

February 28, 2020



PRIVATE FUNDS UPDATE

SOME ISSUES ARISING OUT OF SEBI'S CIRCULAR DATED
FEBRUARY 5, 2020 FOR ALTERNATIVE INVESTMENT FUNDS

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Introduction

The Securities and Exchange Board of India (“SEBI”) issued circular no. SEBI/HO/IMD/DF6/CIR/P/2020/24 dated February 5, 2020 (“Circular”) that introduces standard templates for alternative investment funds’ (“AIF”) private placement memorandums (“PPM”), annual audits of compliance with the terms of the PPM and mandatory performance benchmarking for AIFs with provisions for additional customised performance reporting. An overview of the key changes introduced by the Circular can be found [here](#). This note discusses a few issues arising out of the Circular.

1. Are AIFs which are already registered with SEBI required to modify their PPMs as per the templates provided in the Circular?

The Circular does not explicitly state that existing AIFs who have already issued PPMs would be required to amend their PPMs. In June 2014, when SEBI issued circular no. CIR/IMD/DF/14/2014 calling for increased disclosures in PPMs, it specifically required all existing AIFs to send to their investors an addendum to their existing PPM within 30 (thirty) days of the circular and also to file a copy of such addendum with SEBI at least 7 (seven) days before sending the addendum to the investors. A similar provision has not been included in the Circular.

2. The requirement to use the standardised PPM and have annual audits does not apply, *inter alia*, to an AIF in which each investor commits to a minimum capital contribution of Rs. 70 crore (USD 10 million or equivalent) and if all investors in such an AIF grant a waiver to the AIF from the aforesaid requirements. The waiver has to be in the format provided in annexure 3 of the Circular.

2.1. If an overseas feeder fund has invested in an AIF, should the investors in such feeder fund also satisfy the USD 10 million or equivalent threshold and should the feeder fund also receive a waiver from all of its investors?

It can be argued that it is not necessary to look into the investors of each AIF and ascertain whether underlying investors meet the USD 10 million or equivalent threshold or if all underlying investors have given consent. However, it is industry practice for feeder funds, which have invested in Indian AIFs, to ascertain the wishes of their overseas investors, before voting at the India level. What happens if the investors of an overseas feeder fund which holds 25% (twenty five percent) of the total units of an Indian AIF, support and oppose the waiver (required by the Circular) in the ratio of 3:2 respectively? The feeder fund’s charter documents may permit the feeder fund to apply all its voting rights in favour of the waiver or they may require the feeder fund to convey its vote in the same split ratio, so that out of its 25% (twenty five percent) stake, 15% (fifteen percent) of its units vote in favour and 10% (ten percent) vote against. The PPMs and contribution agreements of many Indian AIFs specifically allow investors which are feeder funds to vote on a split basis. If a feeder fund conveys its vote on a split basis, even if the ratio in favour of the waiver is greater than the ratio against, the waiver would not be unanimous. However, if at the time of voting in favour of the waiver, the feeder fund does not mention the underlying split, the Indian AIF is not required to enquire whether all of the underlying investors have consented to the waiver.

2.2. If an Indian AIF has invested in another Indian AIF, should the investors in investing AIF also satisfy the INR 70 crore threshold and should the investing AIF also receive a waiver from all of its investors?

Since SEBI does not distinguish between Indian investors and overseas investors in an AIF, the principles set out above, with respect to an overseas feeder fund, will arguably apply even when an Indian AIF invests in another Indian AIF. So, unless the waiver is conveyed in a manner which indicates that the investing AIF has not received the approval of all its

investors, it will not be necessary for the AIF receiving the waiver to enquire into whether the investing AIF has received unanimous approval from all its investors. It will also not matter whether any of the investors in the investing AIF have investments less than INR 70 crore.

2.3. For calculating the threshold of INR. 70 Crore, will affiliates, group companies etc. of an investor be considered as one?

On a plain reading of the Circular, it appears that the investment of each investor has to be considered separately and it would not be possible to consolidate the investments made in the same AIF by affiliates for the purpose of crossing the threshold. A clarification in this regard would certainly be welcome. However, it is interesting to note that for the purposes of calculating the minimum investment amount threshold of Rs. 10 million as prescribed in the SEBI (AIF) Regulations, 2012 (“**AIF Regulations**”), SEBI recognises the concept of joint investors in case of certain categories and subject to certain conditions, and their investments are consolidated for testing the minimum investment amount threshold.

2.4. At what stage of fund raising should the waiver be obtained?

The process flow for the establishment, fund raising and documentation of most AIFs is usually as follows. The sponsor registers the trust that constitutes the AIF, the investment manager is formally appointed, the PPM is prepared, potential investors are met and given a copy of the draft PPM, informal commitments received, an application is made to SEBI for registration of the AIF using Form A (which requires the PPM to be enclosed as an annexure to Form A), a certificate of registration for the AIF from SEBI is obtained, formal capital commitments are received in the form of term sheets, the contribution agreements and side letters are negotiated and executed and the first capital call made, which results in the initial closing of the AIF. When Form A is filed with SEBI seeking registration of the AIF (with the draft PPM enclosed), the AIF would not have any formal investors.

The format of the waiver provided in Annexure 3 of the Circular suggests that it is meant to be executed by investors who are planning to invest in the AIF. It also suggests that at the time of execution of the waiver letter, the AIF is registered with SEBI. The following is an extract from Annexure 3:

We are considering to invest in (Name of the AIF/Scheme) managed by (Name of the Manager). We understand that (Name of the AIF) is registered with Securities and Exchange Board of India (SEBI) and as such is required to provide a Private Placement Memorandum in the template prescribed by SEBI, which has two parts viz.:

This raises several unanswered questions. Does SEBI expect the sponsors of the AIF to register the AIF using a PPM which is in a format different from the one prescribed by the Circular, after which, they obtain waivers from investors who are planning to invest in the AIF? What happens if a waiver is not obtained from all investors? Or does SEBI expect waiver letters to be obtained even prior to the registration of the AIF? It is unlikely that any investor would grant the waiver contemplated by the Circular until commercial negotiations are complete and at least a term sheet is signed, if not the contribution agreement itself. What if the investors who plan to invest in the AIF grant waivers without finalising the contribution agreements and then actually invest an amount which is less than what they originally planned, which falls below the threshold of INR 70 crore per investor? Will a new PPM in the format prescribed by the Circular be filed subsequently?

2.5. Can investors waive their rights under either paragraph 2 or paragraph 5 of the Circular, but not both?

The format of the waiver letter given in Annexure 3 of the Circular does not contemplate a waiver only under either paragraph 2 (prescribed PPM format) or paragraph 5 of the Circular

(annual audit). There is no scope for deviating from the prescribed format of the waiver letter which specifically states as follows:

Accordingly, in terms of SEBI circular dated February 05, 2020, we hereby grant waiver to (name of the AIF) from the requirement of providing PPM in the template format as prescribed by SEBI and also grant waiver to (Name of the AIF/ Scheme) from the requirement of conducting an annual audit of compliance with the terms of the PPM furnished to us.

Therefore, investors in an AIF do not have the option to grant an AIF a waiver only under paragraph 2 (prescribed PPM format) or under paragraph 5 of the Circular (annual audit).

2.6. Would the sponsor of the AIF be treated as an investor for the purpose of the waiver?

The AIF Regulations require a minimum commitment from either the sponsor or the investment manager, in the AIF. For categories I and II AIFs, the minimum commitment shall be two and half percent of the corpus or five crore rupees, whichever is lower. For category III AIFs, the minimum commitment shall be five percent of the corpus or ten crore rupees, whichever is lower. Thus, for every AIF, either the sponsor or the investment manager is an investor in the AIF. Hence, if the sponsor or investment manager's commitment is less than INR 70 crore, then the AIF may not be eligible for the waiver.

It is market practice for the sponsors of large AIFs to invest much more than the prescribed minimum commitment. However, for many AIFs, the sponsor or manager would not have invested any more than the minimum prescribed by law. Such AIFs shall not be eligible to receive a waiver from their investors, even if all of their investors (excluding the sponsor) have committed more than INR 70 crore and are willing to grant a waiver.

2.7. Can investors waive their rights under the Circular, irrespective of whether they have invested more than INR 70 Crore?

The doctrine of waiver provides that a person entitled to a right, whether contractual or statutory, can waive such a right. However, in the case of *Basheshar Nath v. The Commissioner of Income Tax*¹, the Supreme Court ruled that statutory rights which have a public element and are for the greater good cannot be waived. This principle has been reiterated by the Supreme Court in *Justice KS Puttaswamy (Retd.) v. Union of India*². Therefore, waiver of rights by investors would also depend on whether such rights have a public element and are for the greater good. In this context it would be pertinent to refer to SEBI's stated objective for standardisation of PPMs as mentioned in SEBI's consultation paper dated December 4, 2010 – "*objective to create a conducive environment for a sound AIF asset class in India*".

3. The Circular provides that the terms of the contribution or subscription agreement (by whatever name it may be called), shall be aligned with the terms of the PPM and shall not go beyond the terms of the PPM. The PPM is a marketing document used by the AIF's sponsors and investment manager to raise money. Once the AIF receives sufficient capital commitments, it enters into contribution agreements with its investors. In many cases, investors bargain for additional rights or cast additional duties on the investment manager, which are not provided for in the PPM. Until now, it was acceptable for the contribution agreements to provide for matters not provided for in the PPM, as long as it did not contradict the PPM. How will AIFs resolve the conflict between the practice described herein and the new rule introduced by SEBI?

¹1959 AIR 149

²(2014) 6 SCC 433

- 3.1. The AIF Regulations permit AIFs to amend their PPMs, from time to time. SEBI's circular dated June 19, 2014 bearing no. CIR/IMD/DF/14/2014 ("**June Circular**") as amended by SEBI's circular dated July 18, 2014 bearing no CIR/IMD/DF/16/2014 ("**July Circular**") specifically states that if any AIF amends its PPM, or modifies the terms or documents of the AIF/ scheme, it needs to intimate such change to investors and SEBI once every 6 (six) months on a consolidated basis.
 - 3.2. If the change in the PPM is a material change significantly influencing the decision of the investor to continue to be invested in the AIF, then the AIF 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 AIF, 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 AIFs, 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 a value not less than the average of the 2 (two) valuations. The July Circular clarifies that 'material' changes may be construed as changes in the fundamental attributes of the AIF/scheme. It also provides that it is not necessary to provide an exit to any investor on account of a material change if such material change is approved by 75% (seventy five percent) of the AIF's investors by investment value in the AIF.
 - 3.3. In certain cases, an AIF's PPM may prescribe a procedure for amending the PPM, which may be more onerous or which may have a higher consent threshold than that prescribed by the June Circular, as amended by the July Circular.
 - 3.4. Therefore, on a practical note, where in the course of fund raising, an AIF agrees to terms with its investors which exceed the terms of the PPM, simultaneously with the execution of the contribution agreements, the AIF ought to amend its PPM to bring it in line with the contribution agreements, as per the procedure for amendment of the PPM prescribed by the PPM itself, or as per the procedure prescribed by SEBI, whichever may be more onerous.
 - 3.5. If an AIF has registered with SEBI prior to March 1, 2020, but is yet to execute contribution agreements with its investors, it would have to ensure that its contribution agreements are in line with the PPM, even though the PPM may not be in the format prescribed by the Circular.
4. **Is it possible to obtain a waiver from the requirement to align the contribution or subscription agreement with the terms of the PPM?**

Paragraph 8 of the Circular which provides for the waiver, makes it clear that the waiver, if obtained, would apply to the requirements of paragraphs 2 and 5, which are standard templates and annual audits of compliance, respectively. The requirement to align the contribution or subscription agreement with the terms of the PPM is mandated by paragraph 7 of the Circular and this requirement cannot be waived.

Further, the format of the waiver letter given in Annexure 3 of the Circular specifically states as follows:

Notwithstanding the waiver granted herein, we understand that (name of the AIF/Scheme) is not permitted, under SEBI Regulations, to sign a Contribution agreement/ Subscription agreement (by any name as it may be called) that is, in any way, in contradiction with the terms of the PPM or goes beyond the terms of the PPM furnished to us.

5. The Circular prescribes an elaborate template for PPMs and prescribes various matters which have to be disclosed. Are there any matters on which the investment manager can exercise discretion? To what extent can one deviate from the template?

The PPM templates consist of two parts, Part A and Part B. Part A consists of 15 (fifteen) sections covering topics ranging from an executive summary of key terms, investment objectives, fund structure, investment manager’s track record, principal terms of the AIF, principles of portfolio valuation, conflicts of interest, risk factors, for legal, regulatory and tax considerations as applicable to the AIF, illustration of fees, expenses and other charges, distribution waterfall and disciplinary history. In Part B, AIFs have the discretion to disclose any information relating to the AIF or its schemes or its investment manager or investment team which is not captured in Part A.

There is no scope for avoiding the mandatory sections contained in Part A. Further, if an investment manager has reserved for itself discretionary powers, the investment manager is required to disclose the existence of all such powers in the PPM. The following are some of such discretionary matters specifically mentioned in the prescribed PPM templates:

- reduce management fees;
- vary 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; and
- retain investment proceeds and taxation related retentions as reserves.

On a plain reading of the PPM templates prescribed by the Circular, it is unclear if, in the event the investment manager has not reserved for itself the discretion to do any of the above actions, the PPM should mention the lack of such discretionary power.

6. What are the information and disclosure requirements prescribed for investment managers?

Regulation 11(2) of the AIF Regulations states that the PPM shall contain, *inter alia*, all material information about the investment manager, including the background of the investment manager’s key investment team, disciplinary history, the terms and conditions on which the investment manager offers investment services and such other information as may be necessary for the investor to take an informed decision on whether to invest in the AIF.

The PPM format prescribed by the Circular specifically requires detailed disclosures about the investment 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; and
- description of portfolio companies and investment exits for the fund.

The prescribed PPM templates for Category I and II AIFs requires 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); and
- TVPI (total value to paid in).

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

7. It is an established industry practice for AIFs to enter into side-letter agreements with their investors. These side-letter agreements essentially supplement or amend the contribution agreements entered into between the investors and the AIF. What will be the impact of the Circular on the practice of entering into side-letters?

7.1. The Circular provides that the PPM of an AIF should contain the following disclosures regarding side-letters:

- a. whether any side-letters shall be offered by the AIF;
- b. a list of the criteria for offering differential rights through side-letters to any investor. AIFs shall have full flexibility to determine the parameters for entering into side-letter arrangements. Such criteria could either be quantitative (based on size of commitment) or qualitative (based on the strategic relevance to the AIF) or both. Such criteria have to be disclosed in the PPM;
- c. the fact that the terms of side-letters shall not have any adverse impact on the economic rights or any other rights of other investors should be clearly stated;
- d. the fact that nothing under the side-letters shall alter the rights available to the other investors under their respective contribution agreements should be clearly stated;
- e. a list of the commercial terms on which differential rights may be offered through side-letters;
- f. a list of the non-commercial terms on which differential rights may be offered through side-letters;
- g. an indicative list of all material commercial terms of the offering (such as management fees, carried interest, cap on expenses, offering of co-investment rights, waiving of compensatory contribution) which may be altered for the qualifying investors through side-letters; and
- h. a list of all terms on which differential rights shall not be offered, including but not limited to, preferential exit from the AIF, contribution to indemnification, giveback obligations and drawdown obligations. AIFs may add to this list if they wish, but they cannot derogate from this list provided by SEBI.

7.2. Currently, it is industry practice for investors to bargain with AIFs for better deals and it is a fact that the larger investors get “better” deals from AIFs, which are recorded in side-letters. It has also been industry practice for AIFs to disclose the existence of side-letters in PPMs. Once the Circular comes into effect, a large number of disclosures would have to be made in the PPM regarding side letters and therefore, the scope of negotiations involving side letters may be restricted to a certain extent. In this context, careful drafting of the PPM would be crucial.

7.3. If an AIF has an overseas feeder fund, and such AIF issues side letters to its investors, the overseas feeder fund may also enter into a side letter with the AIF. If so, the overseas feeder fund is likely to issue back-to-back side letters to its own investors, to replicate the impact of the Indian side letters. It may be said that there are no restrictions under the Circular on the overseas feeder fund issuing side letters to its overseas investors.

8. Is it possible to obtain a waiver from the rules regarding side letters contained in the PPM?

Yes, it is possible to obtain such a waiver. As mentioned above, paragraph 8 of the Circular which provides for the waiver makes it clear that the waiver, if obtained, would apply to the requirements of paragraphs 2 and 5, which are standard templates and annual audits of compliance respectively. The rules regarding side-letters are not contained in the main body of the circular, but are provided for by the standard PPM templates given in Annexures 1 and 2. Therefore, an AIF in which all investors have invested at least INR 70 crore (USD 10 million or equivalent) and where all investors have granted a waiver from the requirements of paragraphs 2 and 5 of the Circular, can continue to issue side-letters without facing the restrictions imposed by the Circular.

9. What is the scope for the annual audit? What are the reporting requirements with respect to the audit to SEBI?

An annual audit is required to ensure compliance with the terms of the PPM and would have to be done by either an internal or an external auditor/ legal professional. The audit would check compliance of matters/ processes set out in the PPM such as: (i) investment process; (ii) sector wise allocation; (iii) allocation of returns; (iv) governance structure of the AIF; (v) the track record of the investment manager; (vi) resolution of conflicts; (vii) process for warehoused investments; (viii) timelines for closing; (ix) on-boarding of investors; (x) side letters; (xi) charging of fees; (xii) expenses borne; (xiii) borrowings; (xiv) valuation; and (xv) reporting requirements etc. The findings of the audit, along with corrective steps, if any, must be communicated to SEBI.

10. Are there any concerns regarding the Circular's requirements for benchmarking?

The Circular calls for development of an industry benchmark to compare the performance of the AIF industry against other investment avenues and other global investment opportunities. An association of AIFs, which in terms of membership, represents at least 51% of the number of AIFs currently in existence, has to be formed and such association has to notify one or more benchmarking agencies for carrying out the benchmarking. The Circular expects the first industry benchmark and AIF level performance versus benchmark reports to be available by July 1, 2020, for performance up to September 30, 2019. This timeline seems unrealistic.

11. What will be the consequence if an AIF does not comply with the Circular?

The Circular has been issued under section 11(1) of the Securities and Exchange Board of India Act, 1992 ("**SEBI Act**") and hence, in case of any non-compliance with the Circular, penalties provided in section 15EA of the SEBI Act would apply, as per which the defaulting AIF may, *inter alia*, be liable to a minimum penalty of Rs. 1,00,000 (Rupees one lac) which may extend to Rs. 1,00,000 (Rupees one lac) for each day during which such failure continues. However, such penalty cannot exceed the higher between Rs. 1,00,00,000 (Rupees one crore) or three times the amount of gains made by the AIF out of such failure.

It is also pertinent to refer to Regulation 35 of the AIF Regulations which, *inter alia* states that, an AIF which contravenes any of the provisions of the SEBI Act or the AIF Regulations shall be dealt with in the manner provided under the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 ("**Intermediaries Regulations**"). Chapter V of the Intermediaries Regulations sets out a detailed procedure for the suspension or cancellation of a person's certificate of registration issued by SEBI in case of any non-compliance by such person with the terms of the certificate of registration or violation of any applicable law

or regulation. Therefore, non-compliance with the Circular could also lead to disciplinary action resulting in the suspension or cancellation of an AIF's certificate of registration.

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