Analytical Speaking

AIF Regulations pave the way for variety of collective investment devices

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SEBI has brought an all-in regulation that covers all private collective investment devices under one omnibus regulation. Thus, other than mutual funds (wjether public or private), and public collective investment schemes, all other collective investment devices come into the fold of the new AIF Regulations. It is now possible to have a hedge fund, or real estate fund, or gold fund, or art fund, or any other fund with any other focus, or lack of focus, as long as the minimal conditions of the AIF Regulations are complied with. The conditions are not very stringent – there is a registration requirement, minimum corpus requirement, and a minimum investment that every investor must make.

If these conditions are satisfied, not only can an AIF raise capital from investors by floating units, it can also leverage itself. Of course, it cannot raise public deposits, as the prohibition of sec. 45S of the RBI Act will apply to all unincorporated entities. If the AIF is a company, in any case, the provisions of sec. 58A of the Companies Act will continue to apply. There are no limits as to the extent of leverage too.

Of course, AIFs may raise subscriptions only by private placement, but they may reach out to as many as 1000 investors. Connecting with 1000 investors, by a so-called private placement, provides a sufficient marketing potential for AIFs who may set up branches, franchisees, and so on, and reach out to a wide base of investors. Notably, the limit on number of investors is not for the AIF, but for a scheme of AIF – thereby allowing AIFs sufficient liberty to keep expanding the family of investors.

The Regulations will have a variety of far reaching implications – on one hand, it will bring harmony in regulations of venture capital funds, private equity funds, etc. Two, it will enable several variety of funds that were not possible in the past – for example, social capital funds, or real estate funds, or hedge funds for that matter. Third, it will possibly give SEBI some more space for regulating the nearly-illicit schemes where money is collected from investors with tall talks of making fanciful returns – ultimately someone packs up everything and vanishes.

The Regulations are generally speaking very flexible, and amount to a very modest regulation.

This article analyses several significant aspects of AIFs.

What are the defining features of an AIF

Note that the stance of the Regulations on AIFs is regulatory and prohibitive – no AIF can carry on the business of an AIF in India without being registered with SEBI. Therefore, while the Regulations bring legitimacy and regulatory approval for collective investment devices, at the same time, they proscribe any form of an unregistered collective investment vehicle. Therefore, it becomes important to understand what exactly is the scope of coverage of the Regulations.

While AIFs are defined in Reg 2 (1) (b), but the Regulation unfortunately does not provide a precise meaning of what exactly are the characteristics which make a vehicle an AIF. However, from the language of the Regulation, and with a bit of intuition, the following defining features of an AIF may be deduced:

(a) It is an **investment vehicle**. The idea of the vehicle should be investment of money and not ownership of property, carrying on of a business or activity other than investment activity, such as charity, public welfare schemes, etc. The essential meaning of "investment" is outlay of money with an objective of generating a rate of return, other than by carrying on a substantive activity. For example, buying land, carrying out construction thereon and then selling apartments is not an investment activity, but buying a property and holding it the purpose of capital appreciation is an investment activity. Lot of contrived confusion may arise as to whether NGOs, social welfare funds, etc are covered by the Regulations. We take up a few

   a. Two or more persons pool money to own a property. Their purpose is not investment of money – that is, realise returns from the property, but to beneficially enjoy the property. This is not an AIF.

   b. Two or more persons pool money to run a business, other than investment business. This is certainly not covered by the Regulations.

   c. A trust set up in India receives contributions either from overseas or domestically, to be spent on charity, social welfare schemes, etc. this is certainly not covered by the Regulations.

(b) There is **segregation between ownership of money and management of money**. The essential idea of the Regulations is investors handing over their money to be managed by a fund manager. If the beneficiaries are managing their own money, even though under a collective banner, there is no AIF.

(c) The contributions are pooled **not in form of ownership capital.** For example, every company does essentially pool shareholders' funds. But every company cannot be called an AIF. So, a company will become an AIF only where the company pools money from persons other than its own shareholders. Even money pooled by issue of bonds or debentures cannot be said to be pooling of money. In the same manner, if an LLP invites capital from its own partners, such pooling of money is not covered by the Regulations. Sometimes, there may be questions about whether issue of bonds by a trust may result into a collective investment device – the prima facie answer should be no, as the returns on the bonds are not based on performance of the pooled fund. The answer, however, may be different if the instrument is labelled as a bond, but it effectively transfers the returns generated from the pooled funds by linking the bond returns to pool returns.

(d) It is a **managed vehicle**. The Regulations are unfortunately very clear on this issue, but this may be a very contentious point. The idea of collective investment devices is that a group of persons provide funds to be "managed" by a manager. The meaning of "managing" is that the manager uses discretion in allocating the funds into investments, and often makes investment decisions, disinvestment decisions, and so on. Whether the fund is actively managed or not, and whether the fund makes a schematic investment or goes by a formula are different questions, but the idea of "managing" is an element of discretion on the manager. A merely co-ownership device or non-discretionary passive investments will not be said to be AIFs under the Regulations.

(e) It is **collective vehicle.** Central to the concept of AIFs under the Regulations is the "pooling" of money. That is to say, once money is commingled into a common fund, the assets held by the fund cannot be identified against any particular investor. In other words, it is a commingled pool of money that collectively makes investment. Portfolio management services, where the investments on behalf of each investor are segregated and separately identifiable, are not covered by the Regulations.

(f) It is a **private vehicle**. Post these Regulations, one understands that that borderline of distinction between collective investment schemes covered by the CIS Regulations, and AIF Regulations will be that the former may invite public subscriptions, while the latter may only privately source their money. The number of investors may be large – as many as 1000. It is a curious question as to what is private placement. In the history of corporate India, the practice of inviting subscriptions from thousands of investors, and still calling it private placement, used to exist several years ago – which prompted a proviso to be inserted in sec. 67 (2) of the Companies Act to provide that subscriptions from more than 50 persons will be deemed to be a public offer. The generic meaning of private placement will be taken on the same lines as in sec. 67 of the Companies Act – something that is not calculated to result into an invitation to subscribe being available to a person other than the one to whom the issuer makes. That is, as long as the AIF makes an offer, and the offer may be accepted only by the person to whom it is made, it is a private placement. Obviously, no public advertisement, circular or marketing literature may be circulated for a private placement.

(g) It must have a certain **constitutional form** – that is, a company, body corporate, LLP, or trust. The definition is not correctly worded – the way the definition reads, it amounts to saying that an AIF is an AIF only if it is a company, body corporate, LLP or a trust. For instance, if an individual raises funds to be pooled and collectively managed, it is possible to contend that this is not covered by the Regulations. Such a view defeats the purpose of the Regulations, but unfortunately, this is how the language is worded. Another significant point is the erroneous use of language "established .. in form of a trust". Securities regulations have consistently been misunderstanding the notion of a trust – a trust is not "established". It is quite common for people to have a wrong notion that a trust is formed by signing a trust deed or by registering a trust. Trust is not a form of organisation – hence, question of establishing a trust does not arise at all. Trust is the name of relation between a fiduciary and a beneficiary. If property is transferred to a fiduciary, to be held for the benefit of beneficiaries, that holding of property with an obligation attached to it is what is called a trust. In that sense, every AIF, irrespective of whether it is a company, or LLP, or any other body corporate, is a trust – since in addition to ownership capital, such entity will pool money which it holds on behalf of the unitholders.

(h) There is no de minimis exemption based on **number of investors**. Notably, even the US Dodd Frank Act provides exemptions for vehicles that pool money from small number of investors - 14 in the case of Dodd Frank. The Regulations do not contain any exemption – so, technically, even if money is held on behalf of two or more persons, to be invested, there will be an AIF. Of course, money held on behalf of a single investor cannot be said to be an AIF at all, as there is no pooling there.

(i) There is no de minimis exemption based on **size of investment**. In other words, irrespective of how small a fund is, it will still incur the prohibition of the Regulations. Note that the Regulations lay down minimum sizes – Rs 20 crores for each scheme. But that does not mean where the size of the fund is less than Rs 20 crores, it does not require registration.

The three categories of AIFs:

The theme that runs across the Regulations is the three different types of AIFs. This seems to be quite a novel and commendable idea of a regulation trying not to paint everything with a single brush.

Category I funds are those that those that invest in spheres which are socially and economically relevant for the country, and have a developmental focus rather than pure commercial motive. These funds will be recognised by the investment category – there are 4 categories listed in the Regulations and there is a scope for the government or SEBI notifying more categories. The 4 strategies listed are – start-up or early stage venture capital funds, social venture funds, SME funds, and infrastructure funds.

Category III is those funds that employ leverage – that is, apart from investors' unit capital, these funds may borrow other than for temporary liquidity purposes. As funds intending to earn higher returns by leveraging the investors' capital may like to keep the liberty of borrowing, real estate funds, venture capital funds, hedge funds, etc. may opt for Category III registration.

Category II consists of all other AIFs. Category II cannot have either *economic leverage* or actual leverage. Economic leverage comes by exposure on derivatives – where the upfront investment required may only be a fraction of the actual underlying exposure. Thus, Category II funds cannot engage in derivatives investments.

Pass through tax treatment:

An innocuous language in the Regulations may actually be containing something that may have far reaching consequences. Explanation below Reg 3 (4) (a) says that only Category I funds shall be treated as venture capital funds for the purpose of sec. 10 (23FB) of the Income tax Act. It may be recalled that in the last Budget 2012, the list of sectors in which venture capital funds may make investments, to get a pass through tax treatment, was abolished, such that the returns of any venture capital fund were made tax free in the hands of the fund.

The Regulations now seemingly curtail that benefit and limit it only to Category I AIFs. This is almost like amending the Income-tax Act through the AIF Regulations, which, actually, in the scheme of delegated legislation in India, is simply not permitted. However, this point will certainly need clarity from SEBI.

Where can AIFs raise money from?

The Regulations seem to provide that AIFs may raise capital from domestic or international investors. This, however, has to depend on the provisions of the FDI policy. It is expected that FDI policy will permit FDI into Category I AIFs, and to a certain extent, in Category II AIFs as well. However, there may be sectoral restrictions – for example category II AIF may not be engaged in real estate strategy, and so on.

In the definition of "units", the Regulations make a reference to partnership interest. A partnership interest, for example, in an LLP, cannot be taken to be a unit, since, as we have discussed before, partnership interest is a source of capital and not investment envisaged in the Regulations.

How will hedge funds work?

One of the key elements that distinguishes hedge funds from other collective investment devices is that hedge funds employ leverage, both economic and financial. The Regulations specifically permit leverage – they only require disclosure of the extent of leverage, and do not put a regulatory bar on the extent of leverage.

Therefore it would be easy to envisage any of the popular hedge fund strategies – equities long and short, macro, event-based, or special situations, or arbitrage, etc. There is no bar on performance-based fees – another feature of hedge funds. In fact, investors may be given to participate in the OTC derivatives market also through AIFs.

How will real estate funds work?

One of the biggest needs of the hour is REITs or other real estate funds in India. There are real estate mutual funds in the country, but there aren't funds that invest in income-earning properties or those that finance construction of properties.

A key element of the REIT structure is tax transparency of the fund. Under Indian tax laws, there are no specific pass-through rules. In fact, a combined reading of sec. 10 (23FB) with section 115O implies that pass-through status will not be given to funds in general. In absence of pass-through status, an AIFs is likely to be taxed at either corporate level, or in representative capacity – either of which may not be tax efficient. Barring taxation issues, which are, though, critical, it is now possible to have real estate funds also in operation.

Will investors be better protected?

India as a nation has been having plenty of collective investment schemes in different shades of gray – they often take investors for a ride. There have been schemes for joint-ownership of plantations, land, animals, gold, and so on. Sometimes, entities have been issuing preference shares, debentures or similar instruments without realizing the regulatory implications.

Question is, will the Regulations make it any better from investors' viewpoint? The answer lies in implementation. We have not had problem with lack of law in the country. It is essentially implementation. Quite often, regulators are unclear as to who would regulate a particular activity. Hence, while frauds mushroom under the eye of the regulators, they keep watching as if helpless. One good thing with the Regulations will be clarity as to who will regulate – so it is SEBI now.