BEACON RESEARCH

Consultation paper on proposal to enhance trust in the Alternative Investment Funds ('AIF') ecosystem to facilitate Ease of Doing Business measures.

January 19, 2024

Objective

This consultation paper addresses concerns about some Alternative Investment Funds (AIFs) exploiting structures to bypass financial regulations, undermining trust in the industry. The proposal suggests implementing a requirement for AIFs, their managers, and key personnel to prevent such circumvention. Verifiable standards will be developed by the Industry Standards Forum for AIFs in collaboration with SEBI. This initiative aims to restore trust, ensuring sustained capital formation and facilitating regulatory considerations for Ease of Doing Business proposals related to AIFs.

Background

The AIF industry has seen consistent growth, reaching INR 3,53,352 Crore by September 30, 2023. AIFs serve as a link between risk-taking investors and enterprises in need of capital, complementing traditional funding sources. Unlike Mutual Funds and Portfolio Management Services, AIFs face a lighter regulatory framework. SEBI has identified 40 cases involving more than INR 30,000 crores in the recent months, highlighting the need to address these circumvention practices.

Brief

Some of the identified modus operandi where AIFs are being structured to facilitate circumvention of financial sector regulatory frameworks are as under: -

- ## Ever-greening loans by regulated lenders.

  AIFs have been established, leading to the ever-greening of stressed loans by some regulated lenders, thus evading RBI regulations and disclosure requirements for asset restructuring and non-performing assets recognition. Typically, regulated lenders subscribe to a junior class of AIF units, which then funds the stressed borrower. This allows lenders to avoid regulatory obligations, such as classification and provisioning under RBI regulations, deferring the recognition of the borrower's deteriorating creditworthiness. While the RBI has taken specific steps to address ever-greening, it is crucial to prevent such instances in different forms involving AIFs and ensure these measures do not impede legitimate investments.

- ## Circumvention of FEMA norms

  FEMA NDI Rules 2019 allow AIFs to classify downstream investments based on the manager/sponsor's domicile, creating room for regulatory arbitrage. Some AIFs exploit this by involving foreign investors with domestic managers to invest in restricted sectors or surpass FDI sectoral limits. Additionally, AIFs may structure investments to channel foreign funds into debt securities, sidestepping regulations intended for foreign investment through FPI/ECB routes.

- ## Circumvention of QIB regulations

  QIBs are expert institutional investors vital for IPO pricing. Currently, all AIFs are considered QIBs. However, some AIFs with few investors, often from the same group, accessed QIB benefits in IPOs. This is a concern as these investors wouldn't qualify as QIBs individually. Allowing such AIFs as QIBs lets otherwise ineligible entities influence price discovery, affecting retail investors in IPOs.

- ## Proposed regulatory approach.

  - The proposal aims to address concerns while ensuring regulatory flexibility for genuine AIF investments.
  - A balanced, risk-based approach is suggested for regulatory intervention, promoting ease of doing business.
  - The goal is to prevent misuse (Type I errors) without hindering legitimate investments (Type II errors)
  - SEBI is engaging industry participants through Standards Fora to formulate effective regulations.
  - A pilot Standards Forum for AIFs is set up to create implementation standards in consultation with SEBI.
  - A general obligation in AIF regulations for AIFs, managers, and key personnel to prevent circumvention of financial sector regulations.
  - Industry Standards Forum, in consultation with SEBI, to define specific responsibilities and obligations.
  - In line with the 'Trust, but verify' principle, the specific verifiable actions by the AIFs and their KMPs to demonstrate adherence set by the industry itself, through the pilot SFA, in consultation with SEBI.
  - SEBI's circular SEBI/HO/AFD-1/PoD/P/CIR/2023/053 dated April 10, 2023, allows AIF managers to exclude investors if their participation violates laws or regulations.
  - In case an investor's participation may facilitate circumvention, the AIF manager can choose not to make the investment or exclude the investor.
  - Enhanced trust and verification process would provide regulatory comfort for Ease of Doing Business proposals related to AIFs under consideration by SEBI.

- ## Proposal

To insert the following provision in Chapter IV (viz. General Obligations and Responsibilities and Transparency) of the SEBI (AIF) Regulations, 2012

Every Alternative Investment Fund, Manager of the Alternative Investment Fund and Key Management Personnel of the Manager and the Alternative Investment Fund, shall carry out specific due diligence, as may be specified by SEBI from time to time, with respect to their investors and investments, before each investment, to prevent facilitation of circumvention of extant regulations administered by any financial sector regulator.

Provided that, if participation of an investor of an AIF in an investment opportunity has been ascertained to result in facilitation of circumvention of any extant regulation, the manager of the AIF shall –

(a) not make the investment; or
(b) exclude the particular investor from the investment

[**Explanation**: "extant regulations" shall mean laws, acts, rules, regulations, guidelines/circulars framed thereunder that are administered by any financial sector regulator including SEBI.]

SEBI will create a framework to address regulatory circumventions in AIFs, defining objectives and principles. This framework will guide the formulation of specific due diligence standards for AIF stakeholders to determine if an investor's participation in a specific AIF investment facilitates regulation circumvention.

The pilot SFA, in consultation with SEBI, will formulate these specific verifiable due diligence standards and reporting requirements for AIFs.

Notes

- The comments / suggestions may be provided by any of the following modes latest by February 11, 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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