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Dawn of a New Era Under New Asset Class and Sweeping Amendments to Alternative Investment Funds, Investment Advisers and Research Analysts by SEBI

INTRODUCTION

Securities and Exchange Board of India (SEBI) held a board meeting on 30 September 2024 wherein it approved amendments, *inter alia*, to the regulatory framework for mutual funds, alternative investment funds (AIF), investment advisers (IAs) and research analysts (RAs).

We have discussed the key aspects of the amendments below.

SCOPE OF THE AMENDMENTS APPROVED IN THE MEETING

➤ Amendments to AIF Regulations

Basis feedback received from stakeholders, SEBI has approved amendments to the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations) wherein the law will now unequivocally clarify that the rights of the investors in investments and distributions of the returns from the fund shall be ***pro-rata to their commitment*** in the fund and that the rights of investors in all other respects (subject to specified exemptions) shall be *paripassu*.

In the recent past, SEBI has not been receptive of the model wherein a particular class of investor in an AIF (other than the sponsor / manager of an AIF) shares losses more than their pro rata holding in the AIF, such that one class has priority in receiving distribution proceeds which accrue to the AIF. SEBI acknowledged in an earlier consultation paper dated 23 May 2024, that while the principle of pro rata rights of investors in an AIF has not been specifically enshrined under the AIF Regulations, it is a sine qua non for AIFs due to they being pooled investment vehicles.

SEBI has now categorically approved amendments to the AIF Regulations to legislate on the above principles, subject to the following exceptions:

(i) ***Certain investors permitted to subscribe to junior units in an AIF***: To provide operational flexibility to

AIFs, SEBI has now allowed entities such as those owned or controlled by Governments, multilateral or bilateral development financial institutions, State Industrial Development Corporations and other entities as may be specified from time to time, to subscribe to junior classes of units of AIFs with less than their pro-rata rights in the investments of the AIF.

Comment: The regulatory intent behind this amendment appears to allow government entities with a developmental agenda to agree to differential returns in terms of priority, from an AIF. This relaxation will pave the way for the inflow of institutional capital into AIFs, who were earlier constrained from making these investments.

(ii) ***Grandfathering of existing AIFs with priority distribution model***: SEBI had prohibited AIFs with priority distribution model from accepting fresh commitments or make new investments until a final view is taken from SEBI. SEBI has now reaffirmed this understanding and existing AIFs with priority distribution model are not permitted to raise fresh commitments or make new investments, directly or indirectly.

Comment: Subject to the exemption under point (i) above, SEBI has now categorically placed an embargo on new funds adopting priority distribution model, and laid to rest a topic which was earlier pending a final view from SEBI.

(iii) ***Side Letters with differential rights to investors***: According to the board meeting, the Standard Setting Forum (SFA), will collaborate with SEBI and formulate the list of specified terms on which differential rights to investors may be offered to investors, without affecting rights of other investors.

Comment: It is now clear that offering differential side letter terms will be limited to the items and conditions formulated by SFA. This could potentially lead to fund managers re-evaluating their approach in offering bespoke terms to limited partners, especially institutional investors.

- (iv) **Large Value Funds for Accredited Investors (LVFs)** may provide differential rights to investors such that *pari passu* rights are not offered amongst its investors, subject to a waiver provided by each investor in the AIF.

Comment: LVFs are a special category of AIFs wherein each investor (other than the sponsor and manager of the AIF) contributes at least INR 70,00,000 (Indian Rupees Seventy Crore) and therefore, the regulatory intent appears to allow such funds to offer differential rights to investors (over and above the list, which would be prescribed by SFA for AIFs which are not LVFs) considering they are sophisticated investors who understand the risks associated with an investment in the fund. It is not entirely clear from the minutes of the meeting whether LVFs would be permitted to offer priority distribution to investors. In our view, given that the bar to participate in an LVF is very high, these funds should be permitted to offer priority in distribution.

AMENDMENTS TO MF REGULATIONS

➤ Introduction of New Asset Class

The introduction of the new asset class under the SEBI (Mutual Funds) Regulations, 1996 (MF Regulations) comes against the backdrop of the consultation paper issued by SEBI on 16 July 2024 seeking public comments. The new asset class will be a professionally managed and regulated investment product, with the objective of curtailing unregistered investment schemes which were earlier soliciting capital from unsuspecting investors without any

regulatory oversight. This asset class will provide investors with a higher risk appetite and investable corpus with professionally managed investment strategies will be introduced under the MF Regulations.

The key features of the new asset class are:

- (i) **Minimum investment amount:** A minimum of INR 10,00,000 (Indian Rupees Ten Lakh) per investor **across all investment strategies** offered by the mutual fund will be required to enter this product category. Hence, an investor may be able to take exposure to less than 10,00,000 (Indian Rupees Ten Lakh) in a single deal. Currently, other sophisticated regulated products by SEBI, such as portfolio management services and AIFs, have a minimum ticket size of INR 50,00,000 (Indian Rupees Fifty Lakhs) and INR 1,00,00,000 (Indian Rupees One Crores) respectively from each investor.
- (ii) **Leverage:** No leverage or borrowing by the fund manager will be permitted under this asset class. This would safeguard the interest of investors as the inability to make leveraged bets would lead to minimizing of losses in the event of fluctuations in the market.
- (iii) **Limited unlisted investments:** Investments in unlisted equity shall be limited to an aggregate of 15% (fifteen per cent) of the total assets of the strategy, similar to the limits prescribed under the MF Regulations.
- (iv) **Derivatives exposure:** Up to 25% (twenty five per cent) of the AUM may be invested in derivative instruments, except for any derivative instrument subscribed for the purpose of hedging and rebalancing.

Comment: SEBI, while introducing a new investment product for investors has ensured that it is attuned to the risk appetite of

participating investors and has adequately placed restrictions on leverage, unlisted investments and derivatives, which are inherently riskier and could result in large swings in value of the investments, which investors would not be able to absorb.

➤ **Amendments to IA Regulations and RA Regulations**

To simplify the regulatory landscape for IAs and RAs and make these intermediaries more accessible to domestic investors, SEBI has amended the SEBI (Investment Advisers) Regulations, 2013 (IA Regulations) and the SEBI (Research Analysts) Regulations, 2014 (RA Regulations) respectively to the following effect:

(i) **The eligibility criteria for IAs and Ras to obtain registration is being relaxed to the following extent:**

- Minimum educational qualification is now a graduate degree instead of relevant professional certification or post graduate degree;
- Requirement of prior experience has been done away with;
- Obtaining NISM certification on a periodic basis has been relaxed to the extent of only incremental changes/developments requiring fresh certification; and
- Net worth requirements have been replaced with a reduced deposit requirement.

Comment: The above relaxations are a welcome move in making the regulation more light-touch, paving the way for more talented individuals now being eligible to obtain the registrations.

(ii) **Other amendments:** An entity carrying out any other business (other than related to securities and subject to conditions which will be fleshed out by SEBI) being able to register themselves as part time IAs or RAs subject to appropriate disclosures pertaining to conflict of

interest. Further, there are also certain other amendments pertaining to flexibility in changing the manner of charging fees from clients, increase in threshold of corporatization of individual IAs. SEBI has also clarified the scope of the 'investment advice' rendered by IAs, by specifically exempting securities not under the purview of SEBI.

CONCLUDING REMARKS

The amendment to MF Regulations introducing a new asset class marks a significant milestone in providing investors in a growing economy like India with one more investment avenue which is regulated and professionally managed. The new asset class will provide investment avenues which traditional mutual funds are not able to offer, while at the same time ensuring appropriate guardrails from a risk mitigation standpoint. The guardrails provided by SEBI for this new product category will ensure that it is not appropriate risk mitigation is ensured by the fund managers. While the fine print of the amendments are awaited, it is expected that SEBI will also provide clarity on the eligibility criteria for existing and new asset management companies who wish to venture into this product category (including clarity on whether existing qualified fund managers of registered portfolio managers and investment managers of AIFs would be eligible to launch strategies under this category), including providing relaxed net worth requirements for the sponsor / asset management company.

As regards the amendments to AIF Regulations, it is crucial that SEBI clarifies that the pro rata rights of investors in an AIF are tied to their contributions made and not commitment (in order to account any adjustments that may be required to default by or excuse / exclusion of investors). Further, the upcoming guidance on the list of terms on which side letters may be offered will be pivotal as historically, fund managers have been able to offer differential rights to investors (except for the prohibited list of items prescribed by SEBI), subject to appropriate disclosures.

The amendments to IAs and RAs are also going to provide meaningful reprieve to this space by providing relaxations in meeting eligibility and compliance related stipulations especially the clarity regarding products not regulated by SEBI being outside the purview of the regulatory framework which will effectively provide clarity that any entity providing advisory services to products in

GIFT City will be exempt from obtaining a registration.

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