



SEBI Circular On

Framework for Category I and II Alternative Investment Funds (AIFs) to create encumbrance on their holding of equity of investee companies.

Dated: 26th April 2024

Source - SEBI/HO/AFD/PoD1/CIR/2024/027



▪ Background of the Circular

To provide ease of doing business and flexibility to Category I and II AIFs to create encumbrance on their holding of equity in investee companies to facilitate raising of debt by such investee companies, SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations") have been amended and notified on April 25, 2024

▪ Brief of the Circular

In terms of provisos to Regulation 16(1)(c) and 17(c) of AIF Regulations, Category I and Category II AIFs may create encumbrance on equity of investee company, which is in the business of development, operation or management of projects in any of the infrastructure sub-sectors listed in the Harmonized Master List of Infrastructure issued by the Central Government, only for the purpose of borrowing by such investee company and subject to such conditions as may be specified by the Board from time to time

In this regard, the following conditions are specified.

1. Creation of Encumbrance by AIFs

AIFs falling under **Category I or Category II**, which haven't onboarded any investors before **April 25, 2024**, can create encumbrances on the equity of investee companies for borrowing purposes, provided explicit disclosure is made in their **Private Placement Memorandums (PPMs)**.

2. Continuation of Existing Encumbrances

- a) Existing encumbrances created by **Category I or Category II AIFs before April 25, 2024**, can continue if disclosed in the PPM.
- b) If encumbrances were created without disclosure, continuation is subject to obtaining consent from all investors by **October 24, 2024**. If Consent of all investors is not obtained within the aforesaid time period, the encumbrances shall be removed latest by **January 24, 2025**.
- c) Encumbrances created without disclosure on securities other than specified must be removed by **October 24, 2024**.

3. Utilization of Borrowings

Borrowings against encumbered equity investments should be utilized only for the development, operation, or management of the investee company, as per specified purposes in brief section.

4. Duration of Encumbrance

The duration of encumbrance should not exceed the residual **tenure of the AIF scheme**.

5. **Compliance with RBI Master Direction**

AIFs with significant foreign investment or involvement must comply with **para 7.11.2** of the RBI Master Direction dated **January 04, 2018**, as if they were persons resident outside India.

6. **Liability in Case of Default**

In case of default by the borrower investee company, the AIF should ensure that the fund or its investors are not subject to any liability beyond the encumbered equity.

7. **Restrictions on Guarantees and Foreign Investments**

AIFs should not extend any form of guarantee for investee companies and should not create encumbrance on investments in foreign investee companies.

8. **Formulation of Implementation Standards**

The **Standard Setting Forum for AIFs (SFA)**, in consultation with SEBI, will formulate implementation standards to ensure that encumbrances created by AIFs are utilized only for facilitating debt raising in **infrastructure sector investee companies**.

9. **Compliance Test Report**

The trustee/sponsor of AIFs should ensure that the **Compliance Test Report** prepared by the manager includes compliance with the provisions of this circular.

Impact of the Circular

- 1. Facilitating Infrastructure Financing:** The circular allows Category I and Category II AIFs to create encumbrances on equity of investee companies in infrastructure sub-sectors for borrowing purposes. This provision facilitates easier access to financing for crucial infrastructure projects, which often require substantial capital investments.
- 2. Regulatory Clarity and Compliance:** By specifying conditions for the creation and continuation of encumbrances, the circular provides much-needed clarity to AIFs operating in the infrastructure sector. It ensures that AIFs adhere to regulatory guidelines, promoting transparency and accountability within the industry.
- 3. Investor Protection and Risk Management:** The circular introduces measures to safeguard investor interests and mitigate risks associated with encumbered equity investments. It mandates explicit disclosure in PPMs and requires consent from all investors for the continuation of encumbrances created without disclosure. Additionally, it limits the duration of encumbrances to the residual tenure of the AIF scheme, preventing indefinite liabilities for investors.
- 4. Alignment with Regulatory Framework:** A noteworthy impact is the requirement for AIFs with significant foreign investment or involvement to comply with specific RBI Master Direction. This aligns AIFs with broader regulatory frameworks, ensuring consistency and adherence to international standards, especially concerning foreign investments.
- 5. Standardization and Monitoring:** The circular mandates the formulation of implementation standards by the Standard Setting Forum for AIFs (SFA), in consultation with SEBI. This initiative aims to standardize practices across AIFs and ensure that encumbrances are utilized only for facilitating debt raising in infrastructure sector investee companies. Moreover, the requirement for Compliance Test Reports adds an additional layer of oversight, enhancing monitoring and regulatory compliance within the AIF ecosystem.



Visit Beacon Research Webpage to get more updates like these.

www.beacontrustee.co.in/research

Follow Us On:



Disclaimer:

This document is neither a legal interpretation nor a statement of the Gazette Notification. All information is posted merely for educational and informational purposes. It is not intended as a substitute for professional advice. Should you decide to act upon any information in this document, you do so at your own risk.