

AIF Regulations raise the bar

By Siddharth Hariani
and Hemant Krishna V,
Phoenix Legal



New Delhi

Second Floor,
254, Okhla Industrial Estate,
Phase III, New Delhi-110020
India
Tel +91 11 4983 0000
Fax: +91 11 4983 0099
Email: delhi@phoenixlegal.in

Mumbai

First Floor, CS-242,
Mathuradas Mill Compound,
NM Joshi Marg, Lower Parel
Mumbai - 400 013, India
Tel: +91 22 4340 8500
Fax: +91 22 4340 8501
Email: mumbai@phoenixlegal.in

In what has otherwise been a quiet year for reforms, the Securities and Exchange Board of India (SEBI) has created a buzz by notifying the SEBI (Alternative Investment Funds) Regulations, 2012, (AIF Regulations).

By taking on board reactions to the concept paper released in August last year and implementing changes in the final version of the regulations, SEBI has honoured the tradition of interactive governance. This column provides an overview of the new rules.

What's the alternative?

The regulations set out a broad definition of alternative investment funds (AIFs) which include any privately pooled investment vehicle established in India that collects funds from investors (Indian or foreign) and invests these funds in accordance with a defined investment policy. Mutual funds, family trusts, employee stock options and welfare trusts, collective investment schemes, foreign funds, and funds specifically governed by any other Indian regulator are excluded from the regulations.

An AIF is required to obtain a certificate of registration from SEBI – similar to venture capital fund registration under the now repealed SEBI (Venture Capital Funds) Regulations, 1996, (VCF Regulations). An existing fund falling within the definition of an AIF, which is not registered with SEBI under the VCF Regulations, may operate for a period of six months from the commencement of the AIF Regulations, after which it must register itself under the new rules.

Fund classes

The regulations classify the pools under three categories. The first category includes welfare funds, infrastructure funds and venture capital funds,

which are seen as having a beneficial impact on the economy and could be considered by the government, SEBI or other regulators for providing certain incentives and concessions.

Pools with the freedom to invest and not falling under the first category, such as private equity funds, are labelled under the second category. These AIFs do not enjoy special incentives and are also prohibited from undertaking leverage other than to meet day-to-day operational requirements.

The third category of AIFs includes hedge funds which trade with a view to make short term returns and employ complex trading strategies and leverage including through investment in listed or unlisted derivatives. These AIFs can pose systemic risks and will be subjected to additional regulations such as operational standards, conduct of business rules, prudential requirements, restrictions on redemption, and conflict of interest conditions.

The regulations employ several minimum investment thresholds to protect unsophisticated players from risk. For instance, an AIF is not allowed to accept investment of less than ₹10 million (US\$180,000) from an investor. The regulations also require that each scheme floated by an AIF must have a corpus of at least ₹200 million and pool managers are expected to shell out 2.5% of the size of the pool or ₹50 million, whichever is lower – thereby ensuring that the managers have their skin in the game.

Accountability

The regulations prescribe a high standard of disclosure for AIFs, which require investors to be informed of conflicts of interest, risk management, portfolio and transactional information regarding fund investments, fees ascribed to the manager or sponsor, inquiries or

legal actions by regulators as and when they occur, breach of a provision of the placement memorandum issued to investors, change in control of the sponsor, manager or investee company, and methodology for valuation of assets.

The regulations also require AIFs to provide investors with a risks report annually. The regulations empower the SEBI with the right to inspect the accounts and records of an AIF upon receipt of a complaint or on its own cognizance.

Pros and cons

The AIF Regulations mark an important step in SEBI's endeavour to achieve a stable system and to rein in previously unregulated investment funds set up in India. At the same time it could be argued that the minimum investment threshold adversely impacts small investors and the ability of investment managers to float small-scale funds. The high cost of compliance places greater onus on investment managers.

A move to permit the listing of units of close-ended funds would have been welcomed by the industry, but this too has been qualified by the regulations, which require a tradable lot of at least ₹10 million – a high benchmark even by a modest estimate.

Startups which would have previously looked to small-size investment channels to weather the funding crisis may now find themselves disadvantaged by the AIF Regulations. While the SEBI has scored highly as a guardian angel, it must now embrace seriously the role of an enabler that our economy needs today.

Siddharth Hariani is a partner at the Mumbai office of Phoenix Legal, where Hemant Krishna V is an associate. They can be reached at siddharth.hariani@phoenixlegal.in and hemant.krishna@phoenixlegal.in.