

Corpsec Hotline

February 14, 2008

SEBI ISSUES ADVISORY ON "ART FUND"

Securities and Exchange Board of India ("SEBI") vide press release dated February 13, 2008 bearing reference number PR No.44/2008 ("Press Release") issued an advisor notice to investors informing them that, investments in "Art Fund" are in the nature of "collective investment schemes" as defined under section 11AA (2)^[1] of the Securities and Exchange Board of India Act, 1992 ("SEBI Act").

Currently there are seven existing art funds in India. These art funds have raised about approximately INR 500 crores (USD 125 million) from investors and hence as per the Press Release, it has been indicated by SEBI that these schemes/ funds have been launched without the obtaining of proper registrations as required under the SEBI (Collective Investment Schemes ("CIS")) Regulations, 1999 ("CIS Regulations") and hence as per the Press Release, the same amounts to a violation of the SEBI Act and the CIS Regulations.

The CIS Regulation prescribes certain mandatory compliances that are applicable to Collective Investment Schemes. While prima facie the definition of CIS could cover essentially all asset classes including art work, however the reading of the CIS Regulations seems to suggest that the CIS Regulations are not conducive to formation and operation of art funds. Also, one needs to recognize that the backdrop against which the CIS Regulations were introduced to regulate the spurring plantation and livestock schemes which were blatantly raising retail monies from the public without being subjected to any regulations. As against this, art as an asset is generally targeted at sophisticated investors on a private placement basis and not to the public at large. it may be useful to focus on how the provisions of the CIS Regulations could conflict with the business practices and the basic tenets of art as an investment:

1. The CIS Regulations prescribe certain rights and obligations of the Trustee. As per the CIS Regulation the Trustee is required get each scheme to appraised at the end of each financial year by an appraising agency^[2] and also get such scheme rated by a credit rating agency^[3]. Currently in India, there are no appraising agencies or credit rating agencies approved by the SEBI to appraise or rate the assets of these investment trusts. The CIS Regulations primarily prescribe appraising and credit rating mechanism for plantation and live stock schemes and the same may not be conducive for art schemes as art is an extremely subjective matter.
2. Another peculiar requirement of the CIS Regulations is that it requires the units of the scheme to be listed on the stock exchange mentioned in the offer document, immediately after date of allotment and no later than six weeks from the closure of the scheme.

The CIS Regulations requires the units of any collective investment scheme to be compulsorily listed on the stock exchange mentioned in the offer document issued to the public at large. The whole concept of listing the scheme is contrary to concept of private placement. The mandatory listing as required under the CIS Regulations as applied to art funds could be against the interest of the public at large as the same may not be a suitable investment for less sophisticated investors

3. The expenses incurred by a manager of an art fund could be significantly higher than the cap of 1%/1.25%/1.5% as provided under the CIS Regulations, thereby the same may not be sufficient to cover the expenses of an art fund manager. Internationally art funds typically charge approximately 3% as management fee and 30% or more as performance fee since the potential upside for the investors could be significantly higher.
4. Even the accounting norms under the CIS Regulations are only prescribed for plantation and live stock schemes. There is no guidance on how art as an asset should be accounted for. Thus, even if the funds are regulated the above accounting norms would be irrelevant for art funds.

To conclude, while it is clearly a SEBI prerogative to regulate such funds in the interest of the investors, it would also be fair to say that if it is to be done, SEBI should look at making the CIS Regulations more conducive to such an asset class. Also, the emphasis of the CIS Regulations should be on the risk disclosure, restrictions on offer to the general public and basic corporate governance aspects rather than regulating the business itself through caps on fees, expenses, etc.

[1] Regulation 11AA of the SEBI Act states:-

(i) Any scheme or arrangement which satisfies the conditions referred to in sub- section (2) shall be a collective investment scheme.

(ii) Any scheme or arrangement made or offered by any company under which,-

(a) the contributions, or payments made by the investors, by whatever name called, are pooled and utilized solely for

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the purposes of the scheme or arrangement;

(b) the contributions or payments are made to such scheme or arrangement by the investors with a view to receive profits, income, produce or property, whether movable or immovable from such scheme or arrangement;

(c) the property, contribution or investment forming part of scheme or arrangement, whether identifiable or not, is managed on behalf of the investors;

(d) the investors do not have day to day control over the management and operation of the scheme or arrangement.

[2] appraising agency means an agency empanelled with the Board for the purpose of conducting technical or financial appraisal of the scheme.

[3] credit rating agency means a body corporate registered under Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999

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You can direct your queries or comments to the authors

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