भारतीय प्रतिभूति और विनिमय बोर्ड
Securities and Exchange Board of India

<u>Consultation paper on flexibility to Category I and II AIFs to create encumbrance on their holding of equity in infrastructure sector investee companies to facilitate raising of debt by such investee companies</u>

1. Objective:

To seek comments and inputs from stakeholders and public on a proposal for amendment to SEBI (Alternative Investment Funds) Regulations, 2012 ('AIF Regulations'), in order to provide ease of doing business for AIFs by allowing Category I and II AIFs to create encumbrance on their holding of equity in infrastructure sector investee companies to facilitate raising of debt by such investee companies.

2. Background

2.1. As per Regulation 2(b) of the AIF Regulations, AIF is a privately pooled investment vehicle that collects funds from investors for investing them in accordance with a defined investment policy for the benefit of its investors. Further, Clause 1 (b) of the Code of Conduct for AIFs, prescribed under fourth schedule of AIF Regulations, requires an AIF to be operated and managed in the interest of all investors. Clause 2(d) of the Code of Conduct for Manager of AIFs and Key Management Personnel of Managers and AIF (KMPs) requires the Managers/KMPs to act in a fiduciary capacity towards investors of the AIF and ensure that decisions are taken in the interest of the investors. Thus, it may be observed from the above that AIFs and Investment Managers are responsible for holding/managing investments of AIFs for the benefit of its beneficiaries, i.e., investors.

2.2. Regulation 16(1)(c) and 17(c) of the AIF Regulations prohibits Category I AIFs and Category II AIFs respectively, from borrowing either directly or indirectly or engaging in any leverage except for meeting temporary funding requirements. Further, Regulation 18(c) of the AIF Regulations permits Category III AIFs to engage in leverage or borrow only to the extent of two times of the NAV subject to consent from the investors.

2.3. SEBI, in a recent order dated May 31, 2023 in the matter of India Infrastructure Fund II, Global Infrastructure Partners India Private Limited and IDBI Trusteeship Services Limited, held that use of expression '*directly or indirectly*' prohibits Category I and II AIFs from being party to any borrowing either directly or indirectly. Pledging of securities of portfolio companies by an AIF for loans availed of by such companies fall within meaning of indirect borrowing. Further, use of expression *'any leverage'* is not confined to leverage availed of by the Category I and II AIFs itself. It prohibits Category I and II AIFs from being party to any leverage availed of either by Category I and II AIFs or by any other entity. Thus, pledging of securities held by an AIF in investee companies for loans availed of by the investee companies, violates provisions of the AIF Regulations.

2.4. Note that, by creating pledge or charge or hypothecation by an AIF on its assets to secure the loans obtained by its investee companies, investors may lose their entire equity in the investee company in case such investee companies default on repayment of their loan/ debt. This may be the case if equity of the investee company post default has some value. Thus, creating pledge on assets of the investee companies by the AIF may, at times, not be in the best interest of the investors.

2.5. Further, availing of loans by the investee companies against the pledge of equity holding of the AIF can tantamount to indirect and additional leverage. Large amounts of such additional leverage, particularly if some of it is also layered and stacked across multiple entities, can become a source of systemic risk to the financial services ecosystem. Global securities market regulators (such as the US SEC and UK FCA) and IOSCO have highlighted the risk of systemic financial sector leverage on the back of private capital investments.

3. Issues for Consideration

3.1. Robust and high quality infrastructure is crucial for the growth of our economy, as it lays down the foundation for growth in all other sectors and has a multiplier effect. Thus, investment in infrastructure sector facilitates steady growth of economy and enhances the quality of life of citizens.

3.2. Government of India has been actively promoting infrastructure development over the years through various measures, including public-private partnerships (PPPs), attracting foreign direct investment, issuance and providing tax benefits on infrastructure bonds, setting up dedicated infrastructure investment funds, and capitalizing multilateral and bilateral assistance. As stated in the Economic Survey for FY 22 -23, the government, in recent years, has provided an increased impetus for infrastructure development and investment through the enhancement of capital expenditure. These initiatives aim to accelerate the development of crucial infrastructure projects in the country. ‘Infrastructure & Investment’ is identified as one of the seven priorities in the Budget Announcement for FY 2023-24 and the importance of private capital in funding infrastructure investment has also been highlighted.

3.3. In the recent past, SEBI has received representations from industry associations and certain funds to allow pledging of equity investments by AIFs to secure borrowing by investee companies to protect/ enhance the value of the AIFs’ investments, particularly for the purpose of facilitating infrastructure financing. It was mentioned that allowing AIFs to create encumbrance on their equity investments in infrastructure sector companies for the purpose of project finance is essential for infrastructure development. In respect of project finance, the following has been represented:

3.3.1. Debt funding of infrastructure projects is provided through ‘Project Finance.’

3.3.2. In ‘Project finance’, the protection provided to the lenders is the pledge of equity of the project [i.e. equity held in the infrastructure Special Purpose Vehicle (“SPV”) holding the project]. Currently, this pledge is crucial requirement for lenders, as it provides lenders the right to step into the project in case the SPV defaults on its payment obligation. It can be said that, in the absence of such equity pledge, project finance is severely hampered.

3.3.3. AIFs have been successful in channelizing global institutional monies into infrastructure funds that have contributed to infrastructure development.

3.3.4. *Such AIFs typically own the equity of downstream project SPVs and hence such equity need to be pledged to project finance lenders. If pledging of equity by AIFs remains constrained, then AIFs would be at a significant disadvantage relative to all other equity participants (listed public companies, unlisted private companies, global pension funds, sovereign funds, global funds, etc.)*

3.4. One of the largest public sector lenders, in the area of project financing, has submitted the following to SEBI in this context:

3.4.1. *The bank cannot lend to AIF but can provide finance to investee companies in which the AIF has invested. The credit facilities are granted against cash flows from the project.*

3.4.2. *The pledge of equity is for the purpose of collateral and to secure the loan. If AIFs are not permitted to extend pledge of equity, the interest of Banks/FIs would get adversely impacted. If AIFs are not permitted to pledge equity of the investee companies, it will lead to loss of opportunity for the companies in which AIFs have invested, as may be unable to source project finance from Banks/ FIs.*

3.5. Considering all the above, it is crucial to facilitate AIFs to invest in infrastructure sector. Therefore, while pledging of assets by Category I and II AIFs is not envisaged under AIF Regulations, there is merit in considering allowing Category I and II AIFs to pledge their equity investments in infrastructure sector investee companies, in order to facilitate such companies to raise debt on their books.

4. Examination of issues

4.1. Based on the aforesaid representation and discussions held with the stakeholders, it is seen that project financing (debt) is one of the important methods of raising capital for capital-intensive infrastructure projects. The borrower is a special purpose vehicle (SPV), and repayment of the financing is dependent on the cash flows to be generated from the project. Particularly in cases of road concessions, the lenders have only limited or no recourse to the underlying assets, as the ownership of the underlying assets does not lie with the borrower/SPV, but with the Govt./ Govt.-owned bodies or other relevant authorities. Therefore, the lenders cannot directly take possession of the underlying asset/ infrastructure project in the event of default by the borrower/SPV.

4.2. Therefore, to protect their commercial interests in the event of a default, lenders require shareholders to pledge their equity at the time of financing the infrastructure project so that in the case of default, the lenders can step in (‘step in’ rights/ ‘substitution’ rights) and take over the management of the borrower/SPV for reviving the project or to find a buyer of the project, in order to recover their dues. Pledging enables lenders to efficiently assume control over the entity in the event of debt defaults, offering an alternative to resorting to insolvency proceedings under Insolvency and Bankruptcy Code (IBC). Thus, it may be argued that the purpose behind such equity pledge is not leverage but to provide comfort to lenders for debt financing of such borrower/SPV.

4.3. Considering the above and with a view to facilitate infrastructure development through private capital, it becomes imperative to facilitate unobstructed funding for infrastructure projects. Constraining AIFs equity investments in infrastructure projects could result in banks and other lending entities being reluctant to extend financial support to these vital projects. This may impede the development of infrastructure in the country. It is, therefore, crucial to undertake initiatives that foster a conducive regulatory environment for investment in infrastructure projects.

4.4. To facilitate an ecosystem wherein private capital effectively complements the various available modes of infrastructure financing, it is proposed that AIFs may be provided flexibility to create encumbrance on equity of investee companies which are engaged in the business of development, operation or management of projects in any of the infrastructure sub-sectors listed in the Harmonised Master List of Infrastructure sub-sectors (“HML”), as issued by the Department of Economic Affairs (DEA), Ministry of Finance, Government of India. The HML aims to harmonise the existing definitions of infrastructure sectors to facilitate a coordinated approach among agencies providing support to infrastructure.

4.5. The infrastructure sub-sectors stipulated in the HML may include projects that are developed under concession agreements where investee companies do not have rights on the project’s underlying assets but have rights on the future cash flows from the project. These may also include projects that do not have an underlying concession agreement (such as telecom / digital infrastructure projects), where investee companies not only hold rights on the project’s underlying assets but also on the future cash flows from the project.

4.6. Further, it was also deliberated whether to broaden the scope of this proposal to allow AIFs to pledge equity of investee companies across sectors i.e. not limited to only infrastructure sector investments. One argument in favour of such a wider leeway was that investors in AIFs are well-informed about associated risks, and are providers of risk capital. If adequate and appropriate disclosures are made to investors, AIFs should perhaps be allowed to create encumbrance on their equity holdings, in favour of the lenders to respective investee companies, subject to the consent of all investors.

4.7. The need for AIFs to pledge their equity holdings in investee companies, particularly in the infrastructure sector, has also been highlighted in the sub-group of the Working Group set up by SEBI to review AIF Regulations from an Ease of Doing Business perspective. In line with the same and in the above backdrop, an agenda in this regard was placed before AIPAC in its meeting held on December 13, 2023. AIPAC deliberated on the agenda and recommended allowing all AIFs to pledge equity of investee companies irrespective of sector, as collateral to secure loans borrowed by respective investee companies, with the following conditions:

i. Upfront disclosure in the Private Placement Memorandum (PPM) of the fund.

ii. Explicit consent of all investors for creating pledge on the equity of each investee company.

iii. *No leverage on leverage – The debt supported by the pledge cannot be in turn used as equity infusion into another company.*
iv. *Liability from pledging should not be beyond forfeiture of the equity pledged by the AIF.*
v. *Such pledging of equity shall not entail any third party guarantee by AIF, since AIFs are not allowed to extend guarantees for investee companies.*

4.8. However, since allowing AIFs to pledge equity of all their investee companies may be a source of systemic risk as mentioned at para 2.5 above and thus, may have an impact from a financial stability perspective, RBI was also consulted in this matter and their views have been considered suitably in the proposed framework.

5. Proposal:

Considering the above and subsequent internal deliberations, the following are proposed:

5.1. Category I and II AIFs may create encumbrance on equity of an investee company only for the purpose of borrowing by the said investee company, if the investee company is in the business of development, operation or management of projects in any of the infrastructure sub-sectors listed in the Harmonised Master List of Infrastructure issued by the Department of Economic Affairs, Ministry of Finance, Government of India, from time to time.

Explanation:
Encumbrance hereinabove shall mean the following *[as defined under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011]:*
i. any restriction on the free and marketable title to shares, by whatever name called, whether executed directly or indirectly;
ii. pledge, lien, negative lien, non-disposal undertaking; or any covenant, transaction, condition or arrangement in the nature of encumbrance, by whatever name called, whether executed directly or indirectly.

5.2. Schemes of Category I and II AIFs who have not on-boarded investors as on the date of aforesaid mandate, shall disclose explicitly in their PPMs if encumbrance on equity of investee companies, as described above, is envisaged as part of their investment strategy.

5.3. Option 1: Schemes of Category I and II AIFs who have already on-boarded investors may create encumbrance on equity of investee companies, as described above, in case all such investors in the scheme of the AIF consent to it.

OR

Option 2: Schemes of Category I and II AIFs who have already on-boarded investors may create encumbrance on equity of investee companies, as described above, in case seventy-five percent of investors by value of their investment in the scheme of the AIF consent to it, and dissenting investors are dragged along.

(Kindly comment which of the above two options should be made applicable)

5.4. The duration of encumbrance on equity shall not be greater than the residual tenure of the scheme of the AIF.

5.5. AIFs shall not create encumbrance on equity of foreign investee company.

5.6. AIFs shall not create encumbrance on equity of investee companies with understanding/arrangement to in turn use the borrowings by investee companies for equity infusion into another company. For this purpose, suitable standards to ensure that the encumbrance on equity of investee companies by AIFs is only utilized for facilitation of debt raising at the infrastructure sector investee company, shall be formulated by the pilot Standard Setting Forum for AIFs in consultation with SEBI.

5.7. Schemes of AIFs, whose downstream investments are classified as Indirect Foreign investment in terms of FEM (NDI) Rules, 2019, desirous of pledging equity of their investee companies shall be required to ensure compliance with para 7.11.2 of RBI Master Direction dated January 04, 2018 on 'Foreign Investments in India'.

5.8. Manager of AIFs shall ensure that the AIF is not subject to any outstanding liability of the borrower investee company towards lenders beyond forfeiture of the equity encumbered by the AIF.

5.9. Flexibility of creating encumbrance on equity investment of Category I and II AIFs shall not be interpreted as allowing such AIFs to extend any form of guarantee for investee companies.

6. Public Comments

6.1. Public comments are invited for the proposal given above. The comments / suggestions may be provided by any of the following modes latest by February 23, 2024:

6.2. 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 23, 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.)

6.3. 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 flexibility to Category I and II AIFs to create encumbrance on their holding of equity in infrastructure sector investee companies”.

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