

## Funds Hotline

June 25, 2014

### SEBI REVISES OPERATIONAL FRAMEWORK FOR ALTERNATIVE INVESTMENT FUNDS

- SEBI issues consolidated circular providing guidelines on disclosures, reporting and clarifications under AIF Regulations. Disclosure norms vastly strengthened.
- Tabulated examples of the distribution waterfall terms and charges to be borne by a fund have to be mandatorily included.
- Changes to the placement memorandum need to be notified to all investors and the regulator. 'Key Changes' may trigger the fund to afford exit opportunities to the investors.

Following closely on the footsteps of the recent observations<sup>1</sup> by U.S. Securities and Exchange Commission (SEC) that there are several disconnects between "what [general partners] think their [limited partners] know and what LPs actually know", the Indian Securities Exchange Board of India ("SEBI") has issued a circular<sup>2</sup> ("Circular") that consolidates guidelines on disclosures and reporting that alternative investment funds ("AIFs") have to make. The Circular also provides certain clarifications on the interpretation of the provisions of the AIF Regulations.

The SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations") were notified on May 21, 2012. Subject to certain exceptions, the ambit of the AIF Regulations is to regulate all forms of vehicles set up in India for pooling of funds on a private placement basis. To that extent, the AIF Regulations provide the bulwark within which the privately pooled discretionary fund management industry operates in India.

The Circular inter alia requires detailed tabular example of how fee and other charges are calculated and how the distribution waterfall is structured. The Circular also provides specifics on how certain identified key-man events are to be handled. This hotline summarises these and other important aspects of the Circular.

#### DISCLOSURE ON FEE AND DISTRIBUTIONS IN THE PLACEMENT MEMORANDUM

The Circular observes that the fee structure applicable to investors in an AIF is generally complex in nature.<sup>3</sup> It is not uncommon for investors to negotiate a preferential fee arrangement with fund managers. Similarly, fund managers have evolved a number of variations to differentiate product offerings and to improve investor friendliness. In view of these variations and to facilitate better understanding among investors, SEBI has directed fund managers to add by way of an annexure to the placement memorandum, a detailed tabular example of (1) how the fees and charges shall be applicable to the investor and (2) the distribution waterfall.<sup>4</sup>

This change is critical for fund managers to note. Such disclosure reduces the space for 'views' being taken by a fund manager in a given liquidity event leading to distribution. This also requires that the fund manager engages more closely with the fund counsel to articulate the waterfall in a manner that they can actually implement with a degree of automation. Any deviance from the waterfall as illustrated in the fund documents could potentially be taken up against the fund manager.

#### DISCLOSURE ON DISCIPLINARY HISTORY

Regulation 11(2) of the AIF Regulations requires an AIF to include disciplinary actions in its placement memorandum. The Circular provides that AIFs should include (1) a disciplinary history of the AIF, sponsor, manager and their directors, partners, promoters and associates<sup>5</sup> and (2) a disciplinary history of the trustees or the trustee company and its directors if the applicant for AIF registration is a trust. Further, the Circular provides guidance on what should be covered under 'disciplinary history'. Disciplinary history inter alia includes details of outstanding / pending and past cases (where the person has been found guilty), criminal or civil prosecution, non-payment of statutory dues, overdues to / defaults against banks or financial institutions, adverse findings with respect to compliance with securities laws, disputed tax liabilities, etc. as well as any disciplinary action taken by SEBI or any other regulatory authority.<sup>6</sup>

#### DISCLOSURE OF CHANGES TO THE PLACEMENT MEMORANDUM

The Circular provides that any changes made to the placement memorandum submitted to SEBI at the time of the application for registration as an AIF must be listed clearly in the covering letter submitted to SEBI and further, such changes must be highlighted in the copy of the final placement memorandum.<sup>7</sup> The Circular provides that any change to the placement memorandum not only needs to be highlighted and brought to the notice of all unit holders within 7 days of making such change but also that such changes must be intimated to SEBI.<sup>8</sup>

However, in case the change to the placement memorandum is a case of a 'material change' (factors that SEBI believes to be a change significantly influencing the decision of the investor to continue to be invested in the AIF), said to arise in the event of (1) change in sponsor / manager, (2) change in control of sponsor / manager, (3) change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders), existing unit holders

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who do not wish to continue post the change shall be provided with an exit option and the unit holders will be provided not less than one month for indicating their dissent.<sup>9</sup> The Circular also lays down the exit options that need to be provided in the case of an open-ended<sup>10</sup> fund and a close-ended<sup>11</sup> fund and provides that the process of providing exit to dissenting investors should be completed within 3 months from the date of expiry of the last date of offer for dissent.

#### REPORTING LEVERAGE

On July 29, 2013, SEBI issued a circular specifying the extent to which leverage can be employed by Category III AIFs and also prescribing a formula for computing leverage. SEBI had also indicated that those Category III AIFs which employ leverage are required to report the amount of leverage to the custodian on a daily basis. SEBI has now formally taken cognizance of the fact that the calculation of leverage by a Category III AIF requires information from various parties who provide such information at varied time periods which has consequently made it difficult for Category III AIFs to report the amount of end-of-day leverage to the custodian on the same day.<sup>12</sup> Accordingly, the Circular now provides that Category III AIFs shall report the amount of end-of-day leverage to the custodian by the end of the next working day.<sup>13</sup>

#### REQUIREMENT OF MAINTAINING MINIMUM CORPUS

Regulation 10(b) of the AIF Regulations provides that each scheme of an AIF should have a corpus of at least INR 20 crores (approx. USD 3.3 million) ("**Minimum Corpus**"). Further, Regulation 2(1)(h) of the AIF Regulation defines "corpus" as the total amount of funds committed by investors to the AIF by way of a written contract or any such document as on a particular date. An AIF cannot commence operations until it has secured the Minimum Corpus. SEBI now proposes to extend regulatory oversight to a post-commencement scenario where an open-ended scheme (post redemption(s) by investors or exits) is not able to sustain the Minimum Corpus. The Circular provides that where the corpus of an open-ended scheme falls below the Minimum Corpus, the AIF shall intimate SEBI within 2 days of receiving request of redemption from the client. Further, the fund manager is given a period of 3 months to restore the Minimum Corpus, failing which, all the interests of the investors will need to be mandatorily redeemed. The Circular also provides that SEBI may take appropriate action where the Minimum Corpus is breached repeatedly.

#### REDEMPTION RESTRICTIONS

Regulation 10(c) of the AIF Regulations provides that an AIF shall not accept an investment of value less than 1 crore (approx. USD 166,667) ("**Minimum Investment Amount**"). The Circular specifically clarifies that (1) in the case of an AIF which is open-ended, the first single lump-sum investment amount received from an investor should not be less than the Minimum Investment Amount and (2) in case of requests for partial redemption of units by an investor in an open-ended AIF, the amount of investment retained by an investor in the AIF should not fall below the Minimum Investment Amount. In other words, an investor cannot redeem its investment in such funds such that their allocation reduces below the Minimum Investment Amount and instead, an investor will need to make a request for full and complete redemption of its investment in the fund.

#### CONCLUSION

A manager to an alternative investment fund must now contend with greater oversight and accountability to both the regulator and the investors. While bespoke terms are designed to maintain investor friendliness, sight must not be lost on the disclosure norms that are now statutorily mandated. Given the recent observations by regulators in sophisticated jurisdictions, the Circular seems to be in line with where the discretionary management industry is expected to be, from a disclosure to investor perspective.

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You can direct your queries or comments to the authors

<sup>1</sup> On May 6, 2014, Andrew Bowden, Director of the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE), stated that the OCIE has found widespread instances of insufficiently disclosed fees in the private equity industry. Also see <http://blogs.wsj.com/privateequity/2014/06/10/sec-official-points-to-disclosure-shortcomings-by-private-equity-firms/>

<sup>2</sup> CIR/IMD/DF/14/2014

<sup>3</sup> See paragraph 2(a)(i) of the Circular.

<sup>4</sup> *Ibid.*

<sup>5</sup> See Regulation 2(1)(c) of the AIF Regulations.

<sup>6</sup> See paragraphs 2(a)(iii)(1) and (2) of the Circular.

<sup>7</sup> See paragraph 2(b)(i) of the Circular.

<sup>8</sup> See paragraph 2(b)(iii) of the Circular.

<sup>9</sup> See paragraph 2(b)(iv)(a) of the Circular.

<sup>10</sup> See paragraph 2(b)(iv)(b) of the Circular.

<sup>11</sup> See paragraph 2(b)(iv)(c) of the Circular.

<sup>12</sup> See paragraph 1(b) of the Circular.

<sup>13</sup> See paragraph 1(c) of the Circular.

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