A Critical Analysis of Amendments in Alternative Investment Funds

SEBI's Board Meeting was held on 29th March 2023. The Board introduced various amendments to improve disclosures and facilitate market players with transparency. Amendments in AIFs followed various consultative papers released in the previous year. Transique has provided a detailed insight w.r.t the amendments introduced in the Alternative Investment Fund space.

A. Standardization of Valuation Approach

With an intent to standardize the valuation approaches, the board has approved the specification of the framework to carry out valuation of investment portfolio of an AIF, along with eligibility criteria for an independent valuer of the portfolio of an AIF. It is also proposed that the valuation of Category-III in unlisted securities and listed debt securities shall also be carried by an independent valuer.

In its recent notification, SEBI introduced a standardized Private Placement Memorandum that provides for a separate section for valuation and other related disclosures. Regulation 23(1) of AIF Regulations also mandates the AIFs to provide to its investors a description of valuation procedures used in valuing the assets.

On one hand disclosures are necessary to maintain transparency in a market and are beneficial to investors. On the other hand, in our view, laying out a panoramic framework for conducting the valuation process or identifying IPEV guidelines as the required valuation methodology may not be fit for all the schemes (Example: Debt Schemes) and will take away the flexibility of the process which is necessary for managers to conduct valuation based on specific strategy. However, how the mechanism will work is highly dependent on the nature and extent of the exact framework, as to be introduced in the regulations.

B. Dematerialization of Units

All new schemes going forward and existing schemes of AIFs with corpus more than Rs. 500 Crore shall dematerialise their units by October 31, 2023. Existing schemes of AIFs with corpus less than Rs. 500 Crore shall dematerialise their units by April 30, 2024.

It is an ideal step forward. The dematerialization of units of AIF is an important step that introduces ease of transfer, transmission and transparency in the system and may also prove essential is laying down the framework for listing of AIFs.

C. Certification Requirement for Manager and Key Investment Members

As per the proposal approved by the Board, now the Manager of the AIF as well as its key investment team as an eligibility requirement, shall require clearing 'certification requirement' as may be prescribed. The said certification requirement is also being mandated for the compliance officer of the AIF.

From the approved amendment it has been felt that a mandatory comprehensive certification requirement as the only criteria for inducting members to the Key Investment Team and Manager of an AIF. In our view of the funds, to manage a fund and take investment decisions largely is derived by experience therefore such a mandatory certification may not be the best step in terms of managing large corpuses. Also, asking a senior member to seek certification shall prove to be an unnecessary constraint for such members with renowned working experience of the investment house. SEBI should revise/clarify the above amendment as to allow additionally persons with not enough experience to be able to be inducted as Key Investment Team members.

D. Approval for Conflicting Transactions

The Board approved a proposal to mandate obtaining approval of 75% of investors by value, for buying or selling of investments potentially involving conflict of interest. The provision would cover transactions by an AIF, from or to, associates of AIF, or schemes of AIFs managed or sponsored by the manager or sponsor or their associates, or an investor who has commitment to the extent of more than 50% of the corpus of the scheme of AIF.

For effective management of any fund, it is primary to keep any conflicts minimal. Thus, generally fund documents provide of require approval of investors to avoid any conflict of interest. The proposed amendment thus validates such requirement. Although, whether all decisions will need approvals, or a monetary threshold will be introduced will be witnessed as regulations come.

E. Illiquid Investments

Also, for AIFs which are unable to sell investments due to lack of liquidity during the winding up process, they will now be required to sell such illiquid investment to a new scheme of the same AIF i.e., Liquidation Scheme or distribute such unliquidated investments to is unit holders (in-specie), in the prescribed manner and subject to approval of 75% investors by value. In the absence of investor consent for aforesaid options during liquidation period, the unliquidated investments shall be mandatorily distributed in-specie to investors. In case an investor is not willing to take in specie distribution, such investment shall be written off. The value of sale of such investments to the Liquidation Scheme shall be determined as per SEBI norms. The proposed amendment may result in tax implication on the investors.

Such a step would have been better if it had provided flexibility to AIF to liquidate the illiquid assets in the manner prescribed, rather than mandating it. Alongside the existing

provision of extending the tenure of the fund with the mandated liquidation may result in tax issues. When an AIF moves illiquid investments from a maturing scheme to a new one, the transfer leads to a loss of holding period benefit to investor. Unlisted shares owned for more than two years qualify for a long-term capital gains tax. Such AIFs generally own shares of unlisted companies that become illiquid in tough market conditions. Moreover, such a mechanism can lead an investor to long-term capital loss in the old fund and short-term capital gain in the new fund. Further the requirement to compulsorily make in-specie distribution in the absence of investors consensus seems to ignore the practical challenges in distributing such securities directly to investors. The major challenge arrives in case of foreign investors in an AIF, where receiving such securities can be subject to approvals from RBI. Further, in some situations, such a distribution may not be legal as the foreign investor may not be qualified to hold the securities that the AIF holds. This amendment would also require an amendment in the recent SEBI's requirement that asks the PPMs to state that the manager shall ensure that no in-specie distribution shall take place in case it violates the applicable laws.

F. Track Record of Manager and Performance Benchmarking

To ensure proper recognition and disclosure of true asset quality, liquidity, and fund performance of AIFs and their managers, the value of sale of such investments to the Liquidation Scheme or their in-specie distribution, shall be recognised as per norms specified by SEBI for capturing in the track record of the manager and for reporting to Performance Benchmarking Agencies.

We believe that the inclusion of value of unliquidated investments of an AIF transferred to a liquidation scheme or distributed in-specie, in the track record of managers is an ideal decision. Considering that the decision to invest in the same, at the time of investment, had been taken by the manager and therefore, it is only fair that the same be added to the track record and reports on performance benchmarking. This is in line with the fiduciary duties of the manager at all points of time towards the fund.

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