

Nangia Andersen LLP

## Newsflash

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SEBI order on 'Indirect borrowings'  
by Infrastructure Funds

June 2023





## Summary

Recently, SEBI vide order<sup>1</sup> dated May 31, 2023, in the case of India Infrastructure Fund II ('IIF II or the Fund') directed that the Funds cannot pledge shares to facilitate borrowings by its portfolio companies. The context and impact of the order and the way forward for the Fund industry is highlighted below.

## Background

The Fund has been registered with SEBI as a Category I AIF since October 18, 2013. It raised money in 2013-14 and had a tenure of 12 years. SEBI during its on-site inspection, noticed that the Fund investing primarily in infrastructure projects had pledged shares and debentures of about 15 of its portfolio companies amounting to INR 1,383 crore (approx.). Based on this pledge by the Fund, some of the investee companies were able to secure larger size loans. The Fund documents had made adequate disclosures for investors.

## AIF Regulations and SEBI order

SEBI (Alternative Investment Funds) Regulations, 2012, (AIF Regulations) bars AIF I from borrowing directly or indirectly or engaging in any leverage except for meeting temporary funding requirements.

SEBI vide the order has held that pledging of securities held by the Fund to facilitate borrowings by its portfolio companies amounts to indirect borrowing which is not allowed under the regulations. By the time SEBI inspection and the process of passing the order was completed, the Fund had got the pledge on its securities released. At the time of passing the order, SEBI have taken cognizance of how AIF Regulations are interpreted by the industry and observed that no loss has been caused to the investors. SEBI has not levied any financial penalty on the Fund manager or the trustees and has directed the Fund to be careful in future and suitably modify terms of its Trust Deed which are inconsistent with the provisions of the AIF Regulations.

<sup>1</sup>QJA/KS/AFD-1/AFD-1-SEC/27020/2023-24



## Implications for the Fund Industry

Typically, a road toll company would construct a project and collect toll revenues for a term as agreed with the owner of the project, generally a government body or agency. Hence, they don't own significant assets which can be offered as security for taking loans. This is where a Fund as a shareholder would offer in the interest of its investee company, its other assets (its investments) as collateral to the lender bank. Borrowing by the project company is essential and unavoidable to fund the project because entire funding through equity is not always possible due to long gestation and unpredictability of revenues and hence high risk, as compared to a lender who is fine with a bank return on a secured loan. Hence the practice of Fund industry pledging its shares has evolved as a financing solution.

However, after the SEBI order, the industry would be expected to amend all legal documents and not to engage in this mode of 'indirect' borrowing.



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### Nangia Andersen LLP's Take

The Fund industry would need to hold discussions with the regulator regarding solutions for existing arrangements and seek either grandfathering of existing arrangement or clarity on timeframe for unwinding the same. Further, in the absence of explicit grandfathering of past transactions alternate financing arrangements may be needed to substitute the existing loans through any other acceptable collateral so that the pledged securities can be released.

Further it's important that regulators in consultation with the industry come up with alternate ways of raising debt capital for the projects if the currently prevalent mode is plugged. Otherwise, one is likely to see Fund structures moving from domestic AIFs to offshore funds or GIFT where IFSCA regulations are relaxed and allow leveraging.

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