Due Diligence reforms for Alternative Investment Funds: SEBI's

On 8th October 2024, Security Exchange Board of India ("**SEBI**") issued a circular aimed at reinforcing the due diligence process for Alternative Investment Funds (**"AIFs"**)[1]. This circular is designed to ensure that AIFs, their managers, and key personnel adhere to strict standards when evaluating their investors and investments.

Key Aspects of SEBI's Circular:

1. **Enhanced Due Diligence for Investors and Investments:** According to the circular, AIFs must carry out specific due diligence for both their investors and their investments. This due diligence is aimed at ensuring that AIFs do not act as a vehicle for circumventing existing laws. For instance, investors who might not qualify as Qualified Institutional Buyers (QIBs) or Qualified Buyers (QBs) on their own cannot use AIFs to avail the benefits designated for such entities.

2. **Focus on High-Contributing Investors:** SEBI's circular mandates that for any scheme where a single investor or group of investors contributes 50% or more of the corpus, specific due diligence must be performed. This is particularly crucial for funds availing QIB benefits under SEBI's Issue of Capital and Disclosure Requirements (ICDR) Regulations or QB benefits under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act).

3. **Addressing Ever-Greening of Stressed Assets:** Another critical issue SEBI has addressed through this circular is the ever-greening of stressed assets by regulated lenders. Some RBI-regulated entities have been known to use AIFs to 'ever-green 'their non-performing assets by masking the true financial health of the underlying investments. To curb this practice, SEBI has imposed restrictions on AIF schemes where the manager or sponsor is an RBI-regulated entity, or where an investor contributes 25% or more to the corpus. These schemes must ensure that their investments do not indirectly enable RBI-regulated lenders to acquire stakes they are not permitted to hold directly.

4. **Investments from Countries Sharing Borders with India:** SEBI's circular also highlights concerns about foreign investments from entities or individuals located in countries that share land borders with India. Given the geopolitical sensitivities, such investments are subject to strict scrutiny. AIFs must ensure that any investment from these countries is in line with the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, and requires government approval. Specifically, if 50% or more of a scheme's corpus is contributed by investors from such countries, additional due diligence must be performed. Moreover, if these schemes acquire 10% or more of

[1] SEBI Circular on Specific due diligence of investors and investments of AIFs, https://www.sebi.gov.in/legal/circulars/oct-2024/specific-due-diligence-of-investors-and-investments-of-aifs_87434.html *(Last visited on 09 October 2024)*

the equity in any investee company, they must report these holdings to their custodians and SEBI.

5. **Implementation and Compliance Standards:** To operationalize these due diligence requirements, SEBI has tasked the Standard Setting Forum for AIFs ("**SFA**") with formulating implementation standards. These standards will be adopted by all AIFs and their managers, ensuring a uniform approach across the industry. The compliance will also be reflected in the 'Compliance Test Report, 'which must now include provisions related to this circular. AIF managers must ensure that they are fully compliant with these standards, as any failure to perform the required due diligence could lead to severe penalties, including the exclusion of certain investors from the fund or a prohibition on making specific investments.

The Bigger Picture: Why This Matters

This circular is part of SEBI's broader efforts to regulate the alternative investment sector and bring it in line with international best practices. As AIFs continue to grow in influence, both in terms of the amount of capital they manage and the sectors they impact, it is crucial that they operate with full transparency and accountability.

For investors, this circular provides an added layer of protection, ensuring that their interests are safeguarded, and that they are not unknowingly exposed to undue risks. For fund managers, it represents a call to adopt more robust governance practices and to remain vigilant in maintaining compliance with regulatory requirements.

The introduction of stricter due diligence measures is particularly timely, given the evolving nature of India's financial landscape. With increasing foreign investment and the rise of new asset classes, SEBI's initiative will help create a more stable and trustworthy investment environment.

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