Participation of Alternative Investment Funds in Credit Default Swaps as protection buyers/sellers

1. Objective

This Board Memorandum proposes to amend SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations") to allow participation of Alternative Investment Funds (AIFs) in Credit Default Swaps (CDS).

2. Background

2.1. Vide Notification dated February 10, 2022, Reserve Bank of India (RBI) has notified 'Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022' which shall apply to credit derivatives transactions undertaken in Over the Counter Markets and on recognised stock exchanges in India (Copy of the RBI Master Direction is placed at **Annexure A).** The notification came into force on May 09, 2022. The following was stipulated under the aforesaid directions:

2.1.1. CDS means a credit derivative contract in which one counterparty (protection seller) commits to pay to the other counterparty (protection buyer) in the case of a credit event with respect to a reference entity and in return, the protection buyer makes periodic payments (premium) to the protection seller until the maturity of the contract or the credit event, whichever is earlier.

2.1.2. Two kinds of participants in CDS market have been envisaged, market makers (an entity which provides prices to users and other market-makers) and users (a person that undertakes credit derivative transactions other than as a market-maker). Users are classified by market makers as retail or non-retail for the purpose of offering credit derivative contracts.

2.1.3. Market-makers and users may undertake transactions in single-name CDS contracts. At least one of the parties to a credit derivative transaction shall be a market-maker or a central counterparty authorised by the RBI for the purpose.

2.1.4. Scheduled Commercial Banks (except Small Finance Banks, Payment Banks, Local Area Banks and Regional Rural Banks), Non-Banking Financial Companies (NBFCs), including Standalone Primary Dealers (SPDs), Housing Finance Companies (HFCs) (having certain minimum net owned funds), Export Import Bank of India, National Bank of Agriculture and Rural Development, National Housing Bank and Small Industries Development Bank of India can act as market makers.

2.1.5. NBFCs, including SPDs and HFCs (other than market-makers), Insurance Companies, Pension Funds, Mutual Funds, AIFs, Foreign Portfolio Investors, Resident companies with minimum net worth of ₹500 crore are classified as non-retail users. Any user who is not eligible to be classified as a non-retail user shall be classified as a retail user.

2.1.6. Non-retail users including AIFs shall be allowed to buy protection for hedging or otherwise. AIFs are also permitted to act as protection sellers subject to approval of SEBI. Market makers and users shall follow the applicable prudential norms and capital adequacy requirements for credit derivatives issued by their respective regulators.

2.1.7. With respect to reference entities and obligations for CDS in OTC market, following has been specified:

(i) The reference entity in a CDS contract shall be a resident entity who is eligible to issue any of the debt instruments mentioned at para 2.1.7(ii).

(ii) The following debt instruments issued in India shall be eligible to be a reference obligation in a CDS contract:
    a) Money market debt instruments;
    b) Rated INR corporate bonds and debentures; and
    c) Unrated INR corporate bonds and debentures issued by the Special Purpose Vehicles set up by infrastructure companies.

(iii) Bonds with call/put options shall be eligible to be reference obligations.

(iv) Asset-backed securities/mortgage-backed securities and structured obligations such as credit enhanced/guaranteed bonds, convertible bonds, etc. shall not be permitted as reference obligations.

(v) The reference obligation/deliverable obligation shall be in dematerialised form.

2.2. Further, as per RBI Guidelines on Credit Default Swaps (CDS) for Corporate Bonds dated May 23, 2011, as part of risk management framework, it is prescribed that protection seller in the CDS market shall have in place internal limits on the gross amount of protection sold by them on a single entity as well as the aggregate of such individual gross positions.

2.3. In this context, RBI vide letter dated May 05, 2022 has requested SEBI that entities regulated by SEBI may be considered for participation in the market for CDS, both as protection buyers and sellers.

3. Extant Regulatory Framework:

3.1. As per the extant AIF Regulations, there are three categories of AIFs, Category I AIF, Category II AIF and Category III AIF. Category I AIF is further subdivided into five sub-categories – Venture Capital Fund, SME Fund, Infrastructure Fund, Social Impact Fund and Special Situation Fund.

3.2. Presently, only Category III AIFs are allowed to invest in listed/unlisted derivatives.

As per Regulation 3 (4) (c) of AIF Regulations:

Category III AIFs are AIFs which employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.

As per Regulation 18(a) of AIF Regulations:

Category III AIFs may invest in securities of listed or unlisted investee companies, derivatives, units of other AIFs or complex or structured products.

3.3. As per Regulation 15(1)(d) of AIF Regulations, Category III AIFs shall invest not more than ten per cent of the investable funds in an Investee Company, directly or through investment in units of other AIFs and the large value funds for accredited investors of Category III AIFs may invest up to twenty percent of the investable funds in an Investee Company, directly or through investment in units of other Alternative Investment Funds.

Provided that for investment in listed equity of an Investee Company, Category III AIFs may calculate the investment limit of ten per cent of either the investable funds or the net asset value of the scheme and large value funds for accredited investors of Category III AIFs may calculate the investment limit of twenty per cent of either the investable funds or the net asset value of the scheme, subject to the conditions specified by the Board from time to time.

Further, as per SEBI Circular CIR/IMD/DF/10/2013 dated July 29, 2013, the leverage of a Category III AIF shall not exceed two times of the NAV of the fund i.e. If an AIF's NAV is Rs. 100 crore, its exposure (Longs+shorts) after offsetting positions as permitted shall not exceed Rs. 200 crore.

3.4. As per Regulation 17(d) of AIF Regulations, Category II AIFs may engage in hedging subject to other guidelines as specified by the Board from time to time. At present, no guidelines have been specified by SEBI with respect to hedging by Category II AIFs. Further, no such enabling provision for engaging in hedging has been provided for Category I AIFs under AIF Regulations.

3.5. Category I and II AIFs are not allowed to undertake leverage. As per Regulation 16(1)(c) and 17(c) of AIF Regulations, Category I and II AIFs shall not borrow funds directly or indirectly and engage in leverage except for meeting temporary funding requirements for not more than thirty days, not more than four occasions in a year and not more than ten percent of the investable funds. Further as per Regulation 3(1)(b) of AIF Regulations, Category II AIFs are AIFs which does not fall in Category I and III and which does not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in AIF regulations.

4. Issues for Consideration

4.1. Allowing Category I, II and III AIFs to buy CDS:

4.1.1. Category I, II and III AIFs are permitted to invest in debt securities. As observed from the quarterly report filed by AIFs as on June 30, 2022, total investment made by AIFs in debt and securitized debt instruments is INR 90,926 crore which is approximately 30% of the total investment made by AIFs in all permissible asset classes. Investment by various categories/sub-categories of AIFs in debt securities are as given below.

AIF Category/sub-category	Total investment in Debt/ Securitised debt instruments (INR crore)	Total investment (INR crore)	% of investment in debt/securitized debt instruments
Category I AIF Infrastructure Fund	701	7076	9.90
Category I AIF-SME Fund	14	186	7.56
Category I AIF-Social Impact Fund	24	560	4.24
Category I AIF-Venture Capital Fund	13	16135	0.08
Category I AIF - Venture Capital Fund (Angel Fund)	56	2079	2.70
Category II AIF	88106	219101	40.21
Category III AIF	2012	66206	3.04
Grand Total	**90926**	**311343**	**29.20**

Source: Quarterly filing made by AIFs as on June 30, 2022

4.1.2. Considering the above and the extant regulatory framework, the following may be specified:

(i) Category I and II AIFs may be allowed to buy CDS only for the purpose of hedging, subject to such conditions or guidelines that may be stipulated or issued by the Board and RBI from time to time.

(ii) Category III AIFs may be allowed to buy CDS for the purpose of hedging or otherwise, subject to such conditions or guidelines that may be stipulated or issued by the Board and RBI from time to time.

4.1.3. Allowing Category I, Category II and Category III AIFs having investment in debt securities to buy CDS would provide such AIFs with a tool to manage and transfer the credit risk, and provide protection to AIFs during credit events. Further, this would instil confidence in AIFs to invest in corporate bond market.

4.2. <u>Allowing Category II and III AIFs to sell CDS:</u>

4.2.1. For any market to be efficient it is essential that there are enough number of buyers and sellers. In order to increase participation in CDS market, RBI has requested SEBI to allow its regulated entities to act as both protection buyer and protection seller.

4.2.2. Considering that Category III AIFs may invest in securities of listed or unlisted derivatives, in order to provide clarity to the industry, it may be clarified that Category III AIFs may sell CDS subject to such conditions or guidelines that may be stipulated or issued by the Board and RBI from time to time.

4.2.3. In line with the risk management framework as specified under RBI guidelines and also mentioned at para 2.2 above, the leverage and concentration norm may be applicable on Category III AIFs while dealing in CDS. Accordingly, it may be specified that Category III AIFs may sell CDS, subject to that effective leverage undertaken is within the permissible limits i.e. upto two times of NAV, and the CDS sold on single entity (including all other exposure to the said entity/investee company) may not exceed the applicable concentration limit.

4.2.4. Category III AIFs may be also allowed to sell CDS by keeping unencumbered Government bonds / Treasury bills equal to the amount of CDS exposure earmarked against the CDS, however, these securities may also be used for maintaining margin requirements for the exposure in the same CDS. Selling of CDS in such manner will not tantamount to leverage undertaken by Category III AIFs.

4.2.5. Further, Category II AIF is the prominent category of AIFs both in terms of number (58% of total number of AIFs) and commitments raised from investors (Category II AIFs raised 80% of total commitments raised by all AIFs). Allowing Category II AIFs to sell CDS would provide liquidity in CDS market. Thus, Category II AIFs may be allowed to sell CDS on permissible reference entities as mentioned at para 2.1.7 above and subject to such conditions or guidelines that may be issued by the Board from time to time.

4.2.6. Category II AIFs are not allowed to undertake leverage except for meeting temporary funding requirements as mentioned at para 3.5 above. Thus, Category II AIFs may be allowed to sell CDS, only by keeping unencumbered Government bonds / Treasury bills equal to the amount of CDS exposure earmarked against the CDS, however, these securities may also be used for maintaining margin requirements for the exposure in the same CDS. This way it will also not tantamount to leverage undertaken by Category II AIFs.

4.2.7. The aforesaid proposals are in line with the recommendations made by Alternative Investment Policy Advisory Committee (AIPAC) in its meeting held on November 22, 2022.

4.2.8. Further, presently under the AIF Regulations, the Sponsor or Manager of the AIF are required to appoint a custodian, registered with the Board, for safekeeping of the securities if the corpus of the AIF is more than five hundred crore rupees. Further, the Sponsor or Manager of a Category III Alternative Investment Fund are required to appoint such a custodian, irrespective of the size of the corpus of the AIF.

4.2.9. Considering that allowing participation in CDS would require prudent monitoring of assets, it is desirable that appointment of custodian is made mandatory for Category I AIFs and Category II AIFs who transact in CDS as proposed in para 4.1.2 (i) and 4.2.5 above. Besides, all categories of AIFs may be required to report details of the CDS transaction to custodian in a time bound manner as specified by the Board.

4.2.10. Custodian appointed by Category II and III AIFs may also be responsible for ensuring that the amount of earmarked Government bonds / Treasury bills is equal to amount of exposure in CDS and report to the Board in case of any deviation.

4.2.11. It may also be prescribed that any gross naked position in CDS in excess of twenty- five percent of investable funds of a scheme of an AIF, may be taken only after informing the same to all the unit holders.

4.2.12. In order to ensure that Category I AIFs and Category II AIFs who deal in CDS do not indulge in prolonged leverage, it may be specified that Category I and Category II AIFs shall maintain thirty days cooling off period between two periods of permissible leverage as provided in Regulation 16(1)(c) and 17(c) of AIF Regulations, as mentioned at para 3.5 above.

4.2.13. In order to enhance transparency and disclosure pertaining to transaction in CDS, it may be prescribed that all such CDS transactions shall be traded on any regulated platform.

4.2.14. It is proposed to specify the proposals at para 4.2.4, 4.2.6 and 4.2.9 to 4.2.13 by way of circular.

5. Proposal

5.1. The Board may consider and approve the following proposals:

5.1.1. Category I AIFs and Category II AIFs may buy CDS on underlying investment in debt securities for the purpose of hedging.

5.1.2. Category III AIFs may buy CDS for the purpose of hedging or otherwise and sell CDS, within the permissible leverage i.e. upto two times of NAV and within the applicable concentration limit as defined under AIF Regulations, taking all forms of exposure together.

5.1.3. Category II AIFs and Category III AIFs may sell CDS by keeping unencumbered Government bonds / Treasury bills equal to the amount of CDS exposure earmarked against the CDS, wherein these securities may also be used for maintaining margin requirements for the exposure in the same CDS.

5.2. The draft amendment to AIF Regulations and the draft notification for the proposed amendment are placed at **Annexure B** and **Annexure C** respectively.

5.3. The Board is requested to consider and approve the proposed amendment to SEBI (Alternative Investment Funds) Regulations, 2012 and authorize the Chairperson to make such necessary consequential or incidental changes to the SEBI (Alternative Investment Funds) Regulations, 2012 and take consequent steps, as may be deemed appropriate, to give effect to the decision.

Annexure A

The ‘Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022’ is given (here).

Annexure B

Amendment to SEBI (Alternative Investment Funds) Regulations, 2012 shall be notified after following the due process.

Annexure C

Amendment to SEBI (Alternative Investment Funds) Regulations, 2012 shall be notified after following the due process.