

GNLU CENTRE FOR LAW & ECONOMICS
Policy Recommendations



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Comments to the Securities and Exchange Board of India on the Consultation Paper on changes in the regulatory framework for Special Situation Funds, a sub-category of Category I Alternative Investment Funds, necessary to facilitate Special Situation Funds to acquire stressed loans in terms of Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021

Comments on behalf of the Research Group on SEBI,
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I. Introduction

On 28th November 2023, the Securities and Exchange Board of India (SEBI) released a consultation paper inviting public comments on proposed changes in the regulatory framework for Special Situation Funds (SSFs), a sub-category of Category I Alternative Investment Funds (AIFs). The reforms aim to empower SSFs to acquire stressed loans as per the Reserve Bank of India (RBI) (Transfer of Loan Exposures) Directions, 2021.

SSFs were introduced in January 2022 to invest specifically in special situation assets, including stressed loans, with a minimum corpus of Rs. 100 crore. As defined by regulation 191(3) of SEBI (AIF) Regulations, 2012, a “special situation fund” is a category I AIF investing in special situation assets and can act as a resolution applicant under the Insolvency and Bankruptcy Code 2016 (IBC). SSFs were allowed to acquire stressed loans as per Clause 58 of RBI Master Directions, subject to their inclusion in the Annexure of the RBI Master Directions and a lock-in period of 6 months.

SEBI, in collaboration with RBI, has created a framework for including SSFs in the RBI Master Directions. The consultation paper outlines six key proposals for consideration to regulate the investment activities of SSFs, including changes to the definition of special situation assets, eligibility of investors in SSFs, restrictions on investment in connected entities, minimum holding period and subsequent transfer of loans, Monitoring of SSFs and Supervision of SSFs.

The GNLU Centre for Law and Economics has created a research group to scrutinize the proposals, research the suggested framework, and put forth comments and suggestions to aid in the creation of a more robust and efficient regulatory framework. This document presents the comprehensive list of comments and recommendations rigorously researched and thoughtfully formulated by the student members of the Centre and carefully reviewed by the esteemed faculty members. We believe that by implementing these recommendations, SEBI can unlock the true potential of SSFs, paving the way for a vibrant financial future where stressed assets become springboards for growth and revitalization.

II. Specific Analysis and Comments

Sr. No.	Proposal No.	Extract from the consultation paper	Comments / Suggestions	Rationale
1	Proposal A	<p>a. 'special situation asset', inter alia, includes securities of investee companies, whose stressed loans are acquired in terms of Clause 58 of RBI Master Directions.</p> <p>b. SSFs having prior investment in securities of stressed companies shall not be disqualified/ barred from acquiring stressed loans of the said companies.</p>	<p>Propose to expand "special situation asset" definition, this amendment proposes broadening the definition of a "special situation asset" to include securities of investee companies whose stressed loans are acquired under RBI Master Directions (Clause 58). This could be further refined to specify the types of securities of investee (e.g., equity, debt, hybrids) companies that would be included. Further expand on "inter alia": Briefly list other potential inclusions for "special situation asset" besides securities of investee companies for greater clarity. Further the inclusions of "inter alia" can be as follows-</p> <ul style="list-style-type: none"> • Securities of companies undergoing restructuring-This 	<p>This could help to clarify the scope of the amendment and prevent potential misuse. Banks and finance companies (NBFCs) are stuck with stressed loan, hindering their ability to lend and hurting the economy eventually. Special Situation Funds (SSFs), a new type of investment fund that buy these stressed and help resolve them. Hence, SSFs are like ambulances for stressed loan (bad loans). The proposed amendments aim to provide definition of 'special situation asset' under AIF regulations. As per Regulation 19I of AIF Regulations, 'special situation asset' including securities of investee companies with stressed loans acquired in accordance with RBI Master Directions. It has</p>

			<p>could involve companies in bankruptcy proceedings, undergoing debt-to-equity swaps, or receiving government bailouts.</p> <ul style="list-style-type: none"> Assets acquired through distressed M&A deals: Assets bought at a discount due to financial or operational distress of the seller. Real estate with potential for turnaround or redevelopment: Properties facing vacancy issues, foreclosure threats, or requiring significant refurbishment. Illiquid assets with potential for future monetization: Intellectual property, art collections, or other assets challenging to sell quickly but holding long-term value. 	<p>been proposed that the term 'available for acquisition' may be substituted by the term 'are acquired'. Further, the proposed amendment states that Investors in SSFs (Special Situation Funds) must be checked to ensure they're not disqualified under Section 29A of the IBC. This section lists people who can't be involved in insolvency and bankruptcy processes, like those who've been convicted of certain offenses or have had their accounts written off by banks. The responsibility for verifying investors' eligibility lies with the transferor (the bank or NBFC selling the stressed loan). This is like checking the background of someone before selling. The goal is to make sure that only responsible and eligible investors are involved in stressed loan transactions because dealing</p>
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				with stressed loan is risky and for the same due diligence is essential for SSF investors to verify compliance with IBC Section 29A's disqualification criteria.
2	Proposal B	AIF Regulations may be suitably amended to specify that SSFs shall not invest in or acquire a special situation asset if any of its investors is disqualified in terms of Section 29A of IBC in relation to such special situation asset.	In order to harmonise the applicability criteria under Section 29A of the IBC to the asset reconstruction companies ("ARCs") and SSFs, the Consultation Paper seeks to apply the aforesaid eligibility not just to the SSF, but also to its underlying investors. This additional criterion stipulated on the SSFs has been suggested on account of a wider investor pool that is typically made available to an AIF, unlike an ARC or any other regulated financial institution authorised to acquire such assets. This would extend the existing requirements, which currently apply only to the SSF itself, to encompass its underlying investors. This additional layer of	While undertaking the activity to harmonise the provisions of AIF Regulations and Section 29A of IBC, the expanded scope may result in regulatory challenges.

			<p>scrutiny stems from the broader investor base typically associated with alternative investment funds (“AIFs”) compared to ARCs or other regulated financial institutions authorized to acquire such stressed assets. However, expanding the eligibility requirement to investors could bring potential challenges, such as increased due diligence and documentation requirements for SSFs. Thus, when amending the same due care needs to be undertaken to set out proper guidelines.</p>	
3	Proposal C	<p>Regulation 19M(1) of AIF Regulations may be suitably amended to specify that special situation funds shall not invest in its ‘related parties’, wherein related party shall have same meaning as given in Companies Act, 2013.</p>	<p>The proposal aims to curb the instances of round-tripping through Special-situation funds. The proposal seeks to curb these transactions by replacing the ‘associate’ with ‘related party’ as defined in section 2(76) of the Companies Act 2013. However, SEBI, in its Securities Listing Obligations and</p>	<p>To curb round tripping it is necessary to identify the parties whose presence leads to a conflict of interests. By including more entites in the definion of ‘related party’ such parites can be identified which will help in the prevention of frauds and scandals that are mostly an outcome of related party trasnsaction.</p>

			<p>Disclosure Requirements Regulations 2015, clause 2zb, has already provided an expanded definition of 'Related party'. This expanded definition encompasses 'related party' defined in the Companies Act 2013, the Indian Accounting standard IND-AS 24; the provision to the section also includes The promoter group, an equity shareholder holding at least 20% of shares or holding 10% in the listed entity or on a beneficial interest basis.</p>	
4	Proposal D	<p>AIF Regulations may be suitably amended to specify that SSFs shall transfer / sell stressed loans, acquired in terms of Clause 58 of RBI Master Directions, only to the entities enlisted in the Annex of RBI Master Directions.</p>	<p>Instead of restricting the transfer or sale of stressed loans by SSFs to the entities permitted in the Annex of the RBI Master Directions, SSFs may be allowed to transfer or sell such loans to any entity that meets the minimum eligibility criteria and prudential norms prescribed by the RBI, SEBI, or other relevant regulators.</p>	<p>Restricting the sale of loans to entities permitted in the Annex of RBI Master Directions can prevent round-tripping and maintain credit discipline. However, this could limit the market for these loans and affect the pricing. There needs to be a certain amount of flexibility to strike a balance between market discipline and market growth. While</p>

				listing requirements might deter certain entities or make them unable to meet the requirements, the suggest way could lead to a lesser regulatory burden. It would also ensure easier inclusion of new entities at any point of time, without having to amend the said list.
5	Proposal E	AIF Regulations may be suitably amended to specify that in respect of stressed loans acquired in terms of Clause 58 of RBI Master Directions, SSFs shall submit to a trade reporting platform notified by RBI, any information as may be specified by SEBl in consultation with RBI from time to time. SSFs shall also submit to RBI any information as may be required by RBI.	Proposal E1 - To optimize this initiative, the development of a standardized digital reporting should be considered. That will streamline the reporting process, ensuring efficiency and minimizing the risk of errors. Furthermore, prioritizing secure data transmission between SSFs and the reporting platform is imperative, with clear guidelines and technical support to implement robust security measures.	Rationale E1 - The proposed suggestion aims to enhance the effectiveness of the reporting framework by introducing practical measures. A standardized template would ensure consistency and accuracy whereas real-time reporting promotes timely regulatory responses. Also, prioritizing secure data transmission aligns with the paramount need to safeguard sensitive information, contributing to a regulatory environment that is both robust and supportive of compliance.

		<p>It may be specified by way of issuance of circular that SSFs shall submit the following information on the aforesaid trade reporting platform notified by RBI, in respect of all investments in stressed loans acquired under Clause 58 of RBI Master Directions:</p> <ol style="list-style-type: none"> a. details of units issued b. details of investors c. subsequent change in unit holdings, if any d. resolution strategies implemented e. recoveries effected f. any other information as may be specified by SEBI 	<p>Proposal E2 - The increase in the cost of compliance may be avoided by incorporating certain changes in the proposal, such as:</p> <ol style="list-style-type: none"> i. restricting reporting to SSFs that are systemically significant or over a minimum Assets Under Management ("AUM") level. ii. Reporting obligations might be made more manageable for smaller or lower-risk participants by being specifically tailored to each SSF's unique risk profile. iii. Introducing the reporting requirements gradually, providing SSFs with the time to adapt and establish essential infrastructure, could facilitate a smoother transition. iv. Utilize technology to simplify and reduce the cost of collecting and reporting data for groups, making the overall process more streamlined. 	<p>Rationale E2 - While it's important to be open and accountable, the rules suggested in the Consultation Paper regarding reporting might be excessive for the current situation as it will eventually increase the cost of compliance and deter investors. These averments may be avoided by incorporating the suggested measures.</p>
6	Proposal F	AIF Regulations may be suitably	Proposal F1 - The purpose of this	Rationale F1 - In order to optimize

		<p>amended to specify that SSFs who have acquired stressed loans in terms of Clause 58 of RBI Master Directions shall be subject to a dedicated supervisory framework as may be specified by SEBI, in consultation with RBI, from time to time.</p>	<p>proposal is that ssf should come up with the proposal for investing in every sector and corresponding industry to zero in on the single special situation asset by analysing parameters for the recovery of bad assets with the goal of identifying single special situation assets. Research in selection of asset should represent diversification to acquire stressed loans as SSFs can invest up to 100% of their investable funds in a single special situation asset.</p>	<p>returns and mitigate risks, it is crucial to explore investment opportunities across a spectrum of sectors and industries. By adopting a comprehensive approach, SSF can strategically position itself to identify and capitalize on special situation assets, particularly those associated with the recovery of bad loans. The proposal should further implement to formulate a diversification strategy that ensures a balanced portfolio of assets across various sectors and industries and to implement a systematic process for identifying single special situation assets within the diversified portfolio.</p>
			<p>Proposal F2 - This proposal advocates the establishment of a dedicated governance body tasked with overseeing a robust risk management framework. The primary goal is to</p>	<p>Rationale F2 - SEBI's provision of a six-month lock-in period underscores the importance of a proactive and strategic approach to managing stressed assets. The proposed governance body</p>

			<p>proactively address and resolve stressed assets within a defined time frame, aligning with SEBI's guidelines that provide a six-month lock-in period for Special Situation Funds (SSFs) to navigate and resolve such assets before considering an exit. The aim being to implement a system for regular monitoring of the progress in resolving stressed assets and to generate comprehensive reports for the governance body and stakeholders to provide transparent insights into the resolution process.</p>	<p>will play a pivotal role in ensuring effective risk management and resolution strategies are implemented within this timeframe. This helps to define a clear and time-bound strategy for the resolution of stressed assets within the stipulated six-month lock-in period as well as to align resolution efforts with SEBI's guidelines to ensure compliance and optimize the chances of successful asset recovery.</p>
			<p>Proposal F3 - This proposal recommends the prohibition of securitization of loans to align with the guidelines set forth by the Insolvency and Bankruptcy Code (IBC). Simultaneously, it suggests that SEBI and RBI explore the possibility of instituting a profit-sharing mechanism when stressed loans are</p>	<p>Rationale F3 - Under Clause 58 and the IBC, the acquisition of retail category loans is not permitted, limiting the scope to corporate entities as defaulters. By disallowing securitization and allowing direct purchase of stressed loans, SSFs can leverage the opportunity to acquire these loans at a</p>

			<p>submitted to Special Situation Funds (SSFs). This approach aims to foster a direct acquisition model for stressed loans, allowing SSFs to optimize recovery and profitability.</p>	<p>discounted rate. This, in turn, enables SSFs to actively engage in the recovery of loans, maximizing the potential for profitability within the regulatory framework. Encourage SEBI and RBI to explore the implementation of a profit-sharing mechanism for SSFs involved in the recovery of stressed loans and to further establish a framework that incentivizes SSFs to actively participate in the resolution and recovery process, aligning their interests with successful outcomes.</p>
			<p>Proposal F4 - This proposal advocates for the extension of regulatory benefits, including rights under the Insolvency and Bankruptcy Code (IBC), stamp duty exemptions, and other relevant incentives, to bolster the attractiveness of Special Situation Funds (SSFs). By aligning regulatory advantages with those traditionally afforded to Asset</p>	<p>Rationale F4 - This helps to facilitate a regulatory environment that empowers SSFs to actively participate in the resolution and recovery of stressed assets. The inclusion of regulatory benefits mitigate financial burdens on SSFs, encouraging their participation in distressed asset transactions and facilitating smoother asset</p>

			<p>Reconstruction Companies (ARCs) and other regulated financial institutions, SSFs can emerge as a compelling alternative in a market historically dominated by these entities.</p>	<p>acquisitions. Lastly, in also to align tax structures with industry norms to enhance the financial viability of SSFs and attract increased participation from potential investors.</p>
			<p>Proposal F5 - This proposal advocates for the establishment of a feedback mechanism, primarily in the form of compliance reports, to monitor and assess stressed assets held by Special Situation Funds (SSFs). Instead of imposing additional capital adequacy requirements, this proactive approach aims to maintain effective oversight while fostering a streamlined and responsive system for managing stressed assets.</p>	<p>Rationale F5 - Special situations inherently involve unique challenges, and SSFs are subject to comparatively lenient capital adequacy requirements when juxtaposed with other regulated entities in the financial sector. Recognizing this distinction, the proposal recommends a feedback mechanism through compliance reports as a more nuanced and flexible means of ensuring robust oversight without unduly burdening SSFs. This helps to encourage a risk-based approach in compliance reporting, wherein SSFs highlight key risk factors associated with their portfolio and</p>

				outline strategies for mitigation and to provide regulatory guidance to standardize risk assessment methodologies while accommodating the diversity of special situations.
7	Other comment, if any, along with relevant para number	B. eligibility of investors in SSFs in terms of Section 29A of Insolvency and Bankruptcy Code, 2016	Proposal B1 - SEBI should issue detailed guidance on due diligence procedures; this may be done by including following points- •Verification of identity and background of investors. •Assessment of financial capability and integrity. •Ongoing monitoring for any changes in eligibility. •Information sharing mechanisms with lenders.	Rationale B1 - This provides clear guidance to SSFs on how to conduct due diligence effectively, considering their unique structure and investor base. This will also promote consistency in implementation and reduces potential for misinterpretation.
		B. eligibility of investors in SSFs in terms of Section 29A of Insolvency and Bankruptcy Code, 2016	Proposal B2 - To propose Self-certification with random audits in order to reduce compliance burden by allowing investors to self-certify their eligibility under Section 29A.	Rationale B2 - The rationale that conducting random audits and verification checks to maintain integrity and deter false certifications. This offers a cost-effective approach while ensuring compliance, balancing trust with oversight and this will also reduce

				administrative burden for SSFs.
		B. eligibility of investors in SSFs in terms of Section 29A of Insolvency and Bankruptcy Code, 2016	Proposal B3 - Proposes to harmonize the definition of "special situation asset" across all regulations. This would ensure clarity and consistency in the investment universe for SSFs. To clarify the relationship between SSFs and ARCs. Define their respective roles and responsibilities in the stressed asset resolution process to prevent overlaps and conflicts.	Rationale B3 - Overlaps and conflicts between the regulation of AIF Regulations, SARFAESI Act, and RBI Master Directions for Investment restrictions are as follows: <ul style="list-style-type: none"> •AIF Regulations: SSFs can invest in a wide range of special situation assets, including stressed loans, securities of distressed companies, and assets held by ARCs. •SARFAESI Act: ARCs can acquire financial assets classified as NPAs by banks and financial institutions. However, their investments are restricted to certain asset classes, such as secured debt and immovable property. •RBI Master Directions: These directions impose specific eligibility criteria and investment restrictions on entities acquiring stressed loans, including

				<p>SSFs.</p> <p>Conflicts between the regulations-</p> <ul style="list-style-type: none"> •The scope of eligible assets for SSFs under AIF Regulations may be broader than what ARCs can acquire under the SARFAESI Act. This could create regulatory arbitrage opportunities. •RBI Master Directions impose additional restrictions on SSFs acquiring stressed loans, which may differ from those under AIF Regulations. This could lead to confusion and compliance challenges.
		<p>D. i. In terms of the aforesaid SEBI Circular dated January 27, 2023, stressed loans acquired by SSF in terms of clause 58 of the RBI Master Directions shall be subject to a minimum lock-in period of six months.</p>	<p>A tiered lock-in period based on the size or nature of the stressed loan may be considered. Larger or more complex loans could have a longer lock-in period.</p>	<p>A fixed lock-in period may deter certain entities from taking part in purchasing stressed loans. Further, the burden of a lock-in period may make some stressed loans unappealing, which would otherwise be considered. Thus, it may limit the liquidity of SSFs. A tiered lock-in system may better address the concerns at hand, like speculative</p>

				activity, while not endangering market liquidity and dynamism.
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