

**Consultation Paper on changes in the regulatory framework for Special Situation Funds, a sub-category of Category I Alternative Investment Funds, necessary to facilitate Special Situation Funds to acquire stressed loans in terms of Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021**

## 1. Objective

To amend SEBI (Alternative Investment Funds) Regulations, 2012 ('AIF Regulations'), to make changes in the regulatory framework for Special Situation Funds ('SSFs') necessary to facilitate SSFs to acquire stressed loans in terms of Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 ('RBI Master Directions').

## 2. Background

- i. The challenges of stressed loans faced by Indian financial system requiring significant capital infusion in Banks, Non-Banking Financial Companies ('NBFCs'), etc., necessitated exploring Alternative Investment Funds ('AIFs') as a potential source of risk capital to supplement the efforts of Asset Reconstruction Companies ('ARCs') in resolution of stressed loans. This also assists in the capital of Banks, NBFCs, etc. locked in stressed loans being released and made available for lending to the desired sectors for contributing to economic development. Infusion of capital in this manner can in turn help the underlying companies in distress, which are unable to function optimally and generate value for stakeholders due to over-leveraging, but have potential to turnaround.
- ii. In this background, in the meeting of the Board held on December 28, 2021, the Board after deliberation, approved the proposal to introduce SSF as a new sub-category of Category I AIFs which shall invest in special situation assets including stressed loans. SSF may acquire stressed loan in terms of Clause 58 of RBI Master Directions, upon inclusion of SSF in the Annex of RBI Master Directions.
- iii. The aforementioned amendment to AIF Regulations was notified on January 24, 2022. Subsequently, vide circular no. SEBI/HO/IMD-I/DF6/P/CIR/2022/009 dated January 27, 2022 (now subsumed under Chapter 6 of Master Circular for AIFs SEBI/HO/AFD/PoD1/P/CIR/2023/130 dated July 31, 2023), it was specified that SSF may acquire stressed loans in terms of Clause 58 of RBI Master Directions upon inclusion of SSF in the Annex of the RBI Master Directions.
- iv. Clause 58 of RBI Master Directions, *inter alia*, states the following –
  - If the transfer of stressed loans are undertaken as a resolution plan under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 resulting in an exit of all lenders from the stressed loan exposure, such transfer is permitted to any class of entities that are permitted to take on loan exposures in terms of a statutory provision or under the regulations issued by a financial sector regulator, and which are listed in the Annex of RBI Master Directions.
  - The Annex will be updated by RBI as and when any new class of entities is permitted by the respective financial sector regulators.
  - The entity permitted to take on loan exposures by its statutory or regulatory framework would have to be separately enabled by its regulatory or statutory framework for taking on loan exposures, and then listed in the Annex by RBI.



- The respective financial sector regulators shall put in place a framework for this purpose in consultation with RBI.
- v. Thus, in order to enable SSFs to acquire stressed loans, it is imperative that SSFs are included in the Annex of RBI Master Directions by RBI, who is the principal regulator for sale and purchase of stressed loans in India, and that SEBI puts in place a framework for the same in consultation with RBI.
- vi. Accordingly, the aforementioned framework for SSFs was referred to RBI for their concurrence / comments for notifying SSFs in Annex of RBI Master Directions.
- vii. RBI has communicated the following requirements in the framework for SSFs to enable RBI to include SSF in the Annex of RBI Master Directions -
  - a. definition of 'special situation assets'
  - b. eligibility of investors in SSFs in terms of Section 29A of Insolvency and Bankruptcy Code, 2016
  - c. restrictions with regard to investment in connected entities
  - d. minimum holding period and subsequent transfer of loans
  - e. monitoring of SSFs
  - f. supervision of SSFs

### 3. Issues for consideration

#### A. Definition of 'Special Situation Asset'

- i. In terms of Regulation 19I of AIF Regulations, 'Special Situation Assets', inter alia, includes securities of investee companies, whose stressed loans are available for acquisition in terms of Clause 58 of the Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 as amended from time to time or as part of a resolution plan approved under the Insolvency and Bankruptcy Code, 2016 or in terms of any other policy of the Reserve Bank of India or Government of India issued in this regard from time to time.
- ii. Thus, SSFs can also invest in securities of those companies whose stressed loans are available for acquisition in terms of Clause 58 of RBI Master Directions.
- iii. However, it is felt that a stressed loan under Section 58 of RBI Master Directions cannot be said to be 'available' for acquisition since visibility of the stressed loan for acquisition occurs only after the lenders agree to resolution plan submitted by the borrower. The term 'available for acquisition' relies on the assumption that at certain point of time, the stressed loans eligible for transfer in terms of Clause 58 of RBI Master Directions shall be visible to the SSFs.
- iv. Accordingly, the term 'available for acquisition' may be replaced by the term 'are acquired'. For the sake of clarity, SSFs having prior investment in securities of stressed companies would not be disqualified / barred from acquiring stressed loans of the said companies.

#### Proposal A:

- v. AIF Regulations may be suitably amended to specify that –
  - a. 'special situation asset', *inter alia*, includes securities of investee companies, whose stressed loans are acquired in terms of Clause 58 of RBI Master Directions.



- b. SSFs having prior investment in securities of stressed companies shall not be disqualified / barred from acquiring stressed loans of the said companies.

**B. Eligibility of investors in SSFs in terms of Section 29A of the Insolvency and Bankruptcy Code 2016 ('IBC')**

- i. RBI Master Directions state that a transferee, to whom the economic interest in a loan exposure is transferred should not be a person disqualified in terms of Section 29A of IBC and the responsibility for verifying and establishing the same shall be with the transferor.
- ii. Thus, the transferor (i.e. the lender bank or NBFC) is required to verify and establish that the transferee is not a person disqualified in terms of Section 29A of IBC. However, it has not been specified that such verification for disqualification under Section 29A of IBC has to be carried out for the investors of the transferee as well.
- iii. It may be noted that ARCs can issue SRs with regard to the underlying stressed asset to investors (including AIFs) and the initial and continuous due diligence of such investors that an ARC is supposed to carry out as has been mandated by RBI.
- iv. Accordingly, in order to ensure that there is no regulatory arbitrage, it was specified in Chapter 6 of Master Circular for AIFs, that SSFs acquiring stressed loans in terms of RBI Master Directions shall comply with the same initial and continuous due diligence requirements for its investors, as those mandated by RBI for investors in ARCs.
- v. However, it was felt that that comparison between SSFs and ARCs may not be appropriate since the legal and regulatory framework governing the two is distinct and that the eligible investors in ARCs (viz. qualified buyers) have been narrowly defined in SARFAESI Act, as compared to AIFs which can raise funds from a comparatively wider spectrum of investors.
- vi. Considering that SSFs shall transact in stressed loans, a greater due diligence may be specified on investors of SSFs in terms of verification of disqualification under Section 29A of IBC.
- vii. The concern relating to economic interest getting transferred to a person disqualified in terms of Section 29A of IBC may exist for SSFs investing in all special situation assets, and may not be limited to SSFs acquiring stressed loans. Thus, it is felt appropriate that the due diligence requirement in terms of Section 29A of IBC may be mandated on all SSFs, irrespective of the type of special situation asset they invest in.

**Proposal B:**

- viii. AIF Regulations may be suitably amended to specify that SSFs shall not invest in or acquire a special situation asset if any of its investors is disqualified in terms of Section 29A of IBC in relation to such special situation asset.

**C. Restrictions with regard to investment in connected entities**

- i. Regulation 19M(1) of AIF Regulations, *inter alia*, state that SSF shall not invest in its associates.
- ii. 'Associate' has been defined in AIF Regulations as a company or a limited liability partnership or a body corporate in which a director or trustee or partner or Sponsor or Manager of the Alternative Investment Fund or a director or partner of the Manager or Sponsor holds, either individually or collectively, more than fifteen percent of its paid-up equity share capital or partnership interest, as the case may be.
- iii. It may be noted that the aforesaid safeguard was introduced in the SSF framework to address the concern of possible round-tripping of funds in terms of SSFs acquiring stressed loans of their associates. However, the aforementioned definition of 'associate' appears to be narrow in order to sufficiently address the concern of round-trapping.
- iv. It is observed that 'Related party', with reference to a company, has been defined in Companies Act, 2013, as –
  - a. a director or his relative;
  - b. a key managerial personnel or his relative;
  - c. a firm, in which a director, manager or his relative is a partner;
  - d. a private company in which a director or manager is a member or director;
  - e. a public company in which a director or manager is a director or holds along with his relatives, more than two per cent. of its paid-up share capital;
  - f. any body corporate whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager;
  - g. any person on whose advice, directions or instructions a director or manager is accustomed to act:

Provided that nothing in sub-clauses (f) and (g) above shall apply to the advice, directions or instructions given in a professional capacity;

- h. any company which is—
    - (A) a holding, subsidiary or an associate company of such company; or
    - (B) a subsidiary of a holding company to which it is also a subsidiary;
  - i. such other person as may be prescribed.
- v. It is seen from para 3C(ii) and 3C(iv) above that the definition of 'related party' as given in Companies Act, 2013, is wider than the definition of 'associate' as given in AIF Regulations, and is also referred in various regulations of SEBI such as the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, etc. Thus, inclusion of 'related party' as defined in Companies Act, 2013, may provide comfort with regard to the concerns related to conflict of interest.



Proposal C:

- vi. Regulation 19M(1) of AIF Regulations may be suitably amended to specify that special situation funds shall not invest in its 'related parties', wherein related party shall have same meaning as given in Companies Act, 2013.

**D. Minimum holding period and subsequent transfer of loans**

- i. In terms of the aforesaid SEBI Circular dated January 27, 2023, stressed loans acquired by SSF in terms of clause 58 of the RBI Master Directions shall be subject to a minimum lock-in period of six months.
- ii. However, to address the prudential concerns on round tripping and credit discipline, it may be desirable that even after the aforementioned lock-in period, SSFs may only be permitted to sell the loans to entities permitted in the Annex of RBI Master Directions.

Proposal D:

- iii. AIF Regulations may be suitably amended to specify that SSFs shall transfer / sell stressed loans, acquired in terms of Clause 58 of RBI Master Directions, only to the entities enlisted in the Annex of RBI Master Directions.

**E. Monitoring of SSFs**

- i. It is felt appropriate that the framework for SSFs should also stipulate adequate data sharing and monitoring arrangements between RBI and SEBI regarding specifics and broad functioning of the SSF including information on investors, manager/sponsor, assets invested, financing etc. Suitable enabling clauses to enable RBI to call information directly from SSFs, if required, may also be incorporated.
- ii. In terms of RBI Master Directions, it has been stipulated that all RBI regulated transferors shall report each loan transfer transaction undertaken under the said directions to a trade reporting platform as notified by the Reserve Bank. As the SSF shall be issuing units to investors, the details of such issuances, including the details of investors, as well as any subsequent change in unit holdings, resolution strategies implemented, recoveries effected, etc. must be reported to the RBI-designated reporting platform.

Proposal E:

- iii. AIF Regulations may be suitably amended to specify that in respect of stressed loans acquired in terms of Clause 58 of RBI Master Directions, SSFs shall submit to a trade reporting platform notified by RBI, any information as may be specified by SEBI in consultation with RBI from time to time. SSFs shall also submit to RBI any information as may be required by RBI.
- iv. It may be specified by way of issuance of circular that SSFs shall submit the following information on the aforesaid trade reporting platform notified by RBI, in



respect of all investments in stressed loans acquired under Clause 58 of RBI Master Directions:

- a. details of units issued
- b. details of investors
- c. subsequent change in unit holdings, if any
- d. resolution strategies implemented
- e. recoveries effected
- f. any other information as may be specified by SEBI

**F. Supervision of SSFs**

- i. Since SSFs shall transact in stressed loans, a dedicated supervisory framework for SSFs may be stipulated in AIF Regulations.
- ii. The said supervisory framework shall, in addition to supervisory framework of other AIFs, also include specific parameters that RBI takes into consideration with regard to supervision of its regulated entities transacting in stressed loans.

Proposal F:

- iii. AIF Regulations may be suitably amended to specify that SSFs who have acquired stressed loans in terms of Clause 58 of RBI Master Directions shall be subject to a dedicated supervisory framework as may be specified by SEBI, in consultation with RBI, from time to time.

**4. Public comments**

- i. Public comments are invited for the proposals A, B, C, D, E and F given above. The comments / suggestions may be provided in MS Excel file as per the format given below:

Name of the person/ entity proposing comments:	
Name of the organization (if applicable):	
Contact details:	
Category: whether market intermediary/ participant (mention type/ category such as AIF, law firm, consultant, etc.) or public (investor, investee company, academician etc.)	

Sr. No.	Proposal No.	Extract from the consultation paper	Comments / Suggestions	Rationale
1	Proposal A			



2	Proposal B			
3	Proposal C			
4	Proposal D			
5	Proposal E			
6	Proposal F			
7	Other comment, if any, along with relevant para number			

- ii. Kindly mention the subject of the communication as, “*Consultation Paper on changes in the regulatory framework for SSFs necessary to facilitate SSFs to acquire stressed loans*”.
- iii. Comments as per aforesaid format may be sent to the following, latest by December 27, 2023, in any of the following manner:
  - a. Preferably by email to [afdconsultation@sebi.gov.in](mailto:afdconsultation@sebi.gov.in), with a copy to Shri Sachin Kisan Jadhav, Manager ([sachinj@sebi.gov.in](mailto:sachinj@sebi.gov.in))
  - b. By post to:

Shri Sanjay Singh Bhati,  
Deputy General Manager,  
Alternative Investment Fund and Foreign Portfolio Investors Department,  
Securities and Exchange Board of India,  
SEBI Bhavan, C4-A, G-Block, Bandra Kurla Complex, Bandra (East), Mumbai -400051

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