

Regulating the market for Units of Alternative Investment Funds

Govt should declare the units as 'securities' for Sebi to regulate these



ANALYSIS

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Earlier this week, the Securities and Exchange Board of India (Sebi) approved the Sebi (Alternative Investment Funds) Regulations, 2012.

The move has extended the perimeter of regulation to assume jurisdiction over: (a) pooled funds beyond venture capital funds, mutual funds (MFs) and collective investment schemes (CISs), and (b) market (listing and trading) for units issued by such pooled funds, hitherto unregulated.

Alternative funds issue units to pool capital privately and invest in fledgling companies for the benefit of investors in the units.

Admittedly, high net worth individuals (HNIs) and institutions, who invest in units of AIFs, do not need the same level of protection as retail investors do as regards the issue of units. They, however, need the same level of protection against fraud and manipulation as regards the market for the units.

Can Sebi assume jurisdiction over such a market, lay down an appropriate regulatory framework and thereby, provide that protection? Under the law, Sebi's jurisdiction is limited to the market for 'securities'; it has responsibility to protect the interests of investors in securities, and to promote the development of, and to regulate, the securities market. Clearly, Sebi can have jurisdiction only if

such units are 'securities'.

The Securities Contracts (Regulation) Act (SCRA) provides an inclusive definition of 'securities', which include shares, debentures, derivatives, units of CISs, units of MFs, security receipts, securitised instruments, government securities, such other instruments as may be declared by the central government to be securities, and rights or interest in securities. The units of AIFs are neither included in the definition of 'securities' nor declared by the central government to be securities.

It is commonly believed that an instrument traded on a stock exchange is 'securities'. Hence, the units of AIF would be 'securities' if these are traded on exchanges. This is wrong. The listing and trading of units of AIFs on exchanges alone would not make them 'securities'.

Some believe if Sebi has jurisdiction over AIFs, it can

regulate the market for their units also. Again, jurisdiction over issuers does not subsume jurisdiction over markets for the instruments issued by them. A company is regulated under the Companies Act, while the market for shares issued by a company is regulated under the SCRA.

The Sebi Act, as originally enacted in 1992, empowered Sebi to register and regulate MFs. This was not enough for the market regulator to issue orders in respect of dealings in units of MFs.

Such orders were being challenged on the ground that units of MFs were not 'securities' and hence Sebi had no powers, authority or jurisdiction in the matter. This led to an amendment in 2004 in the definition of 'securities' in the SCRA to explicitly include the units of MFs within its ambit. Under the circumstances, it

will be difficult for Sebi to lay down a regulatory framework for regulating market for units of AIFs and provide full protection to investors.

The immediate solution is the central government declares units of AIFs to be 'securities'. Such declaration would not be difficult as these units resemble other instruments listed under the definition of 'securities'.

A medium-term solution is to amend the definition of 'securities' under the SCRA to include 'units of AIFs' within its ambit.

However, the ideal solution is to define 'securities' in such a manner the definition does not have to be amended for every new product that emerges in the scene. Otherwise, the new product remains out of the regulatory purview until it is included within the ambit of 'securities' by an amendment

which is time consuming.

It needs to be defined in generic terms like the definition of 'theft' in the Indian Penal Code. Any activity that satisfies the certain specified ingredients is construed as theft. Similarly, an instrument satisfying specified ingredients should be considered 'securities'. This would avoid regulatory gaps and frequent amendments in law.

Presently, the law governing listing of securities does not provide for listing and delisting of units of AIFs as these are not 'securities'. Since these matters are dealt through subordinate legislations, the authorities could quickly develop a standard framework for listing and delisting of securities which would apply with appropriate modifications to different kinds of securities, including units of AIFs.

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