



Consultation paper on proposed amendment to SEBI (Alternative Investment Funds) Regulations, 2012 to strengthen governance mechanisms of Alternative Investment Funds

1. Objective:

To seek comments and inputs from stakeholders and public on the following proposals for amendment to SEBI (Alternative Investment Funds) Regulations, 2012, with the objective of strengthening governance mechanisms of AIFs:

- 1.1. To specify the guidelines for borrowing by Category I and II AIFs;
- 1.2. To mandate AIFs to hold their securities/investments in demat form only;
- 1.3. To extend the mandate for appointment of custodian to all AIFs and to prescribe role of custodians appointed by AIFs;
- 1.4. To specify maximum extension of tenure by Large Value Fund for Accredited Investors (LVFs); and
- 1.5. To mandate renewal of registration of AIFs.

2. Borrowing by Category I and II AIFs

- 2.1. Regulations 16(1)(c) and 17(c) of AIF Regulations place restriction on borrowing by Category I and II AIFs as under:

“Category I Alternative Investment Funds shall not borrow funds directly or indirectly or engage in any leverage except for meeting temporary funding requirements for not more than thirty days, on not more than four occasions in a year and not more than ten percent of the investable funds.”

“Category II Alternative Investment Funds may not borrow funds directly or indirectly and shall not engage in leverage except for meeting temporary funding requirements for not more than thirty days, not more than four occasions in a year and not more than ten percent of the investable funds.”

- 2.2. Further, Regulation 3(4)(b) of AIF Regulations provides the definition of Category II AIFs as under:

“Category II Alternative Investment Fund which does not fall in Category I and III and which does not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in these regulations”.

- 2.3. While the regulatory intent behind permitting borrowing for Category I and II AIFs is that the funds borrowed shall be utilized for meeting operational requirements of the AIF, and not for the purpose of making investment, it is understood that there may be ambiguity among market participants with respect to the purpose for which AIFs may borrow funds.

- 2.4. While the PPMs submitted by Category I and II AIFs generally mention that borrowing shall be done for the purpose of temporary funding, based on industry feedback, it is understood that such AIFs borrow funds for the purpose of making investment, subject to the conditions specified in AIF Regulations.
- 2.5. As per the investment reports submitted by AIFs, the details of temporary borrowings made by AIFs over the last three quarters are as under:

Quarter	Amount borrowed for meeting operating expenses (in INR crore)	Amount borrowed for any other purposes (in INR crore)
Jun-Sept 2022	0	145
Sep-Dec 2022	1.5	275
Dec-Mar 2023	6	288

Amount borrowed for 'any other purpose' and not for meeting operating expenses, indicates that such borrowing may be for the purpose of making investment.

- 2.6. Funds borrowed by Category I and II AIFs for investing in unlisted securities, may lead to asset – liability mismatch. Considering the same, a need is felt to clarify that funds borrowed by Category I and II AIFs shall not be utilized for the purpose of making investments.
- 2.7. However, in order to ensure that an investment opportunity is not lost by any AIF due to the shortfall in drawdown amount called for from an investor, Category I and II AIFs may be permitted to borrow to meet shortfall in drawdown from an investor(s) while making investment, provided that such borrowing shall not exceed 10% of the investment made in an investee company and shall be subject to other conditions specified for borrowing by Category I and II AIFs. Borrowing for meeting such shortfall shall be permitted only in case of emergency and as a last resort and shall not be utilized to facilitate different drawdown schedule/delay in bringing drawdown capital by select investors.
- 2.8. Further, Category I and II AIFs which invest predominantly in unlisted securities carry high risk of illiquidity. In order to ensure that such AIFs do not indulge in prolonged leverage, it is felt that a cooling off period may be maintained between two periods of borrowing/leverage. This has already been mandated for borrowing by Category I and II AIFs transacting in Credit Default Swaps.
- 2.9. The issue was deliberated in meeting of Alternative Investment Policy Advisory Committee (AIPAC) held on May 10, 2023, wherein the committee recommended the aforesaid proposals.



Proposal:

- 2.10. Category I and Category II AIFs shall not borrow funds directly or indirectly or engage in leverage for the purpose of making investments.
- 2.11. Category I and II AIFs may borrow for the purpose of meeting shortfall in drawdown while making investment in an investee company, subject to the following conditions:
- 2.11.1. Such borrowing shall be done only in case of emergency and as a last recourse.
- 2.11.2. The amount borrowed shall not exceed 10% of the investment proposed to be made in the investee company.
- 2.11.3. The cost of such borrowing shall be charged only to such investor who delayed / defaulted on drawdown payment.
- 2.11.4. If the AIF intends to borrow funds for meeting shortfall in drawdown, the same may be disclosed in the PPM of the scheme.
- 2.11.5. The manager shall disclose the details regarding amount borrowed, terms of borrowing and repayment to all the investors of the AIF/scheme.
- 2.11.6. AIF shall not borrow more than once for meeting shortfall with respect to drawdown from the same investor.
- 2.11.7. The borrowing to meet the such shortfall shall not be used as a means to schedule different drawdown timeline for different investors.
- 2.12. Category I and Category II AIFs shall maintain thirty days cooling off period between two periods of permissible leverage as provided in AIF Regulations.

3. Dematerialization of assets/investments of AIFs

- 3.1. Taking into account the recommendations of AIPAC and public comments received on the consultation paper on '*Dematerialisation of units of AIFs*' issued by SEBI on February 03, 2023, SEBI Board in its meeting held on March 29, 2023, approved the proposal to mandate issuance of units of AIFs in demat form for ease of monitoring and administration by stakeholders and for investor protection against operational and fraud risk.
- 3.2. To fully realize the objective of ease of monitoring and administration by stakeholders and enhancing transparency, it is necessary that AIF's asset side (i.e. investments of AIF) is also dematerialised, as has been mandated for AIF's liabilities (i.e. units of AIF).
- 3.3. According to the Depositories Act, 1996, every person subscribing to securities offered by an issuer shall have the option either to receive the security certificates

or hold securities with a depository. Evidently, holding assets of AIFs in demat form has numerous benefits such as:

- Ease of administration and monitoring for AIFs/managers;
- Safer way to hold securities – reduces operational and fraud risk such as fake certificates, delays, bad delivery, missing certificate, mutilation or theft;
- Ease of transfer and transmission of securities;
- Automatic credit to account on stock split or bonus and other corporate actions;
- Reduction in paperwork for administrative aspects;
- Ease of regulatory access to information from depositories; and
- Comfort to investors of AIF that the securities of the fund are held safely in a demat account.

In view of the above, it is being considered to mandate that an AIF shall hold its investments in demat form.

- 3.4. In this context, it may be noted that AIF Regulations define “investee company” as any company, special purpose vehicle or limited liability partnership or body corporate or real estate investment trust or infrastructure investment trust in which an AIF makes an investment. Thus, AIFs’ investments may include equity and debt instruments of companies, partnership interest of an LLP, units of other AIFs, units of REITs, InvITs etc. The details of investment made by AIFs in different type of securities, as on March 31, 2023, are as under:

Type of security	Amount invested (in INR Crore)	Percentage of total investments
Unlisted equity and equity linked instruments	1,31,325	38.86
Unlisted corporate debt and security debt	80,512	23.82
Listed Equity or proposed to be listed equity	66,479	19.67
Listed debt or proposed to be listed debt	14,057	4.16
Liquid MFs	12,709	3.76
LLP	8,783	2.60
Units of AIFs	8,122	2.40
Security receipts listed or unlisted	2,417	0.72
Units of REITs and InvITs	2,375	0.70
Government Securities	1,789	0.53
Others	9414	2.79
Total	337982	100.00

Further, as per NSDL, the AUC of the investments held by AIFs in dematerialised form, stands at INR 2,43,055 Crore as on March 31, 2023, which indicates that a substantial portion of investments is held by AIFs in dematerialised form.

- 3.5. As regards investment in companies, Section 29 of Companies Act, 2013, specifies that every company making public offer and other prescribed classes of companies shall issue the securities only in dematerialised form. Thus, listed companies and unlisted public companies are mandated to issue securities in demat form. Further, as per SEBI (Infrastructure Investment Trusts) Regulations, 2014 and SEBI (Real Estate Investment Trusts) Regulations, 2014, InvITs which raise funds by public issue and all REITs are required to issue units in only in dematerialised form. AIFs have already been mandated to issue their units in demat form only, which is under implementation. Thus, certain types of permissible investments/instruments for AIFs are mandated to be issued in demat form.
- 3.6. While there is cost associated with opening and holding a demat account, it is seen that 1424 demat accounts have already been opened by AIFs/schemes with NSDL and CDSL. Further, for companies which may be required to admit their securities to depositories for dematerialisation, the joining fees and annual fees are given at **Annexure I**, which do not appear to be onerous. It is also understood that the process of admission of securities by the depositories is not cumbersome and is usually completed in 2 to 3 days' time.
- 3.7. It is also understood that, private companies generally issue securities in demat form as per demand from their investors, especially from the foreign investors who prefer to hold the securities in demat form. Similarly, AIFs may insist that their investee companies issue securities in demat form, while making investment.
- 3.8. Thus, considering that AIF industry is a sophisticated space which is rapidly growing, it is now appropriate to introduce the requirement of mandatory dematerialisation of assets of AIFs.
- 3.9. The issue was deliberated in a meeting of AIPAC held on May 10, 2023, wherein the committee in principle recommended the proposal to mandate AIFs to hold their securities/investments in demat form, AIPAC also suggested to consider providing exemption to AIFs from aforesaid mandate, for holding overseas investments, investments in LLPs and temporary investments (investments in Mutual Funds). After examining the suggestion of AIPAC, it is viewed that exemption from the mandate of dematerialising investments may be provided only in case of investment in such types of instruments/securities for which dematerialisation is not available.

Proposal:

- 3.10. It is proposed to mandate that AIFs shall hold the instruments/securities of their investments only in dematerialised form. The aforesaid requirement shall not be applicable in case of investment in such types of instruments/securities for which dematerialisation is not available.
- 3.11. As regard existing investments made by AIFs in investee companies where the AIF or AIFs together have controlling interest, investments in such investee companies shall be held in dematerialised form. A time period of 6 months may be provided for dematerialisation of investment made by AIF in such investee companies.

3.12. Views sought:

With respect to dematerialising existing investments of AIFs in investee companies, where an AIF or AIFs together do not have controlling interest:

- Should there be a mandate to dematerialise such investments within a period of 12 months?
- Should such investments not be subject to requirement of dematerialisation?

4. Mandating appointment of custodian for AIFs

- 4.1. Regulation 20(11) of AIF Regulations specifies norms with respect to appointment of custodian as under:
- 4.1.1. Sponsor / Manager of Cat I and Cat II AIFs shall appoint a custodian for safekeeping of the securities, if the corpus of the AIF is more than INR 500 crore.
- 4.1.2. Sponsor / Manager of all Cat III AIFs shall appoint a custodian, irrespective of the corpus of the AIF.
- 4.1.3. Sponsor / Manager of Cat I and Cat II AIFs transacting in credit default swaps shall appoint a custodian and comply with such terms and conditions as may be specified by SEBI.
- 4.2. In addition to the aforementioned requirement of safekeeping of the securities, custodians appointed by AIFs are also involved in obtaining tax certificate for the AIF, settlement of trade with respect to investment in listed securities, to liaison with companies with respect to post trade corporate action, and any other activity as delegated to it by the AIF as part of the custodial agreement with the custodian.
- 4.3. Following are the details of AIFs, who are required to appoint custodian, including details of their investments (as on Mar 31, 2022):

Category of AIFs	No. of schemes	Total commitments raised (in INR Crore)	Total investment made (in INR Crore)
Cat I and II AIFs with corpus more than INR 500 Crore	247	682912	235059
Cat III AIFs	325	80900	71055
Total	572	763812	306114

The total investment made by AIF industry as on March 31, 2023 stood at INR 3,37,983 crore. Thus, around 90% of the total investments made by AIFs are already covered under the custodian mandate.

- 4.4. It may be noted that under SEBI (Portfolio Managers) Regulations, 2020, every portfolio manager is required to appoint a custodian in respect of securities managed or administered by it. Further, SEBI (Mutual Funds) Regulations, 1996, prescribe '*appointment of custodian in order to keep custody of the securities or goods or gold or gold related instruments or silver or silver related instruments or other assets of the mutual fund held in terms of these regulations, and provide such other custodial services as may be authorized by the trustees*' as one of the eligibility criteria for grant of registration as a Mutual Fund.
- 4.5. Considering the above and in order to bring in parity across all categories of AIFs, it is felt that the requirement of appointing custodians may be extended to all AIFs, irrespective of the size of corpus of the AIF.
- 4.6. Further, custodians monitor the investments of Foreign Portfolio Investors and Foreign Venture Capital Investors in addition to the safekeeping of their investments. If similar responsibility is cast on custodians of AIFs, it will ensure independent monitoring of investments of AIFs. Accordingly, it is proposed to specify that the custodian shall monitor the investments of the AIF.
- 4.7. The issue was discussed in the meeting of AIPAC wherein the committee, after deliberation, recommended the proposal. AIPAC also suggested that AIFs should appoint only an independent custodian and that role of custodian with regard to monitoring of investments of AIFs may be clarified in the AIF Regulations.

Proposal:

- 4.8. The extant requirement of mandatory appointment of a custodian for safekeeping of securities for AIFs with corpus more than INR 500 crore, may be extended to AIFs with corpus less than INR 500 crore as well.

- 4.9. Existing AIFs with corpus less than INR 500 crore shall be given a time period of 6 months to appoint custodian.
- 4.10. Manager of the AIF shall ensure that the custodian appointed by AIF is not an associate of manager / sponsor / trustee of the AIF. Existing AIFs who have appointed custodians that are associate of their manager / sponsor / trustee, shall be given a time period of 6 months to comply with the aforesaid requirement.
- 4.11. In addition to the extant requirements under the SEBI (Custodian) Regulations, 1996 and AIF Regulations, custodians shall also be responsible for monitoring investments of AIFs with regard to investment conditions and other related requirements under AIF Regulations.

5. Maximum extension of tenure by Large Value Fund for Accredited Investors (LVFs)

- 5.1. SEBI, in 2021, introduced the framework for 'Accredited Investors' in the Indian securities market as a class of investors who are considered to be well informed or well advised about investment products. SEBI also introduced a concept of LVF, which is a scheme of an AIF in which each investor is an Accredited Investor and invests at least INR 70 crore.
- 5.2. Certain flexibilities and relaxations have been extended to Accredited Investors in general and LVFs in particular. One of such relaxation provided to LVFs pertain to extension of tenure:
- 5.2.1. For close ended schemes of AIFs, extension of tenure is permitted up to two years, subject to approval of two-thirds of the unit holders by value of their investment in the scheme. The scheme of the AIF is required to fully liquidate within one year following expiration of the tenure or extended tenure of the scheme.
- 5.2.2. LVFs are permitted to extend their tenure beyond two years, subject to terms of the contribution agreement, other fund documents and such conditions as may be specified by SEBI from time to time. In case the requisite conditions specified in the placement memorandum, contribution agreement or other fund documents of LVF for extension of tenure beyond two years are not fulfilled, the LVF is required to fully liquidate in accordance with the AIF Regulations.

- 5.3. As on December 20, 2022, there are 25 LVF schemes filed with SEBI, out of which, 24 LVF schemes are close ended. Out of these 24 close ended schemes, 19 schemes have tenure extendable up to two years' subject to consent of two-thirds of the investors by value, which is in line with the provisions applicable to all AIFs, as stated in para 5.2.1. Thus, despite the flexibility provided to LVFs to determine duration of extension of tenure, most of the LVFs have opted to extend their tenure only up to two years.
- 5.4. The flexibility of having no upper limit on extension of term of an LVF may result in a close ended fund acquiring the colour of a perpetual fund wherein investments of investors may get locked in for an uncertain period of time. This may also result in delayed disclosure/recognition of true asset quality, liquidity, fund value and fund performance of AIFs and their managers.
- 5.5. It is also pertinent to note that, in order to provide flexibility to schemes of AIFs (including LVFs) to deal with investments which are not sold due to lack of liquidity during the winding up process, SEBI has recently enabled a framework to allow AIFs to deal with unliquidated investments by either selling such investments to a new scheme of the same AIF i.e., Liquidation Scheme or distributing such unliquidated investments in-specie, subject to approval of 75% investors by value and in the prescribed manner.
- 5.6. Considering that the aforesaid option of liquidation scheme is proposed to be provided to all schemes of AIFs, including LVFs, it was felt that the extension of tenure of LVFs may be aligned with that provided for other schemes of AIFs.
- 5.7. The issue was deliberated in the meeting of AIPAC, wherein the committee, after deliberation, suggested that, considering LVFs are meant only for very large sophisticated investors, certain reasonable extension over and above the extension available for other regular schemes of AIFs, may be considered for LVFs. Accordingly, AIPAC recommended to allow LVFs an additional extension of two years.

Proposal:

- 5.8. LVFs may be permitted to extend their tenure up to four years, subject to approval of two-thirds of the unit holders by value of their investment in the LVF.

6. Renewal of registration of AIFs

- 6.1. SEBI grants certificate of registration of AIFs, if it is satisfied that the applicant fulfils the eligibility requirements and pays the applicable registration fee as specified in the AIF Regulations.

- 6.2. In terms of Regulation 3(7) of AIF Regulations, the certificate of registration granted to AIFs is perpetual in nature and is valid till the AIF is wound up and certificate of registration is surrendered. Presently, there is no requirement to pay renewal fee to keep the certificate of registration in force.
- 6.3. It is observed from the quarterly reports filed by AIFs that, many AIFs are still holding their certificate of registration despite having no fund raising or investment activity in their schemes for several years. A table showing number of AIFs with no commitments raised in any of their schemes since their registration is given below:

Registration granted to AIFs during Financial Year	No. of AIFs with no commitments raised in any of their schemes
2013-2014	18
2014-2015	14
2015-2016	22
2016-2017	22
2017-2018	35
2018-2019	43
2019-2020	34
2020-2021	27
Total	215

- 6.4. Holding of SEBI certificate of registration even if there is no activity results in the following issues:
- 6.4.1. Inflated number of registered AIFs and misrepresentation of the facts and figures.
- 6.4.2. Consumption of considerable regulatory resources in monitoring and supervision of such inactive AIFs.
- 6.4.3. Prone to be misused for unauthorized fund raising.
- 6.4.4. Such inactive AIFs are required to comply with regulatory provisions of AIFs despite no intention to carry out activity, which adds to compliance cost.
- 6.4.5. At times such inactive AIFs, who fail to file their periodic reports, become untraceable and initiating enforcement action against them becomes challenging.
- 6.5. To address the concerns highlighted at para 6.4 above and to ensure that only those intermediaries who are willing and capable to carry out the activities of a SEBI registered intermediary continue holding the certificate of registration, various other SEBI regulations require intermediaries to renew or timely surrender their registration certificate, as provided below:

- 6.5.1. In terms of para 3 of schedule II of SEBI (Portfolio Managers) Regulation, 2020, a portfolio manager who has been granted a certificate of registration, to keep its registration in force, shall pay a fee of five lakh rupees every three years, from the date of grant of certificate of registration within three months before expiry of the block period for which fee has been paid.
- 6.5.2. In terms of para 3 of schedule II of SEBI (Investment Advisers) Regulation, 2013, an investment adviser who has been granted a certificate of registration, to keep its registration in force, shall pay fee (INR 5,000 for body corporates including LLP and INR 1,000 for individuals and firms) every five years, from the date of grant of certificate of registration.
- 6.5.3. In terms of para 3 of schedule II of SEBI (Research Analysts) Regulation, 2014, a Research Analyst who has been granted a certificate of registration, to keep its registration in force, shall pay fee (INR 10,000 for individuals, partnership firms, proxy advisory firm and INR five lakh for body corporates including LLP) every five years, from the date of grant of certificate of registration.
- 6.5.4. In terms of Regulation 14(23) of SEBI (REIT) Regulations 2014, if the REIT fails to make its initial offer within three years from the date of registration with the Board, it shall surrender its certificate of registration to the Board and cease to operate as a REIT.
- 6.5.5. In terms of Regulation 14(5) of SEBI (InvIT) Regulations 2014, if the InvIT fails to make any offer of its units, whether by way of public issue or private placement, within three years from the date of registration with the Board, it shall surrender its certificate of registration to the Board and cease to operate as an InvIT.
- 6.6. In view of the above, it is felt that a similar requirement may also be prescribed in case of AIFs to ensure that they do not hold a certificate of registration indefinitely, without any intention to carry out the activity of an AIF. This would also enhance standards of transparency and responsibility amongst industry participants.
- 6.7. This issue was deliberated in the meeting of AIPAC, wherein the committee acknowledged the issues with respect to holding certificate of registration by such inactive AIFs and recommended that levying renewal fee on the non-compliant or inactive AIFs may be considered to address this issue.

Proposal:

- 6.8. AIF's manager shall ensure that AIF pays renewal fee equal to 50% of its applicable registration fee for the subsequent block of five years from the date of grant of registration, within three months before expiry of the said block period.

- 6.9. Existing AIFs who have completed five years from the date of grant of certificate of registration shall also pay renewal fee equal to 50% of its applicable registration fee. The fee shall be paid within three months of issuance of a notification in this regard and thereafter every subsequent block of five years from the date of payment of such fee.
- 6.10. In case AIFs fail to ensure the payment of renewal fee in the manner as specified above, then a late fee of an amount equal to 2% of its registration fee shall be charged for each day of delay, up to a maximum of two times of the registration fee. Post which, the certificate of registration of the AIF shall be liable to be suspended/cancelled.
- 6.11. Further, until the renewal fee is paid, AIFs shall not accept any fresh commitment or make investment in a new investee company in any of their schemes, and shall not launch new schemes.
- 6.12. Custodian of the AIF shall monitor the compliance by AIF/Manager with the aforesaid provisions.

7. Public Comments

- 7.1. Public comments are invited for the proposals given above. The comments / suggestions may be provided in MS Excel file as per the format given below:

Name of the person/ entity proposing comments:	
Name of the organization (if applicable):	
Contact details:	
Category: whether market intermediary/ participant (mention type/ category such as AIF, law firm, consultant, etc.) or public (investor, investee company, academician etc.)	

Sr. No.	Para. no. of the consultation paper	Extract from the consultation paper	Comments / Suggestions	Rationale



- 7.2. Kindly mention the subject of the communication as, “*Consultation paper on proposed amendment to SEBI (Alternative Investment Funds) Regulations, 2012 to strengthen governance mechanisms of Alternative Investment Funds (AIFs)*”.
- 7.3. Comments as per aforesaid format may be sent to the following, latest by May 31, 2023, in any of the following manner:
- (i) Preferably by email to afdconsultation@sebi.gov.in, with a copy to Shri Kunwar Abhay Singh, Manager (kunwars@sebi.gov.in) and Shri Sachin Kisan Jadhav, Manager (sachinj@sebi.gov.in)
 - (ii) By post to:
Shri Sanjay Singh Bhati,
Deputy General Manager,
Alternative Investment Fund and Foreign Portfolio Investors Department,
Securities and Exchange Board of India,
SEBI Bhavan,
C4-A, G-Block, Bandra Kurla Complex,
Bandra (East), Mumbai -400051

Issued on: May 18, 2023



Annexure I:

JOINING FEE BY ISSUERS

- Issuer of listed securities shall pay a joining fee of INR. 20,000 plus taxes at the applicable rate at the time of joining Depository, for dematerialising its shares.
- Issuer of unlisted securities shall pay a joining fee of INR. 15,000 plus taxes at the applicable rate at the time of joining Depository, for dematerialising its shares.

ANNUAL CUSTODY FEE

An Issuer shall pay an annual custody fee at the rate of INR. 11 per folio (ISIN position), subject to a minimum amount as mentioned below, plus taxes as applicable:

Nominal Value of securities admitted (INR.)	Amount (INR.)
Listed	
Upto 5 crore	9,000
Above 5 crore and upto 10 crore	22,500
Above 10 crore and upto 20 crore	45,000
Above 20 crore	75,000

Nominal Value of securities admitted (INR.)	Amount (INR.)
Unlisted	
Upto INR. 2.5 crore (applicable only for issuer of unlisted shares)	5,000
Upto 5 crore	9,000
Above 5 crore and upto 10 crore	22,500
Above 10 crore and upto 20 crore	45,000
Above 20 crore	75,000