

SEBI (Alternative Investment Funds) Regulations 2012

The Securities and Exchange Board of India (“SEBI”) has notified the SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”) vide a press release dated May 21, 2012. This notification will supersede and override the concept paper on proposed AIF Regulations released by SEBI on August 1, 2011 and the press release of SEBI board meeting held on April 2, 2012. The objectives of the AIF Regulations is to extend the perimeter of regulation to unregulated funds, and ensuring systemic stability, increasing market efficiency and encouraging formation of new capital.

❖ In what forms can an AIF be established?

AIF means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate.

❖ What do you mean by Alternative Investment Fund (“AIF”)?

An AIF is a privately pooled investment vehicle (including private equity funds, hedge fund, SME fund, Infrastructure funds, etc.) 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.

There are three categories of registration depending on the nature of the fund and the risk to investors (based on leverage, complexity in trading strategies, etc.).

❖ Types of pooling vehicles exempted under the AIF Regulations

Mutual Funds, Collective Investment Schemes, Family Trusts, Employee Stock Options Trusts, Employee Welfare Trusts or Gratuity Trust, holding companies, funds managed by securitization company or reconstruction company, Securitization Trust or any such pool of funds which are directly regulated by any other regulator in India are excluded from the definition of AIF.

❖ Is there any grandfathering provision for existing funds under the existing ‘VCF Regulations’?

- Existing Venture Capital Funds (“VCFs”) will continue to be regulated by the VCF Regulations until being wound up.
- Such registered VCF’s will not raise any fresh funds after notification of the AIF Regulations except where commitments already made by investors as on date of the notification.
- Such VCFs may also seek re-registration under AIF regulations subject to approval of two-thirds of their investors by value.
- SEBI (Venture Capital Funds) Regulations, 1996 (“VCF Regulations”) has been repealed under regulation 39 of the AIF Regulations.

❖ How does one deal with unregistered funds under AIF Regulations?

- Such funds will be required to obtain registration under the AIF Regulations within 6 (six) months of notifications of the same.
- Existing schemes will be allowed to complete their agreed tenure.
- No fresh monies will be raised other than the commitments already made till the fund is registered under the AIF Regulations.
- Existing funds not registered under the VCF Regulations which seek registration but are not able to comply with all provisions of AIF Regulations may seek exemption from the Board from strict compliance with the AIF Regulations.

❖ What are the parameters used for classification of each category of AIF?

The different parameters under the AIF Regulations applicable to each category of AIF are encapsulated below:

Parameters	Category I AIF	Category II AIF	Category III AIF
Categories	Includes (i) Venture Capital Funds, (ii) SME Funds, (iii) Social Venture Funds and (iv) Infrastructure Funds.	Residual category, i.e, includes funds that are not classified as Categories I or III	Includes (i) hedge funds, (ii) fund of funds etc. Fund which employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.
Registration:	With SEBI under the AIF Regulations	With SEBI under the AIF Regulations	With SEBI under the AIF Regulations
Conditions for Investment	<ul style="list-style-type: none"> - Not to borrow funds directly or indirectly or leverage except for meeting temporary funding requirements subject to prescribed restrictions. - Specific investment restrictions and conditions have been prescribed for all types of Category I AIF. 	<ul style="list-style-type: none"> - Not to leverage except to meet day-to-day operational requirements as permitted in the AIF Regulations. - Investment conditions are prescribed in Regulation 17 of the AIF Regulations 	<ul style="list-style-type: none"> - Engage in leverage subject to prescribed limits. - SEBI may issue directions in relation to prudential requirements, operational standards, conduct of business rules, restrictions on redemption and conflict of interest
Investment in AIF:	May raise funds from any investor whether Indian, foreign or non-resident Indians by way of issue of units	Same as Category I AIF	Same as Category I AIF
Minimum Fund Size:	Rs. 20 Crore	Same as Category I AIF	Same as Category I AIF
Minimum Capital Commitment:	<ul style="list-style-type: none"> - Rs.1 Crore - Rs. 25 lakhs shall be the minimum value of investment by employees or directors of the AIF or Manager. 	Same as Category I AIF	Same as Category I AIF
Sponsor Commitment:	2.5% of the corpus or Rs.5 crore whichever is lower minimum investment contribution by the Sponsor/manager. The sponsor manager shall have a continuing interest in the AIF and such interest shall not be through the waiver of management fees.	Same as Category I AIF	5% of the corpus or Rs.10 crore whichever is lower minimum investment contribution by the Sponsor/manager. The sponsor manager shall have a continuing interest in the AIF and such interest shall not be through the waiver of management fees
Term	Close-ended and shall have a minimum tenure of 3 years	Same as Category I AIF	May be close-ended or open-ended
Scheme:	Schemes may be launched under an AIF subject to filing	Same as Category I AIF	Same as Category I AIF

	of information memorandum with the SEBI along with prescribed fees		
Listing on Stock Exchange:	Units of close ended AIF may be listed on stock exchange subject to a minimum tradable lot of Rs.1 crore. However, the AIF shall not raise funds through Stock Exchange mechanism and the units of AIF may be listed on the stock exchange only after final close of the fund or scheme	Same as Category I AIF	Same as Category I AIF
Nominated Investor	Considered as Nominated Investor under SEBI (ICDR) regulations, 2009	Same as Category I AIF	Same as Category I AIF
Investment Limits	<ul style="list-style-type: none"> - Minimum investment limit: 25% of the corpus in one Investee Company, - Not to invest in Associate companies except with the approval of 75% of investors by value of their investment in the AIF 	Same as Category I AIF	<ul style="list-style-type: none"> - Minimum investment limit: 10% of the corpus in one Investee Company, - Not to invest in associate companies except with the approval of 75% of investors by value of their investment in the AIF
Insider Trading	Exemption available under Category II AIF is available for VCF and SME Funds	Exempted from the SEBI (Prohibition of Insider Trading) Regulations, 1992, for investments in companies on SME exchange pursuant to due diligence subject to following conditions: <ul style="list-style-type: none"> - Lock-in period of one year, - Disclose any acquisition or dealing in securities pursuant to due-diligence. 	Exemption under the SEBI (Prohibition of Insider Trading) Regulations, 1992 not available

The above categorization of the AIFs is based on risk analysis. Additionally, criteria as to whether open-ended or close-ended and whether entitled to use leverage are treated as distinguishing factors.

❖ **Analysis:**

- **Investment Strategy:** SEBI's categorization of AIFs into three categories is a welcome move as compared to having straight jacketed nine categories. However, such categorization will affect the flexibility between the investors and investment managers to agree upon investment strategies.

- **Sponsor commitment:** The obligation of contributing and maintaining a continuing interest of the sponsors or the managers in AIFs implies that an increase in the investment base of AIFs would result in the increase of the commitment of such sponsors or the managers. This could be a concern for the manager as prior to the AIF Regulations, the manager contribution was governed by LP-GP relationship.
- **Commercial decisions:** The AIF Regulations will have the effect of curtailing the commercial flexibility of funds as investment limits on investee companies and the terms of co-investment opportunities to be offered to sponsors or the managers will be regulated.
- **Tax Pass through status:** The tax pass through benefits have been extended only to Category I venture capital funds under the explanation to Category I AIFs in the AIF Regulations.
- **Pooling of assets:** The AIF Regulations will ring a death knell to the recent amendments to the PMS Regulations and the Mutual Funds Regulations in respect of segregation of assets as vehicles that propose pooling of assets of investors could fall under the AIF Regulations.

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