

# Investment Funds: Monthly Digest

June 10, 2024

## 2024 AIF MID-YEAR REPORT: SEBI'S FOCUS ON CLARITY, COMPLIANCE, AND CAPABILITY

- SEBI relaxes requirement for changes in terms of PPM to be intimated through Merchant Banker.
- New NISM Certification requirement for KIT members of AIFs.
- SEBI releases consultation paper on the framework for valuation of investment portfolio of AIFs.

### INTRODUCTION

In the past year, the Securities and Exchange Board of India ("SEBI") has been particularly proactive in updating and revising the regulatory framework governing Alternative Investment Funds ("AIFs"). SEBI's momentum in introducing amendments to SEBI (AIFs) Regulations, 2012 ("AIF Regulations") has continued this year, further demonstrating their commitment to evolving market needs. However, some stakeholders have expressed concerns about the pace and scope of these changes, arguing that they may increase compliance costs and operational challenges for fund managers. Balancing innovation with regulation remains a critical task for SEBI as it navigates the complexities of the AIF industry. This month's digest explores the circulars and consultation papers released by SEBI in 2024 so far, highlighting their implications and the broader context of SEBI's regulatory initiatives.

#### 1. Foreign investment in Alternative Investment Funds (AIFs) (January 11, 2024)

##### Summary

Paragraph 4.1.2 of SEBI Master Circular No. SEBI/HO/AFD/PoD1/P/CIR/2023/130 dated July 31, 2023 ("Erstwhile Master Circular") prescribes that an AIF shall, at the time of onboarding a foreign investor, ensure that such foreign investor or its underlying investors contributing 25% or more in the corpus of the investor or identified on the basis of control, is not a person(s) mentioned in the Sanctions List notified from time to time by the United Nations Security Council and is not a resident in the country identified in the public statement of Financial Action Task Force as—

- a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or
- a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies.

SEBI on January 11, 2024 issued a circular revising the threshold from 25% ownership to beneficial owner as defined under *sub-rule (3) of rule 9 of the Prevention of Money-laundering (Maintenance of Records) Rules, 2005* ("PML Rules").

In case an investor who does not meet the aforementioned requirements has already been onboarded, the fund manager is prohibited from drawing down further capital from such an investor until the investor is compliant.

##### NDA Comments

The Ministry of Finance in 2023 amended the PML Rules to lower the thresholds for determining beneficial ownership. As per the changes to Rule 9(3) therein, the threshold for determining beneficial owners of (i) companies has been decreased from 25% to 10% of the shares, capital, or profits; (ii) partnership firms has been reduced from 15% to 10% of the capital or profits.; and (iii) trusts has been reduced from 15% to 10% of the interest in the trust.

Such amendments are not only aimed at ensuring consistency across different laws but also represent a coordinated effort to streamline processes, enhance compliance mechanisms, and promote transparency in AIF industry.

#### 2. Guidelines for AIFs with respect to holding their investments in dematerialised form and appointment of custodian (January 12, 2024)

## Research Papers

### From Capital to Impact: Role of Blended Finance

June 15, 2024

### Opportunities in GIFT City

June 14, 2024

### Start-up Governance Essentials

May 30, 2024

## Research Articles

### Private Client Insights - Sustainable Success: How Family Constitutions can Shape Corporate Governance, Business Succession and Familial Legacy

January 25, 2024

### Private Equity and M&A in India: What to Expect in 2024?

January 23, 2024

### Emerging Legal Issues with use of Generative AI

October 27, 2023

## Audio

### Why is the ad industry unhappy with MIB's self-declaration mandate?

June 18, 2024

### Incorporation of arbitral clause by reference: Position in India and other Asian Jurisdictions

June 12, 2024

### Third-Party Funding: India & the World

April 27, 2024

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April 23, 2024

SEBI issued a circular pursuant to the amendment of the AIF Regulations last year to prescribe guidelines for AIFs with respect to

1. Dematerialization:

- Investments made by AIFs on or after October 01, 2024 to be held in dematerialized form only;<sup>1</sup>
- Investments made by AIFs prior to October 01, 2024 are exempted from being held in dematerialized form, except (i) if the investee company of the AIF has been mandated under law to facilitate dematerialisation of its securities or (ii) the AIF exercises control over the investee company, in which case such investments must be held in dematerialized form by the AIF on or before January 31, 2025; and
- The requirement to hold investments in dematerialised form shall not be applicable to (i) schemes of an AIF whose tenure (exclusive of permissible extension) ends on or before January 31, 2025 or (ii) schemes of an AIF which is in its extended tenure as on date of the circular.

2. Appointment of custodian for AIFs:

- Custodian for a scheme to be appointed prior to the date of the first investment of the scheme;
- Existing schemes of Category I and Category II AIFs with a corpus less than INR 500 crore and holding at least one investment as on date of circular to appoint custodian on or before January 31, 2025; and
- In case of AIFs with custodians that are associates of the manager or sponsor, managers to ensure compliance with Regulation 20(11A) of the AIF Regulations on or before January 31, 2025.

3. Reporting of AIFs under custody:

- The pilot Standard Setting Forum for AIFs (“SFA”) to formulate implementation standards for reporting data on investments of AIFs that are under custody with the custodian.

NDA Comments

This strategic step, building upon the foundation laid by last year’s circular which focused on dematerializing units of AIFs, reflects SEBI’s ongoing efforts to enhance transparency and efficiency throughout the investment ecosystem. By mandating the dematerialization of AIF holdings, SEBI seeks to standardize and streamline the process of tracking ownership and transfers of these holdings, mitigating operational risks and improving regulatory oversight.

SEBI’s requirement to appoint a custodian prior to the date of the first investment for any new scheme ensures that robust custodial oversight is in place from the inception of the scheme, potentially enhancing investor confidence by mitigating early-stage risks associated with investment deployment.

Further, the requirement to appoint a custodian being applicable on all AIFs irrespective of size of corpus extends custodial oversight to a broader spectrum of AIFs, encompassing those with relatively smaller assets under management. Consequently, fund managers of these schemes may need to reassess their operational structures and budgetary considerations to accommodate the additional compliance requirements associated with custodial appointments.

Furthermore, the stipulation regarding AIFs with custodians associated with the manager or sponsor underscores SEBI’s commitment to addressing potential conflicts of interest within the AIF ecosystem. By mandating compliance with Regulation 20(11A) of the AIF Regulations, SEBI aims to strengthen governance practices and promote greater transparency in AIF operations. Fund managers will need to proactively review their custodial arrangements to ensure alignment with regulatory standards, potentially necessitating adjustments to existing custodial relationships or organizational structures.

3. Circular on Standardization of the PPM Audit Report (April 18, 2024)

Summary

- SEBI has now issued a standard reporting format for the audit of compliance with terms of the private placement memorandum (“PPM”) through SFAs.
- SEBI has also confirmed that such audit report is required to be submitted with SEBI through the SI Portal.
- SEBI has also clarified that audit of sections on Risk Factors, Legal, Regulatory and Tax Considerations, Track Record of First Time Managers, Illustration of Fees and Expenses and Glossary of Terms are optional.

NDA Comments

By implementing a uniform reporting format and enabling online submissions, SEBI aims to streamline compliance processes and boost investor confidence. This initiative underscores the collaborative efforts between SEBI and industry stakeholders to advance and regulate the securities market in India. AIFs are required to follow the guidelines set forth in this circular, with the assistance of AIF associations, to ensure seamless adherence to regulatory standards.

4. Flexibility to Alternative Investment Funds (AIFs) and their investors to deal with unliquidated investments of

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## Summary

- Under the outlined framework, AIFs are empowered during the liquidation period to distribute unliquidated investments in-specie or opt for the dissolution period, subject to receiving approval from at least 75% of investors by value, as mandated under Regulation 29(9).
- Prior to initiating this process, AIFs are required to arrange bids for a minimum of 25% of the value of unliquidated investments and disclose pertinent details to investors, including proposed tenure, bid values, and independent valuations.
- Furthermore, the circular mandates investor consent for commencing the dissolution period, with provisions for dissenting investors to exercise an exit option from the 25% of the bid arranged by the AIF. In cases where the minimum bid threshold is not met, the AIF can still enter into a dissolution period with the approval of at least 75% of the investors.
- The circular also emphasizes the importance of performance benchmarking and reporting obligations during the dissolution period, distinct from the pre-dissolution phase. It specifies valuation methodologies for bid-successful and bid-unsuccessful scenarios, aiming to ensure accuracy and transparency in performance tracking.
- Additionally, the circular enforces a mandate for mandatory in-specie distribution in instances where AIFs fail to secure 75% investor consent for dissolution or in-specie distribution during the liquidation period. AIFs are no longer permitted to launch liquidation schemes.

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## NDA Comments

Our views on the dissolution period framework may be accessed [here](#).

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## 5. Framework for Category I and II Alternative Investment Funds (AIFs) to create encumbrance on their holding of equity of investee companies (April 26, 2024)

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## Summary

- SEBI introduced provisos to Regulation 16(1)(c) and 17(c) of the AIF Regulations, which allow Category I and Category II AIFs to create an encumbrance on the equity of an investee company which is in the business of development, operation or management of projects in any of the infrastructure sub-sectors listed in the Harmonised Master List of Infrastructure.
- Existing schemes of Category I or Category II AIFs, which have not onboarded investors before April 25, 2024, are permitted to create encumbrances for borrowing purposes, provided they explicitly disclose such actions and associated risks in their PPMs.
- Encumbrances created prior to April 25, 2024, may continue if explicitly disclosed in the PPM. However, if encumbrances were created without prior disclosure, consent from all investors is required by October 24, 2024, or the encumbrances must be removed by January 24, 2025, if consent is not obtained within the stipulated time frame.
- Furthermore, AIFs must ensure that borrowings against encumbered equity are utilized solely for the development, operation, or management of the investee company and not for other purposes, including investments in other companies.
- SEBI has also specified that the duration of encumbrances should not exceed the residual tenure of the AIF scheme.
- Additionally, AIFs with more than 50% of foreign investment or with foreign sponsor/ manager or with persons other than resident Indian citizens as external members in its decision-making investment committee must comply with RBI Master Direction on 'Foreign Investments in India'.
- In case of default by the borrower investee company, AIFs must ensure that investors are not liable beyond the encumbered equity. Importantly, the flexibility of encumbrance creation does not extend to providing guarantees for investee companies, and encumbrances cannot be created on investments in foreign investee companies.
- The circular has also provided that SEBI, in collaboration with the SFA, will develop implementation standards to ensure that encumbrances are utilized solely for facilitating debt raising in infrastructure projects. Managers of AIFs are required to adopt and adhere to these standards, which will be published on industry association websites, including the Indian Venture and Alternate Capital Association (IVCA), PE VC CFO Association, and Trustee Association of India.

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## NDA Comments

Notably, such amendments come in the wake of the case concerning India Infrastructure Fund II, Global Infrastructure Partners India Private Limited, and IDBI Trusteeship Services Limited, where SEBI had held that Category I and II AIFs are not permitted to pledge the securities of portfolio companies to secure any loan availed of by such portfolio companies. Such practice was deemed to be akin to indirect borrowing by the AIFs.

However, industry associations and certain funds submitted representations to SEBI to consider allowing pledging of equity investments by AIFs to secure borrowing by investee companies to protect/enhance the value of the AIFs' investments.

By allowing AIFs to invest in infrastructure projects without constraints, these amendments pave the way for increased private capital infusion into crucial infrastructure developments. This, in turn, is expected to catalyse infrastructure growth by fostering a more conducive environment for funding.

Further, SEBI should have considered extending this provision to encompass investments beyond the infrastructure sector. Doing so may provide additional avenues for funding across various industries, thereby promoting greater liquidity and investment flexibility. Moreover, with appropriate safeguards and investor consent, such a move could have encouraged more robust participation from AIFs in supporting diverse sectors of the economy.

Moreover, by disallowing guarantees and instead allowing pledging of securities, SEBI aims to strike a balance between facilitating access to financing for portfolio companies and safeguarding the interests of AIF investors. Pledging securities offers a more controlled approach to risk management, limiting the potential losses to the value of the pledged assets and ensuring that investors are not unduly exposed to the financial risks associated with guarantees.

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## 6. Relaxation in requirement of intimation of changes in the terms of the PPM of AIFs through Merchant Banker (April 29, 2024)

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### Summary

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- SEBI specified a list of sections of PPMs as well as specific information and terms therein, changes to which are not required to be intimated to SEBI by way of a merchant banker. Instead, to the extent that changes are limited to the specified sections and/or terms, such changes may be intimated to SEBI by the fund manager itself.
- Additionally, SEBI specified that any changes to PPMs of large value funds for accredited investors (“LVFs”) are not required to be intimated to SEBI through a merchant banker.
- Effective immediately, the changes outlined in Annexure A of the circular are no longer subject to submission through a merchant banker. This includes specific sections of the PPM, such as the analysis of market opportunities, track record of investment managers, risk factors, and legal, regulatory, and tax considerations.
- Additionally, Annexure A lists specific modifications, such as updates to contact details, appointments of auditors or advisors, adjustments in fund size, changes in key investment team, changes in key management personnel, changes in advisory board/advisory committee/investment committee and revisions to disclosure requirements mandated by AIF Regulations. These changes can now be directly communicated to SEBI.

### NDA Comments

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This decision follows a thorough review prompted by feedback from market participants, indicating a strong commitment to improving the ease of doing business and reducing compliance costs for AIFs operating in India. SEBI's decision to allow direct filing of changes in certain terms of the PPM reflects a proactive approach to regulatory reform, aiming to foster a more agile and efficient regulatory environment while safeguarding investor interests and promoting market development. The move is expected to benefit AIFs by reducing procedural complexities and facilitating smoother compliance processes. Further, the exemption for LVFs is consistent with the current framework, which does not require LVFs to submit their PPMs to SEBI via a merchant banker when launching a scheme.

In any case, AIFs are required to ensure strict adherence to regulatory requirements and maintain transparency in their disclosures to uphold investor confidence and market integrity.

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## 7. Certification requirement for key investment team of manager of AIF (May 13, 2024)

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### Summary

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- SEBI specified the ‘*NISM-Series-XIX-C: Alternative Investment Fund Managers Certification Examination*’ (“**NISM Certification**”) as the relevant certification required of at least one key personnel under Regulation 4(g)(i) of the AIF Regulations.
- The circular comes into effect immediately, thereby requiring all (i) proposed AIFs applying to SEBI for registration as an AIF and (ii) schemes applying for launch, after May 10, 2024, to obtain the NISM Certification prior to making such application.
- Some respite has been provided to existing schemes of AIFs and schemes of AIFs whose application for launch of scheme is pending with SEBI as on May 10, 2024, who have an extended timeline of May 09, 2025 to comply with the circular.

### NDA Comments

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While this change was anticipated, given that it was pursuant to the second amendment to the AIF Regulations made back in 2023, it has nonetheless come as a double-edged sword for the funds industry at large.

The removal of the experience qualification for key investment team members of the fund manager lowers the regulatory threshold for the entry of first-time fund managers and is a welcome change from this perspective. This adjustment opens doors for new talent and innovation in the industry, making it easier for fresh faces to establish themselves. This allows individuals with strong academic backgrounds, innovative ideas, or unique perspectives to enter the fund management industry without the previously required years of experience, thereby diversifying the

pool of fund managers in the Indian AIF industry.

However, the introduction of the NISM Certification requirement presents challenges, particularly for seasoned managers. Experienced fund managers now face difficulties in launching new funds or schemes within existing funds without either (i) seeking the certification for professionals with decades of fund management experience, or (ii) including younger professionals willing to obtain the NISM Certification into key investment teams.

Fund managers are now required to allocate considerable effort towards ensuring their key professionals meet these new standards. This might involve arranging for study sessions, covering the costs of certification exams, and adjusting operational timelines to accommodate the certification process. Moreover, for experienced fund managers managing multiple funds or launching new schemes, the certification requirement could delay these processes. The need for certification might interrupt the flow of operations as key professionals prepare for and obtain their certifications, potentially leading to slower fund launches and possibly affecting market opportunities.

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## 8. Consultation Paper on review of certain aspects of the framework for valuation of investment portfolio of AIFs (May 23, 2024)

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### Summary

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Based on industry feedback received on the existing valuation framework under the AIF Regulations and SEBI circular dated June 21, 2023, SEBI has proposed changes to the way AIFs value their portfolio investments.

Summarily, the following proposals have been floated for public comments:

1. Exclusion of unlisted securities held by AIFs from valuation in accordance with SEBI (Mutual Fund) Regulations. Instead, unlisted securities would be valued in accordance with guidelines endorsed by an eligible AIF Industry Association based on AIPAC recommendations (currently the IPEV guidelines);
2. Changes to valuation practices of an AIF made to comply with the standardized valuation framework issued by SEBI shall not be considered a material change; thereby will not trigger the obligation to provide exit options to dissenting investors. Further, adjustments made within IPEV guidelines or MF Regulations should similarly not be considered material changes. However, such adjustments must be disclosed to investors.
3. Clarification on the eligibility of independent valuers being set up in the form of an entity:
  - the entity itself must be a registered valuer entity registered with the IBBI; and
  - it is not necessary that each director/partner/employee have a separate membership in ICAI, ICSI, ICMAI or the CFA Institute such that the designated deputed persons of the valuer firm, who are deputed by the valuer entity to conduct a valuation of the investment portfolio of AIFs, may necessarily be a member of the relevant institute.
4. Extension of the deadline to submit audited valuation data to performance benchmarking agencies from September 30 of each year to October 31 of each year.

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### NDA Comments

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By excluding unlisted securities held by AIFs from the purview of SEBI (Mutual Fund) Regulations, SEBI appears to acknowledge the distinct nature of AIFs compared to mutual funds. AIFs often invest in companies at various stages of development, including early-stage ventures and unconventional sectors, which may lack tangible assets or stable earnings. Therefore, methodologies like net worth or earnings per share, which are commonly used for mutual funds, may not be suitable for valuing these investments. The IPEV guidelines, on the other hand, offer a range of methodologies such as discounted cash flow (DCF) and internal rate of return (IRR), providing flexibility to adapt to the unique characteristics of AIF investments.

SEBI's proposal to not treating necessary adjustments in valuation methodologies as 'material changes', aims at reducing the operational and administrative burden on AIFs. It prevents a potential flurry of redemption requests that could arise from such regulatory alignment, allowing fund managers to focus on investment strategy rather than administrative compliance.

Further, the establishment of clear eligibility criteria for independent valuers is intended to clear industry-wide ambiguities in relation to appointing independent valuers in the form of entities. Eliminating the requirement for every director, partner, or employee of the valuer entity to hold separate memberships in professional institutes provides flexibility in team composition. Valuer entities can now assemble teams based on expertise and experience, rather than solely on individual memberships. This flexibility enables valuer entities to optimize their resources and deliver tailored valuation solutions to AIFs.

Additionally, extending the reporting deadline for AIFs to performance benchmarking agencies by an additional month addresses compliance challenges due to delays in obtaining audited data from investee companies, thereby improving the accuracy and reliability of the reported valuations.

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## CONCLUSION

Notably, the amendments introduced and proposed in 2024 so far signify a dual emphasis on strengthening regulatory compliance and accommodating industry dynamics. Noteworthy measures include the streamlined reporting of annual changes in PPM through Merchant Bankers, a welcoming step towards reducing administrative burdens. Furthermore, by allowing for encumbrance on equity holdings for Category I and Category II AIFs SEBI seems to have recognised evolving market practices. Moreover, the standardization of AIF audit reports represents a step towards harmonizing reporting practices, thereby enhancing transparency and investor confidence. SEBI's introduction of NISM certification for key investment team members, while maintaining a balanced perspective,

underscores its commitment to elevating professional standards within the industry. Looking ahead, the amendments to liquidation framework and proposed amendments to the valuation framework signify further evolution in regulatory clarity and operational efficiency.

While SEBI's proactive approach, coupled with its receptiveness to industry dynamics, infuses confidence in the trajectory of the AIF sector, it must also ensure that the interests of fund managers align with the broader goals of transparency, accountability, and investor confidence. This equilibrium between regulatory oversight and market flexibility is essential for the sustainable growth and integrity of the AIF sector. As stakeholders, we eagerly anticipate the forthcoming changes poised to shape the AIF landscape in the remainder of 2024 and beyond.

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<sup>1</sup>irrespective of whether investment is made directly in the investee company or is acquired from another entity.

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