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AIF Participation in Credit Default Swaps

Article By:

Nandini Pathak

Dr. Dhruv Sanghavi

As of 30 June 2022, Alternative Investment Funds ("**AIFs**") registered with the Securities and Exchange Board of India ("**SEBI**") were reported to have collectively allocated 30% of their total investments towards debt and securitized debt instruments.[1] In response, SEBI[2] has amended[3] the AIF Regulations ("**Amendment**") to authorise AIFs to buy and sell credit default swaps ("**CDS**")[4] to hedge or assume credit risks. This authorisation, however, is subject to certain restrictions and conditions, which vary for various categories of AIFs, which have been explained further in a circular ("**Circular**").[5] These are outlined below.

Particulars	Category I	Category II	Category III
AIF as a buyer of CDS	Category I and Category II AIFs may buy CDS, but only to hedge risks on underlying debt investments.		Category III AIFs may bu hedging risks on an unde debt investment. A Category III AIF may a CDS for purposes other hedging of risks. Howeve exposure to CDS may no twice the net asset value fund.[6]
AIF as a seller of CDS	The Amendment and Circular are silent in this regard. We view this as being not permitted.	Category II AIFs may to sell CDS by earmarking unencumbered Government bonds/treasury bills equivalent to the CDS exposure so that it does not amount to leverage.	Category III AIFs may se provided that "effective l undertaken" within perm limits (i.e., twice the net a value of the fund). They may sell CDS by e unencumbered Governm bonds/treasury bills equi the CDS exposure. Such exposure may not amou leverage.

Concentration Norms	Not applicable as the Amendment and the Circular are silent on the sale of CDS by Category I AIFs.	Total exposure to investee companies via CDS should not breach the concentration norms. These norms, for Category II AIFs, provide that no more than 25% of an AIF's investible funds may be invested in one investee company.	Any unhedged position r the gross value of unhed positions across all CDS transactions exceeding 2 investable funds may be undertaken only after int investors.
Custodian	Sponsor / Manager of a Category I or Category II AIF undertaking CDS transactions must appoint a custodian who is registered with SEBI irrespective of the corpus size.[7]		All Category III AIFs are to appoint a custodian u AIF Regulations.[8]
Reporting	Details of CDS transactions must be reported to the appointed custodian before the end o following working day (in the manner prescribed by the custodian).		
Breach due to earmarked securities falling below the CDS exposure	Not applicable as the Amendment and the Circular are silent on the sale of CDS by Category I AIFs.	If the earmarked securities of a Category II or III AIF fall b CDS exposure, it must 1. report the breach to its custodian on the same da breach; 2. bring the amount of earmarked securities equal to exposure and report the rectification details to the by the end of the following trading day; If the AIF fails to rectify the breach, then the custodian is to report the details thereof to SEBI on the following work	
Breach in leverage limits		Not Applicable as Category II AIFs are not permitted to sell CDS in a manner that is tantamount to leverage.	A Category III AIF in bre leverage limits must 1. report the breach custodian on the working day; 2. report the breach investors by 10 a next working day 3. square off exces exposure and bri the exposure wit and report this to investors by the e day of squaring c
Cooling-off period	Category I and Category AIFs transacting in CDS must maintain a cooling-off period of thirty days between two periods of any borrowing or leverage that they undertake.		Not applicable.

The Circular stipulates that all CDS transactions must be performed on a platform which is regulated by SEBI or the Reserve Bank of India ("**RBI**"). These transactions ought to also be compliant with the Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022 ("**Master Direction**"). The key features of the Master Direction which are relevant to AIFs transacting in CDS are outlined below

1. *Reference Entities*: AIFs may enter into a CDS contract only to hedge against or assume risks of investees (called "reference entities") which are residents of India, against whose credit risk the CDS contract is entered into.[9]

2. *Reference Obligations*:The Master Direction refer to the underlying assets to which a CDS contract is linked as "reference obligations". AIFs are prohibited from entering into CDS contracts which are linked to asset-backed securities/mortgage-backed securities or structured obligations.[10]

3. *Related Parties*: CDS transactions are not permitted when the reference entity is a related party to either the "protection buyer" or the "protection seller".[11]

4. *Accounting*: To follow SEBI prescribed accounting standards. In the absence such standards, AIFs ought to follow the guidance issued by the Institute of Chartered Accountants of India.[12]

OBSERVATION AND REMARKS

By permitting AIFs to participate in CDS, SEBI has facilitated AIFs to manage and transfer their credit risks, and also introduce new institutional players in the market. SEBI remains circumspect about allowing Category II AIFs to become protection sellers without earmarking certain unencumbered securities of an equivalent value to the CDS. Despite this circumspection, the Amendments are welcome inasmuch as they allow AIFs to guarantee the creditworthiness of certain debt instruments. This allows greater flexibility as opposed to SEBI's traditional stance against allowing AIFs to undertake any guarantees.

Be that as it may, it remains to be seen whether the AIF industry's demand for CDS transactions is sustainable in the current regulatory framework. One might remember that mutual funds were permitted to participate in the CDS market a decade ago. However, the market did not take off. The premium for buying CDS ought to be commensurate with the advantage derived by AIFs by hedging credit risks. In the absence of market makers enabling commercial viability of CDS transactions, the new regulatory environment is unlikely to make the market be sustainable. It remains to be seen whether the AIFs' interest in CDS transactions is sustainable in the long term, or if it will follow the footsteps of mutual funds.

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FOOTNOTES

[1] SEBI Board Meeting Memorandum dated December 20, 2022.

[2] SEBI (Alternative Investment Funds) (Amendment) Regulations, 2023.

[3] Regulations 16(1)(aa), 17(da), 18(ab) and 20(11).

[4] A CDS is defined as "*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*." See: Para 2(f), Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022 (February 10, 2022, FMRD.DIRD.10/14.03.004/2021-22).

[5] SEBI/HO/AFD/PoD/CIR/2023/15.

[6] SEBI circular no. CIR/IMD/DF/10/2013 dated July 29, 2013.

[7] Regulation 20 (11), AIF Regulations.

[8] Regulation 20 (11), AIF Regulations.

[9] Para 7, RBI Master Directions.

[10] Para 7, RBI Master Directions.

[11] Para 8, RBI Master Directions.

[12] Para 12, RBI Master Directions.

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