SECURITIES AND EXCHANGE BOARD OF INDIA

Proposal for Amendments to regulatory framework related to Infrastructure Debt Fund (IDF)

1. Objective

The objective of this memorandum is to place a proposal for amendment to SEBI (Mutual Funds) Regulations, 1996 (MF Regulations) with respect to Infrastructure Debt Fund (IDF).

2. Background

2.1. The Hon'ble Finance Minister, in the budget speech for the year 2011-12, proposed to create special vehicles in the form of notified infrastructure debt funds, to attract foreign funds for financing of infrastructure.

2.2. Subsequently, in June 2011, after consultations with potential investors, infrastructure companies, regulators and experts, the Ministry of Finance issued a press release on IDF spelling out the proposed structure of the IDF: either as a Non-Banking Finance Company (NBFC) to be regulated by RBI or as a Mutual Fund to be regulated by SEBI.

2.3. Subsequently, SEBI drafted the amendments to the SEBI (Mutual Funds) Regulations, 1996, inserting Chapter VI B on IDF Schemes; and the said amendments were notified on August 30, 2011.

3. Developments with respect to IDF-MF

3.1. Three applications to set up mutual funds dedicated to IDFs were received. One of the applicants was granted registration as an IDF-MF on November 15, 2012. The other two applicants have been granted in-principle approval and are in process of complying with the requirements of the Regulations for registration.

3.2. With respect to draft Scheme Information Documents (SIDs) for IDF schemes filed by existing mutual funds, SEBI has issued the final observations with respect to one of the SIDs vide letter dated April 18, 2012. However, the concerned mutual fund has not launched the scheme till date.

3.3. In the interim, seven other existing mutual funds filed draft SIDs with SEBI. However, there was limited progress in this area as during discussions on the draft SIDs, many mutual funds raised policy issues and made suggestions for changes in the present structure of IDF- MF to enable the product to become more viable.

3.4. In order to have a better understanding of issues involved, SEBI organized a meeting on November 27, 2012, which was attended by SEBI officials, Joint Secretary (Infrastructure & Investment), Ministry of Finance, and representatives of registered IDFs, applicants to set up IDFs and existing mutual funds which had filed draft IDF schemes.

3.5. Policy changes suggested by the participants with respect to the IDF-MF structure were discussed in detail during the meeting. It was informed to the participants that SEBI would initiate steps to carry out policy changes but would also be vigilant that any steps taken should not harm the investors or the mutual fund industry in the long run. The Alternative Investment Fund (AIF) structure was also analyzed and it was concluded by the participants that the mutual fund route would be preferable to the AIF route for IDF.

3.6. The representations were analysed and the analysis of the representations in respect of which changes are proposed in the MF Regulations is as given below.

4. Analysis:

4.1. Prepayment to investors or alternative investments:

4.1.1. Suggestion:

4.1.1.1. **Prepayment to investors:** In case of periodical repayment of principal/prepayment of principal with respect to underlying assets of the scheme, the AMCs need to invest the same in infrastructure debt securities, which becomes difficult due to lot size issues and maturity mismatch. Thus, to reduce reinvestment risk, prepayment to investors through redemption of units in the IDF scheme should be allowed in the following cases:

- Prepayment of underlying loans by borrowers. Further, if entire assets are prepaid prior to the end of the tenure of the scheme, the IDF should be allowed to be fully redeemed.
- The principal component of periodic cash flows received by the IDF needs to be returned to investors through partial redemption of units.
- The appreciation in the overall portfolio should be distributed to investors by way of periodic redemption of units in addition to payment of dividend. This is because AMCs have received feedback from prospective investors that they are willing to commit funds for a long duration subject to income/cash flow at periodic intervals.

4.1.1.2. **Alternative investments:** An alternative suggestion was received that IDFs may be allowed to invest the principal repaid in corporate bonds and bonds issued by companies like REC, PFC, etc.

4.1.2. SEBI comments:

4.1.2.1. **Prepayment to investors:** Periodical repayment to investors by the AMC is more in keeping with the nature of private equity than with a mutual fund. With respect to a mutual fund, in open ended schemes, repayment by extinguishment of units is at the request of investors and not at the discretion of the mutual fund. In close ended schemes, investors can only exit before maturity of the scheme by trading on the stock exchanges, and in interval schemes, either through stock exchanges or during the Specified Transaction Period when subscription and redemption is allowed.

Further, allowing of regular prepayment to investors at the discretion of the AMC would presuppose the inability of the AMC to find alternative infrastructure investments for the rest of the tenure of the scheme, which would defeat the very purpose of an IDF-MF. This may also contradict the commitment to investors to run a long term fund.

4.1.2.2. **Alternative investments:** The proposal for pre-payment to investors was raised in the context of lack of suitable investment opportunities of the funds thus received. One suggestion was to permit investments in corporate bonds in general. But the same may not be in consonance with the nature of an IDF- MF, which is meant to be a mechanism for financing the infrastructure sector. However, investment of funds received on account of pre-payment of principal or regular repayments of principal with respect to the underlying assets of the IDF in bonds of Public Financial Institutions (PFIs) which are involved in financing infrastructure may be more desirable. Besides, due to the concern that this may lead to a large volume of the scheme assets being deployed in such avenues, which may lead to the divergence from the main objective of IDF, this may be done only if the AMC is unable to find the core assets like debt assets or securitized debt of infrastructure companies, bank loans related to infrastructure, etc for deployment of such funds.

4.2. Extension in the tenure of the scheme:

4.2.1. Suggestion: Projects in the infrastructure sector are typically of long duration. Restructuring of project loans may occur due to cash flow mismatches on account of unforeseen circumstances. This could result in increasing of the tenure of the loan to align with the revised cash flow. Thus, the tenure of the IDF, which is a fixed term scheme, should be allowed to be extended if the underlying assets/loans get restructured. The extension of tenure may be permitted only upon specific consent by unit holders holding at least 75% of the AUM of the IDF.

4.2.2. **SEBI comments:** The SEBI (Alternative Investment Funds) Regulations, 2012, allow for extension of the tenure of a scheme upto two years subject to approval by 2/3rds of unitholders by value of their investment. The same could be prescribed for an IDF scheme.

4.3. Widening the definition of strategic investors

4.3.1. **Suggestion:** The market for IDF is yet to evolve and investment intentions and investor class is not yet established. Further, the role of strategic investors as per the present scheme appears to be essentially financial. The list of strategic investors should be widened to include corporates, long term funds, NBFCs (without infrastructure financing experience also), Sovereign Wealth Funds, trusts, an association of persons, etc.

4.3.2. **SEBI comments:** Presently, strategic investors are defined as the following:

- Infrastructure Finance Company registered with Reserve Bank of India as NBFC
- Scheduled Commercial Bank
- International Multilateral Financial Institution

The main role of the strategic investors is to collectively give a firm commitment of at least Rs. 25 crore before the scheme is marketed to other investors. Thus, the concept is comparable to 'anchor investors' in public issues.

The definition of 'strategic investor' may be broadened to include systemically important NBFCs registered with RBI; and also FIIs which are long term investors registered with SEBI subject to their existing investment limits.

4.4. Extension of New Fund Offer (NFO) period and Specified Transaction period (STP)

4.4.1. Suggestion:

4.4.1.1. **Extension of NFO/STP:** Investments in IDF are expected to be made mostly by institutional investors. The lead time for investments by such investors is usually be longer due to procedural issues, including scheduling of meetings for obtaining approvals for investments, etc. The said lead time could be longer for overseas investors. The fund raising exercise is likely to involve a large number of one to one/ specialized meetings to be scheduled for the purpose. Thus, New Fund Offer (NFO) and subsequent Specified Transaction Period (STP) may be permitted for at least 45 days.

4.4.1.2. **Allowing of private placement:** Further, it was also suggested during the meeting that private placement to less than 50 investors may be allowed as an alternative.

4.4.2. SEBI comments:

4.4.2.1. **Extension of NFO/STP:** Presently, NFO period is of maximum 15 days and STP is upto one month for IDF schemes. The NFO period and the STP may be increased to upto 45 days, only with respect to IDF schemes.

4.4.2.2. **Allowing of private placement:** Further, private placement to less than 50 investors may be permitted as an alternative. In case of private placement, the mutual funds would only have to file a placement memorandum with SEBI instead of a Scheme Information Document and a Key Information Memorandum. However, all the other conditions applicable to IDFs offered through the NFO route like kind of investments, investment restrictions, etc. would be applicable to IDFs offered through private placement.

4.5. Review of limits on sponsor owned assets

4.5.1. Suggestion: Limits on investments in assets owned by sponsor/ associates (presently capped at 20% of AUM of the IDF scheme) should be reviewed. Very often, investors in IDF rely on the support of the sponsor to assist in building the portfolio of the IDF. An alternative could be by ensuring that good quality assets are sold to the IDF by mandating that any seller including the sponsor has a minimum retention requirement of at least 20% of the assets sold to the IDF till the assets are held in the IDF portfolio.

4.5.2. SEBI comments: A minimum retention requirement of the sponsor may not be adequate by itself to mitigate the possibility of a sponsor transferring a large portion of badly performing assets to the IDF. However, keeping in mind the submission of the mutual funds about the reliance on the support of the sponsor, it is proposed that an IDF may be allowed to invest upto 30% of its AUM in assets not below investment grade owned by sponsor/associates (increased from the present 20%). Also, with respect to the desirability of the sponsor/associate continuing to have 'skin in the game' with respect to the assets sold to the IDF, there may be a stipulation that they retain at least 30% of the assets sold to the IDF scheme till the assets are held in the scheme portfolio.

4.6. Investments in pre- COD stage

4.6.1. Suggestion: The regulations state that the IDF can invest in bank loans in respect of completed and revenue generating projects of infrastructure companies or projects or special purpose vehicles. If they are allowed to invest in bank loans in pre Commercial Operations Date (COD) stage, this will increase the investment universe. Thus, the IDF may be allowed in invest in projects in pre-COD stage i.e. the investment universe may be expanded to project finance by mutual funds under IDF. The amount of exposure can be capped to 20% of the overall project cost.

4.6.2. SEBI comments: In order to widen the universe of assets available to IDF and also to widen the avenues of funding to pre-COD projects, this representation may be agreed to and IDFs may be allowed to invest in bank loans to projects at any stage i.e. in pre-COD projects as well as post-COD projects. Thus, as most pre-COD projects may be unrated/below investment grade, investment in such projects as per present Regulations would, in effect, be limited to 30% of net assets, extendable to 50% with the approval of trustee & AMC boards. However, the suggestion regarding direct project financing by the mutual funds i.e. direct lending to projects rather than investing in bank loans, may not be desirable as that would completely obliterate the distinction between a pass through investment structure and a lending entity. Further, the Mutual Funds Regulations do not permit advancing of loans by a mutual fund for any purpose.

4.7. Review of limits of investments in unrated/below investment grade assets

4.7.1. Suggestion: An IDF's maximum exposure to unrated/below investment grade securities is capped at 30%, extendable to 50%. However, most of the loans would get a below investment grade rating in pre COD stage. Further, most of the loans would be in the phase immediately preceding COD stage. Thus, it would be difficult to create a portfolio with 50% investment grade securities. Thus, the limit of unrated/below investment grade papers may be raised to 100%.

4.7.2. SEBI comments:

4.7.2.1. After discussions in the meeting, it was generally concluded that review of these limits was not required. Further, allowing the IDF to invest largely (beyond 50%) in unrated/below investment grade assets may lead to the IDF acquiring a 'junk' character and this may not be conducive to attract investments in the IDF.

4.7.2.2. The MF Regulations mention that an IDF scheme shall not invest more than 30% of its net assets in debt instruments or assets of any single infrastructure company or project or SPV or bank loans in respect of projects of any single infrastructure company or project or SPV, which are rated below investment grade or unrated. Such investment limit may be extended to 50% of net assets of the scheme with the prior approval of the Boards of the trustees and the AMC. A plain reading of this clause may give the impression that an IDF scheme may invest 100% of its assets in unrated/below investment grade instruments as long as single issuer limits are adhered to. However, the intention is to address concentration risk by restricting investment in instruments, irrespective of rating, of a single issuer to 30% of net assets of the scheme, and also to ensure quality of portfolio by limiting overall investment in unrated/below investment grade assets to 30% of the net assets of the scheme, extendable to 50% with the prior approval of the Boards of trustee & AMC. Thus, these restrictions may be accordingly incorporated in the Regulations.

4.8. Carving out a separate limit for mezzanine debt

4.8.1. Suggestion: Investors in IDFs under the mutual fund route are to bear the entire risk without any recourse to the issuer. To make the scheme attractive, it is necessary that the scheme should have the potential to generate higher returns, so that the investors are suitably attracted in investing on a risk reward scale. This has also been mentioned in the Press release dated June 24, 2011 issued by the Ministry of Finance wherein it has been mentioned that “in case of IDFs that issue units, greater credit risk would be borne by the investors who will be free to seek correspondingly higher returns. MFs would be especially useful for non PPP projects”. Investment in mezzanine debt and equity are conventionally considered to be yield enhancers. Thus, under IDF a separate limit of 10% may be carved out for investments in mezzanine debt, so as to enhance the yield on the portfolio to be in consonance with “risk reward” objective. This would also enable the fund manager to have a wider range of instruments to be considered for investments. In other words, investments in mezzanine debt should not be clubbed with other investments like equity, money market instruments, etc.

4.8.2. SEBI comments: Creating a wider canvas of eligible infrastructure related instruments is desirable. Also**,** as the investors in the IDF -MF would be institutions/HNI investors, and as they would be in a better position to understand the risks and rewards associated with various instruments, the representation for a separate limit of 10% for mezzanine debt has merit.

5. Other issues:

5.1. During the meeting held on November 27, 2012, the participants made the following representations:

5.1.1. Units of IDF- MF should be eligible for infrastructure exposure by insurance companies.

5.1.2. IDF-MFs should obtain similar status and rights as banks and financial institutions under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act).

5.1.3. Tax incentives may be given to IDF- MF to make it more attractive.

5.2. The above proposals have been raised with the Ministry of Finance for its consideration.

6. Proposals:

6.1. Alternative investments to be permitted: Investment of funds received on account of pre-payment of principal or regular repayments of principal with respect to the underlying assets of the IDF in bonds of Public Financial Institutions (PFIs) which are involved in financing infrastructure may be allowed. This may be done only if the AMC is unable to find the core assets like debt assets or securitized debt of infrastructure companies, bank loans related to infrastructure, etc for deployment of the amounts of principal.

6.2. **Extension in the tenure of the scheme:** The tenure of the scheme may be allowed to be extended upto two years beyond the original tenure with the consent of 2/3rds of its investors by value.

6.3. **Widening the definition of strategic investors:** The present definition of strategic investors may be widened to include the following:

- Systemically important NBFCs registered with Reserve Bank of India
- FIIs registered with SEBI which are long term investors, subject to their applicable investment limits

6.4. **Extension of New Fund Offer (NFO) period and Specified Transaction period (STP) and allowing of the private placement as an alternative:**

6.4.1. The NFO period may be increased to upto 45 days (from upto 15 days) and the STP may be increased to upto 45 days (from upto 30 days), only with respect to IDF schemes.

6.4.2. Further, private placement to less than 50 investors may be permitted as an alternative. In case of private placement, the mutual funds would only have to file a placement memorandum with SEBI instead of a Scheme Information Document and a Key Information Memorandum. However, all the other conditions applicable to IDFs offered through the NFO route like kind of investments, investment restrictions, etc. would be applicable to IDFs offered through private placement.

6.5. **Review of limits on sponsor owned assets: A**n IDF scheme may be allowed to invest upto 30% of its AUM in assets not below investment grade owned by sponsor/ /associates (as increased from the earlier 20%) subject to the condition that the sponsor/associate retains at least 30% of the assets sold to the IDF till the assets are held in the IDF portfolio.

6.6. **Investments in pre- COD stage:** IDF schemes may be allowed to invest in bank loans to projects at any stage i.e. pre-COD projects as well as post-COD projects.

6.7. **Limits on investments in unrated /below investment grade assets and limits of investment in instruments of a single issuer:** Investments of the IDF scheme in instruments, irrespective of rating, of a single issuer may be restricted to 30% of net assets, and overall investment in unrated/below investment grade assets to may be restricted to 30% of the net assets, extendable to 50% with the prior approval of the Boards of trustee & AMC.

6.8. **A separate limit for mezzanine debt:** A separate limit for investment in mezzanine financing instruments of infrastructure companies upto 10% of net assets may be carved out.

7. The Board may consider and approve the proposals made at para 6 and authorize the Chairman to take steps to implement the proposal by amending the SEBI (Mutual Funds) Regulations, 1996 and circulars, wherever necessary, consequential and appropriate and to notify the necessary regulations and issue guidelines and circulars in this regard.