

Restrictions on Investments in Alternative Investment Funds by Regulated Entities

The Reserve Bank of India ("RBI") has issued a circular on December 19, 2023 on "**Investments in Alternative Investment Funds ("AIF")**" (the "**Instructions**"), for regulating investments in AIF's by banks and financial institutions.

Evergreening

'Evergreening' refers to the practice of a lender extending a new loan to a borrower, for assisting repayment of an existing loan. Evergreening does not resolve the actual financial stress in the borrower and adds to long term asset deterioration and associated systemic risks.

Background

Resultantly, the RBI has stipulated in its Prudential Framework for Resolution of Stressed Assets dated June 7, 2019 ("**June 7 Framework**") that repayment/ refinancing of loans availed from the Indian banking system, or with the support (where permitted) from the Indian banking system in the form of guarantees/ standby letters of credit/ letters of comfort, will be treated as '*restructuring*' if the borrower concerned is under **financial difficulty**.

In what appears to be a step in the same direction, the Instructions restrict Regulated Entities (*as defined below*) from making investments in any scheme of an AIF¹, which has downstream investments, either directly or indirectly, in a 'debtor company of the Regulated Entity'.

Applicability of the Instructions

The Instructions apply to the following ("**Regulated Entities**"):

1. All commercial banks (including small finance banks, local area banks and regional rural banks)
2. All primary (urban) co-operative banks/state co-operative banks/ central co-operative banks
3. All all-India financial institutions

¹ **Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012** define AIF as any fund in the form of a trust, company, limited liability partnership, or a body corporate which is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors and is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.

4. All non-banking financial companies (including housing finance companies)

Restrictions under the Instructions

1. Regulated Entities are prohibited from making investments in any scheme of AIFs which have 'downstream investments', either directly or indirectly, in a 'debtor company of such Regulated Entity'. 'Debtor company of the Regulated Entity', for this purpose, means any company to which the Regulated Entity currently has or previously had a loan or investment exposure anytime during the preceding 12 (twelve) months.
2. If an AIF scheme, in which the relevant Regulated Entity is already an investor, makes a 'downstream investment' in any such debtor company, then the Regulated Entity must liquidate its investment in the scheme within 30 (thirty) days from the date of such downstream investment by the AIF. If investment by the Regulated Entities into such schemes has already been done as on the date of the Instructions, then the 30 (thirty) days period for divestment will be counted from the date of the Instructions.
3. In case the Regulated Entities are not able to liquidate their investments within the time limit prescribed under the Instructions, then they are required to make 100 % provisions on such investments.
4. In addition, investment by Regulated Entities in the subordinated units of any AIF scheme with a 'priority distribution model' will be subject to full deduction from Regulated Entity's capital funds. These priority distribution models are currently pending consideration by Securities and Exchange Board of India. While the RBI has not prohibited Regulated Entities from subscribing to these subordinated units, however, have prescribed a significant economic disincentive against such investments.

Conclusion

The Instructions are a step in the right direction in trying to make timely identification, and comprehensive resolution of financial stress, for the banking sector. The Instructions are different from any other RBI regulations in so far as it not only restricts investments being made to the existing borrowers of the Regulated Entities but also in borrowers, who have had loans from such Regulated Entities in the past 12 (twelve) months.

However, the Instructions appear to be in the nature of sweeping prohibition of investments in AIF having any exposures in debtor companies, and not only those debtor companies which are in financial difficulty – as is the approach adopted in the June 7 Framework. This may have an unintended consequence of Regulated Entities being prohibited from a large pool of quality investments.

Additionally, this may add to complications in closures of AIF schemes and management thereof. Investment portfolios of schemes with more than one Regulated Entities, or with a mix of Regulated Entities and other investors, may become extremely limited and rift with inter- investor conflicts of interest. The investment managers of the AIF schemes may face challenges in either attracting the right mix of investors or in identifying the right investment opportunities which can cater to investors with different investment restrictions.

Further, as a matter of working of AIFs, a unitholder may not always have prior information of where the investment manager proposes to invest. Obtaining this information generally, and also in cases where investments are proposed to be made in listed companies, may pose additional legal complexities. In such a scenario, the compliance obligation on the Regulated Entities and the general investment decision making of AIFs, can get very complex.

Investment managers will need to ensure that the investors who are Regulated Entities are obligated to make disclosures regarding the name/identity of their respective debtor companies, prior to the scheme's initial closing, and also during the tenure of the scheme.

Every Regulated Entity who is an existing investor in an AIF scheme, must also ensure (either through exercise of veto rights or other contractual rights under the contribution agreement or investment management agreement) that the AIF scheme does not make any subsequent downstream investment in any of its debtor company.

Practically, liquidation of existing investments of Regulated Entities within 30 (thirty) days may be fraught with several challenges, in which case, they will be faced with high provisioning requirements.

Investment Funds Practice

JSA advises fund managers as well as investors in funds. It has advised fund managers on structuring and establishment of a range of funds, both onshore and offshore with varied investment objectives and for investment in various types of asset classes. JSA has also advised domestic and foreign investors that invest in Indian alternative investment funds. We have been involved in the establishment of, or investments in, onshore alternate investment funds registered with SEBI, as well as offshore foreign venture capital investors and offshore private equity funds set up to make investments under the foreign direct investment route to invest in India. We have also advised on foreign portfolio investor funds established outside India which are registered with the Indian securities regulator. We advise clients on the structuring of their funds, including the choice of domicile and vehicle, having regard for the need to achieve optimum tax efficiency for the investors and the manager, marketing and regulatory considerations and any specific issues arising because of the proposed asset class(es) in which the fund will invest. We also assist our clients in their applications with SEBI for various types of fund registrations.

Banking and Finance Practice

JSA has a widely recognised market leading banking & finance practice in India. Our practice is partner led and is committed to providing quality professional service combining domain knowledge with a constructive, consistent, comprehensive and commercial approach to issues. Clients trust our banking lawyers to take a practical and business-oriented approach to achieving their objectives. Our lawyers have a clear understanding of the expectations and requirements of both sides to a financing transaction and provide tailored advice to each client's needs. The practice is especially praised for its accessibility and responsiveness and its ability to work well with international firms and clients. We represent a variety of clients including domestic and global banks, non-banking finance companies, institutional lenders, multi-lateral, developmental finance and export credit institutions, asset managers, funds, arrangers and corporate borrowers in different sectors on a wide range of financing transactions.

Our full spectrum of services includes advising clients on corporate debt transactions (including term and working capital debt), acquisition finance, structured finance, project finance, asset finance, real estate finance, trade finance, securitisation, debt capital markets and restructuring and insolvency assignments.

Our practice has been consistently ranked in the top-tier for several years, and several of our partners are regarded highly, by international publications such as Chambers and Partners, IFLR, Asia Law, Legal 500, Asia Legal Business, IBLJ and Leaders League.

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