

## Corpsec Hotline

March 26, 2021

### NEW INVESTOR ON THE BLOCK: PRIVATE PROVIDENT FUNDS PERMITTED TO INVEST IN ALTERNATIVE INVESTMENT FUNDS

#### INTRODUCTION

The Government of India, vide notification<sup>1</sup> dated March 15, 2021 ("**Notification**"), introduced a significant amendment in the investment regime for Non-Government Provident Funds, Superannuation Funds and Gratuity Funds (together referred herein as "**Provident Funds**"). Vide the notification issued by the Ministry of Finance, Department of Financial Services, such private Provident Funds have been permitted to invest their funds into units of Category I and Category II Alternative Investment Funds ("**AIFs**"), in accordance with the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"). However, the Notification does stipulate certain restrictions and thresholds, while opening up the avenue of investing in AIFs for such Provident Funds.

#### EXISTING INVESTMENT REGIME FOR PROVIDENT FUNDS

The Notification has brought in the amendment to the investment guidelines which were introduced vide notification dated March 02, 2015 (as amended from time to time), wherein the Provident Funds had been permitted to invest in different categories of asset classes such as<sup>2</sup>:

1. Minimum investment of 45% up to 50 % in government securities and related investments, which includes securities wherein the principal and interest is fully and unconditionally guaranteed by the Government of India ("**Gol**") or any state government;
2. Minimum investment of 35% up to 45% in debt instruments and related investments, which includes listed debt securities issued by body corporates, rupee bonds having outstanding maturity of at least 3 years, term deposit receipts of not less than one-year duration issued by scheduled commercial banks, units of debt mutual funds as regulated by Securities and Exchange Board of India ("**SEBI**") and such other investments;
3. Up to 5% investment in short term debt instruments and related investments, which includes money market instruments;
4. Minimum investment of 5% up to 15% in equities and related investments such as shares of companies listed on the Bombay Stock Exchange ("**BSE**") or National Stock Exchange ("**NSE**"), subject to certain thresholds;
5. Up to 5% investment in asset backed, trust structured and miscellaneous investments, such as commercial mortgage-based securities or residential mortgage-based securities, units of Real Estate Investment Trusts ("**REITs**") and Infrastructure Investment Trusts ("**INVTs**") as regulated by SEBI and such other investments

The Gol has amended the aforesaid guidelines earlier as well to broaden the investment avenues for the Provident Funds, through notification dated December 11, 2019<sup>3</sup>, whereby under the category of debt instruments and related investments, the Gol had included units of debt exchange traded funds, which are regulated by SEBI and should be managed by an asset management company appointed by the Gol.

From time and again, the Gol has been making attempts to adapt to the dynamic nature of the markets and open more suitable avenues for the betterment and growth of the Provident Funds.

#### PROPOSED INVESTMENT REGIME: CONDITIONS FOR INVESTMENTS IN AIFS

As per the Notification, the Provident Funds shall now be permitted to invest in the units of a Category I and Category II AIFs, subject to fulfillment of the following conditions, in accordance with the AIF Regulations<sup>4</sup>:

1. Provident Funds are only permitted to invest in AIFs, with corpus equal to or more than INR 100 crores;
2. Except for a Government sponsored AIF, the Provident Funds shall limit their exposure to a single AIF to 10% of the AIF size;
3. Under the Category I AIFs, the Provident Funds are allowed to invest in infrastructure funds, SME funds, venture capital funds and social venture capital funds;
4. For the Category II AIFs at least 51% of the funds of such AIFs should be invested in either infrastructure entities or SME's or venture capital or social welfare entities;
5. The Provident Funds are not permitted to invest, either directly or indirectly, in the units of the companies or funds, which are incorporated and/or operated outside India;
6. The sponsor of the AIF, wherein the investment is made, should not be the promoter of the Provident Fund or of the group to which the Provident Fund belongs;

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7. Such AIFs should not be managed by an investment manager, who is directly or indirectly controlled or managed by the Provident Fund or the promoter group of the Provident Fund.

The aforesaid conditions laid down by the Gol limit the risk exposure of the Provident Funds, by restricting their exposure into a single AIF to 10% and allowing investment in those AIFs, which have a higher corpus. The Notification also seems to be aimed at boosting certain sectors such as infrastructure, SME and social welfare over the rest, by allowing Provident Funds (who have access to considerable amount of funds as part of their corpus) to invest in AIFs particularly focused on such sectors. This Notification is yet another move by the Gol to bolster the infrastructure sector, as the cabinet recently also approved setting up of a Development Finance Institution ("DFI"), which will aim to raise funds from global pension and insurance funds for the Indian infrastructure sector<sup>5</sup>.

It is pertinent to note that the Employees Provident Fund Organisation ("EPFO") which manages close to INR 12 lakh crore of retirement savings of the public sector and Gol employees<sup>6</sup>, possibly one of the highest corpus holder when compared to other Provident Funds, has been kept out of the ambit of the Notification. One of the reasons for such exclusion could be the fact that the corpus of a Provident Fund, is essentially life savings of the persons, who have accumulated the wealth over course of many years of service and therefore the stakes involved are much higher and investment of such funds in volatile sectors could lead to value erosion to the public at large.

#### COMPARATIVE ANALYSIS: PRIVATE PENSION FUNDS VS PRIVATE PROVIDENT FUNDS

Owing to the amendment brought in by the Notification, though the regulatory framework and permitted investment avenues for Provident Funds, has been brought closer to the framework for private pension funds, there are certain key differences between the two frameworks that need to be dealt with and aligned by the regulatory authorities in the future, sooner than later.

1. As per the circular dated April 08, 2016<sup>7</sup> read with the investment guidelines for National Pension Scheme ("NPS") dated September 02, 2015<sup>8</sup>, private pension funds (governed by the Pension Fund Regulatory and Development Authority ("PFRDA")) were allowed to invest through Category I and Category II AIF's only in listed or to be listed securities. In contrast to that, as per the Notification read with the investment guidelines for Provident Funds, the investment into AIFs is not limited to listed securities but also extends to unlisted securities.
2. The private pension funds are allowed to invest in only those AIFs (except the government owned AIFs) which have a minimum rating of AA and above from at least **one** rating agency. Whereas, as per the investment guidelines for the Provident Funds, the requirement is to invest in AIFs which have a minimum rating of AA or equivalent from at least **two** credit rating agencies registered with SEBI.

In terms of credit rating, Credit Rating Information Services of India Limited ("CRISIL"), is the sole provider of benchmarks to AIFs and while that exercise is already done at the AIF level, the question that exists is whether a separate rating (whether one or two, as applicable) is really needed at the time the pension funds/ Provident Funds are looking to invest and if yes, the regulators need to clarify the rationale behind.

#### ANALYSIS

The decision of the Gol to open up the gates of AIFs for Provident Funds, can be seen as another step in the mission of promoting Indian startups and companies and allowing access to capital for them to facilitate their growth, in order to establish the Indian startup eco system as one of the most prominent eco systems globally.

The move has been welcomed by the AIFs since they get a new investor on board besides benefitting the Provident Funds by allowing them to invest in AIFs/ specified investment sectors in India, which due to increasing incentives and policy changes introduced by the Gol and SEBI from time to time, has become a desirable avenue for institutional investors, high net worth individuals and other funds to invest their funds in exchange for considerable high value returns. However, the inherent risk associated with such investments given the volatility of the permitted sectors, cannot be disregarded and needs to be duly considered by such Provident Funds, before committing their capital to the AIFs. Though the Provident Funds continue to have some equity exposure in listed securities as on date, the Notification does not clarify the percentage of the corpus of the Provident Funds which can be invested in AIFs. Given the risks associated, the reaction of the stakeholders of the Provident Funds would be interesting to watch out for.

Besides, the decision to keep investments in offshore funds, out of the scope of the Notification comes as a surprise. While the risk exposure would have increased with such investments in offshore vehicles alongside compliance with the extant foreign exchange control regime of India, to avoid any roundtripping or Anti-money laundering issues, a complete disallowance of the same restricts the ability of the Provident Funds to access the global markets, like other investors.

Given the recent surge in the externalization of Indian companies (where more and more Indian companies are setting up holding companies or subsidiaries outside India), the restriction on investment in securities of companies or funds incorporated/ operated outside India needs to be re-analysed. While AIFs are generally permitted to invest in securities of companies outside India subject to compliance with conditions stipulated by the RBI/ SEBI in this regard, a restriction of this kind may truncate the investment opportunities for the Provident Funds. It also does not sound prudent to regulate the same subject of investment in overseas securities at two different levels particularly when at the AIF level, it is already subject to regulatory compliance.

#### CONCLUSION

In light of the above, while the introduction of the Notification is a welcome move and does a bring a significant change in the Indian AIF and Provident Fund landscape, it is still at a nascent stage. The success of the mission of Gol will depend on a plethora of factors and shall be subject to AIFs and Provident Funds formulating an investment process, which is efficient and does not delay the existing process timelines within an AIF.

To sum it up, it appears that the future of the infrastructure, venture capital, social welfare sector and SME's sector looks promising and backed up by Gol initiatives to achieve prominence globally.

April 01, 2025

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- <sup>1</sup> Ministry of Finance (Department of Financial Services) Notification F. No. 1/8/2021-PM dated March 15, 2021  
<<http://egazette.nic.in/WriteReadData/2021/225913.pdf>>
- <sup>2</sup> Ministry of Finance (Department of Financial Services) Notification F. No. 11/14/2013-PR. dated March 02, 2015  
< <https://www.pfrda.org.in/myauth/admin/showimg.cshml?ID=738>>
- <sup>3</sup> Ministry of Finance (Department of Financial Services) Notification F.No. 10/41/2018-PM dated December 11, 2019  
< <http://egazette.nic.in/WriteReadData/2019/214599.pdf>>
- <sup>4</sup> Ministry of Finance (Department of Financial Services) Notification F. No. 1/8/2021-PM dated March 15, 2021 <http://egazette.nic.in/WriteReadData/2021/225913.pdf>
- <sup>5</sup> India to set up development finance institution to fund infra projects <<https://www.vccircle.com/india-to-set-up-development-finance-institution-to-fund-infra-projects>>
- <sup>6</sup> Private PFs can invest up to 5% of surplus in AIFs that back MSMEs  
<<https://economictimes.indiatimes.com/news/economy/finance/private-pfs-can-invest-up-to-5-of-surplus-in-aifs-that-back-msmes/articleshow/81537554.cms>>
- <sup>7</sup> PFRDA Circular No. PFRDA/2016/8/PFM/02 dated April 08, 2016 <https://www.pfrda.org.in/writereaddata/circulars/aif8e56d8df-6719-4d49-8e3e-09ee444ad220.pdf>
- <sup>8</sup> PFRDA Circular No. PFRDA/2015/21/PFM/08 dated September 02, 2015  
<<https://www.pfrda.org.in/writereaddata/links/investment%20guidelines%20for%20nps%20schemes%201295bb93-5c58-441d-af3c-b80e41014b94.pdf>>
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