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PROTECTING INVESTOR INTERESTS: SEBI MOVES TO GOVERN EXCUSAL/EXCLUSION PROVISIONS AND DISTRIBUTOR EXPENSES

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The Securities and Exchange Board of India (SEBI) has been bringing in a plethora of changes to the existing landscape of the alternative asset industry. The SEBI circular no. SEBI/HO/IMD/DF6/CIR/P/2020/24 dated 5 February 2020, which introduced the template(s) for Private Placement Memorandum (PPM) for alternative investment funds (AIFs) marked the beginning of this slew of changes.

In line with SEBI's initiative to streamline disclosure standards in the growing AIF space, SEBI has released circular no. SEBI/HO/AFD-1/PoD/P/CIR/2023/053 dated 10 April 2023 on guidelines with respect to excusing or excluding an investor from an investment of AIF (Circular on Excuse); and circular no. SEBI/HO/AFD/PoD/CIR/2023/054 also dated 10 April 2023 on direct plan for schemes of AIFs and trail model for distribution commission in AIFs (Circular on Distribution Fees).

Circular on Excuse

Legal considerations for Excuse / Exclude provisions

The template PPM has a section on "*Excuse and Exclusion*" which if the AIF proposed to have, then the manager was required to disclose reasons for excuse / exclusion and the consequences of such excuse and exclusion of investors. The template PPM offered flexibility to the manager to have its own terms for excusing / excluding investors in the AIF.

SEBI in its Circular on Excuse has noted that owing to inconsistency and lack of adequate disclosure from the fund managers with respect to certain industry practices, it has now prescribed a list of reasons / circumstances under which only can an investor be excused / excluded from participating in a particular investment. Below is our analysis on such circumstances prescribed by SEBI:

1. Excuse rights of the investors:

There are two instances under which an investor can request to get excused from participating in a particular investment opportunity. The first being, where participation by the investor in an investment opportunity leads to any violation of an applicable law or regulation, then such an investor may be excused. However, such a request from the investor is required to be substantiated with an opinion from a legal professional / legal advisor, confirming the above.

We note that this would lead to an increase in burden on the investors, from a cost perspective. The cost for the legal opinion would have to be borne by the excused investor.

However, the expense issue can be mitigated by procuring an opinion from inhouse legal team which, as a market practice, is considered sufficient.

An investor can also be excused if its participation in the investment would lead to contravention of its internal policy(ies) of the investor, disclosed as a part of the contribution agreement or any other agreement signed with the AIF. Further, any change in such internal policy is required to be disclosed by the investor to the AIF, within 15 (fifteen) days of such change.

2. Exclusion of investors:

The investment manager may also preclude an investor from participating in a particular investment opportunity, if participation of such investor in such investment opportunity would lead to the fund being in violation of applicable law or regulation, or would result in material adverse effect on the fund. The investment manager has the discretion to exclude an investor from participating in such investment opportunity and shall record the rationale for such exclusion, along with the documents relied upon, if any.

It is pertinent to note that preclusion of an investor from participating in a particular investment opportunity, if requested by an investor, shall be accompanied by a legal opinion. However, the same is left to the discretion of the investment manager, without any requirement of a legal opinion in instances of exclusion by the investment manager.

SEBI has also rightfully covered the fund of funds, wherein an AIF (as an investor to another fund) may also be partially excused or excluded from participation in an investment opportunity, to the extent of the contribution of the said fund/investment vehicle's underlying investors who are to be excused or excluded from such investment opportunity. The investment manager of AIF shall record the rationale for such excuse or exclusion along with the supporting documents, if any.

We note that the Circular on Excuse is in line with SEBI's informal communication with several fund managers who were being asked to incorporate the above-mentioned provisions in the PPMs. The current guidelines would also bring in transparency as clear excuse provisions would restrict an investor from cherry-picking deals under the guise of exercising excuse rights. This would also help in retaining the 'blind-pool' structures of these AIFs.

Furthermore, now an investment manager cannot grant to the investors under the side letter, any excuse right other than what has been prescribed under the Circular on Excuse. This will help in setting the boundaries for LP – GP negotiation on excuse rights which is much required considering the larger impact on the Fund, in the event an excuse right gets triggered.

Circular on Distribution Fees

In a move that can be construed as a crackdown to curb mis-selling and ensuring enhanced transparency pertaining to disclosure of expenses chargeable to investors, the Circular on Distribution Fees mandates as under:

Direct Plan for schemes of AIFs

AIFs are required to offer a "Direct Plan" to investors who invest in the AIF without the aid of an intermediary or a distributor. Offering of a Direct Plan would entail that no distribution fee or placement fee shall be payable by investors who subscribe to units of the AIF under such plan.

With regards to investors who approach an AIF with the aid of a SEBI registered intermediary, the Circular on Distribution Fees mandates that on account of the SEBI registered intermediary charging a fee to the investor, such investors shall be onboarded by the AIF under the Direct Plan and shall not be charged a distribution fee or placement fee.

The template PPM identified a provision pertaining to a Direct Plan for investors, and constituents of fees that may be charged by the AIF/ scheme of AIF, including distribution fee/ placement fee.

Building on the provision under the template PPM, the primary intent of the Circular on Distribution Fees is to shield investors from incurring excessive and inapplicable expenses in the form of distribution fee or placement fee and duality of expenses incurred by an investor whilst approaching AIFs through SEBI registered intermediaries. This construct is similar to the one introduced under SEBI (Investment Advisers) (Amendment) Regulations, 2020 which introduced client level segregation of advisory and distribution activities for registered Investment Advisors (IA) and respective payment of fees for such activities.

Trail model for distribution commissions in AIFs

AIFs are required to disclose any distribution fee / placement fee applicable to the investors of the AIF at the time of on-boarding the investor.

With regards to Category III AIFs, the Circular on Distribution Fees prohibits this category of AIFs from charging any upfront distribution fee / placement fee, directly or indirectly. Category III AIFs will only be allowed to charge distribution fee / placement fee to investors on an equal trail basis, i.e. divide it equally during the terms of the AIF. Furthermore, any distribution fee / placement fee paid shall be only from the management fee received by the managers of such Category III AIFs. While close-ended Category III AIFs can charge distribution fee / placement fee on an equal trail basis, it remains to be seen how open-ended Category III AIFs will charge, given that there is no fixed tenure for such AIFs. Further, it may be prudent for Category III AIFs to have a separate sub-class of Units for "Direct Plan" owing to the fact that these investors will not be bearing any distribution fee / placement fee and accordingly, will have higher allocation towards investments.

Category I and Category II AIFs are permitted to pay up to one-third of the total distribution fee / placement fee to the distributors on an upfront basis, and the remaining fee shall be paid thereafter to the distributors on an equal trail basis over the tenure of the scheme of the AIF.

The Circular on Distribution Fees quite evidently seeks to protect investors from falling prey to distributors and intermediaries selling products to investors solely motivated by the commissions. It also paves the way for distributors and intermediaries to have the investor's long-term interests in mind owing to the equal trail levy. This can also be construed as a move to bring parity across investments in the portfolio management services, mutual fund and alternative investment funds industry.

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