

LP RIGHTS TO BE PRO-RATA AND PARI-PASSU IN AIFs

The Indian securities market regulator, Securities and Exchange Board of India (“SEBI”) has issued certain amendments¹ and a circular² (the “**Amendments**”) to the SEBI (Alternative Investment Funds) Regulations, 2012 (the “**AIF Regulations**”) in the past few days defining how the rights of an investor (“**LP**”) in an Alternative Investment Fund (“**AIF**”) shall be governed. These include rights of LPs in each investment of the scheme of an AIF (“**Scheme**”) and distributions therefrom as well as side letter rights.

SEBI's objective is to clarify that AIFs are pooling vehicles and to ensure fair and equal treatment of LPs.³ In other words, SEBI has now codified the principle that a pooling vehicle is one which makes investments and distributions pro-rata to LPs' commitments.⁴ This principle also forms the basis on which SEBI had rejected the industry proposal to allow co-investment class to be included within the AIF structure in 2021.⁵

There are two key changes that have been introduced by the Amendments:

- (1) Rights of LPs in each investment of the Scheme and in distribution of proceeds of such investment needs to be pro-rata to their commitment to the Scheme (“**Pro-rata Rights**”) with some exceptions; and
- (2) Rights of LPs other than as mentioned under (1) above shall be pari-passu in all aspects, except differential rights without affecting rights of other investors (“**Pari-passu Rights**”).

We have examined the Amendments and their potential consequences in this paper.

Pro-rata Rights

The backdrop for these Amendments is the priority distribution model being adopted by certain Schemes, i.e. where certain investors were taking disproportionate share in losses of the Scheme, giving priority in distribution proceeds to other investors. This was a clear digression from the pooling concept for AIFs.

SEBI has been cognizant while introducing the Amendments that in certain circumstances this digression is necessary, i.e. in cases where excused investors and defaulting investors have been identified.

Certain unintended consequences may arise pursuant to the Amendments which affect the ordinary course of business of Schemes which do not have a priority distribution waterfall. These can be divided into concerns arising on account of (i) drawdowns; and (ii) distributions.

Analysis on Drawdowns

¹ SEBI (Alternative Investment Fund) (Fifth Amendment) Regulations, 2024 dated November 18, 2024 available at https://www.sebi.gov.in/legal/regulations/nov-2024/securities-and-exchange-board-of-india-alternative-investment-funds-fifth-amendment-regulations-2024_88647.html.

² SEBI Circular SEBI/HO/AFD/AFD-POD-1/P/CIR/2024/175 dated December 13, 2024, available at https://www.sebi.gov.in/legal/circulars/dec-2024/pro-rata-and-pari-passu-rights-of-investors-of-aifs_89945.html.

³ SEBI Board Memorandum dated September 30, 2024, available at <https://www.sebi.gov.in/sebiweb/about/AboutAction.do?doBoardMeeting=yes#>.

⁴ SEBI Board Memorandum dated September 28, 2021 available at <https://www.sebi.gov.in/sebiweb/about/AboutAction.do?doBoardMeeting=yes&year=2021>

⁵ *Id.*

Queries are arising on whether the Amendments could lead to a dry powder problem for Schemes.

An AIF draws down or makes capital calls from its LPs for various purposes such as expenses, liabilities, management fee, investments and reserves. If all drawdowns from LPs were to be made in pro-rata share of commitments, where different management fee was being charged to different classes of LPs (for example), then there would be a situation where a portion of monies of some LPs would eventually become undrawable, giving rise to dry powder problems.

The Amendments, however, do not seem to refer to all drawdowns being in pro-rata share of commitments but only refer to rights of LPs in investments and distributions thereof to be in pro-rata share of their commitments. Further, capital calls or drawdowns towards expenses, liabilities, management fee and reserves thereof constitute an obligation (and not a right) of LPs. Accordingly, it seems that the problem of dry powder should not arise pursuant to the Amendments. Drawdowns for purposes other than investments should be permitted in the unfunded capital commitment ratio.

Queries also arise on how ratios would be adjusted for excused investors and defaulting investors.

In cases where excused/defaulting investors have been identified by a Scheme, the manager is typically entitled to increase the excused/defaulting investor's relative share of subsequent drawdowns with the goal of causing all LPs' respective aggregate capital contributions in the investments over the life of the Scheme to be proportionate to their respective commitments. If unfunded commitments are not available for such adjustments in future, then adjustments may be made against proceeds distributable to them as a feature of reinvestments specially drafted for excused/defaulting investors. If there are reinvestments from the sale of investments in which certain excused investors are recognized, then they should contribute for such reinvestment unless they are excused again.

Analysis on Distributions

SEBI mandates that the distributions from investments to AIFs should also be in the pro-rata share of commitments except in case of excused and defaulting investors. One of the exceptions is the carry distribution made to the manager / sponsor of the Scheme, i.e. such distributions may be disproportionate to the commitments.

Queries arise whether pursuant to the above, carry distributions may only be made to the manager / sponsor and not to employee benefit trusts or employees / directors / officers directly from the Scheme. In the Master Circular for AIFs (paragraph 4.6, Chapter 4),⁶ SEBI has stated that in cases where units of an AIF are issued to employees for 'profit-sharing', then minimum commitment requirement by employees is not applicable. SEBI has expressly recognized that employees may be entitled to carry distributions from the Scheme. In this regard, there seems to be an anomaly in the law.

Further, SEBI has mentioned that certain type of contributors to the Scheme may share losses disproportionately (subscribe to junior classes), i.e. manager / sponsor, multilateral or bilateral development financial institutions, state industrial development corporations, entities established or owned or controlled by the central government, or a state government or the government of a foreign country including central banks and sovereign wealth funds.

SEBI has, while permitting the above, stated that if the manager / sponsor subscribes to junior classes of a Scheme, the amount invested by the Scheme in a company should not be utilized by that company

⁶ SEBI Circular (SEBI/HO/AFD-1/AFD-1-PoD/P/CIR/2024/39) dated May 07, 2024, available at <https://www.sebi.gov.in/legal/master-circulars/may-2024/master-circular-for-alternative-investment-funds-aifs-83229.html>

to repay any obligations or liabilities towards the manager/sponsor/associates. This is also to avoid the evergreening issue that both SEBI and the Reserve Bank of India have been legislating for.

Applicability on existing AIFs / schemes of AIFs

Existing Schemes AIFs / Schemes are required to stop accepting any fresh commitments, and making investment in a new investee company, directly or indirectly. Pursuant to this, if a Scheme falls foul of concentration norms, it will not be considered non-compliance by SEBI but it shall be recorded in the annual compliance test report.

SEBI should have given a cure period to existing AIFs / Schemes where rights of LPs in investments and distributions are in the ratio of unfunded commitments or (distributions are in the ratio of) invested capital rather than commitments. They may have been able to readjust their allocations, change their documentation and update SEBI as well as its LPs on account of change in law.

Analysis on Pari-passu Rights

The latin phrase 'pari-passu' means ranking equally and without preference / equal footing. While requiring that all rights of LPs in a Scheme (except large value fund for accredited investors) other than Pro-rata Rights and its related exceptions described above have to be pari-passu in all aspects.

As an exception, SEBI has allowed differential rights to be offered to select LPs without affecting interest of other LPs. Until the Amendments, SEBI prescribed a list of items on which side letter rights may not be provided. However, the new rulemaking approach of SEBI is to provide an affirmative list on which differential rights may be provided. Some may consider this to be an excessive regulation, but it is still more diluted than what the US SEC was proposing last year. One of the private fund rules proposed by the SEC required disclosure of all side letter terms to all LPs.

In its pursuit to protect smaller LPs, SEBI might be on its way to create entry barriers for smaller managers who are just starting out, and need the flexibility to determine differential rights to institutional investors. Just as the exceptions given for Pro-rata Rights above, institutional investors should have been carved out from the list of side letter rights.

We will follow this up with a detailed discussion on merits once the SFA releases the positive list of side letter items.

From an abundant caution perspective, SEBI has given broad principles for entering into side letter rights, i.e. (1) no liability to other LPs; (2) no control for decision making except as nominees on investment committees; (3) no alteration of rights of other LPs; (4) disclosure of rights and eligibility to be disclosed in the private placement memorandum ("**PPM**") of the Scheme. Further, the manager / Scheme / AIF / key management personnel need to ensure that only investors meeting specified eligibility criteria for a differential right may opt to avail such right.

Applicability on existing AIFs / Schemes

Existing AIFs whose PPMs were filed after March 01, 2020 have to report details of differential rights which do not fall under implementation standards formulated by the SFA to SEBI in the given format on or before February 28, 2025. Such existing side letters should be carefully examined to lead to a conclusion as to whether they fall foul of SFA standards, especially if they belong to institutional LPs and there is a negotiation context behind each of them.

There is a requirement to immediately terminate / discontinue such differential rights which are ascertained to be affecting the rights of other investors.

Plan Forward

It will take some time for the industry to process and adjust to the Amendments, because some players have been following their current practices for over a decade and across several funds. It is also important to bring LPs up to speed to each of these changes from a good governance perspective because it could (in their view) considerably impacts their rights and return profile. Depending on the final list of side letter rights from SFA, amendment agreements may need to be signed to side letters discontinuing the applicability of certain side letter rights. Existing AIFs / Schemes should examine whether readjusting their allocations to bring themselves in compliance with the current law could permit them to carry on their activities.