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Sebi may allow AIFs to 'exclude' investors from certain investments

Proposal will help address concerns about evergreening of loans

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The Securities and Exchange Board of India (Sebi) is planning to mandate the managers of alternative investment funds (AIFs) to exclude certain investors while making investments, in a bid to address concerns about the evergreening of loans at the fund level.

Sebi first codified the 'excuse-exclude' norms in April 2023, giving AIFs an option to exclude investors in certain circumstances. Through the fresh proposal, Sebi is seeking to convert this discretion into an obligation for AIFs, said legal experts.

According to the proposal, an AIF manager will be required to carry out specific due diligence before each investment by the fund to ensure that it does not facilitate the circumvention of regulations issued by the markets, insurance or banking regulator.

Some industry officials said Sebi's proposal could be a breather for banks and non-banking financial companies (NBFCs), as they may be excluded from making an investment in a debtor firm. However, legal players are of the opinion that this rule will require more clarity from the Reserve Bank of India (RBI).

The RBI has restricted banks and NBFCs from investing in AIFs that have any such firm in their portfolios to which they have already lent. The RBI had directed liquidation or provisioning for such investments. "AIFs may now be required to either excuse the investors whose contribution towards an investment may cause circumvention of any regulations, or refrain from making that investment entirely. However, the diligence obligation imposed on the AIF manager to determine the excusal for each deal specifically is impractical and onerous," said Nandini Pathak, leader, investment funds practice, Nishith Desai Associates.

"Managers or their personnel are not equipped to carry out diligence on potential circumvention of the law and should not be made liable if the circumvention is by the investor. Further, this excusal mechanism will not resolve the issues created by the RBI circular, which prohibits regulated entities from becoming an investor in AIFs with a common downstream link to begin with," she said.

Vinod Joseph, partner, Economic Laws Practice, said, "The RBI does not have any authority over AIFs and the December 19 notification applies to entities regulated by the RBI. Hence, Sebi has now included evergreening of loans as one of the grounds for AIFs to exclude investors."

However, there could be challenges in giving the discretion to an AIF manager to exclude certain investors.

"Sebi's consultation paper states that it is necessary to ensure that these measures do not come in the way of legitimate investments. However, will it be possible for an AIF to decide when a bank's investment in an AIF is legitimate and not meant to circumvent RBI regulations? If an AIF takes a bona fide call, would Sebi and RBI respect the same?" he added.

The market regulator has identified over Rs 30,000 crore worth of investments in circumvention of several regulations by loan evergreening, violation of the Foreign Exchange Management Act (FEMA), and norms around qualified institutional buyers.

Experts have also highlighted practical issues in terms of excluding non-resident investors from specific investments.

"If more than 50 per cent of an AIF's corpus is from non-resident Investors, such an AIF may not be able to make investments in companies where FDI is restricted, even if under current laws, the residency of an AIF depends on the residency and citizenship of its sponsor and manager. If the AIF wishes to proceed with the investment, it may have to exclude all non-resident investors from the investment, which may not be practical," said Joseph.

Vivaik Sharma, partner, Cyril Amarchand Mangaldas, said, “The proposal in the consultation paper is widely worded and doesn't prescribe any safe harbours. The law regarding applicability of FDI conditions to AIFs whose investment managers or sponsors are foreign owned or controlled is well settled.”

“Sebi in its circular dated October 22, 2020, mentioned that it has sought clarity from the government and the RBI on FDI rules…while keeping applications of such AIFs in abeyance until clarity is received by it,” he added.

Curtailing Evergreening

Sebi identified investments worth Rs 30,000 crore in circumvention of regulations

RBI in Dec restricted financial institutions from investing in AIFs with link to debtor firms

Several private lenders like HDFC Bank, ICICI Bank, Kotak Mahindra Bank have made provisions for such exposure

Sebi’s fresh proposal tries to address concerns around over-regulation hindering legitimate investments

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