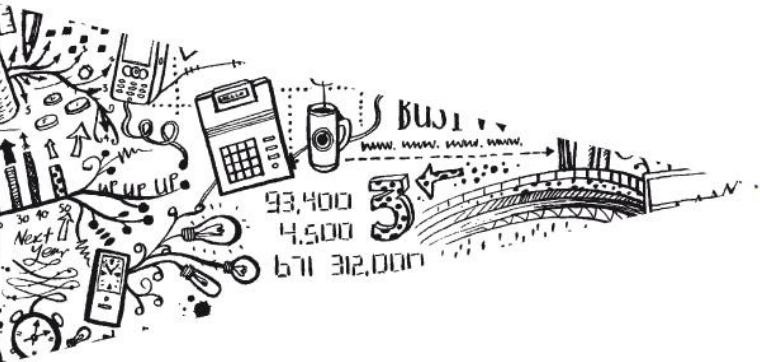


03 August 2011

## EY Regulatory Alert

Concept paper on proposed Alternative Investment Funds  
Regulations



# Background

The Securities and Exchange Board of India (SEBI, India's capital markets regulator) on 1 August 2011 issued a concept paper discussing the proposed introduction of SEBI (Alternative Investment Funds) Regulations, 2011 [AIF Regulations], for public comments. The AIF Regulations will provide a consolidated framework for registration and regulation of investment funds which raise capital from a number of institutional and High Net worth Investors (HNIs).

On introduction of the AIF Regulations, the existing SEBI (Venture Capital Funds) Regulations, 1996 [VCF Regulations] shall be repealed. Further, certain types of services provided by portfolio managers under separate regulations are also proposed to be regulated as private pools of capital under the AIF Regulations.

The AIF Regulations will only impact domestic investment pools and shall not impact offshore funds investing in India under the Foreign Direct Investment (FDI) route.

We have discussed in this alert the salient provisions of the AIF Regulations and our preliminary comments on the same.

## 1. Meaning and scope of Alternative Investment Funds

AIFs are defined to mean pooling or raising of private capital from institutional or HNIs with a view to investing it in accordance with a defined investment policy for the benefit of its investors and would include the following private pools of capital:

- **Private Equity Fund** - for making investments primarily in unlisted equity or unlisted debt securities of companies
- **Venture Capital Fund** - for providing equity seed capital to unlisted start-up or new ventures or early-stage or emerging companies primarily involved in new or unproven products/technology
- **Private Investment in Public Equity (PIPE) Fund** - for investments into small size listed companies
- **Debt Fund** - for making investments primarily in debt instruments of unlisted companies
- **Infrastructure Fund** - for investments in infrastructure companies
- **Real Estate Fund** - for investing in real estate projects or in special purpose vehicles undertaking real estate projects
- **Social Venture Fund** - for investors willing to accept muted returns to invest in social ventures such as micro-finance institutions (MFIs)
- **Small And Medium Enterprises (SMEs) Fund** - for making investments primarily in SMEs in manufacturing, service sectors,

businesses providing infrastructure or other support to SMEs, etc

- **Strategy Fund** - a private investment fund including a hedge fund
- Other similar funds as may be specified by the SEBI

- There are investment restrictions for VCFs under the existing VCF Regulations. The AIF Regulations expand the scope of investment strategies that can be deployed by an AIF especially with regard to introduction of PIPE Funds, Debt Funds and Hedge Funds. It would be useful for SEBI to clarify that a multi-strategy fund with a mixed investment strategy shall be eligible for registration as an AIF under the residual category

## 2. Registration procedure for AIFs

All AIFs are mandatorily required to obtain a certificate of registration from the SEBI.

The funds already registered under the VCF Regulations would continue to be regulated by the said regulations till the existing fund or scheme is wound-up.

Registration from SEBI under the AIF Regulations will be required for each fund scheme; additional schemes cannot be launched under the same registration.

- All unregistered funds will be required to seek registration with SEBI post the commencement of AIF Regulations
- Unlike the VCF Regulations where the trust secures a VCF registration and can then launch several schemes, under the AIF Regulations each scheme will require separate registration

### Key eligibility criteria

The SEBI will consider, inter-alia, the following in granting registration to an AIF:

- Experience of the sponsor or fund manager or asset management company of AIF in managing private pools of capital
- Track record, professional competence, financial soundness, experience, general reputation of fairness, etc of the sponsor or fund manager of AIF

### Consideration of application

The SEBI, while considering application for registration of an AIF, will take into account all matters relating to investment objective of the fund, the target investors, size of the fund, investment style or strategy, professional qualification of the managers, necessary infrastructure, past experience, etc.

- The AIF Regulations do not prescribe for registration of the fund manager. However, the concept paper discusses SEBI's intent to regulate the fund managers under a framework for regulation of investment advisors. A proposed SEBI (Investment Advisers) Regulations, 2007 was released for public comments in the year 2007 though it is yet to be notified

### 3. Investment conditions and restrictions

#### Investment strategy

The AIF will be required to state its investment strategy, investment purpose and business model in an information memorandum to the investors.

#### Key conditions

- The minimum size of the AIF has to be ₹ 200 million
- Fund size has to be specified at the time of launch of the fund. However, it can be revised upward up to 25% after giving suitable reasons to the SEBI
- Minimum investment amount by an investor should be 0.1% of the fund size subject to a minimum of ₹ 10 million
- The sponsor of the fund should contribute from their own account an amount of investment equal to at least 5% of the fund which investment shall be locked-in till the redemption by all investors in the fund. This contribution cannot be through

- the waiver of management fees and has to be invested in the AIF
- AIF can solicit investment by investors only through private placement by issuance of information memorandum

- The minimum investment by an investor in an AIF has been proposed to be increased from ₹ 0.5 million (under the VCF Regulations) to the higher of 0.1% of fund size or ₹ 10 million. The 20 fold increase in the investment limit would significantly restrict the flow of retail monies into the AIFs
- The VCF Regulations currently stipulate a firm commitment of ₹ 50 million for launch of a scheme. The AIF Regulations propose to increase the minimum size of the fund to ₹ 200 million
- The VCF Regulations do not stipulate a sponsor commitment. The AIF Regulations require the sponsor to commit to invest at least 5% of the fund

#### Term of the fund

- All AIFs are required to be close ended and the duration of fund shall be determined at the time of registration
- The tenure of the fund shall be minimum for a period of 5 years
- Extension of the tenure of the fund may be permitted upto 2 years only at a time and to be approved by 75% of the beneficiaries. If the consent for extension is not obtained, the fund has to be

- liquidated within one year following the expiry of the fund term
- d) Unliquidated investments at the end of the fund term are required to be acquired by the AIF's sponsor

- Currently, the VCF Regulations do not prescribe the above; the aforesaid terms are presently governed by the investment memorandum/ contribution agreement with the investors

#### General investment conditions and restrictions

- The AIF can invest only in instruments specified by SEBI for each type of fund
- AIF cannot invest more than 25% of the fund corpus in a single investee company
- AIF are not permitted to invest in (i) Non Banking Financial Companies (excluding Infrastructure Finance Company, Asset Finance Company, Core Investment Company or companies engaged in microfinance activity in case AIF is not a Strategy Fund), (ii) Gold Financing (excluding gold financing for jewellery) (iii) Activities not permitted and under Industrial Policy of the Government of India

#### 4. Key investment conditions specified for each category of AIF

##### 1. Venture Capital Fund

- Objective to promote new ventures using new technology or with innovative business ideas at early stage or start up stage
- The total investment in the venture capital fund cannot be more than ₹ 2.5 billion
- Venture capital fund not permitted to invest in any company that is promoted, directly or indirectly by any of the top 500 listed companies by market capitalization or by their promoters
- Required to invest at least 66.66% of its corpus in unlisted equity shares of the investee company
- Permitted to invest upto 33.33% of its corpus:
  - in the unlisted debt or debt instruments of the investee company where equity investment has been made
  - Preferential allotment of equity shares of a listed company subject to lock-in-period of one year
  - The equity shares or equity linked instruments of financially weak company or a sick industrial company
- The fund cannot invest in warrants of the investee company

##### 2. PIPE Fund

- PIPE fund to invest in shares of small sized listed companies which are not part of any market indices in exchanges having nationwide terminals
- Required to invest at least 66.66% of its corpus in equity shares of investee company
- Permitted to invest upto 33.33% of the corpus in debt or debt instruments of such companies where equity investment has been made
- Notwithstanding anything contained in SEBI (Prohibition of Insider Trading) Regulations, 1992, a PIPE fund may acquire securities of investee company and may be given access to non public information subject to prescribed conditions which, *inter-alia*, includes that PIPE funds shall be prohibited from selling or dealing in securities of investee companies for a period five years.

##### 3. Private Equity Fund

- Required to invest at least 50% of the corpus in equity shares or equity linked instruments of an unlisted company requiring medium to long term capital to develop and grow
- Not more than 50% of its corpus to be invested in the equity or equity linked instruments of a company which is proposed to be listed

- c. Not more than 50% of its corpus to be invested in unlisted debt of a company where the fund has already made equity investment

instruments of an infrastructure company or special purpose vehicles of infrastructure project

debt instruments of real estate projects or special purpose vehicles engaged in real estate projects

#### 4. Debt Fund

- a. Required to invest at least 60% of the corpus in debt or debt instruments of unlisted companies and not more than 25% of which may be invested in convertible debt, with minimum maturity of 5 years
- b. Permitted to invest upto 40% in
  - (i) securitized debt instruments
  - (ii) debt securities of listed company
  - (iii) equity shares of unlisted company where the fund has invested in unlisted debt instruments
- c. Fund to have a system of credit assessment irrespective of whether or not the securities are rated

#### 5. Infrastructure Fund

- a. Required to invest at least 66.67% of its corpus in the equity or equity linked instruments of infrastructure companies or special purpose vehicles of infrastructure projects (as defined by Central Government or Planning Commission)
- b. Permitted to invest upto 33.33% of its corpus in debt instruments of investee company where it has made equity investment or in securitized debt

#### 6. SME Fund

- a. The SME fund can invest primarily in the unlisted equity or equity linked instruments of SMEs in manufacturing, services sector as also businesses providing infrastructure or other support to SMEs as defined by the Ministry of Small and Medium Enterprises
- b. Permitted to also invest in equity or equity linked instruments of SME companies which are listed or proposed to be listed in SME exchange or SME segment of a regional stock exchange
- c. Permitted to enter into an agreement with merchant banker to subscribe to the unsubscribed portion of a public issue or to receive or deliver securities in the process of market making

#### 7. Real Estate Fund

- a. Required to invest at least 75% of its corpus in real estate projects or fully built properties or in special purpose vehicles engaged in real estate projects
- b. Permitted to invest upto 25% of corpus in allied sectors of real estate
- c. Required to invest at least 66.67% of its corpus in equity or equity linked instruments, and permitted to invest upto 33.33% of its corpus in debt or

#### 8. Social Venture Fund

- a. The Social Venture fund could be targeted to investors who are willing to accept muted returns, say 10% to 12%
- b. The fund is required to invest in social enterprises such as MFIs which satisfy social performance norms laid down by the fund

#### 9. Strategy Fund

- a. The Strategy fund may specify any strategy in any class of financial instruments
- b. Permitted to invest in derivatives, and complex structural products subject to requirement of suitability and disclosure to investors
- c. Permitted to leverage or float long or short strategy fund subject to consent from the investors in the fund, subject to a maximum leverage as may be specified by SEBI
- d. The fund which employs leverage will be required to disclose information regarding the overall level of leverage employed, the leverage arising from borrowing of cash or securities and the leverage arising from position held in derivatives, the reuse of assets and the main source of leverage in the fund

- Recently, certain tax sops were provided to Infrastructure Debt Fund (IDF) set-up by NBFCs and Mutual Funds, subject to certain conditions. Presently, AIF Regulations does not seem to cover IDF as a category of funds

## Comments

The implementation of AIF Regulations is a step in the right direction and should go a long way in steering the growth of the industry while at the same-time balancing the need for managing risks to the investors and the stability of the financial system.

### 5. Other provisions

The sponsor of AIF is required to appoint a custodian for safekeeping of securities of the fund if the assets under management are over ₹ 5 billion.

In case of change of control of sponsor or fund manager, prior approval from SEBI is required to be taken by the AIF.

Further, provisions have been prescribed for the following:

- Avoidance of conflicts of interest between the sponsor/manager
- Transparency and disclosure of information to investors
- Maintenance of records
- Redressal of investors complaints
- Dispute resolution

- While the AIF Regulations require sponsors/managers to abide by principles on avoidance of conflicts of interest by associated persons, unlike the VCF Regulations, at this stage, there is no prohibition on investment in associated companies

The move by SEBI to broad base the types of funds that can be launched for participation by HNIs and institutional investors is also a welcome move and will enable fund managers to design a broader suite of fund offerings that can cater to various risk appetites and investment objectives.

While the VCF Regulations are proposed to be subsumed in the AIF Regulations, SEBI (Foreign Venture Capital Investor) Regulations, 2000 [FVCI Regulations] are proposed to be retained and not subsumed in the AIF Regulations. However, it is indicated in the concept paper that FVCI Regulations may be amended to allow FVCI to invest in different categories of AIF such as SME, Social Venture Fund in addition to VCFs.

While foreign investors are covered in the definition of HNIs as eligible for investment in an AIF, clarity would be required for their actual participation in AIFs under the FDI guidelines.

SEBI has sought public comments on the AIF Regulations by 30 August 2011.

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