

## Funds Hotline

November 12, 2020

### SEBI INTRODUCES NEW AIF INVESTMENT COMMITTEE REGULATIONS

- SEBI formalizes constitution of ICOMs; however subjects it to certain conditions.
- ICOM members to be equally responsible and liable for compliances as the AIF manager.
- Until SEBI receives clarity from the GOI and RBI, the applications of AIFs whose ICOMs consist of external foreign members have been put on hold.

On September 29, 2020, the Securities Exchange Board of India (“SEBI”) in its board meeting had approved certain key amendments to be made to the SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”), including expanding the interpretation of the term ‘relevant professional qualification’ under Regulation 4(g) of the AIF Regulations. Further, amendments were also approved, *inter alia*, covering the constitution of an investment committee (“ICOM”) by the manager of the Alternative Investment Fund (“AIF”) for approving investment decisions, and the collective responsibilities of the manager and members of such ICOM.

In furtherance of the board meeting, SEBI vide an amendment dated October 19, 2020 notified the changes as approved in its board meeting (the “New Amendment”), in a bid to provide flexibility and comfort to the AIF managers in constituting their key investment teams and designing the decision - making process for the AIFs.

The year 2020 has been a regulatory swing for the AIF industry. With the regulatory changes being introduced starting with the SEBI circular<sup>1</sup> of February 05, 2020 (introducing template PPM and benchmarking standards), to introduction of stamp duty on AIF units<sup>2</sup>, and up to the amendments summarized above as of October 19, 2020<sup>3</sup>, the regulation of AIFs seems to continually detach itself further from its original charm of being light touch.

The changes introduced by the New Amendment pertaining to ICOM seem to have been introduced basis industry representations made to SEBI; however, we have discussed below how the actual text of the New Amendment may have overreaching effects than what may have been requested by the industry.

### PROFESSIONAL QUALIFICATION

Before we delve further and analyze the changes introduced by the New Amendment, it is pertinent to refer to the relevant provisions of the AIF Regulations. SEBI while providing for the eligibility criteria for the purposes of granting certificate to the applicant had clearly laid down a set of conditions applicable to the fund manager and the sponsors alike. Apart from ensuring that the sponsor and AIF manager are fit and proper persons have the necessary infrastructure and manpower to effectively discharge their duties, the AIF managers were also mandated to ensure that its key investment team has adequate experience, with at least one key personnel having not less than five years’ experience in advising or managing pools of capital or in fund or asset or wealth or portfolio management or in the business of buying, selling and dealing of securities or other financial assets and has relevant professional qualifications.

In recent times, potential AIF managers and sponsors while approaching SEBI for registering an AIF were often told that the at least one of the team members of the AIF manager, must be either a chartered accountant or hold an MBA (Finance) degree.

With SEBI prescribing an elaborate list of degrees and streams such as finance, business management, accountancy, commerce, economics, capital market or banking, for considering the qualification requirement, the AIF Regulations are now more in sync with the SEBI (Portfolio Managers) Regulations, 2020 or the SEBI (Investment Advisors) Regulations, 2013.

The term ‘relevant professional qualification’ as mandated under Regulation 4(g) of the AIF Regulations was used to be interpreted in a limited manner in the industry due to practical precedents and interactions with the regulator. SEBI’s clarification in this regard to provide guidance to the industry on what is considered ‘professional qualification’ by SEBI for team members of AIF managers has been taken positively by the industry. However, from a global standard, with such a list of qualifications SEBI, might run the risk of being too prescriptive. For a better perspective, the EU AIFM Regulations for certain jurisdictions, only stipulate that the key personnel should be of sufficiently good repute and are sufficiently experienced in relation to the investment strategies pursued by the fund so managed.

### INVESTMENT COMMITTEE Amendments

Over the past few months, various AIF managers who had filed for a new AIF registration, received feedback from SEBI officers on their documents mentioning that the board of the AIF manager (and not the ICOM) shall have the final binding authority with respect to investment and divestment decisions of the AIF. SEBI officers were often seen relying on Outsourcing Guidelines<sup>4</sup> to disallow the AIF manager from delegating its core business activities and other

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compliance functions.

Given the above, SEBI received a feedback from the industry that the role of an ICOM to green-light investment and divestment decisions for the fund is globally recognized and accepted practice among funds.

Accordingly, SEBI released the New Amendments to provide a statutory blessing to the concept of ICOMs; however, with certain unexpected conditions as summarised below:

- i. ICOMs will be equally responsible as the AIF managers for investment decisions of the AIF;
- ii. ICOM and AIF manager will be jointly and severally liable for compliance of the AIF with AIF Regulations, governing documents of the AIF and other applicable law;
- iii. External members of the ICOM not identified in the AIF documents at the time of on-boarding of investors will have to be added to the ICOM only upon receiving at least 75% of investors consent by value; and
- iv. any other conditions as may be specified by SEBI.

#### *FEMA Concerns*

Further, from a foreign exchange control perspective it is necessary to attain clarity with respect to the ICOM comprising primarily of non-Indian (resident citizen) members which could then effectively be in control of the investment decisions with respect to the AIF. As per clause (4) of Schedule VIII under FEM (Non-debt Instruments), Rules, 2019 ("**NDI Rules**"), an investment made by an AIF into an Indian entity shall be reckoned as indirect foreign investment for the investee Indian entity if (i) the sponsor or the AIF manager is owned or controlled by persons resident outside India or (ii) the sponsor or the AIF manager is not owned and not controlled by resident Indian citizens. Although, SEBI is awaiting clarifications from the Government of India ("**GOI**") and Reserve Bank of India ("**RBI**"), it has vide a circular<sup>5</sup> dated October 22, 2020 ("**Circular**"), has sought to update the industry.

As mentioned in the Circular, the applications wherein the proposed ICOM comprises of external members who are 'resident Indian citizens', such applications are to be duly processed. However, in what could be a major point of concern for the offshore investors wanting to play an active role in the funds managing their money, SEBI has stated in the Circular that it has written to the GOI and RBI requesting for clarification on how such control by ICOMs would (with external foreign members) affect the nature of investments by the AIFs who are bound by such ICOMs from a FEMA perspective. Until SEBI receives clarity from the GOI and RBI, the applications of AIFs whose ICOMs consist of external foreign members have been put on hold by SEBI.

#### *Role of ICOM in decision-making by the AIF Manager*

The concept of having an ICOM is globally known and used in the funds industry; however, it is not generally a matter of regulation.

ICOMs generally comprise of internal members such as employees/directors/partners of the AIF manager and/or external such as nominees of the Sponsor, employees of group companies of the sponsor/ AIF manager, domain experts, etc. The presence of such diverse members on the ICOM serves the purpose of improving the deal evaluation exercises undertaken by the AIF manager. Investors find comfort with the presence of domain experts in the decision-making process, especially with regard to suitability of the investment decisions in particular sectors.

The decision-making process for an investment fund typically starts with the deal team. The deal team primarily sources deals through *inter alia* the relationship network of the AIF manager, utilising its strong business relationships with developers and intermediaries, and / or through investment banks. The AIF manager's team thereafter conducts preliminary analysis by conducting site visits, location and market analysis, analysis of relevant project details, meetings with the management of the counter party and accordingly formulates the preliminary investment thesis for deals that merit further consideration. Subsequently, a detailed analysis is conducted in preparing an information memorandum which is generally tabled before the ICOM for its approval / views / recommendations depending on the role of the ICOM.

The AIF manager decides the constitution, role and processes of its ICOM (if any) depending on various factors such as its track record, fund raising and investment strategy. The highest degree of responsibility is cast on an ICOM which is formal, i.e. it green-lights the investment and divestment decisions with respect to the fund, and its decisions are binding on the manager.

Noteworthy herein is that the legal and statutory compliances with SEBI Regulations have traditionally been the functions of the AIF manager including the compliance officer. With the members of the ICOM not being generally involved in the day-to-day activities of functioning of the fund, the New Amendments would now require the members to be actively involved in the functioning of the fund, from compliance as well as internal controls perspective. Such changes are of much relevance for the AIF manager since the ICOM often comprises of an external independent member intended to solicit investors. Such independent members given the increased liability and scope of responsibilities can be expected to be bit reluctant in playing any role. In effect, the New Amendments has all the potential to be a hurdle for the AIF manager to get such independent members in the ICOM in future. Also, the AIF manager might be expected to offer greater incentives for such independent members to entice them in future which would in turn lead to an increase in the expenses at the fund level.

#### *External members on the ICOM*

The New Amendment now requires appointment of external members to the ICOM, whose names are not disclosed in the placement memorandum or agreement made with the investor or any other fund documents at the time of on-boarding investors, to be done only after taking consent of at least seventy five percent of the investors by value of their investment in the fund.

This poses an operational hindrance to various AIF managers, as independent members might express reservations on their name being circulated to a wide group of investors of the fund. SEBI has always been unequivocal about the nature of AIFs being that of blind-pool only (i.e. the AIF manager takes all investment and divestment calls with respect to the AIF, and investors do not have a say in the decision-making process of the deals). The requirement of involving investors while constituting the ICOM, arguably takes away from the blind pool nature of AIFs.

Moreover, with the provision of a catch all clause allowing SEBI Board to introduce additional conditions as it may deem fit, the AIF managers need to be always on their toes while structuring the ICOM and tread with utmost caution so as to ensure seamless process both internally and with the SEBI.

### *Not at par with global standards*

Such amendments with respect to the ICOM are not at par with global standards. For instance, the Association of Luxembourg Fund Industry, vide its Code of Conduct<sup>6</sup> providing guidance on governance requirement for fund managers, casts the responsibility for compliance with all applicable laws and fund's constitutional documents with the board of the fund manager. Similarly, while providing for investment advisers to be appointed by the fund managers to derive benefit from the specific skills taking into account the strategy of the fund, the burden of critically and independently analysing the transactions proposed by the investment adviser and ensuring compliances with the investment restrictions were imposed on the fund manager.<sup>7</sup>

### *Liability of ICOM*

It is globally understood (from a legal perspective) that members of a formal ICOM which has the final decision-making power are subject to a fiduciary obligation. Even in India, AIF managers have been undertaking the risk of non-compliance with the AIF Regulations in case the ICOM constituted by them is unable to meet its fiduciary duties. In fact, AIF managers have been covering ICOM members under relevant insurances.

With the New Amendments, it seems that now SEBI has the power to look-through the AIF manager at the ICOM members and treat them with the same liability standard as the AIF managers. It is unclear why SEBI would need to expand the scope of its regulatory purview beyond the AIF manager to the ICOM, instead of continuing to hold the AIF manager responsible for all things pertaining to the AIF, including any wrong committed by the ICOM.

### **CONCLUSION**

The New Amendments do not seem to be at par with global regulatory standards for private funds. Although the decision to give statutory recognition to ICOMs may have been well intended, the actual result is an increase in scope and nature of liability of the members of the ICOM. Pursuant to the New Amendments, the ICOM members may now face penalties for breach of AIF Regulations under the SEBI Act, 1992 which could result in imprisonment, fine or both.

Separately, as discussed above, until SEBI receives clarity from the Government of India and Reserve Bank of India, the applications of AIFs whose ICOM members consist of external foreign members have been put on hold by SEBI. It is interesting to note that the Reserve Bank of India does not disallow AIFs which are managed or sponsored by foreign owned or controlled manager / sponsor. It only imposes certain restrictions on investments made by such AIFs. In the event that the Reserve Bank of India considers foreign members on ICOMs to mean that the manager of the AIF is foreign owned and controlled, there is no reason for SEBI to put on hold processing of the applications of such AIFs with foreign members on their ICOMs.

In any case, GOI and RBI's response on this issue should be applied prospectively and all existing structures should be grandfathered, as ICOMs were not even a matter of regulation until the New Amendments introduced by SEBI (which are going to apply only prospectively).

– Dibya Behera & Nandini Pathak

You can direct your queries or comments to the authors

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1 SEBI Circular on disclosure standards for Alternative Investment Funds, *available at* [https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-\\_45919.html](https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html).

2 SEBI Circular on collection of stamp duty on issue, transfer and sale of units of AIFs, *available at* [https://www.sebi.gov.in/legal/circulars/jun-2020/collection-of-stamp-duty-on-issue-transfer-and-sale-of-units-of-aifs\\_46983.html](https://www.sebi.gov.in/legal/circulars/jun-2020/collection-of-stamp-duty-on-issue-transfer-and-sale-of-units-of-aifs_46983.html)

3 SEBI (Alternative Investment Funds) (Amendment) Regulations, 2020, *available at* [https://www.sebi.gov.in/legal/regulations/oct-2020/securities-and-exchange-board-of-india-alternative-investment-funds-amendment-regulations-2020-\\_47914.html](https://www.sebi.gov.in/legal/regulations/oct-2020/securities-and-exchange-board-of-india-alternative-investment-funds-amendment-regulations-2020-_47914.html).

4 SEBI Guidelines on Outsourcing of Activities by Intermediaries, *available at* [https://www.sebi.gov.in/legal/circulars/dec-2011/guidelines-on-outsourcing-of-activities-by-intermediaries\\_21752.html](https://www.sebi.gov.in/legal/circulars/dec-2011/guidelines-on-outsourcing-of-activities-by-intermediaries_21752.html).

5 SEBI Circular on processing of applications for registrations of AIFs and launch of schemes, *available at* [https://www.sebi.gov.in/legal/circulars/oct-2020/processing-of-applications-for-registrations-of-aifs-and-launch-of-schemes\\_47956.html](https://www.sebi.gov.in/legal/circulars/oct-2020/processing-of-applications-for-registrations-of-aifs-and-launch-of-schemes_47956.html).

6 Association of Luxembourg Fund Industry Code of Conduct, *available at* <https://www.alfi.lu/getattachment/e70bb682-4a0d-4fb5-9656-f8d921457054/alfi-alfi-code-of-conduct.pdf>.

7 Circular CSFF 18/698, *available at* [https://www.cssf.lu/wp-content/uploads/files/Lois\\_reglements/Circulaires/Hors\\_blanchiment\\_terrorisme/cssf18\\_698eng.pdf](https://www.cssf.lu/wp-content/uploads/files/Lois_reglements/Circulaires/Hors_blanchiment_terrorisme/cssf18_698eng.pdf).

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