Investment Funds: Monthly Digest

May 31, 2023

DIFFERENTIAL ECONOMIC RIGHTS OF AIF LPS UNDER THREAT

The Securities and Exchange Board of India ("**SEBI**") has put forward several proposals for stricter regulation of alternative investment funds ("**AIFs**") in India. AIFs, which were proposed as lightly regulated, are privately pooled investment vehicles registered under the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**").

SEBI has recently issued four consultation papers that propose restrictions on various aspects of AIFs, such as priority distribution waterfalls, pari passu rights for LPs, and limitations on borrowings by AIFs. The consultation papers also discuss new governance norms, including the appointment of custodians for all AIFs and the requirement to issue all securities of portfolio entities in dematerialized form. SEBI has invited public comments and feedback on these consultation papers.

The Consultation Papers are as follows:

1. Proposal with respect to pro-rata and pari passu rights of LPs of AIFs ("**Consultation Paper I**")
2. Consultation Paper on strengthening governance mechanisms of AIFs ("**Consultation Paper II**")
3. Consultation Paper on the status of AIF as a Qualified Institutional Buyer ("**Consultation Paper III**")
4. Consultation Paper on strengthening of investor grievance mechanism ("**Consultation Paper IV**")

In this edition of our monthly digest, we have analysed the proposed changes and provided our inputs/

Consultation Paper I - Pro-rata distributions and pari-passu rights of the LPs

Pro-rata distribution to LPs

In Consultation Paper I, SEBI argues that maintaining pro-rata distribution for LPs has always been expected of AIFs even though it may not have been expressly stated.

SEBI has observed that certain AIFs adopt a distribution waterfall wherein one or more class(es) of LPs (referred to as "**Junior Class**"), share(s) loss disproportionately higher as compared to other class(es) of LPs (referred to "**Senior Class**"). This is usually done by compensating the Senior Class for the loss out of residual capital of the Junior Class (in a loss scenario), and by distributing to the Senior Class first until their hurdle rate is met and then distributing the remaining amounts to the Junior Class (in a profit scenario) ("**Priority Distribution Model**" or "**PD model**").

As per SEBI, Priority Distribution Model pose the following risks:

- Evergreening of loans – Regulated lenders are taking advantage of the regulatory arbitrage available due to lack of an express prohibition on disproportionate sharing of losses by LPs. The relevant AIFs are structured in a manner that a regulated lender subscribes to the Junior Class units thereby taking a haircut or loss on its returns from the AIF. The expected loss on the loan portfolio at the time of structuring (haircut) appears to be used to determine the size of investment by the regulated lender in the AIF, as a Junior class LP. The LPs of the Senior class invest to the extent of perceived fair market value of the assets acquired by AIF from the regulated lender. The AIF invests in NCDs of the borrower companies with the understanding that funds so received by them shall be used to repay the loans extended to them by the regulated lender. This way the regulated lender is able to replace the loan portfolio in its books with the amount repaid by the borrower company and remaining as investments in the units of the AIF.
- Conflict of interest – As PD Models are intended to cater to the risk appetite of different set of LPs investing in the same portfolio entities, such models can create conflict of interest issues.
- Potential for mis-selling – SEBI also noted that during the financial crisis of 2008 there was rampant mis-selling of collateralised debt obligations (CDOs) as different tranches of CDOs based on the risk appetite of an LP were subscribed to. However, as the LPs failed to accurately asses the potential risk, when the value of CDOs plummeted, LPs alleged mis-selling.

In the light of such concerns, SEBI via its Circular dated November 23, 2022 applied an interim injunction on AIFs which have adopted PD model from making fresh investments or accepting any fresh capital, until SEBI adopts a view on the matter.

SEBI then appointed a working group to suggest whether PD models of distribution can affect pro-rata distribution rights of LPs. The working group recommended that PD model should not be entirely prohibited and should only be applicable in cases where the evidence of misuse is actually found. The working group also recommended

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measures to mitigate potential conflict and / or mis-selling.

However, SEBI held a contradictory view and has provided arguments against the recommendations of the working group.

PD Model – Key Considerations

Key Parameter	SEBI' View / Concern	Our Analysis
Diverse LP Base When there is a group of LPs who are less willing to take risks but are willing to accept lower returns, and another group of LPs who are willing to take on higher risks in exchange for the potential for higher returns, it creates a diversified LP base. This diversification allows the manager to gather a larger pool of capital.	SEBI argues that instead of having different LPs with varying risk appetites investing through the same scheme of the AIF, managers can launch different schemes to cater to the needs of each LP class while investing in the same investment portfolio	We note that SEBI in its analysis has disregarded the administrative costs and challenges involved in launching a new fee structure that would then be passed on to the LPs. Moreover, if LPs with lower risk appetites can only commit limited funds, it may be difficult for the scheme to maintain a minimum corpus of INR 20 crores. Additionally, SEBI fails to acknowledge that splitting the corpus may downgrade the AIF's position in the market. Having a consolidated and larger corpus enables AIFs to easily secure bids for investments and grants them various rights in the portfolio entity by investing a larger corpus and acquiring a larger stake in the securities of the portfolio company.
Repurposing / Evergreening of Loans	We note that SEBI's concerns related to PD models are centred around such models being used as a mode to repurpose existing loans of entities i.e. regulated lenders being able to change the nature of bad debts in its books as investments.	We believe in an attempt to address a very specific concern, SEBI should not curtail the commercial ability to have disproportionate distribution models which suit the economic interests of the LPs. The AIF industry in India is limited to sophisticated LPs who are well aware of the financial risks of investing in the units of the AIF. Further, certain measures such as the ones applied after the 2008 financial crisis may be adopted by stakeholders in India such as the Volcker Rule, which forbids banks from owning any hedge funds or private equity funds. Hence, rules related to banks or other regulated lenders investing in associate AIFs or AIFs wherein regulated lenders can be a related party should not be allowed.
Inadequate Checks & Balances	SEBI is of the view that concerns related to valuation become multi-fold with respect to units of AIFs with PD model and underlying stressed assets, even after taking safeguards mechanism into consideration.	Certain guiding principles/ valuation methodology may be laid down to ensure adherence to an internationally accepted basis of valuation of assets at the time of the transfer, which would help to mitigate any potential for arbitrage at the time of the contribution. It is suggested that the valuation be supported by a valuation report of an independent registered valuer reflecting the value arrived at based on the above methodology. Therefore, a complete prohibition on PDs may not be appropriate since it would take away the flexibility of all the Category I & II AIFs, on account

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		of certain instances of misuse.
Concessional Capital Concessional capital refers to financing provided on less favourable terms compared to regular financing, and it can include grants, debt at below-market rates, and equity with different returns.	SEBI has not particularly made any exception for blended finance transactions comprising of commercial capital and concessional capital.	Concessional capital aims to support impactful projects that address significant global development challenges. In such cases, the corpus of the AIF usually includes capital invested by private LPs at market rates, as well as by public and philanthropic LPs. Typically, in such blended finance transactions, the LPs providing concessional capital are usually in a subordinate position, i.e. terms offered less favorable than commercial capital. If prohibited from using PD models, the purpose of providing concessional capital, which is to provide developmental capital without a profit motive, would be undermined.

Pari Passu Rights

In the Consultation Paper I, emphasising on the principles of fair and equitable treatment, SEBI has proposed that all LPs of the AIF/scheme shall be treated equally with respect to their economic rights in the Fund i.e., no differential economic rights shall be provided to any LP (excluding economic rights with respect to hurdle rate of return, performance linked fee/additional return and management fees).

The scope of economic rights is not defined other than the clarity around exclusions as mentioned above. It could be considered that differential terms in respect of (i) drawdown timeline; (ii) compensatory contribution; (iii) co-investment rights etc. are economic rights.

The drawdown timeline for different LPs typically depends on the internal policies and administrative compliances required for remitting funds. If the due-date of the drawdown or the date for beginning of the IRR of each LP (other than defaulters) is kept the same, then the difference in timeline for an LP should not be prejudicial to the economic interest of other LPs. In an AIF where many LPs are retail LPs / individual LPs, the manager may prefer taking the funds upfront, instead of going through a longer route of issuing drawdown notices.

Additionally, differential co-investment rights should not have any impact on the economic rights of other LPs. The proposal to ensure that the rights of the LPs are pari passu is only with respect to the rights in the AIF, co-investments rights are with respect to a separate investment in its own capacity by the LP instead of investment via the AIF.

Consultation Paper II - Proposed mechanism to strengthen the governance of AIFs

The proposals are specifically aimed at:

1. Permitting borrowing to meet shortfall in drawdown while making investment in a portfolio company;
2. Dematerialization of the AIF’s assets (i.e. shares of investee companies);
3. Appointment of custodian for AIFs with corpus less than INR 500 crores;
4. Limitation of the maximum tenure extension available to Large Value Funds (“**LVF**”);
5. Renewal of registration of AIFs.

Borrowing by Category I and II AIFs

Under the AIF Regulations, Category I and II AIFs are permitted to undertake leverage / borrowing for meeting temporary funding requirements subject to the following:

1. the sum borrowed / amount of leverage must not exceed 10% of the investable funds of the AIF;
2. the duration of the borrowing / leverage must not be more than 30 days; and
3. the AIF must not borrow on more than 4 occasions in a year.[1]

The AIF Regulations further clarify in the case of Category II AIFs that borrowings shall be undertaken only to meet day-to-day operational requirements.[2]

SEBI has concluded based on investment reports submitted by AIFs that temporary borrowings by AIFs are being utilized for purposes other than meeting operating expenses, including making portfolio investments.[3]

In an attempt to bridge the divide between the provisions of the AIF Regulations and the industry, SEBI has proposed permitting AIFs to utilize borrowings to meet the shortfall in drawdowns while making investments in a portfolio company. SEBI has also prescribed certain conditions to this permission, which are:

1. the amount so borrowed shall not exceed 10% of the investment proposed to be made in the portfolio company;
2. the cost of such borrowing shall be charged only to the LP that has delayed or defaulted on their drawdown payment, thus causing the shortfall;
3. the AIF may borrow only once to meet the shortfall with respect to a specific LP;
4. the AIF must disclose the intent to borrow to make up for any shortfall in drawdowns, in the Private Placement Memorandum ("**PPM**");
5. the Investment Manager ("**Manager**") shall disclose the details of the borrowing such as amount borrowed, terms of borrowing and repayment to all LPs of the AIF / scheme, and
6. the borrowings must not be used to schedule different drawdown timeline for different LPs.

Additionally, SEBI has proposed a cooling-off period of 30 days between two periods of permissible leverage. We note that borrowing more than 10% of the investment proposed to be made in a portfolio investment shall be permitted in cases where existing LPs are interested in buying the units of a defaulting investor provided that appropriate safeguards as well as comfort letters are obtained from such defaulting LPs that they shall return the monies to such LPs.

Further, while it is noted that the cost of borrowings shall be borne by such LP who has defaulted on its drawdown payment, practically a defaulting contributor is unlikely to be able to bear such costs. In cases where some units are already issued, the same could be cancelled by the AIF. In other cases, the non-defaulting LPs may take up the costs to an extent while the remaining is allocated to the Manager.

Dematerialization of Assets of AIFs

SEBI previously issued a consultation paper on 'Dematerialization of Units of AIFs' on February 03, 2023 which proposed mandating AIFs that have a corpus greater than INR 500 crores to compulsorily dematerialize their units.

In furtherance of the same and to fully realize the objective of easing the monitoring and administration of AIFs by stakeholders and enhancing transparency in governance, SEBI has proposed to mandate all AIFs to hold instruments / securities of their investments only in dematerialized form excluding cases where dematerialization is not available for the instrument / security.

In respect of existing investments made by AIFs in investee companies where the AIF or AIFs together have a controlling interest[4], SEBI has proposed that such investments shall be held in the dematerialized form.

SEBI views the benefits of demateralization as outweighing the costs and administrative compliances of requiring the existing portfolio investments to be reissued in demat form.

Appointment of Custodian for AIFs

Presently, Category I and Category II AIFs are required to appoint a custodian for safekeeping of securities only if the corpus of the AIF is more than INR 500 crores or if the AIF is transacting in credit default swaps.[5] Category III AIFs are required to appoint a custodian irrespective of the corpus of the AIF.

Based on the data submitted by the AIF industry, SEBI reckons approximately 90% of the total investments made by AIFs are already covered under the existing custodial mandate.[6]

In light of the independent monitoring and additional services provided by custodians, SEBI proposed to extend the mandate of appointing a custodian to Category I and II AIFs that have a corpus of less than INR 500 crores.

The Manager of the Fund shall ensure that the custodian appointed by the AIF is not an associate of the Manager / sponsor / trustee of the AIF. Further, custodians shall also be responsible for monitoring investments of AIFs with regard to investment conditions and other related requirements under the AIF Regulations.

Limitation of maximum tenure extension available to LVFs

The framework for 'Accredited Investors' ("**AI**") was introduced in 2021 and was shortly followed by the Large Value Funds for Accredited Investors ("**LVFs**") concept, an AIF scheme in which each investor is an AI and invests at least INR 70 crores.

While AIs have been provided certain flexibilities in general, the LVF also benefits from having a contributor pool comprised exclusively of AI. One such flexibility pertains to the maximum permissible extension of tenure. Currently, LVFs are permitted to extend their tenure beyond the two-year limit applicable to close-ended AIFs.[7]

However, based on regulatory filings made with SEBI, it has been observed that 79% of close-ended LVF schemes have provided for a maximum tenure extension of 2 years, subject to the consent of two-thirds of the LPs by value.[8]

The muted utilization of the perpetual fund tenure coupled with the availability of alternatives such as selling unliquidated investments to a new scheme of the same fund, or distributing the unliquidated investments in-kind subject to the consent of 75% of LPs by value – has led to a need to align the extension of tenure of LVFs with that of other AIFs.

SEBI has proposed permitting LVFs to extend their tenure up to four years, subject to approval of two-thirds of LPs by value.

It can be noted that the industry has been awaiting a sub-category of Category I or Category II AIFs which are permitted to exist in perpetuity which shall not necessarily be large value funds of accredited investors.

Renewal of registration of AIFs

AIFs are granted a Certificate of Registration subject to the fulfilment of the eligibility requirements set forth in the AIF Regulations. The Certificate of Registration granted to AIFs is perpetual in nature and is valid till the AIF is wound up.[9]

SEBI has observed, based on the quarterly reports filed by AIFs, that many AIFs are still holding their Certificate of Registration despite having no fund raising or investment activity in their schemes for several years. This may lead to the following issues:

1. Inflated number of AIF registrations,
2. Consumption of regulatory resources in monitoring inactive AIFs,
3. Potential for misuse in unauthorized fund raising,
4. Compliance cost for inactive AIFs,
5. Difficulty in tracing inactive AIFs and initiating enforcement action.

SEBI noted that various market intermediaries are required to renew their registrations with SEBI in three-year or five-year intervals including portfolio managers, registered investment advisers and research analysts, as well as infrastructure investment trusts and real estate investment trusts.

Along similar lines, SEBI has proposed mandating AIFs to pay a renewal fee equal to 50% of the registration fee for the AIF, for every block of 5 years, within 3 months before the expiry of the said block.

We note that this requirement for renewal of registration by existing and well operational AIFs is highly onerous. SEBI via its circular dated November 17, 2022 has already prescribed the requirement to conduct the first closing of the AIF within 12 months from the date of SEBI taking the PPM on record, it further requires refiling of the application in the prescribed Form – A along with fees in case the timelines are not adhered to by the applicant AIF. Further, AIFs are also required to submit quarterly and annual reports to SEBI including no. of LPs, no. of portfolio investments, percentage of corpus invested etc. Despite presence of such elaborate checks to look through the operations of the AIFs, such renewal shall only add to extra costs and administrative hurdles for the AIFs, thereby reducing the ease of doing business in India.

Consultation Paper III - Status of AIF as Qualified Institutional Buyer ("QIBs")

The definition of QIBs under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ("**ICDR Regulations**") includes AIFs registered with SEBI. In common parlance, QIBs are considered to be large institutional investors who possess the acumen to evaluate, invest and manage the risks of their investments in the capital market.

Keeping this in mind, SEBI, under the ICDR Regulations provides various benefits and flexibilities with respect to investment in the capital market.[10] In this regard, SEBI observed that various family or group entities in order to avail the aforementioned flexibilities provided to QIBs, set up AIFs with single or a few (connected) LPs, not including sponsor and manager of the AIF.

This permits such LPs to invest as a QIB (via the AIF) in IPOs, which they otherwise would not have been able to do, due to their ineligibility to qualify as QIB. To remedy this issue, SEBI has proposed that AIFs having 50% or more contribution from a single LP or LPs belonging to the same group shall not be entitled to avail the benefits earmarked for QIBs. For this purpose, "**same group**" shall include relatives and related parties as defined in the Companies Act, 2013.

Consultation Paper IV - Proposal for strengthening of investor grievance mechanism

The purpose of Consultation Paper IV is to invite public feedback on the plan to enhance the investor grievance handling system through the SEBI Complaint Redressal System (SCORES) and establish a connection with the newly approved online dispute resolution (ODR) mechanism by SEBI.

This proposal aims to create a comprehensive approach to resolving grievances in the securities market by offering an end-to-end solution. It seeks to improve the efficiency and speed of the process by reducing timelines and introducing features like auto-routing and auto-escalation. Additionally, the proposal includes provisions for two levels of review that LPs can choose from, as well as the option to refer cases to the recently approved Online Dispute Resolution mechanism by SEBI.

CONCLUSION

It is observed that certain proposals put forth by SEBI may lean towards excessive regulation, which could limit the freedom of private parties to contract and agree on economic terms. These measures are restrictive and narrow down the rights and their interpretation to the regulator's perspective of fairness and justice. The AIF industry primarily caters to sophisticated LPs who understand the financial implications of their investments. Treating them similarly to retail investors and applying regulations meant for mutual funds in India may not provide adequate LP protection and may underestimate the risk appetite of these LPs. These proposed changes are likely to push existing fund managers to offshore jurisdictions, diverting pooling of foreign capital that is much needed in India to other locations.

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You can direct your queries or comments to the authors

[1]Regulations 16(1)(c) and 17(c) of AIF Regulations, 2012.

[2]Regulation 3(4)(b) of the AIF Regulations, 2012.

[3]Paragraph 2.5, Consultation Paper.

[4]Under Regulation 2(1)(ac)(i) of SEBI (Stock Brokers) Regulations, 1992 'controlling interest' means an interest, whether direct or indirect, to the extent of at least fifty-one percent of voting rights in the body corporate.

[5]Regulation 20(11), AIF Regulations, 2012.

[6]Paragraph 4.3, Consultation Paper.

[7]Regulation 13(4), AIF Regulations, 2012.

[8]Paragraph 5.3, Consultation Paper.

[9]Regulation 3(7), AIF Regulations, 2012.

[10]Please refer to paragraph 4.2 and 4.3 of the Consultation Paper II for more information such benefits.