

Investment Funds: Monthly Digest

November 09, 2021

GOVERNANCE OF AIFS: IN CONTRAST WITH CORPORATE GOVERNANCE

Alternative Investment Funds (“AIFs” or “Funds”) are primarily instituted as private trusts in India, even though the Securities and Exchange Board of India (“SEBI”) allows an AIF to be instituted as a company, a limited liability partnership, a trust or as any other body corporate, for well-known reasons including for ease of defining governance norms. In effect, the governance of AIFs set up as trusts are primarily driven by Limited Partners (“LP”)-General Partners (“GP”) negotiations, with (what was originally intended to be) a light-touch regulatory supervision by SEBI.¹

AIFs differ fundamentally from operational corporations, not just in terms of the type of investments that the entities make but also in their legal nature, where (unlike an operating entity) an AIF is both a legal entity and a financial product.

Several guidelines have been introduced globally for better monitoring of fund governance. These include the Institutional Limited Partners Association (ILPA) revised Private Equity Principles which establish a set of best practices to govern the relationship between GPs and LPs² as well as the second version of the UNEP Finance Initiative for Responsible Investment (UNPRI) guide issued in 2011,³ guidelines from the European Private Equity and Venture Capital Association (EVCA), the Australian Private Equity & Venture Capital Association Limited (AVCAL). The increased focus has also led to the development of principles and jurisprudence on the negotiation of fund terms related to better fund governance.⁴

The LP-GP relationship is that of a fiduciary where the LPs entrust the fund managers with their investable funds to be utilized by the GP, through the investment funds, as per an identified investment strategy which is designed with the expertise and resources of the concerned managers.⁵ While this may seem akin to a typical investor-management relationship that we often see in most legal entities, there are structural differences between the functioning of an operating entity as compared to an investment fund in terms of corporate governance (former) and fund governance (latter).

Such differences should be considered while discussing, designing, and documenting AIF terms, and introducing regulations for AIFs (and other similar investment entities). In this context, we have briefly discussed these concepts in this issue of the monthly digest.

CORPORATE GOVERNANCE VERSUS FUND GOVERNANCE

A lot has been said about fund governance being distinguishable from corporate governance.⁶ Fiduciary relationship in pooling vehicles or collective investment schemes is a bit more complex than a typical agency relationship between management and shareholders.⁷

As opposed to an operational entity, an investment fund’s investors are both the capital provider to and service recipient of the investment fund. It differs from a conventional corporate in the sense that operational entities usually have shareholders who are owners and investors of the capital. For example, in the case of an operational entity that operates in the FMCG industry, the shareholder of such entity could also be its customer i.e. it would consume the products offered by such entity; however, this would be a dual relationship and not a hybrid one, in a sense that both relationships would be separable from each other. However, in case of an investment fund, the status of the unitholder as a customer and an investor are intrinsic to each other. Accordingly, investment funds have a hybrid nature, they are a financial product as well as a legal entity.

Further, unlike operational entities where shareholders do not have the right to retract their capital, other than to dispose from it by way of sale or buy-back by the company, LPs in an investment fund often have the right to retract their capital basis certain contingencies.

MANAGER BEING SEPARATE FROM THE FUND

In addition to matters of governance, investment funds also differ from operating companies in the context of having an external or third-party fund manager. It has been argued that the fund manager is always distinguished as a legal entity from the fund itself for reasons such as the ability of the fund manager to launch multiple funds and ring-fencing of the LPs from the fate of such other funds.⁸

In the context of AIFs specifically, while the AIF manager may be a legal entity separate from the AIF itself, its business and operations are not entirely independent of the AIF. LPs (and even SEBI) require the AIF manager to take their prior consent for any change in control, in addition to the consent requirements which the AIF manager

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would need to take pursuant to its own corporate governance framework and laws applicable to it. Further, LPs typically require any replacement of identified 'key personnel' of the AIF manager to also be subject to the prior consent of the LPs. The fate of the manager entity is, to a large extent, determined by the LPs who are neither members nor directors of the manager entity from a legal perspective. However, it is to be noted that some scholars observe that the separation of fund and management entity often puts the fund and the investment managers in conflicting positions depriving the investors of direct control of those who manage the AIF.

Costs involved in the setting up and operation of a fund could distinguish its performance from other comparable funds managed by the same fund manager.⁹ Such costs could *inter alia* be governed by choice of investment vehicle, choice of jurisdiction and choice of investment management model.

IMPLICATIONS

For investment funds, it is imperative that provisions such as those governing the decision-making process, transparency norms, voting rights given to investors, the inter-se relationship of the fund and the fund manager as legal entities with differing legal objectives (e.g. draw-stop right of LPs in case of criminal acts of key personnel of the fund manager or change in control of the fund manager etc., fund performance impacting the business and profits of the fund manager), representations and warranties by the manager to the investors and vice-versa need to be legislated with due regard to the differences as explained above.

For example, fund boards (or decision-makers) are distinguishable from corporate boards where the 'business judgment' rule does not apply in its purest form. While it is the role of the AIF manager's board to ensure that it carries on its own business of fund management per best practices on corporate governance, the same board is not equipped to ensure whether the AIF is being run per best practices of fund governance.

Earlier this year in June 2021, the Dr. K.P. Krishnan committee appointed by the International Financial Services Centres submitted a report on a specific corporate structure to be introduced for investment funds, on the basis of, *inter-alia* their review of the Variable Capital Company (VCC) structure recently introduced in Singapore.¹⁰ Prior to the introduction of the VCC framework, the Monetary Authority of Singapore had issued a consultation paper inviting comments and feedback on the proposal with a template of the proposed law.¹¹ It is important to note that the reasons (for the introduction of a specific VCC regime) in the paper include segregation of assets and liabilities of different sub-funds, capital structure relevant for investment funds, shareholder meeting requirements relevant in the context of fund governance, corporate governance relevant for funds and winding-up.¹²

In order to introduce a corporate framework specifically for investment funds in India, the above differences should be considered.

– Srishti Chhabra, Nandini Pathak & Parul Jain

You can direct your queries or comments to the authors

¹ 'Given that such capital is in short supply in India, a favourable policy and regulatory environment is essential.', Securities and Exchange Board of India, *Third Alternative Investment Policy Advisory Committee Report* (2018) para 1 (AIPAC, 2018) <https://www.sebi.gov.in/sebi_data/attachdocs/jan-2018/1516356419898.pdf> accessed 14 December 2020.

² ILPA, Private Equity Principles, 3.0, January 2019

³ UNEP, Principles for Responsible Investment (UNPRI), Responsible Investment in Private Equity, A Guide for Limited Partners, 2nd edition (2011).

⁴ Recent Trends in PE Fundraising, Fund Governance Terms and Marketplace Initiatives (Part Two of Two) *available at* <https://www.pelawreport.com/2727896/recent-trends-in-pe-fundraising-fund-governance-terms-and-marketplace-initiatives-part-two-of-two.html>

⁵ T Neal McNamara, 'Fiduciary Responsibility and Investment Limitations' (1974) 9 Real Prop Prob & Tr J 451

⁶ Roiter, Eric D., Disentangling Mutual Fund Governance from Corporate Governance (June 10, 2015). Forthcoming, Harvard Business Law Review, Vol. 5, <https://ssrn.com/abstract=2568392> or <https://dx.doi.org/10.2139/ssrn.2568392> accessed June 15, 2021.

⁷ *ibid* 48.

⁸ John Morley, The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation (March 2014) (YLJ, 23(5)) <https://www.yalelawjournal.org/article/the-separation-of-funds-and-managers-a-theory-of-investment-fund-structure-and-regulation> accessed June 15, 2021.

⁹ William F. Jarvis, Understanding the Cost of Investment Management (October 2015), Commonfund Institute, https://caia.org/sites/default/files/understanding_the_cost_of_investment_management.pdf accessed June 15, 2021.

¹⁰ https://www.business-standard.com/article/finance/india-considers-singapore-s-vcc-model-to-get-funds-for-gift-city-ifsc-121060400120_1.html

¹¹ Monetary Authority of Singapore, 'Consultation Paper on the Proposed Framework for SVACC 2' (March 2017) <https://www.mas.gov.sg/-/media/MAS/News-and-Publications/Consultation-Papers/Consultation-Paper-on-the-Proposed-Framework-for-SVACC-2.pdf> accessed June 15, 2021.

¹² *Ibid* 61.

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