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AIF REGULATIONS: MEANING OF OWNERSHIP INTERESTS AND INVESTOR INTERESTS IN A COMPANY



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1. BACKGROUND

There has been a speculation and confusion regarding the extent of applicability of the SEBI (Alternative Investment Fund) Regulations, 2012 (“**AIF Regulations**”), particularly in case of AIFs set up as companies. It is notable that the AIF Regulations permit an Alternative Investment Fund (“**AIF**”) to be organised either as a company, an LLP, or a trust. In case of the SEBI (Venture Capital Funds) Regulations, 1996, options of organising a fund as a company, trust or a body corporate was available. However, most venture capital funds were actually organised as trusts.

The difficulty arises from a reading of the definition of an AIF, and is further compounded by the definition of “units”. Regulation 2(1)(b) of the AIF Regulations defines the term an AIF to mean, subject to the exceptions set out therein, any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership (“**LLP**”) or a body corporate which:

- (a) **is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and**
- (b) is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.

The AIF Regulations do not define the word “investor”. However, the definition of the term “unit” includes shares, and therefore, every shareholder becomes a unitholder, and by extension, an investor. If, therefore, every shareholder of a company is taken to be an investor, then every company, other than a listed public company, irrespective of what business the company carries on, is a privately pooled vehicle which collects money from its shareholders to be used in a particular manner. The question that, therefore, arises, and in relation to which no clarification has been issued by SEBI, is whether all privately pooled capital, such as contribution of ownership capital to a company, would fall within the purview of the AIF Regulations.

If any application of funds by a company is taken to be covered by the expression “investing it in accordance with a defined investment policy”, then every company becomes an AIF. And if the expression “investing it in accordance with a defined investment policy” is taken to mean investments as commonly understood, then every investment company becomes an AIF. There are thousands of investment companies registered with the Reserve Bank of India (“**RBI**”) and yet another thousands which

are not registered. Obviously, the idea of AIF Regulations could not have been to bring all such investment companies, currently under RBI's non banking finance company regime, also under AIF Regulations. If the idea of the AIF Regulations was to include only such funds as companies gather and manage other than shareholders' money, then that meaning is not coming clearly from the extant definition of either AIF or units.

2. WHAT IS REGULATED?

SEBI intends to regulate a pooling vehicle which essentially pools capital from various investors and investing such capital in accordance with defined investment policy. The idea is to ensure benefit of the investors.

Who are investors? The *Black's Law Dictionary (9th Edition)* defines an investor as a buyer of a security or other property who seeks to profit from it without exhausting the principal, i.e. a person who spends money with an expectation of earning profit. Under common parlance, investors are outsiders who are neither the owners of the pooling vehicle, nor are they the managers. Therefore, it makes good sense to have excluded owners and managers.

2.1 Meaning of investment

The *Blacks' Law Dictionary (9th Edition)* defined investment to mean expenditure to acquire property or assets to produce revenue, a capital outlay. Furthermore, *P Ramanatha Aiyar's, The Law Lexicon, (3rd edition)* has also similarly defined the term investment to signify the laying out of money in such a manner that it may produce a revenue, whether the particular method be a loan or the purchase of stocks, securities, or other property.¹

The term investment is defined in the Accounting Standard AS 13 as assets held by an enterprise for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing enterprise and assets held as stock-in-trade are not investments.

It is true that behind every outlay of capital the ultimate purpose is to earning revenue. However, there is a difference in the intentions and purposes while outlaying capital (a) by way of an ownership capital and (b) solely with the purpose of earning profit.

To our understanding where two or more persons come together with a common objective and work together to pursue that common objective, it

¹ In case of *Surat Peoples' Co-Operative Bank v. CIT*, 1958 33 ITR 396 Bom, it was stated that the word "investment" in itself literally means nothing more or less than to lay out money; and, therefore, where a person purchase securities whether as his stock-in-trade or by way of capital investment, he is in either case investing in securities.

cannot be said to constitute an AIF. There is an element of control is present in an ownership interest.

2.2 Key determinants of an AIF

The key deciding factors, as set out in the definition, are:

- (a) a privately pooled investment vehicle;
- (b) collection of funds from investors;
- (c) investment made in accordance with a well defined investment policy; and
- (d) investments are made for the benefit of the investors.

Therefore, funds are collected from investors on a private placement basis which are invested in accordance with an investment policy is drawn with an idea to earn returns in form of dividends, etc., for the benefit of the investors.

In an ownership capital scenario, the primary benefit is attributable to the entity (the company or a LLP, for instance) and the purpose is the growth of such entity. Furthermore, unlike an AIF, there are no third party funds involved.

2.3 Guidance from other jurisdictions

(a) United States

In the US, the Investment Company Act, 1940 (“**US Act**”) regulates an investment company, which has been defined as an issuer of securities that:

- (i) is, holds itself out to be, or proposes to be engaged primarily in the **business of investing, reinvesting, or trading in securities;**
- (ii) is engaged or proposes to engage in the business of issuing face amount certificates of the instalment type, or has been engaged in this business and has such a certificate outstanding; or
- (iii) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of the issuer’s total assets (exclusive of government securities and cash items) on an unconsolidated basis.



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The Financial Accounting Standards Board (“**FASB**”) sets out the following criteria for determination of an ‘investment company’:²

- “1. *An investment company is an entity that does both of the following:*
 - a. *Obtains funds from an investor or investors and provides the investor(s) with professional investment management services*
 - b. ***Commits to its investor(s) that its business purpose and only substantive activities are investing the funds for returns from capital appreciation, investment income, or both.***
2. *An investment company and its affiliates do not obtain or have the objective of obtaining returns or benefits from their investments that are either of the following:*
 - a. *Other than capital appreciation or investment income.*
 - b. ***Not available to noninvestors or are not normally attributable to ownership interests.*** [emphasis supplied]

Of course, the above criteria are only indicative and cannot be construed as a litmus test for determination of an investment company. However, it is pertinent to note that a clear *distinction has been made between the investment interest and ownership interest*, the latter being excluded as an investment company.

(b) United Kingdom

Section 235 of the Financial Services and Markets Act, 2000 defines a collective investment scheme to mean:

“any investment arrangements with respect to property of any description, including schemes, money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.”

It has been further stated that the participants in such scheme shall not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions.

² See Investment Companies Summary of Decisions Reached to Date During Redeliberations as of September 5, 2012. Available at: <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175824491189&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs> (last visited on October 10, 2012)

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Furthermore, both of the following characteristics shall be satisfied:

- (a) the contributions of the participants, and the profits or income out of which payments are to be made to them, shall be pooled; and
- (b) the property shall be managed as a whole by or on behalf of the operator of the scheme.

Therefore, a collective investment scheme is an arrangement that enables a number of investors to pool their assets and have these professionally managed by an independent manager.³ The segregation between management and investors, therefore, is quite clear.

(c) European Union

The Directives relating to undertakings for collective investment in transferable securities (“**UCITS Directive**”)⁴ *excludes a collective investment undertaking undertakings of the closed ended type from the purview of the UCITS Directive.*⁵ In other words, a closed-end vehicle, which is what all companies are, is completely excluded from the UCITS Directive.

The Directive on AIF Managers by the EU Committee of the House of Lords, AIF was defined to include hedge funds, private equity funds, venture capital firms, commodities and real estate funds.⁶

(d) Singapore

The Securities and Futures Act (Cap 289) of Singapore defines a collective investment scheme to mean:

- “(a) an arrangement in respect of any property —
- (i) under which —
 - (A) the **participants do not have day-to-day control over the management of the property**, whether or not they have the right to be consulted or to give directions in respect of such management; and
 - (B) the property is **managed as a whole by or on behalf of a manager**;

³ <http://www.hmrc.gov.uk/collective/what-is.htm> (last visited on October 11, 2012)

⁴ Directive 2009/65/EC of the European Parliament and of the Council. Available at: http://www.esma.europa.eu/system/files/L_302_32.pdf (last visited on October 10, 2012)

⁵ Article 3(a) of the UCITS Directives.

⁶ <http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeucom/48/48i.pdf> (last visited on October 10, 2012).



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(ii) under which the **contributions** of the participants and the profits or income from which payments are to be made to them **are pooled**; and

.....

but does not include —

- (i) an arrangement operated by a person **otherwise than by way of business**;
- (ii) an arrangement under which each of the participants carries on a business other than investment business and enters into the **arrangement solely incidental to that other business**;
- (iii) an arrangement under which each of the **participants is a related corporation of the manager**;

.....

(x) **a closed-end fund** constituted either as an entity or a trust;
.....”

Here again, one would notice a complete exception carved for closed-end funds, which would include all investment companies.

3. ANALYSIS AND CONCLUSION

3.1 Separation of management and investment

As can be noted, a scheme or a fund contemplates management by an external manager and does not constitute an in-house management mechanism. Where the funds are privately pooled for a common purpose and managed in-house on the bases of a private arrangement, agreement or understanding, it cannot be construed as an AIF.

The intention of SEBI is clear: (a) to protect interests of the investors; and (b) ensure proper management of the capital of the investors. Where there is no public money involved, SEBI clearly cannot have any intent to monitor.

3.2 Difficulties with a company form of AIF

Despite the flexibility in organisational form that might have been SEBI's objective in giving the choice of the organisational form, the company form is eminently unsuitable for an AIF. Reasons are several.

First, Category III AIFs may be open-ended. In case of companies, open-ended company would mean free buyback of shares of a company, which is not permissible under the Companies Act, 1956 where buyback of shares by a company is restricted.

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Second, whether closed-ended or open-ended, most AIFs have a limited life span – in case of companies, thinking of taking the company to winding up will be an extremely protracted exercise.

Third, in addition to the above, there are entry and exit norms applicable under the FDI policy, which do not apply in case of LLPs and trusts.

Last, needless to mention the continuous compliance issues associated with a company.

The reason why the corporate form might have made sense elsewhere in the world is that the US regulation (Investment Company Act) is an overarching law on all investment companies. In India, the idea of SEBI could not have been to regulate investment companies.

Our recommendation will be that companies should be completely excluded from the AIF regulations, or it should be clarified that in case of companies, only such part of investment corpus as is different from the share capital of the company is counted as size of the AIF. In case of LLPs, general partners are in the nature of owners/managers of the LLP, while limited partners are external investors. The AIF Regulations should be focused only on the limited partners' investments.

Other Articles that may interest you:

1. [*AIF Regulations: paving the Way for a variety of Collective Investment Devices*](#), by Vinod Kothari
2. [*SEBI AIF Regulations 2012: Opens gate for hedge funds, real estate fund and other collective funds in India*](#), by Aditi Jhunjunwala and Nidhi Ladha