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THE INDIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

Mr. S. K. Kar, CGM
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15th June, 2017

Dear Shri. Kar,

Thank you for your valuable time to meet with us today.

I am enclosing the soft copy of the points that we would like to discuss with you.

We met with Shri. Sen last month and presented him this. He had advised us to meet with Shri. S.S. Barik who in turn had asked us to meet with you.

We do hope that this will be duly incorporated in the July 17 master circular.

We would request you to contact IVCA for any clarifications.

Kind regards

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Gopal Srinivasan

Investments in AIF-II by Schedule Banks

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- The Securities Exchange Board of India ("**SEBI**") issued the SEBI (Venture Capital Fund) ("**VCF**") Regulations, 1996 ("**VCF Regulations**") which constituted the legal regime for establishing and operating funds in India.

- As per SEBI's Annual Report of 2015-16, there are about 200 VCFs operating in India and as of 31 March 2017 they have made approximately INR 28,813 crores worth of investments. Since there was no categorization under the VCF Regulations, all funds (including sector focussed funds such as real estate funds, infrastructure funds, etc.) were established under the same platform.

- In 2012, the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") replaced the VCF Regulations and ushered a new era of fund raising in India. Under the AIF Regulations, closed ended funds got divided between two separate categories, Category I and Category II. As an example, Category I is focused on special sectors where the Government may wish to offer benefits and concessions towards broader public policy objectives. To add further, the CSR regulations can be amended to permit investments into Social Venture Funds, a sub-category under Category I. Other categories in Category I includes, Infrastructure, Venture Capital and SME. Category II encompass a broader category of closed ended funds which includes general private equity, venture capital, debt funds etc, where the strategy may be defined by the Investment Manager, subject to SEBI approval.

- To put things in perspective, as of 31 March 2017, out of a total of INR 35,099 crores worth of investments made by AIFs, the largest portion of the investments were made by Category II AIFs. While 100 Category I AIFs accounted for INR 5,845 crores of investments, 165 Category II AIFs accounted for INR 21,073 crores, which is more than 60% of total investments by all AIFs.
  It may be noted that Schedule Banks are large investors in Category II of AIF

- Undoubtedly, alternative investment funds as alternate asset class is an extremely crucial source of funds for the Indian economy. Domestic banks and other financial institutions have been the primary source of institutional capital for this industry. Banks have invested in VCFs, across strategies and have also been an important investor in Category I and Category II AIFs. Investments by banks through Category I and II AIFs managed by professional fund managers will allow better capital allocation and deepen the market reach of banks thereby increasing their growth.

- The Reserve Bank of India ("**RBI**")'s in its Circular on 'Financial Services provided by Banks' dated 26 May 2016 ("**Master Direction**") stipulates that banks can invest in Category I AIFs up to 10% of their paid-up share capital and reserves (Section 5, Para V (b)). However, this Master Direction is silent on investment by banks in Category II Funds. It has created a potential ambiguity for banks who are investors in Category II Funds in terms of their future investments. **(Attached in Appendix A)**

- This ambiguity has also been noted by the Second Report issued by the Alternative Investment Policy Advisory Committee, chaired by Mr. Narayan Murthy ("**Committee Report**").

- Thus, in the spirit of continuity of the investment policies permissible for Banks to invest in all funds under the VCF regime, we request that this ambiguity is resolved by revising the Master Circular. The revised Master Direction should mention AIF II in section 5, Paragraph V (b) of the 26 May 2016 Circular

Appendix A

1. **Master Direction- Reserve Bank of India (Financial Services provided by Banks) Directions, 2016 (Master Direction/DBR.FSD. No.101/24.01.041/2015-16)**

5. Prudential Regulation for Banks' Investments:

(a) Limits on investments:

V (b) No Bank shall hold more than 10 per cent of the paid-up capital/unit capital of a venture capital fund (VCF)/Category I Alternate Investment Fund (AIF-I)

2. **IRDA Circular pertaining to investments in AIF-II**

Insurance Regulatory and Development Authority in March 2013 through a circular permitted insurer to invest in Category I AIF; Later, August 2013 it allowed investment even in AIF Category II.

Permission to Insurers to Invest in Category I & II Alternative Investment Funds (AIFs) (Circular RDA/F&I/CIR/INV/172/08/2013, Dated 23 August 2016)

The Authority vide its Circular No.IRDA/F&I/INV/CIR/054/03/2013 dated March 18, 2013 permitted insurers to invest in Category I Alternative Investment Funds (AIF) and clarified that such investments would be restricted to Infrastructure and SME sectors.

Pursuant to the issue of this Circular, the Authority received several representations from various stakeholders including large insurance companies to expand the scope of the AIF and include Category II AIF also. This matter was referred to the Expert Committee on Investment constituted by the Authority and the Expert Committee was of the view that the insurance companies should be allowed to invest in Category II AIF also.

In view of the above and in partial modification to the Circular dated March 18, 2013, insurers are permitted to invest in Category I & II AIFs under the extant SEBI Regulations. The permitted Funds in Category I are Infrastructure Fund, SME Fund, Venture Capital Fund and Social Venture Fund as defined in Alternate Fund Regulations. Whereas, in Category II, at least 51% of the funds of such AIF shall be invested in either of the Infrastructure entities or SME entities or Venture Capital undertakings or Social Venture entities. The restrictions regarding investment of funds outside India, promoter group, combined exposure limits in venture capital funds and AIFs under the Other than Approved category of investments will continue to apply. Insurers are also not permitted to invest in AIFs, which has the nature of Funds of Funds and Leverage Funds.