

# Investment Funds: Monthly Digest

February 04, 2021

## EXEMPTIONS FOR AIF INVESTMENT COMMITTEES

- SEBI provides a waiver mechanism to certain Investment Committees (ICOMs) from its regulatory purview.
- AIFs in which each third-party investor has committed at least INR 70 crores may obtain a waiver for their ICOMs from being subject to the responsibilities identical to that of the AIF manager.

On December 16, 2020, the Securities Exchange Board of India (“SEBI”) in its board meeting<sup>1</sup> paved the way for certain exemptions with regard to Investment Committees (“ICOM”) by approving key amendments to Regulation 20(6) of the SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”).

In furtherance of the board meeting, SEBI vide a notification dated January 08, 2021<sup>2</sup> (“Amendment”) introduced a waiver mechanism for certain Alternative Investment Funds (“AIF”) from the requirement of being (i) equally responsible as the AIF manager for investment decisions of the AIFs and (ii) jointly and severally responsible along with the AIF manager to ensure that the investments of the AIF are in compliance with the AIF Regulations, the terms of the placement memorandum of the AIF, agreements made with the investors, any other fund documents and any other applicable law.

While the above has provided some comfort to certain players in the industry, the ideal change would be to allow for such waivers for all AIFs if all investors of the AIF agree to such waiver. The liability of ICOM members in addition to that of the AIF manager should only be imposed when (i) members of the ICOM have the ultimate decision making authority with respect to the AIF; (ii) the control of the ICOM is different from the control of the AIF manager; and (iii) the investors are not deriving sufficient comfort from the governing documents of the AIF regarding the liability of the ICOM members (in which case, they could refuse the waiver).

In any case, SEBI should remove the requirement for ICOM members to ensure compliance of the AIF investments with fund documents and applicable law.

At present, for AIFs which do not fall under the criteria specified by SEBI as above, the liability of ICOM members is likely to be disproportionate to the function being carried out by them. In this issue of the monthly digest, we discuss some of these issues.

## REGULATION OF ICOMS

Notably, SEBI vide its notification dated October 19, 2020 (“October 19 Circular”) had statutorily provided for the constitution of an ICOM by the investment manager of the AIF (“AIF Manager”) for approving investment decisions. Interestingly, the October 19 Circular also provided that members of ICOM shall be held liable on a joint and several basis with the AIF Manager for the investment decisions of the AIF. Furthermore, an obligation was also cast on such members to ensure that investments are in compliance with the AIF Regulations, governing documents of the AIF and any other applicable law.

Accordingly, the scope of liability was effectively extended from the AIF Manager to the members of ICOM who play a role in investment decision-making pre-dominantly from a commercial perspective. In other words, several liabilities of the AIF Manager under the contractual documents, legal and regulatory compliances were extended to the members of the ICOM as well. We have extensively discussed the concerns arising thereon from the amendments in our hotline earlier, which can be accessed by clicking [here](#).

Prior to the amendments introduced in October last year the primary responsibility for investment decisions and compliance with applicable law including the governing documents of the AIF was vested with the AIF Manager. Traditionally, the employees/directors/partners of the AIF Manager and/or external members such as nominees of the Sponsor, employees of group companies of the sponsor/ AIF Manager, domain experts, etc. make up the ICOM. From a commercial stand point, such a diverse set of members helps ensure not only better investment and divestment decisions but also proper deal evaluation exercises. Generally, the governing documents of an AIF provide for indemnification of such ICOM members from any liability, unless it is established that the decisions were as a result of fraud, gross negligence or wilful misconduct.

## INTRODUCTION OF WAIVER MECHANISM

In the wake of such overreaching efforts by the SEBI to regulate the funds industry, the Amendment has been introduced to address the concerns of all stakeholders. Notably, the Amendment has provided for a partial relief from the collective responsibility of the AIF Manager and members of ICOM.

Vide the Amendment, such provisions now shall not be applicable to an AIF in which each investor other than the AIF Manager, sponsor, employees, or directors of the AIF or employees or directors of the AIF Manager, has committed to invest not less than INR 70 crore and has furnished a waiver to the AIF in respect of compliance with the said

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clauses, in the manner as specified by SEBI.<sup>3</sup>

This was enabled vide the insertion of second proviso to Regulation 20 (6) of the AIF Regulations in the manner as follows:

*Provided further that clauses (i) and (ii) shall not apply to an Alternative Investment Fund in which each investor other than the Manager, Sponsor, employees or directors of the Alternative Investment Fund or employees or directors of the Manager, has committed to invest not less than seventy crore rupees (or an equivalent amount in currency other than Indian rupee) and has furnished a waiver to the Alternative Investment Fund in respect of compliance with the said clauses, in the manner specified by the Board.*

#### **Stumble block in India's aspiration to be a global hub for fund management**

Such provisions do not synchronize well with India's aspirations to be a global hub for fund management especially when developed jurisdictions<sup>4</sup> cast such responsibility only upon the fund manager and not the members of the ICOM.<sup>5</sup>

The private equity industry seems to have achieved a fine balance in the governance of the AIFs between the investors and AIF Manager as relevant stakeholders. Since the inception of the AIF Regulations, regulation of AIF has remained light-touch and some sort of flexibility is provided to the AIF Manager and investors to decide the course of action. Rather than defining or imposing any sort of fiduciary responsibilities on individual members of ICOMs or LPAC (limited partner advisory committee), it has been the norm for such considerations to be driven by a commercial arrangement with appropriate disclosures and holding the AIF Manager fully responsible and accountable.

#### **Impact on government - sponsored AIFs**

The ripple effects of such amendments were felt more on the government-sponsored AIFs. Interestingly, the government has been using the AIFs to float sector-specific funds. Conventionally, the state-sponsored AIFs have senior bureaucrats and external experts on ICOMs.

The ICOMs for all such AIFs are actually appointed by the government to play a role in the decision making process limited to the approval of investment and divestments and as such are indemnified by the AIF Manager for any liability so arising therefrom unless it is clearly established that the decisions were as a result of fraud, gross negligence or misrepresentation.

In this regard, SEBI had received representations from Department of Economic Affairs, Ministry of Finance, Indian Private Equity & Venture Capital Association (IVCA) and Indian Association of Alternate Investment Funds (IAAIF) which stated that imputing legal responsibility, onerous compliance obligations and liability on members of ICOM would have the effect of dissuading individuals to accept a seat on the ICOM which would, *inter-alia*, dilute the overall governance structure of the AIF.<sup>6</sup>

The IAAIF requested SEBI to either cast the liability only on the AIF Manager irrespective of whether the AIF Manager has appointed an ICOM or not or limit the responsibility of the members of the ICOM to ensure (i) that investment decisions are in line with the investment strategy of the fund as provided in the placement memorandum and (ii) to act in good faith and with reasonable care while taking the investment related decisions. Not surprisingly, SEBI was of the view that such requests if accepted would have the effect of diluting the principle of accountability accompanying authority, for all AIFs.

#### **SEBI's segmented approach**

SEBI while responding to such concerns raised by the industry bodies, referred to its circular dated February 05, 2020 wherein it introduced a standard template for Private Placement Memorandum ("**PPM**") of AIFs and annual audit of compliance with the terms of the PPM. Notably, the said requirements of standard template for PPM and annual audit for compliance with terms of PPM were waived off for AIFs in which all the investors have substantial capital commitment i.e. INR 70 Crore (USD 10 Million or its equivalent) and provide a waiver to the AIF in the manner prescribed by SEBI.

SEBI while drawing an analogy from the said exemption noted that investors committing such substantial amounts of capital to an AIF have sufficient resources at their disposal to conduct an independent due diligence. As such, they can be considered as informed investors. Such large institutional investors typically negotiate various additional information rights which ensures that such investors are regularly informed of activities of the AIF including regular reporting on various matters.

Accordingly, SEBI adopted a segmented approach in the manner that AIFs in which every investor having a capital commitment of at least INR 70 Crore, provides a waiver to the AIF.

#### **SUMMARY REMARKS**

The act of SEBI striking a middle ground with regard to the joint liabilities of the members of the ICOM and the IF Manager should strike a positive chord amongst some of the AIF Managers, especially those with large institutional investors.

The Amendment seems to have been an attempt by SEBI to (i) encourage qualified consultants to be a part of ICOM thereby further improving the overall governance of the AIF without getting tangled in the compliances and liabilities; and (ii) safeguard the interests of the small and mid-size investors who might not have enough resources to conduct independent due diligence.

On the other hand, it has been a widely accepted industry practice to have the ICOM comprise of an external independent member, the primary purpose of such member being to solicit investors and play an impartial role in decision making processes. With the increase in scope and liability of the members of the ICOM, such independent members may get discouraged from offering their domain specific expertise leading to loss for both the AIF Manager and the investors. This may lead to the AIF Manager having to offer greater incentives to such external members to take up positions in the ICOM which would in turn affect the coffers of the AIF.

As proposed earlier, in the interest of maintaining the ever-so-popular conduciveness of the AIF Regulations, it would be ideal for SEBI to limit the statutory liability of ICOM members only for investment decisions (and not for ensuring compliance), and allow all AIFs to take a waiver from investors unanimously basis their reliance on the contractual

provisions in the AIF's governing documents placing appropriate liability on such ICOM members.

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You can direct your queries or comments to the authors

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<sup>1</sup> SEBI Board Meeting dated 16<sup>th</sup> December 2020, *available at* <https://www.sebi.gov.in/sebiweb/about/AboutAction.do?doBoardMeeting=yes>

<sup>2</sup> SEBI Circular dated January 08., 2021, *available at* [https://www.sebi.gov.in/legal/regulations/jan-2021/securities-and-exchange-board-of-india-alternative-investment-funds-amendment-regulations-2021\\_48708.html](https://www.sebi.gov.in/legal/regulations/jan-2021/securities-and-exchange-board-of-india-alternative-investment-funds-amendment-regulations-2021_48708.html)

<sup>3</sup> Format of Waiver, *available at* [https://www.sebi.gov.in/sebi\\_data/commondocs/jan-2021/Format of waiver to be provided by the investors\\_p.pdf](https://www.sebi.gov.in/sebi_data/commondocs/jan-2021/Format of waiver to be provided by the investors_p.pdf)

<sup>4</sup> Association of Luxembourg Fund Industry Code of Conduct, *available at* <https://www.alfi.lu/getattachment/e70bb682-4a0d-4fb5-9656-f8d921457054/alfi-alfi-code-of-conduct.pdf>.

<sup>5</sup> Circular CSFF 18/698, *available at* [https://www.cssf.lu/wp-content/uploads/files/Lois\\_reglements/Circulaires/Hors\\_blanchiment\\_terrorisme/cssf18\\_698eng.pdf](https://www.cssf.lu/wp-content/uploads/files/Lois_reglements/Circulaires/Hors_blanchiment_terrorisme/cssf18_698eng.pdf).

<sup>6</sup> Para 2.18, SEBI Board Meeting dated 16<sup>th</sup> December, 2020, *available at* <https://www.sebi.gov.in/sebiweb/about/AboutAction.do?doBoardMeeting=yes>.

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