DECIPHERING SEBI’S RECENT AMENDMENTS TO THE AIF REGULATIONS AMID SECOND WAVE OF COVID-19: A DETAILED INSPECTION TO THE SEBI (ALTERNATE INVESTMENT FUNDS) SECOND AMENDMENT REGULATIONS, 2021

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ABSTRACT

Amid second wave of Covid-19 surge, capital markets regulator Securities Exchange Board of India (“SEBI”) vide notification dated May 5, 2021 brought in major amendments to the SEBI (Alternate Investment Funds) Regulations, 2012 (“AIF Regulations/Principal AIF Regulations”) aimed at providing regulatory flexibility, improving clarity and accountability with respect to alternate investment funds (“AIFs”) and their functioning via the SEBI (Alternate Investment Funds) (Second Amendment) Regulations, 2021 (“said Amendment”).

SEBI made the following amendments to the AIF Regulations –

• Approving the insertion of definition of Startup and removal of the list of 'restricted activities or sectors from the definition of 'Venture Capital Undertaking'.

• AIFs, including Fund of AIFs, permitted to simultaneously invest in units of other AIFs and directly in securities of investee companies.

• AIF manager is required to ensure compliances with investment conditions, fund documents and applicable laws under all circumstances.

• prescribe a Code of Conduct for AIFs, key management personnel of AIFs, trustee, trustee company, directors of the trustee company, designated partners or directors of AIFs, as the case may be, Managers of AIFs and their key

1 Notification No. SEBI/LAD-NRO/GN/2021/21, dated 5th May 2021
management personnel and members of Investment Committees and bring clarity in the responsibilities cast on members of Investment Committees.

Thereafter, on May 21, 2021 ("May 21 Circular"), SEBI issued a Circular\(^2\) enhancing the overseas investment limit for AIFs and VCFs from USD 750 million to USD 1500 million.

Further, on May 31, 2021 ("May 31 Circular"), after receiving the representation from the AIF industry thereby requesting the extension of timelines for various regulatory filings and compliances for VCFs and AIFs, SEBI issued a Circular\(^3\) extended the due date for various regulatory filings till September-end.

I. INTRODUCTION

SEBI has for the first time introduced AIF Regulations on May 21, 2012. Prior to the AIF Regulations, it was not mandatory to register investment vehicles with the SEBI, though some private equity funds ("PE Funds") chose to do so under the SEBI (Venture Capital Funds) Regulations, 1996 ("VCF Regulations"). The AIF Regulations made it mandatory for every privately pooled investment vehicle, established or incorporated in India in the form of a trust, a company, a limited liability partnership or a body corporate, which collects funds from investors, whether Indian or foreign, to be registered as an alternative investment fund ("AIF" or "Fund") with SEBI.


We all know that the economic impact of the COVID-19 pandemic in India has been largely disruptive. Amid several concerns in the Indian capital markets, SEBI vide it’s Board Meeting

\(^2\) Notification No. SEBI/HO/IMD/DF6/CIR/P/2021/565

\(^3\) Notification No. SEBI/HO/IMD/IMD-I/DOF6/CIR/2021/568
dated March 25, 2021 extensively dealt with various issues and thereafter released the minutes of the meeting wherein the Board proposed to amend the AIF regulations thereby mentioning their objectives for the said Amendment and various issues for consideration behind this said Amendment. Thereafter, following the said Amendment within a month, SEBI had issued two other Circulars with an aim to enhance the overall limit funding for overseas investments by VCFs and AIFs to reduce the compliance burden on venture capital funds and alternative investment funds.

The main objective behind the implementation of the said Amendment was to replace, amend or insert some of the provisions specified under the Principal AIF regulations.

II. A DETAILED SUMMARY OF THE KEY CHANGES INTRODUCED UNDER THE SAID AMENDMENT AND ITS IMPLICATIONS FOR AIFS

A. The Definition of Startups -

SEBI has added the definition of Start-up in sub-regulation (1) of regulation 2, after clause (w) and before clause (x), the following clause shall be inserted, namely, –

“(wa), “startup” means a private limited company or a limited liability partnership which fulfills the criteria for startup as specified by the Department of Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Government of India, vide notification No. G.S.R. 127(E) dated February 19, 2019 or such other policy of the Central Government issued in this regard from time to time;”

My observation: The AIF Regulations did not define Start-ups. So far, ‘startups’ have been defined differently by different arms of the Indian government. This lack of clarity has created multiple issues and unnecessarily increased the compliance cost. Therefore, the said Amendment will minimize the compliance costs and provide clarity on the definition of Start-ups. The idea behind defining the term ‘start-ups’ in alignment with the definition provided by DPIIT is essentially to avoid the need for recurring amendments in the AIF Regulations. Further, a clear definition shall now leave no room for divergent interpretations.

Anirudh A. Damani, the managing partner of Artha Venture Fund, has been interviewed by Inc42Plus⁵, wherein, he commented that –

“The alignment of startup definitions across DPIIT and SEBI was desperately required. Many companies (especially those in fintech) are kept outside the scope of Category I venture capital funds even though fintech has become a focal area for investors in recent years. The definition of startups should be in sync with the times, and SEBI has vastly relieved the entire ecosystem with this critical change.”

B. Broadening the scope of the definition of Venture Capital Undertaking by SEBI -

SEBI has simplified and broadened the scope of the definition of Venture Capital Undertaking (“VCU”) by removing the earlier list of restricted activities in the definition of a VCU under the Principal AIF Regulations. This should enable Category I AIFs to now allocate monies towards NBFCs which was earlier prohibited.

The said Amendment also substitutes VCUs under sub-regulation (1) of regulation 19F of the AIF Regulations with the word ‘start-ups’, implying that angel funds can now invest in start-ups rather than VCUs, thus widening the investment scope of angel funds in general.

SEBI set forth the following in sub-regulation (1) of Regulation 2 –

clause (aa) in Regulation shall be substituted with the following, namely, –

“(aa) “venture capital undertaking” means a domestic company which is not listed on a recognized stock exchange at the time of making investments;”

My observation: A key concern arising due to the negative list was that a major chunk of start-ups were being excluded. The most prominent example could be the fintech start-ups. As of June, 2020, there were over 2100 fintech start-ups in India. Now, given that these most likely fall under the ambit of NBFCs, are devoid of a crucial source of funding, especially curated for start-ups. Thus, removal of the negative list will open closed doors for VCUs which require substantial funding to kick-start their ventures.

⁵ https://inc42.com/features/decoding-sebis-latest-amendment-for-indian-startups-investors/
C. Addition to the scope of the definition of Placement Memorandum -

In the said Amendment, SEBI set forth the following in the sub regulation (2) of Regulation 11–

“after the words and symbol “key service providers,” and before the words “conflict of interest”, the words and symbol “terms of reference of the committee constituted for approving the decisions of the Alternative Investment Fund,” shall be inserted”

My observation: In addition to the comprehensive list of information required to be disclosed by the AIFs in their Placement Memorandum, the said Amendment require the AIFs to also disclose details with regards to the terms of reference of the committee constituted for approving the decisions of the Alternative Investment Fund.

D. Investment in other AIFs simultaneously: an open-minded yet a guided approach -

With the said Amendment, SEBI has proposed a framework for AIFs to invest simultaneously in units of other AIFs and directly in securities of investee companies.

i. In the Regulation 15(1)(c) of the Principal AIF Regulations, SEBI has permitted that Category I and II Alternative Investment Funds shall invest not more than twenty five percent of the investable funds in one Investee Company;

However, in the said Amendment, SEBI has set forth that clause (c) shall be substituted with the following:

“Category I and II of Alternative Investment Funds shall invest not more than twenty five per cent of the investable funds in an Investee Company directly or through investment in the units of other Alternative Investment Funds;”

My observation: Concentration rules have been broadened to include indirect holding through another AIF.
ii. In Regulation 15(1)(d) of the Principal AIF Regulations, SEBI has permitted that Category III Alternative Investment Fund shall invest not more than ten percent of the investable funds in one Investee Company.

However, in the said Amendment, SEBI has set forth that clause (d) shall be substituted with the following:

“Category III of Alternative Investment Funds shall invest not more than ten per cent of the investable funds in an Investee Company directly or through investment in units of other Alternative Investment Funds;”

My observation: Concentration rules have been broadened to include indirect holding through another AIF.

iii. In Regulation 15(1), SEBI inserted a new clause (da) after clause (d) and before clause (e),

“(da) Alternative Investment Funds which are authorized under the fund documents to invest in units of Alternative Investment Funds shall not offer their units for subscription to other Alternative Investment Funds”

My observation: An AIF cannot act as an intermediary investment vehicle in between two AIF’s.

iv. In Regulation 15(1)(e), in the Principal AIF Regulations, SEBI has permitted that Alternative Investment Fund shall not invest in associates except with the approval of seventy five percent of investors by value of their investment in the Alternative Investment Fund.

However, in the said Amendment, SEBI has set forth that clause (e) shall be substituted with the following:

“Alternative Investment Fund shall not invest except with the approval of seventy five percent of investors by value of their investment in the Alternative Investment Fund in –

(a) associates; or
(b) units of Alternative Investment Funds managed or sponsored by its Manager, Sponsor or associates of its Manager or Sponsor."

My observation: Governance check introduced for investment in AIF under the control of the same fund manager, sponsor or associates.

E. Investment Conditions for Category I AIFs -

i. In Regulation 16(1)(a) of the Principal AIF Regulations, SEBI has permitted that Category I Alternative Investment Fund shall invest in investee companies or venture capital undertaking or in special purpose vehicles or in limited liability partnerships or in units of other Alternative Investment Funds as specified in these regulations;

However, in the said Amendment, SEBI has set forth that clause (a) shall be substituted with the following:

"Category I Alternative Investment Fund shall invest in investee companies, venture capital undertakings, special purpose vehicles, limited liability partnerships or in units of other Category I Alternative Investment Funds of the same sub category

Investment by Category I AIF in units of Category I AIF of same sub-category added in this sub- regulation which was covered in sub-regulation 16(1)(b) (now omitted)"

My Observation: Investment by Category I AIF in units of Category I AIF of same sub-category added in this sub- regulation which was covered in sub-regulation 16(1)(b) (now omitted)

ii. Further, SEBI has omitted Regulation 16(1)(b) via the said Amendment because the clause is covered in regulation 16(1)(a).

F. Investment Conditions for Category II AIFs -

i. In Regulation 17(a) of the Principal AIF Regulations, SEBI has permitted that Category II Alternative Investment Funds shall invest primarily in unlisted investee
companies or in units of other Alternative Investment Funds as may be specified in the placement memorandum.

However, in the said Amendment, SEBI has set forth that clause (a) shall be substituted with the following:

“Category II Alternative Investment Funds shall invest in investee companies or in the units of Category I or other Category II Alternative Investment Funds as may be disclosed in the placement memorandum;”

Explanation. – Category II Alternative Investment Fund shall invest primarily in unlisted companies directly or through investment in units of other Alternative Investment Funds;

My observation - Investment by Category II AIF in units of Category I & II AIF added in this sub-regulation which was covered in sub-regulation 17(b).

ii. Further, SEBI has omitted Regulation 17(b) via the said Amendment because the clause is covered in Regulation 17(a).

G. Investment Conditions for Category III AIFs -

i. In Regulation 18(a) of the Principal AIF Regulations, SEBI has permitted that Category III Alternative Investment Funds may invest in securities of listed or unlisted investee companies or derivatives or complex or structured products;

However, in the said Amendment, SEBI has set forth that clause (a) shall be substituted with the following:

“Category III Alternative Investment Funds may invest in securities of listed or unlisted investee companies, derivatives, units of other Alternative Investment Funds or complex or structured products.”

My observation - Category III Alternative Investment Funds may invest in securities of listed or unlisted investee companies, derivatives, units of other Alternative Investment Funds or
complex or structured products.

Investment by Category III AIF in units of Category I & II AIF added in this sub-regulation which was covered in sub-regulation 18(b).

ii. Further, SEBI has omitted Regulation 18(b) via the said Amendment because the clause is covered in Regulation 17(a).

H. Investment by Angel Funds - Dedicated to Start-ups

Chapter III-A of the AIF Regulations Inserted by the SEBI (Alternative Investment Fund) (Amendment) Regulations, 2013 which came into effect from September 16 2013, lay down provisions with respect to Angel Funds – a Category I AIF, registered with the objective of raising funds from angel investors and invest the same in ventures that encourage entrepreneurship in the country, by financing them at a stage where it would otherwise be difficult for such entities to raise funds from mainstream sources (think banks, other financial institutions etc.)

Thus, Regulation 19F of the AIF Regulations ascribes certain investment conditions for Angel Funds- the most important one being restricted investment in venture capital undertakings and start-ups only.

However, now that the scope of ‘venture capital undertakings’ stands amended and start-ups have been accorded a definite meaning, Regulation 19F (1) also stands amended to accommodate the related changes.

In the said Amendment, SEBI has set forth that sub-regulation (1) of Regulation 19F shall be substituted with the following:

i. The words “venture capital undertakings” shall be substituted with the word “startups”.

ii. Clauses (a) and (b) shall be omitted.

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6 Notification No. LAD-NRO/GN/2013-14/24/6573  
My observation - Given that the scope of VCU’s have been widened, dedicating investments by Angel Funds to Start-ups seems like a natural step. Further, the Principal AIF Regulations did not factor the nature of business proposed by the investees. Now, since the definition is derived from the one given by DPIIT, start-ups propagating innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation shall be focused upon.

I. General Obligations and Responsibility & Transparency –

The said Amendment has substituted Regulation 20 of the Principal AIF Regulations to revamp the general obligations of the key management personnel of the AIF, trustee, the trustee company, directors of the trustee company, designated partners or directors of the AIF. In a nutshell, SEBI has introduced the following obligations on AIFs, so as to ensure transparency with stakeholders–

a) The management should have detailed policies and procedures, in line with the AIF Regulations, that shall be adopted by the AIFs, its managers, sponsors and key management personnel;

b) The Manager shall be responsible for every decision of the Alternative Investment Fund, including ensuring that the decisions are in compliance with the provisions of these regulations, terms of the placement memorandum, agreements made with investors, other fund documents and applicable laws;

c) The Manager may constitute an Investment Committee (by whatever name called), to approve the decisions of the Alternative Investment Fund and such constitution shall be subject to such conditions as specified by the Board from time to time;

d) All Alternative Investment Funds shall inform the Board in case of any change in the Sponsor, Manager or designated partners or any other material change from the information provided by the Alternative Investment Fund at the time of application for registration;

e) In case of change in control of the Alternative Investment Fund, Sponsor or Manager, prior approval from the Board shall be taken by the Alternative Investment Fund;
f) The books of accounts of the Alternative Investment Fund shall be audited annually by a qualified auditor

J. **Newly introduced code of conduct under Fourth Schedule of the AIF Regulations**

The Securities and Exchange Board of India (Alternative Investment Funds) (Second Amendment) Regulations, 2021 on the 5th May, 2021 has laid down a code of conduct for Alternative Investment Fund, key management personnel of the Alternative Investment Fund, trustee, trustee company, directors of the trustee company, designated partners or directors of the Alternative Investment Fund to abide by. The code of conduct lays down following requirements for AIFs:

a) Carry out its business activities and invest in accordance with the investment objectives stated in the placement memorandum and other fund documents.
b) Be operated and managed in the interest of all investors and not only in the interest of the sponsor, manager, directors or partners of the sponsor and manager or a select class of investors.
c) Ensure the dissemination of adequate, accurate, explicit and timely information in accordance with these Regulations to all investors.
d) Ensure the dissemination of any other information as agreed with the investors.
e) Ensure that an effective risk management process and appropriate internal controls are in place.
f) Have written policies and procedures to identify, monitor and appropriately mitigate any potential conflict of interest through-out the scope of its business.
g) Not use any unethical means to sell, market or induce any investor to buy its units.
h) Have written policies and procedures to comply with anti-money laundering laws.

III. **ENHANCEMENT OF OVERALL LIMIT FOR OVERSEAS INVESTMENT BY AIFs/VCFs**

The Principal AIF Regulations regulate alternative investment funds set up in India for pooling of funds on a private placement basis. AIFs are permitted to invest in securities of companies incorporated outside India subject to the conditions or guidelines issued by the RBI and SEBI.
One such condition for overseas investment before the Circular was issued was that the maximum permissible block limit ("Block Limit") for overseas investment by all SEBI registered AIFs and VCFs should not exceed USD 750 million. This Block Limit has now been doubled by SEBI in its May 21 Circular, to USD 1,500 million from the erstwhile limit of USD 750 million. The limit has been enhanced after consultation with the Reserve Bank of India.

IV. SEBI RELAXES COMPLIANCE REQUIREMENTS FOR VCS, AIFS AMID COVID-19

With an aim to reduce the compliance burden on venture capital funds and alternative investment funds, markets regulator SEBI extended the due date for various regulatory filings till September-end. This move comes in the surge of the second wave of the COVID-19 pandemic and restrictions imposed by various state governments, SEBI said in the May 31 Circular.

This decision has been taken after SEBI received representation from the AIF industry requesting extension of timelines for various regulatory filings and compliances for AIFs and VCFs. After consideration, SEBI has decided to extend the due dates for regulatory filings by AIFs and VCFs, during the period ending March 2021 to July 2021 as prescribed under the Principal AIF Regulations and circulars issued thereunder. In the said May 31 Circular, SEBI has mentioned that AIFs and VCFs may submit regulatory filings for the aforesaid periods, as applicable, on or before September 30, 2021. This liberal approach by SEBI is a attestation to promote the development of, and to regulate the securities market.

SEBI also made multiple relaxations for Indian firms, including market intermediaries and depositories, in terms of filing of financial details, disclosure on fund utilization and updating client records.

V. CONCLUSION

On a cumulative reading of the said Amendment, the May 21 and May 31 Circulars, the need for changes to the Principal AIF Regulations, reflect the efforts undertaken by the financial regulator to not only provide flexibility to the AIF managers in running their fund operations effectively but at the same time ensure that their fiduciary responsibilities towards the investors are not compromised with. Further, these efforts should play an important role in the growth of
start-ups in India by expanding the available pool of capital for these entities as well as catalyze the formation of new Category I AIFs. Now more than ever, it is incumbent on the government to facilitate the inflow of investments and cash flow by bringing about the cautious easing of restrictions. A conscious adoption of a harmonious and judicious interpretation of the AIF regulations would be useful in the interests of attracting investments into India, particularly in times like these when both domestic and global economies have been stretched thin.