



Setting the global standard for investment professionals

31 August 2011

Attention: Securities and Exchange Board of India (SEBI)
c/o Ms. Maninder Cheema
Deputy General Manager

Re: Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments

Dear Shareholder Responsibilities Committee:

CFA Institute¹ and the Indian Association of Investment Professionals² (IAIP) are pleased to comment on the consultation paper: *Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments* (the “concept paper”) issued by the Securities and Exchange Board of India (SEBI). CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency and integrity of global financial markets.

Executive Summary

CFA Institute and the IAIP support SEBI’s attempt to establish comprehensive regulation for alternative investment funds (AIFs) in India. The efficient functioning of the market and the price formation process are driven in no small part by the activities of alternative investment funds. We appreciate the efforts of the SEBI to conduct a thorough examination of the issues relating to the regulation of alternative investment funds.

We feel that the SEBI’s efforts to register alternative investment funds, and set the investment conditions and restrictions under which these funds must operate will help set up a transparent and even playing field for market participants and asset managers. We encourage the SEBI to take into consideration the different aims of different funds when setting investment conditions and fund restrictions in its final rules, as it has largely done so in this Concept Paper. Finally, we

¹ CFA Institute is a global, not-for-profit professional association of over 105,000 investment analysts, advisers, portfolio managers, and other investment professionals in 137 countries, of whom more than 93,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.

² The Indian Association of Investment Professionals is an association of over 700 local investment professionals. The Association consists of portfolio managers, security analysts, investment advisers, and other financial professionals, that; promote ethical and professional standards within the investment industry, facilitate the exchange of information and opinions among people within the local investment community and beyond, and work to further the public's understanding of the CFA designation and investment industry.

Re: Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments
31 August 2011
Page 2

applaud the SEBI for encouraging and, when necessary, requiring transparency of AIFs so that investors can make informed investment decisions.

CFA Institute has written often on many of the subjects addressed in the SEBI's consultation, including but not limited to; *Investing in Hedge Funds: Information for the Retail Investor* (2007), [Comment Letter to the European Commission in Response to the Consultation Paper on Hedge Funds](#) (2009), [Comment Letter to IOSCO on Hedge Funds Oversight](#) (2009).

CFA Institute invites the SEBI to review CFA Institute's [Asset Manager Code of Professional Conduct](#) (2010). This code provides a set of globally applicable ethical and professional standards for firms managing assets, including alternative investment fund managers. This code was created with managers of these types of funds in mind and encourages them to put the interests of their investors ahead of those of fund managers and other parties. We believe this perspective is an essential part of market integrity.

Comments on Specific Proposals

E. Proposed Alternative Fund Regulation and Other Related Funds/Regulation

Ticket Size –increase from Rs. 5 lakhs per client to Rs. 25 lakhs, for PMS

We feel that the SEBI's move to increase the ticket size is in the right direction, as this will attract sophisticated clients who are either conversant with markets or have advisers who can apprise them of the risks involved. This however has to be implemented in conjunction with other regulations like those meant for advisory services and pooling of accounts.

Separate accounts for individual clients

We agree and support the SEBI's initiative to segregate client's funds and prohibit pooling the fund/securities of clients.

Model Portfolio

We feel that using a model portfolio approach is beneficial both for the clients and the PMS provider respectively, as it enables control on execution and simplifies most of the operational hassles. Customization of the model portfolio is already done at the client level to meet his/her personal requirements and his service needs are met by dedicated relationship managers (RMs) and individual access to fund managers. This methodology also leverages on the scarce talent pool of fund managers. We therefore suggest that as an efficient mechanism of managing funds, model portfolios should be allowed to continue.

Alternative Investment Fund (AIF) regulations

Closed ended – The SEBI’s thought process on making funds closed ended is lauded. But for funds investing in listed securities, being closed ended can be restrictive. Hence we suggest that SEBI allow strategy and hedge funds to be open ended.

Chapter II: Registration of Alternative Investment Funds

We agree with the SEBI that any alternative investment fund, regardless of its legal domicile, should first obtain a certificate of registration from the SEBI before it can manage any private pool of capital from institutional or High Net Worth investors (“HNWIs”) in India. Funds that receive such registration shall be bound by these regulations and be subject to registration and oversight of the SEBI.

We believe that a consistent, global approach to alternative investment fund manager registration requirements, including hedge fund manager registration, together with prudential oversight of regulated financial counterparties such as prime brokers and banks are important elements of global systemic risk oversight. In particular, this approach by supervisory authorities will improve the quality of information needed to monitor the build-up of risks at the level of these funds. Coordination, cooperation, and sharing of information between regulators will further strengthen the effectiveness of the supervisory framework.

AIF managers should meet the registration requirements of the appropriate securities regulator in the markets in which they operate. Equal treatment prevents abuse of regulation, and provides greater transparency, oversight, and investor protection. Registration enables regulators to regularly review – and more fully understand – the activities of such fund managers. Notification does not interfere with the operations of other collective investment structures and managers who must register with the regulator, but does alert regulatory authorities that a fund manager is operating within their jurisdiction.

Chapter III: Investment Conditions and Restrictions

According to the Concept Paper, the SEBI would prohibit AIFs from soliciting or collecting money or funds from the public or any retail investors through the issuance of a prospectus or other offering documents or advertisements. On the other hand, AIFs would be permitted to

Re: Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments
31 August 2011
Page 4

solicit private pools or funds or money from institutions, professional investors or HNWIs through private placements by issue of information memoranda.

In general, we agree that a distinction is needed between sophisticated and unsophisticated investors. Unsophisticated retail investors may lack the expertise to understand the risks inherent in these types of investments and typically do not possess the kind of financial resources needed to hire the expertise needed to weather the volatile performance of such investments, to endure potential losses financial losses and even to meet the minimum investments such vehicles often require. Moreover, the limited transparency about investment strategies, instruments and risks, together with limited regulatory protections make these instruments less suitable for such investors.

Sophisticated investors, on the other hand, either understand the risks posed by such investment vehicles, or have the financial resources that allow them to hire persons with such expertise as advisers. They also have sufficient financial resources to provide access to fund managers and to sustain possible losses.

The SEBI also considers the issue of whether AIF fund managers should have “skin in the game” through requirements to invest their own money in the funds that they manage. According to the Concept Paper, the manager or sponsor or designated partner would have to maintain an interest of not less than 5% of the fund, which should be contributed by them and not through the waiver of management fees.

The issue of “skin in the game” for AIF fund managers is one that elicits mixed views. On the one hand, some, in a manner similar to the Concept Paper, contend that fund managers should have a minimum interest in the fund as a means of reconciling the interests of external investors with those of fund managers. On the other hand, some see such interests as creating conflicts of interest between fund managers and AIFs’ investors.

We support the ability of fund managers to invest in the funds they oversee and we believe such co-investment should be encouraged but not be made mandatory. However, the proposal may favour larger players at the cost of smaller boutique players and investment professionals. If a fund manager is leveraged then his financial position may endanger a client’s interest in times of market stress.

We believe fund managers should disclose their investment in the fund to their clients in all cases. We also believe that funds that permit managers’ investments also need strong internal controls like those described in the Asset Manager Code of Professional Conduct. These types of controls are needed to help funds managers and trustees manage any potential conflicts of interest that may arise under such arrangements.

Re: Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments
31 August 2011
Page 5

With regard to investment strategy, we support the SEBI's call for transparency from registered AIFs in their information memoranda. We also agree that information about registered AIFs' investment strategies, investment purposes and business models are all important factors that investors need to consider prior to investing.

However, we do not agree with the proposal to require consent of at least 75% of unit holders to alter a fund's strategy. While we support advanced notice of any change in investment strategy, particularly in the case of funds sold to unsophisticated investors to enable them to determine whether the changes meet their risk and return parameters, we have no such position with regard to sophisticated investors. In part, this is because sophisticated investors tend to have the resources needed to ensure fund managers hear what they have to say. With this in mind, such matters should be up to the investors to decide, rather than be a part of regulation.

Regarding performance fees; we recognize that performance fees are an accepted practice in markets throughout the world. The same practice should continue in the Indian context with a properly defined high water-mark and proper disclosure to prospective investors. Also, part of the performance fees can be locked in for the duration of the fund.

On the point of fund tenure, we feel that instead of a fixed tenure for all types of funds, it would be better to keep fund tenure flexible depending on nature of investments and client profile. A lock-in period at 3 years is restrictive from an investor's perspective and may not be suitable to all kinds of investors. We feel that fund tenure can be decided by the managers and their clients. Fund tenure should always be disclosed to potential investors.

Chapter IV: Investment Conditions in Respect of Different Category of Funds

Concerning the Investment Conditions for Venture Capital Funds, we feel the proposed limit of Rs. 250 crores seems limiting in nature as compared to the size of opportunities available. Hence we suggest that the SEBI does not limit VCF fund size.

Chapter V: General Obligations and Responsibilities and Transparency

We agree that AIFs should provide information to help the SEBI monitor and manage systemic risk. According to Concept Paper; AIFs shall provide information that helps the SEBI identify, analyse, and mitigate systemic risks for these purposes

We also believe that a risk-based approach to regulation of AIFs is an appropriate means for regulators to monitor the risks associated with these fund managers, and one that would benefit from additional due diligence by brokers, lenders, and other counterparties in the interaction with

Re: Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments
31 August 2011
Page 6

AIF and AIF managers. This, we believe, is likely to prevent the failure of one or more AIFs from creating systemic market failure.

According to the Concept Paper; an AIF shall disclose through a placement memorandum to a prospective investor all material information about itself, its business, its disciplinary history, the terms and conditions on which it offers investment services, its affiliations with other intermediaries and such other information as is necessary for an investor to make an informed decision on whether to avail its services. The Concept Paper also requires AIFs 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.

We believe that investors and regulators should require AIF disclosures that detail key information on the funds managed. Transparency enables investors to properly evaluate their holdings in the fund, and enables supervisors to monitor for the build-up of risks.

Investors and regulators need transparency from the AIF sector. Information about an AIF's strategies with regard to investing, leverage, and investment vehicles will help investors understand the risks inherent in specific funds. We advocate that the greatest level of transparency possible concerning strategies, leverage, and investment vehicles is provided to investors and regulators.

Finally, we believe that complete and accurate reporting to investors is a necessary cost of seeking capital from others. AIFs, like other entities seeking capital from investors, have an obligation to provide financial and operating information and to periodically make their records available for regulatory review.

However, there should be no obligation of AIF transparency to the general market. Public disclosures on AIFs would enable other market participants to trade on that information. This can lead to market movements that run counter to the strategy of the fund in question. This hurts the fund's investors who suffer diminished returns.

Other recommendations

We request that the SEBI coordinate the creation of final rules with the tax authorities and get clarifications on tax treatment of various alternative investments vehicles and instruments to avoid ambiguity.



Re: Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments
31 August 2011
Page 7

Concluding Comments

CFA Institute and the IAIP are pleased to submit our views on the SEBI's *Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments*. If you or your staff have questions or seek clarification of our views, please feel free to contact either Naveet Munot, CFA at +91 22 22153194 or navneet.munot@sbimf.com, or Matthew Orsagh, CFA, CIPM at +1.212.756.7108 or matt.orsagh@cfainstitute.org.

Sincerely,

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