

Amendments to the SEBI (Alternative Investment Funds) Regulations, 2012

11 July 2023



Background

With an aim to strike a balance between effective oversight and streamlined operations of alternative investment funds (AIFs), the Securities and Exchange Board of India (SEBI) had issued a series of consultative papers in February 2023, laying down proposals on various operational and governance aspects of AIFs for public comments. Later, SEBI, in its board meeting held on 30 March 2023, approved the proposals to amend the SEBI (Alternative Investment Fund) Regulations, 2012 (AIF Regulations).

SEBI has notified the SEBI (Alternative Investment Fund) (Second Amendment) Regulations, 2023 (Amendment Regulations) on 15 June 2023. The key amendments notified in the Amendment Regulations are summarised below:

- Issuance of units of AIFs in a dematerialised form;
- A change in the winding up process of scheme of AIF;
- Introduction of the 'Liquidation scheme'.
- The investor's consent required for buying / selling certain investments;
- A change in the valuation procedure and of the methodology for valuing assets;
- A change in the eligibility criteria for the key investment team;
- Mandatory appointment of a compliance officer;
- Introduction of the 'Corporate Debt Market Development Fund';

On 21 June 2023, SEBI issued three circulars clarifying the amendments introduced in Amendment Regulations.

Key amendments from the Amendment Regulations:

1. Issuance of units of AIFs in dematerialised form:

- The Amendment Regulations have mandated AIFs to issue units in dematerialised form.
- In this regard, SEBI has also issued a circular¹ on 21 June 2023, prescribing the following time frame for the AIFs to dematerialise their units:

Particulars	Schemes of AIFs with corpus \geq INR 500 crore	Schemes of AIFs with corpus $<$ INR 500 crore

Dematerialisation of all the units already 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 above requirement shall not be applicable for the schemes of AIFs whose tenure (excluding permissible extensions) ends on or before 30 April 2024.
- Further, the terms of transfer of units of an AIF held by an investor in a dematerialised form shall continue to be governed by the fund documents.

¹ SEBI/HO/AFD/PoD1/CIR/2023/96

2. Change in the winding up process of scheme of AIF

- The Amendment Regulations have mandated that the AIFs / schemes of AIFs shall be liquidated within a period of 1 year following the expiry of the tenure or extended tenure of the scheme for fully liquidating the scheme of an AIF (liquidation period). Accordingly, these amended provisions would not apply to the existing schemes of AIFs that have exceeded one year from the tenure / extended tenure.
- In order to provide flexibility to the schemes of AIFs to deal with investments which are not sold due to a lack of liquidity, Amendment Regulations have now permitted AIFs, during the liquidation period, to either distribute such investment in specie to the investors or sell such investments to a liquidation scheme (discussed below), subject to approval of at least 75% of the investors by value of their investment in the scheme of an AIF.
- In the absence of an investor's consent for the aforesaid options during the liquidation period, such unliquidated investments must be compulsorily distributed by the AIF / manager of the AIF to the investors of the scheme vide the in specie distribution process.

3. Introduction of 'Liquidation scheme'

- The Amendment Regulations have permitted the existing AIFs to set up a liquidation scheme, which can be launched by an existing AIF (original scheme), subject to obtaining consent of 75% of investors by value of their investment in the original scheme.

- In this regard, SEBI has issued a circular² on 21 June 2023, thereby providing modalities for launching of a liquidation scheme and in specie distribution of investments by AIFs.
- The liquidation scheme shall be launched by filing the placement memorandum with SEBI through a merchant banker, along with the payment of specified fees.
- The tenure of the liquidation scheme of an AIF shall be determined at the time of filing of a placement memorandum with SEBI and shall not be extended.
- Further, the liquidation scheme shall neither accept any fresh commitment from any investor nor shall make any new investments.
- The investments of the liquidation scheme of an AIF, which are not sold due to the lack of liquidity by the end of its tenure, shall be dealt with in the manner as specified by SEBI³.
- The Amendment Regulations have prescribed a list of certain provisions of the AIF Regulations that shall not be applicable to a liquidation scheme, such as the requirement of a minimum corpus, minimum number of investors required in a scheme, etc.

4. Investor's consent required for buying / selling certain investments

- The Amendment Regulations have prescribed that an approval of 75% of investors by value of their investments in the scheme of an AIF shall be required to buy or sell investments, from / to:
 - a) Associates of an AIF, or
 - b) Schemes of AIFs managed or sponsored by the manager or sponsor or their associates, or

² SEBI/HO/AFD/PoD-I/CIR/2023/098

³ Prescribed vide circular SEBI/HO/AFD/PoD-I/P/CIR/2023/098 dated 21 June 2023

- c) An investor who has commitment to the extent of more than 50% of the corpus of the scheme of an AIF (the said investor shall be excluded from the voting process, while obtaining approval from the investors).

5. Change in valuation procedures and of the methodology of valuing assets

• Valuation mechanism prescribed

- The Amendment Regulations provide that the AIFs are required to carry out valuation of their investment portfolio in the manner as specified by SEBI.
- In this regard, SEBI, vide the circular⁴ dated 21 June 2023, has prescribed the following manner of valuation of investments:
 - The valuation of securities for which valuation norms have been prescribed under the SEBI (Mutual Fund) Regulations, 1996 (i.e., traded and non-traded securities other than money market and debt securities), shall be carried out as per the norms specified thereunder.
 - The valuation of securities, other than those mentioned above, shall be carried out as per the valuation guidelines as may be endorsed by any AIF industry association (which in terms of membership represents at least 33% of the SEBI-registered AIFs) after taking into account recommendations of the Alternative Investment Policy Advisory Committee (AIPAC) of SEBI.

- On account of the valuation norms prescribed above, there may be a change in the methodology and approach for the valuation of investments of a AIF scheme, which may be construed as a material change significantly influencing the decision of an investor to continue to be invested in the scheme. In this regard, the circular also prescribes the process of disclosing the said change to SEBI and investors.

- Further, SEBI has specified that for the purpose of calculation of NAV of Category III AIFs, the valuation of their investment in unlisted securities and listed debt securities shall also be conducted by an independent valuer.

• Eligibility criteria prescribed for independent valuer

- SEBI has also notified that the manager of the AIF shall ensure that the AIF appoints an independent valuer who satisfies the eligibility criteria prescribed by SEBI⁵.

⁴ SEBI/HO/AFD/PoD/CIR/2023/97

⁵ Eligibility criteria prescribed vide circular SEBI/HO/AFD/PoD/CIR/2023/97 dated 21 June 2023

- **Process to be followed in case of deviation in valuation approach**

- Additionally, SEBI has clarified that the responsibility to undertake a true and fair valuation would vest on the manager of the AIF. In case where the established policies and procedures of valuation do not result in a fair and appropriate valuation, the manager may deviate from the established policies and procedures to value the assets or securities at a fair value and document the rationale for such deviation.
- In this regard, the said circular has provided the process of identifying a reportable deviation, along with the process of reporting the deviation to the fiduciaries (trustee / trustee company / board of directors / designated partners, as the case may be) and the investors of the AIF.

- Lastly, the circular also prescribes the process of reporting valuation of the investment portfolio of an AIF to performance benchmarking agencies.
- The amendments regarding the valuation of investments shall be effective from 1 November 2023.

6. Change in eligibility criteria for key investment team

- The extant AIF Regulation requires at least one key investment team member of the manager to an AIF to have at least 5 years of experience.
- SEBI, vide the Amendment Regulations, has replaced the said experience criteria, with the requirement of obtaining a relevant certification, as may be specified by SEBI (currently not prescribed).

- The aforesaid amendment shall come into force at a later date, as may be notified by SEBI in the official gazette.

7. Mandatory appointment of a compliance officer

- The extant AIF Regulations provides for provisions related to general obligations, responsibilities and transparency. The Amendment Regulations now provide that the manager of an AIF shall mandatorily appoint a compliance officer.
- Further, the compliance officer shall satisfy the eligibility criteria, as may be specified by SEBI. It shall be the duty of the compliance officer to immediately and independently report to SEBI about any non-compliance observed by him within seven days.

8. Introduction of 'Corporate Debt Market Development Fund'

- SEBI, vide the Amendment Regulations, has notified a new category of AIF as 'Specified AIFs', thereby introducing the Corporate Debt Market Development Fund (CDMDF).
- The CDMDF shall act as a backstop facility for the purchase of investment grade corporate debt securities during the times of stress or market dislocation, to instil confidence among the participants in the corporate bond market and to boost secondary market liquidity. Some of the key provisions for the CDMDF, as laid down in the Amendment Regulations, are listed below:

- **Form of CDMDF:**

The CDMDF shall be constituted in the form of a trust, as a close ended fund with a tenure of 15

years from the date of its first closing. Further, the tenure may be extended with the prior approval from SEBI.

- **Skin-in the game:**

The manager or sponsor shall have a continuing interest in the CDMDF of at least INR 5 crores in the form of investment in the fund.

- **Investments in CDMDF:**

The units of the CDMDF shall be offered to asset management companies and the specified debt-oriented schemes of mutual funds as defined and regulated under the SEBI (Mutual Funds) Regulations, 1996 (MF Regulations).

The units of the CDMDF shall not be listed on any recognised stock exchange.

- **Investments by CDMDF**

During the periods of market dislocation, the CDMDF shall acquire corporate debt securities from the specified debt-oriented schemes of mutual funds which meet the specified eligibility criteria.

During the period other than the market dislocation period, the CDMDF shall invest in liquid and

low-risk debt instruments and undertake any other activity related to the corporate debt market.

Investment by the CDMDF in any one investee company shall not exceed 5% of its fund capital at the time of investment. Further, the CDMDF shall not invest in the securities of companies incorporated outside India.

- SEBI has also provided disclosure norms and governance mechanism for the CDMDF, including appointment of a governance committee.

9. Reporting of compliance with circulars issued (dated 21 June 2023)

- The manager of an AIF shall submit a report on compliance with the provisions of the three circularsⁱ issued on 21 June 2023 on the SEBI intermediary portal in the format as specified therein.
- Further, the trustee/sponsor of an AIF shall ensure that the compliance test report, prepared by the manager on an annual basis, includes compliance with the provisions of the said circulars.

Our comments:

The amendments brought in pursuant to SEBI's proposal in a consultation paper issued in February 2023 are intended towards achieving the objective of better governance and standardising the operations of AIFs. While achieving the objective of standardisation, SEBI has also focussed on improving regulatory oversight on the activities of AIFs. The introduction of the liquidation scheme for AIFs provides an additional avenue for managers and investors to derive the maximum value for unliquidated investments. The amendments in AIF Regulations are a welcome move. However, the industry awaits SEBI's clarification on some of the industry recommendations on consultation papers (such as grandfathering to schemes that have already exceeded their tenure, exemption from dematerialisation of units to small AIFs and angel funds, etc.), which remain unaddressed.

ⁱ Circular on “Standardised approach to valuation of investment portfolio of Alternative Investment Funds”
Circular on “Modalities for launching Liquidation Scheme and for distributing the investments of Alternative Investment Funds in-specie”
Circular on “Issuance of units of AIFs in dematerialized form”