A PEAK INTO ALTERNATIVE INVESTMENT FUNDS - SEBI AND FEMA PERSPECTIVE

Background:

Till 2012 Investment Management regulations of SEBI were limited only to Mutual Funds (MF), Collective Investment Schemes (CIS), Venture Capital Funds (VCF) and Portfolio Managers, and were well regulated. In the absence of dedicated regulations, other private pools of capital and investment vehicles like PE Funds (Private Equity), Real Estate Funds, etc used VCF route for investments. This defeated the basic purpose of VCF which was promotion of early stage companies. As the concessions and other benefits generally available to VCFs cannot be extended to other funds, the need was felt to recognize such other funds as "Alternative Investment Funds" as a distinct asset class apart from promoter holdings, creditors and public investors.

Accordingly, SEBI has released a concept paper in August 2011 followed by issuing SEBI (Alternative Investment Funds) Regulations (herein after referred as 'AIF Regulations') in May 2012 and were amended time to time. SEBI (Venture Capital Funds) Regulations, 1996 were repealed and related provisions were subsumed in to AIF Regulations. However, SEBI (Foreign Venture Capital Investor) Regulations are not subsumed and are still governed separately.

Concept:

"Alternative Investment Fund" 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. AIF can be of different types like Angel Fund, PE Fund, PIPE Fund, Venture Capital Fund, Debt Fund, Infrastructure Equity Fund, Real Estate Fund, SME Fund, Social Venture Fund and Strategy Fund (like hedge fund). AIFs float various schemes for investment based on risk appetite of its investors / unit holders.

The investments of AIF are managed by a person or entity which is called as 'Manager', and such person or team which manages investments shall have enough expertise as stipulated by SEBI. A person or persons who set up an AIF is called as "Sponsor" and includes a promoter in case of a company and designated partner in case of an LLP. A Sponsor can also act as Manager subject to having relevant expertise.

Investible Funds means corpus of AIF net of estimated expenditure for administration and management of the fund.

Eligibility:

AIF can be formed as a company, trust, LLP or a body corporate. However, a family trust, an ESOP trust, an employee welfare trust, funds managed by a securitization company under SARFAESI Act or any other pool of funds which is directly regulated by any other regulator in India, which have functions like AIF, will not be considered as AIF.

Registration

No person or entity shall act as AIF unless it has obtained a certificate of registration from SEBI. Any fund which is already under existence by the time of commencement of AIF Regulations, should get itself registered within six months therefrom. Such existing funds will be allowed to complete their agreed tenure but will not be allowed to raise fresh monies or commitments from investors till registration is granted. Such existing funds need not obtain registration if they do not propose to raise fresh commitments from investors, subject to providing information as required by SEBI.

As VCF regulations are subsumed with AIF Regulations, an existing VCF can seek re-registration as AIF subject to approval by 2/3rd of its investors by value of their investment.

An AIF shall seek registration in one the categories mentioned hereunder:

Category I AIF: It includes such funds which are perceived to have positive spill over effects on the economy, and for which SEBI or Government or other regulators in India might consider providing incentives or concessions. Funds like Angel Fund, SME Fund, Social Venture Fund, VCF or similar funds which invest in early start up or early stage ventures (including social ventures) or sectors / areas which the government considers as socially or economically desirable fall under this category. Such funds shall be close ended.

Category II AIF: It includes such funds which do not fall under Category I and Category III AIF mentioned herein. Funds like PE or debt funds for which no specific incentives or concessions are given by government fall under this category. Such funds shall be close ended.

Category III AIF: It includes such funds which employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives. Typical Hedge funds fall under this category. These funds can be either close ended or open ended, and no concessions or incentives are provided by government.

Once registered, an AIF cannot change its category except with approval of SEBI. Only such AIF which has not raised funds from investors can apply for change in category, along with fresh application fee as mentioned below. There shall be no registration fee for change in category.

Tenure of Category I and II AIF, being close ended, shall be minimum of three years. An extension can be permitted up to 2 years subject to approval of 2/3rd investors by value. In the absence of such approval, AIF shall fully liquidate itself within one year from end of fund tenure or extended tenure.

Application for grant of certificate shall be made in Form A provided in First Schedule of AIF Regulations, and shall be accompanied by a non-refundable fee as mentioned below:

Particulars	Amount INR
Application Fee	100,000
Registration Fee (Other than Angel Funds)	500,000
Scheme Fee (Other than Angel Funds)	100,000
Re-registration Fee	100,000
Registration Fee for Angel Funds	200,000

Information Memorandum

An AIF shall raise monies from investors (by issuing units) for each scheme under it through a placement memorandum / information memorandum. Such memorandum typically contains details of strategy, purpose and methodology of investment, details of manager, targeted investors and size of fund, tenure of AIF or scheme, risk management tools, manner of winding up, and such other information as may be necessary for the investor to take informed decision on investing in AIF. Any alteration to such placement memorandum shall be made with the consent of 2/3rd of investors in value. AIF may launch an investment scheme subject to filing of information memorandum with SEBI at least 30 days prior to its launch along with fees mentioned above.

General Investment Conditions and Restrictions for AIF:

i. Each scheme of AIF shall have a corpus of at least INR 20 Cr
ii. Maximum number of investors per scheme shall be 1000, subject to provisions of Companies Act governing members in case AIF is a company
iii. Minimum value of investment by each investor shall be INR 1 Cr. In case of investors who are employees or directors of AIF or its manager, the minimum value of investment shall be INR 25 Lacs.
iv. The manager or sponsor shall have a continuing interest of not less than 2.5% or INR 5 Cr whichever is less. In case of Category III AIF, the same shall be 5% or 10 Cr respectively. And this interest shall not be through waiver of their management fee.
v. An AIF shall not solicit or collect funds except by way of private placement
vi. Category I and II AIF shall invest not more than 25% of its investible funds in one investee company. In case of Category III AIF, it shall be not more than 10% of its investible funds.
vii. Uninvested portion of AIF funds, if any, can be invested in short term liquid assets of high quality like treasury bills, commercial papers, etc till their deployment as per investment objective
viii. The units of a close ended AIF may be listed on any stock exchange subject to a minimum tradable lot of INR 1 Cr.

Category Wise Additional Conditions

Category I AIF:

i. It shall primarily invest in investee companies or venture capital undertakings (VCU) as specified in AIF Regulations
ii. It may invest in units of another Category I AIF of same sub-category (like SME Fund, Infrastructure Fund, etc) but not in units of Fund of Funds. This is considering the benefits that may be available to Category I AIF.
iii. It shall not borrow funds directly or indirectly or engage in any leverage except for meeting temporary funding requirements for not more than thirty days, on not more than four occasions in a year and not more than 10% of the investible funds.
iv. Conditions specific to sub-category of Category I AIF are as below:

Sub-Category	Additional Conditions
Venture Capital Fund (VCF)	a. At least 2/3rd of investible funds shall be invested in unlisted equity or equity instruments of a VCU or companies listed or proposed to be listed on SME exchange or SME segment of an exchange b. Not more than 1/3rd of investible funds can be invested in IPO of a VCU proposed to be listed, or in debt instruments of VCU in which investment is already made, or preferential allotment of a listed company subject to lock in of one year, or equity / equity linked instruments of a financially weak company or a sick industrial company whose shares are listed
SME Funds	a. At least 75% of investible funds shall be invested in unlisted equity or equity instruments of a venture capital undertaking (VCU) or companies listed or proposed to be listed on SME Exchange or SME Segment of an exchange
Social Venture	a. At least 75% of the investible funds shall be invested in unlisted

Funds	securities or partnership interest of social ventures. b. May accept grants towards such social ventures from any person which shall be minimum of INR 25 Lacs, subject to condition that no profits or gains shall accrue to such grantor c. Can provide grants to social ventures, subject to disclosure in placement memorandum
Infrastructure Funds	a. At least 75% of the investible funds shall be invested in unlisted securities or units or partnership interest of VCU or investee companies or special purpose vehicles which are into operating, developing or holding infrastructure projects b. In addition, can invest in listed securitized debt instruments or listed debt securities of investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects.

v. A VCF or SME Fund may enter in to agreement with merchant banker for subscribing under-subscribed portion of an issue or to receive or deliver securities in the process of market making under SEBI ICDR Regulations

<u>Category II AIF</u>

i. It shall invest primarily in unlisted investee companies.
ii. Unlike Category I AIF, Category II AIF may invest in units of any Category I or Category II AIF, but not in units of other Fund of Funds.
iii. It shall not borrow funds directly or indirectly or engage in any leverage except for meeting temporary funding requirements for not more than thirty days, on not more than four occasions in a year and not more than 10% of the investible funds.
iv. It may enter in to agreement with merchant banker for subscribing under-subscribed portion of the issue or to receive or deliver securities in the process of market making under SEBI ICDR Regulations
v. It may engage in hedging subject to guidelines of SEBI

<u>Category III AIF</u>

i. It may invest in securities of listed or unlisted investee companies or derivatives or complex or structured products.
ii. Apart from above, it may invest in units of Category I or Category II AIFs, but not any Category III AIF or in units of other Fund of Funds.
iii. It may engage in leverage or borrow subject to consent from the its investors and subject to a maximum limit, as may be specified by SEBI. And shall disclose required information in this regard to SEBI on a periodical basis.
iv. It shall also be regulated through issuance of additional directions by SEBI

<u>ANGEL FUNDS:</u>

An Angel Fund is a sub-category of Category I AIF that raises funds from Angel Investors and invests as per investment objectives specified in placement memorandum. All the regulations and conditions as applicable to Category I AIF are also applicable to Angel Funds subject to few changes which are provided in subsequent paragraphs.

Angel Investor means any person who proposes to invest in an angel fund and satisfies one of the following conditions, namely,
(a) an individual investor who has net tangible assets of at least INR 2 Cr excluding value of his principal residence, and who has early stage investment experience (in investing in start-up or other early stage ventures) or who has experience as a serial entrepreneur (i.e., promoter of more than one start-up venture) or who is a senior management professional with at least 10 years of experience; or
(b) a body corporate with a net worth of at least INR 10 Cr; or
(c) any AIF registered under AIF Regulations or a VCF registered under erstwhile SEBI (Venture Capital Funds) Regulations, 1996.

An AIF which is already registered under AIF Regulations can be converted in to an Angel Fund only if it has not made any investments, subject to such conditions as apply to a fresh AIF registration.

<u>Investment Conditions and Restrictions for Angel Funds:</u>

i. An Angel fund shall only raise funds by way of issue of units to angel investors.
ii. It shall have a corpus of at least INR 10 Cr.
iii. It shall accept, up to a maximum period of three years, an investment of not less INR 25 Lacs from an angel investor.
iv. It shall raise funds through private placement only by issue of information memorandum or placement memorandum
v. It may launch an investment scheme subject to filing of information memorandum with SEBI at least 10 days prior to its launch. Scheme fee is not applicable to angel funds.
vi. No scheme of angel fund shall have more than 200 angel investors (previously restricted to 49), subject to provision of Companies Act governing members in case Angel Investor is a company
vii. It shall invest in VCUs which comply with age criteria specified by DIPP from time to time, which have a turnover of less than INR 5 Cr and which are not promoted or sponsored by or related to an industrial group whose group turnover exceeds INR 300 Cr
viii. Its investment in any VCU shall not be less than INR 25 Lacs and shall not exceed INR 5 Cr, and such investment shall be locked in for a period of 1 year
ix. It shall not invest in associates
x. It shall not invest more than 25% of the total investments under all its schemes in one VCU
xi. The Manger or Sponsor of angel fund shall have continuing interest of not less than 2.5% or INR 50 Lacs whichever is lower, and it shall not be through waiver of management fee.
xii. Units of angel fund shall not be listed on any stock exchange.
xiii. An Angel Fund is not permitted to invest in overseas companies

<u>Other Information – all AIFs:</u>

a. All AIFs shall have internal policies and procedures for conduct of its business and shall review them on periodical basis to ensure continued appropriateness.
b. If the corpus of AIF is more than INR 500 Cr, such AIF shall appoint a custodian for safekeeping of its securities. In case of Category III AIF, appointment of custodian is mandatory irrespective of corpus size.
c. Any change in sponsor or manager shall be informed to SEBI. Prior approval of SEBI is required in case of change in control of AIF.
d. Sponsors and managers shall establish and implement policies and procedures to ensure avoidance of conflict of interest, and ensure such conflicts are resolved in the interest of investors

e. All AIFs shall ensure transparency in the conduct of their business by disclosing required information to investors on financial & risk management, operations, legal actions, fee ascribed to Manager / Sponsor, or any other material liability affecting AIF.

f. The manager and sponsor shall maintain records in respect of assets under the scheme / fund, valuation policies and practices, investment strategy, etc for a period of five years after the winding up of the scheme / fund.

g. All AIFs shall file such reports as may be required by SEBI in respect of its activities

h. SEBI may suo moto or up on receipt of compliant or information cause inspection of books of account or any other record / document of AIF, and such AIF shall cooperate with the inspecting authorities.

i. All AIFs shall strictly adhere to disclosure, operational, prudential and reporting norms stipulated by SEBI time to time

FEMA Regulations

1. RBI vide its AP Dir Series Circular No. 49, dated April 30, 2007, has permitted Indian VCFs to invest only in equity and equity linked instruments of offshore VCUs, subject to overall limit of USD 500 Mn.
2. Accordingly, VCFs registered under erstwhile VCF Regulations were permitted to invest in Offshore VCUs having an Indian connection, subject to condition that the maximum investment can be up to 15% of investible funds of VCF (increased to 25% w.e.f October 1, 2015) and that they shall not invest in joint ventures / wholly owned subsidiaries while investing overseas.
3. An Indian VCF desirous of investing abroad shall approach SEBI, and SEBI shall approve such applications on first come first serve basis within the overall limit specified by RBI (USD 500 Mn at that time).
4. Though AIFs (except Angel Funds) are permitted to invest in securities of companies incorporated outside India as per Regulation 15(1)(a) of AIF Regulations 2012, RBI permitted AIFs to invest abroad only vide its AP Dir Series Circular No. 48, dated December 9, 2014.
5. Based on such RBI guidelines, SEBI issued circular on October 1, 2015 permitting AIFs to invest abroad within USD 500 Mn (combined for both AIF and VCF).
6. As like VCFs, AIFs desirous of investing abroad shall approach SEBI, and SEBI shall approve such applications within the overall limit of USD 500 Mn. No separate approval of RBI is required for such investments.
7. Such approval is valid for 6 months, and in case AIF doesn't invest abroad within 6 months, the approval shall lapse, and SEBI can allot such limit to next applicant.
8. The above mentioned USD 500 Mn was increased to USD 750 Mn by SEBI (vide its circular dated July 3, 2018) in consultation with RBI. Vide same circular SEBI mandated the AIFs to disclose their utilization of approved overseas investment limits within 5 working days of its utilization.