

Investment Funds: Monthly Digest

May 06, 2021

2021 Q1 AMENDMENTS TO ALTERNATIVE INVESTMENT FUNDS FRAMEWORK

- SEBI approves the insertion of definition of 'start-up' and removal of the list of 'restricted activities or sectors from the definition of 'Venture Capital Undertaking'.
- AIFs, including Fund of AIFs, permitted to simultaneously invest in units of other AIFs and directly in securities of investee companies.
- AIF manager is required to ensure compliances with investment conditions, fund documents and applicable laws under all circumstances.
- SEBI rationalises regulatory reporting requirements and prescribes a code of conduct for key management personnel of AIF and its manager, including the members of the investment committee.

The Government of India, in recent past, has been proactive in bettering the Alternative Investment Fund ("AIF") regime in India. Apart from providing new avenues of investment, the Government has also proposed certain regulatory reforms to further safeguard the interests of the investors and bolster fundraising activities. In this regard, the Securities Exchange Board of India ("SEBI") in its board meeting dated March 25, 2021¹ ("Board Meeting") has proposed certain amendments to the SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations").

Treading on the footsteps of SEBI, the Insurance Regulatory and Development Authority of India ("IRDAI") vide a circular dated April 5, 2021² ("IRDAI Circular"), has also allowed insurance companies to diversify and expand their investment portfolio by investing in (i) AIFs which undertake leverage in accordance with the AIF Regulations and (b) Fund of Funds ("FoFs") subject to certain prescribed conditions, thus opening up opportunities for the AIF managers and its investors.

In addition to this, SEBI vide its circular dated April 7, 2021³ ("April Circular"), decided to review and rationalize the existing regulatory reporting requirements of AIFs, including changes in the reporting procedures.

In this issue of the monthly digest, we have undertaken a detailed analysis of the key changes introduced for the AIF industry by SEBI.

DEFINITION OF START-UP

Venture Capital Fund ("VCF"), under the AIF Regulations, is set up as a sub-category of a Category I AIF and includes an angel fund ("Angel Fund"). Even though the AIF Regulations allow Angel Funds to invest in 'Venture Capital Undertakings ("VCUs")' or 'start-ups', the AIF Regulations do not define the term 'start-up'. To further elaborate, under the extant AIF Regulations, Angel Funds have been permitted to invest in VCUs, which, *inter alia*, comply with the criteria regarding the age of the VCU / start-up issued by the Department for Promotion of Industry and Internal Trade ("DPIIT"). vide Notification dated February 17, 2016 ("DPIIT Notification"), or such other policy made in this regard.

DPIIT Notification states that an entity shall be considered to be a start-up when, *inter alia*, it has not been formed by splitting up or reconstruction of an existing business and has not exceeded 10 years or an annual turnover of INR 100 crores since its incorporation. In view of the said, SEBI's proposal to define 'start-up' in the AIF Regulations should eliminate any uncertainty around the scope of the term and help bringing it in parity with the said term as defined by other regulators. In other words, such a measure should ensure that the definition of 'start-up' is harmonised with the definition provided by the DPIIT's notification dated February 19, 2019⁴.

REMOVAL OF RESTRICTED ACTIVITIES

SEBI has also proposed to remove the list of the restricted activities from the definition of VCU provided under Regulation 2(1)(aa) of the AIF Regulations. Under the extant framework, Non-Banking Financial Companies ("NBFC") and the companies engaged in gold financing companies, *inter alia*, are not covered within the ambit of VCUs. Therefore, this amendment should not only boost investments in the start-up space but also make Category I AIFs all the more lucrative for managers and investors.

Further, this should grant flexibility to VCFs to make investments in fin-tech companies in India which are mostly established as NBFCs and have business models which require substantial capital investment, often compelling them to rely on private equity and venture capital players. Thus, VCFs might turn out to be a potential source of capital for such NBFCs and assist them in creating institutional frameworks of governance and transparency, scaling up, etc.

SIMULTANEOUS INVESTMENT IN OTHER AIFs

The AIF Regulations permit a fund of Category I AIFs to invest in units of other Category I AIFs of same sub-category,

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and fund of Category II AIFs to invest in the units of other Category I as well as Category II AIFs, provided that in each case, no investment shall be made in the units of other FoFs.

SEBI has now proposed to permit AIFs, including FoFs, to simultaneously invest in units of other AIFs as well as directly in securities of investee companies, subject to certain prescribed conditions. The said proposal should result in diversifying and expanding investments made by AIFs, including FoFs, while enhancing risk management and providing higher returns.

Further, SEBI has also proposed to allow an AIF to invest in units of AIFs managed/ sponsored by the same AIF manager/ sponsor subject to the prior approval of at least 75% of the investors by the value of their investment in such AIF. Such a proposal should prove beneficial for the large fund houses with multiples AIFs under their umbrella since this should allow them to alleviate market risk and reallocate capital basis the prevailing market conditions.

SCOPE OF RESPONSIBILITIES AND CODE OF CONDUCT

In addition to the aforementioned amendments, SEBI in the Board Meeting has also intended to provide further clarity on the responsibilities of the AIF manager and the members of the investment committee. It further sought to prescribe a Code of Conduct for AIFs, trustee, directors of the trustee/designated partners/directors of the AIF, manager, members of the investment committee and key management personnel of the AIFs and their managers. These measures should result in increased investor protection by ensuring transparency and accountability of the concerned personnel.

Presently, the members of the investment committee by the virtue of Regulation 20 (6) are (i) equally responsible as the AIF manager for investment decisions of the AIF; and (ii) jointly and severally responsible for ensuring that such investments are in compliance with the fund documents, AIF Regulations and other applicable law. SEBI has now proposed to cast the responsibility to ensure compliances with the AIF Regulations, terms of the PPM, other fund documents, and all applicable laws on the AIF manager. In this regard, SEBI has proposed that the AIF shall have a detailed policy and procedure jointly approved by the AIF manager and the trustee /board of directors / designated partners of the AIF, as the case may be, and shall ensure that every decision of the AIF is in compliance with such policies and procedures as well as other internal policies of the AIF as applicable. Nevertheless, the members of the investment committee should be required to ensure that the decisions of the investment committee are in accordance with such policy framed by the AIF, provided that such obligation do not apply to the investment committee of 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 at least INR 70 crores and has furnished a waiver to the AIF in respect of such compliance.

The members of the investment committee might also be required to carry out appropriate due diligence while taking decisions, disclose conflicts of interest to the AIF manager as and when they arise in respect of the decisions taken by them, act in good faith and without any fraudulent intent. With such amendments, SEBI has seemed to strike a balance between the accountability of such members and global regulatory standards for private funds. With the members of the ICOM not being generally involved in the day-to-day activities of functioning of the fund, the proposed amendments should provide them the much needed flexibility, from compliance as well as internal controls perspective.

IRDAI'S RELAXATION FOR INSURANCE COMPANIES

In an effort to incentivize a plethora of Indian start-ups who are looking for alternative sources of investment, the IRDAI Circular has allowed the insurance companies to invest into AIFs which undertake leverage or borrowing to meet their day-to-day operational requirements in accordance with the AIF Regulations, and FoFs, provided that these FoFs invest within India. The IRDAI Circular modifies the Master Circular released in 2017⁵, which restricted the insurance companies to invest in AIFs which were FoFs and leverage funds. Furthermore, the IRDAI Circular does not permit the insurance companies to invest in an AIF which in turn has exposure to an FoF in which such company has already made investments.

REPORTING REQUIREMENTS

Subsequent to consultation with various stakeholders and considering the recommendations of the Alternative Investment Policy Advisory Committee, SEBI vide the April Circular, has decided to streamline the stringent reporting requirements applicable to an AIF. All the AIFs are required to submit the reports on their activity to SEBI on a quarterly basis, within 10 calendar days from the end of each quarter, provided that Category III AIFs shall submit their reports on leverage undertaken, on a quarterly basis. Moreover, the April Circular also requires that any changes made to the PPM or any other fund document shall be intimated to the investor and SEBI in a consolidated format, within a month from the end of each financial year (in lieu of previously stipulated half-yearly basis). Such moderations should definitely help the AIF managers to be remain in compliance with the applicable laws without diluting the investor protection objective of SEBI.

CONCLUSION

SEBI's amendments and proposals, along with IRDAI's reforms, reflect the efforts undertaken by the financial regulators to not only provide flexibility to the AIF managers in running their fund operations effectively but at the same time ensure that their fiduciary obligations towards the investors are not compromised with. Further, these efforts should play a key role in the growth of start-ups in India by expanding the available pool of capital for these entities as well as catalyse the formation of new Category I AIFs. SEBI's proposal to clarify the scope and responsibilities of the AIF manager and members of the investment committee, particularly are noteworthy and should be able to provide requisite operational flexibility to the AIF and the members of the investment committee. Furthermore, with the April Circular, SEBI has aimed to provide an ease to the AIF managers with respect to the AIF related compliances. The said amendments and proposals should help the AIF managers in their fund formation and management activities as well as provide an impetus to the diversified investments an AIF may want to make.

– Prakhar Dua & Dibya Behera

You can direct your queries or comments to the authors

¹ SEBI Press Release dated March 25, 2021, available at https://www.sebi.gov.in/media/press-releases/mar-2021/sebi-board-meeting_49648.html.

² IRDAI Circular dated April 8, 2021, available at https://www.irdai.gov.in/ADMINCMS/cms/whatsNew_Layout.aspx?page=PageNo4441&flag=1.

³ SEBI Circular on Regulatory Reporting by AIFs, *available at* https://www.sebi.gov.in/legal/circulars/apr-2021/circular-on-regulatory-reporting-by-aifs_49788.html.

⁴ Department for Promotion of Industry and Internal Trade Notification dated February 19, 2019, *available at* <https://www.startupindia.gov.in/content/dam/invest-india/Templates/public/198117.pdf>.

⁵ IRDAI Master Circular, available at [http://www.dhc.co.in/uploadedfile/1/2/-1/IRDAI%20-%20INVESTMENTS%20-%20MASTER%20CIRCULAR%20-IRDAI%20\(INVESTMENT\)%20REGULATIONS,%202016.pdf](http://www.dhc.co.in/uploadedfile/1/2/-1/IRDAI%20-%20INVESTMENTS%20-%20MASTER%20CIRCULAR%20-IRDAI%20(INVESTMENT)%20REGULATIONS,%202016.pdf).

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