client alert

January 28, 2022

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ahead of the curve

New avenue for investing in stressed assets

The newly introduced 'Special Situation Funds' Regime could potentially emerge as a Preferred Structure to Channelise Private Capital into Stressed Sector

Introduction

During a Board meeting on December 28, 2021, the Securities and Exchange Board of India (**SEBI**) had decided to introduce the 'Special Situation Funds' (**SSFs**), as a sub-category of Category I – Alternative Investment Funds (**AIFs**), by making suitable amendments to the SEBI (Alternative Investment Funds) Regulations 2012 (**AIF Regulations**). SSFs are conceptualised as funds which would invest only in 'stressed assets', as permitted under the AIF Regulations. The minutes of the SEBI's Board meeting indicated that certain key dispensations and relaxations were contemplated to be granted to SSFs.

Pursuant to the above, on January 24, 2022, SEBI has notified amendments to the AIF Regulations to include SSFs as a sub-category of Category – I AIFs (as further supplemented by circular dated January 27, 2022). The amendments are primarily included as a new Chapter (i.e. Chapter III-B) within the AIF Regulations and define SSFs as Category – I AIFs that invest in '*special situation assets*', in accordance with its investment objectives and may act as a '*resolution applicant*' under the Insolvency and Bankruptcy Code, 2016 (**IBC**).

SSFs – A Game Changer for Stressed Asset Space?

The 'special situation assets' in which SSFs are permitted to invest are:

i. *stressed loans* available for acquisition in terms of Clause 58 of Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 (***RBI Transfer Directions***), or as a part of a resolution plan approved under the IBC or in terms of any other policy of the Reserve Bank of India (***RBI***) or the Government of India issued in this regard from time to time (hereinafter, the ***Eligible Stressed Loans***);

ii. *security receipts* (***SRs***) issued by Asset Reconstruction Companies (***ARCs***);

iii. *securities* of investee companies:

a. whose stressed loans are in the nature of Eligible Stressed Loans;

b. against whose borrowings, SRs have been issued by an ARC registered with the Reserve Bank of India;

c. whose borrowings are subject to corporate insolvency resolution process under Chapter II of the IBC;

d. who have disclosed all the defaults relating to the payment of interest/ repayment of principal amount on loans from banks/ financial institutions/ systemically important non-deposit taking non-banking financial companies and / or listed or unlisted debt securities in terms of the Securities and Exchange Board of India

(Issue of Capital and Disclosure Requirements) Regulations, 2018, and such payment default is continuing for a period of at least ninety calendar days, after the occurrence of such default.

Provided that in case of sub-clauses (c) and (d) above, the credit rating of the financial instruments or credit instruments or borrowings of the company has been downgraded to "D" or equivalent;

v. Any other asset as may be specified by SEBI from time to time.

Other key features of SSFs are as follows:

- The restriction on Category I AIFs, of investing not more than 25% of their investable funds in one portfolio company, has not been made applicable to SSFs. Hence, SSFs should be able to invest up to 100% of their investable funds in a single special situations asset and may set up specific schemes targeting specific special situations asset.
- SSFs require to have a minimum corpus of INR 100 crore, and that SSFs would have to raise a minimum commitment of INR 10 crore from each investor. This limit is lower for Accredited Investors at INR 5 crore per investor. However, the amended AIF Regulations indicate that SEBI may make further modifications to the above thresholds in the future.
- SSFs can invest in units of other SSFs, but not in associates or SSFs managed or sponsored by the same manager/ sponsor or associates or its manager/ sponsor units of non-SSF AIFs and also not in units of any non-SSF AIFs.
- An SSF's investment in stressed loans under Clause 58 of the RBI Transfer Directions shall be subject to a lock-in requirement as may be prescribed by SEBI, which is currently 6 months.

Key Considerations:

- As per the definition of 'stressed situation asset', acquisition of stressed loans from individual lenders by the SSFs is not permitted as Clause 58 of the RBI Transfer Directions contemplates acquisition of loans only pursuant to a resolution plan as approved by the lenders under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 (**June 7 Directions**) or as approved under the IBC. It is relevant to note that for clause 58 to operate vis-à-vis SSFs, RBI will have to update the annexure to the RBI Transfer Directions to include SSFs.
- AIFs benefit from a favourable regulatory regime, which permits them to raise capital from both domestic and non-resident investors, subject to certain reporting obligations. Additionally, considering that 'trusts' are proven structures for AIFs, SSFs can be expected to work well for tranching exposure in stressed assets, akin to asset reconstruction trusts set up by ARCs providing for structured returns. From a tax perspective, SSFs should benefit from the tax pass through regime available to Category I AIFs, although some clarity in respect for income from exposure to Eligible Stressed Loans would be helpful.
- SSFs would have the ability to invest in both securities and eligible stressed loans of stressed companies and also subscribe to SRs issued by ARCs. SSFs are also permitted to act as a 'resolution applicant' under the IBC through which the SSF can acquire the debt as well as securities, including shares of stressed companies undergoing a corporate insolvency resolution process under the IBC. Therefore, SSFs can be used to provide a complete exit to the lenders and control the revival of the stressed company, without any restriction on investment concentration.
- Investors, especially stressed credit funds, have frequently used the ARC route (mainly by partnering with existing ARCs) to invest in stressed loans in

India. Few funds have also invested in ARCs in India (as a sponsor). However, the time taken in setting up or investing in an ARC and compliance requirements add to the stretched timelines and increased costs in such structures. SSFs, like other Category I AIFs, are easier to set up with SEBI approval under a relatively more streamlined process of approval.

- For stressed loans where all lenders are not getting an exit as well as for situations where private security enforcement is preferred (as SSFs will not have 'secured creditor' status for the purpose of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (which provide a self-help security enforcement mechanism)), investors are likely to continue partnering with ARCs. Though SSFs can acquire/ subscribe SRs issued by ARCs, who have purchased loans from individual banks, however, the same will not be different from the other AIFs in this respect.

With reference to categories (c) and (d) of the investee companies mentioned above in the definition of 'stressed situation asset', this would provide an SSF the ability to consolidate the debt of a stressed company, including those which are in the nature of debentures or bonds.

Key differences between the ARC route and SSFs

Partnership with ARC	SSFs
SRs can be issued to selling banks providing for structured returns	SSFs can not issue SRs to selling banks
ARC has security enforcement powers under SARFAESI	It is not currently contemplated that SSFs would have such powers
ARCs have directors with adequate professional experience as well as presence on the ground	AIF Regulations prescribes the requirement of the AIF/ manager having a key person with at least 5 years of experience in advising or managing pools of capital, or asset or wealth or portfolio management, etc.
Additional funding from the ARC to the borrower capped to the extent of 25% of the scheme	Up to 100% investable funds may be invested in a single opportunity
ARC can sell the asset once acquired only to another ARC	No such restriction subject to lock-in of 6 months (however, buyers may be limited)
Acquisition of shares of a borrower by ARC (upon conversion or as permitted) exempt from open offer	No such exemption

Conclusion:

Given the ease of setting up and flexibility on structuring investments, SSFs are likely to become a useful platform for foreign investors to acquire both loans and other securities of stressed companies, including in IBC situations. For deals where issuance of SRs is preferred by lenders (especially where an upside is preferred rather than an all-cash deal), the ARC structure will continue to play an important role. With SSFs having been introduced as a vehicle in the stressed asset space and the recommendations for overhauling of the ARC regime currently pending with the RBI, the avenues of investing in stressed assets in India is likely to see revolutionary changes, providing investors (both foreign and domestic alike) with more options and tools.

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