January 2024

The ever-increasing regulatory oversight on AIFs

Increased regulatory oversight on alternative investment funds ("**AIFs**") has been in the news in the recent past. In addition to direct regulatory oversight on the AIFs itself, AIFs are also indirectly impacted by various other statutory and regulatory restrictions or conditions that are applicable to the underlying legal form of the AIF, the investors in the AIF or the investment portfolio of the AIFs.

Some of the recent statutory and regulatory amendments affecting AIFs are discussed below.

1. **Significant beneficial ownership and AIFs**

   Under the SEBI (Alternative Investment Funds) Regulations, 2012 (the "**AIF Regulations**"), an AIF can be established or incorporated in the form of a trust or a company or a limited liability partnership ("**LLP**") or a body corporate.

   After trusts, LLPs have been the most preferred legal form for an AIF, since LLPs are more beneficial from a tax perspective and with lesser compliance requirements than a company.

   However, in the recent past, LLPs are also being subjected to additional compliance requirements.

   One recent compliance/disclosure requirement imposed on the LLPs is pursuant to the LLP (Third Amendment) Rules, 2023 and the LLP (Significant Beneficial Owners) Rules, 2023 (**"SBO Rules"**). As per the SBO Rules, the LLP is required to take necessary steps to find out if any individual qualifies as a 'significant beneficial owner' ("**SBO**") in relation to the LLP. If such SBO has been identified, then the LLP must cause such individual to make a declaration in Form No. LLP BEN-1.

   As per one of the exemptions available under the SBO Rules, the aforesaid requirements will not apply to the extent the contribution in the LLP is held by an investment vehicle registered with SEBI, such as an AIF. Thus, if an AIF is a partner in the LLP, the SBO Rules will not apply in respect of such AIF partner.

   However, where the AIF has itself been set up as an LLP, then the SBO Rules will apply in relation to such AIF.

   Accordingly,

   a) an AIF (set up as an LLP) is required to issue a notice to a non- individual partner in Form No. LLP BEN-4, seeking information in accordance with sub-section (5) of section 90 of the Companies Act, 2013, if such non-individual partner holds atleast 10% of such AIF's:

      i) contribution; or

      ii) voting rights; or

      iii) right to receive or participate in the distributable profits or any other distribution payable in a financial year;

b) every individual who is a SBO in the AIF, is required to file a declaration in Form No. LLP BEN-1 with the AIF within 90 (ninety) days from the date of commencement of the SBO Rules (i.e., November 9, 2023);

c) the SBO Rules define a "significant beneficial owner/SBO" as an individual who acting alone or together or through one or more persons or trust, possesses one or more of the following rights or entitlements in the LLP:

i) indirectly or together with any direct holdings, not less than 10% of the contribution;

ii) indirectly or together with any direct holdings, not less than 10% of voting rights in respect of the management or policy decisions in such limited liability partnership;

iii) right to receive or participate in not less than 10% of the total distributable profits, or any other distribution, in a financial year through indirect holdings alone or together with any direct holdings;

iv) right to exercise or actually exercises, significant influence or control, in any manner other than through direct-holdings alone;

As per the explanation, if an individual does not hold any right or entitlement indirectly under sub-clauses (i), (ii), (iii) or (iv) above, he will not be considered a SBO. The SBO Rules further define what would be considered as holding any right or entitlement 'directly' and what would be considered as holding any right or entitlement 'indirectly'.

As per the SBO Rules, if an individual (acting alone or together or through one or more persons or trust) is entitled to exercise or actually exercises, significant influence or control, in any manner other than through direct holdings alone, then such individual will be considered to be a SBO.

The term "significant influence" has been defined to mean "the power to participate, directly or indirectly, in the financial and operating policy decisions of the LLP but is not control or joint control of those policies." (emphasis added)

d) The SBO Rules mandate filing a declaration in Form No. LLP BEN-1 for individuals who become SBOs or change ownership. The AIF must also file a return in Form No. LLP BEN-2 within 30 (thirty) days of receipt of declaration in Form No. LLP BEN-1, along with prescribed fees. Additionally, the AIF must maintain a register of significant beneficial owners in Form No. LLP BEN-3, open for inspection during business hours.

Until now, it was not common for information of 1 (one) investor to be made accessible to other investors of the AIF.

Further, apart from the sponsors and managers of AIFs, the investors of the AIFs also undergo 'know your customer' verification. Given that AIFs are already regulated by SEBI, it is unclear whether applying the SBO Rules to AIFs was needed.

2. **Evergreening and AIFs**

The Reserve Bank of India's recent circular dated December 19, 2023, seeks to restrict evergreening of debt by banks/NBFCs through investments in AIFs. While the intent behind this circular is well received, the implications seem far reaching. For a detailed analysis, please refer to the JSA Prism of December 21, 2023.

3. **Dematerialisation of units issued by AIFs**

a) In October 2018, dematerialisation of shares of unlisted public companies was mandated. In October 2023, dematerialisation of shares of private companies (that are not small companies) has also been mandated. SEBI, in its consultation paper dated February 3, 2023, proposed dematerialisation of units issued by the AIF. The consultation paper did acknowledge the concerns raised by the Alternative Investment Policy Advisory Committee ("**Committee**") in its meeting held on October 11, 2022. While in-principal agreeing with the proposal of dematerialisation of AIF units, the Committee also raised certain concerns such as (i) administrative hassle/ burden for foreign investors to open demat account; and (ii) transferability of AIF units without the knowledge or control of the managers of AIFs.

b) The AIF Regulations have been amended and notified on June 15, 2023 to include regulation 10(aa) which requires AIFs to issue units in dematerialised form subject to the conditions specified by SEBI from time to time.

c) This was followed by the SEBI circular dated June 21, 2023, which stipulated the dates for dematerialisation of units already issued or to be issued.

Further, recognizing the possibility of unauthorized transfer of dematerialised units, SEBI, in its circular dated June 21, 2023, has clarified that the terms of transfer of AIF units held by an investor will continue to be governed by the terms of fund documents. However, the transfer restrictions under the fund documents may not be adequate, and the managers of AIFs may consider putting in place adequate mechanisms that restrict unauthorized transfer of units.

d) A subsequent SEBI circular dated December 11, 2023, specifies process and stipulates timelines to be followed for crediting the existing units or new units that are to be issued, in demat form, in cases where investors are yet to provide their demat account details to AIFs and also in cases where investors have provided their demat account details to AIFs. The circular *inter alia* provides as under:

   i) Units already issued by schemes of AIFs to existing investors who have not provided their demat account details, are required to be credited to a separate demat account named "Aggregate Escrow Demat Account". This account is permitted for the sole purpose of holding demat units of AIFs on behalf of investors. New units to be issued in demat form must be allotted to such investors and credited to the Aggregate Escrow Demat Account. As and when such investors provide their demat account details to the AIF, their units held in Aggregate Escrow Demat Account should be transferred to the respective investors' demat accounts within 5 working days. No transfer of units of AIFs from/within Aggregate Escrow Demat Account will be allowed, except as above.

   ii) The last date for completion of credit of demat units to (x) demat accounts of investors who have provided demat account details, and (y) Aggregate Escrow Demat Account, for those who have not provided demat account details is January 31, 2024 for schemes with corpus ≥ INR 500 crore (Indian Rupees five hundred crore) (as on October 31, 2023) and May 10, 2024 for schemes with corpus < INR 500 crore (Indian Rupees five hundred crore) (as on October 31, 2023).

   iii) Units of AIFs held in the Aggregate Escrow Demat Account can be redeemed. The proceeds can be distributed to respective investors' bank accounts with full audit trail of such transaction.

   iv) The AIF industry and depositories are required to adopt implementation standards formulated for compliance with the circular, by the recently set up Standard Setting Forum for AIFs ("**SFA**"), along with the 2 (two) depositories jointly, in consultation with SEBI. Such standards will include formats for information to be maintained by managers of AIFs with respect to holdings and transactions in the Aggregate Escrow Demat Account and reporting thereof to depositories and custodians. In this regard, CDSL Central Depository Services (India) Limited and the National Securities Depository Limited have already issued instructions in relation to opening of the Aggregate Escrow Demat Account in the month of December 2023.

   v) Managers of AIFs are required to adhere to such implementation standards. Such standards are required to be published on websites of the depositories and the industry associations which are part of the SFA, i.e., Indian Venture and Alternate Capital Association (IVCA), PEVC CFO Association and Trustee Association of India, within 45 (forty five) days of issuance of the aforesaid circular.

   As per the aforementioned circulars, all existing and new investments in AIFs must be held in dematerialised form.

   While demat of securities and units may not be a cumbersome process, opening of demat accounts by investors, especially by foreign investors or non-resident Indians can be time-consuming.

The process/implementation standards issued from time to time with respect to the Aggregate Escrow Demat Account and related matters should provide some relief and direction to the AIF industry.

4. **Dematerialisation of investments held by AIFs**

   a) In its meeting held on November 25, 2023, SEBI required AIFs to hold their investments in dematerialised form. SEBI has *inter alia* approved the following amendments to be made to the SEBI (Alternative Investment Funds) Regulations, 2012 (the amendments are still to be made):

      i) Any fresh investment made by an AIF after September 2024 must be held in dematerialised form.

      ii) The existing investments made by AIFs made prior to September 2024 have been exempted from the aforesaid requirement, except in the following cases:

         (A) Where the investee company has been mandated under applicable law to facilitate dematerialisation of its securities.

         Given that all private companies (that are not small companies as per the audited financial statements of the period ended March 31, 2023) are also required to dematerialise their securities by September 2024, most of the existing investments made by the AIFs are likely to not benefit from this exemption.

         (B) Where the AIF, on its own, or along with other SEBI registered intermediaries/entities which are mandated to hold their investment in dematerialised form, has control in the investee company.

      iii) The exemption will also apply to:

         (A) Liquidation schemes of AIFs.

         (B) Schemes of an AIF whose tenure (not including permissible extension of tenure) ends within 1 (one) year from the date of this requirement is notified.

         (C) Schemes of an AIF which are in extended tenure as on the date this requirement is notified.

5. **Appointment of custodian**

   Previously, only Category I and II AIFs with a corpus of more than INR 500 crore (Indian Rupees five hundred crore) and Category III AIFs were required to appoint a custodian. However, in its meeting held on November 25, 2023, SEBI has mandated that all AIFs must appoint a custodian. In this regard, SEBI has permitted an associate of manager or sponsor of the AIF to act as a custodian, subject to conditions that are similar to those prescribed under the SEBI (Mutual Funds) Regulations, 1996 in relation to appointment of a related party of sponsor of a mutual fund as its custodian.

Conclusion

Some of these measures are aimed at digitization and strengthening investor protection, which are welcome. However, it is hoped that such measures do not add to the ever-increasing operational costs of the AIFs, which ultimately get passed on to the investors.

Further, as discussed in our update of December 21, 2023, there is an urgent need to revisit the circular issued on December 19, 2023, in connection with evergreening as it has several unintended consequences and imposes an onerous compliance burden on fund managers.

Investment Funds Practice

JSA advises fund managers as well as investors in funds. It has advised fund managers on structuring and establishment of a range of funds, both onshore and offshore with varied investment objectives and for investment in various types of asset classes. JSA has also advised domestic and foreign investors that invest in Indian alternative investment funds. We have been involved in the establishment of, or investments in, onshore alternate investment funds registered with SEBI, as well as offshore foreign venture capital investors and offshore private equity funds set up to make investments under the foreign direct investment route to invest in India. We have also advised on foreign portfolio investor funds established outside India which are registered with the Indian securities regulator. We advise clients on the structuring of their funds, including the choice of domicile and vehicle, having regard for the need to achieve optimum tax efficiency for the investors and the manager, marketing and regulatory considerations and any specific issues arising because of the proposed asset class(es) in which the fund will invest. We also assist our clients in their applications with SEBI for various types of fund registrations.

This Prism has been prepared by:

Aashit Shah
Partner

Arrchana A Panchall
Partner

Chambers TOP RANKED Asia-Pacific 2023 JSA	The LEGAL 500	asialaw OUTSTANDING FIRM 2023-24
17 Practices and 24 Ranked Lawyers	16 Practices and 11 Ranked Lawyers	19 Practices and 19 Ranked Lawyers
IFLR 1000 TOP TIER FIRM 2023	INDIA BUSINESS LAW JOURNAL BEST OVERALL LAW FIRMS 2023 LAW ASIA	ALB EMPLOYER OF CHOICE 2021 THOMSON REUTERS
11 Practices and 39 Ranked Partners **IFLR1000 APAC Rankings 2022** --- Banking & Finance Team of the Year --- Fintech Team of the Year --- Restructuring & Insolvency Team of the Year	Among Top 7 Best Overall Law Firms in India and 9 Ranked Practices --- 11 winning Deals in IBLJ Deals of the Year --- 10 A List Lawyers in IBLJ Top 100 Lawyer List	Banking & Financial Services Law Firm of the Year 2022 --- Dispute Resolution Law Firm of the Year 2022 --- Equity Market Deal of the Year (Premium) 2022 --- Energy Law Firm of the Year 2021
BENCHMARK LITIGATION	vahura	
7 Practices and 2 Ranked Lawyers	**Ranked #1** **The Vahura Best Law Firms to Work Report, 2022** --- Top 10 Best Law Firms for Women in 2022	

For more details, please contact km@jsalaw.com

jsa
advocates & solicitors

Ahmedabad | Bengaluru | Chennai | Gurugram | Hyderabad | Mumbai | New Delhi