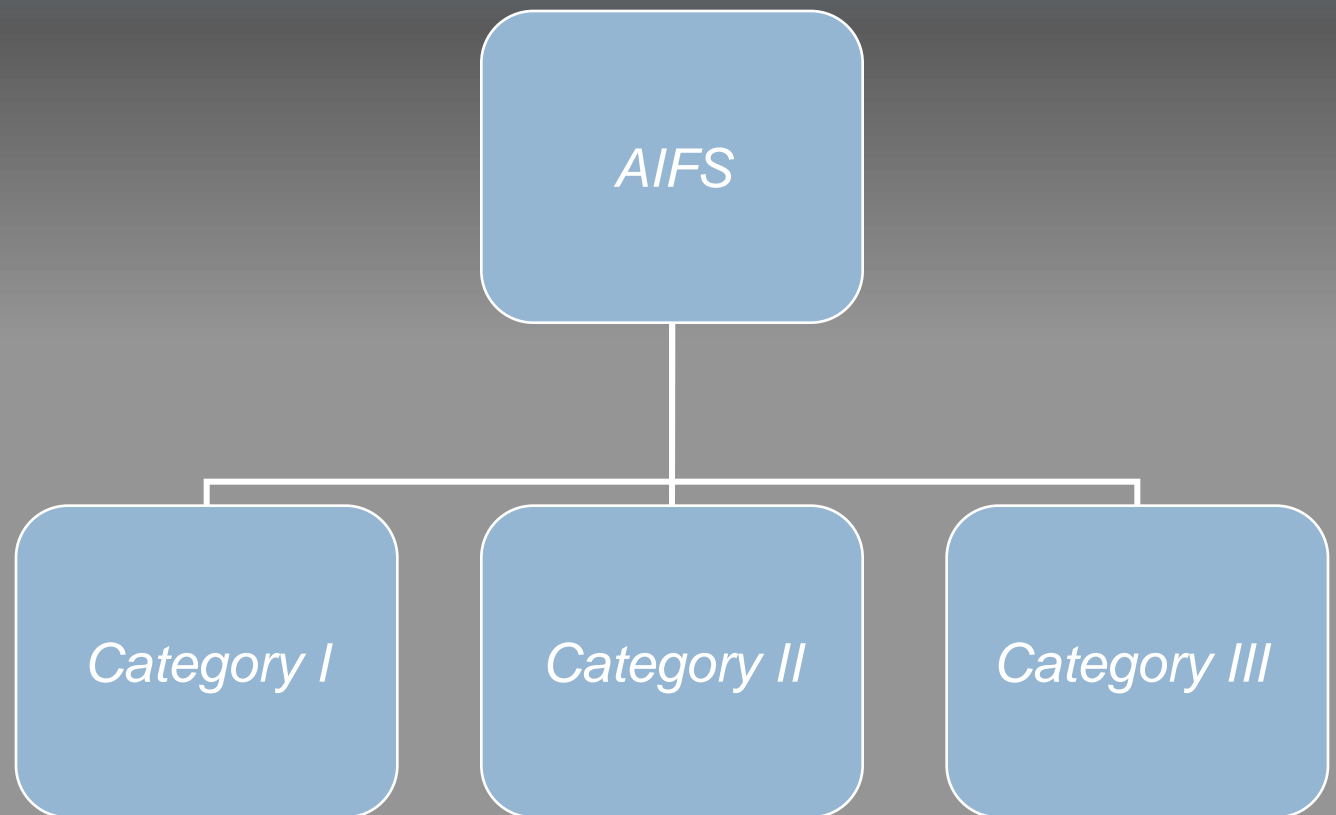
- ◎ The existing fund or scheme managed by the fund is wound up
- ◎ Such funds shall not launch any new scheme after notification of these regulations

What should the existing fund do/not do?

- ◎ Shall not increase the targeted corpus after the notification of Regulations
- ◎ VCFs can seek re-registration under this Regulation- approval of 2/3rds of their investors by value of their investment.



CATEGORIES OF AIFS





CATEGORY I AIF

◎ This category of AIF will invest in:

**Start-up or early
stage ventures**

Social ventures

SMEs

**Infrastructure or
other sectors**

**Areas which the
government or
regulators consider
as socially or
economically
desirable**

Shall include venture capital funds, SME Funds, social venture funds, infrastructure funds and such other Alternative Investment Funds as may be specified



CATEGORY II AIF

Does not fall in Category I or Category II

Does not undertake leverage or borrowing, other than to meet day-to-day obligations.

- Thus, mainly functions out of its own corpus

This category would also include PE funds or debt funds for which no special incentives or concessions are given by the Government.



CATEGORY III AIF



Can employ leverage



Employs diverse or complex trading strategies



also include hedge funds or funds with a view to make short term returns or open ended funds, which do not have any concessions or specific incentives by the government

**Thus,
effectively in
the nature
of hedge
funds
already
defined in
Regulation 2**



INVESTMENT IN AIF [REGULATION 10]

- ◎ **Issue of units allowed to any investor**
 - ◎ Indian,
 - ◎ Foreigner or
 - ◎ Non-Resident Indian (NRI)
 - ◎ Currently the FDI policy allows issue of units only to VCFs and FVCI. Therefore, seems that reciprocal change will be effected in FDI policy so as to bring them in line with the AIF Regulations and include AIFs



CONTD....

- ⊙ Each scheme to have corpus of at least **Rs. 20 crore**
- ⊙ Manager or sponsor to have *continuing interest* in the form of investment of *not less than:*
 - ⊙ 2.50% of corpus
 - ⊙ Rs. 5 crore, whichever is less
 - However, such interest shall not be through the waiver of management fees. Thus, manager or sponsor will be entitled to receive their fees and rightfully so.



FEW THINKERS ON INVESTMENT

- ◉ No explicit bar on **joint investment** as the term “investor” is not defined.
 - So can the limit of Rs. 1 crore be circumvented by two or more persons/entities making investment jointly?
 - Can a body corporate say, LLP with multiple partners invest in AIF and achieve the limit of Rs. 1 crore?
- ◉ Thus, investment under “umbrella structure”/”Fund of Fund”(FoF) can be resorted to.
- ◉ The draft Regulations had identified HNIs as possible investors in AIFs. Thus, although HNIs are still covered by way of requirement of Rs. 1 crore, there is a high possibility of circumvention of this sub-regulation.



LIBERAL SEBI!

- ◎ No scheme to have more than **1000 investors**
- ◎ Private placement to be the only way of collecting funds:
 - AIF can also be in the nature of a company
 - Restriction on no. of members u/s 67(3) of the Companies Act, 1956 is **50** in case of private placement.
 - Thus, effectively AIFs in the nature of a company cannot have investors numbering more than 50, else violation of Act.
 - It is also difficult to comprehend that how having an investor base of 1000 can be classified as private placement.
 - **SEBI has been extremely liberal by classifying investor base of 1000 as “private placement”**



PLACEMENT MEMORANDUM [REGULATION 11]

- ⦿ **Funds to be raised by issue of Information Memorandum/ Placement Memorandum (“IM/PM”).**
- ⦿ **IM to contain information, the key being:**
 - ⦿ **Material information about AIF and Manager**
 - ⦿ **Background of key investment team of manager**
 - ⦿ **Tenure of AIF or scheme**
 - ⦿ **Targeted investors**
 - ⦿ **Investment strategy**
 - ⦿ **Risk management tools and parameters employed**
 - ⦿ **Conflict of interest and procedures to identify and address them**
 - ⦿ **Manner of winding up of the Alternative Investment Fund or the scheme**
 - **The points so covered in the AIF Regulations are only inclusive in nature. AIFs to share other relevant information as required to help investors take an informed decision.**
 - **The procedure contemplated here, is similar to that of public offering of equity shares.**



SCHEMES [REGULATION 12]

- ◎ AIFs may launch schemes subject to filing of PM.
- ◎ PM to be filed with SEBI atleast 30 days before the launch of the scheme along with the fees prescribed in Second Schedule
 - Scheme Fees is Rs. 1 lakh
 - Payment of scheme fees not applicable for launch of first scheme



TENURE [REGULATION 13]

Category I and Category II

- Close ended
- Tenure to be pre-defined, subject to minimum of three years

Category III

- ◎ Open ended or close ended



EXTENSION

- ◎ Extension of close ended AIF permitted upto 2 years
 - Approval of 2/3rds (66.67%) of unit holders required
- ◎ In the absence of consent of unit holders, AIF to fully liquidate within one year following expiry of fund tenure or extended tenure.



LISTING [REGULATION 14]

- ◎ Units of close ended AIFs may be listed subject to minimum tradable lot of Rs. 1 crore
 - Slightly unclear
 - Does it mean that the close ended AIFs *may or may not* go for listing?
 - Therefore, open ended AIFs *may* go for buy back
- ◎ Listing permitted only after final close of the fund or scheme



GENERAL INVESTMENT CONDITIONS [REGULATION 15]

Companies
outside India

- AIFs may invest in securities of companies incorporated outside India subject to such conditions

Category I, II
and III

- Category I and II to not invest more than 25% of corpus in one investee company
- Category III to invest not more than 10% of corpus in one investee company

Uninvested
portion?

- Un-invested portion of the corpus may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality till deployment of funds as per the investment objective.
- Thus, AIFs can invest funds according to their investment objectives states in IM. In case of the un-invested portion, may be invested in liquid assets

Investment barred without consent of 75% of investors by value of their investment in AIFs



INVESTMENT CONDITIONS FOR CATEGORY 1 [REGULATION 16]

- ⊙ Shall invest in VCU or SPV or LLPs or other units of AIFs
- ⊙ May invest in units of Category I AIFs of same sub-category
- ⊙ **Shall not** borrow funds or engage in any leverage *except*:
 - ⊙ **For meeting temporary funding requirements:**
 - Not more than 30 days
 - Not more than 4 occasions in a year
 - Not more than 10% of corpus
- ⊙ **Therefore, Category I can fund in another fund too**



CATEGORY I-SECTORAL CAPS [REGULATION 16]

VCFS

- ◎ **Additional conditions for VCFs- same as VCF Regulations**
 - two-thirds/66.67% of the corpus shall be invested in unlisted equity shares or equity linked instruments
- ◎ **Not more than 1/3rd of corpus in:**
 - IPO of VCU
 - Debt or debt instrument in which investment already made by way of equity or contribution towards partnership interests
 - Preferential allotment of equity shares of listed company- lock in period of 1 year
 - Equity shares of a listed financially weak company or sick industrial company
 - SPV



CONTD....

SMEs

Invest atleast 75% of corpus in unlisted securities or partnerships of VCU's or listed or proposed to be listed SMEs

Such funds may enter into an agreement with Merchant Banker to subscribe to unsubscribed portion of issue

Such funds exempt from Regulations 3 and 3A of Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992 in case of investment in companies listed on SME exchange subject to conditions prescribed.



CONTD....

Social Venture Funds

Atleast 75%
of corpus in
unlisted
securities or
partnership
interest of
social
ventures

May accept
grants,
subject to
limit
provided
above

May give
grants to
social
ventures,
subject to
disclosure
in IM

May accept
muted
returns for
their
investors



CONTD....

INFRASTRUCTURE FUNDS

Atleast
75% of
corpus in

- unlisted securities or partnership interest of venture capital undertaking or SPVs
- involved in *operating, developing or holding infrastructure projects*

may also
invest in

- listed securitized debt instruments or listed debt securities of investee companies or SPVs
- involved in *operating, developing or holding infrastructure projects*



CATEGORY II-SECTORAL CAPS

[REGULATION 17]

Shall not borrow funds, or engage in any leverage except-
For meeting temporary fund requirements
For not more than 30 days, not more than 4 occasions in a year, not more than 10% of the corpus

Invest primarily in unlisted investee companies or in units of other AIFs

May invest in Category I or II AIFs

Barred from investing in units of other FoFs

May engage in hedging, subject to guidelines specified by SEBI

May enter into an agreement with Merchant Banker to subscribe to unsubscribed portion of issue

Exempt from Regulations 3 and 3A from Insider Trading Regulations in case of investment in companies listed on SME exchange subject to conditions prescribed.



CATEGORY III-SECTORAL CAPS

[REGULATION 18]

May invest in securities of listed or unlisted investee companies or derivatives or complex or structured products

May invest in units of Category I or II AIFs
Barred from investing in units of other FoFs

May engage in leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit, as specified by SEBI.
Such funds to make disclosures as specified

To be regulated through issuance of directions on operational standards, conduct of business rules, prudential requirements, restrictions on redemption and conflict of interest as may be specified by SEBI.



GENERAL OBLIGATIONS AND CONFLICT OF INTEREST

Regulation 20

- ◉ Sponsor or manager to appoint custodian for safe keeping of securities if corpus more than Rs. 500 crore
 - For Category III, custodian to be appointed irrespective of size of corpus
- ◉ In case of change in control, prior approval of SEBI required

Regulation 21

- ◉ Sponsor and manager to act in fiduciary position
- ◉ Manager to establish written policies for mitigating conflict of interest



TRANSPARENCY

[REGULATION 22]

- All AIFs to ensure transparency and disclose information to investors relating to *inter alia*:
 - risk management,
 - any fees ascribed to manager or sponsor,
 - any material liability,
 - any enquiries by legal or regulatory bodies
- AIFs to provide on annual basis, within 180 days from year end:
 - Financial information of investee *companies*, material risks and management of the same.
- Category III AIFs to submit quarterly reports within 60 days of end of quarter on the basis of points given above



VALUATION [REGULATION 23]

- Category I and II AIFs to undertake valuation of their investments atleast once
 - in every 6 months
 - by an independent valuer
 - May be enhanced to one year on approval of 75% of investors
- Category III AIFs to ensure calculation of NAV Category is
 - independent from the fund management function.
 - NAV to be also disclosed at intervals provided



WINDING UP [REGULATION 29]

- Methods of winding up by trusts, LLP, company, body corporate provided separately for each
- Trustee or trustee company or BoD or designated partners of AIFs to intimate SEBI about the circumstances leading to winding up
- No investments to be made after such intimation
- Within one year of intimation, assets to be liquidated and proceeds to be distributed to investors after satisfying all liabilities
 - Same treatment as of equity investors in a company



AMENDMENTS TO OTHER REGULATIONS [REGULATION 38]

- ◉ Refers to Third Schedule to amend the following regulations:
 - ◉ SEBI (Issue of Capital and Disclosure) Regulations, 2009
 - ◉ SEBI (Foreign Venture Capital Investors) Regulations, 2000
 - ◉ Securities and Exchange Board of India (Substantial Acquisitions of Shares and Takeover) Regulations, 2011