DEBEVOISE & PLIMPTON LLP | D&P

CLIENT UPDATE

INDIAN REGULATOR RELEASES DRAFT FRAMEWORK FOR THE REGULATION OF ALTERNATIVE INVESTMENT FUNDS

August 29, 2011

To Our Clients and Friends:

On August 1, 2011, the Securities and Exchange Board of India ("SEBI"), following recent trends in the world's advanced economies for increased regulation of alternative investment funds ("AIF"), released its proposals for a comprehensive framework for the regulation of AIFs. SEBI's objective is to build a regulatory framework that reflects the broad spectrum of AIF investment strategies in the marketplace, by creating an overarching regulatory umbrella setting out certain conditions that apply to all AIFs and, in addition, a specific regime for each identified investment strategy. SEBI's concept paper and the draft SEBI (Alternative Investment Funds) Regulations, 2011 (the "AIF Regulations") are open for public comment until August 30, 2011.

The key points to note are as follows:

- The current drafting appears to give the AIF Regulations extra-territorial effect (*i.e.*, it will apply to all AIFs (irrespective of domicile) and all AIF managers that manage investments in India.) However, SEBI has indicated, informally, that (i) the AIF Regulations are intended to apply only to on-shore AIFs and on-shore AIF managers and (ii) where an off-shore AIF has an on-shore sub-advisor, the existence of the on-shore sub-advisor is not sufficient to bring the off-shore AIF within the ambit of the AIF Regulations. Whether this is the case will not be known until the final AIF Regulations are published.
- Assuming the AIF Regulations only apply to on-shore AIF managers, such managers will be required to register with SEBI.
- Assuming the AIF Regulations only apply to on-shore AIFs, such AIFs will be (i) required to register with SEBI under a specific category of AIF (based on investment strategy) and each category of AIF will be subject to specific investment conditions and (ii) subject to investment conditions applicable to all categories of AIF, that include, *inter-alia*, a minimum sponsor commitment and a requirement that the sponsor's commitment be "locked-in" until redemption by the last investor, specified diversification limits, minimum time devotion requirements for key persons, a minimum fund term, a requirement that at the end of the

AIF's term the sponsor acquire any unliquidated assets of the AIF and a requirement that all AIFs be closed-ended.

THE CURRENT REGULATORY FRAMEWORK

The current regulatory framework provides extensive regulation of investment funds aimed at the retail market (*e.g.*, mutual funds and collective investment schemes), however, there is only minimal regulation of investment funds aimed at the non-retail market. The SEBI (Venture Capital Funds) Regulations (the "VCF Regulations") were introduced in 1996 with the aim of encouraging investment in early stage companies. Increasingly, however, these venture capital funds ("VCFs") have been used as a "catch-all" vehicle for non-retail investment funds other than venture capital (*e.g.*, private equity, private investment in public equity and real estate). This "catch-all" approach has resulted in a regulatory framework that fails to meet the needs of its participants (i) making it difficult to target concessions to early stage companies without unfairly benefiting more established companies, and (ii) imposing certain conditions and restrictions on investment funds that may not be appropriate. In addition, registration of VCFs is not mandatory under the VCF Regulations.

THE AIF REGULATIONS

The Scope

Do the AIF Regulations apply to you? The current drafting is ambiguous, however, the view taken by most commentators is that the AIF Regulations propose to regulate and require registration of (i) all AIFs (irrespective of their legal domicile) which raise capital from institutional or high net worth investors ("HNIs") in India; and (ii) managers of AIFs who manage investments in India.

Extra-territorial effect? The broad scope and apparent extra-territorial effect of the AIF Regulations raise a number of concerns for off-shore AIF managers raising capital and making investments in India. It would appear that (i) an off-shore AIF that raises money from Indian investors would need to be registered with SEBI and would be subject to the eligibility restrictions and investment considerations set out in the AIF Regulations (see "Key Concepts and Issues" below), and (ii) managers of off-shore AIFs that invest in India would need to be registered with SEBI. It is not clear whether the requirement for managers to be registered will be under the AIF Regulations or the proposed investment advisor regulations that are yet to be issued. Other potential issues include: (a) the potential for conflicts between the Indian regulatory regime and regulations in other jurisdictions to which such AIF manager is subject, (b) the onerous registration requirement for an AIF manager of a global fund with a small allocation for Indian investments, and (c) the question of whether an on-shore sub-advisor to an off-shore Manager would also require registration.

SEBI has, however, indicated informally that it regards the regulation of off-shore funds and off-shore managers as beyond the scope of SEBI's mandate. SEBI indicated that they do not intend to regulate or require registration of off-shore AIFs or off-shore AIF managers under the AIF Regulations. SEBI also indicated that where an off-shore AIF has an on-shore sub-advisor, it is not expected that the existence of the on-shore sub-advisor would be sufficient to bring the off-shore AIF within the ambit of the AIF Regulations. SEBI also indicated that the AIF Regulations cannot be circumvented by using an off-shore feeder fund investing into an on-shore master AIF (that is subject to the AIF Regulations), and in such case the whole structure would be regulated. It remains to be seen whether SEBI will formalize this intent in the final regulations. In any event, off-shore AIFs will remain subject to India's foreign direct investment rules.

Key Concepts and Issues

Categories of AIF. The following categories of AIF will be regulated under the AIF Regulations: (i) Venture Capital Fund, (ii) PIPE Fund, (iii) Private Equity Fund, (*iv*) Debt Fund, (v) Infrastructure Equity Fund, (vi) Real Estate Fund, (vii) SME Fund, (viii) Social Venture Fund, and (ix) Strategy Fund (a residual category, including hedge funds.) This final category of AIF allows flexibility for investment strategies that do not fit within the specific strategies identified. SEBI has informally advised that a multi-strategy fund could be categorized as a Strategy Fund.

Please note that each category of AIF is subject to specific investment conditions. For example, Venture Capital Funds will be prohibited from investing in any company promoted by any of the top 500 companies in India and Private Equity Funds will not be permitted to invest in any listed equity or debt instruments. SEBI has suggested, informally, that multi-strategy funds may be allowed to define their own investment strategy within the general investment conditions of the AIF Regulations, without any specific conditions being imposed by the AIF Regulations. However, such multi-strategy funds would then not be entitled to any specific benefits extended to a specific category of AIF. Further details are available upon request.

Registration and Eligibility

- **Registration of AIF.** It is mandatory for all AIFs to be registered with SEBI under one of the aforementioned categories of AIF. An AIF is prohibited from changing category once registered. The categorization requirement and the inability to change category once registered make the AIF Regulations very rigid. It is also not clear how the AIF Regulations will deal with AIFs that straddle investment strategies or have multiple strategies. At the time of registration, the targeted size, strategy and details of the AIF's manager must also be specified. Any change to an AIF's strategy requires the consent of 75% in interest of investors. If changes to an AIF's investment team occur, investors will be permitted to "reconsider and reaffirm positively" their decision to invest in the AIF. This requirement could cause particular issues for institutionally-sponsored AIFs where there is potentially a higher turnover of personnel.

- **AIF structure.** Companies, trusts or other bodies corporate (including limited liability partnerships).
- **Key person time devotion.** Key persons are required to devote "substantially all of their business time" to the AIF. This requirement could cause particular issues for institutionally-sponsored AIFs where key persons are more likely to be required to devote time to activities across the institution's investment platform.
- **Fund size.** Minimum size is INR 200 million (approximately US$ 4.4 million). The green-shoe option has been capped at a maximum of 25% over the AIF's size, subject to consultation with SEBI.
- **Closed-ended.** AIFs must be closed-ended. Hedge funds that are typically structured as open-ended vehicles, therefore, may find it difficult to register with SEBI.
- **Investor commitment.** Higher of 0.1% of AIF's aggregate commitments and INR 10 million (approximately US$ 221,000). Stipulating a minimum commitment amount could make it more difficult for HNIs to invest in a number of AIFs to achieve risk diversification. It has been suggested that an alternative approach could be to introduce an "accredited investor" test, using a minimum net-worth test to determine who can participate in an AIF.
- **Fund Term.** Minimum of five years. The AIF's term may be extended beyond its specified term, subject to a maximum two year extension with the consent of 75% of investors in interest. The AIF Regulations contemplate that at the end of the AIF's term, the sponsor, manager or designated partner of the AIF must acquire any unliquidated assets of the AIF. This requirement could have a negative impact on the AIF's returns by forcing the AIF manager to dispose of assets at a time and price that is not advantageous to the AIF to avoid being required to purchase such assets. Such a condition could also lead to cherry-picking of

assets by sponsors towards the end of the term of the AIF, creating a conflict of interest. It may also be detrimental to non-institutionally backed AIFs who may not have sufficient capital to purchase such assets.

- **Number of investors.** Number of shareholders and partners in an AIF constituted as a company or LLP is limited to 50, whereas for other AIFs the minimum 0.1 per cent commitment would ensure that the number of investors is capped at 1000.

- **Private Placement.** Capital may only be raised through private placement. Expressly prohibited from soliciting funds from the public by issuing a prospectus or through advertising.

- **Single Portfolio Company.** No more than 25% of aggregate commitments may be invested in a single portfolio company.

- **Sponsor Commitment.** Not less than 5% of aggregate commitments. Sponsor's commitment is required to be "locked-in" until redemption by the last investor. Management fee reduction mechanisms are not permitted. Restrictions on change in control of AIF to be included. The market position internationally is in the region of 1-2% of capital commitments. 5% is very high and will make eligibility difficult for non-institutional and first-time sponsors in particular. It is not clear whether the lock-in of the sponsor's commitment means that the sponsor's contributions and profits thereon may not be distributed to the sponsor until liquidation of the AIF or just the contributions. Either way, this does not fit conceptually with the market practice for distribution waterfalls. SEBI has informally indicated that "return all capital first waterfalls" will be preferred to "deal-by-deal waterfalls" *i.e.*, prioritizing distributions to investors over the sponsor.

- **Co-Investment.** No co-investment by manager or sponsor of AIF.

- **Transfers.** Investors locked in for a minimum of three years.

- **Non Banking Finance Companies ("NBFC").** AIFs (except Strategy Funds) will be permitted to invest in certain categories of NBFC (*e.g.*, Infrastructure Finance Company, Asset Finance Company, Core Investment Company or companies engaged in microfinance activities).

- **Reporting.** AIF required to maintain records and provide annual and quarterly reports. Records to be retained for at least five years following liquidation of the AIF. Will ensure consistent information flow to investors but will increase administrative burden and costs. This "one size fits all" approach may be burdensome for small funds (*e.g.*, Venture Capital Funds).

- **Concessions.** Not clear whether AIFs will be granted any concessions from a taxation or exchange control perspective.

CONCLUSIONS

The AIF Regulations are a significant step towards comprehensive regulation of the Indian AIF market but whether they will enhance or inhibit growth in this sector remains to be seen. Assuming that SEBI's informal indications are formalized, the intention is that the AIF Regulations will apply only to on-shore AIFs and on-shore AIF managers. SEBI has produced a prescribed set of draft regulations, in contrast to the principles-based regulation preferred by regulators in other jurisdictions. It has been argued by some observers that the AIF Regulations go beyond SEBI's mandate by stipulating commercial terms upon which sophisticated investors may invest. This structural rigidity may, potentially, put Indian AIFs at a competitive disadvantage.

IMPLEMENTATION

The consultation period ends on August 30, 2011. It is anticipated that the AIF Regulations will be finalized and become effective towards the end of 2011. Please note that there are grandfathering provisions for existing VCFs and all pooling vehicles (excluding VCFs) already operating, including VCFs pending registration, which have six months to register from the commencement of the final AIF Regulations.

The concept paper and the AIF Regulations may be found at:
www.sebi.gov.in/commreport/alternativeinvestment.pdf

Please note that we are not qualified to advise on Indian law. This update is based on information that has been published in the press and from other sources in the public domain.

Please note that this update has been produced in conjunction with Nishith Desai Associates ("NDA"), a research-based international law firm with offices in Mumbai, Bangalore, Silicon Valley, Singapore, Basel and New Delhi. If you wish to contact NDA, please let us know and we will put you in touch with the appropriate person.

* * *

Please feel free to contact us with any questions.

Geoffrey P. Burgess
+44 207 786 9075
gpburgess@debevoise.com

Geoffrey Kittredge
+44 207 786 9025
gkittredge@debevoise.com

Andrew M. Ostrognai
+852 2160 9852
amostrognai@debevoise.com

John F. Anderson
+44 207 786 9183
jfanderson@debevoise.com

Tamsin West
+44 207 786 9085
tmwest@debevoise.com