Note on 'Accredited Investors'

Background

The current Alternative Investment Fund (AIF) regulations require an investor to invest at least ₹ 1 crore in any AIF. This is to ensure that only sophisticated investors invest in such AIFs considering the risk involved in such investments. This high threshold, while effective in some cases, creates considerable concentration risk for investors at the lower end of the scale by reducing their diversification.

To be able to prudently invest at least ₹1 Cr in a single investment of the risk profile of AIFs, would require an investable corpus of at least ₹15 - 25 Cr. Hence, only around 50,000 individuals[1] in India would have access financial instruments such as AIFs under the current norms. On the other hand, more than 20.26 lakh individuals[2] had taxable incomes of more than ₹10 lakhs in the assessment year 2014-15. Moreover, there are several sophisticated, knowledgeable investors, with access to the right advisors and who can easily manage the balance-sheet risk of alternative investments. However, they are currently excluded from investing in AIFs as the minimum investment norms would add substantial concentration risk in their portfolios. Even the recent advent of the Fund of funds would only marginally alleviate this because of the higher allocation to a single, high-risk asset class.

Therefore, with investor participation in mind, it would be more rational to assess the investor, rather than assessing the investment. It is perhaps wiser to create an income based accreditation determinant.

Global practices on 'Accredited Investors'

Globally, the concept of "accredited investors" is used wherein an investor who has a certain minimum income or asset or net worth is considered to be an

[1] Industry estimates based on the 'World Wealth Report 2015', released by Capgemini and RBC Wealth Management. 1.98 lakh individuals with an investable wealth of more than $1 million and 14,800 with more than $1 million.

[2] Data from the Central Board of Direct Taxes

accredited investor, and can make such investments. Such investors are usually self-certified, for instance in countries like USA.

In the US (as shown in the attachment), *'a natural person with income exceeding US$200,000 in each of the two most recent year'* is said to fit the definition of the term "accredited investor". In terms of purchasing power parity, this would be equivalent to an income or ₹40 lakhs.

<u>AIPAC Proposal for 'Accredited Investors'</u>

In line with the global practice, it is proposed that the individuals who satisfy the following conditions should be recognised as accredited investors:

a) Capable of identifying potential investments and their underlying risks;
b) Possess sufficient financial sophistication to take on the risks associated with the offerings; and
c) Have a sound financial track record i.e. reported total income exceeding ₹50 lakhs annually in three assessment years immediately preceding the assessment year in which the investment is proposed to be made.

Further, it is also proposed to link the Permanent Account Number (PAN) of the investor in the electronic database of revenue authorities with the total income (including exempt income) of the investor in a manner such that it is easier to determine whether the investor qualifies as an accredited investor.

These financial products are to be sold only to Accredited Investor, who will be evaluated and vetted through a proper KYC process by registered KRAs or other depository participants (DPs).

<u>'Accredited Investors' for Angel investing</u>

Today angel investments are not regulated and are usually private transactions that happen over the counter. The Accredited Investor framework can be utilized to move these transactions to a more regulated exchange framework. Angel investments made by these accredited investors into shares of start-ups dematerialized through a recognized depository should be permitted to avail exemption from Angel Tax [Sec.56(2) (viib)].