

# Investment Funds: Monthly Digest

September 30, 2019

## ALTERNATIVE INVESTMENT FUNDS AND MANAGEMENT FEES: INDIAN LEGAL CONSIDERATIONS (AUGUST-SEPTEMBER 2019 EDITION, PART I)

In India, Alternative Investment Funds (“AIFs”), are legally recognized as a distinct asset class, and regulated by the Securities and Exchange Board of India (“SEBI”) under the SEBI (AIFs) Regulations, 2012 (the “AIF Regulations”).

The AIF Regulations contemplate the manager of an AIF to be distinct from the AIF itself, as a separate legal entity.<sup>1</sup> This is consistent with the global industry practice among investment fund managers, of segregating assets and liabilities of the pooling vehicles from the assets and liabilities (a) of such investment manager; and (b) of other pooling vehicles managed by the same investment manager.<sup>2</sup>

The manager is appointed by the AIF by way of a counterparty agreement which is generally referred to as the investment management agreement (“IMA”). A management fee is charged by the AIF manager for the management services provided by the AIF manager.

The AIF Regulations require the manager to disclose the management fees proposed to be charged by the manager in the private placement memorandum of the AIF (the “PPM”), i.e. the marketing document of the AIF which is also reviewed by SEBI at the time of assessing the application of an entity proposing to operate as an AIF.

In this issue of the digest, we look to discuss certain Indian regulatory considerations and variations with respect to the management fee charged by managers of closed-end AIFs.

### DISCLOSURE REQUIREMENT

The AIF Regulations do not define the format of charging management fees. In other words, the manager may either charge a fixed fee, or a variable which could be a function of the AIF’s performance, or in any other manner as commercially considered appropriate by the manager and agreed with the investors. However, the AIF Regulations do not permit the manager to waive its management fees in order to utilize such amount of management fees as the sponsor’s continuing interest in the AIF.<sup>3</sup>

Generally, closed-end AIFs charge management fees as a percentage of the total capital commitment of each investor during the commitment period / investment period of the AIF (i.e. the period during which the AIF makes fresh investments), and as a percentage of the invested capital after the commitment period and is generally charged as such until the end of the term. The management fee of each investor is computed separately (as opposed to a pro-rata allocation after calculating the fee on an aggregate basis) to avoid any single investor being liable for the default, excuse or redemption by other investors.

The disclosure of fees to be charged by an AIF manager is required to be disclosed in the PPM, along with an illustration / number workings (attached as an annexure to the PPM) of how the fee would be applicable to the investor.<sup>4</sup>

### CONFLICT SITUATIONS

In order to improve investment performance, AIF managers may have associates who may provide certain support services (including research assistance, mentoring assistance to management, distributorship services etc.) to the portfolio companies of the AIF managed by such AIF manager. In such cases, SEBI expects the AIF manager to make appropriate disclosures to the AIF investors.

The AIF Regulations require a periodic disclosure of information by the AIF Manager to the investors about any fees charged to the AIF or to any portfolio company of the AIF by an associate of the AIF or sponsor.<sup>5</sup>

### INVESTORS’ RIGHT TO EXIT

In the event that the AIF manager proposes to change the management fee which results in a higher fee being charged to the AIF manager, the AIF Regulations requires the manager of a closed-end AIF to provide an exit option to the existing investors who do not wish to continue with its investment in the AIF after such change (whether partly, or wholly subject to the regulatory minimum investment requirement). The AIF investors are provided with a timeline of 1 month to express their dissent towards such change.<sup>6</sup>

Any change in sponsor / manager, or change in control of the sponsor / manager would also require the AIF manager to give the abovementioned exit option to investors unless the AIF manager has obtained an approval from at least 75% of the AIF managers by value of their investment. However, in case of management fee, such exemption from providing an exit option does not apply and each investor has to decide for itself meaning that a collective vote of 75% of the investors by value would not entitle the manager to charge a higher fee for all investors.

### SUMMARY

The AIF Regulations do not currently permit AIFs to be self-managed, and contemplate a counterparty relationship

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between the AIF and the AIF manager. This counterparty relationship is established by way of an IMA as a contractual arrangement, with management fees as the consideration.

Computation of management fees is not regulated by the AIF Regulations. However, certain disclosure requirements are imposed including in cases of potential conflict, along with restrictions on waiver, and also provide for investors to exit in case of any change resulting in a higher fee being charged to the investors.

– **Shivam Ahuja & Nandini Pathak**

You can direct your queries or comments to the authors

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<sup>1</sup> The AIF Regulations define 'manager' to mean any person or entity who is *appointed by* the Alternative Investment Fund to manage its investments by whatever name called and may also be same as the sponsor of the Fund (Please see Reg 2(1)(q) of the AIF Regulations).

<sup>2</sup> The contributory interest of the manager in the AIF is generally not more than a *de minimis* proportion, which could be for skin-in-the-game, carry allocation or a combination of both. However, the decision making with respect to the AIF including its set up, investment and other operations and winding-up rests with the manager, subject to investors' consent for certain conflicted items which may be required under the AIF Regulations, and / or contractually as agreed with the investors of the AIF under the AIF documents.

<sup>3</sup> Regulation 10(d) of the AIF Regulations.

<sup>4</sup> SEBI Circular dated June 19, 2014.

<sup>5</sup> Regulation 22(b) of the AIF Regulations.

<sup>6</sup> SEBI Circular dated June 19, 2014.

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