

# Investment Funds: Monthly Digest

October 23, 2023

## SEC STRENGTHENS NORMS FOR PE FUNDS

### BACKGROUND

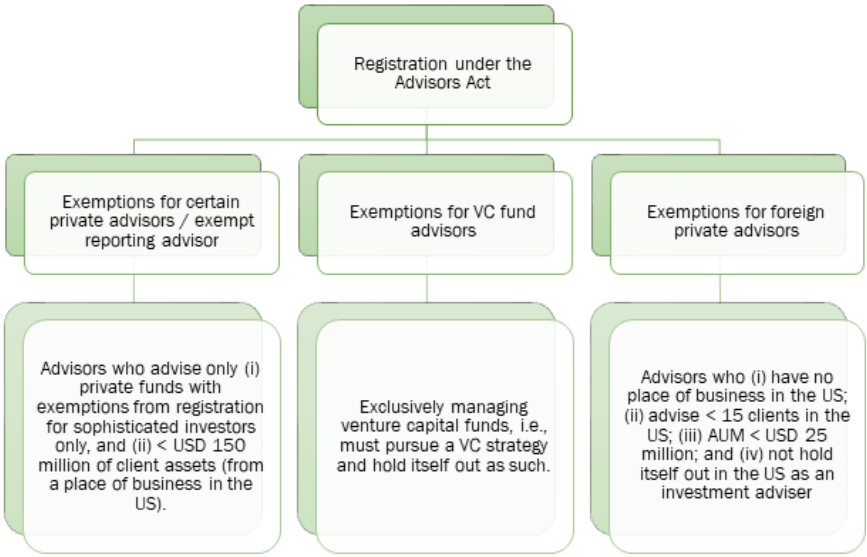
On August 23, 2023, the Securities and Exchange Commission (“SEC”) adopted its final rule on private fund advisors<sup>1</sup> (“**Final Rule**”) ushering in five new rules and certain amendments to existing regulations in furtherance of bolstering investor protection. The Final Rule addresses key aspects of fund governance including but not limited to preferential treatment of certain investors, filing of annual audits, submission of quarterly reports, contours on adviser-led secondaries, and enhanced record-keeping provisions.

Governance norms in private funds (including AIFs in India) are derived from worldwide practices, especially when monies are being raised from global investors. In this monthly digest, we analyze the new changes ushered in by the SEC and undertake a comparative analysis of the same with the prevailing position in India.

Nothing contained in this article should be construed as legal advice including on US laws. This analysis has been done on the basis of market research and experience. We disavow any errors and in specific pertaining to legal accuracy or current status of US laws contained in this article.

### INTRODUCTION TO THE US FUNDS INDUSTRY

A general overview of the US investment funds industry under the Investment Advisors Act, 1940 (“**Advisors Act**”) is provided below.



### NEW RULES INTRODUCED BY THE SEC

Tabulated below is a snapshot of the new rules adopted by the SEC in relation to investment advisers to private funds.

Rule	Any investment adviser	Registered investment adviser	Grandfathered / Legacy Status	Written notice to investors	Majority consent of unrelated investors	Additional documents to investors
Quarterly statement rule	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Annual audits rule	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Adviser-led	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/> <sup>2</sup>

## Research Papers

### M&A In The Indian Technology Sector

February 19, 2025

### Unlocking Capital

February 11, 2025

### Fintech

January 28, 2025

## Research Articles

### Re-Evaluating Press Note 3 Of 2020: Should India’s Land Borders Still Define Foreign Investment Boundaries?

February 04, 2025

### INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals

January 15, 2025

### Key changes to Model Concession Agreements in the Road Sector

January 03, 2025

## Audio

### Securities Market Regulator’s Continued Quest Against “Unfiltered” Financial Advice

December 18, 2024

### Digital Lending - Part 1 - What’s New with NBFC P2Ps

November 19, 2024

### Renewable Roadmap: Budget 2024 and Beyond - Part I

August 26, 2024

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## NDA Hotline

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## Video

### Arbitration Amendment Bill 2024: A Few Suggestions | Legally Speaking With Tarun Nangia | NewsX

February 12, 2025

Preferential treatment rule	<input type="checkbox"/>	-	<input type="checkbox"/>	<a href="#">_3</a>	<a href="#">_4</a>	<input type="checkbox"/>
Restricted activities rule	<input type="checkbox"/>	-	<input type="checkbox"/>	<a href="#">_5</a>	<a href="#">_6</a>	<input type="checkbox"/>
Bookkeeping rule amendments	<input type="checkbox"/>	-	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Compliance rule amendments	<input type="checkbox"/>	-	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Provided below is a comparative table of the provisions covered under the Final Rules and the extant provisions applicable to alternative investment funds (“AIFs”) under various Securities and Exchange Board of India (“SEBI”) regulations and other applicable laws.

## New US Provisions

## Extant Indian Provisions

### Restricted Activities<sup>7</sup>

Investment advisors to a private fund are now required to:

- Obtain majority consent of unrelated investor prior to allocating expenses associated with an investigation of the advisor; provided that the expenses related to an investigation that results / resulted in a sanction for a violation of the Advisors Act may not be allocated to the private fund;
- Distribute a written notice to its investors (with the dollar amount) of any expenses charged to the private fund in relation to an examination of the adviser within 45 days of the fiscal quarter end;
- Distribute a written notice to its investors informing them of the aggregate dollar amount by which an adviser clawback has been reduced by actual / potential taxes (if any) within 45 days of the fiscal quarter end;
- For adviser to allocate expenses related to a portfolio investment on a non-pro rate basis when multiple entities advised by the adviser are involved, it would have to be:
  - The non-pro rate charge should be fair and equitable; and
  - Distribute to each investor a written notice of the non-pro rate charge and how the same is fair and equitable.
- To borrow money / asset or receive a loan / line of credit from a private fund client, the adviser has to:
  - Distribute to each investor a written notice describing the material terms of such borrowing / loan / credit line etc;

### Restricted Activities

- The AIF Regulations have been recently amended to prohibit investment managers from allocating losses / damages / expenses incurred by them in relation to the resolution of investor claims in case the AIF is set up as a trust.<sup>8</sup>
- The AIF Regulations necessitate AIFs to inform investors of any inquiries / legal actions by regulatory bodies both within and outside India – as and when such inquiries / legal actions arise<sup>9</sup>
- The AIF Regulations currently do not have a specific provision that require a written notice to investors of reduced clawback due to tax implications however the provisions pertaining to clawback are required to be well-addressed as per the template private placement memorandum (“PPM”) mandated by SEBI.<sup>10</sup>
- SEBI has recently released a consultation paper when seeks to ensure that the fund does not offer terms to any investors that would affect the pro-rata and pari-passu standing of all investors in the blind pool.<sup>11</sup> Further, the AIF Regulations provide that in case of co-investments, the terms offered to the manager / sponsor / co-investor should not be more favorable than what is offered to the AIF.<sup>12</sup> The nuances of co-investments have been previously covered by us [here](#).
- Category I and II AIFs are prohibited from employing leverage other than to meet except for meeting temporary funding requirements (< 30 days).<sup>13</sup> Further, AIFs are required to annually disclose to its investors, information pertaining to leverage risk both at the fund level and at the portfolio company level.<sup>14</sup>

Whereas Category III AIFs are permitted to utilize leverage provided that investors are provided certain additional SEBI mandated disclosures such as the overall level of leverage and level of leverage arising from derivatives.<sup>15</sup>

2. Obtains a majority consent of unrelated investors in writing.

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### Preferential Treatment<sup>16</sup>

To ensure that the investors in a similar pool of assets or the same fund managed by an investment adviser are not treated unequally, the investment adviser has to ensure that:

1. An investor is not provided an exit from a fund in instances wherein the adviser believes that there would be a material negative effect on the fund unless such an exit is due to a government order or in instances where such a right has been offered to all the investors of the fund.
2. Enhanced information rights regarding the portfolio holdings / exposure of the fund if the adviser believes that the same would have a negative impact on the fund except if such information is offered to all investors;

The investment adviser ought to ensure that a written notice capturing the above information to both current and prospective investors.

### Preferential Treatment

SEBI has recently released a consultation paper when seeks to ensure that the fund does not offer terms to any investors that would affect the pro-rata and pari-passu standing of all investors in the blind pool wherein certain differential economic rights may not be offered to select investors. The ramifications of mandating pro-rata / pari passu treatment of all investors are covered [here](#).

Currently, the template PPM necessitates the disclosure (illustrative) of the differential rights offered (if any).

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### Private Fund Adviser Audits<sup>17</sup>

The investment adviser is obligated to ensure that every fund that it advises undertakes a financial audit and that such audited financial statements are distributed to its investors within 120 days of the fiscal year end<sup>18</sup>.

The abovementioned annual audit is to be conducted by an independent public accountant and is to be prepared in accordance with US GAAP.

### Private Fund Adviser Audits

AIFs are required to on an annual basis (within 180 days from year-end) provide investors with financial information of portfolio companies and material risks (and mitigation strategies) as week as undertake an annual audit by a qualified auditor.<sup>19</sup>

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### Quarterly Statements<sup>20</sup>

Investment advisers are required to, within the prescribed timelines, prepare and distribute quarterly statements for funds it advises that have two full fiscal quarters of operating results. This quarterly statement should, inter alia, contain the following:

1. Detailed accounting of expenses paid to the investment adviser;
2. Detailed accounting of expenses paid by or allocated to the fund;
3. Detailed accounting of compensation (if any) paid by the portfolio investments to the investment advisor;
4. Key financial metrics – IRR and MOIC; and
5. A statement of contributions and distributions (in case of an illiquid fund).

It is to be noted that the above disclosures are to be made in plain

### Quarterly Statements

1. AIFs are required to periodically intimate its investors of fees ascribed to the manager / sponsor and / or fees charged to the AIF by the manager / sponsor;<sup>21</sup>
2. Please refer to point (i) above;
3. The AIF Regulations are currently silent on the disclosures pertaining to compensation received by investment managers from portfolio companies, however, the template PPM requires the investment manager to provide visibility on management fee offsets (if any);
4. AIFs are required to periodically provide the financial information of portfolio companies to investors, however, IRR and MOIC have not been specifically identified;<sup>22</sup>
5. Information pertaining to contributions and distributions are provided to the investors in the quarterly reporting format.<sup>23</sup>

## Adviser-Led Secondaries<sup>24</sup>

For undertaking an adviser led secondary the investment adviser is required to:

1. Distribute to its investors a fairness opinion from an independent opinion provider;
2. Distribute to its investors a written summary of any material business relationship that it may have had with the independent opinion provider in the preceding two years.

## Adviser-Led Secondaries

The AIF Regulations are silent on IM-led secondaries, however, it provides for a liquidation scheme for holding unliquidated investments post the expiry of the AIF's tenure.<sup>25</sup> To ensure fairness in the transfer of unliquidated investments into the liquidation scheme, the AIF Regulations provides that the valuation of such unliquidated investments be done by two independent valuers and the AIF manager arrange for at least 25% bids for the value of such unliquidated investments.<sup>26</sup> We have discussed the modalities of liquidation scheme in our previous digest [here](#).

## Books and Records<sup>27</sup>

The extant recording keeping rules have been amended by the SEC to necessitate the preparation and retention following:

1. Quarterly statements;
2. Audited financial statements;
3. Fairness opinions (and summary);
4. Notices shared with current and prospective investors in relation to preferential treatment; and
5. Copy of consent document or intimation (as the case may be) shared by / with the investors.

## Books and Records

The investment manager is obligated to maintain all the records specified by SEBI which include:

- Minutes of the meetings of decisions to address conflict of interest;<sup>28</sup>
- Rationales of investment decisions;<sup>29</sup>
- particulars of investors (including details of their contributions);<sup>30</sup> and
- Details of the assets held by the AIF (or the scheme therein).<sup>31</sup>

It is to be noted that SEBI has the right to inspect the AIF's books of accounts and the onus is on the AIF (and its officers) to produce the same.<sup>32</sup> We have also talked about the governance standards applicable to AIFs [here](#).

## Compliance Procedures and Practices<sup>33</sup>

Presently, the investment advisers are required to annually review and document in writing the adequacy of policies and procedures adopted by the private fund pursuant to the Final Rules.

## Compliance Procedures and Practices

The master circular for AIFs ("**AIF Master Circular**") necessitates a legal audit of PPM to ensure that the AIF is in compliance with the AIF Regulations.<sup>34</sup>

It may be observed from the table above that the AIF Regulations in the current form place equivalent, if not more restrictive measures on all AIFs (without many practicable exemptions, unlike in the US) in order to ensure adequate investor protection. Herein, it may be noted that, as opposed to necessitating investor consent (under the Advisors Act) for certain actions, the same has been outright prohibited by SEBI for AIFs. For example, while the SEC rules permit the fund to obtain line of credit from a client / investor,<sup>35</sup> the AIF Regulations places a prohibition on AIFs from undertaking any leverage.

Interestingly, the Final Rules have introduced some level of parity between the Indian regulations and its American counterparts- especially in record keeping (however, the AIF Regulations tend to require a greater compliance burden on GPs). For example, the AIF Regulations obligate AIFs to provide information with respect to material risks to investors in addition to purely financial information.

## CONCLUSION

The AIF Regulations substantively address the new rules proposed by the SEC. It may appear that the SEC is playing catch-up when it comes to investor protection as compared to SEBI's AIF Regulations. Nevertheless, the recent SEC move may be examined from two lenses-

1. From the perspective of investors, the move by the SEC is a step in the right direction wherein the regulator has put in place baseline investor protection measures that shall deter fraudulent practices by investment managers. The same was the need of the hour considering that the alternative investments industry now manages assets north of USD 25 trillion.
2. From the perspective of the investment managers, the Final Rules imposes additional compliance burden – to the tune of a billion dollars<sup>36</sup> across the industry. The additional cost acts as a barrier to entry for emerging fund managers, has the potential to adversely impact the economics of smaller fund manager to a great extent, and may ultimately reduce the returns to the investors. The intended investors in such private funds are largely sophisticated investors who are capable of navigating the inherent complexities of such products and, therefore, a more light-touch regulatory regime should have been the norm.



Irrespective of which perspective one prefers, the regulatory dilemma persists i.e. the regulator has to ensure adequate investor protection while encouraging capital development. While upkeeping this fragile balance, it is interesting to observe that the SEC has adopted the Final Rules which bolsters investor protection –with the increased cost of additional compliance burden.

– **Athul Kumar** and **Nandini Pathak**

You can direct your queries or comments to the authors.

<sup>1</sup> Private Fund Advisers; Documentation of Registered Investment Adviser Compliance, Release No. IA-6383; File No. S7-03-22

<https://www.govinfo.gov/content/pkg/FR-2023-09-14/pdf/2023-18660.pdf>

<sup>2</sup> Fairness opinion and summary note

<sup>3</sup> Please refer to the table below for the specific activities under the preferential treatment rule

<sup>4</sup> Please refer to the table below for the specific activities under the preferential treatment rule

<sup>5</sup> Please refer to the table below for the specific activities under the restricted activities rule

<sup>6</sup> Please refer to the table below for the specific activities under the restricted activities rule

<sup>7</sup> Rule 211(h)(2)-1

<sup>8</sup> Clause 11, SEBI (Alternative Dispute Resolution Mechanism) (Amendment) Regulations, 2023

<sup>9</sup> Regulation 22 (c), AIF Regulations

<sup>10</sup> Master Circular for AIFs, SEBI circular SEBI/HO/AFD/PoD1/P/CIR/2023/130, July 31, 2023 (“**AIF Master Circular**”)

<sup>11</sup> Consultation paper on proposal with respect to pro-rata and pari-passu rights of investors of AIFs, May 23, 2023

<sup>12</sup> Regulation 15 (1)(b), AIF Regulations

<sup>13</sup> Regulation 3(4)(b), AIF Regulations & Regulation 16(1)(c), AIF Regulations

<sup>14</sup> Regulation 22 (g)(iii), AIF Regulations

<sup>15</sup> Regulation 3(4)(c), AIF Regulations

<sup>16</sup> Rule 211(h)(2)-3

<sup>17</sup> Rule 206(4)-10

<sup>18</sup> 180 days in case of a fund of funds.

<sup>19</sup> Regulation 22(g) and regulation 22(j), AIF Regulations

<sup>20</sup> Rule 211(h)(1)-2

<sup>21</sup> Regulation 22(b), AIF Regulations

<sup>22</sup> Regulation 22(a), AIF Regulations

<sup>23</sup> Quarterly reporting format, available at: <https://www.ivca.in/regulatory-reports-sebi-circular>

<sup>24</sup> Rule 211(h)(2)-2

<sup>25</sup> Regulation 29A, AIF Regulations

<sup>26</sup> Modalities for launching Liquidation Scheme and for distributing the investments of AIFs in-specie, SEBI circular SEBI/HO/AFD/PoD-I/P/CIR/2023/098 dated June 21, 2023

<sup>27</sup> Rule 204-2

<sup>28</sup> Stewardship code, AIF Master Circular

<sup>29</sup> Regulation 27 (1)(e), AIF Regulations

<sup>30</sup> Regulation 27 (1)(d), AIF Regulations

<sup>31</sup> Regulation 27 (1)(a), AIF Regulations

<sup>32</sup> Regulation 30 and regulation 32, AIF Regulations

<sup>33</sup> Rule 206(4)-7(b)

<sup>34</sup> Clause 2.4, AIF Master Circular

<sup>35</sup> Provided that it obtains a majority consent of investors and provides all investors with a note capturing the material terms of the credit line

<sup>36</sup> Private funds prepare to spend billions on compliance after SEC rule, Financial Times

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