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SIGNIFICANT CHANGES TO THE AIF REGULATIONS: SLOW, BUT STEADY MOVE TOWARDS A NEW REGIME

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The Securities and Exchange Board of India (SEBI) has been making consistent efforts to update and reconstruct the alternate investment space. Pursuant to the SEBI's Consultation Paper on '*Introduction of the Concept of Accredited Investors*' (February Consultation Paper) published on 24 February 2021, the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (AIF Regulations) were amended on 3 August 2021 *vide* the Securities and Exchange Board of India (Alternative Investment Funds) (Third Amendment) Regulations, 2021 (Third Amendment), which primarily introduced the concept of 'Accredited Investors' and granted certain relaxations for Alternative Investment Funds (AIFs) with Accredited Investors.

Further, in line with SEBI's vision to streamline the registration process and investments by AIFs, SEBI *vide* the Securities and Exchange Board of India (Alternative Investment Funds) (Fourth Amendment) Regulations, 2021 (Fourth Amendment) dated 13 August 2021, further amended the AIF Regulations to give effect to the modifications approved during SEBI's Board Meeting dated 6 August 2021. The key changes across both these amendments are highlighted as follows:

1. Introduction of the concept of 'Accredited Investor'

The Third Amendment, consistent with the recommendations under the February Consultation Paper, has introduced the concept of "*Accredited Investors*":

(a) Who is an Accredited Investor?

The Third Amendment inserted the definition of "Accredited Investors" to the AIF Regulations, which means any person who is granted a certificate of accreditation by an Accreditation Agency, subject to meeting the financial parameters prescribed. In addition to the investors who are eligible for accreditation by meeting the prescribed thresholds, the Third Amendment also provides a list of persons who shall be deemed to be Accredited Investors, without requiring such investors to go through the accreditation process.

Comment: Unlike the definition of 'Accredited Investors' under the Portfolio Managers regime, the Third Amendment lays down objective criteria to be met for an investor to qualify as an 'Accredited Investor' and to avail the benefits / relaxations granted to such Accredited Investors. The rationale behind the introduction of the concept, as highlighted under the February Consultation Paper, is to recognise the class of investors who are well-versed with the risks of investments and have the knowledge as well as financial capacity to undertake the risk.

(b) Who will certify an Accredited Investor?

An "Accreditation Agency" will grant certificates of accreditation to the investors who are eligible as Accredited Investors. "Accreditation Agency" has been defined to mean a subsidiary of a recognized stock exchange / a subsidiary of a depository / any other entity as may be specified by SEBI from time to time.

Comment: While the framework and process for granting accreditation, including the process for applications, timelines and duration of validity of the accreditation, is yet to be put in place, the industry is hopeful that Accreditation Agencies will exercise flexibility in accrediting overseas investors and entities receiving foreign capital.

(c) What requirements must potential Accredited Investors fulfil?

As mentioned earlier, the Third Amendment categorises Accredited Investors into 2 (two) categories: (i) investors who meet the specified eligibility criteria and are granted certificates of accreditation by an Accreditation Agency; and (ii) deemed Accredited Investors.

The annual income / net worth thresholds which are to be met by entities to apply for accreditation are:

- (I) Individual, Hindu Undivided Family, family trust or sole proprietorship:
 - (A) annual income of at least INR 2,00,00,000 (Indian Rupees Two crores); or
 - (B) net worth of at least INR 7,50,00,000 (Indian Rupees Seven crores and Fifty lakhs), out of which not less than half (i.e., INR 3,75,00,000 (Indian Rupees Three crores and Seventy Five lakhs)) is in the form of financial assets; or
 - (C) annual income of at least INR 1,00,00,000 (Indian Rupees One crore) and minimum net worth of INR 5,00,00,000 (Indian Rupees Five crores), out of which not less than half (i.e., INR 2,50,00,000 (Indian Rupees Two crores and Fifty lakhs)) is in the form of financial assets;
- (ii) body corporate is a net worth of at least INR 50,00,00,000 (Indian Rupees Fifty crores);
- (iii) trust (other than family trust) is a net worth of at least INR 50,00,00,000 (Indian Rupees Fifty crores); and
- (IV) partnership firm (incorporated under the Indian Partnership Act, 1932, each partner must independently meet the applicable eligibility criteria (detailed above) for accreditation, depending on their form.

Deemed Accredited Investors: Further, government, developmental or fund entities of the Centre and State, qualified institutional buyers under the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, Category I foreign portfolio investors, sovereign wealth funds and multilateral agencies, and other entities notified by the SEBI shall be deemed to be Accredited Investors, with no requirement to obtain a certificate of accreditation.

Comment: While the February Consultation Paper referred to a distinct set of thresholds for non-resident Indians (NRIs) and foreign entities, the Third Amendment does not differentiate between the criteria for resident Indian and NRIs / foreign entities. It is to be seen how the Accreditation Agencies apply the eligibility conditions laid down to entities / persons outside India.

(d) Relaxation in minimum investment value

The AIF Regulations have been amended to grant a relaxation to Accredited Investors from investing a minimum quantum of INR 1,00,00,000 (Indian Rupees One crore), a change that shall be well-received.

Comment: In line with the idea that Accredited Investors are sophisticated investors who require lesser regulatory protection, the minimum investment threshold applicable for investing in AIFs has been done away with for such Accredited Investors, thus allowing them greater flexibility to structure their investments.

2. Large Value Fund for Accredited Investors

To identify AIFs consisting of Accredited Investors only, the Third Amendment has also introduced the concept of "Large Value Fund for Accredited Investors", which is an AIF / scheme of an AIF in which each investor (other than service providers / employees of the AIF and investment manager) is an Accredited Investor and invests not less than INR 70,00,00,000 (Indian Rupees Seventy crores).

The following relaxations in respect of Large Value Fund for Accredited Investors, have been granted:

- (a) The AIF Regulations relating to filing of placement memorandum with SEBI at least 30 (thirty) days prior to launch of a scheme, and incorporation of SEBI's comments in placement memorandum prior to launch of scheme, will not apply to Large Value Fund for Accredited Investors.

Comment: This indicates that while the SEBI may continue to undertake the review and diligence of an AIF being set-up, in the event the first scheme of an AIF is a Large Value Fund for Accredited Investors, it may not examine the private placement memorandum (PPMs) of such Large Value Fund for Accredited Investors.

- (b) Large Value Funds for Accredited Investors are permitted to extend their tenure beyond 2 (two) years, subject to terms of the contribution agreement, other fund documents and such conditions as may be specified by SEBI from time to time.

Comment: The relaxation is based on the assumption that the Accredited Investors have the required knowledge, advice and bargaining power to negotiate the terms of investment and accordingly, need not be bound by pre-decided tenure.

- (c) Large Value Funds for Accredited Investors of Category I and II AIFs are permitted to invest up to 50% (fifty per cent) of the investable funds (as opposed to 25% (twenty five per cent)) in an investee company directly or through investment in the units of other Alternative Investment Funds. Similarly, Large Value Funds for Accredited Investors of Category III AIFs are permitted to invest up to 25% (twenty five per cent) of the investable funds (as opposed to 10% (ten per cent)) in an investee company directly or through investment in units of other AIFs.

Comment: The diversification requirement restricts the flexibility of AIFs formed for specific investment opportunities and platform funds wherein the big-check investors come together with the Manager group to invest in pre-identified assets. Relaxation to the diversification requirement should go a long way in allowing investors as well as the Managers the required room to structure larger, specific investments.

Comment: The concept of 'Accredited Investors' has been prevalent in various other developing and developed jurisdictions, and introduction of the same in India is a step forward in the right direction. Pertinently, the idea of Accredited Investors was floated when the AIF Regulations were formulated. The rationale behind such accredited / qualified / professional investors (as variably described across jurisdictions) is that these investors have the required market knowledge / advice and a high-risk bearing capacity to take informed decisions. Therefore, entities providing financial products and services to this class of investors would be eligible to a "regulation-light" space, i.e., a lower standard of regulatory prescription from the regulators in terms of funds raising capital from such investors.

The changes prescribed by the Third Amendment, particularly for Large Value Fund for Accredited Investors, has immense potential to afford flexibility to platform structures and funds which are raising capital from Ultra High-Net-Worth Individuals (UHNI) / large ticket investors. Considering that many of these investors may be funds themselves, it will be interesting to see how these thresholds are applied and calculated for funds, and whether the 'commitment' from investors can be taken into consideration for determining their accreditation status, or the asset base.

3. Merchant banker's role

The PPMs that accompany the application for the launch of a scheme of AIF shall now have to be filed with SEBI through a merchant banker. Further, the AIF Regulations now provide that SEBI shall communicate the required changes/ comments to the PPMs to such merchant banker, and it will be the merchant banker's responsibility to ensure that these changes are made before the launch of the Scheme.

This modification would come into effect from the 91st day from the date of publication of the Fourth Amendment, i.e., from 14 November 2021.

Comment: The recommendation to route PPMs for applications to launch a scheme of an AIF through merchant bankers may seem counter-intuitive at first since it may potentially increase the cost and time taken to set up a new fund, among other considerations. The recommendations seem to equate products meant for High Net-worth Individuals (HNIs) (with a minimum investment bracket) to a general listing of a company. Further, there could be learning curve for the players of the merchant banking industry as well, who are not typically exposed to or acquainted with such fund structures but may pump synergy into the AIF industry.

4. Revision to definitions

- (a) The Fourth Amendment has revised the definition of "debt funds" to include securitized debt instruments.

Comment: The expansion in the definition of 'debt funds' to include securitised debt instruments, has provided the required clarity by the industry for investment by AIFs in instruments such as asset backed / mortgage-backed securities.

- (b) The definition of "investable funds" has been revised to clarify that net of expenditure for administration and management of the fund is to be estimated for the entire tenure of the fund. Further, the Fourth Amendment has also clarified that "tenure" refers to "the duration of scheme from the day of its launch till last day of the term as specified in the fund documents".

Comment: This clarification may materially impact the deployable corpus available to an AIF. Prior to this clarification, Managers would typically consider only the expenditures which would be borne from capital contributions while calculating "investable funds" of an AIF, and exclude the expenditures borne out of the income of the fund. This is especially important for credit funds, infrastructure funds and other funds which usually start earning income (in the form of interests or otherwise) from an early stage during the life cycle of the fund, and typically do not account for the expenditures which are taken care of from the income for the calculation of investible funds.

- (c) The definition of "units" now includes "fully or partly paid up" units, wherein "partly paid-up units" means "the portion of committed capital invested by the investor in Alternative Investment Fund or scheme of the Alternative Investment Fund".

Comment: While several AIFs have been issuing partly paid-up units, the clarity and codification of the same is a welcome change to clarify the same and settle the dust around issuance of partly paid-up units.

5. Minimum amount of grants by Accredited Investors to Social Venture Funds

Grants by Accredited Investors to social venture funds has been exempted from meeting the requirement of making a minimum grant of INR 25,00,000 (Rupees Twenty Five lakhs).

6. Investment conditions for Category I AIFs

- (a) Prior to the Fourth Amendment, Category I fund of fund AIFs were permitted to invest in the units of other Category I AIFs of the same sub-category. The Fourth Amendment has expanded the range of investments by such Category I fund of fund AIFs to include Category II AIFs.

- (b) Category I Venture Capital Funds must now invest 75% (seventy five percent) of its investable funds (as opposed to the earlier requirement of two-thirds of its investable funds) in unlisted equity shares or equity linked instruments of a venture capital undertaking, or companies listed or proposed to be listed on a SME Exchange or SME segment of an exchange. This threshold of 75% investment is to be met by the end of the life cycle of the Fund.

- (c) The remaining conditions that not more than one-third of the investible funds of a Category I Venture Capital Fund should be invested in initial public offerings of unlisted entities, debt instruments of venture capital undertakings, preferential allotment of shares of a listed entity and equity shares of a financially weak company or sick company whose shares are listed, has been done away with.

7. Temporary Investments

Prior to the Fourth Amendment, the AIF Regulations stated that an AIF could make temporary investments out of the un-invested portions of the investible funds. In line with the market practice, the Fourth Amendment has codified

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that temporary investment can be made from the divestment proceeds pending distribution to the investors as well. Further, from the list of instruments for temporary investments, Collateralized Borrowing and Lending Obligation (CBLOs) has been substituted by Triparty Repo Dealing and Settlement (TREPS), considering that CBLOs have been discontinued from November 2018 and all CBLOs have TREPS.

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