Alternative Investment Funds (AIF) Regulations, 2012: Need to define the Role of Investment Advisors and Fund Managers

Abstract: SEBI under its AIF Regulations, 2012 has comprehensively defined the various Alternative Investment Funds and their registration. However, it has failed to define the Investment Advisors and the Fund Managers for such Investment Funds. The various roles/functions viz. legal, marketing etc. to be played by such advisors/managers have not been defined by the SEBI. In the tune of the USA Private Fund Investment Advisers Registration Act, 2010 and the European Council on the Directives for Alternative Investment Fund Managers SEBI should have defined the role of such Investment Advisors and Fund Managers. The various exemptions which have been given to such Investment Advisors and Fund Managers should have been incorporated in the regulations. Further, it is high time that SEBI should set up a commission which regulates the role of such Investment Advisors and Fund Managers so that better market conditions can exist at par with global scenario for the investors.

The underlying philosophy of the Alternative Investment Funds, (AIF Regulations) 2012 seems to go beyond the SEBI's role of monitoring market malpractices and creating safe investment conditions for investors. The provisions seek to regulate the business of funds and their internal governance. The AIF Regulations have been formulated keeping market exigencies in mind and the flexible nature of such funds. There is the need of creating various regulations to develop the funds industry in India in the right manner, especially as India needs capital to fuel its growth of private funds industry and potential investors. In most of advanced economies, multiple vehicles exist to provide various avenues for the institutional investors to invest based on their investment needs including hedge funds, private equity funds, commodity funds, real estate funds, infrastructure funds, investment trusts, etc. Investors in these funds are largely institutional, high net worth individuals and corporate. These investors while entrusting their funds to the fund managers seeks commitment from such fund manager by way skin in the game. Thus leading to conflict as the fund manager is an investor as well as a manager.

http://old.legalera.in/Front-Page/draft-sebi-aif-regulations-beyond-its-brief.html
http://www.sebi.gov.in/cms/sebi_data/docfiles/21182_t.html

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In India, SEBI has undertaken the steps under drafting Investment Advisors Regulations of 2007 in which it has defined the concept of Investment Advisors, registration of such Investment Advisors and there general obligations and responsibilities. However such has never been incorporated in pith and substance. In its new Alternative Investment Funds Regulations 2012 has again not defined the Investment Advisors and Fund Managers but has given a thorough and detailed legal aspect for the registration for the investment funds.

As in USA’s Private Fund Investment Advisers Registration Act, 2010 (the “Registration Act”) and its related rules that unlike the AIF Regulations, provide for registration of the Investment Adviser and not the funds. While the Registration Act seeks to regulate the private investment industry for investor protection and transparency purposes, it does not dictate terms of investments by funds. The SEBI under its AIF Regulations 2012, has missed the said concept and has defined the funds but not the Investment Advisors and Fund Managers for such funds.

Under the Private Fund Investment Advisers Registration Act of 2010 (The Act), enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 (C P Act 2010), Investment Advisers to private funds including hedge funds and private equity funds are required to register with the Securities and Exchange Commission (SEC) unless they qualify for one of the exemptions provided such as advisers to Venture Capital Funds, smaller advisers (advising to private funds with AUM less than USD 150 million), foreign private fund advisers, family offices etc. The Act eliminates the so called private adviser exemption for advisers with fewer than 15 clients, upon which most private fund managers relied to avoid registration under the Investment Advisers Act of 1940. Now all hedge fund and private equity fund advisers that are required to register with the SEC must do so before July 21, 2011, and must be fully compliant with requirements under the Investment Advisers Act of 1940. Such advisers will be required to file reports containing such information as SEC deem necessary to protect investors or for the assessment of systemic risk. The salient features of the Act are as follows:

http://www.sebi.gov.in/Index.jsp?contentDisp=pnnotes
Foreign Private Advisers: The Private Fund Act creates an exemption from registration for "foreign private advisers". A "foreign private adviser" is defined as an investment adviser who has no place of business in the United States, has, in total, fewer than 15 clients and investors in the United States in private funds advised by it, has less than $25 million in assets under management attributable to clients in the United States and investors in the United States in private funds advised by it (or such higher amount as the SEC may approve by rule), and doesn't hold itself out generally to the public in the United States as an investment adviser or act as an investment adviser to any registered investment company or as a business development company.

Venture Capital Fund Advisers. The Private Fund Act exempts from registration under the Advisers Act any investment adviser who provides investment advice solely to one or more venture capital funds. The PF Act does not define the term "venture capital fund", but instructs the SEC to issue final rules defining the term not later than the first anniversary of the Enactment Date. Although exempt from registration, advisers to venture capital funds will be required to maintain such records and provide to the SEC such annual or other reports as the SEC determines are necessary or appropriate in the public interest or for the protection of investors.

Smaller and Mid-Sized Private Fund Advisers: The Private Fund Act exempts from registration under the Advisers Act any investment adviser who (i) provides investment advice solely to private funds, and (ii) has assets under management in the United States of less than $150,000,000. Any such private fund advisers will still be required to maintain such records and provide to the SEC such annual or other reports as the SEC determines are necessary or appropriate in the public interest or for the protection of investors.

Narrowing of Intrastate Exemption: The Section 203(b)(1) of the Private Fund Advisers Act currently exempts from registration any investment adviser all of whose clients are residents of the State in which the investment adviser maintains its principal office and place of business so long as the adviser does not furnish advice or issue analyses or reports with respect to any securities listed or admitted to unlisted trading privileges on any national securities exchange. The Private Fund Act amends Section 203(b)(1) to make this exemption unavailable to private fund advisers that might otherwise qualify.
Revision of Exemption for Commodity Trading Advisors: The Section 203(b)(6) of the Advisers Act exempts from registration any investment adviser that is registered as a commodity trading advisor with the Commodity Futures Trading Commission (the "CFTC") if such adviser's business does not consist primarily of acting as an investment adviser and it does not provide advice to any registered investment company or business development company. The PF Act amends Section 203(b)(6) to require any private fund adviser who is registered with the CFTC as a commodity trading advisor to register with the SEC as an investment adviser if its business shall become predominately the provision of securities-related advice. The PF Act does not define "predominately" as used in this context.

Advisers to Small Business Investment Companies: The Private Fund Act creates an exemption from registration for any investment adviser (other than any entity regulated as a business development company under the Investment Company) whose only clients are small business investment companies licensed under the Small Business Investment Act of 1958 or certain similar or affiliated entities.

Even if exempt from SEC registration, (such as VCFs or private fund less than 150 million), they will be subject to record-keeping and reporting obligations. They also remain subject to anti-fraud rules and thus to the SEC’s enforcement authority. The Volcker Rule made under C P Act, 2010 prohibits a banking entity from acquiring or sponsoring any hedge fund or private equity fund.

Further, The European Parliament and Council has come out with a the Directive on Alternative Investment Fund Manager (AIFM) such as Hedge Funds, Private Equity Managers, etc.

The salient features of the directives are: The Directive requires any fund manager whose regular business is to manage AIFs in the European Union to be authorised by, or registered with, a competent authority in the EU.

(ii) To operate in the European Union, all Alternative Investment Fund Managers will be required to obtain authorization from the competent authority of their home Member State.

(iii) Alternative Investment Fund Managers to provide to their investors, initially and on an ongoing basis, a clear description of the investment policy, including descriptions of the type of assets and the use of leverage; redemption policy in normal and exceptional circumstances; valuation, custody, administration and risk management procedures; and fees, charges and expenses associated with the investment.

(iv) Disclosures and reporting to the competent authority on a regular basis by Alternative Investment Fund Managers.

(v) Alternative Investment Fund Managers to issue annual disclosure on the investment strategy and objectives of its fund when acquiring control of companies and general disclosures about the performance of the portfolio company following acquisition of control.

(vi) An Alternative Investment Fund Managers authorized in its home Member State will be entitled to market its funds to professional investors on the territory of any Member State. Member States may allow for marketing to retail investors within their territory and may apply additional regulatory safeguards for this purpose. Such requirements shall not discriminate according to the domicile of the AIFM.

(vii) To facilitate international cooperation in macro-prudential regulations, the competent authorities of the home Member State will be required to transmit relevant macro-prudential data, in a suitably aggregated format, to public authorities in other Member States.

(viii) There are a number of key exemptions to the scope of the AIFMD. Specifically excluded from the definition of AIF are holding companies, joint ventures, securitization special purpose entities, pension funds, employee participation or savings schemes and family offices. The Directive foresees some ‘grandfathering provisions’ for fund managers of certain types of closed-ended funds. Managers of (a) closed-ended AIF that do not make any additional investments after 22 July 2013 or (b) closed-ended AIF whose subscription period for investors has closed prior to 22 July 2011 and will be wound up at the latest on 22 July 2016, will not be required to seek an AIFM license. However fund managers falling under category (b) will be required to comply with annual reporting requirements and disclosure requirements where they control portfolio companies.

(ix) The functions of an AIFM: (a) Core functions: The concept of ‘management of AIFs’ is comprised of the core activities of portfolio management and risk management, with the AIFM license covering both these activities. If permitted by its legal structure an AIF could be internally managed, and as such the AIF is authorised as the AIFM. Otherwise an external AIFM can be appointed by one or more AIFs.
(b) Other functions: The AIFM may also perform additional functions in the course of the management of AIFs including administration (legal and accounting services; customer inquiries; valuation, pricing, tax returns; regulatory compliance monitoring; maintenance of unit-/shareholder register; distribution of income; unit/shares issues and redemptions, contract settlements and record keeping), marketing and services specifically related to the assets of an AIF.

(c) Additional investment services: External AIFMs may be authorised by individual Member States to provide additional investment services permitted under MiFID including discretionary portfolio management, investment advice, safe-keeping and administration of fund units and the receipt and transmission of orders in relation to financial instruments.

(d) EU Passports for management and marketing of AIFs: The AIFM license will confer an EU-wide management passport to AIFM that will permit the management of AIFs based in any EU Member State, either directly or through a branch. The host country competent authorities will not be able to impose any additional requirements on the AIFM in respect of the areas covered by the Directive. The AIFMD will also confer an EU-wide marketing passport to the AIFM to market AIFs that it manages to professional investors across the EU.

(x) Small AIFMs – exemption from full AIFMD regime: The Directive foresees a registration regime for fund managers whose assets under management are below certain thresholds, less than €100 million in leveraged AIFs or less than €500 million in unleveraged AIFs that are without redemption rights for a period of five years. These fund managers would fall under a simple registration regime, rather than full AIFMD compliance, and would not benefit from the EU-wide management or marketing passport. However an opt-in procedure is included that would allow small AIFMs to apply for a full AIFM license.

There are two EU regulatory proposals targeting Venture Capital and Social Entrepreneurship Fund Managers going through the EU legislative process. These proposed regulations intend to introduce separate EU regimes and Passports for these particular categories of fund managers to come into effect in July 2013 at the same time as the AIFMD.

Registration regime: As part of the registration process the fund manager must provide information on its identity, the AIFs managed and their investment strategies to the competent authorities. On a regular basis the fund manager will need to report on the main instruments traded, the principal exposures and most important concentrations of AIFs managed. The registration regime in the AIFMD is without prejudice to any stricter local rules adopted by Member States. The main intention of the regime is to allow the competent authorities to effectively monitor systemic risk.
Under the new rules, AIFs will be required to hold more capital and make more disclosures and non-European hedge funds will have to gain a "passport" to operate within the EU.

However, SEBI under its Board meeting has given the Introduction to SEBI (Investment Advisors), Regulations, 2012 (under its Investment Advisors Regulations of 2007) as follows:

All individuals, body corporate and partnership firms engaged in the business of providing investment advice to investors for consideration are required to be registered and regulated under these Regulations. Any person who holds himself as an investment advisor shall also fall under the purview of these Regulations. Investment advice given without any consideration through media at large and widely available to the public shall not be considered as investment advice.

The banks or body corporate which also offer distribution, execution or referral services will be required to offer investment advisory services through a subsidiary or a Separately Identifiable Department or Division (SIDD). Such a SIDD will be required to be clearly segregated from other activities. The Financial Planners will be required to be registered as investment advisors. Only the act of giving advice will be regulated under this regulation, whereas the regulation of selling of products, if any, would be solely under the purview of the product regulators. The investment advisor shall not obtain any remuneration or compensation from any person other than from the client being advised. However, for a bank or body corporate having a distribution, referral or execution business, it would be necessary to keep the investment advisory services segregated from such activities and to make disclosures to the clients being advised about any remuneration or compensation received by it and any of its associates for the distribution, referral or execution services.

The investment advisors registered under the regulations shall use the words “investment advisors” in their name.

Exemptions have been provided to certain persons from registration under these Regulations, as under:

http://www.sebi.gov.in/sebiweb/home/detail/24234/yes/PR-SEBI-Board-Meeting
a. Persons giving general comments in good faith in regard to trends in the financial or securities market or the economic situation provided such comments do not specify any particular securities or investment product.

b. Persons providing advice exclusively in areas like insurance and pension products provided they are regulated by sectoral regulators.

c. Professionals such as lawyers, Chartered Accountants etc., providing advice incidental to their professional services.

d. Stock Brokers, Sub-brokers, Portfolio Managers and Merchant Bankers registered with SEBI providing investment advice incidental to their primary activity. Such intermediaries under SEBI are however required to comply with obligations under these Regulations such as acting in fiduciary responsibility, risk profiling etc.

e. AMFI registered distributors providing investment advice incidental to their primary activity.

f. The Fund Manager of a Mutual Fund or Alternative Investment Fund.

The Representatives of body corporate or a bank who provides advice on behalf of a bank or a body corporate need to be qualified and certified.

The regulations provide for code of conduct, fiduciary duties, record keeping, risk profiling of the clients and also deal with the issue of suitability and appropriateness of the advice.

Requirements relating to experience, qualification, certification and net worth/ net assets have been prescribed for a person to act as an investment advisor. Initially, SEBI will directly register and regulate the Investment Advisors.

**Conclusion:** Although SEBI has given a detailed legal framework for registration of the various Alternative Investment Funds under its new AIF Regulations, 2012, it has not been able to give the ample definitions of the Investment Advisors and the Fund Managers with respect to such funds viz. private equity funds, hedge funds, PIPE, real estate funds, venture capital funds etc. SEBI has failed to give the various legal and marketing functions to be done by such Investment Advisors and Fund Managers for such Alternative Investment Funds. In the global economic environment various regulations has been incorporated for the Investment Funds as in case of USA's Private Fund Investment Advisers Registration Act, 2010 (the “Registration Act”) which defines Investment Advisors for each and every separate fund. Similarly, The European Parliament and Council has the Directives on Alternative Investment Fund Manager (AIFM) which has the legal requirement of defining the Investment Advisors and Fund Managers along with various exemptions, compulsory
registration of such managers etc for Alternative Investment Funds. Under its AIF Regulations 2012, SEBI should have differentiated between who can be the Fund Manager and who shall be the Investment Advisor for different Investment Funds. The various exemptions should have been given to the open ended and close ended funds in relation to the Fund Managers and Investment Advisors. Although steps have been taken by the SEBI in its board meeting on Introduction to SEBI (Investment Advisors), Regulations, 2012 still a legal framework has to be defined for such Fund Managers and Investment Advisors with respect to various Alternative Investment Funds. Further, at this stage it is required that SEBI should set up a commission which should monitor the activities of the Fund Managers and Investment Advisors so that better regulations and control can be made in the market thus creating a better environment for the investors.

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