

# **Enhancing trust in the Alternative Investment Funds ecosystem by introducing due diligence measures with respect to investors and investments, thereby facilitating introduction of other Ease of Doing Business measures**

## **1. Preamble to the Board Memorandum**

- 1.1. Alternative Investment Funds (AIFs) play a crucial role in capital formation, catering to sophisticated investors, while channelling risk capital to enterprises, including unlisted companies. AIFs as an asset class have shown strong growth in India since their introduction in 2012. However, a number of instances of AIFs facilitating circumvention of financial sector regulations have come to light. To ensure sustained capital formation, it is important to take steps to restore trust in the ecosystem and prevent facilitation of circumvention of financial sector regulations through AIFs, while at the same time ensuring minimal impact on legitimate AIF investments.
- 1.2. In this regard, this Board Memorandum proposes to amend SEBI (Alternative Investment Funds) Regulations, 2012 ('AIF Regulations') to introduce an obligation on AIFs, Managers of AIFs, and their Key Management Personnel (KMP), to carry out specific due diligence of their investors and investments, to ensure that AIFs do not facilitate circumvention of specified regulations administered by financial sector regulators.
- 1.3. In order to ensure that such due-diligence requirements are not open ended or subject to interpretation and that the responsibility cast on the AIFs is neither open-ended nor ambiguous, the following approach is recommended:
  - 1.3.1. A suitable framework shall be prescribed under the aforesaid obligation, to prevent occurrence of circumvention of specifically identified financial sector regulations.
  - 1.3.2. Guided by the framework issued, the specific implementation standards of verifiable due diligence checks to be conducted or overseen by AIFs, their managers, and their KMPs, on investors and investments of AIFs to demonstrate their adherence to the regulatory obligation, are proposed to be formulated by the pilot Industry Standards Forum for AIFs, in consultation with SEBI.

- 1.4. The proposed finite list of identified financial sector regulations is given in **Annexure A**. Any additions to the same would be after having public consultation on the proposed measures to address the circumvention of identified financial sector regulator.
- 1.5. The enhanced trust that would result from verifiable compliance with such due-diligence requirements shall provide the regulatory comfort necessary for the introduction of other Ease of Doing Business (EoDB) proposals/ measures relating to AIFs and avoiding detailed business model related regulations.

## **2. Background and issues under consideration**

- 2.1. AIFs, being privately pooled investment vehicles, connect sophisticated investors having risk appetite with enterprises in need of risk capital, complementing other sources of funding such as banks, financial institutions, and public markets. The AIF industry has shown consistent growth over the years with Compound Annual Growth Rate (CAGR) of approximately 35% p.a. in last 5 years. As of December 31, 2023, the cumulative commitments raised and investments made by AIFs amount to INR 10,84,875 Crore and INR 3,99,653 Crore respectively.
- 2.2. While the normal perception of AIFs is that they primarily provide risk capital to the start-up ecosystem, it may be noted that, as per data submitted by AIFs for quarter ending December 31, 2023, the investments in start-ups as specified in the DPIIT notification no. G.S.R. 127(E) dated February 19, 2019, is only about 7% of the total investments made by AIFs.
- 2.3. Further, to highlight the channelization of funds, the top 5 sectors where AIFs have invested, as on December 30, 2023 is given below -

<b>Sector</b>	<b>Investments made by AIFs (in INR Crore)</b>	<b>% of total investments made by AIFs</b>
Real Estate	66,035	16.4 %
IT/ ITes	42,694	10.6 %
Financial Services	27,009	6.7 %
Pharmaceuticals	21,343	5.3 %
E-Commerce	19,610	4.9 %

2.4. Compared to other SEBI registered investment channels such as Mutual Funds and Portfolio Management Services (PMS), AIFs have a relatively light-touch regulatory framework. While this light touch regime offers flexibility of operations to AIFs, in the recent past, several instances of AIFs facilitating circumvention of extant financial sector regulations have emerged. Over the past one year or so, more than 40 cases involving over INR 30,000 crores of investment have been observed, where AIFs appear to have facilitated circumvention of certain financial sector regulations. The details of number of cases of AIFs potentially facilitating circumvention of financial sector regulations are given at **Annexure B**.

2.5. Some of the identified modus operandi by which AIFs appear to be facilitating circumvention of financial sector regulatory frameworks are explained, as under:

2.5.1. Ever-greening of loans by regulated lenders:

2.5.1.1. In this modus operandi, typically, a regulated lender would subscribe to junior class of units of an AIF that has lower priority in distribution of proceeds over other classes of units, and the AIF in turn would fund the lender's stressed borrower by subscribing to debt securities issued by the borrower.

2.5.1.2. As per a pre-agreed arrangement, the borrower would use these funds to repay the loan given by the regulated lender & junior class investor, without disclosure of any stress. The stressed asset in the books of the regulated lender would in effect be replaced with the investment in the junior class units of the AIF.

2.5.1.3. This structuring has allowed some regulated lenders to avoid classification, provisioning and other applicable regulatory requirements under the RBI Regulations with respect to these stressed assets. The recognition of deteriorating creditworthiness of the borrower may have also been deferred.

2.5.1.4. Considering this, the aforesaid modus operandi and details of instances involved were brought to the attention of RBI.

2.5.1.5. RBI acknowledged the regulatory concerns in this regard as corroboration of issues already identified under their own supervision. Subsequently, RBI issued a notification dated

December 19, 2023 on 'Investments in Alternative Investment Funds (AIFs)' requiring their regulated entities (viz., Banks, Non-Bank Financial Institutions, and other Financial Institutions) inter-alia, to address concerns relating to possible ever-greening through the AIF route.

2.5.1.6. It is critical to require verifiable due diligence by AIFs, their managers, and their KMPs, to ensure that such circumventions do not recur in any other form or through layering of transactions, and that the issue of AIFs facilitating circumventions is addressed without coming in the way of legitimate investments.

2.5.2. Circumvention of FEMA norms:

2.5.2.1. As per extant Foreign Exchange Management (Non-Debt Instrument) Rules, 2019 ('NDI Rules'), classification of downstream investment made by an AIF is based on the domicile of ownership and control of manager and sponsor of the AIF, with the understanding that investment decisions of an AIF are taken by its Manager and/or Sponsor since they are effectively controlled by Manager/ Sponsor. Thus, downstream investment made by an AIF having domestically owned and controlled sponsor and manager is not classified as indirect foreign investment for the investee company.

2.5.2.2. It is understood that this was intended to facilitate domestic fund managers in raising bona fide foreign investment from a large number of investors in a pooled vehicle. However, the aforesaid provision has also created scope for regulatory arbitrage. Some AIFs having limited number of, often related, investors, appear to have been set up specifically with the intent to circumvent the provisions and restrictions relating to foreign investment in a particular sector, company, or security/ instrument.

2.5.2.3. For instance, some AIFs with domestic owned and controlled manager/ sponsor have been set up with limited number of investors who are non-residents/ foreigners, which can facilitate such investors to bypass norms for FDI investment such as sectoral limit (for

example, 74% sectoral cap for banking –private sector), or pricing guidelines (for example, the price of equity instruments issued by an Indian company to a person resident outside India shall not be less than the price worked out in accordance with the SEBI guidelines in case of a listed Indian company or in case of a company going through a delisting process as per the SEBI (Delisting of Equity Shares) Regulations, 2009) etc. These investors, by virtue of having majority contribution in the AIF scheme, may exercise indirect control/influence over the investment decisions of the AIF.

2.5.2.4. In an earlier communication to SEBI, RBI had also stated that the investment in debt from non-residents can come only through two approved channels, Foreign Portfolio Investment (FPI) or External Commercial Borrowing (ECB), and that indirect investment by AIFs having investment from non-residents in securities permitted for FPI through AIF route could lead to regulatory arbitrage. RBI has further conveyed that any channel for investment by non-residents must not defeat the regulations of other channels. However, it is seen that there are AIFs which have received investment only from a limited set of foreign investors and have predominantly invested in debt securities.

2.5.2.5. It may be noted that, vide letter dated March 16, 2017, SEBI had written to RBI raising this concern with respect to downstream investment norms for AIFs and to consider beneficial interest held by foreign investors in the fund (instead on ownership and control of sponsor/manager) as basis for determining indirect foreign investment by AIFs. Subsequent to deliberations over the years on this issue, RBI has recommended to Government of India that if more than 50% of the units of a scheme of an AIF are held by/issued to person resident outside India, then all investments held or made by such AIF scheme shall be treated as Indirect Foreign Investment for the investee entities and SEBI has also concurred with the same. A decision is this regard with respect to amendment to NDI Rules is awaited.

2.5.2.6. It may be noted that the National Security Council Secretariat (NSCS) issued a concept paper on “Strengthening Foreign Investment Regulatory Framework in India” outlining specific proposals considering that there is scope for strengthening and modernising India’s foreign investment regulatory regime, particularly from a national security perspective. NSCS also highlighted that Press Note 3 on Foreign Direct Investment (FDI) Policy of 2020 was a significant step in the direction of factoring national security risks that could arise from investments flowing from our land border sharing countries. In this regard, owing to the aforesaid classification of downstream investment made by AIFs, there is scope that the investments could flow from our land border sharing countries through AIFs in companies beyond the permissible limit for automatic route under FDI policy, undermining the spirit of Press Note 3 notification and the steps taken by Government of India in this regard.

2.5.3. Circumvention of regulations pertaining to Qualified Institutional Buyers (QIBs):

2.5.3.1. QIBs, in general, are large, regulated, sophisticated and informed institutional investors. It is also observed that many entities designated as QIBs are professional, expert money managers undertaking investment on behalf of a large body of stakeholders. They are expected to possess the expertise and ability to evaluate, invest and manage financial risks. They are also expected to contribute in an expert manner, to price discovery for IPOs/ FPOs. As per extant regulations, all AIFs are designated as QIBs.

2.5.3.2. In terms of SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018 (“ICDR Regulations”), the following flexibilities/benefits, *inter alia*, are available to QIBs –

(a) In an issue made through the book building process under Regulation 6(1) of ICDR Regulations (i.e. meeting eligibility requirement), up to 50% shall be allocated to QIBs.

- (b) In an issue made through the book building process under Regulation 6(2) of ICDR Regulations (i.e. not meeting eligibility requirement), at least 75% is allocated to QIBs.
- (c) QIBs are not counted for the purpose of the numerical restriction (viz. 200) stipulated in the Companies Act, 2013, for private placement of securities.
- (d) QIBs can become 'anchor investor' and avail benefits such as –
  - In terms of Regulation 32(3) of ICDR Regulations, in an issue made through the book building process, the issuer may allocate up to 60 per cent of the portion available for QIB allocation to anchor investors.
  - Anchor investors are offered to invest in the IPO and gets confirmed allotment a day before the IPO is open for public subscription.
- (e) Issuer company, post listing, can undertake "qualified institutions placement" which means issue of eligible securities by a listed issuer to qualified institutional buyers on a private placement basis and includes an offer for sale of specified securities by the promoters and/ or promoter group on a private placement basis.

2.5.3.3. Certain AIFs, where a single investor or a few connected investors likely have significant influence or control over the investment decisions of the AIF, have invested in IPOs under the QIB quota, thereby availing benefits available to QIBs under ICDR Regulations. It may be noted that such investors of AIFs would otherwise not be eligible for QIB status on their own.

2.5.3.4. It is not desirable that such ineligible entities/ persons avail QIB status through AIF route and influence the price discovery process in the public market, which in turn affects other retail investors participating in the IPO.

#### 2.5.4. Circumvention of SARFAESI Act and/or Insolvency and Bankruptcy Code:

2.5.4.1. AIFs, designated as Qualified Buyers ('QBs') in terms of SARFAESI Act, can subscribe to Security Receipts ('SRs') issued by Asset

Reconstruction Company ('ARC'). QBs are typically large institutional investors and professional money managers undertaking investments on behalf of a large body of investors, and does not include domestic individuals, family offices and corporates.

2.5.4.2. It has been observed that certain AIFs with single or very few connected investors have subscribed to SRs issued by ARCs. In some of these cases, the holdings in SRs are also concentrated in terms of underlying assets. Thus, entities which may not qualify as QBs on their own, or are otherwise not eligible to buy an SRs (such as an entity connected to the defaulting borrower), can set up an AIF for purchase of such SRs.

2.5.4.3. The said modus operandi was referred to RBI for its comments. RBI, prima-facie, stated that there does not seem to be any regulatory concerns in the acquisition of stressed assets by the potential buyers or interested stakeholders from the same industry segment as they may be best suited to keep the firm running as a going concern, however it was essential that defaulting borrowers are not permitted to acquire the underlying assets through ARCs.

2.5.4.4. In a recent meeting of the RBI-SEBI Information Sharing Mechanism, it was discussed that although defaulting borrowers are not permitted to acquire underlying assets through ARCs or through AIFs, whether it may be a concern that a group of investors may use the AIF structure to award acquisition bid for the underlying asset to their related party by gaining control on the Committee of Creditors. In this regard, it was agreed that RBI may ascertain if any such instances were observed during supervisory examinations of the ARCs and that both RBI and SEBI co-ordinate in the matter and take necessary steps to prevent such instances of circumvention of SARFAESI Act through AIF Structure.

2.6. It has been observed that most of the identified cases of AIFs facilitating circumvention had a single investor, or narrow and connected investors having majority contribution in the corpus of the AIF scheme, thereby indirectly exercising significant influence/control over decisions of the scheme of the AIF.



- 2.7. In this regard, it is pertinent to note that, as per data submitted by AIFs for quarter ending December 31, 2023, there are 228 schemes of AIFs (not including Angel Funds and open ended schemes) which have less than or equal to 3 investors, other than sponsor and/or manager. The total commitments raised and investment made by such schemes stands at INR 5,03,907 Crore and INR 1,15,405 Crore respectively.
- 2.8. Out of the 228 schemes, final close of 108 schemes has been declared, on or before December 31, 2023, i.e., these funds are understood to have completed their activities for raising commitments from investors. The total commitments raised by such schemes stands at INR 2,74,434 Crore. Further, the total investment made by such schemes stands at INR 67,540 Crore respectively. Out of the 108 schemes, 41 schemes have 4 or less investment holdings.
- 2.9. The specific instances mentioned at para 2.5 above were identified based on thematic inspections and examination of periodic reports submitted by AIFs and hence, is not an exhaustive list of all cases of such type of circumventions. Moreover, the possibility of certain other types of circumvention of extant financial sector regulations being facilitated by AIFs cannot be ruled out.
- 2.10. Based on data reported by AIFs for the quarter ending June 30, 2023, the investments made by schemes of AIFs which appear to have been involved in identified cases of circumvention is over INR 30,000 Crore out of total AIF investments of approximately INR 3.5 Lakh Crore over 40 such AIFs appeared to be circumventing extant regulations. Such practices severely impact the overall trust and integrity of the AIF ecosystem and may result in affecting sentiment of investors and other stakeholders towards AIFs in the long run.
- 2.11. It may be noted that, in all such identified instances of circumvention, there is regulatory arbitrage that has been taken advantage of by some industry participants in order to misuse AIF vehicles to facilitate circumvention. Thus, it may be acknowledged that there is a need for a regulatory intervention to address the aforesaid concerns with respect to AIFs facilitating circumvention, in order to enhance trust in the AIF ecosystem.
- 2.12. In this context, it is pertinent to note that there are heightened global regulatory concerns around the private equity industry. The same is also seen from IOSCO-

CER report of September 2023 on “Thematic Analysis: Emerging Risks in Private Finance” and new rules adopted in August 2023 by the US Securities and Exchange Commission (US SEC) for regulation of Private Fund Advisors. It is also noted from various sections of the media that the UK’s Financial Conduct Authority is set to review certain risks related to private assets and the potential spill over of such risks to the larger financial sector.

### **3. Regulatory approach to address circumvention through AIF route**

- 3.1. As is evident from the cases of circumvention highlighted above, there is a need to prevent undesirable events/misuse (i.e. prevent Type I errors), while ensuring that any regulatory action does not come in the way of legitimate investments (i.e., prevent Type II errors).
- 3.2. Thus, while there is a need to address concerns as mentioned above in an effective manner, it is necessary to also ensure that any regulatory intervention should not take away the flexibility of AIFs to carry out genuine and legitimate investments.
- 3.3. Accordingly, an approach that addresses the regulatory concerns in a proportionate, risk-based manner, while at the same time facilitates ease of doing business and ease of compliance, is being proposed in this Board Memorandum.
- 3.4. To address the specific regulatory concerns around misuse of AIF structure for circumvention as articulated above, it is proposed to introduce an obligation on AIFs, Managers of AIFs and the Key Management Personnel of AIFs and their Managers (KMPs) to carry out specific due diligence with respect to their investors and investments, to prevent facilitation of circumvention of specified extant regulations administered by financial sector regulators. In order to ensure that such due-diligence requirements are not open ended or subject to interpretation and that the responsibility cast on the AIFs is neither open-ended nor ambiguous, the following approach is proposed:
  - 3.4.1. Under the aforesaid obligation, a suitable broad framework shall be prescribed by way of circular, to prevent occurrence of circumvention of specifically identified financial sector regulations.

- 3.4.2. A clear set of implementation standards shall be formulated to cast limited and specific responsibilities and obligations on AIFs, Managers and their KMPs, so that they are not subject to open ended obligations/liability.
- 3.5. It may be noted that SEBI is piloting deeper engagement with industry participants through the formation of various pilot Industry Standards Fora across segments of the securities market. It is envisaged that such industry fora, in consultation with SEBI, shall formulate standards for effective implementation of regulations prescribed by SEBI.
- 3.6. Along these lines, SEBI has facilitated setting up of a pilot Standards Setting Forum for AIFs ('SFA') for formulating standards for ease of implementation of AIF Regulations, in consultation with SEBI.
- 3.7. In line with the 'Trust, but verify' principle, the implementation standards, i.e., specific verifiable due diligence checks to be carried out by the AIFs, managers and their KMPs to demonstrate adherence to the above general obligation and the principles prescribed under it, shall be set by the industry itself through the pilot SFA, in consultation with SEBI. The implementation standards formulated would be such that, AIFs that intend to comply with the regulations should face no challenge in demonstrating adherence to them.
- 3.8. It may be noted that, vide circular no. SEBI/HO/AFD-1/PoD/P/CIR/2023/053 dated April 10, 2023, SEBI has prescribed guidelines with respect to excusing or excluding an investor from an investment of AIF. As per the said circular, manager of an AIF may exclude an investor from participating in a particular investment opportunity, if the manager of the AIF is satisfied that the participation of such investor in the investment opportunity would lead to the scheme of the AIF being in violation of applicable law or regulation.
- 3.9. In line with the same, in case it is ascertained that the participation of an investor in a particular investment of an AIF might result in circumvention of a specified regulation/ provision, the manager of the AIF has the flexibility to either exclude the investor from the particular investment or not make the said investment.
- 3.10. The enhanced trust that would result from adherence to such an obligation, underlying principles, and implementation standards, along with verification of the adherence, would provide regulatory comfort for introduction of other Ease of

Doing Business (EoDB) proposals/ measures relating to AIFs and obviate the need for granular regulations.

#### **4. Consultation with stakeholders:**

- 4.1. In line with the regulatory approach discussed above, an agenda in this regard was placed in meeting of AIPAC held on December 13, 2023, with the proposal to introduce the following regulation in the AIF framework:

*“Every Alternative Investment Fund, Manager of Alternative Investment Funds and Key Management Personnel of the Manager and Alternative Investment Funds shall ensure that the Alternative Investment Fund is neither organized, operated, managed, nor the portfolio of securities is selected in a manner that results in circumvention of these Regulations or any other extant regulation or law issued or administered by any financial sector regulator.*

*Provided that the specific guidelines for managers to demonstrate adherence to these principles shall be as specified and enumerated by SEBI from time to time.”*

- 4.2. After deliberation, AIPAC recommended the aforesaid proposal to introduce a general obligation on AIFs, Managers and their KMPs to prevent circumvention, along with the proposal that the specific implementation standards for the same shall be formulated by the Standards Setting Forum for AIFs ('SFA'), in consultation with SEBI. It was also recommended that any glide-path needed for implementation may be considered by SEBI.

#### **5. Public Consultation:**

- 5.1. While internally deliberating the proposal given at para 4.1 above, it was felt that the scope of the regulation draft given above is broad and does not clearly convey the intent that the specific obligations to be cast on AIFs, managers and their KMPs will be limited to addressing specific regulatory circumventions and that the only requirement would be to do investor and investee due-diligence as per the accompanying implementation standards. Accordingly, the draft language for the obligation to be cast on AIFs, managers and their KMPs has been modified to clarify that such obligation is limited to carrying out specific due-diligence checks with respect to investors and investments of the AIF.

5.2. Considering the above, taking into account the recommendations of AIPAC and internal deliberations, SEBI issued a consultation paper on January 19, 2024 soliciting comments from public on the following proposals –

5.2.1. To insert the following provision in Chapter IV (viz. General Obligations and Responsibilities and Transparency) of AIF Regulations:

*“Every Alternative Investment Fund, Manager of the Alternative Investment Fund and Key Management Personnel of the Manager and the Alternative Investment Fund, shall carry out specific due diligence, as may be specified by SEBI from time to time, with respect to their investors and investments, before each investment, to prevent facilitation of circumvention of extant regulations administered by any financial sector regulator.*

*Provided that, if participation of an investor of an AIF in an investment opportunity has been ascertained to result in facilitation of circumvention of any extant regulation, the manager of the AIF shall –(a) not make the investment; or (b) exclude the particular investor from the investment.”*

5.2.2. SEBI shall prescribe a framework under the above-mentioned regulation, to specify the objectives and the principles envisaged to address regulatory circumventions. Such principles shall guide the framing of the specific and verifiable standards for due diligence that the stakeholders of the AIF will need to conduct for ascertaining as to whether the participation of an investor in a particular investment of the AIF facilitates circumvention of extant regulations.

5.2.3. The specific implementation standards of verifiable due diligence accompanied by suitable standards of reporting by AIFs, shall be formulated by the pilot SFA, in consultation with SEBI.

5.3. Total 23 entities, including AIFs, AIF industry associations, and legal consultants, have provided comments on the proposals in the consultation paper. The proposed regulatory approach has elicited mixed response from the stakeholders, including positive as well as negative views. A copy of the said consultation paper and proposal-wise analysis of the comments received from public are placed at **Annexure C** and **Annexure D** respectively.

5.4. Majority commenters, including AIF industry associations, have raised concerns that the scope of the proposed regulation is too broad and have, inter-alia, suggested limiting the scope of the obligation cast on the AIF, managers and their KMPs. Few commenters have agreed with the introduction of the proposed obligation, acknowledging the intent to ensure that AIFs, either directly or indirectly, do not become a tool to circumvent the applicable regulations. The major concerns raised and suggestions provided by the commenters over the proposed approach are discussed in detail in the following paragraphs, along with our views on the same.

5.5. Necessity of the proposed obligation:

5.5.1. Many commenters have expressed reservation over the need for such obligation, stating that for any circumvention of regulations through AIF which is identified, the principal regulation of respective financial sector regulator has to be amended to address such circumvention instead of casting obligation on AIF Managers to look for it. It is also stated that introducing the proposed due-diligence processes to be conducted by Managers of AIFs will bring in regulatory uncertainty for investors seeking to deploy their funds in AIFs and reduce the attractiveness of the asset class to investors.

5.5.2. In this regard, it may be clarified that the intent behind introducing the proposed obligation is to prevent AIFs facilitating circumvention of other regulatory framework without affecting legitimate AIF investments. If the principal regulation is sought to be amended, it could lead to severe restrictions on the activities of all AIFs – including those AIFs which didn't facilitate circumvention. Thus, it is in the interest of the AIF industry that regulatory intervention be of a limited nature.

5.5.3. Nonetheless, whenever some modus operandi of possible circumvention of regulatory framework of other regulators through AIFs is identified, the same is referred to the respective financial sector regulator for necessary action at their end. Any action by the respective regulator with respect to the entity which is circumventing the particular regulation, does not address the issue of AIFs facilitating, aiding and abetting such circumventions.

5.5.4. Further, if AIFs adhere to the proposed regulatory approach and operate for making only legitimate investments, the same would consequently result into enhanced trust of investors and all other stakeholders in this asset class. Hence, the suggestion provided above may not be accepted.

5.6. Limiting the scope of the proposed obligation:

5.6.1. Many commenters have highlighted concerns with respect to the broad nature of the proposed obligation stating that it is not possible for AIF managers to have knowledge about every “extant regulation” i.e. laws, acts, rules, regulations, guidelines/circulars framed thereunder that are administered by any financial sector regulator including SEBI, that may be applicable to thousands of investors across multiple AIF schemes that are managed.

5.6.2. In this regard, it may be clarified that the intent is that due-diligence checks shall be stipulated to address identified cases of circumvention of specific provisions or regulations of financial sector regulators. Therefore, the proposal may be modified accordingly to state that the due-diligence checks shall be carried out to prevent circumvention of such laws as may be specified by SEBI from time to time. The list of regulations identified at this juncture, to address circumvention, is given at **Annexure A**.

5.6.3. Commenters have also emphasised that it might not be economically feasible or practical for AIFs that manage substantial portfolios, their managers or KMPs to carry out specific due diligence, with respect to their investors and investments, before each investment to avoid circumvention of extant regulations. While material investments/ investors can be subject to additional due diligence, making such due diligence applicable in relation to every investor and investment can be a challenging task. In relation to this concern, many commenters have also suggested casting this obligation only on such schemes which have limited number of investors or connected investors.

5.6.4. It is pertinent to note that the intent behind the general obligation, is to address the identified circumventions in a targeted manner, that is, to cast responsibility only on such type of funds which have high possibility of

facilitating such circumventions. For instance, as already stated in the consultation paper in this regard, in some of the identified cases of circumvention, the schemes of AIFs had a single investor, or investors of the same group i.e., narrow and connected investors, having majority contribution in the corpus of the scheme, thereby indirectly exercising significant influence/control over decisions of the scheme of the AIF. Such circumventions can be ascertained or tested through specific due-diligence checks under the standards. Such schemes of AIFs having a concentrated investor base, shall require additional due-diligence. It must also be emphasised that circumventions – including in some of the instances enumerated earlier in this note - are not limited to such type of funds alone. The specific due diligences in respect of each specific regulatory framework, as set by the pilot SFA in consultation with SEBI, will take into account the specific context in each case.

#### 5.7. Confidentiality of investments:

- 5.7.1. Commenters have stated that there may be apprehensions about the leakage of investment deals due to the due-diligence checks, since AIFs usually execute Non-Disclosure Agreements (NDAs) with investee companies. It is stated that sharing the details of investee company with investors before investments will impact investment deals and chances of leakage may even break the deal process entirely. Commenters have expressed concerns that this may adversely impact entire AIF industry and may position AIFs in disadvantageous position compared to other investors interested in such investment opportunities.
- 5.7.2. It is understood that, in many AIFs, large investors who have significant contribution in a scheme of AIF, are members of investee committee set up to approve decisions of the scheme of AIF. Thus, such investors have significant influence on the decisions with respect to investments proposed to be made by the scheme of AIF.
- 5.7.3. It may be noted in this regard that, the implementation standards formulated shall be such that, the manager of AIF shall collect requisite information from investors and investee companies and carry out necessary due-diligence checks at its end. Further, the checks specified



shall be limited to investors and investments falling under the ambit of the framework prescribed to address specific circumventions.

5.8. Increased compliance burden of the proposed obligation:

5.8.1. Commenters have also highlighted the proposed obligation will be onerous for AIFs due to increased compliance burden on manager and KMPs of AIFs which comes with the additional due-diligence checks to be carried out with respect to investors and investments. Hence, commenters have suggested to have clearly specified due diligence criteria to be met by the manager.

5.8.2. Commenters have also suggested that it is essential that SEBI identifies objective and quantitative, rather than vague, criteria to determine the investments or investors that should be subject to a higher degree of due diligence. To ensure uniformity in practice, such determination should not be based on subjective criteria or be left upon the discretion of AIFs.

5.8.3. The intent of this regulation is indeed in line with the above ask from the commentators. As stated earlier, the implementation standards in the form of due-diligence checks shall be formulated by SFA, which has representation from AIF industry, in consultation with SEBI. Hence, such concerns of the industry participants shall be addressed suitably by SFA while framing specific standards for verifiable due-diligence checks, in consultation with SEBI.

5.9. Applicability of due-diligence checks on investments already made by AIFs:

5.9.1. Commenters have suggested that the due diligence checks should be carried out only at the time of investment and not subsequently. One of them has also suggested that, in case at any time post the investment, if it is found that a particular investor should have been excluded from the investment / the investment should not have been made, the Investment Manager should have an option to dispose of the investment within a specified duration.

5.9.2. The purpose of the due-diligence check is to prevent facilitation of any circumvention of provisions of financial sector regulators, which cannot be a time specific check. An entity who intends to circumvent can design the

structure in such a way that, at a later date post investment, it acquires the units of AIFs post investment, such as buying the units of an existing investor or by acquiring control over the exiting investor entity, as per prior arrangement. Hence, the suggestion may not be accepted and the requirement of due diligence around investors and investments will be an ongoing one.

5.9.3. Further, some commenters have suggested that any proposed due diligence criteria should only be applicable in relation to prospective investments and SEBI should grandfather investments made as on date. However, in case it has been ascertained that the AIF has facilitated circumvention with respect to the investments already made, the manager may be mandated to report the same to SEBI for examination. In case of circumvention of regulations of other regulators, the information collected may be forwarded to respective financial sector regulator for necessary action, if any, in this regard.

5.10. The compilation of other minor comments received from the stakeholders on the consultation paper and our views on the same are given at **Annexure E**.

## **6. Proposal:**

6.1. Taking into account SEBI's discussions with AIPAC and the AIF industry, comments received from public and internal deliberations, it is proposed that AIF Regulations may be suitably amended to insert the following provision in Chapter IV (viz. General Obligations and Responsibilities and Transparency) of AIF Regulations:

*“Every Alternative Investment Fund, Manager of the Alternative Investment Fund and Key Management Personnel of the Manager and the Alternative Investment Fund shall exercise specific due diligence with respect to their investors and investments, to prevent facilitation of circumvention of such laws, as may be specified by the Board from time to time.*

*Explanation: “laws” shall include Acts, Rules, Regulations, Guidelines or circulars framed thereunder that are administered by a financial sector regulator, including that by the Board.”*

- 6.2. SEBI shall prescribe a framework under the above-mentioned regulation, by way of issuance of circular, to address circumvention of specifically identified financial sector regulations. The framework shall guide the framing of implementation standards for specific and verifiable due diligence checks that AIFs, Managers and their KMPs need to carry out with respect to their investors and investments for ascertaining whether the participation of an investor in a particular investment of the AIF facilitates circumvention of the identified regulation.
- 6.3. The implementation standards for specific, verifiable due diligence checks (guided by the framework issued by SEBI) accompanied by suitable standards of reporting by AIFs, shall be formulated by the pilot Standard Setting Forum for AIFs ('SFA'), in consultation with SEBI.
- 6.4. The framework and implementation standards formulated shall be such that only those specific type of schemes that meet certain objective risk criteria, as may be specified by SEBI, would be required to carry out specific due-diligence checks with respect to their investors and investments.
- 6.5. Further, prior to making the investment, if participation of an investor of an AIF in an investment opportunity, has been ascertained to result in facilitation of identified circumvention, the manager of the AIF shall –
  - (a) not make the investment; or
  - (b) exclude the particular investor from the investment.
- 6.6. With respect to existing investments made by AIFs, based on due-diligence checks prescribed, if it is ascertained that such AIFs have facilitated circumvention of specific regulations, the manager of AIF may be mandated to report the same to SEBI, which may be forwarded to respective financial sector regulator for necessary action in this regard.

## **7. Proposal to the Board:**

- 7.1. The Board may consider and approve the proposed amendments to AIF Regulations as given at para 6 above.
- 7.2. The draft amendment to AIF Regulations and the draft notification for the proposed amendment are placed at **Annexure F** and **Annexure G** respectively.

7.3. The Board is requested to consider and approve the proposals as in the Memorandum and authorize the Chairperson to make consequential and incidental changes and take necessary steps to give effect to the decisions of the Board.

**Encl:**

**Annexure A** (No. of pages – 01)

**Annexure B** (No. of pages – 01)

**Annexure C** (No. of pages – 07)

**Annexure D** (No. of pages – 01)

**Annexure E** (No. of pages - 08)

**Annexure F** (No. of pages – 01)

**Annexure G** (No. of pages – 03)

**List of identified specific regulations of financial sector regulations for which specific due-diligence checks shall be formulated to prevent AIFs facilitating circumvention of the same**

- I. Regulations of Reserve Bank of India specifying prudential norms for regulated lenders on Income Recognition, Asset Classification, Provisioning and restructuring stressed assets.
- II. Provisions of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, and other regulations of SEBI under which benefits or relaxations are provided to entities designated as Qualified Institutional Buyers.
- III. Provisions of FEMA (Non-Debt Instruments) Rules, 2019 specifying norms for foreign investment in equity instrument of Indian entities such as sectoral cap, pricing guidelines etc.
- IV. Provisions of FEM (Debt Instruments) Regulations, 2019, for foreign investment in debt instruments issued by Indian companies.
- V. Rule 6 of FEMA (Non-Debt Instruments) Rules, 2019 for investment from countries sharing land border with India (Press Note 3 of FDI Policy 2020).
- VI. Provision under Section 7(1) of SARFAESI Act for definition of Qualified Buyers and provisions under Insolvency and Bankruptcy code providing benefits to Qualified Buyers in the resolution process.

This has been excised for reasons of confidentiality.

The consultation paper is available at the following link:

[https://www.sebi.gov.in/reports-and-statistics/reports/jan-2024/consultation-paper-on-proposal-to-enhance-trust-in-the-alternative-investment-funds-aif-ecosystem-to-facilitate-ease-of-doing-business-measures\\_80799.html](https://www.sebi.gov.in/reports-and-statistics/reports/jan-2024/consultation-paper-on-proposal-to-enhance-trust-in-the-alternative-investment-funds-aif-ecosystem-to-facilitate-ease-of-doing-business-measures_80799.html)

The proposal-wise analysis for the comments received on consultation paper on proposal to enhance trust in the Alternative Investment Funds ('AIF') ecosystem to facilitate Ease of Doing Business measures

No. of people/entities agreeing to the proposal						
Proposal Description	Strongly Agree	Agree	Partially Agree	Disagree	Strongly Disagree	Total Count
To introduction of the proposed general obligation in Chapter IV of AIF Regulations	3	4	5	4	7	23
To prescribe a framework under the general obligation to address regulatory circumventions	2	2	7	4	3	18
Specific implementation standards of verifiable due diligence shall be formulated by pilot SFA, in consultation with SEBI	3	3	4	6	0	16



This has been excised for reasons of confidentiality.

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

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