



Demystifying SEBI's consultation papers on alternative investment funds

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Over the last few years, alternative investment funds (“AIFs”) have emerged as an integral class of investors. As part of the ongoing efforts of the Securities Exchange Board of India (“SEBI”) to evaluate and further ease the regulatory landscape for AIFs in India, SEBI has released five consultation papers, each of which covers a different element of the AIF norms and also includes a suggestion for an alternative review. The **objective of the consultation papers** is to seek comments / inputs / suggestions from all stakeholders on the proposals presented by SEBI. The consultation paper puts forth the following points of review:

- 1) Dematerialisation of units of AIFs;
- 2) Review of eligibility criteria for key investment team and prescribing qualification for compliance officer of Manager of an AIF;
- 3) Investor consent for buying / selling investments from / to associates of AIFs;
- 4) Option to AIFs and their investors to carry forward unliquidated investments of a scheme upon completion of its tenure; and
- 5) Direct plan for schemes of AIFs and trail model for distribution commission in AIFs.

The above matters were placed before the Alternative Investment Policy Advisory Council (“AIPAC”), wherein AIPAC deliberated and recommended several proposals. An overview of the SEBI proposals is provided below.

1) Dematerialisation of units of AIFs:

By way of the consultation paper, SEBI proposes dematerialisation of the units to be mandatory and by 1st April 2024, all schemes of AIFs with a corpus exceeding INR 500 crore to be obliged to dematerialise their units. Presently, AIF unit holders have a choice to have their units in physical form or dematerialized form. Further, the terms of transfer of units of AIFs would be governed by the terms of the private placement memorandum (“PPM”).

Key Takeaways:

Mandating the dematerialisation of units of AIFs is a positive move towards enhancing the tradeability, transparency and efficiency of AIF investments. This reduces the risk of fraud and potential damage or loss of physical units. It will also streamline the process of buying, selling and transferring AIF units, making it more efficient and cost-effective. Additionally, it will make the transfer of units easy and seamless.

2) Relaxing Eligibility Criteria of Key Investment Team:

Regulation 4(g) of the extant Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, as amended from time to time (“AIF Regulations”) requires investment manager of the AIF to have at least five years of “adequate experience” in advising and managing pools of capital or in fund or

asset or wealth or portfolio management by atleast one key managerial person and at least one key managerial person shall hold a qualification in finance, accountancy or other qualifications as specified by SEBI.

Highlighting the fact that the above requirement may:

- (a) act as a barrier for new age managers who are competent and have expertise in fund management to generate returns for the investors;
- (b) cause significant delay in registering AIFs as the investment managers fail to meet the experience criteria prescribed by SEBI; and
- (c) lack of similar experience requirements for key personnel of Asset Management Companies under the SEBI (Mutual Funds) Regulations 1996 and the responsibility of the compliance officer of manager of the AIF to comply with applicable regulations and laws, SEBI has proposed to replace the existing experience criteria of the key investment team, with the requirement of obtaining relevant certification from an institution notified by SEBI. Additionally, the compliance officer of the manager of such an AIF shall also be required to obtain certification from an institution notified by SEBI.

Key Takeaways:

This proposal is poised to boost interest of potential first-generation managers who will be motivated to showcase their expertise. As managers introduce new and creative ideas, this will also give AIFs a new viewpoint. Further, the reduced eligibility criteria will also accelerate the process at which AIFs are registered and result in a surge in the number of registered AIFs in the market. A special fusion of conventional methods and contemporary approaches could be seen in the AIF market.

3) Consent of Investors in transfer of investments between associates entities:

Under the current framework, an AIF needs to take the approval of 75% of its investors (by value of their investments) when it is making investments in associate entities or units of the AIFs managed or sponsored by its manager, sponsor or associates of its manager or sponsor.

Based on discussions with the Alternative Investment Policy Advisory Committee it is proposed by SEBI that AIFs need 75% approval from investors by value of their investment in the AIF in order to buy or sell investments from or to its associates or schemes of AIFs which are managed or sponsored by its manager, sponsor or their associates.

Key Takeaways:

This will not only increase investor trust but also help in effectively identifying and resolving the conflict of interests.

4) Providing option to AIFs and their investors to carry forward unliquidated investments of a scheme upon completion of its tenure:

- (a) SEBI proposes to provide AIFs and their managers with an additional option to carry forward the unliquidated investments beyond the currently available extended tenure.
- (b) Once the said tenure ends, the AIFs and their managers will be provided with an additional option to close the existing scheme and transfer the unliquidated investments into a new scheme, provided that they receive the consent of 75% of the investors by value of their investment in the AIF.
- (c) In case the approval of these investors is not received, then the funds shall be mandatorily liquidated within a year of expiry.

Key Takeaways:

This is a step in the right direction towards giving investors freedom and assurance. By allowing investors to keep their investments even after the scheme's tenure is up, tax consequences resulting from selling the units can be reduced. This can also aid in creating a stable environment for AIFs as it would allow them to hold onto investments for a longer period and provide greater flexibility.

5) Direct plan for schemes of AIFs and trail model for distribution commission in AIFs:

(a) Direct Plan for AIFs: According to a proposal from SEBI, AIFs must ensure that all investors have the choice of a direct plan. Investors who choose to invest in an AIF through a SEBI registered Investment Adviser or Portfolio Manager, run the risk of being charged twice, i.e., once in the form of Investment Adviser's or Portfolio Manager's fee and subsequently by the AIF distribution fee.

SEBI proposes to address this issue of double charging by mandating investment by such investors only through the direct route. In order to make up for the lower fees, the investors who are brought on board using this technique should be allotted a greater number of units, bringing the net asset value of unit holdings to parity among all investors.

(b) In case investors choose to invest in a Category III AIF, then they shall be charged fees only on a trail basis. Trail fees are more distributed where the investor doesn't have to pay a higher upfront fee, thus, decreasing the initial burden of payment. In case of Category I and Category II AIFs, investors may also be charged on a trail basis, but a higher distribution fee may be charged upfront.

Further, the SEBI (Mutual Funds) Regulations, 1996 and SEBI (Portfolio Managers) Regulations, 2020 mandate trail mail commission to distributors instead of upfront commission, thereby reducing mis-selling. There are no regulatory guidelines with respect to commission / distribution fees in case of AIFs.

Key Takeaways:

This is a positive step towards protection of investor interests and ensures that investors are not double charged, thus being cost effective. It is also a beneficial development as it not only enables the investors to save adequate financial resources to make better and larger investments, thereby increasing investor confidence, but also encourages distributors to give investors better and continuous support. It further ensures parity with other SEBI regulations.

In conclusion, the proposals made by SEBI in unison with the AIPAC seem to be a step in the right direction for the AIF market. The multi-fold approach by the authorities has created an optimistic environment, for investors and AIFs alike which will only boost participation in the AIF market. Ensuring that AIFs and their managers accurately recognise and disclose the asset quality, liquidity and fund performance to meet the regulatory and financial stability are the clear goals of the consultation papers. The consultation papers are an invaluable tool for investors, fund managers, and other industry participants to better understand India's regulatory environment as AIFs gain popularity as an investment alternative.

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