

Investment Funds: Monthly Digest

March 30, 2023

SEBI APPROVES FIVE PROPOSALS ON AIF REFORMS

The Securities and Exchange Board of India ("SEBI") in its board meeting held on March 29, 2023 has approved the changes proposed in the five consultation papers released by it earlier this year with respect to alternative investment funds ("AIFs") in India.

The industry had made several recommendations to SEBI on the ambiguities in the proposals which could lead to undue compliance burdens. However, as per the [press release](#) of the board meeting ("Press Release") it seems that SEBI has approved most of its original proposals with minor modifications. Perhaps the circulars or amendments which will give effect to these proposals will provide more clarity and comfort.

In this edition of the monthly digest, we have reviewed the proposed changes against the Press Release and provided our inputs (including from our interactions with various stakeholders in the industry). The contents of this digest may change substantially depending on the language of the formal amendments which are introduced to give effect to SEBI's approvals in the Press Release, and to that extent our thoughts here are qualified.

The changes which have been approved as per the Press Release are as follows:

1. Compulsory Dematerialization of the Units of the AIF;
2. Carry forward of unliquidated investments after the closure of a scheme;
3. Eligibility Criteria for Key Investment Team;
4. Requirement for investor consent for buying/selling investments from/to associates of AIFs; and
5. Principles of valuation proposed

Dematerialisation of Units

Existing AIFs with a corpus of more than INR 500 Crore and any new AIFs are required to dematerialise their units ("AIF Units") by October 31, 2023. Other AIFs with corpus less than (or equal to) INR 500 crores are required to dematerialise their units by April 30, 2024.

AIF Units represent the beneficial interests of such investors in the AIF. The Finance Act, 2021 brought AIF Units under the definition of 'securities' under the Securities Contracts (Regulation) Act, 1956.¹ We had covered the implications of the same [here](#).

SEBI had, in its consultation paper for this proposal, observed that despite the depositories having laid down procedures for dematerialisation of units pursuant to the above, most AIF Units are not dematerialised. The arguments favouring dematerialisation include ease of monitoring of AIF investments by investors as well as managers and reduced risk of damage and forgery.

It is unlikely for AIF Units of Category I and Category II AIFs to be freely redeemable or transferable because these AIFs make long-term and illiquid investments. The transfer of AIF Units by investors would typically be subject to prior consent of the AIF manager. The AIF manager is also required to conduct KYC on the incoming investor. SEBI does not intend to compromise the position of AIF managers in such cases due to dematerialisation. Therefore, SEBI has clarified in its proposal that the terms of transfer of AIF Units even after the dematerialisation will continue to be governed by the placement memorandum and subscription documents of the investors.

While this is an additional administrative step for investors to hold AIF Units, the potential efficiencies may far exceed the administrative burden. Foreign investors have time and again faced difficulties in opening demat accounts in India.² The industry's request to SEBI has been to make the process for opening a demat account digitised, automated and with minimum involvement of intermediaries.

The industry had also recommended that instead of making dematerialisation of AIF Units mandatory for all AIFs, it should be made mandatory for those AIFs which propose to list their units (particularly relevant for angel funds, as they are not permitted to list).

The above proposals do not seem to have featured in the approved changes.

Continuation Funds

AIF managers have been permitted to carry forward unliquidated investments of one scheme of an AIF to a new scheme of the same AIF or distribute such investments in-specie (in the prescribed manner) and in each case, upon obtaining consent of 75% of the AIF investors by value. In case the requisite investors consent is not obtained, the

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unliquidated investments shall be mandatorily distributed in-specie to the investors. In case an investor is unwilling to take in-specie distribution, such investment must be written off by the AIF.

Category I and Category II AIFs are required to be close-ended with a definitive tenure which needs to be at least 3 years. The tenure is extendable up to 2 years subject to approval of two-thirds of the AIF unit holders by value of their investment with an exception for large value funds for accredited investors which are permitted to extend beyond 2 years.

Upon the end of the tenure (including extended tenure), AIFs are required to liquidate themselves within 1 year. As mentioned above, such AIFs make long-term investments which are illiquid. Early AIFs of vintage 2014-2016 started facing issues during COVID when their tenure was ending but there was no visibility to liquidate the portfolio within 1 year. AIFs are currently permitted to make in-specie distribution after obtaining consent of 75% of AIF investors by value. However, during COVID years, AIF investors were not agreeable to in-specie distributions of the unliquidated portfolio of such AIFs and the managers did not want to write off investments without giving it some more time for recovery after COVID.

The Press Release is silent on the price discovery mechanism and transfer details which were stipulated in the consultation paper. It is not clear at present whether SEBI has modified some of these items while approving this proposal. Our thoughts on these steps are provided below.

Step I – Consent: Obtaining consent of at least 75% of AIF investors by value to transfer unliquidated investments to a new AIF.

The proposal suggested that the manager is required to liquidate the investments at liquidation value within a year of expiry of the term if no investor approval is obtained.

The original problem of reaching a dead-end with respect to the unliquidated portfolio would continue if the AIF investors are not forthcoming. However, it seems from the Press Release that SEBI now expects such investments to be written off. The recommendation of the industry was to allow further extension going beyond 2 years for the tenure. It may be easier for investors to comprehend, assess and consent to an extension of the tenure rather than reviewing a new structure and the related transfers. Further, transfer from one scheme to another would lead to a taxable event, resulting in a host of tax consequences.

Certain AIFs near closing of their investments, may only require additional period of 1-2 years to find suitable exits. At the least such AIFs should have been allowed to extend the tenure further by 2-3 years instead of having to launch a new scheme. The request was for SEBI to consider an interim solution which is time, cost and tax efficient for all parties involved.

Step II - Price discovery: Inviting bids for a minimum of 25% of unliquidated investments.

The method for arriving at such '25% of unliquidated investments' (i.e. whether by number, or if by value then using what methodology) was unclear. Further, there was ambiguity around how the bids for a minimum of 25% of the unliquidated portfolio will be applied to the remaining unliquidated portfolio.

It was proposed that valuation reports of two independent valuers be provided to investors while disclosing the proposal to them. The industry had commented that the price discovered through bids may not be comparable with valuation done by independent valuers. Therefore, this requirement should be done away with.

In case the bid is received from related parties of the AIF/manager/sponsor or from other existing investors, the same was proposed to be transparently disclosed to all investors. Such bids are only to be used to provide pro-rata exit to other remaining investors. The industry had requested clarity on this proposal. While the disclosure requirement is clear and generally acceptable, what remains ambiguous is that the investors who make a bid (which is purely for price discovery) were proposed to be precluded from the exit procedure. SEBI should segregate the bid process from the exit process.

If fresh bids for a minimum of 25% of the unliquidated investments cannot be arranged, the closing valuation was proposed to be based on the liquidation value as determined under IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 or other applicable IBC norms.

None of these aspects have been touched upon in the Press Release, and the details will need to be examined once the formal amendments are released.

Step III - Transfer to new AIF and exit to original AIF investors

The unliquidated investments were proposed to be transferred to the new AIF (or scheme) at closing value (as per Step II above). The transfer consideration would also be utilized by the original AIF towards pro-rata exit of those investors who do not wish to continue.

In terms of process, clarity was sought on whether the price so discovered will form the basis for raising of fresh capital for the new scheme. There was also lack of clarity around how the existing investors (who do not wish to exit) would continue or roll-over to the new scheme. A unit swap would procedurally be most optimum, but if foreign investors are involved, then a swap would lead to issues under foreign exchange laws. The industry's request was to allow the existing AIF to continue rather than mandating transfer to a new AIF. A transfer could lead to tax consequences for both the AIFs' investors, and may lead to double taxation for continuing investors. It would also be easier to structure the cash-flows and exit through the existing AIF.

Additionally, as per the consultation paper, such new AIFs / schemes were to be exempt from the following – (i) minimum corpus requirement; (ii) minimum investment requirement from each investor; (iii) requirement of fixed tenure; and (iv) diversification norms, in each case, if such AIFs undertake to not make any new investments. These have not been mentioned in the Press Release.

In addition to the above-mentioned exemptions, the request was for SEBI to exempt such continued or new AIFs from the minimum sponsor commitment requirement because the original AIF's sponsor will be required to continue. The requirement to have a minimum tenure of 3 years should also be done away with.

Eligibility Criteria for Key Investment Team

The Press Release indicates that SEBI has approved to replace the eligibility criteria for the key investment team with a requirement to obtain a 'comprehensive certification'. The same requirement is to apply to the compliance officer.

In its consultation paper on this topic, SEBI had observed that new fund managers are not able to satisfy the experience criteria which requires minimum 5 years of relevant experience. This proposal was intended to allow a channel for being considered eligible even without past experience.

An unintended outcome of this change would be that seasoned managers who have been managing AIFs and similar products for a while may need to sit for an examination in order to be considered eligible as AIF managers. Even for new managers, it would be not be time or cost efficient to clear an examination in order to qualify under the AIF Regulations. Submissions were made to SEBI to clarify that this requirement would be in stark deviation from global best practices. Most jurisdictions provide general guidance for 'appropriate experience' of GPs without any specific requirements and investors in AIF-type products are considered self-informed.

SEBI should provide an option for certification as an alternative to minimum experience (if it is not being satisfied) rather than completely replacing it. It is also unclear whether this certification requirement would replace the professional qualification criteria as well.

Investor consent for investment in associates

SEBI has mandated that an AIF shall not buy or sell investments, except with the approval of 75% of investors by value of their investment in the AIF, from or to (i) associates;³ (ii) other AIFs managed or sponsored by the same manager, sponsor or their associates; or (iii) an investor who has committed to the extent of more than 50% of the corpus of the scheme of AIF. In the consultation paper, SEBI had only included (i) and (ii), but not (iii) above.

AIFs are currently not permitted to invest in its associates, or any units of AIFs managed or sponsored by the manager, sponsor or associates of its manager or sponsor, unless 75% of investors by value provide their affirmative consent for the same. However, no guidelines or restrictions were provided for buying or selling of securities from/to associates and other AIFs managed/sponsored by the same manager/ sponsor or the associates of such manager / sponsor.

From a conflict disclosure and mitigation perspective, AIF managers were already making these disclosures in the placement memorandum and going to their investor advisory committees for conflict clearance. The requirement of obtaining 'affirmative consent' may be too burdensome. If the placement memorandum provides an appropriate disclosure, then investors' consent should be deemed as having been provided. For example, warehoused investments would typically be bought from an associate and should not require any investor consent. The manager acquires such investments even prior to the first closing in the interests of investors.

One of the recommendations was for SEBI to allow a deemed consent mechanism, wherein if the consent of the investors is not received within a certain time period (say 30 days), it would be deemed that the investor has consented to such transfer.

New Valuation Principles Proposed

SEBI had proposed a standardized approach to valuation of investment portfolio of AIFs by mandating a uniform valuation methodology to insulate investors against asymmetry issues. The proposal was to adopt the International Private Equity and Venture Capital Valuation Guidelines ("**IPEV Guidelines**") for portfolio valuation and ensure compliance with the valuation norms specified under other SEBI regulations – particularly, those under Eighth Schedule of SEBI (Mutual Funds) Regulations, 1996⁴ ("**MF Regulations**") and circulars therein.⁵ Further, Category III AIFs were proposed to undertake the valuation of their investments into unlisted securities (if any) by an independent valuer, for the calculation of NAV. The Press Release also states that investment in listed debt securities by Category III AIFs will be subject to independent valuation.

In the Press Release, SEBI has not provided any details with respect to the proposals approved by it on valuation principles. There is a general reference to 'framework for AIFs to carry out valuation of their investment portfolio' being approved.

In the consultation paper it was also proposed that AIF managers now be required to ensure that the portfolio companies are bound by the investment agreement / subscription agreement to provide its audited accounts to the AIF within a specific timeline. Further, AIF managers were proposed to ensure that the valuation based on audited data of the portfolio company is reported to the performance benchmarking agencies after the audit of books of account.

The proposal also stipulated that AIF managers would be held responsible for the true and fair valuation of the investments of the AIF. AIF managers would need to inform investors of deviations of more than 20% between two consecutive valuations or a deviation of more than 33% in a financial year. In furtherance of the same, managers would also be required to provide reasons for such changes to the investors.

SEBI had proposed the following criteria for independent valuers:

1. registration with the Insolvency and Bankruptcy Board of India;⁶
2. membership of a professional institute established by an Act of Parliament enacted for the purpose of regulation of a profession, viz Institute of Chartered Accountants of India, Institute of Company Secretaries of India, Institute of Cost Accountants of India, etc. or a CFA charter from the CFA institute;
3. at least three years of experience in valuation of unlisted securities; and
4. not an associate of manager / sponsor / trustee of the AIF.

The language of the Press Release suggests that the above criteria has been approved by SEBI.

It has been more than a decade since the regulations governing the AIFs industry were enforced in India, however, SEBI had not prescribed any valuation methodologies or qualifying criteria for valuers undertaking the investment portfolio valuation of AIFs. AIF Regulations⁷ mandate only rudimentary disclosures and timelines for valuation.

Unlike other AIFs, Angel Funds invest on a deal by deal basis in start-ups with no current/stable earnings and cashflows. Particularly, tech sector start-ups may have their funding rounds far apart for various stages of product development and product launch. Further, each investor may not participate in all deals sourced by Angel fund. Accordingly, various possible scenarios with respect to the financial performance of such portfolio companies becomes difficult to project given the number of portfolio companies and nature of the portfolio companies. Considering that the AIF Regulations provide a separate regulatory framework for Angel funds and given the difference in the manner in which an Angel fund operates, a separate valuation mechanism for Angel fund should be provided. A milestone approach such as Price of Recent Investment method should be allowed to be adopted as a valuation technique for angel funds.

It is practicable to rely on one set of guidelines i.e. either IPEV Guidelines or Mutual fund guidelines for valuation by AIFs rather than both. Alternatively, it should be clarified that mutual fund guidelines will apply to AIFs only in cases wherein IPEV Guidelines are silent.

In summary

SEBI by releasing its consultation paper in advance made an attempt to adopt a collaborative approach in rolling out the changes in the AIF Framework and many industry bodies, GPs, and other stakeholders have provided constructive comments and recommendation on the proposed changes. The Press Release only provides an overview of the approved changes and the detailed guidelines are yet to be released. On a peripheral view it seems that SEBI has accepted majority of its proposals with minor changes, and it is yet to be seen if industry feedback has been taken into consideration in terms of clearing ambiguities.

One of the consultation papers on direct plan for investors which covered the issue around double whammy on fees paid by investors coming into the AIF through intermediaries such as investment advisers or portfolio managers does not seem to be approved in the Press Release.

The changes are a step in the right direction as they seek to bolster investor protection, increase investor convenience, ease of compliance and introduce better transparency. The industry did not push back on any of the proposals in entirety, but only provided constructive recommendations from a practical perspective to align the regulatory expectations with the realities of managing an AIF and its investors. Upon reading of the summary of approvals in the Press Release, it seems that some of key the substantive recommendations of the industry did not make their way to SEBI.

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You can direct your queries or comments to the authors

¹Section 149 of the Finance Act, 2021 available at <https://egazette.nic.in/WriteReadData/2021/226208.pdf>

²Foreign investors face demat hurdle in closing FDI deals, Economic Time available at <https://economictimes.indiatimes.com/markets/stocks/news/foreign-investors-face-demat-hurdle-in-closing-fdi-deals/articleshow/76502807.cms>

³Associate as defined in the AIF Regulations means company or a limited liability partnership or a body corporate in which a director or trustee or partner or Sponsor or Manager of the AIF or a director or partner of the Manager or Sponsor holds, either individually or collectively, more than fifteen percent of its paid-up equity share capital or partnership interest, as the case may be.

⁴Available at: https://www.sebi.gov.in/legal/regulations/nov-2022/securities-and-exchange-board-of-india-mutual-funds-regulations-1996-last-amended-on-november-16-2022-_65274.html

⁵SEBI circular on valuation of money market and debt securities, available https://www.sebi.gov.in/legal/circulars/sep-2019/valuation-of-money-market-and-debt-securities_44383.html

⁶The qualifications required for being a valuer registered with IBBI have been provided under rule 3 and rule 4 of the Companies (Registered Valuers and Valuation) Rules, 2017.

⁷Available at: https://www.sebi.gov.in/legal/regulations/jan-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-january-9-2023-_67273.html

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