Alternative To Alternative Investment Fund

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The Alternative Investment Fund space has seen a considerable growth over last 8 years with total investments made by the Alternative Investment Funds (AIFs) of Rs. 0.2 crores as on 31 December 2012 growing to Rs. 14,031.39 crores as on 31 December 2015 and to Rs. 1,42,115.104 crores as on 31 December 2019[1].

Looking at this, the Securities and Exchange Board of India (SEBI) has issued circulars enforcing disclosure standards and stewardship code for the AIFs showing its intent to make this Alternative Investment Fund Space more mature and attractive by ensuring enough disclosures and compliances to safeguard the interest of the investors.

Though, over the years, the AIF, has evolved as an alternative platform of pooling and managing money alongside portfolio management scheme, in our experience, there are certain regulatory issues which the SEBI needs to look at/consider. Because of these issues many Investment Managers who are currently managing a pool of money under portfolio management schemes are not looking at setting up the AIFs or those Investment Managers who have already set up the AIFs are looking at alternative platforms to the AIFs or portfolio management schemes as a better platform of pooling and managing money. Some of the issues are discussed here under:

A. Impact of investment restrictions provided in Regulation 15 of the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations):

As per Regulation 15(1)(*c*) of the AIF Regulations, the Category I and the Category II AIFs cannot invest more than 25% of the investible funds **[*i.e.* funds committed by the investors by way of a written contract or any other document (hereinafter referred to as 'corpus') less estimated expenditure for administration and management]** in one investee company **[*i.e.* any company, special purpose vehicle or limited liability partnership or body corporate or real estate investment trust or infrastructure investment trust]** and as per Regulation 15(1)(*d*) of the AIF Regulations, the Category III AIFs cannot invest more than 10% of the investible funds in one investee company.

For *e.g.* The Category III AIF has a corpus of Rs. 1,00,000 and has estimated the expenditure for administration and management of Rs. 5,000 - as per Regulation 15(1)(*d*) of the AIF Regulations, this Category III AIF cannot invest more than Rs. 9,500 in one investee company.

Now, those Investment Managers who are currently managing a pool of money under portfolio management schemes with a strategy of making investments in Government Securities being G-secs, State Development Loans etc. and generating returns by playing on the yield spread between the two Government Securities - for them to set up the AIFs with such a strategy, it becomes very critical to evaluate the impact of Regulation 15 of the AIF Regulations by answering:

Whether investment restrictions provided in Regulation 15 of the AIF Regulations are also applicable to investments in Government Securities being G-secs, State Development Loans etc. or not?

OR

Whether the Central Government and the State Government can be said to be an 'investee company' for the purposes of the AIF Regulations, or not?

If an answer to the above questions, is 'Yes', then it is all the more critical to answer the following regarding how to comply with such investment restrictions *i.e.*:

Whether the AIFs can invest in different types of securities issued by the Central Government and/or the State Government, with varying maturities and/or interest rates, subject to these investment restrictions, or not?

(For *e.g.*: Whether the Category III AIF can invest up to Rs. 9,500 in a Treasury Bill and up to Rs. 9,500 in a G-sec being 7.17% GS 2028, or not?)

OR

The AIFs can only invest in one type of security issued by the Central Government and/or the State Government, with varying maturities and/or interest rates, subject to these investment restrictions.

(For *e.g.*: The Category III AIF can only invest up to Rs. 9,500 in one G-sec being 7.17% GS 2028 and another Rs. 9,500 in another G-sec being 8.28% GS 2028.)

OR

The AIFs can only invest in one type of security issued by the Central Government and/or the State Government, of the same maturity and interest rates, subject to these investment restrictions.

(For *e.g.*: The Category III AIF can only invest up to Rs. 9,500 in one G-sec being 7.17% GS 2028)

In our view, rationale behind having investment restrictions as provided in Regulation 15 of the AIF Regulations, is to ensure that the AIFs diversify their portfolios and minimize the concentration risk to one particular investee company to safeguard the interest of the investors. However, Government Securities being G-secs, State Development Loans etc. are risk free securities - thus, by investing in multiple securities issued by the Central Government and/or the State Government with varying maturities or interest rates, the AIFs are not minimising their concentration risks - as the amount of money invested either goes to the Central Government or the State Government. Accordingly, in our view such investment restrictions shall not apply to investments in Government Securities being G-secs, State Development Loans etc.

Alternatively, one may also say that investments in Government Securities being G-secs, State Development Loans etc. are actually nothing but a 'loan' and since the AIFs are privately pooled vehicles to invest money collected from the investors according to defined investment policy and not to grant loans, the AIFs cannot make investments in Government Securities being G-secs, State Development Loans, except on a temporary basis as permitted by Regulation 15(1)(*f*) of the AIF Regulations.

However, clarity from the SEBI on this aspect is likely to encourage Investment Managers in debt markets to also look at setting up the AIFs.

B. Computation of investment restrictions provided in Regulation 15 of the AIF Regulations:

As mentioned earlier, as per Regulation 15(1)(*c*) of the AIF Regulations, the Category I and the Category II AIFs cannot invest more than 25% of the investible funds in one investee company and as per Regulation 15(1)(*d*) of the AIF Regulations, the Category III AIFs cannot invest more than 10% of the investible funds in one investee company.

Currently, these investment restrictions are linked to the corpus of the AIF less estimated expenditure for administration and management and not to the asset under management. Due to this, many Investment Managers are not able to maximise returns for their investors. Let's understand how:

For *e.g.* The Category III AIF has a corpus of Rs. 1,00,000 and has estimated the expenditure for administration and management of Rs. 5,000 - as per Regulation 15(1)(*d*) of the AIF Regulations, this Category III AIF cannot invest more than Rs. 9,500 in one investee company. Accordingly, in Year 1, this Category III AIF made investments as under:

Investment in	**Amount (cost)**	**Value at the end of**		
		Year 1	**Year 2**	**Year 3**
Shares of Company A - (*a*)	Rs. 9,500	Rs. 9,500	Rs. 12,000	Rs. 14,000
Shares of Company B - (*b*)	Rs. 9,500	Rs. 9,500	Rs. 11,500	Rs. 13,000

Shares of Company C - (*c*)	Rs. 9,500	Rs. 9,500	Rs. 12,500	Rs. 15,000
Temporary Investments - (*d*)	Rs. 50,000	Rs. 50,000	Rs. 50,000	Rs. 50,000
Balance in Bank account - (*e*)	Rs. 16,500	Rs. 16,500	Rs. 11,500	Rs. 6,500
Expenses	Rs. 5,000	Rs. 5,000	Rs. 5,000	Rs. 5,000
Total value of asset under management (*a*) + (*b*) + (*c*) + (*d*) + (*e*)		Rs. 95,000	Rs. 97,500	Rs. 98,500

(*Please note that there is no change in the cost of investments made, in Year 2 and Year 3*)

One can observe that even though there is an increase in the value of investments in Year 2 and Year 3, still the Category III AIF cannot invest more than Rs. 9,500 in shares of Company A, Company B or Company C and maximise returns for its investors.

The SEBI in the case of Kelly Gamma Fund One - the Category III AIF, by way of an informal guidance, has clarified that investment restrictions should be linked to the corpus less estimated expenditure for administration and management, as provided in the AIF Regulations, rather than asset under management.

However, we believe, linking of investment restrictions to asset under management *i.e.* in the given example to Rs. 97,500 at the end of Year 2 and Rs. 98,500 at the end of Year 3 will give more flexibility to Investment Managers managing the AIFs to maximise returns for their investors.

This is also likely to encourage Investment Managers who are currently managing a pool of money under portfolio management schemes to set up the AIFs.

C. Breach of investment restrictions provided in Regulation 15 of the AIF Regulations:

Generally, we have not seen any AIF having an investment strategy to make investments in shares of Indian companies as well as units of mutual funds. However, where any AIF is having an investment strategy to make investments in shares of Indian companies as well as units of mutual funds, it becomes very critical to evaluate the impact of Regulation 15 of the AIF Regulations.

For *e.g.* The Category III AIF has a corpus of Rs. 1,00,000 and has estimated the expenditure for administration and management of Rs. 5,000 - as per Regulation 15(1)(*d*) of the AIF Regulations, this Category III AIF cannot invest more than Rs. 9,500 in one investee company. Accordingly, the Category III AIF has invested Rs. 9,500 into shares of Company A and Rs. 9,500 into units of an equity oriented mutual fund which in turn has also invested in shares of Company A - now does this mean that by investing Rs. 9,500 in units of an equity oriented mutual fund which has also invested in shares of Company A, the Category III AIF has violated the applicable limit of 10%?

At present, there is no clarity or guidance on this aspect and may pose significant challenge practically. Thus, it is advisable to seek informal guidance from the SEBI on this aspect. In our view, in such situations, investments in units of an equity oriented mutual fund should be avoided to ensure strict compliance with investment restrictions provided in Regulation 15 of the AIF Regulations.

Way forward:

The above regulatory issues may discourage Investment Managers from setting up the AIFs. From a tax perspective, the higher surcharge rates introduced by the Finance Act, 2019, may only add fuel to the fire and further discourage Investment Managers from setting up the AIFs, given that such higher surcharge rates will adversely impact the trust structures adopted for setting up the AIFs, specifically the Category III AIFs, as such AIFs do not enjoy a pass thru status under the Income-tax Act, 1961. Thus, it becomes important for Investment Managers to look at alternative platforms to the AIFs - may be its time to look at or introduce, platforms similar to the Variable Capital Company introduced by the Monetary Authority of Singapore early this year.

1. Based on the data published by the Securities and Exchange Board of India