

SEBI consultation paper on proposed amendment to SEBI (Alternative Investment Funds) Regulations, 2012

24 May 2023



Summary

With an objective of strengthening governance mechanisms of alternative investment funds (AIFs), the Securities and Exchange Board of India (SEBI), in consultation with the Alternative Investment Policy Advisory Committee (AIPAC), has issued a consultation paper on 18 May 2023. The SEBI has requested comments on the following aspects in relation to the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations), by 31 May 2023:

- Guidelines for borrowings by Category I and II AIFs;
- Dematerialisation of assets / investments of AIFs;
- Appointment of custodians for AIFs;
- Maximum extension of tenure by large value funds (LVFs) for accredited investors; and
- Renewal of registrations for AIFs.

Key aspects of consultation paper

The following are the key aspects of the consultation paper:

1. Borrowing by Category I / II AIFs

- The extant AIF Regulations permit Category I and II AIFs to borrow funds 'for meeting temporary funding requirements for not more than 30 days' and 'to meet day-to-day operational requirements' for Category II AIFs.
- Considering the ambiguity among market participants regarding the purpose for which AIFs may borrow funds, SEBI has clarified that Category I and II AIF should not borrow funds directly or indirectly or engage in leverage for making investments to avoid asset-liability mismatch.
- However, Category I and II AIFs may borrow for meeting the shortfall in drawdown while making investments in an investee company, subject to the following conditions:
 - Such borrowing should only be in the case of an emergency, as a last recourse;
 - The amount borrowed should not exceed 10% of investment proposed to be made in the investee company;

- Cost of such borrowing should be charged only to the investor who delayed on drawdown payment;
 - Disclosure to be made in Private Placement Memorandum (PPM) for such borrowing;
 - The manager shall disclose the amount borrowed and the terms of borrowing and repayment to all investors;
 - The AIF may only borrow once for meeting shortfall with respect to drawdown from the same investor;
 - Borrowing for such shortfall should not be used to schedule different drawdown timeline for different investors.
- Category I and II AIFs should maintain a cooling off period of 30 days between two periods of permissible leverage.

2. Dematerialisation of assets / Investments of AIFs

- The SEBI Board, in its meeting held on 29 March 2023, approved the proposal to mandate the issuance of units of AIFs in a demat form.
- Considering that the AIF industry is a sophisticated space that is rapidly growing, it is now proposed to mandate AIFs to hold their investments in the demat form

(except for securities where dematerialisation is not available).

- **Existing investments by AIFs**
 - A transition period of six months is provided for the dematerialisation of securities of investee companies, in which AIF/AIFs together have controlling interest.
 - SEBI has sought views on the dematerialisation of investments of AIFs in investee companies where AIF/AIFs together have no controlling interest.

3. Mandatory appointment of custodian of AIFs

- Currently, Category I / II AIFs having a corpus less than INR 500 crore are not required to appoint a custodian.
- Considering that all mutual funds and portfolio managers are mandatorily required to appoint a custodian, and in order to bring parity across all categories of AIF, SEBI has proposed the mandatory appointment of an independent custodian for all AIFs, irrespective of their corpus.
- For existing AIFs having no custodian / non-independent custodian, a transition period of six months is proposed to be provided to appoint an independent custodian.
- Further, it is proposed that custodians shall also be responsible for monitoring investments of AIFs with respect to investment conditions and other related requirements under the AIF Regulations.

4. Maximum extension of tenure by LVFs for accredited investors

- As per extant AIF Regulations, LVFs are permitted to extend their tenure beyond two years, subject to the terms of fund documents.
- The flexibility of having no upper limit on the extension of the term of LVFs

may result in a close ended fund acquiring the colour of a perpetual fund, wherein the funds of investors may get locked for an uncertain period.

- It has been proposed that LVFs be permitted to extend their tenure up to four years, subject to the approval of two-thirds of the unit holders by value of their investment in the LVF.

5. Renewal of registration of AIFs

- Currently, there is no requirement for AIFs to pay a renewal fee to keep the certificate of registration in force.
- On perusal of the quarterly reports filed by AIFs, SEBI observed that many AIFs held the certificate of registration even though there was no fund raising / investment activity in their schemes for several years. This resulted in practical risks / challenges for SEBI, apart from the risk of being misused for unauthorised fund raising.
- Considering that various other SEBI registered intermediaries are required to renew their licenses on a periodic basis, it is now proposed that AIFs should pay a renewal fee equal to 50% of its applicable registration fee for the subsequent block of five years from the date of registration, within three months before expiry of the said block.
- Existing AIFs, which have completed five years, should pay renewal fee equal to 50% of its applicable registration fee within three months of the issuance of a notification in this regard, and thereafter, every subsequent block of five years from the date of payment of such fee.
- Failure to pay the renewal fee would require the payment of a late fee equal to 2% of its registration fee for each day of delay, up to a maximum of two times of the registration fee, post which, the certificate of

registration of the AIF would be liable to be suspended / cancelled.

- Until the renewal fee is paid, AIFs cannot accept any fresh commitment or make investment in a new investee company in any of their

schemes or launch any new schemes.

Our comments:

The aforesaid proposals laid down in SEBI's consultation paper would promote the ease of administration, efficient monitoring, streamline processes and maximise investor protection.

While the above-mentioned proposals are a welcome move from an investor perspective, they would entail a higher compliance burden and increase the operational cost of AIFs.



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