

## **Amendment to SEBI (Alternative Investment Funds) Regulations, 2012**

### **1. Objective**

This Board Memorandum proposes to amend certain provisions of SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”) to simplify and rationalise compliance requirements for AIFs, provide flexibility to the managers of AIFs and to streamline regulatory processes.

### **2. Background**

2.1. The AIF Regulations were notified on May 21, 2012. Over a period of nine years, the AIF industry has grown steadily, with commitments raised as on March 31, 2021, aggregating approximately Rs 4.5 lakh Crore. Over the years, amendments have been made in AIF Regulations, to address specific issues raised by the industry and to ensure that the extant regulatory framework is aligned with the changing landscape of the industry.

2.2. In December 2020, under the initiative of Government of India on minimizing compliance burden for citizens and business activities, SEBI has received reference(s) from Department of Economic Affairs (DEA) for rationalizing compliance requirements by various SEBI registered entities/ intermediaries including AIFs.

2.3. In this backdrop, AIF Regulations were reviewed and certain provisions were identified for rationalization. The proposals for regulatory changes were discussed in the meeting of Alternative Investment Policy Advisory Committee (AIPAC) held on July 7, 2021 and the recommendations of AIPAC have been analysed.

### **3. Issues for Consideration**

3.1. For rationalizing compliance requirements for AIFs and also providing investment flexibility, the following regulatory changes are proposed:

### 3.1.1. Temporary Investments

- (a) AIF Regulations provide for AIFs to invest the un-invested portion of investable funds in specified liquid assets till deployment of funds as per the investment objective (“temporary investments”). As seen from industry feedback, for greater operational ease and in the interest of the investors, it is desirable to extend the flexibility of such temporary investments to the proceeds of portfolio divestments that are pending distribution to investors in terms of the fund documents.
  
- (b) The issue of flexibility with regard to temporary investments was discussed in AIPAC and the Committee agreed with the proposal to permit proceeds of portfolio divestments that are pending distribution to investors to be invested in temporary investments. Accordingly, it is proposed to amend Regulation 15 (1)(f) of AIF Regulations to provide that proceeds of portfolio divestments that are pending distribution to investors in terms of the fund documents may also be invested in temporary investments.

### 3.1.2. Investment conditions and restrictions for Venture Capital Funds

- (a) In terms of Regulation 16(2)(a) of the AIF Regulations, Venture Capital Funds (VCFs) registered under Category I are required to invest at least 2/3rd of the investable funds in unlisted equity shares or equity linked instruments of a venture capital undertaking (VCU) or in companies listed or proposed to be listed on a SME exchange or SME segment of an exchange. Regulation 16(2)(b) also specifies that not more than 1/3rd investable funds may be invested in other permitted investee companies.
  
- (b) In comparison, other subcategories of Category I AIFs are mandated to invest at least 75% of the investable funds in investee companies in specified sectors and there is no investment restriction on the remaining 25% of the investable funds. There is a need to provide greater investment flexibility to managers of VCFs, while ensuring that the sub-category is ‘true to label’.

- (c) AIPAC recommended that the investment threshold of 2/3<sup>rd</sup> (67%) of investable funds specified in Regulation 16(2)(a) may be increased to 75%, but only after examination of investment data of VCFs. Based on analysis of the investment data it is observed that VCFs presently invest significantly more than 75% of investable funds in unlisted equity shares or equity linked instruments and therefore, it may not be difficult for VCFs going forward also, to comply with the requirement of minimum 75% investment in unlisted equity shares or equity linked instruments of VCUs or SMEs.
- (d) Accordingly, it is proposed to amend Regulation 16(2)(a) of AIF Regulations to specify that at least 75% of the investable funds shall be invested in unlisted equity shares or equity linked instruments of a venture capital undertaking or in companies listed or proposed to be listed on a SME exchange or SME segment of an exchange.
- (e) AIPAC also recommended that to enhance investment flexibility of VCFs, investment norms for remaining 25% of the investable funds of VCFs may be aligned with that of other sub categories. Accordingly, it is proposed to delete the Regulation 16(2)(b) of the AIF Regulations in order to provide investment flexibility to managers of VCFs.

### 3.1.3. Investment conditions for Infrastructure Funds and SME Funds

- (a) AIF Regulations provide for registration of AIFs set up with the objective to invest in infrastructure sector or SME companies, inter-alia, as Infrastructure Funds and SME Funds, sub categories of Category I AIFs, respectively. However, over the years, these sub-categories have witnessed low growth. As on March 31, 2021 there are only 16 Infrastructure Funds and 15 SME Funds under Category I and their investments as compared to the total investments by all AIFs is small.
- (b) Presently, Infrastructure Funds and SME Funds of Category I are required to invest at least 75% of the investable funds in unlisted

securities or partnership interest of venture capital undertakings or investee companies in the sectors /areas specified for that sub-category. They may also invest in units of AIFs of the same sub category.

- (c) To provide greater investment flexibility to these sub-categories while ensuring that they are true to label, it is felt that the AIFs set up as SME Funds and Infrastructure Funds under Category I may be permitted to invest in units of such Category II AIFs whose investment objective is aligned with that of the relevant sub-category. AIPAC recommended that the proposal may be taken up for amendment to AIF Regulations as such investment flexibility may aid to generate interest in these sub-categories.
- (d) Accordingly, to provide flexibility to enable Category I AIFs to invest in units of AIFs of other categories, it is proposed to amend Regulation 16(1)(a) of AIF Regulations to provide that in addition to specified investee companies and units of other AIFs of the same sub category, Category I AIFs may also invest in units of other AIFs as specified by the Board.
- (e) Further, it is proposed to specify that SME Funds and Infrastructure Funds under Category I AIFs may invest in units of only such Category II AIFs whose investment objective is aligned with that of the relevant sub-category, by way of issuance of a Circular.

#### 3.1.4. Receipt of grants by SVFs

- (a) Currently, the minimum investment amount by an investor in an AIF is INR 1 Crore and the minimum grant that may be accepted by a Social Venture Fund (SVF) from any person is INR 25 lakhs.
- (b) The Board in its meeting held on June 29, 2021 approved the proposal to introduce a framework for 'Accredited Investors' in the Indian securities market. Under the said framework, accredited investors participating in

AIFs shall have the flexibility to invest in AIFs with an amount lesser than INR 1 Crore, the minimum amount mandated in the AIF Regulations.

- (c) In order to align with the relaxation in investment amount being extended to Accredited Investors in AIFs, it may be considered to extend the benefit of lower ticket size to receipt of grants by SVFs from Accredited Investors. AIPAC recommended that the proposal may be taken up for amendment to AIF Regulations as such flexibility may be beneficial to the industry.
- (d) Accordingly, it is proposed to amend Regulation 16 (4)(b) of AIF Regulations to provide that the minimum amount of grant that may be received by SVFs i.e. INR 25 Lakhs, shall not apply to grants received from Accredited Investors.

3.2. For clarity and ease of compliance by AIFs, the following regulatory changes are proposed:

3.2.1. Investment in 'debt'

- (a) AIF Regulations provide for debt funds to invest in 'debt and debt securities' of investee companies, without specifying the securities covered under 'debt'. It is clarified by way of Frequently Asked Questions (FAQs) published on SEBI website that the amount contributed by the investors of an AIF shall not be utilised for the purpose of giving loans.
- (b) AIPAC recommended that AIF Regulations may be amended to clarify that 'debt and debt securities' shall mean only securities as specified under Securities Contracts (Regulation) Act, 1956 ('SCRA, 1956').
- (c) Accordingly, it is proposed to amend Regulation 2(1)(i) of the AIF Regulations to provide clarity on what constitutes permissible investments in debt under AIF Regulations and thereby to clarify that such investment in debt shall not include extending loans or any lending activity.

### 3.2.2. Issuance of partly paid units

- (a) AIFs may be set up in the form of trusts, companies, limited liability partnerships or body corporates. Beneficial interest of the investor in the AIFs, termed 'units', may be in the form of beneficial interest in the trust, partnership interest in the LLP or shares of the Company, depending on the legal structure of the AIF. As seen from the placement memoranda filed with SEBI and the inputs received from industry, the capital commitment of investors in AIFs is usually drawn down for investments in tranches.
- (b) Based on feedback from the AIF industry, there is a need to specify that AIFs may raise funds by way of issuance of partly paid or fully paid units, wherein partly paid units shall represent the portion of committed capital invested by the investor in the AIF or scheme of the AIF. AIPAC recommended that AIF Regulations may be suitably amended to provide the necessary clarity in this regard.
- (c) Accordingly, it is proposed to amend Regulation 2(1)(y) of AIF Regulations to specify that schemes of AIFs may issue fully paid or partly paid units to investors.

### 3.2.3. Launch of schemes by Category III AIFs

- (a) AIF Regulations provide that Category I and Category II AIFs shall be close ended and Category III AIFs may be open ended or close ended. Further, AIFs may launch multiple schemes under a single registration.
- (b) Considering that open ended or close ended is a scheme attribute and not an attribute of the AIF, AIPAC recommended that AIF Regulations may be amended to expressly clarify that Category III AIFs may launch one or more open ended or close ended schemes under the same registration.
- (c) Accordingly, it is proposed to amend Regulation 13(3) of the AIF Regulations to specify that schemes of Category III AIFs may be open ended or close ended.

#### 3.2.4. Definition of 'Investable Funds'

- (a) Under the extant regulatory framework, prudential norms for AIFs such as concentration norms, limits on overseas investment, etc. are calculated as a percentage of investable funds of the AIF. AIF Regulations define 'investable funds' as corpus of the AIF net of estimated expenditure for administration and management of the fund.
- (b) Based on industry feedback and experience in monitoring of AIFs, it is observed that there is a lack of clarity amongst managers of AIFs on the manner and period of estimating expenses for the purpose of arriving at investable funds. While calculating investable funds, some AIFs account for estimated expenditure for the entire life cycle of the fund while certain other AIFs may estimate such expenditure on annual basis.
- (c) The issue was discussed in AIPAC and the Committee was apprised that the term 'investable funds' is used in the regulatory framework in the context of compliance with prudential norms for investments by AIFs and therefore, uniformity in determining 'investable funds' across the industry is important for the purpose of regulatory compliance. It was clarified that this would not preclude the investment per se of the entire amount raised, in the interest of investors. AIPAC confirmed that this clarification was important for the industry.
- (d) Accordingly, it is proposed to amend Regulation 2(1)(p) of AIF Regulations to clarify that, for calculation of investable funds, expenditure for administration and management of the fund shall be estimated for the tenure of the fund, as defined in the fund documents.

3.3. To align the provisions in the AIF Regulations which refer to SEBI (Prohibition of Insider Trading) Regulations, 1992 ('PIT Regulations, 1992') with applicable provisions of SEBI (Prohibition of Insider Trading) Regulations, 2015 ('PIT Regulations, 2015'), the following regulatory changes are proposed:

- 3.3.1. AIF Regulations provide for exemption to VCFs, SME Funds and Category II AIFs from Regulation 3 and 3A of PIT Regulations, 1992 in respect of their investment in companies listed on SME exchange or SME segment of an Exchange pursuant to due diligence of such companies, subject to disclosure and lock-in of one year.
- 3.3.2. Regulations 3 and 3A of PIT Regulations, 1992 dealt with prohibition on dealing, communicating or counselling on matters relating to insider trading when in possession of Unpublished Price Sensitive Information ('UPSI'). PIT Regulations, 1992 have since been repealed and replaced by PIT Regulations, 2015. Under PIT Regulations, 2015 Regulations 3(1) and 3(2) deal with prohibition on communication or procurement of UPSI and Regulation 4(1) deals with prohibition of trading when in possession of UPSI. There is a need to amend the AIF Regulations to update the reference with regard to PIT Regulations, 1992 with corresponding provisions of PIT Regulations, 2015.
- 3.3.3. In addition, for the purpose of disclosure of trades undertaken by AIFs, the disclosure requirement under AIF Regulations may be aligned with that under PIT Regulations, 2015 and the phrase 'acquisition or dealing in securities' may be replaced with 'trading in securities'.
- 3.3.4. Accordingly, it is proposed to amend Regulation 16(2)(d), 16(3)(c) and 17(f) of AIF Regulations to replace the references to PIT Regulations, 1992 with corresponding provisions of PIT Regulations, 2015 and align the regulatory requirements with those of PIT Regulations, 2015.
- 3.4. To streamline the process of approval of applications for registration of AIFs and launch of new schemes by AIFs, the following regulatory changes are proposed:
- 3.4.1. The number of applications filed with SEBI for registration of AIFs and launch of scheme has seen significant increase over the years. One of the documents required to be filed along with these applications is the draft

placement memorandum (PPM) for the fund/ scheme. In addition, in terms of Circular dated April 07, 2021 AIFs are also required to submit updated PPMs to SEBI, incorporating modifications made in the terms or documents of the fund / scheme, once every year on a consolidated basis.

- 3.4.2. PPMs filed with SEBI are required to be scrutinized to ensure that the terms of the PPM are in line with the AIF Regulations and Circulars issued thereunder. Very often, errors and deficiencies are observed in the PPMs, many of which are recurring in nature. Significant regulatory resources are consumed in the process of rectifying the errors and deficiencies in such PPMs.
- 3.4.3. To ensure that a minimum standard of disclosure is available in the PPM, in February 2020, SEBI introduced templates for PPMs, with specific pointers on what information is to be provided under each section of the PPM. Further, the AIFs are also permitted to provide additional information, if so desired, through supplementary sections in the PPM. Despite the availability of templates, several PPMs are filed with SEBI with incorrect or incomplete information.
- 3.4.4. Accordingly, the issue of PPMs with errors and deficiencies being filed with SEBI and the list of frequently observed errors in such PPMs along with a proposal to mandate appointment of a SEBI registered Merchant Banker for filing of PPMs with SEBI, was discussed in the meeting of AIPAC on July 07, 2021.
- 3.4.5. The industry representatives in AIPAC submitted that mandatory appointment of Merchant Banker would increase the cost of compliance for AIFs. Instead it was suggested that skill development courses or workshops on drafting of PPMs may be conducted by Industry association(s), which may lead to improvement in the quality of PPMs submitted to SEBI.

3.4.6. The inputs of AIPAC were considered and after further internal deliberations, it is considered appropriate to mandate AIFs to appoint a Merchant Banker for filing of placement memorandum with SEBI, for reasons as under:

- (a) Merchant Bankers are registered with SEBI under the SEBI (Merchant Bankers) Regulations, 1992 and governed by the Code of Conduct for Merchant Bankers, which casts responsibility on them to exercise due diligence, ensure proper care and exercise independent professional judgment. It is expected that appointment of Merchant Banker would result in better quality of PPMs filed with SEBI due to their due diligence and this would enhance the compliance culture in the AIF Industry.
- (b) It is observed that other SEBI registered investment vehicles such as Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) require a SEBI registered Merchant Banker to be appointed for filing offer documents with SEBI where offer of units is made through a public issue. It is observed that even in case of private placement where units are not proposed to be listed, InvITs appoint merchant bankers to file their placement memorandum with SEBI. It may be mentioned that AIF Regulations provide for listing of units of close ended Alternative Investment Fund on stock exchange, subject to certain conditions.

3.4.7. Accordingly, in order to streamline the process of approval of applications for registration of AIFs and launch of new schemes by AIFs, it is proposed to amend Regulation 12 of the AIF Regulations to specify that placement memorandum shall be filed with SEBI, only through SEBI registered Merchant Bankers. It is further proposed that the requirement to appoint SEBI registered Merchant Banker shall come into force on the ninety first day from the date of notification of the amendment to the AIF Regulations in this regard.

3.4.8. Further, it is proposed to specify that, updated PPMs as mentioned in para 3.4.1 shall be filed with SEBI only through a SEBI registered Merchant Banker, by way of a Circular.

#### **4. Proposals**

4.1. The Board may consider and approve the proposals at paragraphs 3.1.1(b), 3.1.2(d), 3.1.2(e), 3.1.3(d), 3.1.3(e), 3.1.4(d), 3.2.1(c), 3.2.2(c), 3.2.3(c), 3.2.4(d), 3.3.4 and 3.4.7. The draft amendment to AIF Regulations and the draft notification for the proposed amendment are placed at **Annexure A** and **Annexure B** respectively.

4.2. 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**

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

## **Annexure B**

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