Investment Funds: Monthly Digest

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RBI'S REVERSE GEAR ON AIFS

INTRODUCTION

The Reserve Bank of India (**"RBI"**) has caused some consternation by issuing an administrative Circular[1] on 19 December 2023. This circular prevents all regulated banks, financial institutions and non-banking financial companies[2] (each a "**regulated entity**") from holding units of Alternative Investment Funds (**"AIFs"**) which have invested in a "**debtor company**" of such regulated entities. A debtor company is one which has been a debtor or has an investment exposure from a regulated entity at any time during the preceding 12 months.

BACKGROUND

The RBI Circular is motivated by a consultation paper issued by the Securities and Exchange Board of India (**"SEBI"**) on May 19, 2023. SEBI had identified in its consultation paper dated May 23, 2023 certain structures which could be used for "evergreening" of loans by regulated entities.

In such structures involving AIFs, a regulated entity could invest in a debtor company, which could in turn be utilised by the debtor company to repay a loan to the regulated entity, which might otherwise have become a bad debt. This could be achieved by the regulated entity investing in a 'junior class' of AIF units, which, in turn would be invested by way of non-convertible debentures into the debtor company to be used to repay the regulated entity. Other (*bona fide*) investors could invest in a senior class of units securing priority of return over the junior class held by the regulated entity.

Economically, the regulated entity's exposure may well have remained unaltered. but the books would show the potentially bad debt as having been repaid. That debt would be replaced by another asset in the form of the investment into the AIF reflected at a value which is at par with senior class of units. Such a structure could also allow the debtor company to defer the recognition of its deteriorating creditworthiness.

The RBI Circular is aimed at preventing such, potentially abusive, evergreening structures from operating.

ANALYSIS

Whilst the RBI's motive to prevent evergreening structures appears to be a valid justification for action, the chosen action itself is disproportionate. The blanket ban on all investments in AIFs with downstream investments in debtor companies suggests a misplaced notion that all such investment are tantamount to "evergreening". For example, an AIF which regulated entities as investors may have invested in the equity of a company which has taken a loan from one of the regulated entities. There should not be any concerns in these cases of "evergreening".

The largest domestic capital into Indian AIFs comes from regulated entities. This puts Indian-sourced institutional capital at a disadvantage vis-a-vis foreign capital. This is antithetical to the Government's *Start-up India* initiatives as the circular raises obstacles on Indian capital from reaching Indian start-ups as venture capital is generally invested via AIFs.

The Circular seems unfavourable not only to Indian enterprises and AIFs, but also to the regulated entities. They will no longer be able to benefit from the exponential growth and capital appreciation that start-ups bring to the economy. This upside is likely to flow exclusive to private investors and foreign institutional investors.

AIF REGULATIONS

The RBI Circular seems to be out of sync with the fundamental nature of AIFs. AIFs (Category I and Category II) by law are privately pooled blind investment vehicles which are close-ended in nature.[3] AIF investors generally do not have visibility of investments by the AIFs and do not have a right to redeem their units in the AIFs at will because the AIF's investments are highly illiquid. Further, any transfer of AIF units is subject to the express consent of the investment manager of the AIFs.

The RBI Circular, on the other hand, requires regulated entities to liquidate their investments in AIFs with downstream investments in debtor companies within 30 days from 19 December 2023. Assuming the investment manager's consent is secured for the transfer, finding buyers in this market would be difficult for regulated entities. The cheques cut by these regulated entities for AIFs are quite large and may not be easily picked up by a single buyer. Buyers will also be circumspect about buying stakes in AIFs which have senior-junior tranches of units, even if there was no evergreening at play. Assuming further, that a buyer is identified, commercial prudence would require such a buyer to undertake a due diligence exercise whilst investing billions of rupees. There are tax and valuation concerns which would need to be analysed. It appears that the rigid timelines stipulated by the RBI will result in the

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regulated entities to write-off 100% of their AIF investments.

Critically, the AIF Regulations permit regulated entities to sponsor AIFs. The sponsor commitment for AIFs (Category I and Category II) is an amount not less than 2.5% of the corpus or INR 5 crore, whichever is lower.[4] This sponsor commitment is of a continuing interest nature wherein such amounts have to been maintained throughout the life of the AIF. The RBI Circular fails to distinguish between commitments of regulated entities as investors on the one hand and those made as sponsors on the other. Requiring regulated entities, who are sponsors, to liquidate their investments in AIFs will require finding a replacement sponsor and taking prior SEBI approval. The RBI ought to clarify and remedy this inconsistency.

A workable interim solution would have been to prohibit the AIF in which these regulated entities invest from participating in any debt investments in debtor companies. In respect of existing investments, there should be an AIF-by-AIF analysis to identify the ones which may have engaged in evergreening and exit requirements may have been imposed only in those cases.

CONSTITUTIONALITY OF THE RBI CIRCULAR

Whilst the rationale to abate "evergreening" seems justifiable, the blanket ban seems to be arbitrary and disproportionate. Article 14 of the Constitution of India, which provides for equal protection of the law, prohibits any form of discrimination by the state.[5] However, the scope of the application of right to equality is limited to arbitrary and unreasonable laws and actions. Discrimination, based on adequate grounds, is permissible as long as it is reasonable.[6] In the present case, the RBI Circular discriminates against regulated entities by imposing a ban on certain investments made by them. This ban does not appear to be founded on the basis of a reasonable classification, given how widely it casts its net. Further, the ban does not seem targeted towards preventing evergreening, as much as it reflects a patently arbitrary measure taken against regulated entities.[7]

The RBI Circular also seems to violate of Article 19(1)(g) of the Constitution of India as it unjustly restricts[8] the right to practice any profession or to carry on any occupation, trade or business guaranteed to all citizens. Article 19(6) allows the state to make reasonable restrictions in the interests of general public to the right to freedom of trade. Whilst examining reasonable restrictions as provided under Article 19(6), both substantive and procedural restrictions should be examined from lens of reasonableness,[9] i.e., a test of reasonableness should be applied to each statute (including circular) and an abstract standard[10] or limitation should not be imposed on a person in the enjoyment of a right. The restriction imposed must have a reasonable relation to the object which the legislation seeks to achieve and must not go in excess of that object.[11] The RBI Circular, by imposing an entirely blanket restriction on all regulated entities, appears to fail as a reasonable measure in restricting the issue of evergreening. Given its disproportionate response to the object sought to be achieved, it may be argued that it restricts the freedom to carry on their trade unreasonably.

CONCLUSION

The RBI Circular suffers from a number of issues from an administrative, legal and equitable perspective, and is likely to cause some consternation for a number of *bona fide* regulated entities, start-ups and AIFs. It would be desirable for the RBI to revise the current iteration of the Circular to align with commercial realities of the AIF industry, lest it be forced to seek judicial remedy.

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You can direct your queries or comments to the authors.

[1]Investments in AIFs, RBI circular RBI/2023-24/90 dated December 19, 2023.

[2]The circular refers to "regulated entities", which include all commercial banks (including small finance banks, local area banks and regional rural banks), all primary (urban) co-operative banks/state co-operative banks/ central co-operative banks, all all-india financial institutions, and all non-banking financial companies (including housing finance companies).

[3]Regulation 13(1) of the AIF Regulations

[4]Regulation 10(d) of the AIF Regulations

[5]State of West Bengal v Anwar Ali Sarkar, AIR 1952 SC 75; E.P.Royappa v. State of Tamil Nadu , AIR 1974 4SCC 3; Charanjeet Lal Chowdhary v. Union of India, AIR 1951 SC 41.

[6]State of Bombay v FN Balsara, AIR 1951 SC 318, para 49; Baburao Shantaram More v. Bombay Housing Board (1953) 2 SCC 845;

[7]East Coast Railway v. Mahadev Appa Rao, (2010) 7 SCC 678

[8]Sodan Singh & Ors. V. New Delhi Municipal Committee (1989) 4 SCC 155

[9]State of Madras v. VG Row (1952) 1 SCC 410

[10]Id; also see Pathumma v State of Kerala, AIR 1978 SC 771

[11]Kochuni KK v State of Madras, AIR 1960 SC 1080; PP Enterprises v UOI, AIR 1982 SC 1016; Dwarka Prasad Laxmi Narain v State of Uttar Pradesh, AIR 1954 SC 224

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