

AIFs jittery over Sebi move to ban priority distribution

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Prohibition will crimp ability to raise funds; consider better transparency checks, say AIFs



The issue arose when Sebi discovered that a real estate lender and a Mumbai-based non-bank lender misused the AIF route to evergreen loans. (Mint)

NEW DELHI/MUMBAI : Alternative investment funds (AIFs) fear their ability to raise funds may be hurt by a recent regulatory move to curb so-called priority distribution models and have called for better transparency checks instead.

In November 2022, the Securities and Exchange Board of India (Sebi) asked AIFs with priority distribution models not to accept any fresh investments until the regulator took a call on the permissibility of such models. This was followed by a Sebi discussion paper in May, proposing to prohibit such models outright.

Such models are an integral part of debt AIFs, an industry executive said. "The industry feedback is for Sebi to consider a separate category that could allow priority distributions with certain checks and balances," said Nandini Pathak, leader of investment funds at Nishith Desai Associates.

In a priority distribution model, the AIF creates two classes of investors; senior investors hold superior rights, such as the distribution of proceeds until a hurdle rate is met, after which junior investors are paid. Similarly, in case of a loss, investors in the senior tranche take higher losses than the junior tranche investors.

Development finance institutions, debt funds and blended finance lenders may be the most adversely impacted by this proposal. The industry, through Indian Private Equity and Venture Capital Association (IVCA), has made representations to Sebi requesting it to provide an exemption to credit funds, two industry executives said on condition of anonymity. IVCA has also proposed that Sebi could put in place higher transparency checks for such funds.

Priority distribution models have always been a grey area in Sebi regulations since they are neither expressly allowed nor prohibited. According to the people cited above, the issue started when Sebi noticed a real estate lender and a Mumbai-based non-bank lender misusing the AIF route to evergreen loans, which were at high risk of turning into non-performing assets (NPAs).

"You cannot punish the whole industry for the wrongdoings of a few. Over-regulation will kill the industry. There is a need for structured products, and corporates with different sets of needs will access capital differently," said a senior fund official, one of the two people cited above. Development finance institutions, debt funds and blended finance lenders will be the most affected by the move, the person added.

Priority distribution turned popular since one section of investors may be willing to take a higher risk than others and to accommodate investors of such varying risk appetite in the same fund, the AIFs use such models.

If the Sebi proposal becomes law, even equity AIFs will be impacted, the second person said. Some organizations in the private equity and venture capital funds also use priority distribution models.

"When institutions put money in AIFs, they seek greater powers and are willing to take risks that individual investors may not be ready to," the second person said. "It would become a challenge for AIFs with individual investors to attract institutional capital."

AIFs have in total raised funds worth ₹3.65 trillion and have invested ₹3.37 trillion as of 31 March, according to available data.

Market participants say Sebi should grandfather existing funds, at least. Grandfathering is a process through which regulators exempt existing market entities from being subject to a new rule.

"Existing schemes of AIFs which have adopted priority distribution model may continue with the existing investments, but shall not accept any fresh commitment or make an investment in a new investee company," Sebi had said in the 20 May discussion paper.

A lawyer with a fund management company said existing funds having priority distribution models might be forced to split the fund into multiple new funds to ensure compliance with Sebi rules. "If they want to continue making new investments, these AIFs will have to demerge each fund into two: one for senior tranche investors and the other for junior tranche," the lawyer said.

The AIF advisory committee appointed by the regulator had recommended allowing priority distribution models. However, Sebi overruled its recommendations, observing that the 2008 global financial crisis was a result of such tranching.