

Amendment to SEBI (Alternative Investment Funds) Regulations, 2012

1. Objective

- 1.1. This Board Memorandum proposes to amend the SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”) to:
- a. provide a framework for Alternative Investment Funds (AIFs) to invest simultaneously in units of other AIFs and directly in securities of investee companies;
 - b. provide a definition of ‘startup’ as provided by Government of India and to clarify the criteria for investment by Angel Funds in startups;
 - c. prescribe a Code of Conduct for AIFs, key management personnel of AIFs, trustee, trustee company, directors of the trustee company, designated partners or directors of AIFs, as the case may be, Managers of AIFs and their key management personnel and members of Investment Committees and bring clarity in the responsibilities cast on members of Investment Committees; and
 - d. remove the negative list from the definition of venture capital undertaking.

2. Issues for Consideration

2.1. Framework for AIFs to invest simultaneously in units of other AIFs and directly in securities of investee companies

- 2.1.1. The Ministry of Finance vide email dated September 18, 2020 has informed SEBI about a few issues raised by global investors at various forums. One of the issues highlighted by global investors is with respect to investment conditions for AIFs set up to invest in units of other AIFs i.e. Fund of AIFs (hereafter referred to as “AIF FoFs”). A proposal was made to permit AIF FoFs to invest directly in investee companies along with investments in units of AIFs. Similar requests have also been made by the AIF industry in the recent past.

- 2.1.2. Currently, AIF FoFs may be set up under all categories of AIF. AIF FoFs registered as Category I AIFs under a specific sub-category shall invest only in units of Category I AIFs of the same sub-category. AIF FoFs registered under Category II or Category III shall invest only in units of Category I or Category II AIFs. Further, AIF FoFs are not permitted to invest in units of other AIF FoFs.
- 2.1.3. Based on inputs of industry, it is felt that there is a need to provide flexibility to AIF FoFs to invest a certain portion of their investable funds directly in securities of investee companies provided for under the relevant category/ sub-category, as against the present requirement of investing the entire investable funds in units of other AIFs. Further, to provide flexibility to Category III AIF FoFs there is a need to permit them to invest in units of other Category III AIFs in addition to units of Category I and II AIFs.
- 2.1.4. To enable Managers of AIFs to create well diversified portfolios that meet their desired risk-return profile without deviating from the investment objective of the specific category/ sub-category of their Fund, there is a need to permit simultaneous investments by AIFs other than AIF FoFs also, in securities of investee companies and units of other AIFs.
- 2.1.5. Accordingly, a draft framework to enable all AIFs to simultaneously invest directly in securities of investee companies and in units of other AIFs with adequate safeguards was discussed in the meeting of Alternative Investment Policy Advisory Committee (AIPAC) held on February 10, 2021 and the committee recommended that the draft framework may be considered by SEBI.
- 2.1.6. Based on internal deliberations, the recommendations of AIPAC were reviewed. For better clarity and ease of compliance with investment conditions, and considering that AIFs are investment products for sophisticated investors, it was felt that rather than providing flexibility in investment to AIF FoFs and other AIFs separately, all AIFs may be provided the flexibility to invest either directly in securities of investee companies or in

units of other AIFs or in both. This shall be subject to compliance with investment conditions applicable to the relevant category/ sub-category and appropriate disclosures in the Private Placement Memorandum (PPM).

2.1.7. Further, considering that investment in units of AIFs are generally illiquid, Category III FoFs investing in units of other AIFs may be permitted to undertake leverage only up to two times the value of their portfolio excluding value of investment in units of AIFs. The proposed flexibility may also be accorded to existing AIFs including AIF FoFs, subject to obtaining consent of investors for change in investment strategy, as specified in the AIF Regulations.

Proposal for Consideration

2.1.8. It is proposed as under:

- (i) AIFs may invest in units of other AIFs without labeling themselves as a Fund of AIFs.
- (ii) AIFs which have invested or are enabled by their fund documents to invest in units of AIFs, shall not offer their units for subscription to other AIFs.
- (iii) Category I AIFs may invest directly in securities of investee companies specified for the sub-category under which the AIF is registered and/or in units of other AIFs of the same sub category.
- (iv) Category II AIFs may invest directly in securities of investee companies and/or in units of Category I AIFs and/or Category II AIFs.
- (v) Category III AIFs may invest directly in securities specified for all categories of AIFs and/or in units of other AIFs.
- (vi) AIFs may invest in units of AIFs managed/ sponsored by the same Manager/ Sponsor or associates of the Manager/ Sponsor, only with the

approval of at least seventy-five percent of the investors by value of their investment in the AIF.

- (vii) AIFs shall ensure that, combined investment through direct investment and through investment in units of other AIFs, is in compliance with all applicable investment conditions of the respective category/ sub-category under which the AIF is registered.
- (viii) Category III AIFs investing in units of other AIFs may undertake leverage up to two times the value of portfolio excluding value of investment in units of AIFs.
- (ix) Existing AIFs may invest simultaneously in securities of investee companies and in units of other AIFs, subject to appropriate disclosures in the PPM and consent of at least two-thirds of unit holders by value of their investment in the AIF in terms of Regulation 9(2) of the AIF Regulations.
- (x) The PPMs of the AIFs which propose to invest in units of other AIFs shall provide details of the proposed allocation of investments to units of other AIFs, fees and expenses associated with investment in units of other Funds and the process to be followed by the Manager to ensure compliance with investment conditions. The PPM shall also explicitly state whether any investments are proposed to be made in units of other AIFs managed/ sponsored by the same Manager/ Sponsor or associates of the Manager/ Sponsor.

2.1.9. The proposals at clauses (ii) to (vii) of Paragraph 2.1.8 are to be implemented by way of amendment to Regulations 15(1), 16(1), 17 and 18 of the AIF Regulations.

2.1.10. The proposals at clauses (i), (viii), (ix) and (x) of Paragraph 2.1.8 are to be implemented by way of issuance of Circular.

2.2. Definition of startup and criteria for investment by Angel Funds

- 2.2.1. Angel Funds are registered under the AIF Regulations as Category I AIFs – Venture Capital Funds – Angel Funds. Angel Funds encourage entrepreneurship in the country by financing startups at a stage where such startups find it difficult to obtain funding from traditional sources of finance such as banks, financial institutions, etc. Further, such funds also provide mentoring to the entrepreneurs as well as access to their own business networks. As on March 09, 2021, there are 731 AIFs registered with SEBI out of which, 20 are Angel Funds.
- 2.2.2. To ensure that the investments by Angel Funds are made in such startups, who may not have funding support from their group entities/associates and are in genuine need of risk capital, Regulation 19F(1) of the AIF Regulations provides the criteria of age and turnover for venture capital undertakings in which Angel Funds can invest.
- 2.2.3. Further, Regulation 19F(1) also specifies that the said venture capital undertakings should not be promoted by/sponsored by/related to an industrial group with group turnover more than INR 300 crore and should not be companies with family connection with any of the angel investors who are investing in the company.
- 2.2.4. A definition of ‘startup’ was introduced by Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce and Industry, Government of India in 2016, wherein, the criteria for age of startup was specified as up to 5 years from the date of its incorporation/registration, as compared to 3 years, which was the then criteria for age of startups specified in AIF Regulations. AIF Regulations were amended in 2017 to specify that the venture capital undertaking complies with the criteria regarding the age of venture capital undertaking/startup issued by DIPP.
- 2.2.5. Subsequently, Department for Promotion of Industry and Internal Trade (DPIIT, erstwhile DIPP) in its notification dated February 19, 2019, amended

the definition of 'startup', wherein the turnover criteria was increased from INR 25 crore to INR 100 crore. Thus, the present criteria for turnover of startups in AIF Regulations, i.e. INR 25 crore, is different from the criteria for turnover in DPIIT's definition of startups.

2.2.6. As defined by DPIIT, an entity shall be considered as a startup-

- (i) Up to a period of ten years from the date of incorporation/ registration, if it is incorporated as a private limited company (as defined in the Companies Act, 2013) or registered as a partnership firm (registered under section 59 of the Partnership Act, 1932) or a limited liability partnership (under the Limited Liability Partnership Act, 2008) in India.
- (ii) Turnover of the entity for any of the financial years since incorporation/ registration has not exceeded one hundred crore rupees.
- (iii) Entity is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.

Provided that an entity formed by splitting up or reconstruction of an existing business shall not be considered a 'Startup'.

Explanation – An entity shall cease to be a Startup on completion of ten years from the date of its incorporation/ registration or if its turnover for any previous year exceeds one hundred crore rupees.

2.2.7. In view of the above it was felt that, the definition of 'startups' as provided by DPIIT may be incorporated in AIF Regulations so that, in future, no corresponding amendment is required in AIF Regulations if the definition of startup is modified by DPIIT / Government. However, for the purpose of investments by Angel Funds, the additional criteria with respect to group turnover and family connection, for identifying startups for investment by Angel Funds may be retained in AIF Regulations.

2.2.8. The proposal regarding alignment with definition of startup by DPIIT/ Government and criteria of startups for investment by Angel Funds were discussed in the meeting of AIPAC held on February 10, 2021, wherein the committee recommended that SEBI may consider the proposal.

Proposal for Consideration

2.2.9. It is proposed as under:

- (i) to provide definition of 'startup' in AIF Regulations, as per the definition of 'startup' provided by Government of India.
- (ii) to provide that Angel Funds shall invest in 'startups', which satisfy the additional criteria with respect to group turnover and family connection, as mentioned in paragraph 2.2.3 above.

2.3. Code of Conduct in AIF Regulations and clarification on responsibilities of Managers and members of Investment Committees

2.3.1. The regulatory framework for the various intermediaries registered and regulated by the Board, such as Stock Brokers, Depository Participants, Merchant Bankers, etc. specify appropriate Codes of Conduct for such intermediaries. Based on industry inputs, media references and review of AIF Regulations, it was felt that there is a need to prescribe a Code of Conduct for AIFs and their Managers also, thereby laying down guiding principles on their accountability towards the various stakeholders including investors, investee companies and regulators.

2.3.2. Meanwhile, to provide flexibility to Managers of AIFs, in taking investment decisions for AIFs, the AIF Regulations were amended and notified on October 19, 2020, by inserting Regulation 20(6) which defines the roles and responsibilities of the Manager and members of Investment Committee constituted by the Manager to approve investment decisions for AIFs. The underlying principle of Regulation 20(6) is that accountability should accompany authority at all times.

- 2.3.3. The aforesaid amendment was discussed in the meeting of AIPAC held on November 03, 2020 wherein, the committee members agreed that responsibility for investment decisions should rest with those who have the authority to make such decisions and that transparency to investors should be ensured. However, the committee members also stated that the amendment may be open to interpretation and therefore, clarity may be required on the scope of responsibilities cast on members of the Investment Committee.
- 2.3.4. While the above suggestions of AIPAC were under consideration by SEBI, representations were received from certain AIFs to provide exemption to certain AIFs from responsibility cast on the members of Investment Committee in terms of Regulation 20(6). Further, representations were also received from the industry to, inter-alia, dilute the responsibilities cast on the members of Investment Committee to the extent that Investment Committee members may be responsible only for ensuring that investment decisions are in line with the investment strategy of the fund as provided in the placement memorandum and to act in good faith and with reasonable care while taking the investment related decisions. Feedback was also received from the industry that there is a lack of clarity among industry participants regarding the scope of responsibilities cast on members of Investment Committees.
- 2.3.5. Keeping in mind the interest of investors and the principle of accountability accompanying authority, it is felt that accountability with respect to the decisions taken by Investment Committees should continue to be with the members of Investment Committee.
- 2.3.6. Presently, in terms of Regulation 20(6), the scope of responsibilities of the members of Investment Committee comprises (i) responsibility for investment decision, (ii) responsibility for compliance with PPM and other Fund documents, (iii) responsibility for compliance with AIF Regulations and (iv) responsibility for compliance with other applicable laws. In order to address the issue of lack of clarity regarding scope and form of responsibilities of Investment Committee, clarity may be provided as under:

- (i) Manager has to under all circumstances ensure compliance with the AIF Regulations, terms of PPM, other fund documents, and all applicable laws. For this purpose, the AIF shall have a detailed policy and procedure jointly approved by the Manager and the Trustee or the Board of Directors or Designated Partners of the AIF, as the case may be.

- (ii) For all decisions taken by the Investment Committee, members of the Investment Committee shall-
 - a) ensure that the decisions are in accordance with the policy and procedure laid down as mentioned at para 2.3.6.(i).
 - b) carry out appropriate due diligence while taking decisions.
 - c) disclose conflicts of interest as and when they arise in respect of the decisions taken by them and follow the policy in respect of the same.
 - d) act in good faith and without any fraudulent intent.

2.3.7. Thus it was felt that the AIF Regulations may be amended to clarify the above scope and form of responsibilities by incorporating a Code of Conduct and provision for AIFs to have detailed policies and procedures. Further, as members of Investment Committee also have a fiduciary responsibility towards the AIF and its investors, it was felt that the Code of Conduct should also be prescribed for members of Investment Committees.

2.3.8. Taking into account the representations for providing exemption to eligible AIFs as mentioned above, it was felt that exemption may be considered for such AIFs in which all investors have committed significant capital (INR 70 Crore or its equivalent), as such investors have the resources to do their independent due diligence and may be treated as informed investors. If such investors are willing to furnish a suitable waiver, then a segmented approach may be considered with respect to the provisions of Regulation 20(6).

2.3.9. Accordingly, proposals to specify a Code of Conduct for AIFs, Managers and members of Investment Committee, provide clarification on the scope and form of responsibilities of the members of Investment Committee and

introduce a segmented approach for applicability of Regulation 20(6) were discussed in the meeting of AIPAC held on December 08, 2020. Industry association sought time to revert with comments and inputs of industry on the proposals to clarify the scope and form of responsibilities of the members of Investment Committee and on the Code of Conduct.

2.3.10. Based on the discussion in AIPAC and further internal deliberations, a Board Memorandum (83 of 2020) to provide certain exemptions to the members of Investment Committees of eligible AIFs was placed for consideration of the Board in its meeting held on December 16, 2020. The Board was also informed that the proposals for prescribing a Code of Conduct and for clarification on the scope of responsibilities of the members of Investment Committee were under deliberation in AIPAC and are to be taken up for consideration after the inputs of AIF industry are discussed in AIPAC. Pursuant to approval of the Board, AIF Regulations were amended and notified on January 8, 2021.

2.3.11. In terms of the above mentioned amendment, AIFs in which each investor other than the Manager, Sponsor, employees or directors of the AIF or employees or directors of the Manager, has committed to invest not less than INR seventy crore (or an equivalent amount in non-INR currency) and has furnished a waiver to the AIF in the manner specified by the Board, are exempted from the requirements specified at clauses (i) and (ii) of the proviso to Regulation 20(6) of the AIF Regulations notified on October 19, 2020.

2.3.12. Subsequently, the proposals to clarify the scope of responsibilities of the members of Investment Committee and prescribe a Code of Conduct, along with corresponding draft amendments to AIF Regulations were discussed in the meeting of AIPAC held on February 10, 2021, wherein the committee provided inputs for consideration by SEBI.

2.3.13. Based on inputs of the AIF industry and discussion in the meeting of AIPAC it is noted that Managers of AIFs may set up Investment Committees (by whatever name called) with terms of reference to approve all decisions for

the AIF, including investment decisions. It was felt that while flexibility may be provided to Managers to set up such Committees, the members of such Committees shall be responsible for ensuring that the decisions of the Investment Committee are in compliance with the policies and procedures laid down, as mentioned at para 2.3.6.(i).

2.3.14. Further, considering that Trustee and directors of the Trustee or Designated Partners or directors of the AIF (as applicable) and key management personnel of Manager and AIF also have fiduciary responsibilities towards the AIF and its investors, there is merit to specify a Code of Conduct for these entities also.

Proposal for Consideration

2.3.15. Based on internal deliberations and taking into account the inputs of industry and AIPAC, it is proposed as under:

- (i) To specify a Code of conduct for the AIF, Key Management Personnel of AIF, Trustee, Trustee Company, directors of the Trustee Company or Designated Partners or directors of the AIF (as applicable), Manager of the AIF, Key Management Personnel of Manager and members of Investment Committee. The responsibility to ensure compliance by AIF with the Code of Conduct shall be with the Manager and Trustee or Trustee Company or the Board of Directors or Designated Partners of the AIF, as the case may be.
- (ii) To specify that the Manager shall be responsible for all decisions of the AIF, including ensuring that the decisions are in compliance with the provisions of AIF Regulations, terms of the placement memorandum, agreements made with investors, other fund documents and applicable laws.
- (iii) AIF to have detailed policies and procedures, as approved jointly by the Manager and the Trustee or the Board of Directors or Designated Partners of the AIF, as the case may be, to ensure that all decisions of

the AIF are in compliance with the AIF Regulations, terms of the placement memorandum, agreements made with investors, all other fund documents and applicable laws.

- (iv) To specify that the Manager shall be responsible for ensuring that every decision of the Alternative Investment Fund is in compliance with the policies and procedures laid down for the Alternative Investment Fund as stated in para (iii) above, and other internal policies of the AIF as applicable.
- (v) To provide flexibility to Manager of AIF to set up Investment Committee (by whatever name called) to approve all decisions for the AIF, with suitable disclosure of the terms of reference of the Committee in the PPM.
- (vi) To specify that the members of Investment Committee shall be responsible for ensuring that the decisions of the Investment Committee are in compliance with the policies and procedures laid down as stated in para (iii) above.
- (vii) To provide that the requirement specified in para (vi) above shall not apply to an AIF in which each investor other than the Manager, Sponsor, employees or directors of the AIF or employees or directors of the Manager, has committed to invest not less than seventy crore rupees (or an equivalent amount in currency other than Indian rupees) and has furnished a waiver to the AIF in respect of compliance with the said provision, in the manner as may be specified by the Board.

2.3.16. The proposals at paragraph 2.3.15. are to be implemented by amending Regulation 11 and Regulation 20 of the AIF Regulations and inserting a new Schedule for Code of Conduct in the AIF Regulations.

2.4. Investment by AIFs in Venture Capital Undertakings (VCUs)

2.4.1. AIF Regulations define “venture capital undertaking” as a domestic company

- (i) which is not listed on a recognised stock exchange in India at the time of making investment; and
- (ii) which is engaged in the business for providing services, production or manufacture of article or things and does not include following activities or sectors:
 - 1) non-banking financial companies;
 - 2) gold financing;
 - 3) activities not permitted under industrial policy of Government of India;
 - 4) Any other activity, which may be specified by the Board in consultation with Government of India from time to time.

2.4.2. In light of the negative list specified for VCUs, there are constraints for VCFs to invest in Non-Banking Financial Companies (NBFCs). In this context, SEBI is in receipt of an industry proposal seeking to allow VCFs to invest in NBFCs by removing NBFCs from the negative list provided under the definition of VCUs (hereafter referred to as “negative list”). Industry has stated that most fin-tech companies in India are registered as NBFCs and have business models that require heavy capital investment and that they have been receiving significant investments by Private Equity and Venture Capital investors. However, VCFs which are capable of providing the initial capital for NBFCs and assist in creating institutional frameworks of governance and transparency, scaling up, etc. are constrained in investing in NBFCs.

2.4.3. It is observed that the negative list in the AIF Regulations was brought forward from the erstwhile SEBI (Venture Capital Funds) Regulations, 1996 (“VCF Regulations”) with certain modifications. The negative list under VCF Regulations was brought in based on the recommendation in the report of the Committee led by Shri. K.B. Chandrashekhar (“Chandrashekhar Committee”) submitted in January 2000, which suggested that a negative list

could be specified by SEBI for definition of VCU, which could include areas like real estate, finance companies and activities prohibited by law and any other sectors which could be notified by SEBI in consultation with the Government. However, the Committee did not provide any rationale for suggesting specific sectors in the negative list.

2.4.4. Further, the report of Chandrashekhar Committee has also stated that sectoral restrictions for investment by VCFs are not consistent with the very concept of venture in promotion of innovation and technology and that they create unnecessary obstacles and hamper the growth of venture capital activity. Further, there are no similar restrictions on AIFs of other sub-categories of Category I, Category II and Category III to invest in NBFCs. As on December 31, 2020 the total investment by such AIFs (which do not undertake leverage) in NBFCs is INR 11984.809 Crore. In view of the above, it is felt that there is merit in allowing VCFs under Category I AIFs to invest in NBFCs.

2.4.5. The proposal to remove NBFCs from the negative list was discussed in the meeting of AIPAC held on January 10, 2020, and the committee recommended that the said proposal to allow VCFs to invest in NBFCs may be considered by SEBI, while also seeking comments of Central Board of Direct Taxes (CBDT) on the same, since certain provisions of the Income Tax, 1961 refer to “venture capital undertaking” as defined in the AIF Regulations. In the said meeting, the representative of RBI informed that, prima-facie, RBI has no objection to the proposal to permit VCFs to invest in NBFCs.

2.4.6. Considering that a similar negative list of investments is not specified for any other sub category or category of AIFs other than VCFs, the present provision for negative list for VCUs in the AIF Regulations may be done away with.

2.4.7. As certain provisions of the Income Tax, 1961 refer to “venture capital undertaking” as defined in the AIF Regulations, comments of CBDT were

sought on the above mentioned proposal. CBDT has informed that doing away with the negative list has no direct tax implications and therefore CBDT has no comments in this regard.

Proposal for Consideration

2.4.8. It is proposed that the definition of VCU may be modified to remove the negative list, by way of amendment to Regulation 2(1)(aa) of AIF Regulations.

3. Proposals

- 3.1. The Board may consider and approve the proposals at paragraphs 2.1.9, 2.2.9, 2.3.16 and 2.4.8. The draft amendment to AIF Regulations and the draft notification for the proposed amendment are placed at **Annexure A** and **Annexure B** respectively.
- 3.2. The Board is requested to consider and approve the proposed amendment to SEBI (Alternative Investment Funds) Regulations, 2012 and authorize the Chairman to make such necessary consequential or incidental changes to the SEBI (Alternative Investment Funds) Regulations, 2012 and take consequent steps, as may be deemed appropriate, to give effect to the decision.

Annexure A

This section has been excised for reasons of confidentiality.

Annexure B

Amendment to SEBI (Alternative Investment Funds) Regulations, 2012 shall be notified after following the due process.