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## **Legal implications of operating an investment fund in India by unincorporated syndicates and incorporated entities: Yes, there are serious legal implications for not registering as an alternate investment fund including imprisonment**

A privately pooled investment vehicle which collects funds from investors (Indian or foreign) for investing these funds in India is categorized as an Alternate Investment Fund (hereinafter referred to as “**AIF**”) under the Securities Exchange Board of India (Alternative Investment Funds) Regulations 2012, (hereinafter referred to as “**AIF Regulations**”). Broadly speaking, the AIF Regulations govern venture capital funds, impact funds, private equity funds, SME funds, hedge funds etc. The AIF Regulations do not extend to investment vehicles that are governed by any other regulatory framework such as *Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999, or any other regulations of the Board to regulate fund management activities*). *The AIF Regulations do not extend to family trusts, ESOP trusts, employee welfare or gratuity trusts, and holding companies.*

*Please note that it is unequivocally clear from a literal reading of the AIF Regulations that unincorporated syndicates which are in essence carrying out the activities envisaged under the AIF Regulations are required to register themselves with the Security Exchange Board of India (“**SEBI**”) and comply with the said regulations. **So basically, if you are operating an investment fund and are not regulated by any other regulation in India you are regulated by the AIF Regulation.***

***Non-compliance with such a requirement could have serious legal implications for the investment managers operating such syndicates without obtaining the requisite registration under the AIF Regulations.** SEBI has also taken note of instances of non-compliance with the AIF Regulations by investment vehicles and in one such case involving HBJ Capital Services Private Limited (which is discussed below) it has also taken serious action against the defaulting investing entity and its directors. In its order against HBJ Capital, SEBI has amongst other things directed the company/directors to refund the investments along with any promised returns within a period of 3 months. **Similar actions could also be taken against a defaulting unincorporated entity such as a syndicate and the people operating it. Legal implications and measures against non-compliance with the AIF Regulations could include monetary penalty, restrictions, and restraint from participation in the securities market and imprisonment.***

*Penalty for person contravening, attempting contravention or abetting contravention of AIF Regulations - b imprisonment up to 10 years and penalty up to 25 crores USD \$ 3,367,253 approx.) and penalty upto three times amount of gains made out of such contravention.*

In this article, we have broadly provided the procedure for registration of an AIF and the implications of non-registration of an AIF.

### **Objective of the AIF Regulations**

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AIF Regulations were enacted to provide a regulatory framework for various kinds of privately pooled investment funds so that such funds are channelized in the desired space in a regulated manner without posing systemic risk.

The AIF Regulations also prescribe a separate code of conduct for an AIF and all participants of an AIF namely, AIF managers, their key management personnel, AIF trustees, directors of the AIF trustee, and the members of the investment committee.

Under the AIF Regulations the term AIF has been defined as follows:

“Section2(1)(b)

**Alternative Investment Fund** means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which,-

(i) is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and

(ii) is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities:

*Provided that the following shall not be considered as Alternative Investment Fund for the purpose of these regulations,-*

*(i) family trusts set up for the benefit of 'relatives' as defined under 1[Companies Act, 2013];*

*(ii) ESOP Trusts set up under the Securities and Exchange Board of India (Share Based Employee Benefits) Regulations, 2014 or as permitted under Companies Act, 2013;*

*(iii) employee welfare trusts or gratuity trusts set up for the benefit of employees;*

*(iv) 'holding companies' as defined under sub-section 46 of section 2 of Companies Act, 2013;*

*(v) other special purpose vehicles not established by fund managers, including securitization trusts, regulated under a specific regulatory framework;*

*(vi) funds managed by securitisation company or reconstruction company which is registered with the Reserve Bank of India under Section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; and*

*(vii) any such pool of funds which is directly regulated by any other regulator in India.”*

### **Registration of an AIF<sup>11</sup>**

The AIF Regulations prohibit a person or an entity (***unincorporated or incorporated***) from acting as an AIF unless it has obtained a certificate of registration from SEBI in accordance with the AIF Regulations.

The AIF Regulations provide for the eligibility criteria for grant of certificate of registration and the conditions that such a certificate will be subject to.

The AIF Regulations bucket AIFs into the following three specific categories under which it can be registered:

**Category I AIF:** Such funds invest in start-ups or early-stage ventures or 'social ventures' or small and medium enterprises (hereinafter, referred to as "SME(s)") or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and shall include (following subcategories) 'venture capital funds', 'SME funds', 'social venture funds', 'infrastructure funds' and such other AIFs as may be specified.

Explanation. — AIFs which are generally perceived to have 'positive spill over effects' on economy and for which the SEBI or Government of India or other regulators in India might consider providing incentives or concessions shall be included.

**Category II AIF:** Such funds which do not fall in Category I and III and which do not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in these AIF Regulations.

Explanation— AIF such as a private equity fund or debt fund for which no specific incentives or concessions are given by the government, or any other regulator shall be included.

**Category III AIF:** Funds which employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.

Explanation— AIFs such as hedge funds or funds which trade with a view to make short term returns or such other funds which are open ended and for which no specific incentives or concessions are given by the government, or any other regulator shall be included.

In view of the abovementioned, an AIF is required to make an application for registration under the AIF Regulations under any one of the above-mentioned categories along with all the necessary documents and prescribed fees.

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Source: Freepik[/caption]

### **Implications of Non-Registration of an AIF under SEBI**

It is pertinent to note that an AIF (unincorporated/ incorporated) that has not obtained the requisite registration under the AIF Regulations would be considered to have acted in contravention of the AIF Regulations. This could result in serious legal implications for such an entity and the people involved such as the managers/ promoters etc. The legal implications for such a contravention could include monetary penalty, imprisonment, restrictions and restraint on participation in the securities market. An AIF that contravenes the provisions of the SEBI Act, 1992 (“**SEBI Act**”) or the AIF Regulations is dealt with in accordance with the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 and the SEBI Act.<sup>[2]</sup>

## **a) Issuance of Direction by SEBI**

**Regulation 34 of the AIF Regulations and Regulation 35 of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 provide for the directions which can be issued by the SEBI Board in cases of default and states as follows:**

“34.

*The Board may after consideration of the inspection report and after giving reasonable opportunity of hearing to the Alternative Investment Fund or its trustees, directors or manager issue such direction as it deems fit in the interest of securities market or the investors including directions in the nature of:—*

*(a) requiring an Alternative Investment Fund not to launch new schemes or raise money from investors for a particular period;*

*(b) prohibiting the person concerned from disposing of any of the properties of the fund or scheme acquired in violation of these regulations;*

*(c) requiring the person connected to dispose of the assets of the fund or scheme in a manner as may be specified in the directions;*

*(d) requiring the person concerned to refund any money or the assets to the concerned investors along with the requisite interest or otherwise, collected under the scheme;*

*(e) prohibiting the person concerned from operating in the capital market or from accessing the capital market for a specified period.”*

“Directions.

35.

*Without prejudice to any order under the securities laws and the directions, guidelines and circulars as may be issued thereunder including an order under Chapter V of these regulations the Board may in the interest of the securities market, in the interest of the investors or for the purpose of securing the proper management of any intermediary, issue, necessary direction including but not limited to any or all of the following -*

*(a) directing the intermediary or other persons associated with securities market to refund any money or securities collected from the investor under any scheme or otherwise, with or without interest;*

*(b) directing the intermediary or other persons associated with securities market not to access the capital market or not to deal in securities for a particular period or not to associate with any intermediary or with any capital market related activity;*

*(c) directing the recognised stock exchange concerned not to permit trading in the securities or units issued by a mutual fund or collective investment scheme;*

(d) directing the recognised stock exchange concerned to suspend trading in the securities or units issued by a mutual fund or collective investment scheme;

(e) any other direction which the Board may deem fit and proper in the circumstances of the case....”

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Source: Freepik[/caption]

## **b) Penalty under the SEBI Act**

Section 15EA and Section 24 of the SEBI Act provides for the penalty that will be imposed if a person contravenes with the provision of the SEBI Act or the regulations made thereunder, and states as follows:

*“Penalty for default in case of alternative investment funds, infrastructure investment trusts and real estate investment trusts.*

*15EA.*

*Where any person fails to comply with the regulations made by the Board in respect of alternative investment funds, infrastructure investment trusts and real estate investment trusts or fails to comply with the directions issued by the Board, **such person shall be liable to penalty which shall not be less than one lakh rupees but which may extend to one lakh rupees for each day during which such failure continues subject to a maximum of one***

***crore rupees or three times the amount of gains made out of such failure, whichever is higher.”***

*“Offences.*

24.

*(1) Without prejudice to any award of penalty by the adjudicating officer or the Board under this Act, if any person contravenes or attempts to contravene or abets the contravention of the provisions of this Act or of any rules or regulations made thereunder, he shall be punishable with imprisonment for a term which may extend to ten years, or with fine, which may extend to twenty-five crore rupees or with both.*

*(2) If any person fails to pay the penalty imposed by the adjudicating officer or the Board or fails to comply with any directions or orders, he shall be punishable with imprisonment for a term which shall not be less than one month but which may extend to ten years, or with fine, which may extend to twenty-five crore rupees or with both.”*

In view of the above-mentioned provisions, it is clear that any person found to be acting in contravention of the AIF Regulations shall be liable for a penalty of one lakh rupees for each day during which the contravention continues subject to a maximum of one crore rupees (one hundred thirty-four thousand six hundred ninety dollars) or three times the amount of gains made out of such failure whichever is higher.

*Further, without prejudice to any other award of penalty by the adjudicating officer (including the penalty mentioned hereinabove), if any person contravenes or attempts to contravene or abets the contravention of the provisions of the AIF Regulations, he/ she shall be punishable with imprisonment for a term which may extend to ten years, or with fine, which may extend to twenty-five crore rupees (three million three hundred sixty-seven thousand two hundred fifty-three dollars) or with both.*

*Penalty for person contravening, attempting contravention or abetting contravention of AIF Regulations - be years and penalty up to 25 crores USD \$ 3,367,253 approx.) and penalty upto three times the amount of gain contravention.*

**Judicial Decision on non-registration of an AIF**

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Source: Freepik[/caption]

SEBI has been entrusted with the duty to protect the interests of investors and protect the integrity of the securities market. Further, SEBI may, where it deems necessary, take effective and expeditious action to prevent any possible harm to investors caused by the unauthorized and fraudulent activities of the intermediaries.

In a recent case, HBJ Capital Services Private Limited (hereinafter referred to as “HBJ Capital”) was offering trading tips and investment advice to general public through its website under various schemes. Further, HBJ Capital was running a limited liability partnership in the name of HBJ Capital Ventures LLP (hereinafter referred to as “HBJ Capital LLP”) which was an equity investment vehicle promoted by HBJ Capital which collected funds from various persons (partners) and administered and managed the funds for the purpose of creating profits.

SEBI received information from its local office and complaints alleging that HBJ Capital failed to provide the returns they promised and failed to refund the money invested by the complainants. On perusal of the details available from the website of HBJ Capital and the documents provided by HBJ Capital, it was observed that HBJ Capital was pooling funds in the name HBJ Capital LLP.

In view of this, one of the issues which was dealt with by SEBI in its order was whether HBJ Capital and its directors through its group entity, viz. HBJ Capital LLP is pooling funds from HNIs with the objective of generating profits from investments made in the securities market, without obtaining registration from SEBI, in violation of the AIF Regulations.

SEBI on considering the facts and circumstances of the matter was of the view that it was evident that the activities carried out by HBJ Capital LLP and its partners fall within the definition of AIF provided under the AIF Regulations. Further, HBJ Capital LLP and its partners continued to act as AIF without obtaining the necessary registration for the same which is mandated under the SEBI Act read with AIF Regulations.

SEBI in its order was of the following view:

*“Similarly, SEBI (Alternative Investment Advisers) Regulations, 2012 inter alia provide the framework for regulating the activity of entities who are acting as "Alternative Investment Funds". These Regulations seek to create a standardized operating structure within which these entities will operate and also make them duly accountable for their investment advices and investment activities by requiring them to comply with the criteria, set out in the relevant provisions of the aforesaid Regulations. **In view of this, subjecting such intermediaries to the statutory requirement of registration with SEBI is imperative for the protection of interests of investors and to safeguard the integrity of securities market.**”*

SEBI in its ad interim ex-parte order (which was to be treated as a show-cause notice to the company and its directors to show as to why the appropriate directions under the SEBI Act and relevant regulations should not be issued) dated 15<sup>th</sup> June 2015 had directed HBJ Capital, and HBJ Capital LLP, and their designated partners to:

*“i. cease and desist from acting as an Investment Adviser and Alternative Investment Fund and cease to solicit or undertake such activities or any other unregistered activities in the securities market directly or indirectly, any manner whatsoever;*

*ii. immediately withdraw and remove all advertisements, representations, Literatures, brochures, materials publications, documents, websites, etc. in relation to those schemes/activities (investment adviser and Alternative Investment Fund) or any unregistered activity in the securities market,*

*iii. not to divert any funds raised from investors, kept in bank account(s) and/or in the custody of HBJ Capital or its directors and HBJ Capital LLP and its designated partners;*

*iv. furnish all the information sought by SEBI.....*

*v.furnish copies of LLP agreements.....”*

SEBI while exercising its powers under the SEBI Act passed an **order dated 7 January 2020** against HBJ Capital for indulging in unregistered investment advisory activities and alternative investment fund activities. SEBI issued the following directions:

**(i) HBJ Capital to refund the money collected by it from its clients/investors in the form of fees along with promised return if any within a period of three months from the date of service of the order. If HBJ Capital fails to repay the money, then the directors shall jointly and severally refund the money collected as fee with two months of the order.**

**(ii) HBJ Capital LLP to refund the money collected by them from the investors/partners along with promised return if any, within a period of three months from the date of service of the order.**

If HBJ Capital LLP fails to repay the money, then the designated partners shall jointly and severally refund the money collected.

(iii) The directors and designated directors are obligated not to alienate or dispose of or sell any of their assets except for the purpose of making refunds to HBJ Capital's clients and HBJ Capital LLP investors.

(iv) HBJ Capital, HBJ Capital LLP, directors, and designated directors were restrained from, directly or indirectly, accessing the securities market and prohibited from buying, selling, or otherwise dealing in the securities market till the money is refunded/repaid and they have been restrained for a further period of 2 years from the date of completion of refund of the money to its investors.

(v) HBJ Capital, HBJ Capital LLP, directors and designated directors were restrained from holding positions as directors or key managerial personnel of any listed company or any intermediary registered with SEBI, and they were restrained from associating themselves with any listed public company and any public company which intends to raise money from the public, or any intermediary registered with SEBI, for a period equal to the period of their debarment from the date of the order.

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Source: Freepik[/caption]

## Conclusion

SEBI'S order in HBJ Capital is a welcome decision. It establishes the seriousness and efficacy of the investor protection measures in India and helps build faith in the rule of law. It also sets precedence against *unregistered* investment advisory activities and alternative investment fund activities. In view of this decision, it is clarified that the AIF Regulations extend to unincorporated and incorporated entities. If any person is found to be acting in contravention of the AIF Regulations, then as per Section 15EA of the SEBI Act that person shall be liable for a penalty of one lakh rupees for each day during which the contravention continues subject to a maximum of one crore rupees (one hundred thirty-four thousand six hundred ninety dollars) or three times the amount of gains made out of such failure whichever is higher. Further, *without prejudice to any other award of a penalty by the adjudicating officer (including the penalty mentioned hereinabove), if any person contravenes or attempts to contravene or abets the contravention of the provisions of the AIF Regulations, he/ she shall be punishable with imprisonment for a term which may extend to ten years, or with fine, which may extend to twenty-five crore rupees (three million three hundred sixty-seven thousand two hundred fifty-three dollars) or with both.*

In our opinion, it is through such an enforcement action that the investment climate and investor confidence in India will improve and increase, ultimately resulting in the overall growth of our economy.

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[\[1\]](#) Regulation 35 of AIF Regulations

[\[2\]](#) Regulation 3 of AIF Regulations