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SIGNIFICANT AMENDMENTS TO THE SEBI AIF REGULATIONS: GLOBALISING THE ALTERNATIVE ASSET SPACE

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The Securities and Exchange Board of India (**SEBI**) rolled out the fourth amendment this year to the SEBI (**Alternative Investment Funds**) Regulations, 2012 (**AIF Regulations**) dated 15 November 2022 (**Fourth Amendment**) to bring the alternative investment funds (AIF) regulatory space closer to global standards. Two days after, SEBI prescribed guidelines in relation to operational aspects of AIFs referred to in the Fourth Amendment *vide* SEBI circular SEBI/HO/AFD-1/PoD/P/CIR/2022/155 dated 17 November 2022 (**2022 Circular**).

The Fourth Amendment and the 2022 Circular were a culmination of the proposals approved during the Board Meeting of SEBI held on 30 September 2022. A detailed analysis of the Fourth Amendment, the 2022 Circular and its implications for AIFs is set out hereunder.

1. **Ring-fencing of assets and liabilities of Schemes of an AIF**

Owing to the flexibilities offered, AIFs are mostly set up as private trusts under the Indian Trusts Act, 1882 (**Trusts Act**) with a common investment manager for all schemes (**Scheme**). A Scheme is merely a contractual creation and is not distinct from the trust for the purposes of Trusts Act. Each Scheme operates basis the strategy enumerated under its private placement memorandum (**PPM**) and Scheme-wise agreements with the investors. In line with such segregation between Schemes, SEBI had clarified *vide* SEBI Circular dated 01 October 2015 (**2015 Circular**) that the investment manager shall ensure Scheme-wise segregation of bank accounts and securities accounts.

Investor-friendly jurisdictions such as Singapore, Hong Kong, Mauritius, Cayman Islands, Luxembourg and the United Kingdom, require an investment manager (or its jurisdictional equivalent) of a fund to ensure that *all assets and liabilities* of sub-funds of umbrella funds are segregated and have introduced classes of investment vehicles like variable capital companies, protected cell companies or segregated portfolio companies for this purpose. While ring-fencing and segregation of assets and liabilities of sub-funds is part of the code of conduct for asset managers / trustees of mutual funds in India and fund managers in International Financial Services Centres, such ring-fencing and segregation was not codified under the AIF Regulations for onshore AIFs.

With the objective of granting comfort to the investors, the Fourth Amendment introduces Regulation 20(15) to the AIF Regulations, requiring the investment manager and trustee (or its structural equivalent) of an AIF to ensure that assets and liabilities of each Scheme of an AIF are ring-fenced and segregated from other Schemes of the AIF. It also subsumes language from the 2015 Circular on segregation and ring-fencing of bank accounts and securities accounts of each Scheme of the AIF.

Comment: This amendment grants relief to foreign investors in particular since lack of regulatory clarity on segregation meant that the assets of Schemes that they invested in were unprotected from potential litigation

against or liquidation of other Schemes of the AIF. This amendment therefore demands a closer look at the drafting of fund documents given the onus on the investment managers and trustees.

Separate bank accounts and demat accounts addresses the issue to an extent. However, from an operational standpoint, each Scheme also procures a separate PAN to give the Scheme protection from an income tax perspective. Given that SEBI grants a one-time registration to the AIF as an umbrella trust, SEBI may consider a separate identification for each of the Schemes since the PPMs for each subsequent Scheme are placed separately with SEBI. This would help in strengthening the segregation of assets of liabilities from a regulatory standpoint.

2. **First Close**

- (a) **First close by existing Schemes:** Existing Schemes of AIFs, who have not declared their first close, shall declare their first close within 12 months from the date of the 2022 Circular. Existing Schemes of AIFs, whose PPMs were taken on record prior to 12 months from the date of the 2022 Circular and have not declared their first close, shall submit an updated PPM with SEBI in the standardised format through a SEBI registered merchant banker along with a due diligence certificate from the merchant banker and such updated PPM shall be circulated to investors before declaration of first close.
- (b) **First close for registrations after the date of the 2022 Circular:** The first close of a Scheme shall be declared within 12 months from the date on which communication is sent to SEBI for taking the PPM of the Scheme on record. In case of open-ended Schemes of Category III AIFs, the first close shall be declared within 12 months from the close of their 'initial offer period'.
- (c) **Large Value Funds:** The first close of Schemes of large value funds for accredited investors shall be declared within 12 months from the date of grant of registration of the AIF or date of filing of PPM of Scheme with SEBI, whichever is later. Existing Schemes shall declare their first close within 12 months from the date of the 2022 Circular.
- (d) **Failure to declare first close:** In case the first close of a Scheme is not declared within the timeline prescribed above, the AIF shall file a fresh application for launch of the said Scheme as per applicable provisions of AIF Regulations by paying an amount equivalent to the registration fee for the respective category/sub-category of the AIF to SEBI.

Comment: SEBI's intent can be discerned to be the identification and establishment of a concrete timeline for declaring the first close. This guideline curbs the discretion that investment managers enjoyed towards declaring the first close at an opportune moment of their choosing. However, from a global standard perspective, regulating 'closings' is not something that the regulators pay heed to and leave it to the commercial discretion of the investment manager since closings would typically be linked to, *inter alia*, market dynamics and strategy of the investment manager.

3. **Corpus**

- (a) **Corpus:** Corpus of the Scheme at the time of declaring its first close shall not be less than the minimum corpus prescribed in the AIF Regulations for the AIF, i.e., INR 5 crores for social impact funds and angel funds registered as Category I AIFs, INR 100 crores for special situation funds and INR 20 crores for all other categories / sub-categories of AIFs.
- (b) **Sponsor / investment manager commitment:** The commitment provided by the sponsor or investment manager at the time of declaration of first close, towards the AIF meeting the minimum corpus requirement, shall not be reduced or withdrawn or transferred, post the first close.

- (c) *Investor commitment*: An investor shall be given the option of withdrawing or reducing their capital commitment to the Scheme prior to declaration of the first close.

Comment: The AIF Regulations prescribe a minimum corpus that an AIF is required to have, and SEBI has now mandated that the corpus of the AIF shall not be lesser than the minimum corpus prescribed in the AIF Regulations at the time of the AIF declaring the first close, which the industry already followed as an unlegislated rule. Further, in a move geared towards curbing investment managers / sponsors from making a commitment to the AIF solely towards the AIF meeting the minimum corpus requirements, and thereafter reducing it to suit themselves, the commitment provided by the sponsor or investment manager at the time of declaration of first close, cannot be reduced or withdrawn or transferred, post the first close.

4. **Tenure of AIFs**

The 2022 Circular provides that:

- (a) The tenure of close ended Schemes of AIFs shall be calculated from the date of declaration of the first close.
- (b) An AIF may modify the tenure of a Scheme at any time before declaration of its first close.
- (c) Existing Schemes which have declared their first close, may continue to calculate their tenure from the date of final close. Such existing Schemes of AIFs, which are yet to declare final close, shall declare their final close as per the timeline provided in the PPM of the Scheme with their investment manager having no discretion to extend the said timeline provided in the PPM.

Comment: SEBI's intent is for the AIF to establish and identify a hard coded tenure. Given that the first close will be within a fixed period now and the tenure of the AIF is to be linked to the first close, the tenure of the AIF becomes abundantly clear to the potential investors.

Defining the tenure of a Scheme from the final close gave added flexibility to the investment manager to make drawdowns and investment decisions. However, investors lacked clarity in respect of timelines of their investments given that the final close was not a verifiable point in time at the time of launch of the Scheme. With SEBI now requiring the tenure of a Scheme to be calculated from the first close, it would offer investors a fixed time frame within which their investment may fructify and avoid unwarranted revisions to the tenure of the Scheme.

Furthermore, the tenure of the Scheme can be modified only up until the first close, further restricting the discretion of the investment managers in tweaking the tenure of the Scheme. This may be a ripple effect of the recent SEBI order no. WTM/SM/AFD-1/AFD-1-SEC/20965/2022-23 dated 31 October 2022 in the matter of Urban Infrastructure Venture Capital Fund wherein the investment manager and its directors were penalised for extending the life of a venture capital fund beyond the available statutory extensions (although with investor consent).

5. **Change in control / Change of investment manager or sponsor**

Pursuant to the Fourth Amendment, the AIF Regulations now require the investment manager / sponsor of an AIF to seek prior approval from SEBI in case of change in the investment manager / sponsor of the AIF for a fee, in place of the earlier requirement of only notifying SEBI of such change.

The 2022 Circular provides for the following modalities in this regard and fees for a change in control of the investment manager / sponsor:

- (a) A fee equivalent to the registration fee applicable to the respective category / sub-category of the AIF, shall be levied in case of change in control of investment manager / sponsor and in case of change in

investment manager / sponsor. The cost paid towards such fee by investment manager / sponsor shall not be passed on to the investors of the AIF in any manner.

- (b) A fee equivalent to the registration fee applicable to the respective category / sub-category of the AIF, shall be levied in case of change in control of investment manager / sponsor and in case of change in investment manager / sponsor. The cost paid towards such fee by investment manager / sponsor shall not be passed on to the investors of the AIF in any manner.
- (c) In case a change in control of investment manager / change of investment manager and change in control of sponsor / change of sponsor of an AIF is proposed simultaneously, the aforesaid fee equivalent to single registration fee shall be levied.
- (d) No fee shall be levied in case the investment manager is acquiring control in or replacing the sponsor and exit of a sponsor in case of an AIF having multiple sponsors.
- (e) The fee shall be paid within 15 days of effecting the proposed change in investment manager / sponsor or change in control of investment manager / sponsor.
- (f) In case of the applications pending with SEBI as on the date of the 2022 Circular, for change in control of investment manager / sponsor or change in investment manager / sponsor, the requirement of fee shall be applicable only in those applications where none of the Schemes of AIFs managed / sponsored by investment manager / sponsor have declared their first close.
- (g) The prior approval granted by SEBI in this regard shall be valid for a period of 6 months from the date of SEBI communication for the approval.

Comment: A change in the sponsor / investment manager now requiring approval, rather than an intimation to SEBI goes to show the rationalisation of SEBI's approach to such change. SEBI shall now treat an application for a change in the investment manager / sponsor as a new application for the AIF, for all practical purposes, given that SEBI shall conduct a thorough KYC and background check on the incoming investment manager / sponsor. It also remains to be seen if investors will be offered an exit in case of a change in investment manager / sponsor, which is required pursuant to a change in control of the sponsor / investment manager.

The levy of fees for a change / change in control of the investment manager / sponsor may result in significant monetary impact on such investment manager / sponsor given that the registration fee for Category I, II and III AIFs is INR 5 lakhs, INR 10 lakhs and INR 15 lakhs respectively. The requirement to pay a hefty fee may impact the investment managers where the investment managers were unable to perform, and investors were looking for a change in the investment manager.

Further, given the nature and complexity of corporate reconstructions, the validity of 6 months may fall short in order to execute a large-scale private equity / M&A transaction. A timeline for processing of such approvals, similar to timelines introduced by the International Financial Services Centre Authority for granting approvals would go a long way in strengthening industry confidence in the regulator.

- Sahil Shah (Counsel), Chirayu Heddthale (Senior Associate) and Vaidehi Balvally (Associate)

For any queries please contact: editors@khaitanco.com

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