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PRIVATE FUNDS UPDATE

SEBI INTRODUCES NEW REQUIREMENTS FOR AIFs

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SEBI introduces new requirements for AIFs

Introduction

On February 5, 2020, the Securities and Exchange Board of India ("**SEBI**") issued a circular ("**Circular**") introducing significant changes to the existing legal regime concerning alternative investment funds ("**AIFs**"). AIFs are privately-pooled investment funds which collect funds from investors, whether Indian or foreign, for investing in accordance with a defined investment policy for the benefit of the investors. AIFs are governed by the SEBI (Alternate Investment Fund) Regulations, 2012 ("**AIF Regulations**").

The Circular, *inter alia*, introduces the requirement of mandatory performance benchmarking, prescribes standardization of private placement memorandums ("**PPMs**") and also prescribes annual audits for AIFs. The objective of such measures is to enhance disclosure standards amongst others. Prior to issuing the Circular, SEBI had issued a consultation paper on December 4, 2019 where the above proposals were discussed. In the consultation paper it was stated that performance benchmarking would facilitate dissemination of necessary information on industry performance and would enable investors to compare an individual AIF's performance with the performance of industry or peer group AIFs. Standardisation of PPMs was recommended to ensure availability of a minimum standard of information.

The requirements introduced by the Circular will come into effect from March 1, 2020. This update discusses the key changes introduced by the Circular.

Standardisation of PPMs and Annual Compliance Audit

Template for PPMs

A PPM is the primary document in which all the necessary information about the AIF is disclosed to prospective investors. Currently, the AIF Regulations stipulate only the broad areas of disclosures that should be incorporated in a PPM and do not prescribe any format. The Circular introduces a detailed format for PPMs which is required to be followed by AIFs. PPMs can contain additional information.

2 (two) distinct templates of PPMs have been prescribed, one in respect of Category I[1] and Category II[2] AIFs ("**Category I and II PPM**"), and the other, in respect of Category III[3] AIFs ("**Category III PPM**").

Annual Compliance Audit

The Circular makes it mandatory for AIFs to carry out an annual audit of their compliance with the terms of PPMs. The audit may be carried out by either internal or external auditor/legal professionals. However, audit of the sections of PPMs relating to 'Risk Factors', 'Legal, Regulatory and Tax Considerations' and 'Track Record of First Time Managers' has been made optional.

The findings of the audit, along with corrective steps, if any, are required to be communicated to the trustee or board or designated partners of the AIF, board of the manager of the AIF ("**Manager**") and SEBI.

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[1] Category I AIFs are those AIFs which invest in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and includes venture capital funds, SME Funds, social venture funds and infrastructure funds.

[2] Category II AIFs are those which do not fall in Category I and III and which do not undertake leverage or borrowing other than to meet day-to-day operational requirements. Category II AIFs include private equity funds or debt funds for which no specific incentives or concessions are given by the government.

[3] Category III AIFs are those which employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives. Category III AIFs include hedge funds or funds which trade with a view to make short term returns.

Exemptions

The Circular exempts the following AIFs from the abovementioned requirements of following the prescribed template of PPMs and carrying out an annual audit of compliance with PPMs:

a. 'Angel Funds' as defined in the AIF Regulations; and
b. AIFs in which each investor commits to a minimum capital contribution of Rs. 70 crore (USD 10 million or equivalent, in case of capital commitment in non-INR currency) and issues a waiver to the AIF, a format of which has been prescribed in the Circular.

Contribution agreements – alignment with PPMs

Typically AIFs submit their PPMs to SEBI prior to launching a scheme, to enable SEBI to provide its comments. Thereafter, AIFs launch their schemes, invite funds and enter into separate contribution agreements with investors. There may be provisions in the contribution agreements which could possibly go beyond what is stated in the PPM, without contradicting any provision of the PPM. It must be mentioned that in a 2015 circular, SEBI had clarified that Managers should ensure that they carry out all activities of the AIF in accordance with the PPM and that they should maintain fairness in all their dealings.

The Circular now introduces a specific requirement that the terms of a contribution or subscription agreement (by any name it may be called) must be aligned with the terms of the PPM and cannot go beyond the terms of the PPM. Hence, the new requirement is not just to ensure that contribution agreements and PPMs do not have contradictory provisions, but to also ensure that contribution agreements do not go beyond what is stated in PPMs The above requirement is also applicable to AIFs which are exempted from following the prescribed templates for PPMs.

Further, with respect to the matters set out in the template of the PPM, at first brush, the above requirement appears to restrict the flexibility of AIFs which are required to follow the template, to negotiate terms of contribution agreements with individual investors. However, a closer look at the template prescribed for PPMs would reveal that there are certain areas where such flexibility is still available.

Key provisions of the standard format of PPMs: A brief overview

The following paragraphs provide a brief overview of some of the provisions prescribed in the formats of PPMs. As mentioned above, separate formats have been prescribed for Category I and Category II PPM and Category III PPM. In the following paragraphs, certain provisions of the formats for Category I and Category II PPM and Category III PPM have been discussed.

Structure

The AIF Regulations currently provide only the broad areas of disclosures which are required to be contained in the PPM[4]. In comparison, the scope of the information to be included in the PPMs is significantly higher under the formats prescribed in the Circular. However, it has also been stated that in case any section included in the format is not applicable to any AIF, in any manner whatsoever, the inapplicability will be required to be mentioned, against such section of the PPM.

[4] Regulation 11(2) of the AIF Regulations provide that a PPM should include, *inter alia*, all material information about the AIF and the Manager, background of key investment team of the Manager, targeted investors, fees and all other expenses proposed to be charged, tenure of the AIF or scheme, conditions or limits on redemption, investment strategy, risk management tools and parameters employed, key service providers, conflict of interest and procedures to identify and address them, disciplinary history, the terms and conditions on which the Manager offers investment services, its affiliations with other intermediaries, manner of winding up of the AIF or the scheme and such other information as may be necessary for an investor to take an informed decision on whether to invest in the AIF.

Investment strategy

A percentage or range is required to be given for maximum investment proposed per portfolio company and allocation for investment in overseas portfolio companies.

Governance Structure

Details of sponsor, trustee, Manager, key investment team, key persons of the AIF and description of the investment committee are required to be given. Fees to be paid to members of the investment committee have to be disclosed. Further, details of advisory board, advisory committee, operating partners and portfolio companies are also required to be disclosed.

Track record of Manager

The format requires detailed disclosures about the Manager's track record including track record of previous funds. The broad points to be included about previous funds are as follows:

- Investment strategy of the fund
- Size of the fund
- Number of investments made by the fund
- Amounts deployed by the fund
- Description of portfolio companies and investment exits for the fund

Category I and II PPM provides for the following additional points to be included in the disclosures related to previous funds:

- Gross IRR (internal rate of return) for the fund
- Gross MOIC (multiple on invested capital)
- DPI (distributed to paid in)
- RVPI (residual value in multiple)
- TVPI (total value to paid in)

In case of experienced Managers, description of portfolio company exits also have to be provided.

Management Fees and other fees

The following information regarding management fees have to be disclosed amongst others:

- Management fees for each class of units
- Rate and the basis of charging management fee
- Frequency of charging the management fee
- Method of collection and management fee offset, if any
- Whether the Manager may reduce the management fee for any class of unit and basis, if any

Constituents for other fees that may be charged by the AIF including placement fees, etc. have to be disclosed.

Side Letters

While execution of side letters is fairly common in the AIF industry, the AIF Regulations did not make any express stipulations regarding side letters. The formats of PPMs prescribed under the Circular however stipulate that in the event the Manager intends to offer side letters to certain categories of investors, the following should be clearly stated:

a. whether any side letters will be offered; and
b. the criteria for offering differential rights through side letters to any investor.

Flexibility has been given to determine the parameters for qualifying an investor for entering into a side letter arrangement. Such criteria could either be quantitative (based on the size of the commitment) or qualitative (based on the strategic relevance to the AIF/scheme) or both. However, the basis on which side letters are awarded to certain investors, must be specified in the PPM.

The PPM is required to confirm that the terms of the side letter shall not have any adverse impact on the economic rights or any other rights of the investor and nothing under the side letters would alter the rights of the other investors available to them under their respective contribution agreements. The PPM is also required to provide an indicative list of the items in respect of which differential rights may not be offered, which include, *inter alia*, 'preferential exit from Fund/scheme', 'contribution to Indemnification', 'giveback', 'drawdown' (except as per the provision for 'excuse and exclusion').

The PPM must also specify the list of commercial terms and non- commercial terms on which differential terms may be offered through side letters. An AIF is required to list down an indicative list of all material commercial terms of the offering which may be altered for the qualifying investors through a side letter, for e.g. management fees, carried interest, cap on expenses, offering of co-investment rights, waiving of compensatory contribution, etc.

It is required to be confirmed that the terms of the side letter shall not have any adverse impact on the economic rights or any other rights of the investor and nothing under the side letters would alter the rights of the other investors available to them under their respective contribution agreements.

Rights of unit holders

The PPM has to clearly state that special rights attached to such classes of units issued by the AIF/ scheme shall not have any adverse impact on the economic or any other rights of other investors.

Expenses

Detailed breakup of operating expenses, organisational expenses and other expenses alongwith an estimate or cap, if any, has to be disclosed in the PPM. Where there is no cap applicable on the expenses, an indicative break-up of the ranges that are applicable to all individual constituents of such expenses for the AIF/ scheme (including operating expenses and set-up expenses) will be required to be inserted.
It has been clarified that expenses to be borne by the Manager, cannot be charged to the AIF/scheme.

Distribution

The detailed process of distribution including distribution waterfall, hurdle rate of return, catch-up and carry have to be incorporated.

Conflict of interest

The AIF Regulations already require the sponsor and Manager of an AIF to disclose all conflicts of interests as and when they arise or seem likely to arise. Such disclosures have to be included in the PPM under the AIF Regulations. The format for the PPM elaborates on the disclosures required to be made for conflicts of interest.

Exercise of discretion

A Manager can exercise discretion in the following matters:

- Reduction in management fees
- Varying additional return/ carried interest
- Determine the parameters for qualifying an investor for entering into a side letter arrangement
- Accept a lower than minimum capital commitment for any class of unit in the AIF/ scheme, subject to the AIF Regulations
- Exercise of default recourses against defaulting investors
- Retain investment proceeds and taxation related retentions as reserves

Additionally, Category I and II PPM provides that the Manager may waive additional charges on subsequent closings.

The Manager is required to disclose the existence of all of the above powers in the PPM.

Performance Benchmarking

Introduction

A need for introducing performance benchmarking of AIFs was felt so that an industry benchmark can be developed to compare the performance of the AIF industry against other investment avenues as also global investment opportunities. Accordingly, SEBI has introduced mandatory benchmarking of the performance of AIFs and the AIF industry and has also introduced a framework for facilitating the use of data collected by benchmarking agencies to provide customized performance reports. These requirements are however not applicable to ‘Angel Funds’ that are registered under sub-category of Venture Capital Fund under Category-I AIF.

Formation of an Association

Any association of AIFs (“**Association**”) representing 51% of the number of AIFs in terms of membership may notify one or more benchmarking agencies, with whom each AIF is required to enter into an agreement for carrying out the benchmarking process.
The Association and benchmarking agencies are required to ensure that the first industry benchmark and AIF level performance versus benchmark reports are available latest by July 1, 2020, for the performance upto September 30, 2019. Further the Association is required to submit a progress report in this regard to SEBI on a monthly basis till the creation of first industry benchmark.

Disclosures

- All necessary information, including scheme-wise valuation and cash flow data is required to be reported to the benchmarking agencies for AIF schemes that have completed at least one year from the date of ‘First Close’.
- AIFs are required to provide data on cash flows and valuation of their scheme-wise investments to the benchmarking agencies within 45 days from the end of every half year ending on September 30 and within 6 months from the end of every half year ending on March 31.
- In a scenario where an applicant claims a track-record of the funds incorporated overseas, on the basis of India performance, the applicant is required to provide the data of the investments of the said funds in Indian companies to the benchmarking agencies, when they seek registration as AIF.
- The performance versus benchmark report provided by the benchmarking agencies for AIF/scheme is required to be incorporated in PPMs, as well as in any marketing or promotional or other material, where past performance of the AIF is mentioned.

Frequency

Performance benchmarking is required to be done on a half yearly basis based on the data as on September 30 and March 31 of each year.

Audit

Data that is provided for March 31 of every year is required to be audited.

AUM

Assets under Management (AUM) for the purpose of reporting and benchmarking is required to be the value of total capital drawn down under the scheme.
The performance reporting and benchmarking shall be carried out on pre-tax Net Asset Value (NAV) of the scheme.

Past data

Benchmarking agencies are required to compile the data received from AIFs and create comparable industry performance benchmarks for the various categories of AIFs i.e. Category I, II and III, separately for each year since **2012**. The industry performance benchmarks are also required to be disseminated in a manner that is accessible to the public.

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