October 11, 2019

SEBI's AIF REGULATIONS 2012

- A FEW TWEAKS REQUIRED

argus partners
SOLICITORS AND ADVOCATES
MUMBAI I DELHI I BENGALURU I KOLKATA

Introduction

The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") came into effect on May 21, 2012. Prior to the AIF Regulations, it was not mandatory to register investment vehicles with the Securities and Exchange Board of India ("**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 ("**LLP**") 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.

Though the AIF Regulations were better drafted than the VCF Regulations, the AIF Regulations had a few loopholes, which were addressed by circulars issued by SEBI dated July 29, 2013, June 19, 2014 and July 18, 2014. However, in our view, a few more tweaks are required to be made to the AIF Regulations in the interests of the PE Funds industry.

Skin in the Game

The investment manager of a Fund is expected to have some 'skin in the game'. In other words, the investment manager should not merely place bets using investors' monies but should put some of its own money at risk, alongside that of investors.

Regulation 19(d) of the AIF Regulations requires either the manager or the sponsor of the Fund to have a commitment in the Fund of not less than 2.5% (two point five percent) of the Fund's corpus[i] or Rs. 5,00,00,000 (Rupees five crore), whichever is lower, in the form of an investment in the Fund. In the case of Category III Funds, the required minimum commitment is double that of Category I and II Funds, and is 5% (five percent) of the Fund's corpus or Rs. 10,00,00,000 (Rupees ten crore), whichever is lower. The AIF Regulations use the words "continuing interest" for this minimum required commitment and forbid the making of such commitment through the waiver of management fees.

Interestingly, the AIF Regulations permit the "skin in the game" to be supplied by either the sponsor or the investment manager. In other words, it is not mandatory that the investment manager should have skin in the game. It is sufficient if the sponsor does. Even more interestingly, the AIF Regulations do not require the sponsor to be an affiliate of the investment manager. The AIF Regulations define the sponsor as "*any person or persons who set up the Alternative investment Fund and includes promoter in case of a company and designated partner in case of a limited liability partnership*".

Usually, the sponsor is an affiliate of the investment manager and the sponsor's main, albeit one-time, role is to establish the trust (which is registered with SEBI as the Fund) by acting as its settlor by entering into a trust deed with the trustee. Depending on convenience, the "minimum commitment" (a.k.a. skin in the game) is invested in the Fund by either the manager or the sponsor. In many cases, the investment manager doubles as the sponsor and this is in line with the AIF Regulations which explicitly states (in the definition of "manager") that the sponsor and the investment manager may be the same entity.

However, it is possible, at least theoretically, for the sponsor to be unrelated to the investment manager and still invest the minimum required commitment in the Fund. Why would an entity unrelated to the investment manager invest the minimum required commitment in a Fund? It is possible that one of the early investors in the Fund could be persuaded by the investment manager to front as the sponsor of the Fund and have such investor's investment in the Fund treated as the requisite minimum regulatory commitment. Such a scenario is not very likely to materialise, since

i "Corpus" has been defined in the AIF Regulations to mean the total amount of funds committed by investors to the Fund

other investors may be put off when a fellow investor is dressed up as the sponsor. Nevertheless, this is a loophole which ought to be plugged. The AIF Regulations should be amended to state that if the minimum commitment is being stumped up by the sponsor and not the manager, then the sponsor should be required to be an affiliate of the investment manager and/or be a part of the investment manager's corporate group.

Consent from Investors

One of the fundamental principles of fund management is that all important actions of the investment manager, that deviate from the Fund documents, should be carried out only with the consent or approval of the investors. The AIF Regulations specifically prescribe that the investors approval be obtained in, *inter alia*, the following situations:

a) Any material alteration to the Fund's strategy requires the consent of at least two-thirds of unit holders by value of their investment in the Fund[ii];
b) Extension of the tenure of a close ended Fund by up to 2 (two) years requires the approval of two-thirds of the unit holders by value of their investment in the Fund[iii];
c) Category III Funds may engage in leverage or borrow subject to consent from the investors in the Fund[iv];
d) A Fund cannot invest in associates except with the approval of 75% (seventy five percent) of investors by value of their investment in the Fund[v]. Such approval has to be obtained prior to every investment in an associate[vi];
e) Category I and II Funds may have their investments valued by an independent valuer every 12 (twelve) months, instead of the prescribed 6 (six) months, if so approved by at least 75% (seventy five percent) of their investors by value of their investment in the Fund[vii];
f) The approval of not less than 75% (seventy fiver percent) of unit holders by value of their investment in the Fund is required (in addition to SEBI's approval) where there is a material change in the Fund, such as a change in the Fund's sponsor or investment manager or change in control of the investment manager or sponsor or any change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders. Failure to secure the aforementioned approval from 75% (seventy fiver percent) of investors by value shall result in the Fund having to provide an exit for those investors who did not consent to the material change[viii].

The AIF Regulations do not spell out how consent from the investors is to be obtained in the situations mentioned above. In practice, Funds usually obtain investors' consent by email or through postal ballot. In this regard, one of the issues faced by Funds is that of investor apathy, that is, investors failing to respond to a request to vote on a proposed material change. For example, a Fund proposes an alteration to its investment strategy and investors are requested to approve the proposed change. Some of the investors, say 50% (fifty percent) of the total investors, respond and the rest don't. Of the investors who have responded, everyone is in favour of the proposed alternation because the new strategy is more suited to the then prevailing investment conditions. However, since the proposed change has not been approved by 75% (seventy five percent) of the investors by value, it is not implemented.

Investor apathy (and the resulting failure to vote on circulated resolutions) is a bigger problem in Funds which have numerous investors rather than ones which have a score or so investors. Where

ii As per Regulation 9(2) of the AIF Regulations

iii As per Regulation 13(4) of the AIF Regulations

iv As per Regulation 18(c) of the AIF Regulations

v As per Regulation 15(1)(e) of the AIF Regulations

vi As per paragraph 3(h) of SEBI's circular dated June 19, 2014.

vii As per Regulation 23(2) of the AIF Regulations

viii As per paragraph 2(b)(iv) of SEBI's circular dated June 19, 2014 read with paragraph 3 of SEBI's circular dated July 18, 2014.

the Fund has only a handful of institutional investors, it is relatively easy to obtain a response of some sort.

This issue could be addressed in 2 (two) ways. Instead of stating that the material change has to be approved by 75% (seventy five percent) of investors by value of their investment in the Fund, the AIF Regulations may be amended to provide that the material change needs to be approved by 75% (seventy five percent) (by value of investment) of unit holders who actually vote. Therefore, if only those investors who hold 60% (sixty percent) of the total units vote, then approval from 75% (seventy five percent) of such 60% (sixty percent), that is, 45% (forty five percent) of the total investors would be sufficient to approve the material change. The alternative would be to specifically incorporate the concept of deemed consent in such voting processes, whereby all those who fail to vote in the prescribed format are deemed to have consented to the proposed resolution.

It is common for some investors to bargain with the Fund and its management and seek concessions when they are asked to vote on a material change. Though there's nothing illegal in such an approach, the proposed amendment ought to make it clear that any response other than a clear cut yes or no, in the format prescribed in the communication sent to the investors when soliciting their approval, will not be counted as a vote.

Consent from Investors which are Overseas Feeder Vehicles

It is common for Funds which raise funds from overseas investors to do so through feeder vehicles incorporated in a tax friendly jurisdiction. Unlike in India where funds are usually set up as trusts, these foreign feeder vehicles are usually set up as companies. When such a feeder fund, in its role as an investor in the Indian Fund, is required to approve a resolution, it usually goes back to its investors and ascertains their wishes, before voting at the India level. What happens if the investors of a feeder fund which holds 27% (twenty seven percent) of the total units of the Fund, support and oppose the proposed resolution in the ratio of 5:4 respectively? The feeder fund's charter documents may permit the feeder fund to apply all its voting rights in favour of the resolution or they may require the feeder fund to convey its vote in the same split ratio, so that out of its 27% (twenty seven percent) stake, 15% (fifteen percent) of units vote in favour and 12% (twelve percent) vote against. On a practical note, many Funds do accept such split voting by investors, but ideally, the AIF Regulations ought to specifically state that investors with more than 1 (one) unit have the right to split their votes without having to provide any explanation for or documents evidencing such split.

Consent Threshold for a Change of Investment Manager

The AIF Regulations, as originally issued in 2012, provided that if the investment manager or sponsor of a Fund was replaced, SEBI had to be informed[ix]. However, if there was any change in control of the Fund or of the sponsor or investment manager, SEBI's prior consent had to be obtained by the Fund[x]. Regulation 22 of the AIF Regulations which dealt with transparency required that any change in control of the sponsor or investment manager had to be disclosed to investors. In other words, the replacement of a Fund's investment manager did not require the prior approval of the Fund's investors!

SEBI's circular dated June 19, 2014 drastically changed the above position. This circular provided that all Funds had to intimate to their investors any change in the private placement memorandum ("**PPM**") within 7 (seven) days of making such change. SEBI too has to be informed, though the aforesaid 7 (seven) day time limit does not apply to the intimation to SEBI. If the change is a

ix As per Reg 20(3) of the AIF Regulations

x As per Reg 20(4) of the AIF Regulations

material change, such as a change in a Fund's investment manager or sponsor (other than on account of any internal restructuring) or any change in control of a Fund's sponsor or investment manager, the Fund is required to provide an exit to investors who do not approve of the change. Investors have 30 (thirty) days to express their dissent, presumably from the time they receive intimation of the change. In case of an open-ended Fund, the exit option may be provided by either buying out of units of the dissenting investors by the investment manager or any other person as may be arranged by the investment manager, for a value based on market price of underlying assets or by redemption of units of the investors through a sale of underlying assets. In case of close-ended funds, dissenters could be given an exit by the investment manager or by any other person arranged by the investment manager by buying out of their units. Prior to buying out of such units, valuation of the units shall be undertaken by 2 (two) independent valuers and the exit shall be at value not less than average of the 2 (two) valuations. Interestingly, SEBI's circular dated June 19, 2014 did not envisage investors' consent for a change of investment manager or sponsor or a change in control of investment manager or sponsor!

A month later, on July 18, 2014, SEBI issued another circular which provided that it would not be necessary to provide an exit to any investor if the change of investment manager or sponsor or a change in control of investment manager or sponsor was approved by 75% (seventy five percent) of the Fund's investors by investment value in the Fund.

Even though it is now settled that a change (or a change in control) of a Fund's investment manager or sponsor does not require the approval of all of the Fund's investors, there would be practical reasons why the consent of all investors may be required when a Fund's investment manager or sponsor changes. One such reason could be the Fund's documentation architecture, which usually involve (i) a trust deed entered into between the settlor (sponsor) and the trustee, (ii) an investment management agreement entered into between the trustee and the investment manager, (iii) a private placement memorandum, (iv) contribution agreements between each of the investors and the trustee acting on behalf of the Fund and in some cases, the investment manager and (v) side agreements between the investors and the investment manager or the trustee.

Change in control of the investment manager does not require any change in any of the documents mentioned above, since the investment manager is the same, albeit under the control of a new set of promoters. However, where there is a change of investment manager, some of the documents mentioned above would have to be assigned to the new investment manager.

Investors are usually not a party to the investment management agreement, which is the instrument by which the investment manager is appointed. However, it is possible to take the view that since the investment management agreement is for the benefit of the investors and because the investors invested in the Fund after examining the credentials of the investment manager, as set out in the PPM, the consent of every investor would be needed for assignment of the investment management agreement. Also, if the investment manager is a party to the contribution agreement and such contribution agreements have an assignment clause which forbids the investment manager from assigning the agreement in favour of any other entity, it would be necessary to obtain the investors' specific written consent for such assignment. Side agreements usually offer specific concessions to investors and their terms vary from investor to investor. If these side agreements are entered into by the trustee and not the investment manager, there would be no obstacles to the replacement of the investment manager. However, if the investment manager has entered into a side agreement with 1 (one) or more investors offering them a rebate on the investment management fee payable by the investor to the Fund and such side agreements have an assignment clause which forbids the investment manager from assigning the side agreement in favour of any other entity, it may be necessary to obtain the investor's specific written consent for the assignment of the side agreement in favour of the new investment manager. Thus, even after obtaining SEBI's approval and the approval of 75% (seventy five percent) of the investors by value, the Fund's documents may require the obtaining of every investor's consent for the replacement of the investment manager.

If the contribution agreements and side agreements do not have any assignment clause, that is, the documents neither forbid nor permit assignment, there are mixed views of whether such documents may be assigned by the outgoing investment manager in favour of the new investment manager.

Where the investment manager is being replaced, usually the sponsor will also be replaced, since the sponsor is usually an affiliate of the investment manager. The sponsor is usually a party to only the trust deed (where it plays a one-time role as the settlor of the trust) which does not have to be assigned. Thus, replacement of the sponsor does not require any changes in the Fund's documentation.

M&A activity in the asset management space is increasingly common and ought to be encouraged since it makes asset management more lucrative and will encourage more players to enter that arena. A Fund's investment manager needn't necessarily remain wedded to the Fund for the entire tenure of the Fund. Since SEBI has intended that obtaining SEBI's approval and the approval of 75% (seventy five percent) of investors by value is sufficient for the replacement of the investment manager, SEBI could provide (through an amendment of the AIF Regulations) that once the aforementioned approvals have been obtained, unless the Fund's private placement memorandum or any other contract executed by the investment manager specifically requires the consent of all investors (or at a threshold higher than 75% by value of investment) for the replacement of the investment manager, all Fund related documents entered into by the investment manager shall automatically stand novated in favour of the new investment manager, without the requirement for investors to execute any document.

Investments by Infrastructure Funds

Regulation 16(5) of the AIF Regulations deals with investments by infrastructure Funds and provides as follows:

> "*The following conditions shall apply to Infrastructure Funds in addition to conditions laid down in sub-regulation (1):-*
> *(a) at least seventy five percent of the investible funds shall be invested in unlisted securities or units or partnership interest of venture capital undertaking or investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects;*
> *(b) notwithstanding clause (a) of sub-regulation (5), such funds may also invest in listed securitized debt instruments or listed debt securities of investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects.*"

From the above regulation, the following principles can be formulated:

a) Infrastructure Funds have to invest at least 75% (seventy five percent) of their investible funds in entities which are engaged in or are formed for the purpose of operating, developing or holding infrastructure projects;
b) Infrastructure Funds can invest 100% (one hundred percent) of their investible funds in listed securitized debt instruments or listed debt securities issued by entities which are engaged in or are formed for the purpose of operating, developing or holding infrastructure projects;
c) Infrastructure Funds can invest 25% (twenty five percent) of their investible funds practically anywhere, including in listed securities, but subject to the principles laid out in regulation 15 and regulation 16(1) of the AIF Regulations.

Over and above the principles mentioned above, regulation 16(5) of the AIF Regulations seems to suggest that infrastructure Funds cannot invest in a holding company which owns companies engaged in, or formed for the purpose of, operating, developing or holding infrastructure projects

for the purpose of meeting the requirement of investing 75% (seventy five percent) of their investible funds in infrastructure projects. This is because the words *"operating, developing or holding infrastructure projects"* seem to preclude an entity which is a pure holding company and has no operations of its own and does not own any infrastructure project.

It is unclear if SEBI actually intended to prevent an investment by infrastructure Funds in a company which owns other companies which are engaged in operating, developing or holding infrastructure projects. A circular issued by SEBI in June 2014 clarified that *"for the purpose of Regulation 15(1)(c), in case the Fund proposes to invest into real estate or infrastructure projects, every such investee company shall hold not less than one project".* Interestingly, this circular did not refer to regulation 16(5) of the AIF Regulations. Regulation 15(1) of the AIF Regulations contains investment restrictions generally applicable to all Funds and regulation 15(1)(c) of the AIF Regulations states that *"Category I and II Alternative Investment Funds shall invest not more than twenty five percent of the investible funds in one Investee Company"*. A month later, on July 18, 2014, SEBI issued another circular clarifying that *"such investee company shall hold or propose to hold not less than one project, directly or indirectly"*. Even the second circular did not refer to regulation 16(5) of the AIF Regulations.

It would be helpful if regulation 16(5) of the AIF Regulations could be amended to make it abundantly clear that infrastructure Funds can invest in infrastructure projects indirectly as well, that is, by investing in holding companies of entities which own or operate infrastructure projects. The necessary clarification could be provided by the simple expedient of inserting the words 'directly or indirectly' in regulation 16(5) of the AIF Regulations in the following manner:

> *"engaged in or formed for the purpose of, directly or indirectly, operating, developing or holding infrastructure projects."*

It should be noted that a pure holding company would be an NBFC, which would exclude it from the definition of a venture capital undertaking.

Extension of Tenure and Winding Up

Regulation 13(4) of the AIF Regulations provides that a close-ended Fund's tenure may be extended by up to 2 (two) years, subject to the approval of two-thirds of the unit holders by value of their investment in the Fund. In the absence of such consent from unit holders, the Fund is required to fully liquidate within 1 (one) year following expiration of the Fund's tenure or extended tenure.

Regulation 29 of the AIF Regulations deals with winding up of a Fund. If a Fund has been set up as a trust or as an LLP, it shall be wound up when the tenure of the Fund or all schemes launched by the Fund, as mentioned in the PPM, are over, or if 75% (seventy five percent) of investors by value resolve that the Fund should be wound up or if so directed by SEBI. In the case of a Fund set up as a trust, the AIF Regulations give an additional ground for winding up, namely if the trustees are of the opinion that it should be wound up, then the Fund shall be so wound up.

If a Fund has been set up as a company, the AIF Regulations provide that the Fund shall be wound up in accordance with the provisions of the Companies Act, 2013[xi]. In the same vein, it is stated that a Fund set up as a body corporate shall be wound up in accordance with the provisions of the statute under which it is constituted. Under existing Indian company law, a company can be wound up on a basis of a special resolution by its shareholders, which has to be then approved by the National Company Law Tribunal ("**NCLT**"). A special resolution requires the votes cast in favour of the resolution to be not less than 3 (three) times the number of the votes, if any, cast against the

xi The provisions relating to voluntary winding up under the Companies Act, 2013 have been omitted by the Insolvency and Bankruptcy Code, 2016 ("IBC") and replaced with section 59 of the IBC read with the Insolvency and Bankruptcy Board of India (Voluntary Liquidation Process) Regulations, 2017 ("Regulations").

resolution by members so entitled and voting, and thus, the threshold of consent required to wind up a company is roughly at par with that for trusts[xii].

Category I and Category II Funds are required to be close-ended and so, if a close-ended Fund is set up in the form of a company, winding up of such company would still require votes cast in favour of the resolution to exceed the 3 (three) times the votes, if any, cast against the resolution and the NCLT's approval.

Once the winding up of the Fund has been finalised, either through an investor resolution or on expiry of the term, the requisite process prescribed by the AIF Regulations is as follows:

a) The trustee (in case of a trust) or the board of directors (in case of a company) or designated partners of the Fund (in case of an LLP), shall intimate SEBI and the investors of the circumstances leading to the winding up of the Fund[xiii]. On and from the date of such intimation ("**Intimation Date**"), no further investments shall be made on behalf of the Fund[xiv];
b) Within 1 (one) year from the Intimation Date, the assets of the Fund need to be liquidated, and the proceeds accruing to investors in the Fund shall be distributed to the investors after satisfying all liabilities[xv];
c) In specie distribution of the assets of the Fund can be made if approved by at least 75% (seventy five percent) of the investors by value[xvi].

The last sub-clause of regulation 29 of the AIF Regulations actually states that upon winding up of the Fund, the certificate of registration shall be surrendered to SEBI[xvii].

What does "winding up" of a Fund mean?

In the context of a company, the meaning and impact of 'winding up' is very clear. After a winding up order has been passed by the NCLT, liquidation proceedings are initiated in relation to the company and a liquidator is appointed to monitor the proceedings, including, *inter alia*, taking over assets, examination of the statement of affairs, recovery of property, cash or any other assets of the company including benefits derived therefrom and sale of assets. The NCLT may, upon receipt of a report from the liquidator, order the sale of the company as a going concern, or its assets or a part thereof. Once a company is successfully wound up, the liquidator applies to the NCLT for dissolution of the company. Even in the case of an LLP, winding up entails the appointment of a liquidator who is responsible for, *inter alia*, disposing of the property and assets of the LLP and fully discharging its debts or discharging its debts to the satisfaction of the creditors and adjusting the rights of the partners amongst themselves. The NCLT may, upon receipt of a report from the liquidator, order the sale of the LLP as going concern, or its assets or a part thereof. Once an LLP is successfully wound up, the liquidator applies to the NCLT for dissolution of the LLP.

However, in the case of a private trust, the term "winding up" is not accurate usage. Most Funds in India are set up in the form of trusts. When a Fund is set up in the form of a trust, it is established as a private trust under the Indian Trusts Act, 1882 ("**Trusts Act**"). Under the Trusts Act, the equivalent term for "winding up" is "extinguishment". Do remember that a trust is not a legal entity, but the trustee is, and that all assets of the trust are held in the

xii If the company's articles of association have provided a fixed term for the company, an ordinary resolution of the members of the company in a general meeting requiring the company to be liquidated voluntarily is sufficient as per Section 59(3)(c)(ii) of the IBC.

xiii As per Reg 29(5) of the AIF Regulations

xiv As per Reg 29(6) of the AIF Regulations

xv As per Reg 29(7) of the AIF Regulations

xvi As per Reg 29(8) of the AIF Regulations

xvii As per Reg 29(9) of the AIF Regulations

name of the trustee. As per section 77 of the Trusts Act, a trust is extinguished when: (a) its purpose is completely fulfilled; (b) its purpose becomes unlawful; (c) the fulfilment of its purpose becomes impossible by destruction of the trust-property or otherwise; or (d) the trust, being revocable, is expressly revoked. Section 78 of the Trusts Act provides that a trust (other than a trust created by a will) can be revoked only with the consent of all beneficiaries if all beneficiaries are entitled to contract.

Regulation 29 of the AIF Regulations appears to be contrary to sections 77 and 78 of the Trusts Act since the former provides that a Fund set up as a trust can be wound up with the consent of 75% (seventy five percent) of investors by value. However, it is not really a contradiction since the "winding up" of a Fund, for the purposes of the AIF Regulations, does not require the extinguishment of the trust.

Funds face a number of practical difficulties in connection with winding up. Below, we discuss some of the practical difficulties and suggest regulatory amendments which could make life easier for Funds:

Let's assume that at the expiry of a Category II Fund's fixed term (of say 5 (five) years), 4 (four) of its investments (each worth over Rs. 100,00,00,000 (Rupees one hundred crore)) have not been liquidated. The investors of the Fund approve the maximum permitted extension of 2 (two) years, in instalments of 1 (one) year each. During the period of extension, the investment manager manages to sell 2 (two) of the 4 (four) investments. 2 (two) investments remain unsold. Under existing law, there can be no further extension of the Fund's tenure and the Fund is required to fully liquidate within 1 (one) year following expiration of the Fund's extended tenure. Once the market gets to know that the investment manager is required to liquidate all its investments within 1 (one) year of expiry, it becomes even more difficult to find a buyer willing to pay market value. In some cases, it may not be possible to liquidate within a year of expiry at all. Therefore, we propose that for close-ended funds, there should be no limit to the number of extensions of tenure that may be approved by the investors of the Fund, though each extension should be for a period of 1 (one) year. This would enable investment managers to breathe easy and dispose of the Fund's investments in the most appropriate manner.

When the tenure of a Fund is extended, the investment manager will be entitled to continue to receive investment management fees for the extended period. If at the time of extension, the approval given by the investors may be contingent on the investment manager agreeing to a lower investment fee for the period of extension. If the investors do not prescribe such reduced fee, then by implication, the investment manager will be entitled to receive the investment management fees provided for in the PPM. It is common for Funds to pay the investment manager a higher fee during the deployment period and a lower fee once the deployment phase is over. If the investors of a Fund agree to extend the Fund's term and the approval is silent regarding the fees payable to the investment manager during the period of extension, the investment manager would be entitled to receive the fee applicable to the post-deployment phase. It would be best if the AIF Regulations are amended to expressly provide that during any extension, investment managers shall be entitled to receive the same fees they received immediately prior to the extension, unless a different fee is prescribed by the investors when approving the extension. If the lower fee prescribed by the investors is not acceptable to the investment manager, the extension shall not come into effect and the Fund shall be required to fully liquidate within a year.

As Benjamin Franklin put it so aptly, there are only two things certain in life, namely death and taxes. In India, a tax claim may be raised by the income tax authorities within 6 (six) years after the end of the relevant assessment year in which income chargeable to tax

may have escaped assessment[xviii]. Further, income tax assesses are required to maintain books of account and other documents for a period of 6 (six) years from the end of the relevant assessment year, which effectively works out to a period of 8 (eight) years after the relevant transaction[xix]. Therefore, the trustee of a Fund may receive a tax claim many years after it ceases operations. If a Fund established in the form of a trust is wound up and extinguished immediately after it ceases operations and all its assets are distributed to its investors, it would not be possible for the trustee to meet its tax claim. On a practical note, many trustees, with the consent of investors, hold back a reasonable amount to meet any tax liability and distribute the same to investors only when they are sure that they have seen the last of the tax man. It would be a good idea for SEBI to specifically provide that the trustee of a Fund established as a trust or the board of directors of a Fund established as a company or the designated partners of a Fund established as an LLP may, at their own discretion, hold back a portion of the liquidated exit proceeds of the Fund, to meet any potential tax liability and such amount shall be returned to investors once all tax claims have been settled or after the relevant limitation period is over. It should not be necessary to have investors' consent for such hold back, though investors should have the right to complain to SEBI if the amount being held back is unnecessarily large.

It may be clarified by SEBI that the legal entity behind the Fund, namely the trustee if the Fund is a trustee, the LLP or the company itself, if the Fund is an LLP or a company, should not have to be wound up in the full legal sense until all tax liabilities are met or the limitation period is over. In other words, "winding up" at the end of a Fund's tenure should only mean the cessation of operations and the return of the exit proceeds (minus the amount kept aside to meet tax liabilities).

Permanent Capital Vehicles

Category I and Category II Funds are required to be close-ended, whilst, Category III Funds can be open-ended. A close ended Fund is one where the Fund has a fixed term, at the end of which, investors shall be entitled to a return on their investment. An open-ended Fund is one where investors enter and exit at any time, or at prescribed intervals. The AIF Regulations do not prescribe the maximum tenure for Category I or Category II Funds and these could be very long, say, 30 (thirty) years. However, a very long tenure is not the same as being open-ended. Even a Fund with a tenure of 30 (thirty) years would be required to offer an exit to all investors towards the end of the tenure. For an investment manager, the attraction of being open-ended is that there is no pressure to exit from all investments by a certain date. On a practical note, unless a Fund's portfolio is entirely or is substantially composed of listed securities, it would not be possible to be open-ended, which is why only Category III Funds are permitted to be open-ended since Category III Funds are allowed to have most, if not, all of their investments, in listed equity or derivatives. As and when a redemption request is received, if the Category III Fund does not have cash in hand to meet the redemption request, it can liquidate a portion of its portfolio and return the investor's capital.

A permanent capital vehicle ("**PCV**") is an investment vehicle where capital is available for an unlimited horizon. The concept of a PCV is relatively new and Berkshire Hathaway, the well-known (and very successful) investment vehicle managed by Warren Buffet is a good example. It would be a welcome step if sponsors and investment managers had the option to structure Funds (across categories) as PCVs. This would enable investment managers to not worry too much about having to liquidate the Fund's portfolio at the end of the investors' tenure.

xviii Section 149 of the Income Tax Act, 1961

xix Section 44AA of the Income Tax Act, 1961 read with Rule 6F of the Income Tax Rules, 1962

The structure of an Indian PCV, if permitted by SEBI, could be as follows:

a) The Fund would have an exceptionally long tenure or an unspecified tenure, but the investors in the PCV would have fixed tenures;
b) The investment manager may receive performance fees either on a deal by deal basis or at fixed, periodic intervals, such as every 7 (seven) years;
c) When an investor's tenure comes to an end, say at the end of 7 (seven) years, the PCV has to provide an exit, by arranging for a new or an existing investor to buy out the exiting investor's units or shares at the fair market value of such units or shares ("**FMV**") or by extending the term of the original investor with the consent of such investor;
d) If the PCV is unable to attract new investors and the original investor does not agree to an extension, the PCV will have to redeem the original investor's units or shares at FMV, for which it would have to liquidate all or some of its investments.
e) If the PCV is unable to so redeem, because of a failure to liquidate or for any other reason, the PCV may be required to distribute some of its portfolio in specie to the exiting investor.

This paper has been written by Vinod Joseph (Partner) and Deeya Ray (Associate).

argus partners
SOLICITORS AND ADVOCATES

DISCLAIMER

This document is merely intended as an update and is merely for informational purposes. This document should not be construed as a legal opinion. No person should rely on the contents of this document without first obtaining advice from a qualified professional person. This document is contributed on the understanding that the Firm, its employees and consultants are not responsible for the results of any actions taken on the basis of information in this document, or for any error in or omission from this document. Further, the Firm, its employees and consultants, expressly disclaim all and any liability and responsibility to any person who reads this document in respect of anything, and of the consequences of anything, done or omitted to be done by such person in reliance, whether wholly or partially, upon the whole or any part of the content of this document. Without limiting the generality of the above, no author, consultant or the Firm shall have any responsibility for any act or omission of any other author, consultant or the Firm. This document does not and is not intended to constitute solicitation, invitation, advertisement or inducement of any sort whatsoever from us or any of our members to solicit any work, in any manner, whether directly or indirectly.

You can send us your comments at:
argusknowledgecentre@argus-p.com

Mumbai I Delhi I Bengaluru I Kolkata

www.argus-p.com