

Amendment to SEBI (Alternative Investment Funds) Regulations, 2012

1. Objective

This Board Memorandum proposes to amend the SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”) to facilitate Category III Alternative Investment Funds (AIFs) in calculating the permissible concentration norm for investment in a single investee company based on Net Asset Value (NAV) of the AIF.

2. Issue for consideration

- 2.1. Category III AIFs are distinct from other categories of AIFs considering that Category III AIFs may invest in listed or unlisted securities of investee companies, derivatives, units of other AIFs and in complex or structured products. They may also employ diverse or complex trading strategies and undertake leverage including through investment in listed or unlisted derivatives.
- 2.2. As per the concentration norm provided in Regulation 15(1)(d) of AIF Regulations, Category III AIF is allowed to invest not more than ten percent of its investable funds in an investee company, either directly or through investment in units of other AIFs. Whereas, large value fund for accredited investors of Category III AIF may invest up to twenty percent of its investable funds in a single investee company.
- 2.3. As per Regulation 2(1)(p), ‘Investable funds’ means corpus of the AIF, i.e. the total amount of funds committed by the investors, net of expenditure for administration and management of the fund estimated for the tenure of the fund.
- 2.4. In terms of Regulation 23 (3), Category III AIF is required to disclose NAV to the investors at intervals not longer than a quarter for close ended funds and at intervals not longer than a month for open ended funds.

- 2.5. Further, in terms of SEBI circular dated July 29, 2013, NAV of Category III AIF is calculated as the sum of value of all securities adjusted for mark to market gains/losses (including cash and cash equivalents), excluding any borrowings by the fund.
- 2.6. In this context, AIF industry submitted representations to SEBI to review the aforesaid investment concentration norm applicable to Category III AIFs, stating that the concentration norm for investment in a single investee company for Category III AIFs should be calculated based on the NAV of the fund immediately preceding the date on which the AIF proposes to make investment in the investee company. It was further submitted that, the NAV of a Category III AIF can substantially vary from the investible funds, for various reasons which, inter alia, include the following:
- 2.6.1 The deployment of funds by Category III AIFs are much quicker and the fund managers generally call a substantial portion of funds committed by the investors to the fund upfront.
- 2.6.2 The level of portfolio churning is high. Especially, in case of close ended Category III AIFs, with a mix of long short strategy, churning of investment portfolio may generate superior returns, which boost the NAV. However, the “corpus” remains more or less constant due to close ended nature of the Fund.
- 2.6.3 Category III AIFs are permitted to seek leverage or borrow funds for the purpose of making investments, which can stretch up to a maximum of two times of the NAV of the fund.
- 2.6.4 Assuming the corpus of the fund as ‘Rs.200’, if the NAV becomes ‘Rs.300’ (50% appreciation), the fund can borrow or seek leverage to the extent of ‘Rs.600’ for making investment in securities. Post deployment of borrowed funds, if the investment portfolio achieves 20% appreciation in a year, the NAV of the fund can reach to Rs.480 [300 + 20% of (300+600)], whereas the Corpus remains at Rs.200.

- 2.6.5 As illustrated above, the NAV of a Category III AIF or its scheme could be substantially higher than the “Corpus”, especially if the fund seeks leverage. In the above example of leverage, when the NAV of the fund becomes Rs.480, the investment concentration calculated based on “corpus” is Rs.20 (10% of 200), which is approximately 4% (20/480) of the NAV.
- 2.6.6 Diversification is a common investment technique to reduce exposure of investors to any one particular asset or risk. However, over diversification can make it difficult for the fund to outperform the market index.
- 2.6.7 There could also be situations where the NAV of the fund is substantially lesser than the Corpus of the fund due to under performance or unfavorable market conditions. If the NAV of the fund depreciates to 50% of the Corpus of the fund, the concentration norm based on the NAV shall stand increased to 20%, permitting the funds to take larger exposure in a single investee company, which may pose investment risk to the unitholders of the fund.
- 2.7. The said proposal from AIF industry was placed before Alternative Investment Policy Advisory Committee (AIPAC) for deliberation, in its meeting held on July 07, 2021. AIPAC recommended that the concentration limit for investment in a single investee company for Category III AIFs, may be calculated based on the NAV of the fund for investment in listed equity and based on investable funds for investment in all debt securities and unlisted equity.
- 2.8. Category III AIFs may invest in listed or unlisted securities (both equity and debt securities) of the investee companies. In case Category III AIFs are allowed to calculate the concentration norm based on NAV and the NAV depreciates significantly, the market value of the existing investments of Category III AIFs may exceed the investment limit which may result into

passive breach of concentration norm. Such passive breach may be rectified in case of investment in listed equity, due to availability of liquidity. However, in case of investment in securities other than listed equity, rectification of passive breach may be difficult due to insufficient liquidity.

2.9. Considering the above, Category III AIFs may be allowed to calculate concentration norm based on NAV, only in case of investment in listed equity of an investee company and calculate concentration norm based on investable funds in case of investment in securities other than listed equity of an investee company.

2.10. The limit for investment in listed equity may be calculated based on the NAV of the fund on the business day immediately preceding the date on which the Category III AIF makes such investment. In this regard, an illustration for calculation of concentration norm and passive breach is placed at **Annexure A** for reference.

2.11. In case of passive breach in concentration norm for investment in listed equity, considering that rectification of such passive breach in a shorter duration may be onerous and affect the fund and its investors adversely, it may be mandated to rectify such passive breach within 30 days from the date of the passive breach. The AIF industry has also requested 30 days time for rectification of such breach.

2.12. The requirements at para 2.10 and 2.11, above may be specified by way of issuing a Circular.

3. Proposal for Consideration

3.1. Regulation 15(1)(d) of AIF Regulations may be amended to allow the Category III AIFs including any large value funds for accredited investors of Category III AIFs, to calculate the concentration norm based on NAV of the fund for investment in listed equity of an investee company and based on investable funds for investment in securities other than listed equity of an investee company.

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

Annexure A

This has been excised for reasons of confidentiality

Annexure B

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

Annexure C

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