SEBI - Alternative Investment Fund regulation 2011 – (AIF)

An Accounting and Tax perspective

The proposed AIF regulation has clearly demonstrated, that High networth Individuals and Qualified investors in the country are sizeable, have the knowledge to take on risks and are well informed, when investing into alternative investments. The alternative asset class itself, has been recognized as an mainstream investment for certain investors. The regulation at its highest level, seeks to prevent retail investors from straying or being induced to this asset class. Further the regulation also classifies Investment strategies based on objectives of the investment. Therefore, while the regulation caters to monitoring & regulating the liability side of the fund, it also ensures that monies are invested into assets or securities that match the philosophy & strategy, disclosed by the fund manager during the capital raising process. This also makes it easy for the government of the day to target benefits to sections of the economy that need investments.

Key Salient features of the proposed regulation:

- High Net worth Individual defined as a person capable of investing Rs 1 Crore in all investments combined has been defined.

- Minimum subscription would be Rs.1 Crore or 0.01% of the fund raised.

- Tax benefits / incentives available to a particular philosophy strategy or certain sectors of the economy are availed only by those that were intended to.

- Regulation grandfathers DVCF funds into the new regulation. None regulated funds need to register on the regulation coming into effect.

- Funds can be structured as LLP's. This is a major development as funds globally prefer these structures for ease of operation, tax pass through, limited liability and other benefits. This would also mitigate some of the disadvantage of structuring the fund as a trust mainly to avoid the issues related to an irrevocable trust.

- Regulation 13(2) :

  AIF registered under one category cannot change its category. This is in contradiction with regulation 9(2), which says that Strategy can be changed with 75% on investors consent. Defining Strategy and Category is important for clarity.

- Minimum size of the fund needs to be Rs. 20 crore.

- Fund manager needs to contribute at least 5% of the size of fund in hard contributions. This contribution will be locked in till the last redemption is made. This would pave way for sponsored investment managers, backed by outside or solicited capital in the investment manager's entities themselves.

- Maximum number of investors in the AIF shall be 50. It is not clear, if this includes underlying pooled investors like partnership, trusts or association of persons or the fund entity level only. There is a discrepancy though. It appears that the 50 investor limit applies to companies and LLPs. It does not seem to apply to trusts.

- Winding up methodology needs to be explicitly mentioned in the prospectus.

- The last residual investment, that cannot be disposed in the fund needs to be picked up by the investment manager.

- The board may specify criteria for charging performance fees. This could create uncertainty. Also it would restrict the ability of two parties to a private contract.

- No fund shall have sub-funds underlying. It is not clear however, if the regulation allows the fund of fund as a possibility.

- Minimum tenor of the fund shall be 5 years extendable by 2 years.

- Funds with size greater than Rs.500 crores would need to have a custodian.

- The regulation has categorized strategies into a) PIPE b) Debt. c)VCF (maximum of 250 crore) d) Infrastructure e) SME f) Real estate g) Social Venture funds h) Strategy (i) PE funds. Of the above, it seems that strategy funds includes all other strategies, not listed separately and therefore offer amply flexibility. These categories can include funds that can invest long/short, derivatives and structured products. It seems that this category may spawn growth of "Hedge funds". All the categories come with minimum and maximum exposures to issuer,-class of securities, exposure to follow-up investment, etc. Board may impose appropriate restrictions on investments in complex structured products, if no investor approval is acquired.

Basiz
Fund Accounting KPO

The regulation does cast reporting responsibilities on the fund and investment managers.

Some of the important reporting & disclosure responsibilities are:

1) Risk management & conflicts of interest reporting :

   a) Identification, analysis and reporting of systemic risks. This might result in regular risk reports that need to be filed with the SEBI. This will also mean regular review of policies and procedures related to risks. Further adoption of globally accepted reporting & risk management practices may also be required.

   b) Reporting on excessive risk strategies that are a result of aggressive performance structure will need to be reported separately.

   c) Reporting on conflict of interest. This will necessitate documentation of procedures that will mitigate conflict of interest.

2) Financial reporting to include :

Quarterly and Annual financial statements may need to state or disclose

(i) Description of investment strategy
(ii) Use of leverage
(iii) Redemption policies in normal and exceptional circumstance
(iv) Valuation methodologies
(v) Risk management procedures
(vi) Fees charged by managers shall be disclosed. This includes all types of fees and includes those paid to affiliates of the managers
(vii) Cost of doing the investment transaction and related charges
(viii) Fees charged to portfolio companies by manager or affiliate of the managers
(ix) Custody policies & procedures
(x) Risk reporting in financial reports
The regulation has specified that the following be reported in annual financial statements. The requirements are similar to IFRS 7. They include:
   a) Concentration risk
   b) Forex risk
   c) Leverage risk both liabilities & asset side including those of the portfolio companies
   d) Realization risk at the time of exit
   e) Strategy deviation risk
   f) Reputation risk at portfolio company level. It is however hard to fathom, how this can be measured.

g) Environmental, social & corporate governance risks at fund and portfolio company level. Again hard to fathom how this can be measured.

(xi) Books & records of the funds shall cover
 (a) Portfolio statements including valuation, valuation policies and procedures.
 (b) Deal sheets, buy & sell ledgers
 (c) Investor statements describing contribution, allocation and distributions
 (d) Portfolio company selections research and analytical methodologies
 (e) Books & records of the fund may need to be maintained for 5 years.

(xii) Fund audits need to be completed within 90 days of the year end and financial information of the fund needs to be provided to investors within 90 days of the year end of the fund.

(xiii) Disclosure related to non accounting matters. Breach of the provisions in information memorandum, inquiries or action by regulators and material contingency or liabilities related to the fund shall be disclosed in full.

3) Investment operation reporting & Standard operation procedures for investor

a) Estimation of quarterly projections of capital calls and distributions (including beneficial interest) need to be made & reported.
b) Changes in ownership interest/transfer, rating control to related parties to the fund need to be disclosed.
c) Financial information of underlying portfolio companies need to be provided to investors within 90 days of the fund's year end to the investors. This means that all underlying portfolio companies need to complete their audit well within 90 days of the year end of the fund.

Tax issues related to the new regulation

This regulation has tax, legal and banking impact. Thus other regulations like the Income tax, RBI, Company Law, regulations will have to be harmonized with changes in this regulation. For example, LLP's will now be allowed as investment vehicle structures. However the ROC's need to accept this change, when the regulations come into force. The Income tax department has already included an LLP within the definition of a "partnership firm". However partnership structures currently do not have "Pass through status". They are taxed at partnership level unlike trust structures. Regulated LLP's structures need to have "Pass through status" if they invest in 10 sectors, that qualify as venture capital similar to trust structure. Thus pass through benefits under section 115U should be available to LLP's too to ensure level playing field. However MAT has been imposed on LLP's recently. This would create discrimination for even the regulated LLP's, that invest in the designated sectors. Regulated Investment LLP's need to

be given exemption from MAT provisions as well. The Income tax department however needs to ensure a level playing field between FVCF and the DVCF, as far as tax treatment on capital gains go. LLP's are better equipped to provide solutions compared to irrevocable trusts as investment vehicles.

Sesh is the Managing Director of Basiz Fund Service Pvt. Ltd. Basiz is a global fund administrator with focus on India especially the PEVC segment administering more than USD 8 billion in assets. Sesh can be contacted @ Cell : +91 8286008554 ; email : sesha@basizfa.com