

Guidelines for borrowing by Category I and II AIFs and maximum permissible limit for extension of tenure by Large Value Fund for Accredited Investors

1. Objective

With the objective of investor protection and risk reduction in Alternative Investment Funds, while also considering the need for Ease of doing business and operational flexibility, this Board Memorandum proposes to amend SEBI (Alternative Investment Funds) Regulations, 2012 ('AIF Regulations') to -

- 1.1. Provide explicit clarity regarding the purpose for which Category I and II AIFs may be allowed to borrow;
- 1.2. Allow Category I and II AIFs to borrow to meet shortfall in the drawdown amount called for from investors;
- 1.3. Specify cooling off period between two periods of borrowing by Category I and II AIFs; and,
- 1.4. Specify maximum period for which tenure of a Large Value Fund for Accredited Investors can be extended.

2. Guidelines for borrowing by Category I and II AIFs

- 2.1. Regulations 16(1)(c) and 17(c) of AIF Regulations place restriction on borrowing by Category I and II AIFs as under:

“Category I Alternative Investment Funds shall not borrow funds directly or indirectly or engage in any leverage except for meeting temporary funding requirements for not more than thirty days, on not more than four occasions in a year and not more than ten percent of the investable funds.”

“Category II Alternative Investment Funds may not borrow funds directly or indirectly and shall not 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.”

- 2.2. Further, Regulation 3(4)(b) of AIF Regulations provides the definition of Category II AIFs as under:

“Category II Alternative Investment Fund 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 these regulations”.

- 2.3. The regulatory intent behind permitting borrowing for Category I and II AIFs is that the funds borrowed shall be utilized for meeting operational requirements of the AIF and not for the purpose of making investment. However, it is understood from market practice that there is an ambiguity amongst market participants with respect to the purpose for which AIFs may borrow funds, especially due to the phrase ‘temporary funding requirements’ as stated in para 2.1 above.
- 2.4. The Private Placement Memorandums (PPMs) submitted by Category I and II AIFs generally mention that borrowing shall be done for the purpose of temporary funding. However, based on industry feedback, it is understood that certain AIFs also borrow funds for the purpose of making investment, not just to meet temporary funding requirements.
- 2.5. To assess the type and purpose of the borrowing made by Category I and II AIFs, the requisite information was sought from those Category I and II AIFs which reported availing borrowing in their filing with SEBI for Jan - March 2024 quarter. The following is observed from the same -

Details	Apr - Jun 2023	Jul - Sep 2023	Oct - Dec 2023	Jan - Mar 2024
No. of instances of borrowing	4	3	1	11
No. of schemes which borrowed	4	3	1	7
Amount borrowed (in INR Crore)	133.1	98.9	0.8	124
Amount borrowed for temporary funding (in INR Crore)	132.4	98.9	0.8	123.4

Details	Apr - Jun 2023	Jul - Sep 2023	Oct - Dec 2023	Jan - Mar 2024
Amount borrowed for meeting operating expenses (in INR Crore)	0.7	0	0	0.6

From the information collected from AIFs, it is observed that the facility has not been utilised much in comparison to the AUM/size of the industry, perhaps reiterating the perceived ambiguity around the purpose for which borrowing facility may be availed.

- 2.6. Category I and II AIFs are required to invest primarily in unlisted securities. Considering the illiquid nature of unlisted securities, the practice of borrowing by Category I and II AIFs for investing in unlisted securities may lead to asset – liability mismatch, since, if the AIFs borrow money to invest in long-term illiquid assets, the same is required to be repaid within 30 days. To improve ease of doing business, it is now proposed to explicitly permit Category I and II AIFs to borrow temporarily in the event of delay in drawdown being met by some investors, subject to some guardrails.
- 2.7. In case the AIF fails to repay the debt due to either unavailability of funds or refinancing constraints, the AIF shall face issue of asset liability mismatch and also shall be in non-compliance with the regulatory mandate, thereby adversely affecting the interest of investors in the AIF. Considering the same, AIF Regulations intends that funds borrowed by Category I and II AIFs shall not be utilized for the purpose of making investments.
- 2.8. It is pertinent to note that Global securities market regulators such as the U.S. Securities and Exchange Commission, U.K. Financial Conduct Authority and the global standard setting body for securities market, i.e., International Organization of Securities Commissions (IOSCO), have also highlighted the risk of systemic financial sector leverage on the back of private capital investments.
- 2.9. Further, since Category I and II AIFs which invest predominantly in unlisted securities carry high risk of illiquidity, it is essential to ensure that such AIFs do not indulge in prolonged leverage, that is, they do not end up rolling over the debt availed to circumvent the requirement of repaying the debt in 30

days. Therefore, it is felt appropriate that a cooling off period may be maintained between two periods of borrowing/leverage. It is important to note that the requirement of cooling off period between two periods of borrowing has already been mandated for borrowing by Category I and II AIFs transacting in Credit Default Swaps.

2.10. Notwithstanding the above, it is understood that there may be scenarios where a Category I or II AIF issues drawdown notice to investors for providing money for making investment and the investor fails to bring the amount called for within the due date mentioned in the drawdown notice. In such a scenario, the AIF runs the risk of losing the investment opportunity. In order to ensure that the investment opportunity is not lost by any AIF due to such shortfall and to provide ease of doing business and operational flexibility to AIFs, it is proposed that Category I and II AIFs may be permitted to borrow up to ten percent of the investment amount while making the investment, to meet shortfall in drawdown from an investor, subject to certain specified conditions.

2.11. It was felt that the borrowing for meeting such shortfall may be permitted only in case of emergency and as a last recourse and shall not be utilized to facilitate different drawdown schedule or longer/delayed timeline for bringing capital called for from select investors. Further, the cost of availing such borrowing may be passed on only to the investor(s) who fails to bring the drawdown amount.

Consultation with stakeholders:

2.12. An agenda to streamline the provisions pertaining to leverage/borrowing by Category I and II AIFs was placed for discussion in the meeting of Alternative Investment Policy Advisory Committee (AIPAC). The committee, after deliberation, recommended the following proposals:

2.12.1. Category I and II AIFs shall not borrow funds directly or indirectly or engage in leverage for the purpose of making investments.

2.12.2. If funds borrowed by Category I and II AIFs are utilized for the purpose of meeting shortfall in drawdown while making investment, the borrowing shall not exceed 10% of the investment made in an

investee company. The cost of borrowing shall accrue only to such investor who delayed / defaulted on drawdown payment.

- 2.12.3. Category I and II AIFs shall maintain thirty days cooling off period between two periods of borrowing as provided in AIF Regulations.
- 2.13. Taking into account the recommendations of AIPAC and internal discussions, SEBI issued a consultation paper on May 18, 2023, given at **Annexure A**, soliciting comments from public on the proposals made therein.
- 2.14. A total of 16 responses to the consultation paper have been received from the stakeholders such as AIFs, industry associations, law firms, custodians etc., on the aforesaid proposal. Majority of the commenters have expressed negative views and concerns with respect to the proposal affecting the flexibility of the fund managers. Consequently, some modifications have been incorporated with respect to the guidelines proposed to be prescribed for borrowing by Category I and II AIFs.
- 2.15. Commenters have stated that flexibility for Category I and II funds to engage in temporary borrowing is an important feature for the viability of the asset class and that, internationally AIFs are also given flexibility to borrow. They have emphasised that AIFs should have the ability to immediately disburse funds to the investee company. Commenters have also suggested to either remove the cap of 10% of investment amount for borrowing for meeting shortfall or increase the said limit to 40% or 50%.
- 2.16. In this regard, SEBI is of the view that, Category I and II AIFs should make investments only out of the capital drawn down from the investors, for the reason stated at para 2.6 and 2.7 above, since, allowing borrowing for the purpose of making investment, even if it is to cover temporary liquidity gap until the contribution is drawn down from the investors, exacerbates the liquidity risk for the Category I and II AIFs.
- 2.17. At the same time, since the investors in AIF may get affected if an investment opportunity is lost due to shortfall in drawdown from an investor, flexibility is proposed to be accorded to Category I and II AIFs to borrow to meet such shortfall. However, it is essential that necessary safeguards are prescribed to avail such flexibility, to ensure that the same does not result into becoming

a common practice and being misused to provide preferential treatment to select investors.

- 2.18. As regards the suggestion to remove the proposed limit of ten percent of investment for the purpose of borrowing for meeting shortfall in drawdown amount from an investor, it may not be prudent to remove the said limit entirely, as the fund may face difficulty in repayment of the borrowed amount if the defaulting investor fails to bring in the amount owed by him/her due to various reasons. However, to provide more flexibility to managers of AIFs in availing borrowing for meeting shortfall in drawdown, it is proposed that such limit may be enhanced to twenty percent of the investment size.
- 2.19. Yet, there may also be risk associated with securities of the AIF being kept as collateral for the debt availed. This may affect the interest of other investors as well, if the fund is unable to service or repay the debt. Accordingly, it is proposed that such limit for borrowing for meeting shortfall shall be the lower of twenty percent of investment amount, or ten percent of the investable funds of the scheme of AIF, or the net undrawn down capital contribution of the investors in the scheme. This will ensure that the leverage on account of such borrowing is capped at the total undrawn-down commitment of capital from the scheme.
- 2.20. Commenters have also expressed concern that the terms 'emergency' and 'last resort' are vague in nature. In this regard it is proposed to clarify that 'emergency' shall refer to cases where the investment opportunity is imminent to be closed and the capital called for drawdown from an investor has not been received by the Manager and 'last recourse' shall mean that, in spite of best efforts by manager to get the drawdown amount from the delaying investor, the pending drawdown amount called for has not been received.
- 2.21. Further, commenters have also stated that restricting the Category I and II AIF to borrow only once per investor to cover the shortfall due to delay by that investor, will put other investors of AIF at risk of losing the potential investment opportunity and would result in penalising other investors of the fund more than the defaulting investor. It is felt that the said suggestion merits consideration, considering the other safeguards in place and proposed to be put in place.

2.22. The summary of responses received on this proposal and our comments on the same are given at **Annexure B**.

2.23. Further, as stated at para 2.2 above, Regulation 3(4)(b) of AIF Regulations provides the definition of Category II AIFs as under:

“Category II Alternative Investment Fund 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 these regulations”.

Since it is now being proposed to allow Category II AIFs to borrow to meet shortfall in drawdown amount, the definition of Category II AIF may be suitably revised.

Proposal:

2.24. Taking into account the recommendations of AIPAC, comments received from public and internal deliberations, it is proposed that AIF Regulations may be suitably amended to –

2.24.1. Specify that Category I and II AIFs shall not borrow funds directly or indirectly or engage in any leverage for the purpose of making investments or otherwise, except for borrowing to meet temporary funding requirements and day-to-day operational requirements subject to conditions as may be specified by the Board from time to time.

2.24.2. Revise definition of Category II AIF to align with proposal at para 2.24.1 above, as under:

“Category II Alternative Investment Fund which does not fall in Category I and III and which does not undertake leverage or borrowing other than as permitted in these regulations”.

2.25. It is further proposed that the following guidelines for borrowing by Category I and II AIFs may be specified by way of issuance of circular:

2.25.1. Category I and II AIFs may borrow for the purpose of meeting shortfall in drawdown amount called for while making investment in an investee company, subject to the following conditions:

- (i) Such borrowing shall be done only in case of emergency, when the investment opportunity is imminent to be closed and the capital called for drawdown from an investor has not been received by the Manager and as a last recourse when the amount pending for drawdown has not been received before the date of investment, in spite of best efforts by manager to obtain the drawdown amount from the delaying investor.
- (ii) The amount borrowed shall not exceed twenty per cent of the investment proposed to be made in the investee company, or ten per cent of the investable funds of the scheme of AIF, or the capital contribution pending to be drawn down from investors other than investor(s) who have failed to provide the capital called for, whichever is lower.
- (iii) The cost of such borrowing shall be charged only to such investor(s) who delayed in payment for drawdown notice.
- (iv) The flexibility to borrow to meet such shortfall shall not be used as a means to provide different drawdown timelines to investors.
- (v) If the AIF intends to borrow funds for meeting shortfall in drawdown, the same shall be disclosed in the PPM of the scheme. The manager shall disclose the details regarding amount borrowed, terms of borrowing and repayment to all the investors of the AIF/scheme, on a periodic basis as agreed with the investors of the AIF.

2.25.2. Category I and II AIFs shall maintain thirty days cooling off period between two periods of borrowing as provided in AIF Regulations. The cooling off period of thirty days shall be calculated from the date of repayment of previous borrowing.

3. Maximum permissible limit for extension of tenure by Large Value Fund for Accredited Investors (LVF)

3.1. In 2021, SEBI introduced the framework for 'Accredited Investors' in the Indian securities market as a class of investors who are considered to be well informed or well advised about investment products and their associated risks. With the introduction of framework for Accredited Investors, SEBI also introduced the concept of LVF under AIF Regulations. LVF is an AIF or a scheme of an AIF in which each investor is an Accredited Investor and invests at least INR 70 crore. As per available information, the details of investments by LVFs as on March 31, 2024, are as under –

Details	Particulars
No. of LVF schemes	56
Total Commitments (in INR Crore)	1,07,297
Total investments (in INR Crore)	26,207

3.2. Certain flexibilities and relaxations have been extended to Accredited Investors in general and LVFs in particular. One such relaxation is pertaining to extension of tenure for LVFs. For close ended schemes of AIFs, extension of tenure is permitted up to two years, subject to approval of two-thirds of the unit holders by value of their investment in the scheme. However, LVFs are permitted to extend their tenure beyond two years, subject to terms of the contribution agreement, other fund documents and such conditions as may be specified by SEBI from time to time. The conditions for extension of tenure by LVFs is specified in para 12.14 of SEBI Master circular dated May 07, 2024 for AIFs.

3.3. As on March 31, 2024, there are 56 LVF schemes filed with SEBI, out of which, 50 LVF schemes are close ended. Out of these 50 close ended schemes, 45 schemes have tenure extendable up to two years, which is in line with the permissible extension applicable to all other schemes of AIFs, as stated in para 3.2 above. Thus, despite the flexibility provided to LVFs to extend their tenure beyond two-year period, most of the LVFs have opted to extend their tenure only up to two years.

- 3.4. Further, the flexibility of having no cap on period for extension of tenure of an LVF may result in a close ended fund acquiring the colour of a perpetual fund wherein investments of investors may get locked in for an uncertain period of time. This may also result in delayed disclosure and recognition of true asset quality, liquidity, fund value and fund performance of AIFs and their managers.
- 3.5. AIFs have the flexibility to decide the tenure of the scheme, however long it may be, as each investor would be aware of the overall tenure before making investment in the AIF. Further, AIFs have been given flexibility to extend their original tenure (which was determined at the time of launch of scheme) by two years so that they do not end up selling the investments in distress, in case the market conditions are not favourable by the end of the original tenure. Thus, the provision of extension of tenure for AIFs is to ensure that while investors have clear investment horizon, their investments are not affected due to the constraint of timeline of original tenure.
- 3.6. Further, in order to provide flexibility to schemes of AIFs (including LVFs) to deal with investments which are not sold due to lack of liquidity during the winding up process, SEBI has recently enabled a framework to allow AIFs to deal with unliquidated investments by entering into a dissolution period or distributing such unliquidated investments in-specie, subject to approval of 75% investors by value and in the prescribed manner. This flexibility is over and above the flexibility to extend tenure of schemes of AIFs by two years.
- 3.7. Considering that the aforesaid option of dissolution period has been provided to all schemes of AIFs, including LVFs, it was felt appropriate that the extension of tenure of LVFs may be capped, similar to other schemes of AIFs.
- 3.8. As stated at para 3.2 above, it has been specified in the AIF Regulations that LVFs may be permitted to extend their tenure beyond two years, subject to terms of the contribution agreement, other fund documents and such conditions as may be specified by SEBI from time to time. Considering that it has been decided to limit the period for extension of tenure by LVFs, as in case of other schemes of AIFs where there are no additional conditions attached for extension of tenure other than investor consent, the conditions

for extension of tenure by LVFs, as given in para 12.14 of Master Circular for AIFs, may not be required.

Consultation with stakeholders

- 3.9. An agenda to specify maximum extension of tenure by LVFs was placed for discussion in the meeting of AIPAC. The committee, after deliberation, suggested that, considering LVFs are meant only for very large sophisticated investors, certain reasonable extension of tenure over and above the extension of tenure available for other regular schemes of AIFs, may be considered for LVFs. Accordingly, AIPAC recommended to allow LVFs an additional 2 years for extension of their tenure.
- 3.10. Taking into account the recommendations of AIPAC and internal discussions, SEBI issued a consultation paper on May 18, 2023, given at **Annexure A**, soliciting comments from public on the proposals made therein.
- 3.11. Total 7 responses to the consultation paper have been received from the stakeholders including AIF industry associations on the said proposal. Summary of responses received and our comments on the same are given at **Annexure B**.
- 3.12. The commenters have suggested allowing either indefinite or minimum 30 years of extension of tenure of LVFs, subject to specified investor consent. It is important to mention that similar suggestions with respect to extension of tenure of LVFs were discussed in past meetings of AIPAC. However, in the meeting of AIPAC where this matter was discussed again, AIPAC after deliberation recommended to allow LVFs an additional two years in extension of tenure.
- 3.13. Also, allowing indefinite extension of tenure or for prolonged duration may not be in the interest of investors, as the investors may not have clarity about their investment horizon while making investment in LVFs. Thus, LVFs with indefinite tenure ends up acquiring the colour of a perpetual fund, and the investors may not have an avenue to exit from such schemes. This is also prone to misuse as it defers the true recognition of value of investments of AIFs. Thus, it is felt that the suggestion of indefinite extension or long period for extension of tenure of LVF does not merit consideration.

3.14. As regards existing schemes of LVFs, it is felt that it is necessary to ensure that their tenure is also aligned with the proposed limit of extension of tenure by LVFs. However, in order to ensure that their existing strategies based on the earlier determined tenure and extension thereof are not affected, such LVFs whose extension of tenure is indefinite or beyond the permissible limit, may be allowed to modify their existing original tenure with consent of all investors.

3.15. As per available information on LVFs, a summary table regarding impact of the proposed policy on existing LVFs as on March 31, 2024, is as under:

Details	No. of Schemes	Impact of the proposed policy
No. of close ended schemes of LVFs with possible extension up to 2 years	45	No adverse impact
No. of close ended schemes of LVFs with possible extension up to 5 years	3	The proposed limit may be revised to 5 years instead of 4 years recommended by AIPAC, to accommodate such LVFs.
No. of close ended schemes of LVFs with no limit on number of extensions	2	Each of these schemes have only one investor other than sponsor and manager. One of the schemes has not made any investment whereas the other scheme has made investment of INR 396 Crore. Flexibility may be given to such LVFs to revise their original tenure with investor consent, while realigning extension of the original tenure, as per this proposed policy.

Details	No. of Schemes	Impact of the proposed policy
Total no. of close ended schemes of LVFs	50	

Proposal:

3.16. Taking into account recommendations of AIPAC, comments received from public and internal deliberations, it is proposed that AIF Regulations may be suitably amended to specify that LVFs shall be permitted to extend their tenure up to five years, subject to approval of two-thirds of the unit holders by value of their investment in the LVF.

3.17. It is further proposed the following may be specified by way of circular:

3.17.1. Existing LVF schemes who have not disclosed the extensions in tenure in their PPMs or whose extension period is beyond the permissible five years, shall align the same with the aforesaid requirement within three months from the date of issuance of circular. However, while realigning, such schemes shall have a flexibility to revise their original tenure with the consent of all their investors.

3.17.2. The existing conditions for extension of tenure for LVFs as given in para 12.14 of Master Circular for AIFs shall no longer be applicable.

4. Proposal to the Board:

4.1. The Board may consider and approve the following proposals to amend the AIF Regulations, to:

4.1.1. Specify that Category I and II AIFs shall not borrow funds directly or indirectly or engage in any leverage for the purpose of making investments or otherwise, except for borrowing to meet temporary funding requirements and day-to-day operational requirements subject to conditions as may be specified by the Board from time to time.

- 4.1.2. Revise definition of Category II AIF, as under:
- “Category II Alternative Investment Fund which does not fall in Category I and III and which does not undertake leverage or borrowing other than as permitted in these regulations”.
- 4.1.3. Specify that LVFs shall be permitted to extend their tenure up to five years, subject to approval of two-thirds of the unit holders by value of their investment in the LVF.
- 4.2. The draft amendment to AIF Regulations and the draft notification for the proposed amendment are placed at **Annexure C** and **Annexure D** respectively.
- 4.3. The Board is requested to consider and approve the proposals as in the Memorandum and authorize the Chairperson to make consequential and incidental changes and take necessary steps to give effect to the decisions of the Board.

Encls:

- 1. Annexure A (14 pages)**
- 2. Annexure B (05 pages)**
- 3. Annexure C (03 pages)**
- 4. Annexure D (04 pages)**

The consultation paper is available at the following link:

<https://www.sebi.gov.in/reports-and-statistics/reports/may-2023/consultation-paper-on-proposed-amendment-to-sebi-alternative-investment-funds-regulations-2012-to-strengthen-governance-mechanisms-of-alternative-investment-funds-aifs-71387.html>

This has been excised for reasons of confidentiality.

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

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