Ref No. SIDBI/ L002265086A/FFS

April 29,2022

To,
All SEBI Registered Cat I & II AIFs.

Sir / Madam,

फंड ऑफ फंड्स फॉर स्टार्टप्स / Fund of Funds for Start-ups :
Modifications in Policy / Framework for Operations

The Fund of Funds for Start-ups (FFS) has been in operation for around 5 years during which course the momentum of operations has increased multi-fold and facilitated growth and encouraging trends in the ecosystem.

Based on day-to-day operations of FFS and regular interactions with AIFs / other stakeholders, it was felt necessary to develop modalities for enabling "accelerated drawdowns" / enhanced deployment of capital to start-ups. Further, a framework was needed to facilitate equitable consideration of requests from fund managers pertaining to certain commercial / operational aspects.

Salient features of the aforesaid are furnished at Annexure for information.

The above framework shall come into force with immediate effect.

भवदीय / Yours faithfully,

[सुबोध कुमार / Subodh Kumar]
महाप्रबंधक / General Manager

Encl : As above

Modifications in Policy / Framework for Operations
Annexure

1. **Accelerated drawdowns:** Change in modalities for quantum of drawdown under FFS with a view to accelerate deployment of funds out of FFS and enhance grass root level fund deployment / multiplier effect.

(a) Quantum of commitment under FFS is capped based on the following matrix:

Fund Corpus Size [Rs. crore]	Eligible % to be covered under FFS	Maximum Eligible Amount [₹ crore]	
<=300	25%	300 x 25%	75.00
>300 <=500	20%	200 x 20%	40.00
>500 <=750	15%	250 x 15%	37.50
>750 <=1000	10%	250 x 10%	25.00
Total			177.50

(b) At present, actual commitment is sanctioned within the cap as worked out above. Based on amount finalised at the time of sanction [say, ₹175 crore for a ₹1000 crore fund], the commitment is also specified as a % of the target corpus [in this case, commitment would be specified as 17.50% of drawable corpus or ₹175 crore, whichever is lower]. Thereafter, drawdown is always subject to a cap at the same % i.e., in this case, at 17.50% of drawable corpus (irrespective of the actual level of drawable corpus).

(c) Going forward, the drawdown shall be released in line with the formula / matrix at (a) above. Thus, even if FFS commitment is capped overall at say, 20% of the corpus size, until the fund has drawable corpus of upto ₹300 crore, drawdown would be permitted at a higher level of upto 25% of the corpus. Similarly, for drawable corpus upto ₹500 crore, drawdown would be permitted upto 25% until drawable corpus of ₹300 crore, 20% for corpus between ₹300 crore - ₹500 crore, and so on.

(d) **Course of action / drawdown formula to be followed when the commitment sanctioned is lower than the maximum / cap as per matrix above:**

(i) There could be such a scenario wherein, say, for a fund of ₹1000 crore, as against cap of ₹177.50 crore or 17.75%, the actual sanction is ₹100 crore or 10% of drawable corpus.

(ii) In such a case, the drawdown shall be released in the same proportion as would have been released in case the commitment is equal to the exposure cap.

(iii) The relevant conditions which presently stipulate FFS drawdown as pro rata to other LPs / capped at the specified % of total amount drawn at fund level will be suitably revised.

(iv) Documentation / related clauses shall be finalised based on vetting / suggestion of empanelled FFS Legal Counsel.

(v) As mentioned, incidental aberrations, if any, on returns on investment arising out of accelerated drawdowns may be ignored given the larger benefit for the ecosystem.

2. Operational aspects of clause relating to breach of terms under FFS.

(a) One of the terms / conditions as per the approved / standardised term sheet for contribution under FFS provides as under:

"In future, at any point of time, if the information submitted by the Fund, is found misleading or incorrect in any manner or in the event of any breach in terms and conditions stipulated, SIDBI shall intimate the same to the fund manager / Trustee. In case, the Investment Manager fails to address the concerns of SIDBI within 30 days, SIDBI shall have the right to cancel the commitment to the fund immediately and SIDBI's contribution already made will be returned with effective interest of 15% p.a."

(b) At the time of considering invocation of the clause or triggering its consequences, the following process may be followed:

(i) breaches of technical / inadvertent / "compoundable" nature, i.e., where the issues can be suitably resolved between the fund / IM and SIDBI based on mutual agreement need not be escalated and may be closed at the level of SIDBI.

(i) for other instances, i.e., where the issues are considered serious or mutual agreement between IM / Fund and SIDBI is not feasible / possible, a committee comprising a member from VCIC, a member from the industry and a member from SIDBI may be constituted for suitable decision / adjudication.

(ii) the final decision in the matter shall be taken by DMD / CMD, SIDBI.

3 Permitting higher share of carry to Investment Managers (IMs) linked to performance of the fund / returns to the investors

Allowing higher carry would be one of the ways to incentivise fund managers to perform better. As a general practice, share of carry to IM may be kept at 20%. However, only in cases where there is a specific request for higher carry from the IM, the same can be considered if other LPs also consider the request. Accordingly, based on the performance of past funds of IM/ rationale provided by IM for higher carry etc, a graded carry in two buckets shall be considered as under:

(i) **If Net cash IRR to the investor exceeds 25% p.a. over the entire fund life:** Higher share of carry of 25% shall be permitted for the IM on the incremental returns earned over and above the returns which have resulted in IRR of 25% p.a. In other words, until net IRR is 25% p.a. or lower, upon meeting the stipulated hurdle rate to investors, carry to IM will remain 20%. Beyond IRR of 25% p.a., on the incremental portion, the carry share of the IM will be enhanced to 25%.

(ii) **If Net cash IRR to the investor exceeds 30% p.a. over the entire fund life:** Similarly, when net IRR to the investor is more than 30% p.a., carry share of 30% shall be permitted to the IM on the incremental returns earned over and above the returns which have resulted in IRR of 30% p.a.

(iii) Either of the above two options / scenarios may be permitted for the same fund. In other words, a single fund should not permit carry share of 25% for return above 25% (and upto 30%) as well carry share of 30% for returns above 30% p.a.

(iv) The carry structure i.e., usual 20% or graded 25% / 30% shall be agreed upon upfront / at the time of sanction and prior to execution of documents.

(v) The overall carry distribution shall as per the allocation structure as agreed to the team and partners by the IM and shall ensure that the higher carry structure/incremental carry shall not be restricted/reserved only to partners/GPs/sponsors.

(vi) The summary of the options at (i) and (ii) above is furnished below:

(a) Higher carry on incremental returns over and above 25% p.a. (net IRR) to investor requested by IM:

Return to the investor in terms of net IRR	Share of Carry to IM	Share of Carry to Investor(s)
Upto 25% p.a.	20%	80%
Higher than 25% p.a.	25% [of incremental returns after / over and above net IRR of 25% p.a. to investor]	75% [of incremental returns after / over and above net IRR of 25% p.a. to investor]

(b) Higher carry on incremental returns over and above 30% p.a. (net IRR) to investor requested by IM:

Return to the investor in terms of net IRR	Share of Carry to IM	Share of Carry to Investor(s)
Upto 30% p.a.	20%	80%
Higher than 30% p.a.	30% [of incremental returns after / over and above net IRR of 30% p.a. to investor]	70% [of incremental returns after / over and above net IRR of 30% p.a. to investor]

(vii) Note: In some cases, IMs have offered a lower management fee for FFS commitment (compared to other investors) subject to IM's share of carry (for FFS commitment only) being enhanced. Such proposals for higher share of carry (for FFS commitment only) as a condition for lower management fee may not be agreed to. Higher carry may be permitted subject to achievement of higher return / performance by the IM as per scenarios indicated above.

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(viii) To sum up, there will be three options available to prospective fund managers for share of carry.

(1) **Option 1:** Usual / normal scenario of 80:20 (Investor: IM); subject to achieving hurdle rate of return.

(2) **Option 2:** Higher share of carry of 75:25 (Investor: IM); for incremental returns over and above net IRR of 25% p.a. to Investor. For returns upto 25% p.a., carry share will be 80:20 (Investor: IM).

(3) **Option 3:** Higher share of carry of 70:30 (Investor: IM); for incremental returns over and above net IRR of 30% p.a. to Investor. For returns upto 30% p.a., carry share will be 80:20 (Investor: IM).

In addition to option 1, either of option 2 or option 3 may be permitted to the AIF, upon recommendation of VCIC.

4. Hurdle Rate with / without catch up:

(i) Some IMs are offering hurdle without catch up albeit with a lower hurdle rate in the range of 8% p.a. (equity funds) as compared to hurdle rate of 10% – 12% p.a. (mostly closer to 10% p.a.) being offered with catch up by other funds. The said IMs have been indicating that hurdle without catch up is more beneficial to the investor. This would be true for funds which deliver returns higher than the hurdle.

(ii) FFS mandate is not entirely focussed on returns and places emphasis on other factors such as impact, innovation, employment, etc. as well. In view of the same, lower hurdle rate without catchup may be accepted subject to the terms offered to FFS being in alignment with terms of other participating investors (or more favourable as compared to other investors).

5. Differential Management Fee:

(a) The issue regarding management fee has been discussed / reviewed from time to time both at the level of VCIC and EC based on ongoing developments in the industry / trends seen in proposals in general.

(b) Mostly, fund managers are open for a lower management fee exclusively for FFS. However, challenges are faced wherein fund managers have already onboarded reputed / institutional investors who may have agreed to a higher fee but have MFN clause. Hence, when a lower fee is agreed for SIDBI, MFN clause is triggered and fee at the entire fund level gets reduced. The same is a constraint for most IMs.

(c) To address such circumstances, a standardized structure offering flexibility in considering management fee is furnished below.

A	Basic management fee	
1	Base Management fee	upto 1.50% p.a
B	Criterion for higher management fee - additions permitted (independent events)	

	– for AIFs investing in / focussed on equity only
1	if the IM is a 1st time Fund manager
2	if corpus is less than ₹500 crore *[it may be mentioned however that operating expenses of upto 0.50% p.a. are permitted for such funds as against 0.30% p.a. for larger funds]*
3	Any other specific parameters including / such as : - fund being oriented towards impact / priority areas (including, say, sustainable development, agro-rural segment, financial inclusion, funding of start-ups with research orientation in areas of national importance, etc.) - fund / IM committing to make investments proposed in tier two / tier-three centres, - fund being women led / focussed on women led start-ups / enterprises, etc. The additions over base fee would be made after assessment on a case-to-case basis taking into account respective fund theses, track record of the IM / key persons (if any), rationale furnished by the IM, etc.

(d) The additions to fee over and above the base / standard management fee of 1.50% p.a. as decided upon may be considered only in case of equity / equity focussed funds.

(e) Higher management fee (than the base fee of 1.50% p.a.) can also be considered after taking an overall view on the total expenses being charged by the IM / fund under different buckets such as one-time fee, operating expenses, etc. Thus, higher management fee could be accepted if the same is offset by lower expenses in other buckets such as operating expenses or one-time / set up fee.

(f) While the Vertical shall have the elbow room / flexibility to recommend the fee structure within the above framework, the final decision shall be taken by VCIC (at the time of recommendation of the proposal) / EC (at the time of sanction).

6. Commitment to AIFs having corpus of more than ₹1000 crore.

(i) In terms of minutes of the review meeting held by DPIIT on May 09, 2018, DPIIT had advised SIDBI that FFS may not make contributions to funds with corpus in excess of ₹1000 crore. Thereafter, any fund with basic corpus of more than ₹1000 crore of corpus size is not being considered for commitment under FFS.

(ii) Several developments (some cited below) have taken place thereafter based on which review of the above guideline is merited:

a. revision in definition of start-ups (with increase in turnover cap from ₹25 crore to ₹100 crore) and consequently, increase in funding requirements of start-ups,
b. requests from the industry,
c. prescriptions / suggestions in the report on "Financing the Start-up ecosystem" of the Standing Committee on Finance
d. recommendation the report on third party evaluation of FFS undertaken by Arun Jaitley National Institute of Financial Management, etc.
e. at the instance of DPIIT, the matter was submitted to VCIC. VCIC recommended the proposal for removal of cap on corpus size subject to certain conditions. The recommendations were submitted by SIDBI to DPIIT

vide letter dated October 05, 2021 (copy enclosed as Annexure I) for approval.

(iii) It is proposed to consider sanction of commitments to AIFs having corpus (excluding greenshoe) of above ₹1,000 crore subject to the following conditions:

(a) The Investment Manager should be a domestic entity.
(b) The IM / key persons of IM entity shall have managed funds to which SIDBI has made commitment in the past.
(c) The exposure to the fund shall be capped at the same level as applicable for funds with corpus of ₹1,000 crore.

7. Timelines for execution of Contribution Agreement and availment of Drawdown.

(i) It has been experienced that post issue of LoI by SIDBI for FFS commitment, fund managers have often been taking inordinately long for finalisation and execution of contribution agreements (CAs). Based on request of fund managers, need based extension of time is being permitted for execution of documents, etc.

(ii) However, delayed execution of CAs is resulting in delay in drawdowns and funds reaching start-ups. DPIIT has also been emphasising on faster deployment of FFS corpus. To address this aspect, it is proposed to incorporate the following stipulation in the LoI as a pre-commitment and pre-disbursement condition:

*"The contribution agreement between contributor, AIF & its trustee shall be executed withing **90 days** from the date of issue of Letter of Intent (LoI). Further, the request for first drawdown shall be raised by the Investment Manager / AIF within **180 days** from the date of issue of LoI. The commitment / sanction shall stand lapsed / cancelled in the event of delays beyond the aforesaid timelines."*

(iii) Commitments which are cancelled / get lapsed on account of the above stipulation may be reconsidered / revisited only after a fresh application is made by the AIFs.

(iv) Additionally, to shorten the timeline between issue of LOI and execution of CAs, vertical is finalising a model contribution agreement in consultation with empanelled legal counsel viz. M/s Trilegal, Mumbai, which shall be shared with all the AIFs at the time of application for commitment under FFS and shall also be hosted in SIDBI's portal for ready reference before applying for commitment under FFS.

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