

Investment Funds: Monthly Digest

February 08, 2025

PRO-RATA AND PARI-PASSU RIGHTS: THE POSITIVES, THE NEGATIVES AND EVERYTHING IN BETWEEN

- Pro-rata Rights: SEBI mandates equal treatment of AIF investors in relation to portfolio investments and distributions to ensure rights of investors are on basis of their 'commitments'
- Pari-passu Rights: SEBI mandate that rights of all investors in an AIF (except for LVFs) to be pari-passu in all aspects i.e. rights of all investors should rank equally without any preference – differential rights allowed to be offered in certain cases
- SFA introduces positive list of rights on which managers may offer differential treatment among investors – Existing AIFs are required to disclose details of differential rights which foul the implementation standards formulated by SFA on or before *February 28, 2025*
- Differential rights which are affecting the rights of other investors, have to be immediately terminated

The Security Exchange Board of India (“SEBI”) through the Securities and Exchange Board of India (Alternative Investment Funds) (Fifth Amendment) Regulations, 2024 (“Fifth Amendment”) and the circular dated December 13, 2024¹ (“Circular”) has amended the SEBI (Alternative Investment Fund) Regulations, 2012 (“AIF Regulations”). The amendments introduce significant changes to rights of investors in an alternative investment fund (“AIF”).

While SEBI provided the overarching law stating the manner in which economic and differential rights may be granted to investors of an AIF, the Standard Setting Forum for AIFs (“SFA”) was tasked with the formulation of the positive list of differential rights which may be offered. The SFA released this positive list, titled the ‘Implementation Standards for Offering of Differential Rights to Select Investors of an AIF’ in late January of 2025 (“Implementation Standards”).

The Fifth Amendment, Circular and the Implementation Standards are collectively referred to as the “Amendments”.

1. BACKDROP

The Amendments have been made with an objective to clarify the regulatory intent of an AIF being a pooled investment vehicle and to ensure fair and equal treatment of investors of an AIF.² SEBI has been clear that maintaining pro-rata rights of investors in each investment of the scheme of the AIF, including while making distribution of investment proceeds, is an essential characteristic of AIF structures. SEBI has explicitly allowed only sponsor / manager of an AIF to share losses higher than their pro-rata holding vis-a-vis other investors.³

In 2022, SEBI noted that some AIFs were adopting a priority distribution model where one class of investors (other than sponsor/manager) shares losses in the AIF disproportionately vis-a-vis other classes of investors/unit holders (such as structured debt models). SEBI had prohibited such AIFs from accepting any fresh capital commitments or make new investments.⁴

Subsequently, in 2023, SEBI issued a consultation paper advocating maintaining pro-rata and pari-passu rights of investors of AIF.⁵

In light of the above backdrop, SEBI has now issued the Amendments. In this hotline, we examine the impact of the Amendments to AIFs and its investors.

2. SEBI AMENDMENT

2.1 Maintaining pro-rata right of investors of AIF

- SEBI has mandated for all investors of a scheme of an AIF to have rights, pro-rata to their 'commitment' to the scheme, in each investment and distribution of proceeds by such scheme, except to the extent an investor has been excused or excluded from participating from an investment or an investor has defaulted on providing its pro-rata contribution.⁶

SEBI had earlier proposed that investors of an angel fund should also have pro-rata rights in investment and distribution.⁷ Importantly, the Amendments now provide that the requirement to maintain pro-rata right is not applicable to angel funds. This is a welcome relaxation for angel funds which follow a deal-by-deal model and profit is often shared with investors who sourced the relevant deal.

No exemption has been provided to large value funds for accredited investors in relation to maintaining pro-rata rights.

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The Circular mandates that all investors of a scheme of an AIF have rights pro-rata to their ‘commitment’ to the scheme. However, the Amendments are silent on whether ‘commitment’ should be read as total capital commitment or unfunded capital commitment.

The total capital commitment of an investor is inclusive of the amounts drawn down by the AIF for fund expenses, management fees, portfolio investments etc. It is not uncommon of investors to negotiate different management fees or fund expenses, leading to variations in actual contributions to the fund. The unfunded capital commitment, on the other hand, fluctuates over the life of the fund due to adjustments on account of excuse of investors, default by certain investors, reinvestment of proceeds, return of unutilized contributions, fund distributions, etc. As a result, drawdowns are typically based on the ratio of unfunded capital commitments rather than total capital commitments.

If the requirement to maintain pro-rata rights is read in context of total capital commitment of an investor, it may lead to impractical outcomes. For instance, if drawdowns are made strictly on total capital commitments, an investor with higher unfunded capital commitment may have unutilized capital till the end of the commitment period. Conversely, an investor with a lower unfunded capital may be unable to meet further drawdowns.

- An investor may share returns or profits from investments with the AIF’s investment manager or sponsor in terms of the contribution agreement executed between the AIF and the investment manager or sponsor.

While SEBI has permitted the sharing of profit with the manager / sponsor, it is very common for managers to share profits with their employees. Often, managers set-up employee welfare trusts to facilitate sharing of carried interest with employees. The Master Circular on AIF provides that in case AIFs issue units to employees for profit-sharing, the minimum investment amount (INR 25 lakhs for employees) mandated by AIF Regulations should not be applicable. This implies that employees can be issued units for profit-sharing. As per harmonious reading of the Amendments and the AIF Master Circular, one should be able to argue that employees may be issued units for profit-sharing. However, an explicit clarification from SEBI in this regard will be useful.

Further, there are often situations when a manager may want to share carried interest with a key investor or advisor. Earlier, such an investor or advisor could have been issued a separate class of unit for allocation and distribution of carried interest. This would no longer be possible considering the current mandate from SEBI.

There is now also a need to reassess unified and parallel fund structures to determine how carried interest is allocated among the GPs. Historically, offshore GPs had been drawing carried interest from Indian investments via offshore funds directly – this practice may no longer be allowed under the new law.

- To provide flexibility in fundraising from investors with varied risk appetites, SEBI has notified certain entities (like multilateral or bilateral development financial institutions, entities established by Central Government etc.) which may accept lower returns or share losses beyond their pro-rata rights in AIF/scheme investments. This flexibility may be useful in structuring impact financing models.
- In instance where the manager / sponsor of an AIF subscribes to junior classes of units in an AIF, it has to be ensured that the amount invested by the AIF is not utilized by the investee company, directly or indirectly, to repay any of its obligations or liabilities towards manager or sponsor or their associates.

Applicability to existing AIFs / schemes of AIF

- SEBI has mandated existing AIFs/ schemes of AIF to stop accepting any fresh capital commitments or make new investments, directly or indirectly, in case where such AIFs/ schemes are not providing pro-rata rights to its investors. SEBI has however clarified that pursuant to this, in case where investment limits specified under the AIF Regulations are breached, it shall not be considered as non-compliance by SEBI.

Absence of grandfathering for existing AIFs / scheme can be a cause of concern for investors as well as fund managers. SEBI’s mandate is likely to impact fund performance and all LPs of the fund as a whole. Prohibition on making fresh investments will lead to reduction in fund size. It may also create issues in cases where commitment for investment was made by the AIF. Similarly, the prohibition on accepting capital commitments may hinder such fund’s ability to achieve subsequent closings. Fund managers may have to initiate fresh negotiations with investors who negotiated higher returns at time of investment. This may put fund managers in a rather tricky situation.

While an AIF / scheme is prohibited from accepting capital commitments or making fresh investments, there is no express restriction on the ability of such AIF / scheme to continue to distribute carried interest to investor other than investment manager or sponsor.

2.2 Pari-passu Rights

- SEBI in the 2023 consultation paper acknowledged that differential rights are being provided by AIFs to certain investors over others. In this regard, SEBI noted that aspect of economic parity between investors of AIF is critical. SEBI noted that while the terms may be commercial or non-commercial in nature, some of these terms provide differential rights which may affect the economic rights of other investors.
- Currently, while the AIF Regulations are silent on differential rights, the PPM template prescribed by SEBI provides a list of terms (example, management fees, carried interest, cap on expenses, co-investment rights etc.) on which differential rights may be given. The PPM template also lists certain terms (example, preferential exit from fund, contribution to indemnification etc.) on which differential rights cannot be offered.
- The Amendments now mandate that rights of all investors in an AIF (except for LVFs⁸) are to be pari-passu in all aspects i.e. rights of all investors should rank equally without any preference. As an exception to the aforesaid rule, SEBI has allowed differential rights to be offered to select investors without affecting the interest of other investors. In this regard, SEBI has clarified the following:
 - Any such right should not result in any investor bearing liability accrued or accruing to other investors of the AIF/scheme of AIF (template PPM provided that differential rights should not have any adverse impact on economic rights or any other rights of other investor);
 - In terms of non-monetary/ non-commercial rights, SEBI has provided that such rights should not give investor any decision making rights in the AIF/ scheme of AIF;

- Any such right shall not alter the right(s) available to other investors under their respective agreements with the AIF/manager (provided in the SEBI template PPM as well); and
- Any such right and eligibility to avail the same shall be transparently disclosed in the PPM of the AIF/scheme of the AIF

A wide range of rights are granted to investors in AIFs based on their specific needs, size, and sophistication. These beneficial rights, often negotiated through side letters, are especially common among larger and more sophisticated investors, such as institutional players, who typically have the leverage and expertise to negotiate more favorable terms.

As the Indian economy grows, smaller investors are also foraying into AIFs and understandably it is important for SEBI to ensure that such less experienced investors – who may not have the visibility or bargaining power to negotiate similar rights – are protected. These investors may not always be aware of the specific terms being negotiated on their behalf, making safeguards critical to their protection. There are, however, reasons behind GPs agreeing to grant certain (usually larger) LPs more beneficial differential terms. Larger investors bring several benefits to the table: their involvement can provide comfort to smaller investors, create a larger capital pool therefore opening doors to better investment opportunities, and bring relevant experience and guidance to the fund. All of these ultimately benefit small investors in the long run. Moreover, the involvement of these larger investors fosters long-term relationships and aligns interests, contributing to the overall good faith of the fund.

- The Implementation Standards require that the eligibility criteria for an investor to avail each differential right is disclosed in the PPM. Only investors meeting the specified criteria may opt for the corresponding differential right. This requirement is somewhat out of step with industry practice. In reality, investors negotiate these rights at the time of their investment. Hence, the differential rights that a fund offers evolve dynamically over time based on negotiations with investors at each closing.
- List of positive rights released by SFA includes the following rights:

Economic differential rights

- Fund expenses: alterations to the quantum, manner or basis of charging operational and set-up expenses are among the most commonly terms under side letters. While SEBI permits differential rights on these aspects, including adjustments to the quantum of fund expenses (whether through waivers or changes to expense caps), any such differential treatment must explicitly state that any resulting shortfall will be borne by the manager.

Funds often cap fund expenses at a certain percentage of, say, the aggregate contributions to the fund. While an investor may negotiate a lower cap for itself, it typically is not concerned with how the shortfall from its lower cap will affect the other investors of the fund. As a result, the shortfall is often prorated between the remaining investors, subject to such increased fee being within the original, fund-level cap. However, now this shortfall will have to be borne by the managers themselves, even if it falls within the fund-level cap on expenses already agreed to by the other investors.

Notably, some government-backed institutional investors were already requesting that such shortfall not be passed on to other investors and be borne by the manager instead. With managers being required to pick up the tab for every investor wanting reduced or waived expenses, these rights will likely be much more heavily negotiated.

- Management fees, hurdle rate of return, carried interest: the Implementation Standards also allow variations in the quantum, manner or basis of charging management fees, as well as differential hurdle rates of return and rates of carried interest. This flexibility without any conditions is well received, as investors often request higher hurdle rates and lower carried interest rates be applied to them.

Non-economic differential rights

- Co-investment rights - While offering co-investment opportunities to select investor is permitted, the Implementation Standards require the common expenses related to the co-investment to be shared proportionately between the AIF and the co-investors.

It is very common for LPs to request for co-invest rights wherein fund managers provide such LPs the right to invest in a particular deal on same or similar terms on which investment is being made by the fund. Such co-invest opportunities are typically offered pro-rata in proportion to eligible investor's capital commitment to the fund. Considering this, inclusion of co-investment rights in the Implementation Standards is welcome. However, whether offering differential economics on such co-investment opportunities is permissible under the Implementation Standards is not expressly addressed.

Reporting and information rights – The SFA permits the provision of additional information, and at a higher frequency, to select investors beyond what is required under AIF Regulations or disclosed in the PPM. Informational rights are also one of the most requested and negotiated set of rights between managers and investors. Institutional investors often successfully negotiate additional information about other investors, portfolio companies, drawdowns and the manager's governance in order to comply with internal policies and / or applicable regulations.

However, this differential right does not include sharing information that would violate any applicable law or any information that should be made available to all investors. The slight resultant discord then, is whether the Implementation Standards intend to restrict sharing of information which should be available to all investors, at a higher frequency, or in greater detail, with specific investors. For instance, may the manager provide financials relating to the underlying investee companies to one investor more frequently than to the remaining investors – who receive this information annually under the AIF Regulations?

The SFA has also required that any additional costs relating to such differential information sharing be charged only to the respective investor(s) or be borne by the GPs. While not entirely unfair, this increasingly burdens and complicates operations for the manager. The manager must now decipher how to bifurcate expenses across its investors based on added (and likely incremental costs). This requires an analysis on a case-by-case basis for each investor and is especially cumbersome when compared to the far simpler practice of charging all such

expenses as operating expenses to the fund as a whole.

- Representation on committees constituted by the AIF/ Scheme – Subject to AIF Regulations, SFA allows LPs the right to nominate or appoint a member to various committees of the fund, with the added flexibility to provide further differential rights relating to such LP/nominee's term, tenure, remuneration, attendance requirements, information rights, voting rights, and resignation procedures.

Such rights are often requested by LPs, specifically larger and institutional LPs cutting large cheques and therefore wanting greater visibility over and participation in the functioning of the fund. The inclusion of additional terms that typically accompany the right to representation on committees makes this one of the more comprehensive rights granted under the Implementation Standards.

- Most Favoured Nation ("MFN") - These clauses ensure that incoming investors have the option to adopt any more favourable rights granted to previous or subsequent investors through their side letters. MFNs are generally extended to investors who commit capital equal to or greater than that of investors holding such favourable terms. Given the confidentiality typically associated with side letters, MFN clauses help prevent inequities by ensuring that investors with side letters are not unfairly disadvantaged in comparison to one another.

As MFNs are a standard provision in nearly all side letters, this differential right is a valuable addition to the Implementation Standards.

- Confidentiality of investors details / information – the Implementation Standards also expressly enable GPs to allow select LPs to receive information on other investors in the fund, subject to explicit consent of such investors whose information is being sought. While not as common as some of the other differential rights on the positive list, this is often sought by DFIs to comply with internal policies.

This provision comes with both advantages and challenges. On one end, it ensures that the consent of investors, who might otherwise be unaware that their information is being shared with their counterparts (due to the confidentiality of side letters), is properly obtained. However, this also creates an operational burden for GPs, who will now be required to secure consent from all LPs – a process that can be slow and cumbersome, especially during fast-paced negotiations with incoming LPs requesting this right.

Notably, the differential confidentiality rights under the Implementation Standards only capture one-way confidentiality, i.e., disclosure of the information relating to investors. However, it is equally common for LPs to seek the right to disclose (other than to their service providers) certain information of the fund they are investing in, for compliance with internal policy or even otherwise.

- Representation and warranties – The Implementation Standards also allow LPs to be provided with representations and warranties, which may include undertakings and confirmations regarding the fund, its manager, or compliance with applicable laws and regulations. However, these representations and warranties may not grant any rights to investors that go beyond those already clearly outlined and agreed upon in the fund's governing documents. The intent of this seems to be to ensure that investors are provided with necessary assurances without altering or expanding their contractual entitlements.
- The Negatives from the Positive List:

While the above list is welcome and covers common rights generally negotiated by LPs, the Implementation Standards in their current form do not address several key rights that LPs and GPs typically negotiate.

For instance, differential rights surrounding default – i.e., extended cure periods, reminders to make contributions prior to being adjudged a defaulting contributor, ability for default provisions to apply, permissible consequences against this specific LP in the case of a default, are all frequently negotiated by LPs.

Similarly, side letters often provide for consent rights over and above / parallel to existing governance or regulatory frameworks. For example, some LPs may require that items like change in control of manager / sponsor, cure of a key person event, amendment to fund documents, etc. which already require investor consent under regulation or fund documentation, be subject to explicit consent of such LP.

LPs often also negotiate lower restrictions on transfer of their interests in the fund, whether to their own affiliates or sometimes, even to third parties. Similarly, requests for different dispute resolution forums or governing laws, specifically in case of offshore investors who cannot afford to be bound to the Indian judicial process, are commonly accommodated by GPs. Other examples of differential rights include the manner and form of distribution (e.g. cash-only distribution, no in-specie distribution), restrictions on reinvestments, exemption from equalization premiums and draw-stop rights to name a few.

The complexity of fund operation coupled with the diversity of investors leads to uncountable of permutations and combinations of rights that can be, and are, requested and granted between LPs and GPs. Moreover, as the private funds industry grows and attracts new kinds of domestic and offshore capital, it must remain adaptable to the evolving demands of these participants. From an investor's standpoint, maintaining a positive list, even with regular updates in consultation with industry stakeholders, could be seen as overregulation in a field meant for sophisticated players.

Applicability to existing AIFs / schemes of AIF

Existing AIFs/ schemes of AIF are required to disclose details of differential rights which foul the implementation standards formulated by SFA on or before February 28, 2025. Therefore, AIFs have one month to see whether side letter rights provided to LPs are in line with the Implementation Standards. Those differential rights which are affecting the rights of other investors, have to be immediately terminated. Conducting an investor-by-investor exercise to determine whether their rights are in conformity with SEBI's mandate may be a daunting exercise.

Terminating negotiated rights may put AIF managers in a tricky situation with investors. Grandfathering for existing AIFs/ schemes of AIFs may have been a more industry favourable approach in this case.

Funds Team

Nishith Desai, Global Strategy

Parul Jain, Fund Formation and International Tax

Radhika Parikh, Fund Formation and GIFT City

Prakhar Dua, Fund Formation and FSR

You can direct your queries or comments to the relevant member.

¹Pro rata and pari passu rights of investor of AIF, circular SEBI/HO/AFD/AFD-POD-1/P/CIR/2024/175 dated December 13, 2024

²SEBI Board Memorandum dated September 30, 2024; available at: https://www.sebi.gov.in/sebi_data/meetingfiles/oct-2024/1728471403967_1.pdf

³SEBI circular no. CIR/IMD/DF/14/2014 dated June 19, 2014

⁴SEBI Circular: Schemes of AIFs which have adopted priority in distribution among investors, available at: https://www.sebi.gov.in/legal/circulars/nov-2022/circular-schemes-of-aifs-which-have-adopted-priority-in-distribution-among-investors_65393.html

⁵https://www.sebi.gov.in/reports-and-statistics/reports/may-2023/consultation-paper-on-proposal-with-respect-to-pro-rata-and-pari-passu-rights-of-investors-of-alternative-investment-funds-aifs-_71540.html

⁶Sub-regulation 21 of Regulation 20 of the AIF Regulations

⁷SEBI consultation paper on the review of regulatory framework for Angel Funds in AIF Regulations dated November 13, 2024

⁸LVFs can avail the exemption and provide differential rights to its investors by making appropriate disclosure in the PPM and obtaining a prescribed undertaking from investors at time of on-boarding

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