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AIFS ON ALERT: PLETHORA OF CHANGES IN THE WORKS

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The alternative asset industry is the pulse of any growing economy, and to keep up with the dynamism of a growing economy, the industry itself must constantly evolve. The evolution of the industry requires a strong support in the form of a conducive regulatory landscape within which the industry operates. Investor protection is clearly one important tenet for the growth and development of the securities market and going by the series of measures being announced by the Securities and Exchange Board of India (SEBI) in this direction over the last 12 months clearly suggests that SEBI is in an overdrive mode as far as AIFs and investor protection is concerned. So much so that the pace at which the proposals were being announced by SEBI seem to be leaving the industry out of breath! The series of consultative papers issued by SEBI in the beginning of February 2023 was clearly evidence of that.

As a culmination of that exercise, SEBI in its board meeting held on 30 March 2023 (SEBI Board Meeting) has announced several decisions in relation to fund management and operations of, *inter alia*, Alternative Investment Funds (AIFs) by approving amendments to the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations).

These decisions have been released to the public through the press release PR No. 6/2023 (Press Release) and the amendment regulations should follow shortly. The relevant contents of the Press Release, pertaining to AIFs have been summarised below.

1. Standardisation of Valuation

Approved Amendment: SEBI, through the Press Release, has approved to amend the AIF Regulations to codify a framework for valuation of investments by AIFs and to also stipulate eligibility criteria for independent valuers engaged to conduct the valuation. The requirement for conducting valuation is also proposed to be extended to investments by Category III AIFs in unlisted securities and listed debt securities. It has been clarified that the responsibility to undertake true and fair valuation would vest on the manager of the AIF.

Purpose: SEBI has stated that the purpose of the proposed amendments is to provide guidance to AIFs towards a consistent and standardised approach for valuation of their investment portfolios.

Comment: SEBI had, through its circular dated 5 February 2020, stipulated the standardised template for private placement memorandum (PPM) to be followed by AIFs, which required inclusion of a separate section on valuation and prescribed the details to be disclosed under the same, including valuation principles used by the AIF and other guiding principles relevant for investors to know with respect to valuation of the AIF. Regulation 23(1) of the AIF

Regulations also requires AIFs to provide to its investors a description of its valuation procedure and methodology of valuing assets.

The approved amendment is pursuant to the consultation paper on '*Standardised approach to valuation of investment portfolio of Alternative Investment Funds*' issued on 06 January 2023 by SEBI (Consultation Paper on Valuations), wherein the regulator observed that while managers of AIFs have flexibility to adopt any valuation principle / methodology / standard by disclosing the same to investors in PPMs, presently, the modalities are not disclosed and not reported to SEBI subsequently. The Consultation Paper on Valuations also noted that the Alternative Investment Policy Advisory Committee (AIPAC), in its meeting held on 11 October 2022 and 22 November 2022, specified International Private Equity and Venture Capital Valuation Guidelines (IPEV Guidelines) as a standard for valuing investment portfolio of private equity / venture capital funds in various jurisdictions.

While disclosures are healthy for the market and beneficial to investors, which is already a requirement under the AIF Regulations and the standardised template PPM, laying out a framework for conducting the valuation process or identifying IPEV Guidelines as the required valuation methodology for valuation would make the process over prescriptive and remove the flexibility necessary for managers to conduct valuation based on the specific strategy and considerations applicable to a particular AIF, as one size fits all cannot be the solution. For example, a credit / debt fund may not opt for IPEV Guidelines as it is more suited for private equity strategy. However, much would depend on the content of such framework.

2. Dematerialisation of units of AIFs

Approved Amendment: In 2021, units of AIFs were included under the definition of '*securities*' as per the Securities Contracts (Regulation) Act, 1956. However, there is no central repository or database which records the issuance or transfer of units of AIFs. Accordingly, SEBI has proposed to mandate AIFs to dematerialise their units. For existing AIFs with a corpus of more than INR 500 crore, the deadline for dematerialising their units would be 30 October 2023 and for AIFs with a corpus of less than or equal to INR 500 crore, the deadline will be 30 April 2024, while all new AIFs would be required to issue dematerialised units.

Purpose: Through this proposal, SEBI intends to ease monitoring and administration by stakeholders and to protect investors against operational and fraud risk.

Comment: This move, approved pursuant to the consultation paper on '*Dematerialisation of units of AIFs*' issued by SEBI on 03 February 2023 (Consultation Paper on Dematerialisation), will provide investors with greater clarity and certainty on their holdings in AIFs and also enable investment managers and SEBI to track any transfers of units systematically. The Consultation Paper on Dematerialisation noted that on 31 December 2022, while there were 1022 AIFs registered with SEBI, only 12 International Securities Identification Numbers (ISINs) have been created with Central Depository Services Limited as on 03 October 2022 and 87 ISINs have been created with National Securities Depository Limited as on 30 December 2022, due to various factors such as private placement of AIFs, meagre trading of units of AIFs, etc. The dematerialisation of units of AIF will also ensure ease of transfer and transmission of AIF units and may be essential in lying down the groundwork for listing of units of AIFs.

3. Eligibility Criterion for Key Investment Team

Approved Amendment: As per the Press Release, SEBI has approved a proposal to replace the existing requirement for a key investment team member to have work experience of a minimum number of years, with a comprehensive certification requirement.

Purpose: The stated intent behind this proposal is to facilitate skill based approvals and to ensure objectivity in ascertaining eligibility for registration of AIFs.

Comment: On release of the consultation paper on '*Review of eligibility criteria for key investment team and prescribing qualification for compliance officer of Manager of an Alternative Investment Fund*' issued by SEBI on 3 February 2023 (Consultation Paper on Eligibility Criteria), the industry represented that introduction of a certification requirement should be an alternate eligibility criterion to enable persons who may not have a certain level of experience in terms of investment management or advisory. However, the approved amendment seems to have overlooked the representation and provided a comprehensive certification requirement as the only criteria for inducting members to the key investment team for an AIF. In situations where fairly senior members of fund houses, with a rich working experience, are to be names as members of the key investment team, this requirement of undergoing an additional certification may prove to be an unnecessary constraint. SEBI has, instead of revising the AIF Regulations to additionally allow persons with not enough experience to be able to be inducted as key investment team members, in a way excluded persons with adequate experience from qualifying to be appointed as key investment team member.

4. Requirement to obtain 75% Investor Consent for Conflicted Transactions

Approved Amendment: It has been proposed that AIFs be mandated to obtain consent of 75% of their investors by value in order to buy or sell investments potentially involving conflict of interest, transactions with associates of an AIF, or schemes of AIFs managed or sponsored by the manager or sponsor or their associates, or an investor who has commitment to the extent of more than 50% of the corpus of the scheme of AIF.

Purpose: To improve governance and transparency to investors with respect to transactions involving conflict of interest.

Comment: On the face of it, this proposal is the codification of the existing market practice whereby most institutional and anchor investors require the manager to obtain the consent of investors in some form, prior to entering into conflicted transactions. However, such consent mechanism is typically through an advisory committee which has representatives of large and sophisticated investors in the fund, which eliminated operational hurdles of approaching the entire body of investors for every such matter. The practice of obtaining advisory committee / board consent is also in line with the standards suggested by the Institutional Limited Partners Association under the 'Model Limited Partnership Agreement'. Further, the nature of transactions requiring consent are often linked to a monetary threshold, which eliminates the need to seek approval for routine transactions involving small amounts. While the devil would lie in the detail, a reading of the Press Release suggests that this flexibility may be taken away by the proposed amendment.

5. Sell / in-specie distribution of unliquidated investments

Approved Amendment: Allow AIFs to either sell unliquidated investments at the time of winding up to a new scheme of the same AIF, i.e., liquidation scheme or distribute such unliquidated investments in-specie, in the prescribed manner and subject to the approval of 75% investors by value. In the event investor approval for transfer to liquidation scheme or for in-specie distribution is not procured, the unliquidated investments shall be mandatorily distributed in-specie to the investors and in case an investor is not willing to take in-specie distribution, such investment is to be written off.

Purpose: To provide flexibility to AIFs to deal with investments which are not sold due to lack of liquidity during the winding up process.

Comment: While the approval to procure bids for at least 25% of the unliquidated investments, under the consultation paper on '*Providing option to Alternative Investment Funds and their investors to carry forward unliquidated investments of a scheme upon completion of its tenure*' issued by SEBI on 03 February 2023 (Consultation Paper on Unliquidated Investments), has

not been included in the approved amendment for unliquidated investments, the requirement to mandatorily make in specie distribution in the absence of investors consensus seems to overlook the practical challenges in distributing securities directly to investors. The most glaring issue that may arise due to the amendment requiring mandatory in specie distribution is that in case of foreign investors in an AIF, receiving securities of Indian entities may prove to be onerous to such foreign investors and require approvals from the Reserve Bank of India. Further, in a number of situations, such in specie distribution may not be legal as the foreign investor may not be qualified to hold the securities that the AIF holds. This is also in contradiction to the recent SEBI practice on requiring PPMs to state that the manager shall ensure that no in specie distribution is made in case such distribution violates any applicable laws. Another critical aspect to be borne in mind is that in case of a foreign owned and controlled AIF, the portfolio investments by the AIF is considered 'indirect foreign investment' and transfer of such investments will be required to be in line with the foreign direct investment conditionalities, including pricing guidelines. This may prompt fire sale of the unliquidated investments due to the practical challenges with a mandatory in specie requirement and take away the flexibility of permitting extension of the term of the existing scheme bases on the wisdom of the investors of the fund.

Further, as represented by the industry at large as comments on the Consultation Paper on Unliquidated Investments, SEBI seems to have rejected the request to permit the same scheme holding the unliquidated investments to act as liquidation vehicle rather than transferring such investments to another scheme. The transfer of the unliquidated investments to another scheme may be hindered due to the various reasons such as litigations restricting transfer of securities, ROFO obligations on the original scheme under the investment documents, tax issues, etc.

The finer print of the amendment is to be seen to ascertain the repercussions of the approved changes as winding up and treatment of unliquidated investments will become a primary considerations for fund managers as the AIF industry matures and more and more AIFs reach the stage of liquidation.

6. Value of unliquidated investments in track record of manager and reporting by performance benchmarking agencies

Approved Amendment: SEBI has approved the amendment to require the value of unliquidated investments of an AIF being transferred to a liquidation scheme or distributed in-specie to be captured in the track record of managers, to be disclosed under the PPM, and for reporting to performance benchmarking agencies.

Purpose: To ensure proper recognition and disclosure of true asset quality, liquidity and fund performance of AIFs and managers.

Comment: Considering that the unliquidated investments form very much a part of the portfolio of AIFs managed by the managers and the decision to invest in the same had, at the time of investment, been taken the manager, it is only fair that the same be included in the track record and reports on performance benchmarking. This is in line with the fiduciary duties of the manager at all points of time to the fund and may nudge the managers to go an extra mile and pay due attention to exit strategies at the time of investment.

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