KHAITAN & CO ADVOCATES SINCE 1911

UPDATE

ERGO

Analysing developments impacting business

SEBI NOTIFIES THE FRAMEWORK FOR ENHANCED GOVERNANCE OF AIFS AND SETTING UP OF CORPORATE DEBT MARKET DEVELOPMENT FUND

31 July 2023

In our previous ERGO (link), we had analysed the impact of the amendments to the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (AIF Regulations) approved by the Securities and Exchange Board of India (SEBI) in its board meeting dated 29 March 2023 (SEBI Board Meeting) aimed at introducing enhanced governance and disclosure standard for Alternative Investment Funds (AIFs).

In furtherance of the above, SEBI on 15 June 2023 notified the amendment approved in the SEBI Board Meeting in its SEBI AIF (Second Amendment) Regulations, 2023 (**Amendment Regulations**). SEBI has thereafter, on 21 June 2023, issued a slew of circulars laying down the operating framework for enhanced governance and disclosure standards.

Alongside introducing the framework for enhanced governance and disclosure standards, SEBI has also enabled setting up of Corporate Debt Market Development Fund (**CDMDF**) aimed at providing a backdrop facility for the purchase of investment grade corporate debt securities during times of stress or market dislocation.

In this ERGO, we have analysed the changes brought into effect by the Amendment Regulations and the operational circulars. The specific amendment relating to introduction of Liquidation Scheme has been analysed in detail in a separate ERGO which can be accessed here.

PART I – Enhanced Governance Framework

The key amendments brough into effect pursuant to the Amendment Regulations are as under:

A. **Replacing the subjective 5 years of experience criteria for members of the key investment team of AIFs with an objective certification requirement**

   In respect of the professional qualification of the members of the key investment team of the investment manager, the AIF Regulations required:

   i. at least one key personnel having adequate experience of 5 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;

   ii. Additionally, either the same person or any other member of the key investment team was required to have professional qualification in finance, accountancy, business management, commerce, economics, capital market or banking or a CFA charter.

The requirement at (i) has been replaced with a more objective certification requirement. Though SEBI is yet to come out with the details of the certification requirement for the key investment team personnel, it is expected that certification requirements would be on similar lines as is required for key personnel of other securities market intermediaries such as portfolio managers, investment advisers and stock brokers who are required to pass the certification examination conducted by an organization specified by NISM pursuant to the SEBI (Certification of Associated Persons in the Securities Markets) Regulations, 2007. The course module and the continuing professional education criteria would of course be tailor made to suit the skill required for being part of the key management team of an investment manager of an AIF.

Comment: The amendment is a positive shift as it eliminates the ambiguity tied to the seemingly harmless 'adequate experience of 5 years' requirement, which has recently been a contentious issue with SEBI officials during the registration application process. Furthermore, the need for a certification will enable investment managers to draw from a broader range of professionals who, despite their skills, were previously excluded due to the rigid 5-year criterion.

B. **Dematerialisation of units of the AIF**

The Amendment Regulations require AIFs to issue units in dematerialised form only. The SEBI Circular Number SEBI/HO/AFD/PoD1/CIR/2023/96 dated 21 June 2023 has laid down the operational framework for issuance of units of AIFs in dematerialised form. As per SEBI AIF are required to follow the below stipulated time frame for issuing units in dematerialised form:

Particulars	***Schemes of AIFs with corpus ≥ Rs 500 Crore***	***Schemes of AIFs with corpus < Rs 500 Crore***
Dematerialisation of all the units issued	Latest by 31 October 2023	Latest by 30 April 2024
Issuance of units only in dematerialised form	1 November 2023 onwards	1 May 2024 onwards

The schemes whose tenure (excluding permissible extensions in tenure) ends on or before 30 April 2024 are exempt from dematerialising their units.

Comment: The move towards the dematerialization of AIF units represents a step towards the digitization of financial securities, which promotes transparency and adequate oversight. However, this could escalate organizational expenses, which might not always be feasible for AIFs with a considerably smaller fund size. Typically, AIF investors anticipate that organizational costs should not exceed roughly 1% of the total fund size. Therefore, investment managers will need to account for the initial costs of issuing dematerialized units to investors in the future.

In its consultation paper released on 18 May 2023, regarding proposed amendments to the AIF Regulations to bolster governance mechanisms, SEBI has also suggested that AIF investments should be held in a dematerialized form. Although this is currently just a proposal, if both assets (i.e., AIF investments) and liabilities (i.e., AIF units) are required to be in dematerialised form, it could certainly enhance the governance and transparency framework for AIFs. However, this could make capital raising more expensive, at least in the short term.

C. **Requirement of consent for investors for conflicted transactions**

The Amendment Regulations now stipulate that AIFs need the consent of a minimum of 75% of investors, based on the value of their investment in the AIF, for the purchase or sale of investments from or to:

a) associates; or

b) schemes of AIFs managed or sponsored by its investment manager, sponsor or associates of its investment manager or sponsor; or

c) an investor who has committed to invest at least 50% of the corpus of the AIF.

Comment: Before the amendment, AIFs had to obtain approval from 75% of investors, by investment value, for investing in associates or schemes managed or sponsored by the AIF's investment manager, sponsor, or their associates. Now, such approval will also be necessary for the sale of these investments. Additionally, buying or selling investments to or from a person who has committed to invest at least 50% of the AIF's corpus is now considered a conflict-of-interest transaction.

The stipulation for 75% approval could potentially prove detrimental for AIFs, as it might not be practical for investment managers to seek approval for each investment from the investors. Generally, in India and globally, 'conflict of interest' situations are addressed by an advisory committee composed of representatives from the fund's primary and seasoned investors. This procedure helps avoid the operational hurdles of soliciting approval from every investor for each respective issue. This consent gathering from the advisory committee or board is in line with the principles proposed by the Institutional Limited Partners Association in their 'Model Limited Partnership Agreement'. Also, only certain transactions, usually tied to a specific monetary threshold, require consent, thus exempting routine transactions of smaller amounts from needing approval.

D. **Appointment of compliance officer**

SEBI initially introduced the requirement for a compliance officer for all AIF managers in its circular dated 24 June 2022, and this has now been formally incorporated into the AIF Regulations through the Amendment Regulations. According to the Amendment Regulations, the compliance officer must meet eligibility criteria as determined by SEBI periodically. Additionally, the compliance officer is required to report any non-compliance observed to SEBI immediately and independently as soon as possible, but no later than 7 working days from the date of observing such non-compliance.

Comment: The purpose of defining the role of a compliance officer is commendable. However, the requirement for a compliance officer to be an internal member of the investment manager should be more flexible, allowing investment managers to appoint professional services firms and their members to fulfil this role. This change could not only improve the quality of compliance but also alleviate concerns among the key investment team members, who may feel pressured to take on this responsibility. Furthermore, considering the rising costs of managing an AIF, it would have been beneficial if SEBI had set a threshold for Assets Under Management, above which a compliance officer would be obligatory. This modification could have provided some relief to smaller and startup managers.

E. **Standardised approach of valuation norms and reporting of valuation of investments of AIF to performance benchmarking agencies**

Until now, AIFs were required to provide to its investors, a description of its valuation procedure and of the methodology for valuing assets. Pursuant to the Amendment

Regulations read with the SEBI Circular No. SEBI/HO/AFD/PoD/CIR/2023/97 dated 21 June 2023, AIFs have been directed to adopt a standardised approach for valuation of its assets with effect from 1 November 2023. The key provisions are summarised as under:

i. *Independent Valuer Appointment*: AIFs are obligated to assign an independent valuer who cannot be affiliated with the manager, sponsor, or trustee of the AIF.

ii. *Valuation of Listed Securities*: The valuation of listed securities must comply with the methods detailed in Schedule VIII of the SEBI (Mutual Funds) Regulations, 1996.

iii. *Valuation of Unlisted Securities*: The valuation of unlisted securities must align with valuation guidelines approved by any AIF industry association. This association should, in terms of membership, represent at least 33% of the total number of SEBI registered AIFs.

iv. *Deviation from Established Valuation Procedure*: If the established valuation policies and procedures do not yield fair and appropriate valuations, the investment manager can deviate from them to achieve fair asset or security valuation. However, the reasoning for such deviation must be documented by the investment manager and disclosed to the trustee (or partners if the AIF is set up as a limited liability partnership) and the AIF's investors.

v. *Reporting to Performance Benchmarking Agencies*: The investment manager is obligated to ensure that valuations based on the audited data of the investee company are reported to performance benchmarking agencies only after the audit of the AIF's books of accounts.

vi. *Change in Valuation Methodology*: Any alteration in the methodology or approach for the valuation of investments in an AIF scheme will be considered a significant material change that may impact an investor's decision to remain invested in the AIF's scheme. Therefore, such a change necessitates offering an exit option to the investors, unless the change is approved by 75% of investors, by value, in the AIF, following SEBI Circular No. CIR/IMD/DF/14/2014 dated 19 June 2014 and SEBI Circular No. CIR/IMD/DF/16/2014 dated 18 July 2014.

<u>Comment</u>: As the size of the AIF industry is growing, adopting a standardised approach towards valuation methodology will facilitate a fair evaluation of performance of AIFs, by the investors, its peers and SEBI.

PART II – Introduction of CDMDF

Following the proposal made by India's Finance Minister, Shrimati Nirmala Sitharaman, during the Union Budget 2021 - 2022, it was suggested to establish a credit backstop facility to stimulate the development of India's corporate bond market. The introduction of this backstop facility was aimed at preventing events like the Franklin Templeton Mutual Funds incident, where Franklin Templeton Asset Management Company abruptly closed six credit mutual fund schemes that had exposure to higher-yielding, lower-rated credit securities. They cited a lack of liquidity amid the coronavirus pandemic, leading to a freeze on existing investments in the wound-up schemes.

According to SEBI, the role of the CDMDF will be to serve as a backstop facility for the purchase of investment-grade corporate debt securities during periods of stress or market dislocation. It is designed to be readily available to buy such bonds from secondary market participants during stressful times. The CDMDF is expected to instill confidence among corporate bond market participants and enhance secondary market liquidity. The key features of the CDMDF are as follows:

A) **What is the CDMDF?**

CDMDF will be a specialized investment pooling vehicle. It will be registered as an AIF with SEBI under the newly added Chapter III-C of the AIF Regulations. This will enable the CDMDF to raise capital from specified investors and make investments in specified securities, as outlined in the Amendment Regulations.

SEBI has stipulated that the CDMDF will be structured as a registered trust. The CDMDF will be strictly close-ended and will have a lifespan of fifteen years from the date of its first closing. Any extensions to this tenure can only be made with prior approval from SEBI.

B) **Who can invest in the CDMDF?**

Investment in the CDMDF has been restricted to asset management companies under the SEBI (Mutual Fund) Regulations, 1996 and the specified debt-oriented schemes of mutual funds. Further, the requirement of continuing interest for the manager or sponsor in the CDMDF has been prescribed to be INR 5 crores.

Further, the CDMDF may borrow funds up to 10 times its corpus, which borrowings would be included in the calculation of '*fund capital*'.

C) **What are the investment conditions applicable to CDMDF?**

The Amendment Regulations specify that the CDMDF shall, during the periods of '*market dislocation*', purchase corporate debt securities in specified mutual funds which meet the necessary requirements as under:

a) The corporate debt securities shall be listed and must have an investment grade rating.

b) Residual maturity of the securities shall not exceed 5 years on the date of purchase.

c) Securities shall have no material possibility of default or adverse credit news or views.

The CDMDF can hold the securities till maturity or sell the same after reversal of market dislocation.

For the periods other than market dislocation period, CDMDF shall invest in liquid and low risk debt instruments, further the CDMDF is not allowed to invest in securities of companies incorporated outside India. The threshold for investing in one investee company is 5% of its fund capital at the time of investment.

The Amendment Regulations state that the trigger of '*market dislocation*' and its reversal shall be determined by SEBI.

D) **What is the governance mechanism for the CDMDF?**

The CDMDF will appoint a trustee company just like any other AIF, the role and responsibilities of which trustee company will be similar to the ones mentioned in the SEBI (Mutual Funds) Regulations, 1996. Further, two-thirds of the board of directors of the trustee company is required to be independent, having no relation to the trustee or the sponsor of CDMDF.

The governance of CDMDF will be through 2committees, namely an *audit committee of the trustee company* and a *governance committee*. The audit committee of the trustee company will be responsible for ensuring compliance with the provisions of placement memorandum of CDMDF. The aim of the governance committee will be to approve policies of the CDMDF along with the board of directors of the manager and trustee company, supervise the activities of the CDMDF and have oversight on management of asset liability mismatches during times of market dislocation.

Comment: CDMDF has been implemented by SEBI for a very specific purpose and is not a fund that any individual can sponsor voluntarily, seeking to employ this strategy. Due to the unique aspects of the CDMDF that significantly diverge from those generally applicable to existing AIF categories (including exclusive investment in listed debt instruments, high leverage, inability to list the units, a predefined tenure of the fund under the AIF Regulations, type of investors, minimum investment value, listing provisions, etc.), SEBI has wisely established a distinct framework for the CDMDF.

- *Shikhar Kacker (Counsel) and Parth Gala (Associate)*

For any queries please contact: editors@khaitanco.com