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Regulatory Considerations Impacting Lp-Gp Negotiations For Indian Funds

Contributor

Cyril Amarchand Mangaldas

Vivaik Sharma

Partner | vivaik.sharma@cyrilshroff.com

Divya Laxman

Associate | divya.laxman@cyrilshroff.com

Kartik Dhir

Associate | kartik.dhir@cyrilshroff.com

Sneha Raheja

Associate | sneha.raheja@cyrilshroff.com

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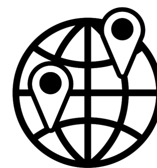
REGULATORY CONSIDERATIONS IMPACTING LP-GP NEGOTIATIONS FOR INDIAN FUNDS



Introduction

In the past few years, domestic funds registered with the Securities and Exchange Board of India ("**SEBI**") as alternative investment funds ("**AIFs**") have emerged as preferred structures for raising and deploying global capital in India. The total number of AIFs in India have increased from ~700 AIFs in the year 2020, to ~970 AIFs registered with SEBI as of July 2022, with cumulative commitments of ~ 87 billion US$ and deployed capital of ~ 39 billion US$.

In the past few years, global investors including sovereign wealth funds, and multilateral institutions and corporates have become accustomed to the idea of investing in Indian funds. Factors contributing to the prominence of AIFs amongst LPs and GPs are the ability to raise foreign capital without regulatory approvals, streamlined regulatory regime, and favourable tax treatment for specific categories of AIFs. In view of an uptick in the popularity of AIFs, SEBI has turned its focus to strengthen regulatory norms for AIFs, aiming to boost good governance and fair play between LPs and GPs. However, in certain instances, the regulatory vigilance has led to improvised and simplistic 'solutions' being introduced in the regulatory framework, overstepping the commercial freedom in negotiations.

In this article, we analyse some of the recent regulatory updates concerning AIFs and their bearing on the LP-GP negotiations. Further, we explore a few workable alternative solutions and structures which may be considered by LPs and GPs.

Co-investment Portfolio Management License Requirement for Managers

Globally, co-investments are used as a key attraction by GPs to offer to sophisticated LPs the ability to participate in investment opportunities by investing alongside the fund. Fund managers in India too, have been using co-investment as a tool to enable investors to increase their stakes in specific portfolio entities, in addition to their exposure in the blind pool.

Until recently, offering co-investment was envisaged as an activity ancillary to the manager's main activity of managing the AIF, which did not require any additional licenses to be procured from the regulators. However, in November 2021, SEBI issued a circular specifying that managers of AIFs would mandatorily require an additional license i.e. co-investment portfolio manager license ("**CPM License**") from SEBI to be able to offer co-investment opportunities. Further, the circular provides that a CPM License holder may only offer co-investment opportunities to the AIF's investors and that such CPM License holder shall be required to ensure that the terms and timing of co-investments shall be identical

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to the terms of investments and timing of exit by the AIF.

While SEBI has granted some dispensations for managers of category I and II AIFs for easing the registration process, the overall compliance obligations would increase for all such AIF managers. Importantly, the restrictions on the terms and the timing of co-investments and exit being identical with the terms and timing of investments by the AIF, to some extent defeats the very purpose of co-investments. Typically, a co-investor would have a different investment horizon and risk appetite in comparison with the blind pool investors and may want to retain flexibility on the terms and tenure of holding co-investments. Further, a manager may not be able to meet its regulatory obligations stated above without requiring each co-investor to furnish a ‘power of attorney’ in its favour, thereby enabling the manager to effect exit transactions for co-investors simultaneously with the AIF. In addition to the above, a CPM license holder would not be able to offer co-investment opportunities to persons who are not investors in the AIF.

SEBI’s rules regarding co-investments being offered by managers have impacted their ability to offer co-investments as ‘deal sweeteners’ to LPs. In certain cases, deals may be sourced independently by other entities in the manager’s group (like a non-banking finance company, an investment advisor, a wealth advisor or asset manager) which may be allocated to the fund manager and any co-investors. However, considering that the CPM regime is in its nascent stage, clarity is yet to emerge on such aspects. It is hoped that SEBI would take note of these complications and make suitable adjustments to its regulatory framework.

Priority in distributions for investors

In addition to the blind pool construct, the AIF platform has catered to various curated investment structures wherein a ‘club’ of likeminded sophisticated investors would participate. In such cases, certain investors may agree to receive subordinated returns, while allowing other investors to receive distributions in priority (typically, until a capped amount), for various commercial reasons like providing a ‘first-loss’ cover to other investors, or to take higher returns at a later stage. However, in the recent past, SEBI has clamped down on funds offering priority in returns to one investor over another investor. SEBI’s rationale seems to be based on the intrinsic nature of AIFs as ‘pooled investment vehicles’, wherein all investors are expected to receive proportionate economic returns.

From a practical standpoint, priority in returns is usually offered by managers to LPs seeking to ‘spice-up’ returns for investing in distressed assets, and thus seek to accommodate investors with different risk and reward appetites. Further, there are other structures under the Indian legal framework (like, issuance of ‘pass through certificates’ issued by securitisation trusts under the guidelines of the Reserve Bank of India) under which it is possible to structure junior and senior tranches of investment amongst different investors. The priority distributions construct is usually offered to sophisticated investors with complete disclosure, and subordination is agreeable to investors seeking higher returns for partaking in relatively higher risk due to subordinate economic interest.

SEBI’s position on investors of AIF having priority of distributions vis-à-vis other investors places serious embargo on domestic fund structures in comparison with Singapore, Mauritius, and other prominent jurisdictions for structuring India-focused funds. There is a strong case for such structures being allowed, subject to adequate disclosures. and checks and balances, so that AIFs remain attractive for

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sophisticated LPs seeking customised terms of participation in returns.

LP participation in decision making

While it is imperative that the governance and decision making for an AIF vests in the manager, it is also customary for institutional LPs to seek rights to participate in the decision-making process of fund vehicles. Participation of investors in key decisions improves the overall governance of the fund, and ensures LP-GP alignment. However, SEBI has created various impediments for investors, especially overseas investors, to participate in the key investment decisions of an AIF.

Firstly, SEBI has explicitly decided not to process applications for registration of funds wherein any member of the investment committee ("**IC**") of the fund is not a person resident in India. This, to some extent, compromises the ability of overseas LPs to appoint representatives to ICs. Secondly, SEBI has mandated merchant bankers (who diligence the registration applications for AIF) to categorically confirm whether investors have any role in approving investment decisions of the fund. Lastly, SEBI regulations have been amended to provide that any external members (i.e. other than employees, directors or partners of the manager) who are not specifically named in the offer document cannot be appointed to the IC except with approval of at least 75% of investors by value of their investments in the fund.

Although, SEBI's intent seems to be ensure that the liabilities linked to decision making vest with the fund manager; the above conditions create a retrograde impediment on the ability of LPs seeking active participation in investment decisions of the fund. Having stated the above, there may be certain alternative solutions to enable investor participation in the functioning of the fund. As such, the investor nominee to the IC may act as an observer to the IC without voting rights. Alternatively, the IC may be set up as a recommendatory body whose advice is not binding on the manager of the fund, in which case the limitations placed by the regulations should disapply to some extent. Further, LPs may insist on appointment of independent representatives to the IC. LPs may also seek participation in a limited partner advisory committee ("**LPAC**"), which could be empowered with decision-making on specific matters like conflicts of interest, removal of the manager, key person event, etc.

Restriction on Investments from 'Nations with Land Border with India'

As per the FDI policy of India, an entity of a country which shares land border with India, or the beneficial owner of an investment into India who is situated in or is a citizen of any such country, shall invest only with approval from the Government of India. Provided that in the event of transfer of ownership of any existing or future FDI in an entity in India, directly or indirectly, resulting in the beneficial ownership falling within the restriction or purview of the above statement, such subsequent change in beneficial ownership shall also require government approval. The FDI policy clarifies that a multilateral bank or fund, of which India is a member (such as the World Bank Group, Asian Development Bank, etc.) shall neither be treated as an entity of a particular country, nor shall any country be treated as the beneficial owner of the investments of such bank or fund in India.

Considering the above conditions of the FDI policy, SEBI now requires fund managers to confirm that the AIFs managed by them would not be accepting capital from entities or persons from such jurisdictions.

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Interestingly, the FDI policy does not stipulate any thresholds for determining 'beneficial ownership' and does not provide any guidance as to how such determination should be made. In the absence of clarity based on the letter of the law or formal guidance from the regulators, market participants (including investors and authorised dealer banks) have relied on analogous definitions used in other legislation to guide their applicability for interpreting the FDI policy. The two key statutes that are considered in this context are the Companies Act, 2013 and Prevention of Money Laundering Act, 2002 and the rules thereunder ("**PMLA**") which define 'beneficial ownership'.

To comply with the above requirements, AIF managers may require investors seeking to invest in India, to furnish declarations or undertakings in respect of their beneficial owners not being situated in or citizens of any country with which India shares a land border. However, the uncertainties under the legal framework pertaining to the threshold of 'beneficial ownership', other commercial considerations like LP confidentiality, and the multi-jurisdictional structure of classical overseas funds, often require an assessment as to the feasibility and the extent of which such confirmations may be provided.

Side letters

Often, investors seek special rights on account of their status, governing policies, or their sizeable investment in the fund. Such rights may include a most favoured nation treatment, excuse, affirmative rights, conditions for reinvestment, reporting and information rights, independent valuation, audit, etc. Side letters or letter arrangements are a means of formalising such negotiated arrangements between an AIF and an investor, while keeping the arrangement confidential and limited to the concerned LPs. A side letter is usually drafted in a manner to supplement and override the terms of the fund documents to the extent of its applicability to the concerned investor. In the Indian context, it is important to visit the restrictions or limitation placed by SEBI on the ability of fund managers to enter into side letters.

SEBI requires a disclosure of a list of commercial and non-commercial terms on which differential rights may be offered through issue of side letters to specific investors, in the offering document of the AIF. Further, the regulations prescribe a duty of an AIF manager to ensure that the terms of side letters do not have any adverse impact on the economic or other rights of other investors. Further, SEBI has mandated that differential rights shall not be offered for preferential exit from fund/scheme, contribution to indemnification, giveback and drawdowns from investors (except as per the provision for 'excuse and exclusion'). Such restrictions are relevant and need to be adhered to during fundraising negotiations.

GIFT City: An Alternative?

Although the increased regulatory oversight is prescribed for AIFs to boost good governance and safeguard investor protection, it is important for GPs to note that regulatory conditions may have a bearing on their ability to curate fund terms. While compliance with the AIF regulations is principally an obligation of the fund manager, LPs may face challenges in enforcing contractual obligations which are not within the four-walls of the regulatory framework. Several representations from industry associations have been made to the regulator and it is hoped that appropriate regulatory changes would be made to ensure competitiveness of the AIF regulatory framework.

To some extent the challenges posed by the Indian regulations may be resolved for investors participating in a feeder vehicle channelising capital into the AIF. Notably, the International Financial

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Services Centre ("**IFSC**") in the Gujarat International Finance Tech-City ("**GIFT City**"), which is being developed as an international financial hub, offers an alternative regulatory framework for funds, including for feeder funds. Specific restrictions of the AIF Regulations are not included in the IFSCA (Fund Management) Regulations, 2022 ("**IFSC Funds Regulations**"), granting it the potential of becoming a preferred jurisdiction for fund management. The IFSC aspires to compete with globally acclaimed financial services jurisdictions like Singapore and London; and is governed by the IFSC Authority, which has notified the IFSCA Funds Regulations permitting registered fund management entities to launch funds or schemes in IFSC ("**IFSC Funds**").

IFSC Funds Regulations offer higher operational flexibilities like the ability to employ leverage or borrowing at the IFSC Fund level (subject to appropriate disclosure to investors), offer co-investment units at the fund level, make 100% investments in a single portfolio investment, and to invest in overseas entities without requiring regulatory NOCs on a case-by-case basis, each of which is restricted under the SEBI AIF Regulations. Various favourable tax provisions have been notified for IFSC Funds and their managers, including a waiver from levy of goods and services tax. Additionally, non-resident investors making investments into units of an IFSC Fund are not required to obtain a tax account number, or file income tax returns in India.

Notably, IFSC Funds are deemed to be 'persons resident outside India' under the Indian foreign exchange regulations and are treated at par with foreign investors under the FDI policy of India. The IFSC Funds Regulations require fund management entities ("**FMEs**") to register themselves with the IFSC Authority, and such fund managers must possess relevant fund management experience and necessary infrastructure in IFSC.

To summarise, the IFSC offers an attractive, flexible and cost-efficient alternative for setting up India-focused funds. However, challenges such as developing infrastructure, talent shortage, treatment of foreign investors, inability to pool domestic and global capital for investment into India, and a nascent regime currently limit the applicability and relevance of the IFSC regime.

Contributors

Vivaik Sharma
Partner
vivaik.sharma@cyrilshroff.com

Divya Laxman
Associate
divya.laxman@cyrilshroff.com

Kartik Dhir
Associate
kartik.dhir@cyrilshroff.com

Sneha Raheja
Associate
sneha.raheja@cyrilshroff.com

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