भारतीय प्रतिभूति और विनिमय बोर्ड
Securities and Exchange Board of India

Consultation paper on proposal to enhance trust in the Alternative Investment Funds ('AIF') ecosystem to facilitate Ease of Doing Business measures

Objective & Executive Summary:

While the AIF industry has registered robust growth over the years, a number of instances of AIFs being structured to facilitate circumvention of different financial sector regulations have come to light, thereby eroding trust in the system. To ensure sustained capital formation, it is important to take steps to restore the trust and prevent such circumvention, while at the same time ensuring minimal impact on legitimate AIF investments. This consultation paper proposes to introduce a requirement that AIFs, Managers of AIFs and the Key Management Personnel of AIFs and their managers ensure that AIFs do not facilitate circumvention of extant financial sector regulations. The specific verifiable standards to demonstrate adherence to this obligation are proposed to be formulated by the pilot Industry Standards Forum for AIFs, in consultation with SEBI. The enhanced trust that should result from such a process, along with a process to verify adherence to the accompanying standards, would provide a regulatory comfort in considering other Ease of Doing Business (EoDB) proposals relating to AIFs which are under examination with SEBI.

Comments and inputs are sought from all stakeholders and the public on this proposal.

Background and issues identified:

1. The AIF industry has shown consistent growth over the past few years with the investments rising to INR 3,53,352 Crore as on September 30, 2023. AIFs connect sophisticated investors having risk appetite with enterprises in need of risk capital, complementing other sources of funding such as banks, financial institutions, and listed markets.

2. Compared to other SEBI registered investment channels such as Mutual Funds and Portfolio Management Services (PMS), AIFs have a relatively light-touch regulatory regime. In the recent past, in this context, several instances of AIFs being structured to circumvent extant financial sector regulations have emerged. Over the past few months, SEBI has come across more than 40 cases involving over INR 30,000 crores, where AIFs appear to have been structured to facilitate circumvention of certain financial sector regulations.

3. Some of the identified modus operandi where AIFs are being structured to facilitate circumvention of financial sector regulatory frameworks are as under –

   3.1. *Ever-greening of loans by regulated lenders:*

   3.1.1. AIFs have been set up resulting in ever-greening of stressed loans of some regulated lenders, thereby circumventing RBI regulations and disclosure requirements around asset restructuring and recognition of non-performing assets.

3.1.2. Typically, a regulated lender would subscribe to a junior class of units of an AIF, and the AIF in turn would fund the lender's stressed borrower. The borrower would use these funds to repay the loan given by the regulated lender, without disclosure of any stress. The stressed asset in the books of the regulated lender would in effect be replaced with the investment in the junior class units of an AIF.

3.1.3. This has allowed some regulated lenders to avoid classification, provisioning and other applicable regulatory requirements with respect to these assets under the RBI Regulations. The recognition of deteriorating creditworthiness of the borrower may have also been deferred.

3.1.4. Though specific steps have since been taken by RBI to address this issue of ever greening by regulated lenders, it is critical to take steps to ensure that such instances do not recur in other forms and that the issue of AIFs facilitating such structures is also addressed. At the same time, it is necessary to ensure that these measures do not come in the way of legitimate investments.

3.2. *Circumvention of FEMA norms:*

3.2.1. As per existing norms under FEMA NDI Rules 2019, classification of downstream investment by AIF is based on the domicile of ownership and control of manager/ sponsor of AIF. This has created a scope for regulatory arbitrage. Some AIFs appear to have been set up specifically with the intent to circumvent the provisions relating to regulatory framework for foreign investment in a particular sector, company, security/ instrument, etc.

3.2.2. For instance, some foreign investors appear to have set up AIFs with domestic managers/sponsors to invest in sectors prohibited for FDI, or to invest beyond the allowed FDI sectoral limit. Further, foreign investors may set up AIFs to invest foreign money in debt/debt securities where foreign investment is envisaged through the FPI/ECB route.

3.3. *Circumvention of QIB regulations:*

3.3.1. QIBs, in general, are large, regulated, sophisticated and informed institutional investors/money managers managing the investments of a large number of investors. They are expected to possess the expertise and financial ability to evaluate, invest and manage risks in the capital markets. They are expected to contribute in an expert manner, to price discovery for IPOs/ FPOs, etc. Currently, all AIFs are designated as QIBs.

3.3.2. Certain AIFs, which have single or very few investors (often belonging to same investor group), have invested in IPOs under QIB quota, thereby availing benefits available to QIBs under SEBI (Issue of Capital and

Disclosure Requirements) Regulations, 2018. Note that such investors of AIFs would otherwise be ineligible for QIB status on their own.

3.3.3. Also, permitting such AIFs as QIBs would allow otherwise ineligible entities/ persons to influence the price discovery process in the public market, which in turn affects the other retail investors participating in the IPO.

4. It was observed that most of the identified cases of circumvention had a single investor, or investors of the same group i.e., narrow and connected investors, having majority contribution in or exercising control over the AIF.

5. The above list is not an exhaustive one of all cases of AIFs being used as structures to facilitate circumvention of extant financial sector regulations. The specific instances above were identified on the back of thematic inspections and examination of periodic reports submitted by AIFs.

6. The identified circumventions have already assumed significant levels (over INR 30,000 Crore out of investments of approximately INR 3.5 Lakh Crore) and SEBI has not yet completed its thematic inspections. Such practices seriously impact the overall trust and integrity of the AIF ecosystem.

Global developments in this context:

7. There are heightened global regulatory concerns around the private equity industry. The September 2023 IOSCO-CER report “Thematic Analysis: Emerging Risks in Private Finance” and new rules adopted in August 2023 by the US Securities and Exchange Commission (SEC) for regulation of Private Fund Advisors are cases in point. It is also seen from various sections of the media that the UK’s Financial Conduct Authority is set to review certain risks related to private assets and the potential spill over of such risks to the larger financial sector.

Proposed regulatory approach:

8. While there is a need to address concerns as mentioned above in an effective manner and obtain requisite data for ongoing monitoring of the same, it is necessary to also ensure that regulatory intervention should not take away the flexibility of AIFs to carry out genuine and legitimate investments.

9. Accordingly, an approach that addresses the regulatory concerns in a proportionate, risk-based manner, while at the same time facilitating ease of doing business and ease of compliance, is being proposed.

10. To summarize, there is a need to prevent undesirable events/misuse (i.e. prevent Type I errors), while ensuring that regulations do not come in the way of legitimate investments (i.e., prevent Type II errors).

11. It may be noted that SEBI is piloting deeper engagement with industry participants through the formation of various Industry Standards Fora across segments of the securities market. It is envisaged that such industry fora, in consultation with SEBI, shall formulate standards for effective implementation of regulations prescribed by SEBI.

12. Along these lines, SEBI has facilitated the setting up of a pilot Standards Forum for AIFs ("SFA") for formulating standards for ease of implementation of AIF Regulations, in consultation with SEBI.

13. To address the specific regulatory concerns around misuse of AIF structure as articulated above, it is proposed to introduce a general obligation in the existing AIF regulations that would require AIFs, managers and their key management personnel ('KMPs') to ensure that their operations and investments do not facilitate circumvention of regulations administered by any financial sector regulator.

14. To achieve the objective of this general obligation through effective implementation, this general obligation conveying the regulatory intent needs to be translated into a clear set of implementation standards to set definitive and specific responsibilities and obligations on all stakeholders.

15. In line with the 'Trust, but verify' principle, the specific verifiable actions by the AIFs and their KMPs to demonstrate adherence to the above general obligation and the standards under it shall be set by the industry itself, through the pilot SFA, in consultation with SEBI. The standards would be such that those that intend to stay within the letter and spirit of regulations should face no challenge in demonstrating adherence to them.

16. It may be noted that, vide circular no. SEBI/HO/AFD-1/PoD/P/CIR/2023/053 dated April 10, 2023, SEBI has prescribed guidelines with respect to excusing or excluding an investor from an investment of AIF. As per the said circular, manager of an AIF may exclude an investor from participating in a particular investment opportunity, if the manager of the AIF is satisfied that the participation of such investor in the investment opportunity would lead to the scheme of the AIF being in violation of applicable law or regulation or would result in material adverse effect on the scheme of the AIF.

17. In line with the same, in case it is ascertained that the participation of an investor in a particular investment of an AIF may facilitate circumvention of a specified regulation/provision, the manager of the AIF has the flexibility to either not make the said investment or exclude the investor from the particular investment.

18. The enhanced trust that should result from such an obligation, along with a process to verify adherence to the general obligation and accompanying standards, would

provide a regulatory comfort in considering other Ease of Doing Business (EoDB) proposals relating to AIFs to be actively considered which are under examination with SEBI.

Consultation with stakeholders:

19. Considering the above, an agenda in this regard was placed in meeting of Alternative Investment Policy Advisory Committee ('AIPAC') of SEBI held on December 13, 2023. After deliberations, AIPAC recommended the introduction of the general obligation as proposed above along with specific implementation standards to be formulated by the Standards Forum for AIFs ('SFA'), in consultation with SEBI. It was also recommended that any glide-path needed for implementation shall be considered by SEBI.

Proposal:

20. To insert the following provision in Chapter IV (viz. General Obligations and Responsibilities and Transparency) of the SEBI (AIF) Regulations, 2012:

Every Alternative Investment Fund, Manager of the Alternative Investment Fund and Key Management Personnel of the Manager and the Alternative Investment Fund, shall carry out specific due diligence, as may be specified by SEBI from time to time, with respect to their investors and investments, before each investment, to prevent facilitation of circumvention of extant regulations administered by any financial sector regulator.

Provided that, if participation of an investor of an AIF in an investment opportunity has been ascertained to result in facilitation of circumvention of any extant regulation, the manager of the AIF shall –
(a) not make the investment; or
(b) exclude the particular investor from the investment.

[Explanation: "extant regulations" shall mean laws, acts, rules, regulations, guidelines/circulars framed thereunder that are administered by any financial sector regulator including SEBI.]

21. SEBI shall prescribe a framework under the above-mentioned regulation, to specify the objectives and the regulatory principles envisaged to address regulatory circumventions. Such principles shall guide the framing of the specific and verifiable standards for due diligence that the stakeholders of the AIF will need to conduct for ascertaining as to whether the participation of an investor in a particular investment of the AIF facilitates circumvention of extant regulations.

22. The specific standards of verifiable due diligence (guided by the framework and principles enumerated by SEBI) accompanied by suitable standards of reporting by AIFs, shall be formulated by the pilot SFA, in consultation with SEBI.

Public Comments:

23. Considering the implications of the aforementioned matter on the market participants, public comments are invited for the proposal given above. The comments / suggestions may be provided by any of the following modes latest by February 11, 2024:

23.1. Preferably through Online web-based form through the following link: https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes

(It may be noted that the online web-based form will accept comments till February 11, 2024.

The instructions to submit comments on the consultation paper are as under:

1. Before initiating the process, please read the instructions given on top left of the web form as "*Instructions*";
2. Select the consultation paper you want to comment upon from the drop-down under the tab –"*Consultation Paper*" after entering the requisite information in the form;
3. Email ID and mobile number cannot be used more than once for providing comments on the same consultation paper;
4. If you represent any organization other than the types mentioned under dropdown in "Organization Type", please select "Others" and mention the type, which suits you best. Similarly, if you do not represent any organization, you may select "Others" and mention "Not Applicable" in the text box;
5. There will be a dropdown of proposals in the form. Please select the proposals one-by-one and for each of the proposal, please record your level of agreement with the selected proposal. Please note that submission of agreement level is mandatory;
6. If you do not want to react on any proposal, you may skip the same by selecting "Skip this proposal";
7. If you want to provide your comments for the selected proposal, please select "Yes" from the dropdown under "Do you want to comment on the proposal" and use the text boxes provided for the same;
8. After recording your response to the proposal, click on "Submit" button. System will save your response to the selected proposal and prompt you to record your response for the next proposal. Please follow this procedure for all the proposals given in the dropdown;
9. Please download the pdf file, link of which is given at the bottom of the form, just before finally submitting the comments to last and final proposal. This pdf will help in case technical issue is faced while final submission of comments;
10. The final comments shall be submitted only after recording your response on all of the proposals in the consultation paper.)

23.2. In case of any technical issue in submitting your comment through web based public comments form, the comments may be forwarded by email to afdconsultation@sebi.gov.in. Kindly mention the subject of the email as, "Consultation paper on proposal with respect to enhancing regulatory trust in the AIF ecosystem".

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