KHAITAN & CO ADVOCATES SINCE 1911

UPDATE

ERGO

Analysing developments impacting business

INTRODUCTION OF SPECIAL SITUATIONS FUND – STEP TOWARDS DE-STRESSING STRESSED ASSETS

28 January 2022

Introduction

The Securities and Exchange Board of India (SEBI) in its board meeting on 28 December 2021 (Board Meeting) declared the introduction of the 'Special Situations Fund' (SSF), as a new sub-category of Category I Alternative Investment Funds (AIFs) under the SEBI (AIF) Regulations, 2012 (AIF Regulations).

In furtherance of the decision taken in the Board Meeting, SEBI notified the SEBI (AIF) (Amendment) Regulations, 2022 (AIF Amendment) on 24 January 2022 whereby '*Chapter III-B – Special Situation Funds*' has been introduced under the AIF Regulations that govern SSFs.

Investments by SSFs

As per the AIF Amendment, SSFs can invest in '*special situation assets*', which is defined to include the following:

- stressed loan available for acquisition in terms of Clause 58 of Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 (Transfer of Loan Exposure Directions) as amended from time to time or as part of a resolution plan approved under the Insolvency and Bankruptcy Code, 2016 (IBC) or in terms of any other policy of the Reserve Bank of India (RBI) or Government of India issued in this regard from time to time;

- security receipts (SRs) issued by an Asset Reconstruction Company (ARC) registered with the RBI;

- securities of investee companies:

  - whose stressed loans are available for acquisition in terms of Clause 58 of the Transfer of Loan Exposures Directions as amended from time to time or as part of a resolution plan approved under IBC or in terms of any other policy of the RBI or Government of India issued in this regard from time to time;

- against whose borrowings, security receipts have been issued by an ARC registered with the RBI;

- whose borrowings are subject to corporate insolvency resolution process under Chapter II of the IBC;

- who have disclosed all the defaults relating to the payment of interest / repayment of principal amount on loans from banks / financial institutions / Systemically Important Non-Deposit taking Non-Banking Financial Companies (NBFCs) / Deposit taking NBFCs and/or listed or unlisted debt securities in terms of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR Regulations) and such payment default is continuing for a period of at least 90 (ninety) calendar days after the occurrence of such default:

Provided that in case of sub-clauses (iii) and (iv), the credit rating of the financial instruments or credit instruments or borrowings of the company has been downgraded to "D" or equivalent; and

➢ Any other asset as may be specified by SEBI from time to time.

The AIF Amendment, in line with the decision taken in the Board Meeting, exempts SSFs from complying the requirement to investment not more than 25% of its investable funds in an Investee Company, directly or through investments in units of other AIFs. Further, there is no limitation on investments in listed securities.

Unlike other categories of AIF, SSFs are not permitted to invest outside India, as the intention behind introduction of SSFs is to address the issue of stressed assets in India.

Comment:

Under the current Transfer of Loan Exposure Directions, the entities to which lenders are permitted to transfer stressed loan exposures include: (i) Scheduled Commercial Banks, (ii) All India Financial Institutions (i.e., NABARD, NHB, EXIM Bank and SIDBI), (iii) Small Finance Banks, (iv) All NBFCs including Housing Finance Companies, (v) ARCs registered with RBI, and (vi) Companies (other than a financial service provider as defined in Section 3(17) of the IBC. Clarity on whether in accordance with the AIF Amendment, the Transfer of Loan Exposure Directions may be required to be updated to include SSFs which are now permitted transferees to acquire stressed loans, or whether the inclusive description of 'permitted transferees' of stressed loans can be relied upon for SSFs to acquire stressed loan is yet to be confirmed. Further, the AIF Amendment clarifies that investment by SSFs in stressed loans transferred in accordance with Clause 58 of the Transfer of Loan Exposure Directions shall be subject to lock-ins as may be specified by SEBI.

Subject to aforementioned amendment to the Transfer of Loan Exposure Directions, this would unlock a huge potential for restructurings, since now AIFs will also be able to acquire direct loan exposures. Prior to the introduction of SSF as a category of AIF, AIFs could only invest in 'securities' of companies or partnership interests of LLPs. Using an AIF for acquiring distressed investments was becoming a challenge since many loans to defaulting companies were pure loans and not structured through NCDs and since the portfolio companies were already in default, it would have been difficult to restructure such loans as NCDs.

Further, the AIF Amendment also permits SSFs to invest in SRs. While other categories of AIFs have been notified as 'qualified buyers' under the Securitisation and

Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), such investment by AIFs in SRs were subject to the following conditions:

- AIF which has invested in an ARC shall not be permitted to invest in the SRs issued by that ARC;
- AIFs shall not invest in SRs issued on the underlying loans of any of its associate or group company; and
- AIFs shall not invest in SRs backed by non-performing assets of banks which hold equity of more than 10% (ten percent) in that AIF.

It is to be clarified by the regulators whether the above conditions shall apply to investments by SSFs in SRs as well or not. Further, from a tax perspective, there are still unaddressed risks attached with investments in SRs through AIFs, which enjoy the tax pass through status for its income other than 'business income'. The Government is yet to elucidate on such income from SRs.

In addition to acquisition of stressed loans and investment in SRs, SSFs are also permitted to directly invest in securities of entities under stress and entities that have disclosed a continuous default of at least 90 (ninety) days in payment of interest / repayment of principal amount on loans from banks / financial institutions / Systemically Important Non-Deposit taking NBFCs / Deposit taking NBFCs and/or listed or unlisted debt securities in terms of the ICDR Regulations.

SSFs are not permitted to invest in (i) its associates, (ii) units of any other AIF other than the units of a SSF, and (ii) units of SSFs managed or sponsored by its Manager, Sponsor or associates of its Manager or Sponsor.

The AIF Amendment also permits an SSF to act as a resolution applicant under the IBC. On 02 November 2021, the '*Report of the Committee to Review the Working of Asset Reconstruction Companies*' formulated by the RBI recommended that ARCs may be allowed to participate in the IBC process as a Resolution Applicant either through a SR trust or through the AIF sponsored by them. With SSFs and ARCs being permitted to act as resolution applicant under IBC, the ability of these vehicles to drive the resolution process for stressed companies is expected to be enhanced.

The exemption granted to SSFs from complying with the diversification norm indicates that a single stressed asset focussed SSF can be launched. This may encourage players to launch asset specific schemes of SSFs, with smaller tenure, to encash on turnaround of a stressed company. The rationale behind the exemption could be that while other categories of AIFs may not require substantial involvement of the AIF or its Manager in the operations of the investee company, an SSF would be expected to dedicate considerable amount of time in addressing the issues being faced by an investee company in stress.

Guidelines for investing in SSFs

While the press release of the decisions taken in the Board Meeting highlighted that the minimum corpus of an SSF would be INR 100 crores and the minimum investment by each investor in an SSF should be of INR 10 crores (which shall be reduced to INR 5 crores for accredited investors), the AIF Amendment has refrained from detailing the thresholds and have accorded SEBI the flexibility to decide the minimum corpus of and minimum investment in an SSF. The AIF Amendment also restricts other categories of AIFs from investing in an SSF.

Comment:

The AIF Amendment is silent on the category of investors as well as the minimum investment required by each investor. We except that in line with the decision taken in the Board Meeting, given the higher risk attached with investment in stressed assets, the minimum investment required by an investor in an SSF shall be higher than the minimum ticket size for investment in other categories of AIFs.

Conclusion

While AIFs have been emerging as players in the stressed asset space in the past half a decade, introduction of a dedicated sub-category for investments in stressed assets can be seen as an indication from the regulators of its approval of unlocking private capital coming through pooling vehicles for addressing the stress in the market. While the reaction of the market to regulations pertaining to SSFs is yet to be seen, there are a couple of nuances that will be required to be address before SSFs can gain popularity. One such nuance would be the taxability of income earned from investment in stressed loan and security receipts.

- *Divaspati Singh (Partner) and Khusboo Agarwal (Senior Associate)*

For any queries please contact: editors@khaitanco.com

Mumbai
One Indiabulls Centre, 13th Floor
Tower 1 841, Senapati Bapat Marg
Mumbai 400 013, India

T: +91 22 6636 5000
E: mumbai@khaitanco.com

New Delhi
Ashoka Estate, 12th Floor
24 Barakhamba Road
New Delhi 110 001, India

T: +91 11 4151 5454
E: delhi@khaitanco.com

Bengaluru
Simal, 2nd Floor
7/1, Ulsoor Road
Bengaluru 560 042, India

T: +91 80 4339 7000
E: bengaluru@khaitanco.com

Kolkata
Emerald House
1 B Old Post Office Street
Kolkata 700 001, India

T: +91 33 2248 7000
E: kolkata@khaitanco.com