

Funds Hotline

July 08, 2020

SEBI'S INFORMAL GUIDANCE: INTERPRETATION OF ANGEL FUND REGULATIONS

On January 13, 2020, a company acting as an investment manager to a Securities and Exchange Board of India ("SEBI") registered Category I Alternative Investment Fund ("AIF"), under the venture capital fund sub-category as an angel fund under the SEBI (AIF) Regulations, 2012 ("AIF Regulations") ("Fund") wrote to SEBI seeking clarifications in the form of an interpretative letter under the SEBI (Informal Guidance Scheme), 2003 ("Informal Guidance Scheme"), in relation to segregation of investments made by different schemes of an angel fund.

SEBI'S INFORMAL GUIDANCE SCHEME

With a view to ensure better regulation and orderly development of the securities market, SEBI introduced its Informal Guidance Scheme in June, 2003. Under the Informal Guidance Scheme, SEBI may issue an informal guidance in the following two forms¹:

1. No-action letters: The specific department of SEBI, to which the request is made, shall indicate whether or not it shall recommend an action to SEBI should the proposed transaction in securities as described under a request be effectuated.
2. Interpretative letters: The specific department of SEBI, to which the request is made, shall interpret a specific provision of any legal regulation administered by SEBI in light of the factual position or a proposed transaction in securities.

However, it is pertinent to note that the guidance provided by a particular department of SEBI through any of the aforementioned forms constitutes a view only of that specific department and should not be construed as a conclusive decision or determination of any question of law or fact or as an order by SEBI.²

ANGEL FUND REGULATIONS

Historically, the angel network provided funding to start-up companies privately on a one to one basis. With the intent to provide impetus to the growth of Indian start-ups brought by the angel network, SEBI vide an amendment to the AIF Regulations in 2013, introduced the angel fund regulations. Accordingly, the mainstream AIF platform was offered by SEBI to the Indian angel network to provide a framework for setting up funds focused on investments in start-ups. In this regard, angel funds were added as a sub-category to the venture capital funds, a form of Category I AIFs.

Angel funds have been provided with more beneficial terms by SEBI under the AIF Regulations in comparison to other categories of AIFs viz. the minimum corpus of an angel fund is INR 5 crores³ (as opposed to INR 20 crores for other categories of AIFs or each scheme in case of multi-schemed AIFs) with the minimum commitment amount by angel investors set at INR 25 lakhs⁴ (as opposed to INR 1 crore⁵ for other categories of AIFs or each scheme in case of multi-schemed AIFs). However, to ensure that the fund platform pools only angel investors and utilizes the funds towards the growth of start-up companies, SEBI incorporated certain pre-conditions under the angel fund regulations viz. (a) the eligibility criteria for angel investors⁶ which can be pooled into a scheme of an angel fund; and (b) the portfolio companies⁷ which a scheme of an angel fund can invest in; and (c) lock-in period⁸ for each investment made by a scheme of an angel fund.

In a similar vein, the AIF Regulations also require the investment manager of an angel fund to launch a new scheme for each portfolio investment identified by an angel fund and such scheme shall, in turn, invest in the portfolio company so identified. Accordingly, the investment manager is required by the AIF Regulations to seek consent from angel investors to invest in a portfolio company (which satisfies the pre-conditions⁹ under the AIF Regulations) and once it receives investor consent, the investment manager launches a new scheme under the angel fund to make such investment. The AIF Regulations and circular issued by SEBI dated June, 2018¹⁰ ("Circular") require the investment manager to file a term sheet with SEBI which contains the details of the portfolio company and commercials agreed upon between such scheme and the portfolio company it proposes to invest in along with details of the scheme viz. name of the scheme, list of investors in the scheme, compliance with AIF Regulations, total commitments raised etc. This differs from the requirement set out by the AIF Regulations for launching schemes by other categories of AIFs which includes filing a new private placement memorandum for the proposed scheme containing the specific commercials sought to be offered by the proposed scheme to its investors.

In this manner, the angel fund regulations were introduced by SEBI to provide a separate regulatory framework to cater to the interests of the angel network industry in India.

BACKGROUND

Ankur Fincon Management Pvt. Ltd. is the investment manager to the Fund ("Investment Manager"). As required by the AIF Regulations and the Circular, the Investment Manager established a new scheme under the Fund for each new investment proposed to be made by the Fund and prior to filing such new scheme documents with SEBI, the

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Fund sought consent from each of its existing investors to commit capital to the proposed investment under the proposed new scheme of the Fund. In this regard, the Fund proposed to invest in a company outside India ("Company A") and accordingly, sought consent from its existing investors to commit capital towards such proposed investment under a new scheme proposed to be launched by the Fund.

Investor X, an insurance company, dissented from committing capital towards such proposed investment in Company A¹¹ and was hence, not included as an investor under the new scheme term sheet. Further, the Fund also maintained separate accounts for each scheme of the Fund with a view that each scheme under the angel fund is treated as independent under the AIF Regulations. Therefore, Investor X's capital commitment was not taken into account for investment proposed to be made in Company.

In line with the above, the Investment Manager posed certain queries to SEBI which have been summarized below in two parts:

Part I: Investor discretion to participate in investments

The Investment Manager primarily requested SEBI to confirm whether (a) the intent of the angel fund regulations under the AIF Regulations is to enable investors to selectively participate in each scheme of an angel fund; and (b) each scheme of an angel fund is an independent vehicle with its own set of investors who have approved to be part of such scheme.

Part II: Ringfencing schemes of an angel fund

The Investment Manager also requested SEBI to provide a more interpretive response in relation to specific circumstances where investor interests in different schemes may be ringfenced from each other under an angel fund. Accordingly, the Investment Manager queried whether an investor shall be ringfenced from the investments made by a scheme (a) in which such investor has dissented from committing capital; and (b) from which such investor has excused itself from committing capital on account of regulatory limitations that it may be subject to and whether by doing so, it will not be in non-compliance for its investments in other schemes which it has approved to invest in.

SEBI'S RESPONSE

Given that an investment manager is required under the AIF Regulations to procure an undertaking from each investor to contribute capital towards a particular investment under a scheme of an angel fund, the regulator confirmed the understanding that investors may selectively participate in each scheme of an angel fund. Separately, it also confirmed the understanding under the second query of Part I above, observing that prior to launching a new scheme, the angel fund has to file a new term sheet in a form as mentioned under the AIF Regulations and the Circular.

Further, the regulator also translated the above confirmed understandings into its clarifications for queries under Part II above by observing that on account of the existence of investor discretion to invest in a particular scheme of an angel fund, each scheme of an angel fund is to be viewed as independent and therefore, investors in a particular scheme of an angel fund are ring-fenced from the activities of another scheme in which such investor has not participated for the purpose of compliance with the AIF Regulations.

ANALYSIS

The responses provided by the regulator in relation to queries posed under Part I above were fairly straightforward. Given the backdrop of angel fund regulations, the fact that the angel fund regulations already stipulate that an angel investor shall have the option to consent to contribute to each portfolio investment sought to be made by a scheme of an angel fund and further, angel funds may launch new schemes for new portfolio investments, SEBI re-confirmed what is already postulated under the AIF Regulations. However, the clarifications provided for queries under Part II above are a welcome move as the regular confirmed an interpretation which has been practically followed by the industry in respect of angel funds. As the AIF Regulations enable investor discretion to participate in a portfolio investment identified by an angel fund, the regulatory intent is for the investment manager to launch a new scheme for each new portfolio investment sought to be made by an angel fund. This enables the investors to be segregated from the implications of another portfolio investment made by a separate scheme in which such investor may have not participated.

In terms of the present facts, Investor X dissented to invest in the scheme of an angel fund probably on account of regulatory restrictions applicable to it. It is pertinent to note that such excusal is permitted even for other categories of AIFs whereby, the fund documents contain excuse provisions whereunder Indian and foreign investors are permitted to excuse themselves (subject to provision of certain documentation and prior notice to the investment manager) from a proposed portfolio investment sought to be made by the AIF on account of regulatory restrictions, internal policy restrictions or restrictions imposed by the law of their jurisdiction which may be applicable to such investors. However, unlike for angel funds, the AIF Regulations do not permit investors in other categories of AIFs, to dissent from investing in a portfolio investment sought to be made by such AIF on account of commercial reasons alone.

Separately, the regulator also specified that such scheme wise ringfencing is to be interpreted only for the purposes of compliance with the AIF Regulations. This may create certain ambiguity as to whether the scheme wise segregation could be interpreted in respect of other applicable laws as well. Further, there is also the question of whether the investment manager should obtain a separate permanent account numbers (PAN) and file separate tax returns for each scheme (which could be impractical and cumbersome given the number of investments an angel fund may make in its lifetime) or whether obtaining one PAN and filing one tax return for the fund as a whole could come in the way of achieving ringfencing of assets of one scheme from liabilities on another. Nonetheless, the guidance provided by SEBI is a welcome move as it provides clarity to fund managers managing angel funds.

— **Blanche Dsouza & Parul Jain**

You can direct your queries or comments to the authors

¹ Clause 5 of the Informal Guidance Scheme.

² Clause 13 of the Informal Guidance Scheme.

³ Regulation 19D(2) of the AIF Regulations.

⁴ Regulation 19D(2) of the AIF Regulations.

⁵ Regulation 10(c) of the AIF Regulations.

⁶ Regulation 19A(2) of the AIF Regulations.

⁷ Regulations 19F(1) of the AIF Regulations.

⁸ Regulation 19F(3) of the AIF Regulations.

⁹ Regulation 19F(1) of the AIF Regulations.

¹⁰ SEBI Circular No. CIR/IMD/DF1/102/2018 dated June 29, 2018 available at https://www.sebi.gov.in/legal/circulars/jun-2018/filing-of-term-sheet-by-angel-funds_39395.html

¹¹ Insurance companies are not permitted by the Insurance Regulatory and Development Authority to invest in securities of companies incorporated outside India.

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