



## ERGO

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### AMENDMENT TO THE AIF REGULATIONS: STRENGTHENING GOVERNANCE OF AIFS

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The Securities and Exchange Board of India (SEBI) *vide* the SEBI (Alternative Investment Funds) (Amendment) Regulations 2020 (Amendment Regulations), which were notified on 19 October 2020, have amended the SEBI (Alternative Investment Funds) Regulations 2012 (AIF Regulations) to clarify the position with respect to: (I) conditions to be met by the key investment team of the Manager of the Alternative Investment Fund (AIF), and (II) composition and responsibility of the body taking the investment decisions of the AIF other than the Manager (referred to as the Investment Committee or otherwise). The Amendment Regulations do, to some extent, clear the air around the subjectivity with which these issues were being dealt with by SEBI until now on a case by case basis. However, it also appears to raise some concerns, amongst alternate asset manager, around the increasingly prescriptive nature that the AIF Regulations are taking.

In furtherance of the Amendment Regulations, SEBI has also issued a [follow-up circular](#) dated 22 October 2020 ("Clarification Circulation"), on the concerns around the India owned and controlled nature of an AIF, as it stands under the Foreign Exchange Management (Non-debt Instruments) Rules 2019, in cases where the investment decisions are undertaken by external members who are not resident Indian citizens. SEBI informed the stakeholders under the Clarification Circular that it has written to the relevant authorities, *viz*, the Government of India and the Reserve Bank of India, seeking clarity on the position of law. Pending response from the authorities, applications for registration of an AIF, where the Investment Committee consisting of external members who are not resident Indian citizens are taking investment decisions, would not be processed. While it is hoped that the clarification will be released soon, applications already filed and pending with SEBI may face further delay till a firm view has been formed around the matter.

#### **Eligibility conditions of the Key Investment Team - Err on the side of caution!**

Before the Amendment Regulations, the AIF Regulations required that at least 1 (one) key personnel should have a minimum experience of 5 (five) years in advising or managing pools of capital or in fund or asset or wealth or portfolio management or in the business of buying, selling and dealing of securities or other financial assets. However, in addition to the requirement of having the adequate working experience, the regulator has also been cognizant of the educational qualification of the members of the key investment team of the Manager and took into consideration the degrees / diplomas held by such members during the review of application of an AIF. Due to the absence of any specific provision or guidelines laying down the broad educational qualifications that the key investment team of the Manager should possess, the

applications for registration of AIFs with SEBI were being considered on a case-to-case basis. With the Amendment Regulations, the subjectivity around what constitutes adequate educational qualifications for the key investment team of the Manager has been done away with and in addition to the experience of 5 (five) years in the relevant field, at least 1 (one) key personnel of the investment team should have a professional qualification in finance, accountancy, business management, commerce, economics, capital markets or banking from a university or an institute recognised by the Central Government or any State Government or a foreign university, or a CFA charter from the CFA institute or any other qualification as may be specified by SEBI.

### **Comment**

The Amendment Regulations clarifying the educational qualification that at least 1 (one) key personnel of the investment team of the Manager is required to possess, has codified what SEBI has been keeping an eye out for since close to a year. The Amendment Regulations identifies the subjects in which a key personnel should be well-versed. The professional qualification prescribed for an AIF Manager appear to be broader than the qualifications prescribed for the principal officer of a Portfolio Manager, which does not include commerce, economics capital markets or banking. Further, under the Amendment Regulations, SEBI left room for specifying such other qualifications as being eligible for this purpose with the plausible intention to ensure that an otherwise eligible and worthy Manager is not declared to be ineligible due to the absence of a degree or diploma. It has also been spelt out in the Amendment Regulations, for abundant clarity, that the key personnel with the adequate experience and professional qualification need not be mutually exclusive and could be fulfilled by the same person.

SEBI's attempt to prescribe the minimum experience requirement as well as the professional qualifications for the key investment team of the Manager of an AIF is in-line with the overall endeavour of the regulator to lay down the eligibility criteria for the fiduciaries unambiguously and at par with global practices.

However, we would urge SEBI to also exercise reasonable discretion in applying this test of 'professional qualification' so as avoid creating any additional hurdle or unfair disqualification for deserving applicants. For example, would a Bachelor of Arts (B.A) / Master of Arts (M.A) in Economics qualify as a '*professional qualification*' or not? Similarly, whether a post graduate diploma in business administration (popularly referred to as PGDBA) would qualify as a professional qualification? Some of these questions will need to be dealt with by SEBI with a degree of sensitivity and discretion since it has spelt out the eligibility conditions under the Amendment Regulations.

### **Investment Decisions by an Investment Committee - Heavy is the head that wears the crown!**

The second set of clarifications under the Amendment Regulations pertain to the investment decisions of AIFs. The Amendment Regulations have clarified that while the Manager of an AIF is permitted to assign its power of making the final investment decision to an Investment Committee (by whatever name it may be called), such Investment Committee would be held on the same pedestal as the Investment Manager and will be equally responsible as Manager for the investment decisions of the AIF. The fiduciary duty, which was cast on the Manager, has now been extended to the members of the Investment Manager, who shall be jointly or severally held responsible for ensuring that the investments of the AIF are in compliance with the provisions of the AIF Regulations, the terms of the placement memorandum, agreements with the investors and other fund documents and applicable laws. Further, while external members are permitted to be a part of the Investment Committee, to ensure transparency, the names of such external members have to be disclosed upfront in the placement memorandum or agreements with the investors or in other fund documents at the time of admission of the investors in the AIF. In the event the names are not

disclosed, due to subsequent appointment of such members of the Investment Committee or otherwise, the Manager will be required to obtain the consent of at least 75% (seventy five per cent) of the investors by value of their investment in the AIF or the relevant scheme to on-board an external member as part of the decision making Investment Committee.

#### **Comment**

The investment decision making process has been a point of concern for SEBI for some time now and has been brought up for discussion by the Investment Management Department of SEBI on several instances where the investment and divestment decision was being made by a committee or a body consisting of members other than employees or directors or partners of the Investment Manager. Given the significance of the process of making investment decisions, clarity in the form of amendment to the AIF Regulations has, to say the least, afforded certitude to the operations of the AIF.

As per the Amendment Regulations, while the Manager of an AIF now has the discretion to formulate an Investment Committee, consisting of either internal or external members, and equip such committee with the powers to take investment decisions, SEBI expects such committees to take on the same level of responsibility and accountability with respect to the investment decisions as the Manager. The Amendment Regulations also vest the Investment Committee with the responsibility of ensuring that the investments by the AIF comply with the thresholds and other investment conditions specified under the AIF Regulations as well as the investment guidelines or objectives laid down under the placement memorandum.

Fundamentally, Investment Committee positions are sought by investors so to have a say in the investment decision making process in order to protect the investor's own interest and is typically offered to investors who are either strategically important or have a significant capital at risk in the Fund. Imposing a wider fiduciary responsibility and liability upon the individual members, who are appointed to protect an investor's own interest and not necessarily that of every other investor in the Fund, could potentially discourage investors from taking up such positions. This could take away ability of the investors to participate in the investment decision making and could potentially pose a significant challenge for some of the large institutional investors (including Fund of funds, Pension Funds, Endowments, etc.), who, as a fiduciary themselves, are obligated to actively participate in investment decision making when they invest in a pooling vehicle like an AIF, but would otherwise not be willing to assume the attendant fiduciary liability for other investors in the AIF. Putting the onus upon an investors' nominees to adequately protect the interest of other investors may prove to be potentially counter intuitive to the very purpose of seeking this position on the Investment Committee, besides creating fiduciary liability for the member.

Further, an Investment Committee is typically mandated for a limited role of approving or disapproving a deal which has been identified, diligenced and presented by the investment team of the Investment Manager to the Investment Committee. For this relatively limited, albeit important role, as compared to the broader fiduciary role of an Investment Manager, putting them on the same pedestal as the Investment Manager and casting upon the individual members the same level of fiduciary duty and liability as that of an Investment Manager of an AIF, including the duty to ensure compliance with law, AIF Regulations, fund documents and agreements with investors, as currently proposed, can be seen as a degree of overreach by the regulation leading to disproportionality of liability.

Further, it is to be noted that despite the flexibility granted to the Manager to formulate a committee and delegate its investment decision making powers to such committee, SEBI expects complete transparency in the composition of the Investment Committee. In a bid to ensure such transparency, SEBI has directed that in the event external members whose names are not disclosed in the placement memorandum upfront, are

inducted as members of the committee taking the investment decisions, consent of 75% (seventy five per cent) of the investors by value is required to be obtained. Therefore, the members to such committees or bodies who are representative of investors and whose names could not be disclosed under the placement memorandum upfront, would be subject to the approval of super-majority of the investors, nullifying the right of an investor to unilaterally appoint a member to such committee or body.

- *Siddharth Shah (Partner), Divaspati Singh (Partner) and Khusboo Agarwal (Associate)*

For any queries please contact: [editors@khaitanco.com](mailto:editors@khaitanco.com)

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**Mumbai**

One Indiabulls Centre, 13<sup>th</sup> Floor  
Tower 1 841, Senapati Bapat Marg  
Mumbai 400 013, India

T: +91 22 6636 5000  
E: [mumbai@khaitanco.com](mailto:mumbai@khaitanco.com)

**New Delhi**

Ashoka Estate, 12th Floor  
24 Barakhamba Road  
New Delhi 110 001, India

T: +91 11 4151 5454  
E: [delhi@khaitanco.com](mailto:delhi@khaitanco.com)

**Bengaluru**

Simal, 2nd Floor  
7/1, Ulsoor Road  
Bengaluru 560 042, India

T: +91 80 4339 7000  
E: [bengaluru@khaitanco.com](mailto:bengaluru@khaitanco.com)

**Kolkata**

Emerald House  
1 B Old Post Office Street  
Kolkata 700 001, India

T: +91 33 2248 7000  
E: [kolkata@khaitanco.com](mailto:kolkata@khaitanco.com)