

Investment Funds: Monthly Digest

July 01, 2020

DISCLOSURE STANDARDS FOR AIFS: RECENT UPDATES

BACKGROUND

In a landmark step, the Securities and Exchange Board of India ("SEBI") issued a circular dated February 05, 2020 providing for certain disclosure standards to be followed by SEBI registered Alternative Investment Funds ("AIFs") in India (the "Original Circular").

The Original Circular was issued taking into account public comments received pursuant to a Consultation Paper published on December 04, 2019, whereby SEBI first provided the "Introduction of Performance Benchmarking" and "Standardization of Private Placement Memorandum (PPM) for AIFs". Through the Original Circular, SEBI introduced (a) template(s) for PPMs for Category I AIFs and Category II AIFs on one hand and Category III AIFs on the other; (b) annual audit to verify compliance with the terms of the PPM; and (c) performance benchmarking.

Subsequently, on June 12, 2020, SEBI issued a new circular ("New Circular" and together with the Original Circular, the "Circulars") clarifying the mechanism and timelines for compliance specifically in relation to the annual audit requirement and performance benchmarking as introduced under the Original Circular.

While the New Circular has provided some clarity in terms of compliance timelines, there continues to remain certain unanswered questions with respect to compliance with the Original Circular.

In this issue of the monthly digest, we have discussed key recent updates on compliance by AIFs with the Circulars.

ANNUAL AUDIT

The PPM is a risk disclosure document used in the process of marketing of an AIF to its potential investors. It contains *inter-alia* the information based on which an investor should be able to determine whether to participate in the AIF viz. the commercial terms for investor participation, the investment thesis of the AIF and the management team and in a similar vein, the risk factors, potential conflict of interest situations and legal, regulatory and tax implications, should the investor decide to participate in the AIF.

With a view to ensure that the management team is in compliance with the aforementioned terms as populated by it under the PPM, SEBI (under the Original Circular) introduced a new requirement for annual audits of the PPM, whereby AIFs are required to conduct an audit of compliance with their PPM terms annually either through an internal or external auditor / legal professional. The Original Circular has also mandated certain reporting requirements whereby findings of the audit along with any corrective measures are to be reported to the trustee, board of directors or designated partners of the AIF (as applicable), the board of directors of the investment manager and SEBI. However, SEBI did not provide the timeline for beginning such compliances under the Original Circular.

Through the New Circular, SEBI has clarified that the annual audit should be conducted at the end of each financial year and the findings should be reported to the aforementioned parties within 6 months from the end of such financial year.

Similarly, the Original Circular carved out (i) angel funds in general; and (ii) AIFs / schemes of AIFs in which each investor has committed a minimum of INR 70 crores (USD 10 million or equivalent, in case of capital commitment in non-INR currency), from the requirement of template PPMs and annual audits subject to the investor providing a waiver to the Investment Manager, permitting it to be carved out from these requirements.

Further to the above, the New Circular has also deferred the annual audit requirement for AIFs which have not raised any funds from investors, provided that, the Fund submits a certificate from a chartered accountant confirming the same within 6 months from the end of the financial year. Further, SEBI has also clarified that in respect of (a) annual audit compliance; or (b) provision of certificate of chartered account in respect of AIFs that have not raised funds, for the financial year 2019-20, the compliance process along with reporting or in the case of exempt AIFs that have not raised funds, the provision of the chartered accountant certificate shall be completed on or before December 31, 2020.

While the aforementioned amendments under the New Circular have set clear timelines for complying with the audit requirement, some concerns surrounding the annual audit requirement are yet to be addressed. For example, given that the annual audit requirement was introduced along with the template PPM, the templates provided by SEBI contain notes clarifying whether a certain section of the PPM is required to be audited. Similarly, while the text of the Original Circular provides a broad list of sections for which audit may be optional viz. risk factors, legal, regulatory and tax considerations and track record of first time managers, this has been deemed optional by SEBI upon referring to the templates prescribed by it. Since the annual audit requirement is also applicable to PPMs which are not required to follow the SEBI templates viz. closed-end AIFs which have completed Final Closing prior to the effective date of the Circulars, it is still unclear as to the which section is required to be audited with respect to such non-template PPMs (as they may not contain sections in a form as provided under the template viz. track record of

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experienced managers). This could leave room for interpretation as auditors will have to compare the sections under the template PPM which have to be audited and whether such sections are also present under the non-templated PPMs and accordingly, carry out the audit process. Similarly, the text of the Original Circular provides that the annual audit could be done either through an internal or an independent auditor / legal professional however, Section V (*Governance Structure*) of the template PPMs for Category I AIFs, Category II AIFs and Category III AIFs specifically mentions that the annual audit is to be conducted by an independent auditor. While this constitutes a discrepancy, the text of the Original Circular (being the governing provision) should prevail over the text of the template PPM in this regard.

PERFORMANCE BENCHMARKING

With a view to create a comparison mechanism between the AIF industry and other investment avenues and global investment opportunities, the Consultation Paper had proposed a performance benchmarking mechanism and consequently, the Original Circular introduced (a) mandatory benchmarking of the performance of AIFs (including venture capital funds) and the AIF industry; and (b) a framework for facilitating the use of data collected by Benchmarking Agencies to provide customized performance reports. Under the Original Circular, SEBI delegated the authority to appoint such Benchmarking Agencies for carrying out the benchmarking process to any industry association which in terms of membership, represents at least 51% of the number of AIFs. However, the New Circular has diluted this threshold from 51% to 33%.

Accordingly, the industry association that satisfies the membership threshold set under the New Circular may appoint one or more Benchmarking Agencies, enter into an agreement with them covering the mode and manner of data reporting, the kind of data that is to be reported and confidentiality terms in relation to the data that shall be received by the Benchmarking Agency from all AIFs and VCFs. Thereafter, the industry association shall set a timeline within which all AIFs and VCFs are required to report the data to the Benchmarking Agency. The Original Circular had set a deadline of July 01, 2020 within which the data so reported was to be collated by the Benchmarking Agency and along with the association, the first industry benchmark and AIF level performance versus Benchmark Reports were to be made available for the performance up to September 30, 2019. SEBI also mandated for the industry association to provide a monthly progress report to SEBI in terms of collection and collation of data. However, in light of the recent pandemic, through the New Circular, SEBI has extended this deadline from July 01, 2020 to October 01, 2020. Separately, it has also been noted that AIFs have received emails from SEBI requiring certain information in respect of such AIF and also the designated contact person. This could constitute as an initial collation of AIF information by SEBI to understand the length of benchmarking process.

On a perusal of the above, it is pertinent to note that while the New Circular has reduced the membership threshold (which should pave the way for more industry associations to satisfy the condition) and extended the industry benchmark timeline, it has not clarified whether an industry association shall be officially identified by SEBI or whether an industry association is *ipso facto* an industry association eligible to appoint Benchmarking Agencies upon satisfying the membership threshold. Given that this is a delegation of authority by the regulator, there should be an official appointment / acknowledgment by SEBI of the industry association(s) which satisfy(ies) the membership threshold and accordingly, has the right to appoint Benchmarking Agencies. Separately, given the vast amount of data sought to be collected and processed to provide an industry benchmark of AIF performance from 2012 onwards, the aforementioned authorities should be appointed at the earliest, so they can consider and publish the manner in which AIFs are required to provide the requisite data. This could further help in providing AIFs with adequate time to collate the data in a manner as required by the Benchmarking Agencies and avoid any last-minute confusion.

In summary, it is pertinent to note that the Original Circular had introduced enhanced reporting / disclosure requirements for AIFs, an industry which until now enjoyed flexibility given the light touch regulations on account of its sophisticated investor base. While the New Circular has assisted in clarifying the timelines for compliance, it could have gone a little further in its scope in terms of providing additional clarifications and guidelines on the application of the Original Circular.

– **Blanche Dsouza & Nandini Pathak**

You can direct your queries or comments to the authors

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