

Investment Funds: Monthly Digest

July 12, 2024

SEBI APPROVES BORROWINGS FOR AIFs AND CAP ON LARGE VALUE FUND EXTENSIONS: INSIGHTS AND IMPLICATIONS

- SEBI permits borrowing by Category I and Category II AIFs to meet temporary shortfall in drawdown from investors.
- Cooling off period of 30 days to be applicable between 2 instances of borrowing.
- SEBI caps extension of tenure of Large Value Funds to a maximum period of 5 years.

INTRODUCTION

The Securities and Exchange Board of India ("SEBI") in its recent board meeting dated June 27, 2024 ("Board Meeting") has approved a slew of amendments including certain proposals related to Alternative Investment Funds ("AIFs"). In particular, SEBI has now approved amendments to permit borrowing by Category I and Category II AIFs for a period of up to 30 days for the purpose of meeting temporary shortfall in drawdown from investors, where such drawdown was required to make investments in portfolio companies.. In addition to this, SEBI has also approved the proposal to limit the extension of tenure of a large value fund for accredited investors ("LVF") to five years, subject to the approval of 2/3rd of the unit holders by value for such extension. In this issue of the monthly digest, we discuss the background and implications of the proposals approved by SEBI.

CONSULTATION PAPER – PROPOSALS ON BORROWING BY CATEGORY I AND CATEGORY II AIF

SEBI (AIFs) Regulations, 2012 ("AIF Regulations") prohibits Category I and Category II AIFs from borrowing funds directly or indirectly, or from engaging in any leverage except for meeting temporary funding requirements. Further, even when borrowing or leveraging in order to meet temporary funding requirements, AIFs are prohibited from entering into such arrangements (i) for more than thirty days, (ii) more than four times a year; and (iii) if the amount borrowed is more than 10% of the investable funds. The primary reason behind such restrictions was to ensure that Category I and II AIFs borrow funds only for meeting operational requirements of the AIF, and not for the purpose of making investment which may further lead to asset-liability mismatch. However, SEBI in its consultation paper dated May 18, 2023 ("Consultation Paper") had noted that although the Private Placement Memorandums ("PPMs") of Category I and II AIFs typically state that borrowing is intended for temporary funding, often these AIFs borrow funds specifically for making investments.

One of SEBI's key proposals in the Consultation Paper was to ensure that Category I and Category II AIFs avoid leveraging for investments, except in emergencies, with borrowing treated strictly as a last resort. SEBI further proposed that borrowing should be permissible for Category I and Category II AIFs only in situations where an investor delays or defaults on a drawdown payment. In such cases, the cost of borrowing should be borne by the defaulting investor. Furthermore, the borrowing should be limited to meeting the shortfall from that specific investor and should not exceed 10% of the proposed investment in the investee company. Moreover, SEBI proposed that AIF shall not borrow more than once to meet a shortfall from the same investor.

To enhance transparency, SEBI proposed that all relevant details of any borrowing, including the amount and terms, should be disclosed in the Private Placement Memorandum (PPM) of the AIF. Additionally, the investment manager should be responsible for disclosing the borrowing details to ensure that all modalities are transparent to the investors. SEBI also suggested introducing a mandatory cooling-off period to prevent prolonged leverage, ensuring that Category I and Category II AIFs do not repeatedly engage in borrowing without a break.

BOARD MEETING - APPROVALS

After more than a year since the Consultation Paper was released to the public, SEBI in the Board Meeting has approved the proposal to permit Category I and Category II AIFs to borrow money for a period of 30 days for the purposes of meeting temporary shortfall in drawdown from investors, while making investments.. While the detailed framework for borrowing by Category I and Category II AIFs is yet to be notified, it is expected that SEBI will follow through with the proposals made in the Consultation Paper. According to the minutes of the Board Meeting, borrowing by AIFs will be allowed only when an investor defaults on the drawdown amount on the due date, making the defaulting investor liable for the borrowing costs. Additionally, SEBI has mandated a minimum cooling-off period of at least 30 days between 2 instances of borrowing.

ANALYSIS

The move to expressly permit Category I and Category II AIFs to borrow for the purpose of meeting temporary

Research Papers

Little International Guide (India) 2024

November 08, 2024

Unmasking Deepfakes

October 25, 2024

Are we ready for Designer Babies

October 24, 2024

Research Articles

The Bitcoin Effect

November 14, 2024

Acquirers Beware: Indian Merger Control Regime Revamped!

September 15, 2024

Navigating the Boom: Rise of M&A in Healthcare

August 23, 2024

Audio

Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part I

August 26, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part II

August 26, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

"Investment return is not enough" Nishith Desai with Nikunj Dalmia (ET Now) at FI8 event in Riyadh

October 31, 2024

Analysing SEBI's Consultation Paper on Simplification of registration for FPIs

September 26, 2024

shortfall in drawdown required to make investments in portfolio companies is a welcomed move. The relaxation should enhance liquidity management by ensuring that AIFs can execute investments on time, even if there are delays in investor drawdowns, thus preventing missed opportunities and aligning with investment timelines. Further, with the ability to leverage, AIFs can promptly seize market opportunities without waiting for delayed investor drawdowns, potentially leading to better investment returns. From a risk management perspective, borrowing mitigates the risks associated with delays in investor drawdowns, ensuring that investment commitments of the AIF are met without disruption. It also allows for better financial planning, enabling AIFs to align their cash inflows and outflows more effectively, which would ultimately benefit the investors.

Having said that, the proposal as outlined in the Consultation Paper have their own share of challenges in implementation. Particularly, the cap on borrowing of up to 10% of the proposed investment, if implemented, may be restrictive. If an AIF plans a significant investment and faces a shortfall that exceeds this limit, it might still struggle to complete the deal. For instance, if an AIF plans to invest INR 100 crore in a company, it can only borrow up to INR 10 crore. If the shortfall is INR 15 crore, the AIF would still face a gap in funding the company and may have to lose the investment opportunity.

If implemented, the proposal in the Consultation Paper to restrict AIFs from borrowing more than once to meet a shortfall from the same investor could have significant implications for fund operations, risk management, and investor relations. AIFs would need to enhance their planning and communication strategies to meticulously avoid multiple shortfalls from individual investors. This requirement necessitates advanced forecasting and proactive engagement with investors to ensure timely contributions. For example, if an investor defaults or delays a drawdown after the AIF has already borrowed once to cover a shortfall caused by the same investor, it could lead to a severe liquidity crunch for the AIF. This situation might force the fund to postpone or miss investment opportunities, potentially impacting the AIF's overall returns.

Moreover, in compliance with the condition as approved in the Board Meeting, if an investor fully defaults and subsequently fails to honor future drawdown requests, the AIF is authorized only to charge the interest and borrowing costs to that investor. Consequently, the AIF would be required to pay costs, as well as repay the borrowed amount within 30 days without having received any additional funds from the investor. In such a situation, the AIF may end up having to deduct such costs as well as the loan amount from the distribution proceeds owed to the investor (if any), or otherwise find a way to repay the liability.

CONSULTATION PAPER – CAPPING THE EXTENSION OF TENURE FOR LVFS

AIF Regulations define a “Large Value Fund for Accredited Investors” to mean an AIF or scheme of an AIF in which each investor (other than the investment manager, sponsor, employees or directors of the AIF or employees or directors of the investment manager) is an accredited investor and invests not less than INR 70 crore (“LVP”). AIF Regulations further provide that an LVP can extend its tenure beyond 2 years, subject to the terms of its contribution agreement, other fund documents and such conditions as may be specified by SEBI from time to time¹.

In the Consultation Paper, SEBI highlighted concerns over the risks associated with allowing Large Value Funds (LVFs) to operate without a defined upper limit on their term. SEBI noted that such flexibility could potentially lead LVFs to resemble quasi-perpetual funds, thereby locking investors' capital for an indefinite period. This scenario raises significant challenges, including the delayed disclosure of critical information such as asset quality, liquidity, fund value, and overall performance metrics of AIFs and their investment managers.

Furthermore, the Consultation Paper emphasized the importance of aligning LVFs with other AIF schemes in terms of operational frameworks, especially concerning the management of unliquidated investments during winding-up processes. Consequently, SEBI has proposed to cap the maximum extension period of an LVP's tenure to 4 years.

BOARD MEETING - APPROVALS

In the Board Meeting, SEBI approved the proposal to provide for a maximum extension period of 5 years for LVFs. SEBI has also approved that any extension beyond the initial term of the LVP would require approval from at least 2/3rd of the investors by value of their investments. In cases where an LVP has unliquidated investments at the end of its extension period, it will have the option to enter a dissolution period, similar to other AIFs. For further details on the dissolution period, please refer to our [article](#).

In addition to the above, SEBI also approved that existing LVP schemes, which do not currently specify or provide for a cap on extension of tenure in their PPMs, or have extension periods exceeding 5 years, must update their PPMs within 3 months from the issuance of SEBI's circular on this issue. During this process, such AIFs will have the flexibility to amend their original base tenure with unanimous consent from all investors.

ANALYSIS

SEBI's recent directive aimed at enhancing governance and safeguarding investor interests in LVFs marks a significant regulatory shift, yet they introduce nuanced challenges, particularly concerning operational flexibility.

By imposing a cap on the extension of LVFs' tenures, SEBI seeks to prevent these funds from morphing into quasi-perpetual structures, thereby mitigating risks associated with prolonged investor lock-ins and delayed disclosures of fund performance and asset quality. However, under the current framework, LVFs have the flexibility of potentially unlimited extensions, although such extensions typically require negotiation between the investment manager and investors. This dialogue is crucial as it allows the manager to justify extension needs based on specific market conditions or circumstances affecting the fund's investments. This flexibility has traditionally been a cornerstone of LVFs, which typically attract sophisticated investors committing substantial amounts, starting from a minimum of INR 70 crore. It is specifically because LVFs can only raise funds from sophisticated investors that SEBI has provided a more flexible governing framework allowing investment managers to adjust strategies and effectively manage assets over time. The capping of extension of tenure could impact this flexibility, potentially limiting the investment manager's ability to respond promptly to market dynamics or unforeseen challenges.

Further, the requirement for unanimous investor consent to revise base tenures for existing LVFs could pose significant challenges, impacting efficiency. SEBI's decision contrasts with thresholds set for other significant changes in PPMs, such as alterations in fund strategy or simultaneous investments in securities of investee

companies and in units of other AIFs, which typically require only a 2/3rd majority consent of investors. Applying a unanimous consent requirement for tenure revisions may lead to practical difficulties in achieving consensus among diverse investor groups, each with varying investment horizons and risk appetites. Alternatively, SEBI could have considered a 2/3rd majority consent for base tenure revisions, similar to changes in fund strategy, or even a 75% threshold, reflecting the significance of alterations that materially impact investor commitments and fund operations.

Authors

- Dibya Behera and Radhika Parikh

Funds Team

Nishith Desai, Global Strategy

Parul Jain, Fund Formation and International Tax

Radhika Parikh, Fund Formation and GIFT City

Prakhar Dua, Fund Formation and FSR

You can direct your queries or comments to the relevant member.

¹Regulation 13(5) of AIF Regulations.

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.