# 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.

February 02, 2024

# Objective

Seeking feedback on a proposal to amend SEBI (Alternative Investment Funds) Regulations, 2012, aiming to enhance ease of doing business for Category I and II AIFs. The amendment would permit these AIFs to create encumbrances on their equity holdings in infrastructure sector investee companies, facilitating the companies in raising debt.

# Background

- Regulation 2(b) of the AIF Regulations define Alternative Investment Funds (AIFs) as privately pooled investment vehicles managing funds in line with a specified policy for investor benefit. The Code of Conduct emphasizes AIFs and their managers acting in a fiduciary capacity for investor interests.

- 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.

- A recent SEBI order clarified that "directly or indirectly" in Regulations 16(1)(c) and 17(c) prohibits AIFs from participating in any borrowing, including pledging securities of portfolio companies for loans.

- Creating pledges on AIF assets for investee company loans poses risks to investor equity if defaults occur. Additionally, availing loans against AIF equity holdings may introduce indirect leverage, contributing to systemic risks in the financial ecosystem, as noted by global regulators like the US SEC and UK FCA and IOSCO.

# Issue For Consideration

Infrastructure is vital for economic growth and citizens' well-being, serving as a catalyst for various sectors. The government actively promotes infrastructure through initiatives like PPPs, FDI, and tax benefits, with a heightened focus in recent years, as highlighted in the FY 22-23 Economic Survey and emphasized in the FY 2023-24 Budget. SEBI has received requests to enable Alternative Investment Funds (AIFs) to pledge equity for infrastructure financing, recognizing their role in attracting global funds. However, challenges in project finance, where equity pledges are crucial, impact AIFs and banks, potentially hindering opportunities for invested companies. A proposed solution involves allowing Category I and II AIFs to pledge equity investments in infrastructure companies, acknowledging their pivotal role in sector growth and facilitating debt raising for companies.

# Proposal

**Considering the above the following are proposed: -**

1. Category I and II Alternative Investment Funds (AIFs) can pledge equity of an investee company solely for its borrowing, provided the investee is involved in infrastructure projects listed in the Harmonized Master List by the Department of Economic Affairs Ministry of Finance, Government of India, from time to time.
2. Category I and II AIFs who have not on-boarded investors as on the date of aforesaid mandate must clearly state in their Private Placement Memorandums (PPMs) if such encumbrance on investee company equity is part of their investment strategy.
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.
4. The duration of encumbrance on equity shall not be greater than the residual tenure of the scheme of the AIF.
5. AIFs are prohibited from creating encumbrance on equity of foreign investee companies.
6. AIFs cannot encumber equity with an understanding/arrangement to use borrowings for equity infusion into another company. For this purpose, suitable standards will be set by the pilot Standard Setting Forum for AIFs in consultation with SEBI.
7. AIFs with downstream investments classified as Indirect Foreign Investment must comply with RBI Master Direction dated **January 04, 2018.**
8. AIF Managers must ensure that the AIF is not liable for the borrower investee company's outstanding debts beyond the forfeiture of encumbered equity.
9. The flexibility to encumber equity for **Category I and II AIFs doesn't permit them to provide guarantees for investee companies.**

## Notes

- 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**

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

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