THE ECONOMIC TIMES

Sebi Regulations 2012: A ray of hope for private equity funds

May 23, 2012, 05.45AM IST

By Bijal Ajinkya & Siddharth Shah

The Sebi (Alternate Investment Funds) Regulations, 2012 have finally been notified which would set the stage for the next phase in the evolution of the fund industry in India. It is commendable that Sebi has realigned the regulations to international developments and has also been agile enough to attune the same to the Indian economy and requirements by rolling out a stoic regulation after hearing out all stake holders.

Sebi appears to have taken a more practical grandfathering approach. Funds already registered under the VCF Regulations would continue to be governed by those regulations including raising commitments up to its targeted corpus.

The only restriction is that the existing VCFs may not be permitted to increase their targetted corpus. This puts to rest the controversy on how to deal with funds which are raising funds at the time of this notification. However, new funds and funds not registered under any regime would now need to be registered under the AIF Regulations.

Sebi has categorised AIFs into the following three categories:

Category I AIF - Under this category, Sebi seeks to include funds which invest in start-up, early-stage ventures, social ventures, SMEs, infrastructure or other sectors or areas which the government or regulators perceive to have a positive spillover effects on the economy .

Category II AIF - This category includes funds which do not fall under Category I and III and will not undertake leverage or borrowings other than to meet the day-to-day operational requirements.

What is clearly a big positive is that contrary to the earlier proposal of Sebi to impose various asset-side restrictions for various strategies of the fund, it has refrained itself from imposing such conditions offering them more latitude to design their investment strategies to suit the investor's need.

Category III AIF - This category includes those funds which employ diverse or complex trading strategies and may leverage through investments in listed or unlisted derivatives. Further, the fund industry in India will see the entry of two new investment strategies, viz., domestic hedge funds and 'fund of funds'.

The 'fund of fund' regime would soften the blow on the raised minimum capital commitment of an investor (to Rs 1 crore under the AIF Regulations from the previous Rs 5,00,000 under the Sebi VCF Regulations) whereby investors, on their raised minimum commitment of Rs 1 crore, could get the benefit of risk diversification through investment in a fund-of-fund AIF which in turn can make broader allocation across multiple AIFs in various categories.

Also, the introduction of the social venture funds would see an emergence of a conducive platform for social venture businesses in India.

On the tax front, the Finance Budget 2012 which was announced this year brought a big sigh of relief to the fund industry by re-instating the complete tax pass through to funds registered under the Sebi (VCF) Regulations, 1996.

The industry had hoped that once the AIF Regulations are notified, the Income Tax Act, 1961 would be amended to extend this complete tax pass through to all categories of AIFs. However, the explanation to Category I AIFs in the AIF Regulations, seems to restrict the tax pass through benefits only to Category I venture capital funds.

On the investor side, what is a huge positive is that Sebi has refrained itself from getting too prescriptive on the LP-GP relationship and has adopted a more matured approach of identifying key considerations in relation to the sponsor/investment manager such as conflict of interest, change in control, reporting and valuation and the custodian.

It has prescribed disclosure standards in this regard rather than sitting as an arbitrator for implementing some of these governance standards.

This will be welcome by the industry and will ease unnecessary administrative and compliance burden at the same time make the market more matured and transparent.

The authors are partners at Nishith Desai Associates

© 2012 Bennett, Coleman & Co. Ltd. All rights reserved