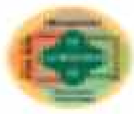

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# ALTERNATIVE INVESTMENT FUND: RE-DEFINING THE MODUS OPERANDI OF VENTURE CAPITAL

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***Abstract***
*The Securities and Exchange Board of India had issued the SEBI (Alternative Investment Funds) Regulations, 2012 which has broadened the scope of SEBI to monitor almost all kinds of private funds in India, including real estate funds and hedge funds. Until now, the only regulation that governed a limited category of private funds in India was the SEBI (Venture Capital Funds) Regulations, 1996 which had intended to promote investments into start-ups and mid-size companies. However, most venture capital funds operated as real estate funds, infrastructure funds, etc. Thus, a need was felt to frame a more exhaustive set of regulations to govern all types of funds. Among the main reasons cited by SEBI to highlight its rationale behind introducing the AIF Regulations are to recognize AIFs as a distinct asset class; promote start-ups and early stage companies; to permit fund investment strategies in the secondary markets; and to tie concessions and incentives to investment restrictions.*

*This article seeks to cover the development which has been included by the new regulation of 2012 and modalities involved in the regulation. Along with all the regulatory compliances, restrictions and implications thereof under the Indian laws. The author has tried to summarize the SEBI Regulations and has put forward all developments which this new regulation has brought forward.*

## INTRODUCTION

Earlier the basic source of funding were private placements, public offerings and lending by financial institutions, these means of funding were largely used to raise capital, but the said did not prove to be optimal means of raising capital. It is since the emergence of the Venture Capital – Private Equity (“VCPE”) market in India, that there are other means of rising of funds and capital which gained importance. It is with the implementation of the Securities and Exchange Board of India (Venture Capital Funds) Regulations (“VCF Regulations”) in 1996, the VCPE market has successfully filled the void space between capital requirements of rapidly booming and funding available from traditional sources such as banks, IPOs, etc. The impact of the VCPE industry has brought out a positive elect on various stakeholders – depth and quality of companies in the capital markets, providing much needed risk capital and mentoring to entrepreneurs, offering risk-adjusted returns to investors, improving the stability.

Various factors can also be attributed to the VC funding in India. The benefit of the VC investment caught the eye of the Government of India and once it became aware of the benefits and criticality for the growth of the various sectors such as software technology and internet, favorable regulations were passed regarding the investment in VCF and ability of various financial institutions to invest in it. Further, the process was simplified and tax treatments for VC Funds were liberalized.

It was the intention behind framing of VCF Regulation to provide financial capital to early-stage, high-potential, growth start-up companies and mid-sized companies. Since its enforcement the venture capital route was being used by several other funds such as Real Estate funds, Private Equity (PE) funds, etc. As this route was being used by many other funds it made it difficult to target incentives specific to VCFs without enabling other funds to avail of such incentives.

Further, the investment restrictions placed on VCFs were not suitable for such funds. Hence, on one hand, there were a set of funds like VCF which required incentives and concessions and were comfortable with consequent restrictions attached and on the other hand, there were another set of funds like PE funds which did not require incentives and concessions but required investment flexibility[1].

[1] *http://www.arthapedia.in/index.php?title=Alternative_Investment_Funds_(AIFs)*

Subsequently, in 2012, The Securities and Exchange Board of India (“SEBI”) with intention to regulate all privately pooled investment vehicles took steps to completely overhaul the regulatory framework for domestic funds in India and introduced the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”) which repealed the SEBI (Venture Capital Funds) Regulations, 1996 which was commonly known as “VCF Regulations”.

There were many problems and benefits for the enactment of the regulation. The main reasons cited by SEBI for introducing the AIF Regulations were to recognize AIFs as a distinct asset class; to permit fund investment strategies in the secondary markets; promote start-ups and early stage companies; and to tie concessions and incentives to investment restrictions.

**DEFINATION AND MEANING**

To find the proper definition of the term AIFs in India, one has to go through the definition in Regulation 2(1)(b) of Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012. This regulation provides for and includes all privately pooled investment fund irrespective of Indian or foreign sources, these includes a trust or a company or a body corporate or a Limited Liability Partnership (LLP) which were unheeded by any Regulation of SEBI governing fund management (like, Regulations governing Mutual Fund or Collective Investment Scheme) and were also covered under the direct regulation of any other sectoral regulators in India- IRDA, PFRDA, RBI. Thus, it is to be understood that in India, AIFs are private funds which are not cover by any regulator in India which has utmost jurisdiction.

Excluding few exceptions in India, AIF Regulations has its ambit which is to regulate all forms of vehicles set up in India for pooling of funds on a private placement basis. Further, in respect to the operations which AIF Regulation carries out are completely bulwark to its extent.

An Alternative Investment Fund (“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 which:

i. 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
ii. 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.[2]

Thus, the definition of AIFs includes venture Capital Fund, hedge funds, private equity funds, commodity funds, Debt Funds, infrastructure funds, etc., while, it excludes Mutual funds or collective investment Schemes, family trusts, Employee Stock Option / purchase Schemes, employee welfare trusts or gratuity trusts, ‘holding companies’ within the meaning of Section 4 of the Companies Act, 1956, securitization trusts regulated under a specific regulatory framework, and funds managed by securitization company or reconstruction company which is registered with the RBI under Section 3 of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

Hence, basically AIFs are considered to be the funds which are established or incorporated in India specifically for the purpose of pooling in capital from Indian and foreign investors for investing as per a pre-decided policy.

**TYPES OF AIFs**

AIFs are categorized into the following three categories, based on their impact on the economy and the regulatory regime intended for them:[3]

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[2] *Rule 2 (b) Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012.*
[3] *Available on (http://www.arthapedia.in/index.php?title=Alternative_Investment_Funds_%28AIFs%29)*

**Category I AIF** – those AIFs with positive spillover effects on the economy, for which certain incentives or concessions might be considered by SEBI or Government of India or other regulators in India; and which shall include Venture Capital Funds, SME Funds, Social Venture Funds, Infrastructure Funds and such other Alternative Investment Funds as may be specified. These funds shall be close ended, shall not engage in leverage and shall follow investment restrictions as prescribed for each category. Investment restrictions for VCFs are similar to restrictions in the existing VCF Regulations.

**Category II AIF** – those AIFs for which no specific incentives or concessions are given by the government or any other Regulator; which shall not undertake leverage other than to meet day-to-day operational requirements as permitted in these Regulations; and which shall include Private Equity Funds, Debt Funds, Fund of Funds and such other funds that are not classified as category I or III. These funds shall be close ended, shall not engage in leverage and have no other investment restrictions.

**Category III AIF** – those AIFs including hedge funds which trade with a view to make short term returns; which employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives. These funds can be open ended or close ended. Category III funds shall be regulated through issuance of directions regarding areas such as operational standards, conduct of business rules.[4]

## CHOICE OF POOLING VEHICLE

The AIF Regulations contemplate the establishment of funds in the form of a trust, a company, an LLP or a body corporate. The following table provides a comparison of these entities from an investment fund perspective:[5]

| Issue | Trust | Limited Liability Partnership | Company |
|---|---|---|---|
| General | The person who reposes or declares the confidence is called the "author of the trust"; the person who accepts the confidence is called the "trustee"; the person for whose benefit the confidence is accepted is called the "beneficiary"; the subject matter of the trust is called "trust property"; the "beneficial interest" or "interest" of the beneficiary is the right against the trustee as owner of the trust property; and the instrument, if any, by which the trust is declared is called the "instrument of trust" | The concept of LLP was recently introduced in India under the Limited Liability Act, 2008 ("LLP Act"). An LLP is a hybrid form of a corporate entity, which combines features of an existing partnership firm and a limited liability company (i.e. the benefits of limited liability for partners with flexibility to organize internal management based on mutual agreement amongst the partners). The functioning of a LLP is governed by the limited liability partnership agreement. | A Company can be incorporated under the Companies Act, 1956 or the Companies Act, 2013.<br><br>The control of the company is determined by a board of directors which is elected by the shareholders.<br><br>Separate classes of securities could be issued to different shareholders that shall determine their rights and obligations (as distinct from other classes) from both the 'voting' perspective as well as from a 'distribution' perspective. The class structure however would need to be in compliance with Companies Act, 2013 as and when all relevant sections thereof are brought into effect. |

[4] *http://www.sebi.gov.in/sebiweb/home/document_detail.jsp?link=http://www.sebi.gov.in/cms/sebi_data/docfiles/23767_t.html*

[5] *On May 6, 2014, Andrew Bowden, Director of the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE), stated that the OCIE has found widespread instances of insufficiently disclosed fees in the private equity industry. Also see http://blogs.wsj.com/privateequity/2014/06/10/sec-official-points-to-disclosure-shortcomings-by-private-equity-firms/*

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|---|---|---|---|
| Entities Involved | The Settlor:<br>The Settlor settles a trust with an initial settlement. Terms of the indenture of trust (“Indenture”) shall administer the functioning of the trust (“Trust”).<br><br>The Trustee: The Trustee is in charge of the overall administration of the Trust and may be entitled to a trusteeship fee. The Trustee may also appoint an investment manager, who in turn manage the assets of the Trust and the schemes/ funds as may be launched under such Trust from time to time.<br><br>The Contributor : The contributor is the investor to the Trust (the fund) and makes a capital commitment under a contribution agreement | Partner:<br>A ‘partner’ represents an investor in the fund. The LLP structure is onceptually akin to a limited partner as internationally understood in a LP structure. To that extent, a partner has an obligation to fund its ‘commitment’ to the Fund and is entitled to istributions based on fund documents (being the LLP Agreement in this case).<br><br>Designated Partner: Though the expression ‘designated partner’ is not explicitly defined, however on a plain reading of the LLP it is understood that such ‘designated partner shall be the person responsible and liable in respect of the compliances stipulated for the LLP. | Shareholders:<br>Shareholders hold the shares of the company and are granted special privileges depending on the class of shares they own.<br><br>Directors: Directors have a fiduciary duty towards the company with respect to the powers conferred on them by the Companies Act and by the Memorandum of Association and Articles of Association of the company. They are trustees in respect of powers of the company that are conferred upon them, for instance, powers of (a) issuing and allotting shares; (b) approving transfers of shares; (c) making calls on shares; and (d) forfeiting shares for non-payment of call etc. They must act bona fide and exercise these powers solely for the benefit of the company. |
| Management of Entities | The Trustee is responsible for the overall management of the Trust. In practice this responsibility is outsourced to an investment manager pursuant to an investment management agreement | The LLP itself has to manage the entities and relies on the Designated Partner in this respect. In practice, this responsibility may be outsourced to an investment manager pursuant to an investment management agreement | The board of directors manages the entities involved. In practice this responsibility is outsourced to an investment manager pursuant to an investment management agreement |
| Market Practice | Almost all funds formed in India use this structure.<br>The regulatory framework governing trust structures is stable and allows the management to write its own standard of governance | Barely a few funds are registered under this structure. The registrar of companies does not favor providing approvals to investment LLPs.<br>As per section 5 of the LLP Act, 2008, only an individual or a body corporate is eligible to be a partner in an LLP. | There are no clear precedents for raising funds in a ‘company’ format. |

**REGISTRATION OF AIFs**

**Permission to market a fund prior to registration with SEBI[6]**

The amendments now provide that subject to certain eligibility criteria being met, SEBI may grant in-principle approval to applicant funds even if draft constituent documents (for example, the trust deed in case of trust applicants) have been submitted. On the basis of the 'in-principle' approval, the fund manager is now permitted to seek commitments for a period of 6 months, post which, duly executed constituent documents need to be submitted.

While the fund needs to obtain formal registration with SEBI in order to issue calls and accept contributions, the amendments are a welcome move as it cuts the lead time for fund managers for seeking commitments. Further, based on marketing efforts, the manager can now fine tune the product offering description in the constituent document at the time of approaching the regulator.

**Initial Formal Implementation of the Regulation**

The registration is mandatory for all varieties of AIFs under SEBI (Alternative Investment Funds) Regulations, 2012. Existing funds shall get the registration within six months from the date of commencement of these regulations. Further, the registration is compulsory for each fund. It means that it is not an umbrella registration. However, existing funds registered under SEBI (Venture Capital Funds) Regulations, 1996 shall continue until completion of tenure of the existing fund/scheme. But, they are not allowed to launch new schemes.[7]

SEBI has classified AIFs into three categories for registration. AIFs shall seek registration under any of the specified categories. Category I AIF shall include Venture Capital Fund, SME Fund, Social Venture Fund, Infrastructure Fund and any other funds specified from time to time. Category II AIF does not fall in Category I and Category III. It does not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in these regulations. Private Equity funds and Debt funds which are not getting any concessions or incentives either from the government or any other regulator shall get registration under this category. Category III AIF like Hedge Fund which employs diverse or complex trading strategies and employs leverage including through investment in listed or unlisted derivatives. Eligibility Criteria The following important aspects, among others, are taken into account by SEBI for the purpose of considering an entity for registration:

1. There should be permission from the Memorandum of Association in case of a Company; the Trust Deed in case of a Trust; the Partnership Deed in case of a Limited Liability Partnership (LLP) to carry on the activity of an AIF.
2. The applicant is prohibited by its Memorandum and Articles of Association, Trust Deed or Partnership Deed from making an invitation to the public to subscribe to its securities.
3. The applicant should have been registered under the applicable laws to it.
4. The Applicant, Sponsor and Manager are fit and proper persons based on the criteria specified in Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008.
5. The key investment team of the Manager of AIF has adequate experience, with at least one key personnel having not less than five years experience in advising or managing pools of capital or in fund or asset or wealth or portfolio management or in the business of buying, selling and dealing of securities or other financial assets and has relevant professional qualification.
6. The Manager or Sponsor has the necessary infrastructure and manpower to effectively discharge its activities.
7. The applicant has clearly described, at the time of registration, the investment objective, the targeted investors, proposed corpus, investment style or strategy and proposed tenure of the fund or scheme

[6] *Mukul Aggarwal and Richie Sancheti, SEBI Updates AIF Regulations: Angel Funds Notified, Published by Nishith Desai associate (on-line publication) dated 3 October 2013.*

[7] *Adhitya Srinivasan and Richie Sancheti, SEBI Revises Operational Framework for Alternative Investment Funds, Published by Nishith Desai associate (on-line publication) dated 7 July 2014.*

**AIF AND VCF REGULATION**

The existing VCF Regulations are proposed to be subsumed in AIF Regulation as the VCFs would be one kind of AIF. The existing investment criterion for VCF is proposed to be retained substantially. After the commencement of AIF Regulation, the VCF Regulation would stand repealed and VCFs would be governed by AIF Regulation.

Following are the important aspect which is stated in the AIF regulation:

- Total corpus shall not exceed INR 2500 million;
- VCFs shall not invest in any company promoted directly / indirectly by any top 500 listed companies (by market cap) or by their promoters;
- Minimum 66.66 percent of the fund to be invested in unlisted equity shares of investee companies; unlike the existing regulations, the AIF Regulations do not provide that a VCF can invest in equity linked instruments such as optionally convertible debentures/preference shares within this window. Warrants are expressly prohibited; and
- Up to 33.33 percent of the fund may be invested in (i) debt of investee companies where equity is held (ii) preferential allotment of equity shares of listed companies (iii) equity shares / equity linked instruments of listed financially weak /sick companies. As compared to the existing regulations, initial public offering and SPVs are excluded from this window.

**DISCLOSURE ON DISCIPLINARY HISTORY**

Under the AIF Regulations, the regulation 11(2) requires an AIF to include disciplinary actions in its placement memorandum. The Circular provides that AIFs should include:

1. A disciplinary history of the AIF, sponsor, manager and their directors, partners, promoters and associates;[8] and
2. A disciplinary history of the trustees or the trustee company and its directors if the applicant for AIF registration is a trust. Further, the Circular provides guidance on what should be covered under ‘disciplinary history’. Disciplinary history inter alia includes details of outstanding / pending and past cases (where the person has been found guilty), criminal or civil prosecution, non-payment of statutory dues, overdue to / defaults against banks or financial institutions, adverse findings with respect to compliance with securities laws, disputed tax liabilities, etc. as well as any disciplinary action taken by SEBI or any other regulatory authority.[9]

**Other Salient Features**

a. The fund may raise funds from any investor whether Indian, foreign or non-resident Indians by way of issue of units.
b. Each scheme of the fund should have a minimum corpus of Rs. 20 crores and each investor should make a minimum investment of Rs. 1 crore. Provided that if the investor is either a director or employee of the fund or an employee or director of the manager of the fund, the minimum investment will be Rs. 25 lakhs.
c. No scheme of the fund is permitted to have more than 1000 investors.
d. The sponsor/manager of the fund should continue to have a minimum interest of the lower of 2.5% of the corpus or Rs. 5 crore other than through the waiver of his management fees. For category III funds, the sponsor/manager’s interest should continue to be the lower of 5% of the corpus or Rs. 10 crores.
e. These funds are not permitted to raise funds through the stock exchange mechanism but may be listed on stock exchange, subject to a minimum tradable lot of Rs. 1 crore. Listing of AIF is permitted only after final close of the fund or the scheme.
f. Category I and II funds cannot invest more than 25% of the investible funds in any one investee company whereas category III cannot invest more than 10% of the investible funds in any one investee company. Co-investment in an investee company by a Manager or Sponsor shall not be on terms more favourable than those offered to the AIF.

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[8] *See Regulation 2(1)(c) of the AIF Regulations.*
[9] *See paragraphs 2(a)(ii)(1) and (2) of the Circular no. CIR/IMD/DF/14/2014.*

g. AIFs will have Qualified Institutional Buyer (“QIB”) status as per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.
h. While a Category III AIF may be either close-ended or open-ended, the other two categories of AIFs will have to be close-ended funds with a minimum tenure of 3 years. Tenure for the close-ended funds can be extended for a maximum tenure of up to 2 years subject to the approval of two-thirds of its unit holders by value.

**CONCLUSION**

Post AIF Regulations scenario is that the VCF Regulations stands repealed and VCFs would be governed by AIF Regulations. However, VCFs registered under VCF Regulations shall continue to be regulated by the VCF regulations till the existing fund/scheme is wound up. While such a special treatment will not be provided for unregistered trusts, such unregistered trusts may be compelled to register under and be subject to the AIF Regulations.

There would be paramount shift in the Investment management regulation in India, after adapting the regulation in letter and spirit. There is still scope for improvement as the regulations are ambiguous on the point as to how funds, which are sector agnostic with a relatively flexible investment strategy are to be dealt with. The move taken by the legislator regarding the regulatory framework adapted to funds with different investment objectives is appreciable and welcomed however being a relatively new concept there is scope for improving and rationalizing the regulations by clarifying and relaxing certain category which would meet the commercial reality. As there is room for improvement the regulation may be suitable amended to avoid any uncertainty.

The AIF Regulation has pushed the Managers of Alternative Investment Fund to the extent that they have to deal with the regulators and the investor with greater oversight and accountability. Looking towards the new regulation pertaining to the alternative investment fund, the investor must lose sight from the disclosure norms which are statutorily mandated in the regulation itself. Given the recent observations by regulators in sophisticated jurisdictions, the Circular seems to be in line with where the discretionary management industry is expected to be, from a disclosure to investor perspective.

SEBI in a surprising move appears to have considered the inputs sought by floating concept paper & the draft regulations on its Website received from various stakeholders and have accordingly re-classified the categories of the AIFs based on such inputs and risk exposure. As the expectations are high from the AIF Regulation with respect to meet SEBI’s objectives and increase investor protection, time will tell whether the objective has been achieved or resulted into more cost deterrent for the investors.