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SEBI'S PROPOSED REVISIONS FOR AIF'S INVESTING INTO STRESSED ASSETS: AN OVERVIEW

In a recent development, the Securities and Exchange Board of India (SEBI) on 28 November 2023, released a consultation paper (Consultation Paper) and put forth significant proposals aiming to revamp the regulatory framework governing acquisition of stressed assets by Special Situation Funds (Special Situation Funds). The Consultation Paper seeks to refine the operational landscape and enhance oversight of Special Situation Funds, and is currently inviting public comments.

1. SPECIAL SITUATION FUNDS

1.1. Special Situation Funds constitute a subcategory of Category I Alternative Investment Funds, falling under SEBI's purview. These funds are specific to the stressed assets sector and are formed to acquire the following assets (collectively, the "Special Situation Assets"):

- (a) stressed loans '*available for acquisition*' under the Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021, dated 24 September 2021 (TLE Master Directions)¹ 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;
- (b) security receipts (*issued by asset reconstruction companies* (ARCs)); and
- (c) securities of specified companies:
 - (i) with underlying stressed loans as set out in paragraph (a) above;
 - (ii) against whose loans the security receipts mentioned in

paragraph (b) above have been issued; and (iii) whose borrowings are subject to corporate insolvency resolution process under Chapter II of the IBC.

1.2. The incorporation and operation of Special Situation Funds is currently regulated primarily by the SEBI (AIF) Regulations dated 21 May 2012 (AIF Regulations),² and the Master Circular on Alternative Investment Funds dated 31 July 2023 issued by the SEBI (AIF Master Circular).³

2. ACQUISITION OF STRESSED LOANS UNDER TLE MASTER DIRECTIONS

2.1. The business of granting loans in India is subject to nuanced regulation by the RBI. Similarly, the selling or buying of stressed loans by entities regulated by the RBI, is governed by the TLE Master Directions.

2.2. As a matter of general principle, entities regulated by the RBI and identified as lenders in the TLE Master Directions, can only sell a loan to, or purchase a loan from, another entity regulated by the RBI and identified as a lender in the TLE Master Directions. However, in light of the systemic issue of stressed loans, transfer of stressed loans is generally allowed to: (a) ARCs; and (b) certain other entities (not regulated by the RBI, but specifically listed in the TLE Master Directions), and in each case, subject to specific conditions set out in the TLE Master Directions.

2.3. The transfers identified in (b) above are only allowed if the transfer of stressed loans is undertaken pursuant to a resolution plan under the Reserve

¹Ref. Master Direction No. DOR.STR.REC.51/21.04.048/2021-22 on the subject 'Transfer of Loan Exposures' dated 24 September 2021, accessible at https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12166.

²Ref. LAD-NRO/GN/2012-13/04/11262 dated 21 May 2012, accessible at

https://www.sebi.gov.in/sebi_data/attachdocs/1337599839661.pdf.

³ Ref. Master Circular No. SEBI/HO/AFD/PoD1/P/CIR/2023/130 on the subject 'Alternative Investment Funds', accessible at https://www.sebi.gov.in/legal/master-circulars/jul-2023/master-circular-for-alternative-investment-funds-aifs-_74796.html.

Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 (Prudential Framework)⁴ resulting in an exit of all lenders (*i.e., entities regulated by the RBI and identified as lenders in the TLE Master Directions*) from the stressed loan exposure. Furthermore, these transferee entities need to be specifically listed in the annexure of the TLE Master Directions (Annex).

2.4. In view of the paramount risk posed by stressed loans to the Indian lending market, there have been discussions around inclusion of Special Situation Funds in the Annex. By way of this Consultation Paper, the SEBI has proposed the following steps, basis certain proposals put forward by the RBI for enabling the inclusion of Special Situation Funds in the Annex:

(a) Modification of the definition of Special Situation Assets

As set out in paragraph 1.1 above, presently, the definition of 'Special Situation Assets' includes, *inter alia*, securities issued by companies whose stressed loans are deemed to be 'available for acquisition' under the TLE Master Directions. However, the interpretation of the term 'available for acquisition' hinges on the assumption that the stressed loan becomes visible for acquisition when the lenders agree to a resolution plan submitted by the borrower under the Prudential Framework or the IBC. The SEBI, recognising this ambiguity in the phrase, proposed to replace the term 'available for acquisition' with the term 'are acquired'.

This proposed amendment aims to explicitly clarify that the securities issued by the companies whose stressed loans are acquired (and not just

'available for acquisition') would be included within the definition of 'Special Situation Assets'. Furthermore, the SEBI also proposes to clarify that Special Situation Funds with previous investments in securities of companies (having underlying stressed loans) should not face disqualification or be barred from acquiring stressed loans of such companies.

(b) Eligibility criteria for Special Situation Fund investors

As a matter of general principle, the TLE Master Directions restrict the transfer of any stressed loans to a person disqualified in terms of Section 29A of the IBC.

The AIF Master Circular currently provides that Special Situation Funds acquiring 'stressed loans' in terms of the TLE Master Directions, shall adopt the same due diligence requirements for its investors, as those mandated by RBI for the investors of ARCs (who invest in the security receipts issued by an ARCs).

However, concerns have arisen regarding the asymmetry between the capital accessible to a Special Situation Fund and those accessible to an ARC. Notably, in addition to the RBI-mandated due diligence requirements, the eligibility criteria for investors in ARCs under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 requires such investor to be a 'qualified buyer' and is generally difficult to comply. Such higher threshold for ARC investors creates an asymmetry between capital raised by ARCs and those

⁴ Ref. DBR.No.BP.BC.45/21.04.048/2018-19 dated 7 June 2019 on the subject 'Prudential Framework of Resolution of Stressed Assets', accessible at

<https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580>.

raised by AIFs which are Special Situation Funds.

In light of the above asymmetry, the SEBI proposes to amend the Special Situation Fund regulatory framework such that Special Situation Funds having investors that are disqualified under Section 29A of IBC in relation to a particular Special Situation Assets, are barred from investing in or acquiring such Special Situation Assets (*not limited to stressed loans*).

(c) Restriction on Special Situation Funds in relation to investment in connected entities

Currently, Regulation 19(M)(1) of the AIF Regulations stipulates that Special Situation Funds are, *inter alia*, prohibited from investing in their associates. The term 'associates' is defined to mean entities in which a director or trustee or partner or sponsor or manager of the Special Situation Funds or a director or partner of the manager or sponsor, either individually or collectively, holds more than 15% of ownership interest.

This prohibition was introduced to mitigate concerns about round-tripping of funds, specifically related to Special Situation Funds acquiring stressed assets of companies held or managed by their sponsors or manager.

However, the SEBI has expressed an opinion that the current restriction on investment in associates is narrow and might not comprehensively address the broader concerns related to the round tripping of funds. Therefore, SEBI recommends replacement of the prohibition on associates with the prohibition on 'related parties', as defined under Companies Act 2013, which is a more expansive definition.

(d) Minimum holding period on acquired stressed loans

The AIF Master Circular currently provides that the stressed loans acquired by Special Situation Funds in terms of the TLE Master Directions shall be subject to a minimum lock-in period of 6 (six) months. However, to further reinforce prudential concerns related to round-tripping and to instill credit discipline in relation to acquired stressed loans, the SEBI proposes continued restrictions on the acquired stressed loans even post the lock-in period, such that Special Situation Funds would be allowed to sell or transfer the stressed loans to only those entities that are listed in the Annex.

(e) Monitoring and oversight of Special Situation Funds

In a bid to enhance monitoring and oversight, the SEBI suggests that Special Situation Funds furnish requisite information to the RBI upon request for monitoring purposes. Additionally, there is a recommendation to establish a dedicated supervisory framework for Special Situation Funds in collaboration with the RBI, aiming to streamline supervision and regulatory compliance.

COMMENT

Overall, the Consultation Paper is a great step towards cohesive regulation of the financial sector. The proposed revisions introduced by the SEBI signify a deliberate effort to refine the operational framework governing Special Situation Funds such that the overarching principles of stressed asset acquisition are upheld. The proposals encompass a spectrum of crucial amendments, each aimed at addressing specific intricacies within the Special Situation Funds landscape, such as curtailing regulatory arbitrage *vis-à-vis* ARCs and alternate investment funds, tightening the restrictions on investment in connected entities, upholding the restrictions under Section 29A of the IBC, etc.

As these proposed revisions are open for public comments, stakeholders and industry participants hold a crucial opportunity to contribute their perspectives, enriching the evolving regulatory landscape before the final amendments are put into effect.

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