



**Amendments to AIF
Regulations**

**Amendments to the AIF Regulations-
A new way ahead?**



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BACKGROUND:

The Securities and Exchange Board of India (SEBI) in its board meeting dated 25 March 2021 proposed certain amendments to the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations). In order to implement the proposed amendments, SEBI notified the SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 (Amendment Regulations) on 5 May 2021. These amendments are far reaching with respect to the governance of alternative investment funds (AIFs) as an investment vehicle in India.

This ERGO summarises the key amendments introduced under the Amendment Regulations and its implications for AIFs.

A. CHANGES TO INVESTMENT CONDITIONS

➤ **INVESTMENTS IN OTHER AIFs:** The Amendment Regulations now explicitly permit all AIFs to make investments in other AIFs, subject to the following conditions:

- (a) **Eligible Investors:** AIFs, which are authorised to invest in other AIFs, cannot have investors that are AIFs as well, i.e., there cannot be more than two layer AIF structure that invests in the ultimate investee entity;
- (b) **Calculation of Investment Limits:** The maximum limit of investible funds that can be invested in a single entity by an AIF (25% in the case of Categories I and II, and 10% in the case of Category III), shall now include both its direct holdings as well as its indirect holdings, including through an investment in another AIF, in such entity.
- (c) **Approval Requirements:** Investment in another AIF, which is managed / sponsored by the same manager / sponsor or their respective associates, shall require an approval from 75% of the investors of the AIF, by value (*akin*

to how investments in associates by AIFs require such approval);

Comment: This amendment permits an AIF to invest in both investee entities and AIFs, as opposed to exclusively in either, which has been a long-standing ask of the AIF industry and which will ensure that the spirit of the diversification restrictions under the AIF Regulations is retained.

➤ **EXPANDING THE SCOPE OF 'VENTURE CAPITAL UNDERTAKING':** A venture capital undertaking is of significance as all venture capital funds that are Category I AIFs are required to invest at least two-thirds of their investible funds in this category of entities. The term has now been defined to mean any company which is not listed on a stock exchange at the time of making the investment. This rejig of the definition removes the requirement of an entity to be engaged in the business of providing services, production or manufacture of article or things in order to qualify as a venture capital undertaking, and potentially permits most Category I AIFs to invest in NBFCs. Additionally, it has also been clarified that angel funds may now invest in 'startups' alone and not venture capital undertakings.

Comment: This amendment has now opened up opportunities for Category I AIFs to also invest in NBFCs and VCs in the fintech space. With the fintech space booming with innovation and new tech focussed financing options and alternatives emerging on account of this boom, the proposed change is a step forward and would certainly prove to be a very helpful amendment for development of the fintech industry.

B. INVESTMENT COMMITTEE: SUB-SET OF THE MANAGER

While the AIF Regulations did not initially, and till 2020, formally recognise investment committees (ICs), the AIF industry in India has been familiar with the concept for a long time

now. Considering the growing significance and role of ICs in the functioning of AIFs over the years, SEBI eventually formally documented the setting up of ICs and drew the perimeter of their functioning *vide* the SEBI (Alternative Investment Funds) (Amendment) Regulations, 2020 (Amendment Regulations 2020) notified on 19 October 2020. The Amendment Regulations have now provided greater details on the concept.

At the outset, the Amendment Regulations has mandated that the placement memorandums of AIFs duly lay down the terms of reference of the committee constituted for approving the decisions of AIF, typically referred to as 'Investment Committee'.

Further, the Amendment Regulations appears to have widened the ambit of 'Investment Committee' to include committees that have the power to approve **decisions of the AIF**, as opposed to the Amendment Regulations 2020, which referred to committees taking **investment decisions of the AIF**. Another notable departure in the provision pertaining to IC under the Amendment Regulations, from the Amendment Regulations 2020, is the omission of the responsibility of the IC to be on the same footing as the Investment Manager for the investment decisions of the AIF. The Amendment Regulations instead attaches the liability of the IC to the decisions taken by the IC and has built in corresponding accountability of the IC for ensuring that its decisions are in compliance with the AIF Regulations, the placement memorandum, agreements with the investors and other fund documents and applicable laws.

In sync with the Amendment Regulations 2020, the Amendment Regulations continue to require all AIFs with external members, whose names are not disclosed in the placement memorandum or otherwise to the investors, to procure the consent of at least 75% of the investors by value in the AIF / scheme for effecting such appointment of the external member. While ensuring transparency, this may be viewed as a compliance burden by the managers.

Comment

In what may be a noteworthy move, the Amendment Regulations has omitted the

reference to 'investment' decisions while describing an IC and has settled on a wider language to include 'decisions of the AIF'. While it cannot be ruled out that on a strict interpretation of the Amendment Regulations, omission of 'investment' and usage of an unqualified phrase, i.e., '*decisions of the AIF*' may cover within its realm bodies taking decisions other than investment decisions (such as other boards or committees constituted for the AIF), it is more likely that the omission may be an indication of the regulator to ensure accountability of the IC for decisions other than the investment decisions taken by it.

The liability of the IC has also been detached from investment decisions, as was the case under the Amendment Regulations 2020 which casts a joint and several liability on the members of the IC to ensure that the investments of the AIF are in compliance with the provisions of the AIF Regulations, the terms of the placement memorandum, agreement with the investors, any other fund documents and applicable laws. In a more structured approach, the IC members, under the Amendment Regulations, are responsible of ensuring that the decisions that such IC takes (as opposed to investment decisions) are in compliance with the policies and procedures laid down AIF Regulations, the placement memorandum, agreements with the investors and other fund documents and applicable laws. The exemption to IC of AIFs where each investor (other than the Manager, Sponsor, employees or directors of the AIF or employees or directors of the Manager) has committed at INR 70 crores from being liable for the decisions of the IC continues to be applicable.

Further, the code of conduct prescribed for the members of the IC reaffirms the intention of the regulator to cast a fiduciary duty on such members. Requirements under the prescribed code of conduct such as ensuring independent professional judgement in carrying out their roles may prove to be a further deterrent for investors seeking a seat on the IC or other similar bodies taking decisions for an AIF. It may be worth it to seek clarification from SEBI as to whether the intention of bringing all bodies taking decisions for an AIF is to cast the members of such bodies in the same mould as the manager or trustee of an AIF.



C. CODE OF CONDUCT: AFTER MUTUAL FUNDS, IT IS THE AIF'S TURN

The Amendment Regulations have prescribed separate codes of conduct (AIF Code of Conduct) and have covered all participants of an AIF in a sweep stake depending on the role of the participant. The AIF Code of Conduct has been bifurcated into three categories and lays down directives that ought to be followed by (a) the AIF; (b) the manager and key management personnel (KMP) of the manager and of the AIF; and (c) the members of the IC, trustee/directors/designated partners of the AIF. It must be recalled that in October 2020, SEBI had notified the code of conduct for asset management companies and trustees and for fund managers and dealers of mutual funds (MF Code of Conduct). The AIF Code of Conduct has been largely imported from the MF Code of Conduct.

The overall responsibility to ensure compliance with the AIF Code of Conduct has been cast on the manager along with either the trustee or trustee company or board of directors or designated partners of the AIF (as the case may be). AIFs are now required to maintain written policies to address conflicts of interest, comply with anti-money laundering laws and have an effective risk management process with internal controls. Further, in a bid to promote fairness and equality to all investors, AIFs are required to be managed in interest of all investors to achieve the investment objectives as laid down in the private placement memorandum (PPM) and other fund documents and ensure dissemination of accurate, adequate, explicit and timely information to all investors as required under the AIF Regulations or as agreed with the investors.

Comment

1. Certain key directives provided under the AIF Code of Conduct that investment managers of the AIF need to keep in mind are discussed below.
 - *The AIF shall be operated and managed in the interest of all investors and not only in the interest of the sponsor, manager, directors or partners of the sponsor and manager or a select class of investors.*

AIFs have investor advisory committees known as LPACs with representation from select investors. The role of these LPACs ranges from providing approvals on conflicts of interest, extension of fund closings and investment periods, appointment of key service providers to general advisory oversight of activities of the AIF during a suspension period, depending on the negotiations which are hard coded in the PPM as well as other fund documents. LPACs are comprised of select investors and will not have representation by all investors. Hence, while negotiating with investors, managers should carefully construct the roles and responsibilities of LPACs to avoid breach of this code of conduct principle.

- *The manager and KMP shall act in a fiduciary capacity towards investors of the Alternative Investment Fund and ensure that decisions are taken in the interest of the investors.*

While Regulation 21(1) of the AIF Regulations had already enshrined fiduciary role on the manager, the text of Regulation 21(1) permitted a view limiting the same to conflict of interest. This principle explicitly now provides for a fiduciary duty under general principles of jurisprudence to include a duty of care and loyalty towards investors.

- *The manager and KMP shall not make any misleading or inaccurate statement, whether oral or written, either about their qualifications or capability to render investment management services or their achievements.*

This obligates the managers to ensure that the business write-ups about the outlook of Indian economy and target sectors, the track record and background information about the manager and its team is factually accurate and backed by verified sources.

- *The manager and KMP shall record in writing, the investment, divestment and other key decisions, together with appropriate justification for such decisions.*

While Regulation 27(1)(e) of the AIF Regulations requires the manager to maintain records on rationale for



investments made, this principle makes it explicitly clear that managers shall not take any investment/exit or other key decisions of the AIF without maintaining a proper trail of documents and processes followed which can be audited in the annual audit on compliance with PPM.

- *The manager and KMP shall not enter into arrangements for sale or purchase of securities, where there is no effective change in beneficial interest or where the transfer of beneficial interest is only between parties who are acting in concert or collusion, other than for bona fide and legally valid reasons.*

We believe this principle has been laid down to prevent misuse of AIF as a colourable device to make investments which are otherwise not permissible, such as rogue promoters routing funds in their company which they could not invest otherwise or setting up an AIF to enable investments by investors resident in countries prohibited under Press Note 3 and FDI policy.

- *The manager and KMP shall not offer or accept any inducement in connection with the affairs of or business of managing the funds of investors.*

This principle is very broad in application and may result in unintended consequences and SEBI may consider further clarifying the same. Often, the manager is part of a wider conglomerate wherein certain value-added services are provided to an AIF. For instance, group companies of the manager may act as a banker to sell the AIF's stake in an investee company and may earn fees in consideration for such services. Such group companies may share the same KMP as the manager which can likely result in breach of the AIF Code of Conduct as the KMPs accept compensation to act as

banker which is directly connected to the affairs of the AIF. In our view, such transactions should be considered legitimate as long as they are disclosed and in the interest of investors. However, the explicit absence of a caveat on the lines 'which is likely to conflict with duties owed to unitholders', as provided in the MF Code of Conduct, may cast a shadow on such business practices.

- *The manager and KMP shall document all relevant correspondence and understanding during a deal with counterparties as per the records of the Alternative Investment Fund, if they have committed to the transactions on behalf of Alternative Investment Fund.*

We welcome this move as it promotes transparency in the dealings of the manager and KMP. Further, it should not evoke any privacy claims, unlike the MF Code of Conduct, which stipulates that all conversations of fund managers and dealers during the market hours are to be recorded.

2. *Absence of Sponsor from the scope of the Code of Conduct:* It may be argued that the deliberate omission of sponsor from the AIF Code of Conduct could mean the lowering of compliance and regulatory responsibility of the sponsor towards the operations and management of AIF and acknowledgement of its role as limited to that of maintaining the mandatory continuing commitment in the AIF.
3. *Enforcement:* Unlike the Mutual Fund Regulations, while the amendments do not prescribe that the AIF Code of Conduct should be '*adhered to in letter and spirit*', in our view, the expectation from SEBI would be for an adherence to the AIF Code of Conduct in letter and spirit by the Investment Manager and the KMP.

- Funds Team

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