INDIAN REGULATOR RELEASES NEW ALTERNATIVE INVESTMENT FUNDS REGULATIONS; OFFSHORE FUNDS UNAFFECTED

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To Our Clients and Friends:

Following recent trends in the world's advanced economies for increased regulation of alternative investment funds ("AIFs"), on May 21, 2012, the Securities and Exchange Board of India ("SEBI") issued the SEBI (Alternative Investment Funds) Regulations, 2012 (the "AIF Regulations") to provide a comprehensive framework for the regulation of AIFs in India.[1] SEBI seems to have adopted many of the suggestions and comments it received from stakeholders when it released a draft of the AIF Regulations back in August 2011.

The key points to note are as follows:

- Offshore funds are not affected by the AIF Regulations. The AIF Regulations cover AIFs, which are defined to include any fund established or incorporated in India that is a privately pooled investment vehicle which collects funds from investors, Indian or foreign, for investment in accordance with a defined strategy.
- The AIF Regulations will replace the SEBI (Venture Capital Funds) Regulations, 1996 ("VCF Regulations"). However, funds registered as venture capital funds under the VCF Regulations shall continue to be regulated as such until they are wound up. Such funds will not be allowed to launch new funds or increase their total committed funds until they re-register under the AIF Regulations.
- All AIFs will be required to register with SEBI under one of three categories of AIFs (based on investment strategy) and various restrictions on raising capital and on investments have been imposed, some applying to all categories of AIFs, and some specific to each category.

1 *The AIF Regulations may be found at:* http://www.sebi.gov.in/cms/sebi_data/attachdocs/1337601524196.pdf

THE AIF REGULATIONS

The Scope

Do the AIF Regulations apply to you? The AIF Regulations will regulate and require registration of **all** AIFs established or incorporated in India which raise capital from institutional or high net worth investors ("HNIs"), Indian or foreign.

The following have been excluded from the definition of AIFs: (a) mutual fund/collective investment schemes (under the relevant regulations); (b) family trusts for relatives; (c) ESOP trusts; (d) employee welfare or gratuity trusts; (e) holding companies; (f) SPVs not established by fund managers (*e.g.*, securitization trusts); (g) funds managed by securitization or reconstruction companies; and (h) pools of funds directly regulated by any other regulator.

Extra-territorial effect? The scope of the regulations is limited to funds set up in India, but is not limited with respect to where the fund invests or where it draws investors from.

Key Concepts and Issues

Categories of AIFs. The AIF Regulations recognize the following three categories of AIFs:

- **Category I**: AIFs that invest in start-up or early stage ventures, social ventures, small and medium enterprises ("SMEs"), infrastructure or other areas which the government or regulators consider as socially or economically desirable fall in Category I. This category includes venture capital funds, social venture funds, SME funds, infrastructure funds, and other funds as may be specified by SEBI.

- **Category II**: AIFs that do not fall in Category I and Category III, and which do not undertake leverage other than to meet day-to-day operational requirements, fall in Category II. Private equity funds and debt funds for which no specific incentives or concessions are given by the government or any regulator fall under this category.

- **Category III**: AIFs that employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives will have to register in this category. This category includes hedge funds, funds which trade with a view to make short-term returns and funds that are open-ended and for which no specific incentives or concessions have been or will be given by the government or any regulator.

Registration, Eligibility, and General Conditions

- Registration of AIFs. It is mandatory for each AIF to be registered with SEBI under one of the above-mentioned categories. SEBI approval is also required for an AIF to change its category of registration. At the time registration is sought, the registrant must disclose a host of information including the targeted size of the AIF, its strategy and details about the AIF's manager. The manager does not have to separately register.

- SEBI review. Registration as an AIF is not guaranteed and SEBI will consider a host of factors in making its adjudication. For example, the manager of the AIF must have at least one key personnel with five years or more of experience in advising or managing pools of capital or in fund or asset or portfolio management or in the securities business and the manager and sponsor must have "the necessary infrastructure and manpower" to effectively discharge its activities.

- AIF structure. AIFs may be established or incorporated in the form of a company, trust or other bodies corporate (including limited liability partnerships).

- Number and identity of investors. An AIF may raise funds from any investor whether Indian, foreign, or of Non-Resident Indian ("NRI") status. A fund of an AIF may have a maximum of 1,000 investors.

- Private placement. Capital may only be raised through private placement and AIFs are expressly prohibited from soliciting funds in any other manner. Every AIF is required to issue an information memorandum or placement memorandum to potential investors, containing all material information about the AIF, its manager, background of its key investment team, targeted investors, fees and expenses, tenure, conditions on redemption, investment strategy, risk management tools, etc. If an AIF intends to launch a new fund, the information or placement memorandum must be filed with SEBI at least 30 days before launch and any comments from SEBI must be incorporated prior to launch. AIFs must also disclose their valuation procedures and the methodology for valuing assets to investors and obtain independent valuations of their investments as set out in the AIF Regulations. The sponsor and manager of the AIF must disclose all conflicts of interests to the investors.

- Investment size. Each fund of an AIF needs to have a corpus of at least INR200 million (approximately US$3.6 million). An AIF may not accept an investment of less than INR10 million (approximately US$180,000) from an investor. However, the minimum amount is INR2.5 million (approximately US$45,000) in case of employees or directors of the AIF or its manager.

- Permitted investments. AIFs may invest in securities of companies incorporated outside India, subject to applicable Reserve Bank of India and SEBI guidelines and in associated entities after obtaining approval of 75% of the investors (by value). Un-invested portions of the fund may also be invested in liquid mutual funds or bank deposits until funds are deployed.

- Co-investment. The sponsor or manager may not be offered more favorable terms than the AIF if they co-invest with the AIF in an investee company.

- Changes in Investment Strategy. Material alterations to the investment strategy may only be made upon two-thirds approval of investors (by value).

- Periodic reporting requirements. AIFs are required to provide investors with annual reports within 180 days after year-end. Category III funds are required to provide quarterly reports to investors within 60 days of the end of each quarter.

- Custodian. The sponsor or manager of an AIF has to appoint a custodian registered with SEBI for safekeeping of securities if the fund size is more than INR5 billion (approximately US$90 million). However, a Category III AIF must appoint a custodian irrespective of its size.

- Change in control. SEBI approval is required in case of a change in control of the AIF, its sponsor or its manager.

Category-Specific Permitted Activities and Investment Conditions

- Fund term/tenure. Category I and II AIFs must be closed ended. Category III AIFs may be open-ended. Hedge funds that are typically structured as open-ended vehicles, therefore, must register as a Category III fund. Category I and II AIFs have a minimum tenure requirement of three years and extensions may be authorized for up to two years subject to the approval of two-thirds of the investors by value of investment in the AIF, barring which, the AIF must be liquidated within one year following expiration of the fund tenure or extended tenure. Category III funds do not have a minimum tenure.

- Investment allocation. For Category I and II funds, no more than 25% of aggregate commitments may be invested in a single portfolio company. For Category III funds, the limit is 10%.

- Sponsor commitment. A sponsor or manager of Category I or II AIFs should have a continuing interest in the form of investment in the AIF of not less than 2.5% of the corpus or INR50 million (approximately US$900,000), whichever is lower. In case of Category III AIFs, the continuing interest should be 5% of the corpus or INR100 million (approximately US$1.8 million), whichever is lower. The interest of the manager or the sponsor may not be effected through the waiver or reduction of management fees and the sponsor and manager must disclose their investment in the AIF to the investors.

- Investments in other funds. Category I AIFs may invest in units of Category I AIFs of the same sub-category. Category II and III AIFs may invest in units of Category I or Category II AIFs. No AIF may invest in units of other fund of funds.

- Borrowing. Category I and II funds may not borrow funds directly or indirectly or leverage except for meeting temporary funding requirements (for not more than thirty days) on not more than four occasions in a year and amounting to no more than 10% of its fund size. Category II AIFs may engage in hedging subject to SEBI guidelines. Category III funds may leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit, as specified by SEBI, provided that such funds make appropriate disclosures as specified under the AIF Regulations.

- Sector specific Category I funds. The following specific restrictions apply to Category I funds depending on their sub-sector focus.

  - **Venture capital fund:** At least two-thirds of the fund's capital must be invested in unlisted equity instruments of a venture capital undertaking ("VCU") or in companies listed or proposed to be listed on an SME exchange or SME segment of an exchange. A VCU may not invest more than one-third of its corpus in (i) subscription to an initial public offering of a VCU whose shares are proposed to be listed; (ii) unlisted debt or debt instruments where equity investment has been made; (iii) preferential allotment of equity shares of a listed company that are subject to a lock-in period of one year; or (iv) equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.

  - **SME fund**: At least 75% of the fund's capital must be invested in unlisted securities or partnership interests of VCUs or investee companies which are SMEs or in companies listed or proposed to be listed on SME exchange or SME segment of an exchange.

- **Social venture fund**: At least 75% of the fund's capital must be invested in unlisted securities or in partnership interests of social ventures.

- **Infrastructure fund**: At least 75% of the fund's capital must be invested in unlisted securities or in partnership interests of VCUs, investee companies or SPVs, which operate, develop or hold infrastructure projects.

CONCLUSION

The AIF Regulations are a significant step towards comprehensive regulation of the Indian AIF market and may make it easier for investors to make an informed decision when considering an investment in an AIF. It is interesting that various terms that were previously subject to commercial negotiation and could be tailor-made have now been prescribed by regulation, thereby creating a common standard across the industry. Though the AIF Regulations impose additional regulatory and disclosure burden on the funds, it does so in line with global best practices and are thus, a step in the right direction.

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.

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