IVCA

SPECIAL SITUATION FUNDS: AN ATTEMPT TO REVOLUTIONALIZE STRESSED ASSETS SPACE

By Dibya behera, shivam ahuja, arjun gupta ○ February 15, 2022

- SEBI introduces 'Special Situation Fund' as a sub-category under Category I AIF.
- Special Situation Funds ("SSFs") may invest in stressed loans and security receipts issued by ARCs. SSFs can also act as a resolution applicant under IBC.
- Minimum corpus of INR 100 crores, minimum investment size of INR 10 crores and no diversification norms for SSF.

Introduction

The financial system of India has over the years been plagued by stressed assets thereby propelling the requirement of significant capital infusion into banks, Non-Banking Financial Companies ("**NBFCs**") and other financial institutions.

Under such circumstances financial institutions are not able to provide credit facilities to sectors which would assist in overall economic development in India. Noteworthy herein is that the stressed assets of Indian NBFCs and mortgage lenders are expected to rise by 10-11% by the end of financial year 2021-22, with COVID-19 affecting almost all their asset classes.[1]

The Securities and Exchange Board of India ("**SEBI**"), in an attempt to address the stressed assets woes of the banking and finance industry has paved way for introduction of a new sub-category of Alternative Investment Fund ("**AIF**") called 'Special Situation Fund' ("**SSF**") under Category I Alternative Investment Funds ("**AIFs**") under the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**").

In this regard, on January 24, 2022, SEBI has notified the SEBI (Alternative Investment Funds) (Amendment) Regulations 2022[2] ("**Amendment Regulations**"), as further supplemented by a SEBI circular dated January 27,2022[3] introducing SSF to address the aforementioned issues. Given that AIFs manage and raise privately pooled funds from sophisticated investors who are open to high-risk investments, they can effectively serve as a source of risk capital to deal with the issue of stressed loans. Such a move is expected to bring in a new set of investors in the stressed asset space and create a more efficient market for buying distressed assets.

---

[1] Bank gross NPAs to rise to 8-9%, stressed assets to touch 10-11% (crisil.com), *available at* https://www.crisil.com/en/home/newsroom/press-releases/2021/10/bank-gross-npas-to-rise-to-8-9percent-stressed-assets-to-touch-10-11percent.html

[2] SEBI (Alternative Investment Funds) (Amendment) Regulations 2022, *available at:* https://www.sebi.gov.in/legal/regulations/jan-2022/securities-and-exchange-board-of-india-alternative-investment-funds-amendment-regulations-2022_55525.html.

[3]Introduction of Special Situation Funds as a sub-category under Category I AIFs, *available at:* https://www.sebi.gov.in/legal/circulars/jan-2022/introduction-of-special-situation-funds-as-a-sub-category-under-category-i-aifs_55625.html.

Special Situation Funds

The Amendment Regulations primarily provide for a new chapter (i.e. Chapter III-B) within the AIF Regulations defining SSFs as a sub-category under Category – I AIFs that invest in 'special situation assets', in accordance with its investment objectives and such SSF may act as a 'resolution applicant' under the Insolvency and Bankruptcy Code, 2016 ("**IBC**").

However, prior to the Amendment Regulations, AIFs were only permitted to invest in debt by way of investment in debt securities and were prohibited from providing loans. Therefore, the AIFs currently tend to invest in distressed assets through investing in securities of stressed companies and Security Receipts ("**SRs**") issued by ARCs. Notably, staying invested in an investee company for longer duration is quintessential for turnaround of companies lingering through a state of distress.

In this regard, AIFs should prove to be the most suitable investment vehicle for resolution of stressed assets, especially when coupled along with the managerial skills required to turn around a struggling business. As SEBI also notes in its board meeting memorandum, the purchase of stressed loans at a discounted price from the original lender should prove to be attractive to AIFs as they will have a claim on the assets of the portfolio companies to the extent of outstanding loans.

Special Situation Assets

Notably, Category I AIFs invest, inter alia, in sectors which the Government or regulators consider as socially or economically desirable and which are generally perceived to have positive spill over effects on the economy. Further, SEBI or Government or other regulators in India might consider providing incentives or concessions to such AIFs. SSFs are allowed to invest in special situation assets which includes:

- Stressed loans available for acquisition in terms of Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 ("**Transfer Directions**") or as part of a resolution plan approved under IBC;
- Security receipts issued by ARCs;
- Securities of investee companies (i) whose stressed loans available for acquisition in terms of Transfer Directions or as part of a resolution plan approved under IBC; (ii) against whose borrowings, security receipts have been issued by an ARC; (iii) whose borrowings are subject to corporate insolvency resolution process under Chapter II of IBC; (iv) who have disclosed all the defaults relating to the payment of interest/ repayment of principal amount on loans from banks / financial institutions; and
- Any other asset/security as may be prescribed by SEBI from time to time.

With the introduction of such provisions, SSFs will be able to provide much needed capital to companies in distress, which are unable to function optimally and generate value for stakeholders due to over-leveraging, but may have potential of a turnaround.

Key Features of SSFs

SEBI while introducing the SSFs has provided for a slew of relaxations to make them more attractive and conducive for investors and fund manager alike, as discussed below.

No investment concentration limits

Currently, under the provisions of Regulation 15(1)(c) of AIF Regulations, a Category I AIF cannot invest more than 25% of its investable funds in one investee company. Further, under Regulation 16 of AIF Regulations, conditions for investment by various sub-categories of Category I AIFs have been specified, wherein all sub-categories of Category I AIFs are required to invest at least seventy-five percent of the investable funds in unlisted securities of investee companies as applicable in respective sub-category.

Notably, given that SSFs will be formed with the objective of reviving identified entities under stress and may also act as resolution applicants under IBC, they should not be burdened with diversification norms. In the past although the AIFs were eligible to act as resolution applicants under IBC, the diversification norms have often been a major roadblock considerably diluting the objective behind acting as a resolution applicant.

In the wake of such considerations, SEBI has decided to exempt the SSFs from the diversification norms as applicable under the AIF Regulations thereby allowing SSFs to invest up to 100% of their investable funds in a single special situation asset.

If we compare SSFs to ARCs, while ARCs may also raise and utilise funds by formulating schemes for acquiring financial assets, they are restricted from utilizing not more than 25% of the funds so raised towards reconstruction of the financial assets so acquired. An SSF, on the other hand, is not subject to such limits for restructuring support finance.

Currently, if a foreign company/investor intends to acquire an Indian company under the IBC route, it is required to invest in the shareholding of the Indian company. Such foreign company/investor will thereafter acquire the entire shareholding with the purchase consideration being used to pay off the existing creditors. However, if the debtor entity is in a restricted sector (media company or insurance company) then the foreign investor will not be able to invest in such entities. Such issues should not arise in respect of an SSF whose sponsor and manager are owned and controlled by resident Indian citizens.

Other investment considerations

In addition to the above, SEBI has also permitted the SSFs to set up specific schemes targeting specific special situation assets. In order to provide adequate capital for revival of the distressed company, SEBI has mandated that the SSFs shall have a minimum corpus of INR 100 crores with a minimum commitment of INR 10 crores from each investor (Accredited Investors can commit a minimum of INR 5 crores). Further, while the SSFs are allowed to invest in units of other SSFs, they are prohibited from investing in (i) associates; (ii) SSFs managed or sponsored by the same manager/ sponsor or associates; or (iii) units of non-SSF AIFs; (iv) overseas investments.

Acquisition of debt as well as shares of stressed companies

Noteworthy herein is that SEBI while providing for SSFs to acquire stressed loans has effectively barred acquisition of stressed loans from individual lender since Clause 58 of the Transfer Directions contemplates acquisition of loans only pursuant to a resolution plan as approved by the lenders under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019[1] or as approved under the IBC. In the wake of such amendments, it is expected that Reserve Bank of India ("**RBI**") will update the annexure to the Transfer Directions to include SSFs. ARCs under the current framework are only permitted to acquire stressed loans which are in default for more than 60 days or classified as non-performing assets.[2] In this regard, no such restrictions are applicable for SSFs.

Further, stressed loans acquired by SSF in terms of Clause 58 of the Transfer Directions are subject to a minimum lock-in period of six months. However, the lock in period shall not be applicable in case of recovery of the stressed loan from the borrower. Moreover, in order to ensure that there is no regulatory arbitrage in respect of the due diligence requirements mandated for ARCs, SSFs acquiring the stressed loans are required to comply with the same initial and continuous due diligence requirements for its investors, as those mandated by for ARCs.

SEBI by permitting SSFs to act as a 'resolution applicant' under the IBC has provided for a way through which the SSF can acquire the debt as well as securities, including shares of stressed companies undergoing a corporate insolvency resolution process under the IBC. Considering that investment in Special Situation Assets would require extensive monitoring and managerial support from the SSFs, such provisions allow the SSFs to provide a complete exit to the lenders and control the revival of the stressed company, without any restriction on investment concentration.

Conclusion

In the past, credit funds focussed on stressed assets have often used the ARC route to invest in stressed loans with some of the funds investing in an ARC as a sponsor. However, setting up of an ARC and the stringent compliance requirements mandated by RBI adds to the cost and complexities of such structures. On the other hand, AIFs are regulated under the AIF Regulat

ions which provides optimum flexibility to the fund managers and encourages investments by investors. SEBI's decision to introduce SSFs as a sub-category under Category I AIF to resolve the issues of stressed loans is praiseworthy and is expected to open up sources of capital for the companies in distress. Deep pocketed funds from developed markets could look at buying distressed loans with an intention of recovery or restructuring. SEBI has also provided certain safeguards to ensure that the SSFs do not acquire stressed loans of their associates and investments are not made outside India. In addition to the same, SEBI in the form of six-month lock-in period has provided the SSFs reasonable time to work towards potential resolution of the stressed asset, before making an exit. Further, the exemption from diversification norms

---

[1] Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 *available at:* https://rbidocs.rbi.org.in/rdocs/notification/PDFs/PRUDENTIALB20DA810F3E148B099C113C2457FBF8C.PDF.

[2]Paragraph 73, Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 *available at:* 86MDLOANEXPOSURESC6B1DFB428C349D885619396317F04DE.PDF (rbi.org.in).

will ensure that SSFs can be used as special purpose vehicles by both sophisticated investors with a risk appetite and foreign investors alike who have been looking to invest in the restricted sectors in the stressed assets space.

However, SSFs not being accorded the status of 'secured creditor' for the purposes of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 might prove to be a roadblock for certain investors where there is no exit option for lenders. On the contrary, ARCs by the virtue of being a 'secured creditor' have a well-established resolution framework for recovery of their investments i.e. any security interest created in favour an ARC may be enforced, without the intervention of the court or tribunal.

Further, while the Amendment Regulations permit SSFs to invest in SRs no clarity has been provided by SEBI in respect of the applicability of the restrictions to AIFs investing in SRs such as prohibition to invest in SRs by an ARC in which the AIF has invested. Noteworthy herein is that SEBI has written to RBI seeking for clarifications.

SEBI has also written to the Central Board of Direct Taxes (CBDT) regarding tax treatment of income from security receipts. It is imperative for the CBDT to issue necessary clarifications in this regard as the profits and gains from business or profession earned by Category I AIFs are taxed at the AIF level (and not passed through to the investors), and in the absence of clarity on this, the tax viability of SSFs may remain a concern among industry participants.

Disclaimer:

This article was originally published by **Dibya Behera, Shivam Ahuja and Arjun Gupta, Nishith Desai Associates**