

Amendment to SEBI (Alternative Investment Funds) Regulations, 2012, to facilitate ease of compliance and strengthen protection of interest of investors in Alternative Investment Funds

1. Objective

In order to facilitate ease of compliance and to strengthen protection of interest of investors in Alternative Investment Funds ('AIFs'), this Board Memorandum proposes to amend SEBI (Alternative Investment Funds) Regulations, 2012 ('AIF Regulations') to:

- 1.1. mandate AIFs to hold their investments in dematerialised form; and,
- 1.2. extend the mandate for appointment of custodian, currently applicable to AIFs with corpus more than INR 500 Crore, to all AIFs and clarify the role of custodian in reporting information on investments of AIFs to SEBI.

2. Mandating AIFs to hold their securities/investments in dematerialised form

- 2.1. SEBI Board in its meeting held on March 29, 2023, approved the proposal to mandate issuance of units of AIFs in dematerialised form for ease of monitoring and administration by stakeholders and for protection against operational and fraud risk.
- 2.2. To fully realize the objective of ease of monitoring and administration by stakeholders, facilitate ease of compliance and protect against operational and fraud risk, it is necessary that AIF's asset side (i.e. investments made by AIF) is also held in dematerialised form.
- 2.3. According to the Depositories Act, 1996, every person subscribing to securities offered by an issuer shall have the option either to receive the security certificates or hold securities with a depository. Holding assets of AIFs in dematerialised form has numerous benefits, such as:
 - 2.3.1. Ease of administration and monitoring for AIFs/managers;
 - 2.3.2. Safer way to hold securities – reduces operational and fraud risk such as fake certificates, delays, bad delivery, missing certificate, mutilation or theft;
 - 2.3.3. Ease of transfer and transmission of securities;
 - 2.3.4. Automatic credit to account on stock split or bonus and other corporate actions;
 - 2.3.5. Reduction in paperwork for administrative aspects;

2.3.6. Ease of regulatory access to information from depositories, obviating the need for submission of data by the AIFs for monitoring, inspections, investor complaint examinations etc.; and,

2.3.7. Comfort to investors of AIF that the investments of the fund are held safely in a demat account.

In view of the above, it was felt appropriate to mandate AIFs to hold their investments in dematerialised form.

2.4. In this context, it may be noted that AIF Regulations define “investee company” as any company, special purpose vehicle or limited liability partnership or body corporate or Real Estate Investment Trust (REIT) or Infrastructure Investment Trust (InvIT) in which an AIF makes an investment. Thus, AIFs’ investments may include equity and debt instruments of companies, partnership interest of a Limited Liability Partnership (LLP), units of other AIFs, units of REITs, InvITs, etc. The details of investment made by AIFs in different type of securities, as on June 30, 2023, are as under:

Type of security	Amount invested (in INR Crore)	Percentage of total investments
Unlisted equity and equity linked instruments	1,31,255	37.47 %
Unlisted corporate debt and security debt	85,665	24.45 %
Listed Equity or proposed to be listed equity	70,955	20.26 %
Listed debt or proposed to be listed debt	15,576	4.45 %
Partnership interest of LLP	9,081	2.59 %
Units of AIFs	8,527	2.43 %
Security receipts listed or unlisted	1,864	0.53 %
Units of REITs and InvITs	2,350	0.67 %
Others (includes temporary investment in Liquid Mutual Funds, Government securities etc.)	25,033	7.15 %
Total	3,50,306	100.00%

2.5. As regards investment in companies, Section 29 of Companies Act, 2013 specifies that, every company making public offer and other prescribed classes of companies shall issue the securities only in dematerialised form. Listed companies and unlisted public companies are mandated to issue securities in dematerialised form. Further, InvITs which raise funds by public issue and all REITs are required to issue units in dematerialised form. AIFs have also recently been mandated to issue their units in dematerialised form, which is under implementation.

2.6. As regards investment in private companies, Companies (Prospectus and Allotment of Securities) Rules, 2014, has recently been amended and notified on October 27, 2023, to mandate that every private company, other than a small company, shall issue the securities only in dematerialised form and facilitate dematerialisation of all its securities. A private company, which as on last day of a financial year, ending on or after 31st March, 2023, is not a small company as per audited financial statements for such financial year, shall, within eighteen months of closure of such financial year, comply with the provisions of this rule. The said provision is not applicable in case of a Government company.

(As per Companies Act, 2013, “small company” means a company, other than a public company, —

- (i) paid-up share capital of which does not exceed four crore rupees; or
- (ii) turnover of which as per profit and loss account for the immediately preceding financial year does not exceed forty crore rupees:

Provided that nothing in this clause shall apply to— (A) a holding company or a subsidiary company; (B) a company registered under section 8; or (C) a company or body corporate governed by any special Act)

Prior to this amendment, it is understood that, private companies have generally been issuing securities in dematerialised form as per the preference of their investors.

2.7. From the information given above, it may be noted that, most of the permissible instruments for investment by AIFs are already mandated to be issued in dematerialised form.

2.8. Further, as per the information collected from depositories, namely, National Securities Depository Limited (NSDL) and Central Depository Services (India)

Limited (CDSL), the value of holdings in the demat accounts of AIFs stands at INR 2,47,023 Crore as on June 30, 2023, which indicates that more than 70 percent of total investments of INR 3,50,306 Crore made by AIFs, are already held in dematerialised form.

2.9. It is also seen from the information submitted by depositories that, as on June 30, 2023, 1,498 demat accounts have already been opened by AIFs/schemes of AIFs, having 1,075 unique Permanent Account Number associated with it, out of which 967 accounts are active. Thus, it is inferred that around 75 percent of total 1,274 schemes of AIFs already have active demat accounts with NSDL and CDSL.

2.10. Further, for investee companies which may be required to admit their securities to depositories for dematerialisation, the joining fee and annual fee are as under:

Joining Fee by Issuers	
<ul style="list-style-type: none"> • Issuer of listed securities - INR 20,000 plus taxes at the applicable rate • Issuer of unlisted securities - INR 15,000 plus taxes at the applicable rate 	
Annual Custody Fee	
An Issuer shall pay an annual custody fee at the rate of INR 11 per folio (ISIN position) in respective depositories, subject to a minimum amount as mentioned below, plus taxes as applicable:	
Nominal Value of securities admitted	Annual Custodial Fee payable by an Issuer to each Depository (INR)
Up to INR 5 crore	9,000
Above INR 5 crore and up to INR 10 crore	22,500
Above INR 10 crore and up to INR 20 crore	45,000
Above INR 20 crore	75,000

The fee as given above, appears to be reasonable in terms of the value of securities to be admitted with depositories. Further, as stated at para 2.5 and 2.6 above, in any case, listed companies and unlisted public companies, private companies other than small companies, AIFs, REITs and InvITs which raise funds by public issue, are required to issue securities in demat form. Thus, the

proposal would not result into any incremental cost to such entities, in case they raise funds from AIFs.

As far as small companies are concerned, considering that the number of investors are capped at 200 and types of instruments issued are understood to be less, number of ISINs created are usually limited. If such companies have to dematerialise their securities only for raising capital from AIFs, the cost of dematerialisation may not exceed the minimum amount given in the table above, as the depository charges are on per folio basis (investors holding securities). Also, the process of admission of securities with the depositories is not cumbersome and is usually completed within a week's time.

2.11. Considering that AIF industry is a sophisticated space that is rapidly growing, this may be an appropriate time to introduce the requirement to mandate AIFs to hold their investments in dematerialised form.

Consultation with stakeholders:

2.12. An agenda to mandate AIFs to hold their investments in dematerialised form was placed for discussion in the meeting of Alternative Investment Policy Advisory Committee ('AIPAC'). The committee, after deliberation, in-principle recommended the proposal to mandate AIFs to hold their investments in dematerialised form. As regards existing investments made by AIFs in investee companies where the AIF or AIFs together have controlling interest, for dematerialising investments in such investee company, the committee members suggested to provide a time period of six months.

2.13. AIPAC also suggested to consider providing exemption to AIFs from aforesaid mandate, for holding overseas investments, investments in LLPs and temporary investments. After examining the suggestion of AIPAC, it was viewed that instead of exempting temporary investments and overseas investments as a whole, exemption from the mandate of dematerialising investments may be provided in cases of investment in those instruments that are ineligible for dematerialisation.

2.14. Taking into account the recommendations of AIPAC and internal discussions, SEBI issued a consultation paper on May 18, 2023 soliciting comments from public on the proposals made therein, as given at **Annexure A**.

2.15. A total of 15 responses have been received from the stakeholders such as AIFs, industry associations, law firms, etc., on the proposal to mandate AIFs to hold their investments in dematerialised form. The proposal has received both positive and negative views. While some commenters have welcomed the proposal stating that it will bring in a strong handle in the hands of AIFs to seek dematerialisation of all instruments from portfolio companies, others have expressed concern over the proposal adversely affecting the sentiment of private companies towards raising capital from domestic AIFs. Many commenters have also sought various types of exemptions from the proposed mandate. A summary of the comments received from the commenters on this proposal is given at **Annexure B**.

2.16. Some of the major areas highlighted by the commenters and our views on the same are given as under:

S. No.	Comments received	SEBI's views
(i)	This action should be brought forth by Ministry of Corporate Affairs and not by AIFs.	Ministry of Corporate Affairs has already expressed its views favouring dematerialisation of securities issued by companies and has been implementing the same in a phased manner. Onto this, all public companies, listed or unlisted, and private companies (excluding small companies and Government companies), have already been mandated by Ministry of Corporate Affairs to issue securities in dematerialised form only. Further, considering the perspective of investor protection in AIFs, if AIFs are mandated to hold their investments in dematerialised form, it would certainly reduce the risks associated with physical holdings and provide comfort to investors of AIFs.
(ii)	Companies who are start-ups and hold a DPIIT start-up certificate	While there is cost associated with dematerialisation, as seen from

S. No.	Comments received	SEBI's views
	<p>from Government of India, Ministry of Commerce and Industry and companies who are not mandatorily required to appoint a Company Secretary as per Companies Act, 2013 may be exempted from dematerialisation.</p> <p>These entities are at a very initial stage to pursue dematerialisation of their securities as dematerialisation of securities would involve additional cost and they lack the institutional capability for the same.</p>	<p>information given at para 2.10 above, it does not appear to be onerous.</p> <p>Further, considering the objective of minimizing the risks of physical holdings and providing comfort to investors of AIFs, it is necessary that all type of investments of AIFs are held in dematerialised form, except those which are ineligible for dematerialisation.</p>
(iii)	<p>This proposed action will cause companies to shun Indian AIFs for other investors (foreign or from GIFT IFSC), who do not have such a requirement. This proposal may adversely impact the sentiment of private companies towards raising capital from domestic AIFs.</p> <p>This will reduce the attractiveness of Indian AIFs also as a pure</p>	<p>As stated at para 2.6 above, private companies, other than small companies, have recently been mandated by Ministry of Corporate Affairs to issue their securities in demat form and facilitate dematerialisation of all its securities.</p> <p>Thus, any investor, domestic or foreign, shall subscribe to securities issued by the private company in demat form only and hence, there may not be any disparity in such cases.</p> <p>As stated at para 2.8 above, as per NSDL and CDSL, the value of holdings in the</p>

S. No.	Comments received	SEBI's views
	foreign vehicle investing in a company directly will not have this requirement.	<p>demat accounts of AIF, including investment in private companies, stands at INR 2,47,023 Crore as on June 30, 2023, which indicates that more than 70 percent of investments by AIFs are already held in dematerialised form and that investee companies also generally issue their securities in dematerialised form.</p> <p>As such, AIFs holding investments in both demat form and physical form, would require resources to reconcile and aggregate the same. Mandatory dematerialisation of investments would bring efficiency in holding and monitoring of investments of AIFs in such cases.</p>
(iv)	For the existing AIFs, there may be already a contractual arrangement in place between the AIF and the investee company in relation to issuance of securities in physical form to the AIFs and as such, it may not be possible for the AIFs to ensure that the investee companies dematerialize their securities.	The comment is valid. Accordingly, it is proposed that the requirement for dematerialisation may be exempted for investments already made by AIFs, except in certain cases as discussed in para 2.20 below.
(v)	All existing investments of AIFs should be dematerialised within a period of 12 months	The suggestion of providing timeline of 12 months for dematerialising existing investments of AIFs may be accepted.

S. No.	Comments received	SEBI's views
	unless the security itself cannot be dematerialised.	In investments where there is no mandate for investee company to dematerialise its securities and where AIF does not have control, the AIF may not be able to direct the investee companies to dematerialise their securities. Hence, such existing investments of AIFs may be grandfathered and exempted from the mandate of dematerialisation.
(vi)	AIFs should be permitted to make temporary investments in both physical and dematerialised form. Since at times quick decisions are required to be taken in respect of temporary investments, option should be available with AIF to invest in both physical and dematerialised form.	As per AIF Regulations, AIFs are permitted to temporarily deploy un-invested portion of the investable funds in liquid mutual funds or bank deposits or other liquid assets of higher quality such as Treasury bills, Triparty Repo Dealing and Settlement, Commercial Papers, Certificates of Deposits, etc. In most of the aforesaid type of securities, there is an option to hold the securities in dematerialised form with ease. Buying and selling of any securities in dematerialised form is speedier in comparison to physical securities. In any case, exemption from the mandate of dematerialising investments has been proposed for any securities/instruments held by AIFs, which are ineligible for dematerialisation.
(vii)	The funds that are exiting or completing tenure in next three years can be exempt from this requirement.	The suggestion may be considered, but limited to – - Schemes of AIFs completing tenure as disclosed in the Private Placement Memorandum (PPM), within next one

S. No.	Comments received	SEBI's views
		<p>year (without including permissible extension of tenure) and,</p> <p>- Schemes of AIFs which are already in extended tenure period.</p>

2.17. Considering that mandating AIFs to hold their investments in dematerialised form will enhance transparency, reduce risk and provide comfort to investors, it is felt that it is advisable to mandate AIFs to hold their investments in dematerialised form.

2.18. This initiative will also supplement consistent strides taken by financial regulators in encouraging digitalisation of financial market in India, to facilitate access to the market and ease of doing business. Considering the focus on Digital India, and specifically on digitalisation across the financial market, it is felt that AIFs, as an investment vehicle with sophisticated investors should also align with this national priority.

2.19. Accordingly, it is proposed that, any fresh investment proposed to be made by an AIF, whether directly in the investee company or by purchasing securities of investee company from another entity, shall be held in dematerialised form only. A time period of six months may be given for the implementation of the said mandate, so that the investment deals currently under discussion/negotiation are not affected.

2.20. While it may not be appropriate to mandate dematerialising existing investments of AIFs where they do not collectively have controlling interest, in such cases, in order to ensure that investments are held in demat form to the extent possible, the requirement of holding existing investments in dematerialised form may be mandated only in the following cases where-

2.20.1. Investee company has been mandated under applicable law to facilitate dematerialisation of its securities; and,

2.20.2. Investments wherein the AIF, on its own, or along with other SEBI regulated intermediaries/entities that are required to hold their investments in dematerialised form, has control in the investee company.

(The definition of 'control' shall be construed in terms of Regulation 2(1)(f) of AIF Regulations)

2.21. In cases where there is a regulatory mandate for investee company to facilitate dematerialisation of securities, AIFs may not face any difficulty in holding such investment in dematerialised form. In remaining cases, irrespective of any contractual agreement at the time of making investment, wherever the AIF on its own, or along with other SEBI regulated intermediaries/entities that are required to hold their investments in dematerialised form, has control in investee company, the AIF and such SEBI regulated intermediaries/entities together can take necessary steps to ensure that the investee company dematerialises its securities within a reasonable period of time.

2.22. Further, considering that the AIF industry is in the process of dematerialising their units and that private companies, other than small companies, have been given time period till September 2024 to dematerialise their securities, it is felt that a time period of twelve months may be provided for dematerialising existing investments of AIFs as per para 2.20 above, instead of six months as proposed in the consultation paper.

2.23. Also, it may not be reasonable to mandate dematerialisation of investments held by existing close-ended schemes of AIFs that are nearing end of their tenure or in extended tenure period. Therefore, schemes of AIFs that have less than one year for end of their tenure as disclosed in the PPM or those already in their extended tenure period, may be exempted from the proposed requirement.

2.24. Further, the said requirement may not be made applicable to Liquidation Scheme of an AIF, for acquiring unliquidated investments of original parent scheme of the AIF which are not in demat form, since such transaction of unliquidated investments is essentially a part of launch of Liquidation Scheme.

Proposal:

2.25. Taking into account the recommendations of AIPAC, comments received from public and internal deliberations, it is proposed that AIF Regulations may be suitably amended to specify the following:

2.25.1. AIFs shall hold their investments in dematerialised form, subject to conditions as may be specified by the Board from time to time.

2.25.2. The said requirement shall not apply to –

- (a) investments by AIFs in such type of instruments which are not eligible for dematerialisation;
- (b) investments held by a liquidation scheme of the AIFs that are not available in the dematerialised form; and,
- (c) such other investments by AIFs and such other schemes of AIFs as may be specified by the Board from time to time.

2.26. It is further proposed that the following may be specified by way of issuance of circular:

2.26.1. Any fresh investment made by an AIF, six months post the issuance of the circular, whether directly in the investee company or by purchasing securities of investee company from another entity, shall be held in dematerialised form only.

2.26.2. The requirement for dematerialisation may be exempted for investments already made by AIFs or made within six months from the issuance of the circular, except in the following cases where –

- (a) Investee company has been mandated under applicable law to facilitate dematerialisation of its securities; and,
- (b) Investments where the AIF, on its own, or along with other SEBI registered intermediaries/entities which are mandated to hold their investment in dematerialised form, has control in the investee company.

(The definition of 'control' shall be construed in terms of Regulation 2(1)(f) of AIF Regulations);

The investments of AIFs as specified at sub-clauses (a) and (b) above, shall be dematerialised within twelve months from the issuance of the circular.

2.26.3. The aforesaid requirement of holding investments in dematerialised form shall not be applicable for –

- (a) Scheme of an AIF whose tenure (not including permissible extension of tenure) ends within one year from the date of issuance of the circular; and,

- (b) Scheme of an AIF which is in extended tenure as on the date of issuance of the circular.

3. Mandating appointment of custodian for AIFs and clarifying the role of custodian in reporting information on investments of AIFs to SEBI:

3.1. Regulation 20(11) of AIF Regulations specifies norms with respect to appointment of custodian as under:

3.1.1. Sponsor / Manager of Category I and Category II AIFs shall appoint a custodian for safekeeping of the securities, if the corpus of the AIF is more than INR 500 crore.

3.1.2. Sponsor / Manager of Category III AIFs shall appoint a custodian, irrespective of the corpus of the AIF.

3.1.3. Sponsor / Manager of Category I and Category II AIFs transacting in Credit Default Swaps shall appoint a custodian and comply with such terms and conditions as may be specified by SEBI.

3.2. In addition to the aforementioned requirement of safekeeping of the securities, custodians appointed by AIFs are also understood to be involved in fund accounting, settlement of trades with respect to investment in listed securities, liaising with investee companies with respect to post trade corporate action, obtaining tax certificate for the AIF and any other activity agreed as part of the custodial agreement with the AIF.

3.3. Out of 1274 schemes of AIFs, the details of schemes of different categories of AIFs which are presently required to appoint custodian, including details of their investments as on June 30, 2023, are as under:

Category of AIFs	No. of schemes	Total commitments raised (in INR Crore)	Total investment made (in INR Crore)
Category I and II AIFs with corpus more than INR 500 Crore	251	6,88,979	2,44,460

Cat III AIFs	314	85,058	72,499
Total	565	7,74,037	3,16,959

The total investment made by AIF industry as on June 30, 2023 stands at INR 3,50,306 crore. Thus, around 90 percent of the total investments made by AIFs are already required to be under the safekeeping of the custodian. Thus, if the requirement for appointment of custodian is mandated for AIFs with corpus less than or equal to INR 500 Crore, 709 schemes having total investment of INR 33,347 as on June 30, 2023, will need to appoint a custodian.

- 3.4. It is understood that the annual custodian fee charged by custodians varies from a few thousand rupees to a few lakh rupees, depending on various factors such as corpus of the scheme, negotiations between the manager of the AIF and the custodian, nature of additional services availed from the custodian by the AIF such as fund accounting, clearing and settlement of trades, depository services, etc.
- 3.5. In order to study the implication of cost of appointment of custodian, sample data was collected from 4 custodians with respect to fee collected for their AIF clients. The data was collected for around 40 schemes. From the information collected, it is seen that, for funds having corpus more than INR 20 Crore, the custodian fee varied from 0.11 % to 0.0004% of the corpus of the scheme, averaging at 0.018% of the corpus. For funds with corpus less than INR 500 Crore, the custodian fee is, on an average, 0.03% of the corpus. The aforesaid sample set of data representing cost of appointment of custodian for the AIFs is given at **Annexure C**.
- 3.6. It may be noted that, under SEBI (Portfolio Managers) Regulations, 2020, every portfolio manager, other than those who provide only advisory services, is required to appoint a custodian in respect of securities managed or administered by it. Further, SEBI (Mutual Funds) Regulations, 1996 ("MF Regulations"), prescribe 'appointment of custodian in order to keep custody of the securities or goods or gold or gold related instruments or silver or silver related instruments or other assets of the mutual fund held in terms of these regulations, and provide such other custodial services as may be authorized by the trustees' as one of the eligibility criteria for grant of registration as a Mutual Fund.

- 3.7. Considering the above, in order to bring in parity across all categories of AIFs and to provide comfort to investors with respect to safety of AIFs' investments, it is felt that the requirement of appointing custodians may be extended to schemes of AIFs with corpus less than or equal to INR 500 Crore.
- 3.8. Further, it is noted that, the role of custodian in reporting information relating to investments of their Foreign Portfolio Investor (FPI) and Foreign Venture Capital Investor (FVCI) clients has been prescribed under SEBI (Foreign Portfolio Investors) Regulations, 2019 and SEBI (Foreign Venture Capital Investors) Regulations, 2000, respectively.
- 3.9. It has been envisaged in the aforesaid Regulations that the custodian acts as information repository with respect to investment activities of the FPI or FVCI. If similar role is assigned to custodians of AIFs, data required by SEBI for supervision can be easily extracted from reports that are already available with custodians. This would help in ease of reporting of investment related information of AIFs and also facilitate effective regulatory oversight of SEBI on the industry without adversely impacting the cost of compliance for them. It may be noted that custodians are already required to submit reports to SEBI for leverage and Credit Default Swap related transactions of AIFs. Similarly, reporting of information on investments of AIFs under custody to SEBI may also be carried by custodian.

Consultation with stakeholders:

- 3.10. An agenda to extend the mandate for appointment of custodian to all AIFs and to clarify the role of custodians appointed by AIFs was placed for discussion in the meeting of AIPAC. The committee, after deliberation, recommended the following proposals:
- 3.10.1. The extant requirement of mandatory appointment of a custodian for safekeeping of securities for Category I and II AIFs with corpus more than INR 500 crore, may be extended to Category I and II AIFs with corpus less than INR 500 crores as well.
- 3.10.2. Existing Category I and II AIFs with corpus less than INR 500 crore, may be given a time period of 6 months from the date of mandate to appoint custodian.
- 3.10.3. AIFs should appoint only an independent custodian i.e., not a related party.

- 3.10.4. Role of custodian with regard to reporting and subsequent monitoring of investments of AIFs may be clarified in AIF Regulations.
- 3.11. Taking into account recommendations of AIPAC and internal discussions, SEBI issued a consultation paper on May 18, 2023 soliciting comments from public on the proposals made therein, given at **Annexure A**.
- 3.12. Total 21 responses have been received from the stakeholders such as AIF industry associations, AIFs, custodians, law firms, individuals, etc. on the proposal to mandate appointment of custodian for AIFs. Summary of comments received in this regard is given at **Annexure B**.
- 3.13. While few commenters have welcomed the proposal to mandate custodians for AIFs having corpus less than or equal to INR 500 Crore, some commenters have highlighted that the proposed mandate may add to cost and administrative burden on smaller AIFs and eventually may add to cost to the investors.
- 3.14. As regards the cost of appointment, it is understood that the same may not be significant in comparison to the corpus of the fund. As seen from information given at para 3.5 above, based on sample data collected for schemes with corpus greater than INR 20 Crore and less than INR 500 Crore, the custodian fee varied from 0.11 % to 0.0004% of the corpus of the scheme, averaging at 0.03% of the corpus of the fund. Further, it may also be noted that, as stated at para 3.6 above, all Mutual Funds and Portfolio Managers have been mandated to appoint custodian for safekeeping of their securities irrespective of the size of investment or corpus of the fund. Accordingly, the requirement of custodian is proposed to be made applicable to all AIFs irrespective of corpus of the fund.
- 3.15. Some commenters have suggested to remove the proposed prohibition on custodian and trustee of AIF being associate companies of each other, as both these services are provided by separately registered entities and do not pose any risk of mutual conflict. Since the trustee is responsible for overseeing the activities of the manager in managing investments of the AIF and the custodian is responsible for safekeeping of AIF's securities, both the entities act with the objective of protecting the interest of the investors of the AIF. Thus, it is felt that the said suggestion merits consideration and thus, no restriction may be placed on custodian being an associate of the trustee of the AIF.

3.16. Further, several commenters have suggested that the AIF may be allowed to appoint custodian which is an associate of Manager / Sponsor of the AIF, subject to disclosure in PPM and other fund documents and consent of investors. The commenters supported their suggestion stating that custodians are regulated by RBI and SEBI and that the activity of a custodian is ring fenced, following arm's length principle from other activities undertaken by its own entity or by its associates.

3.17. Few commenters have also stated that MF Regulations allow for appointment of related party of asset management company or sponsor as custodian, subject to certain conditions given as under –

As per Regulation 26(2) of the MF Regulations, where the sponsor or its associates hold 50 % or more of the voting rights of the share capital of the custodian, such custodian may act as custodian for a mutual fund constituted by the same sponsor or any of its associates or subsidiary company, if:

- (a) the sponsor has a net worth of at least INR 20,000 crore at all points of time;
- (b) fifty percent or more of the directors of the custodian are those who do not represent the interest of the sponsor or its associates;
- (c) the custodian and the asset management company of a mutual fund are not subsidiaries of each other;
- (d) no person is a director of both the custodian and the asset management company of a mutual fund; and,
- (e) the custodian and the asset management company of a mutual fund sign an undertaking that they will act independently of each other in their dealings with the scheme.

It has been suggested by commenters that similar condition may be considered for custodian of AIFs which is an associate of sponsor or manager of AIF.

3.18. It is understood that the aforesaid conditions as stated at para 3.17 above, are prescribed so that while Mutual Funds have flexibility to appoint a related party as custodian, the entities shall carry out their respective roles/activities independently, at arm's length basis. In line with the same, an AIF may be allowed to appoint a custodian which is an associate of manager or sponsor of

the AIF, subject to conditions similar to those specified under MF Regulations as given at para 3.17 above.

- 3.19. As regards the role of custodian with respect to reporting and monitoring of investments, some commenters have stated that AIF Regulations place such responsibility on the trustee and manager and that adding the custodian will only increase administrative and compliance burden for AIFs. They have also stated that this may lead to extensive and unnecessary intermediation and administrative excesses in a set up that already provides for periodic compliance test reports to be filed with SEBI. Several commenters have also suggested providing further clarity or guidelines with regard to role of custodian for reporting and monitoring of investments and other related requirements under AIF Regulations. Few commenters have also highlighted that the investment norms specified in AIF Regulations are based on 'investable funds' and custodian may find it challenging to have real time access to investable funds of an AIF.
- 3.20. It may be noted that SEBI (Custodian) Regulations, 1996, specifies that every custodian shall maintain records containing details of securities, goods, assets or documents received and released on behalf of each client. Further, the custodians are reporting investments of their FPI clients to depositories for monitoring for compliance with prescribed investment norms such as group limit, debt limit utilisation etc. In line with the same, similar role may be prescribed for custodians of AIFs, to report necessary information with respect to investments of AIFs under their custody to SEBI. It is expected that the same will also facilitate ease of compliance with respect to reporting of information relating to investments of AIFs to SEBI.
- 3.21. On a pilot basis, the Standards Setting Forum for AIFs has been recently set up for formulating granular implementation standards to be adopted by AIFs, in consultation with SEBI, to comply with the regulatory intent behind the principles and framework prescribed by SEBI. In this context, the said forum shall specify standards, in consultation with SEBI, for reporting of data on investments of AIFs that are kept under custody with the custodian.
- 3.22. Some commenters have suggested that a timeline of twelve months, instead of the proposed six months, may be provided to existing Category I and II AIFs with corpus less than INR 500 crore for appointment of custodian, for smooth

completion of procedural aspects involved in appointment of custodian by AIFs and establishing new relationship including carrying out necessary due diligence. In view of the same, twelve months may be provided to existing Category I and II AIFs with corpus less than INR 500 crore for appointment of custodian.

Proposal:

3.23. Taking into account the recommendations of AIPAC, comments received from public and internal deliberations, it is proposed that AIF Regulations may be suitably amended to specify that:

3.23.1. The requirement of appointment of custodian shall be mandated for schemes of AIFs with corpus equal to or less than INR 500 crore also.

3.23.2. An AIF may appoint a custodian who is an associate of manager or sponsor of the AIF, subject to the following conditions –

- (a) the sponsor or manager has a net worth of at least twenty thousand crore rupees at all points of time;
- (b) fifty per cent or more of the directors of the custodian do not represent the interest of the sponsor or manager or their associates;
- (c) the custodian and the sponsor or manager of the AIF are not subsidiaries of each other;
- (d) the custodian and the Sponsor or Manager of the Alternative Investment Fund do not have any common director; and,
- (e) the custodian and the manager of the AIF sign an undertaking that they shall act independently of each other in their dealings of the schemes of the Alternative Investment Fund.

3.23.3. The custodian of an AIF shall report information regarding investments of AIFs under custody in the manner as may be specified by the Board from time to time.

3.24. It is further proposed that the following may be specified by way of issuance of circular:

3.24.1. Existing Category I and II AIFs with corpus equal to or less than INR 500 crore shall appoint custodian within twelve months from the date of issuance of the circular.

3.24.2. Managers of existing AIFs who have appointed custodians that are associate of their manager or sponsor shall ensure compliance with the condition at para 3.23.2 above within twelve months from the date of issuance of the circular.

3.24.3. The Standards Setting Forum for AIFs, on a pilot basis, shall adopt the standards for reporting of data on investments of AIFs that are kept under custody with the custodian, in consultation with SEBI. Such standards shall specify the format and frequency of reporting of data by the manager of AIF to the custodian and subsequently, custodian to SEBI.

4. Proposal to the Board:

4.1. The Board may consider and approve the following proposals to amend the AIF Regulations, to specify that:

4.1.1. AIFs shall hold securities of their investments in dematerialised form, subject to conditions as may be specified by the Board from time to time.

4.1.2. The requirement of mandatory appointment of custodian by AIFs shall be extended to schemes of AIFs with corpus less than or equal to INR 500 crore also.

4.1.3. AIFs may appoint custodian who is an associate of manager or sponsor of the AIF, subject to the conditions as specified by the Board from time to time.

4.1.4. The custodian of an AIF shall report information regarding investments of AIFs under custody in the manner as may be specified by the Board from time to time.

4.2. The draft amendment to AIF Regulations and the draft notification for the proposed amendment are placed at **Annexure D** and **Annexure E** respectively.

4.3. 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.

The consultation paper is available at the following link:

<https://www.sebi.gov.in/reports-and-statistics/reports/may-2023/consultation-paper-on-proposed-amendment-to-sebi-alternative-investment-funds-regulations-2012-to-strengthen-governance-mechanisms-of-alternative-investment-funds-aifs-71387.html>

This has been excised for reasons of confidentiality.

Data on fee charged by custodians for AIF clients

Sr. No.	Name of Custodian	Top/Bottom Schemes (corpus/investment wise)	Scheme of AIF	Category	Corpus of the scheme (in INR Cr.)	Services offered to the AIF (in brief pointers)	Annual custodial fee (INR)	% of corpus
1	Custodian 1	Top Schemes	Scheme 1	Cat I	137.50	Custody, Fund Accounting	6,018	0.0004%
			Scheme 2		212.91	Custody, Fund Accounting	2,84,436	0.0134%
			Scheme 3		1,927.93	Custody, Fund Accounting	4,25,482	0.0022%
		Bottom Schemes	Scheme 1		90.62	Custody, Fund Accounting	70,800	0.0078%
			Scheme 2		47.50	Custody, Fund Accounting	2,36,215	0.0497%
			Scheme 3		4.66	Custody, Fund Accounting	2,36,034	0.5065%
		Top Schemes	Scheme 2	-	Custody	1,77,000	NA	
			Scheme 3	-	Custody	2,60,116	NA	
		Bottom Schemes	Scheme 1	Cat II	79.16	Custody, Fund Accounting	1,94,700	0.0246%
			Scheme 2		25.31	Custody, Fund Accounting	1,77,224	0.0700%
			Scheme 3		23.00	Custody, Fund Accounting	2,59,801	0.1130%
		Top Schemes	Scheme 1	Cat III	2,052.03	Custody, Fund Accounting, PCM	1,02,95,715	0.0502%
					1,558.83	Custody, Fund Accounting, PCM	5,75,163	0.0037%
					328.02	Custody, Fund Accounting, PCM	5,02,685	0.0153%
			Bottom Schemes		Scheme 1	17.77	Custody, Fund Accounting, PCM	36,732
Scheme 2	11.61				Custody, Fund Accounting	2,95,250	0.2542%	
Scheme 3	8.70				Custody, Fund Accounting, PCM.	95,116	0.1093%	
2	Custodian 2	Top schemes	Scheme 1	Cat I	671.04	Custodial services, Depository services	4,88,344	0.0073%

Sr. No.	Name of Custodian	Top/Bottom Schemes (corpus/investment wise)	Scheme of AIF	Category	Corpus of the scheme (in INR Cr.)	Services offered to the AIF (in brief pointers)	Annual custodial fee (INR)	% of corpus		
		Top schemes	Scheme 1	Cat II	5,663.94	Custodial services, Depository services	46,72,336	0.0082%		
			Scheme 2		3,109.29	Custodial services, Depository services	28,22,270	0.0091%		
			Scheme 3		2,000.00	Custodial services, Depository services	5,56,533	0.0028%		
		Bottom schemes	Scheme 1	Cat III	0	Custodial services, Depository services	552	NA		
			Scheme 2		0	Custodial services, Depository services	552	NA		
		Top schemes	Scheme 1	Cat III	15,905.42	Custodial services, Depository services	1,49,28,889	0.0094%		
		Bottom schemes	Scheme 1		0	Custodial services, Depository services	500	NA		
		<p>Basis of charging fee: Custodial fees vary depending on the financial institution and the type of custody services provided. Types of custodial fees that may apply in case of AIF is as below:</p> <ul style="list-style-type: none"> > Transaction Fees: These fees apply to each transaction made within the custody account, such as buying or selling securities. > Safekeeping Fees: A fee for the safekeeping and custody of the assets held in the account. > Corporate Actions Fee: Custodians may charge a fee for processing corporate actions on behalf of their clients, such as proxy services. > Other charges: Depository charges, SEBI AUC charges, audit confirmation charges, courier charges etc. 								
		3	Custodian 3 (Custody fees is	Top schemes	Scheme 1	Cat I	25.22	Custody	15,281	0.0061%
					Scheme 2		2.72	Custody	30,459	0.1119%
Top schemes	Scheme 1			Cat II	904.70	Custody	1,31,800	0.0015%		
	Scheme 2				718.70	Custody	1,82,965	0.0025%		
	Scheme 3				566.54	Custody	30,000	0.0005%		

Sr. No.	Name of Custodian	Top/Bottom Schemes (corpus/investment wise)	Scheme of AIF	Category	Corpus of the scheme (in INR Cr.)	Services offered to the AIF (in brief pointers)	Annual custodial fee (INR)	% of corpus	
	calculated on average AUC)	Bottom schemes	Scheme 1		19.75	Custody	26,359	0.0133%	
			Scheme 2		0.97	Custody	251	0.0026%	
			Scheme 3		0.60	Custody	13,468	0.2248%	
		Top schemes	Scheme 1	Cat III	677.12	Custody	2,31,497	0.0034%	
			Scheme 2		577.17	Custody	1,60,216	0.0028%	
			Scheme 3		408.47	Custody	95,062	0.0023%	
		Bottom schemes	Scheme 1		14.62	Custody	32,471	0.0222%	
			Scheme 2		14.59	Custody	5,494	0.0038%	
			Scheme 3		4.04	Custody	2,992	0.0074%	
		4	Custodian 4		<p>Basis of fee charged: 1bps – 2bps charged on the AUC/AUM with a minimum charge of 12 lacs a year (this depends on the services being offered and the overall relationship with the entity).</p> <p>The charging of fees is dependent on various factors like overall relationship with the bank, the nature of services being offered, size of the fund, etc.</p>				

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

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