

CO-INVESTMENT UNDER THE SEBI AIF REGULATIONS

With limited partners (**LPs**) increasingly seeking co-investment opportunities with SEBI registered alternative investment funds (**AIF**), general partners (**GPs**) are looking at providing co-investment opportunities to LPs. The SEBI AIF Regulations¹ were amended in 2021 to permit GPs to officially offer co-investment opportunities to LPs, within a given framework for such co-investment. We delve into some of the key aspects that one should bear in mind in relation to co-investments.

- **What is co-investment under the AIF Regulations? What form of co-investments are covered under the ambit of the AIF Regulations?**

Co-investment under the AIF Regulations cover any LPs of the fund or the manager or the sponsor of the AIF (collectively, **Co-Investors**) investing in the same investee company into which the AIF is investing. Co-investments for investors under AIF Regulations are permitted only for unlisted securities for category I and category II AIFs. Co-investments by global LPs with offshore parallel investment funds are not covered within SEBI's co-investment framework.

- **What are the conditions for co-investment under the AIF Regulations?**

The manager of the AIF needs to be registered as a co-investment portfolio manager (**CIPM** or **Co-invest PMS**) under the SEBI PMS Regulations. Under the AIF Regulations, (a) the terms of co-investment by Co-Investors cannot be more favourable than the terms at which the AIF invests; (b) the terms of exit, including the timing of exit shall be identical.

- **How is the co-investment implemented by the AIF?**

The co-invest route under the AIF is to be implemented by the manager of the AIF as a Co-invest PMS, i.e. in a manner that portfolio managers usually implement portfolio investments under the SEBI PMS Regulations². This usually includes opening accounts to maintain cash as well as securities by the Co-invest PMS on behalf of each Co-Investor, with a broad power of attorney (**POA**) being provided to the Co-invest PMS.

- **What are the main incentive for both GPs and LPs to opt in for the co-investment route under the AIF Regulations?**

From a GP / manager's perspective, the co-investment route offers multiple advantages.

- Deal size: AIFs are subject to concentration norms (25%) beyond which they cannot invest in an investee company and may have other internal / contractual restrictions to ensure limited concentration in a single portfolio company. However, the co-investment route permits the AIFs to undertake larger deals, with the AIF doing a portion of it, and the remaining being undertaken through co-investors.

¹ Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2014

² Securities and Exchange Board of India (Portfolio Managers) Regulations, 2020

- Carried interest: Co-investment permits the manager / GP to charge carried interest / promote from the sale of securities acquired by the Co-investors under the co-investment route as well. Any carried interest / performance fee / promote from investments outside the CIPM route may be subject to SEBI scrutiny.
- Control: Under the CIPM route, the GP is entitled to take all decisions on behalf of the Co-Investors under the POA. This provides the GP, as well as the investee companies adequate comfort that despite having multiple names on the shareholding cap table, one person takes all decisions. The POA being recognised by SEBI, coupled with the securities being held by the Fund under custody, provides substantially more comfort than merely contractual arrangements.

From an LP perspective, the co-investment route works well for certain reasons:

- Access to deals: From an LP's perspective, the co-investment route provides the investors access to larger number of deals without spending time scouting and finalising deals.
 - Testing the waters: LPs, including global sovereign and pension funds use the co-investment route to test the waters before becoming primary investors itself. Generally global LPs prefer this model to enter and evaluate jurisdictions before making a larger direct investment play in jurisdictions.
- ***How does the exit for Co-Investors usually work? Is this different for investee companies that go listed after the acquisition?***

The SEBI AIF Regulations expect parity to be maintained between the AIF and the Co-Investors with respect to exit terms. Accordingly, no Co-Investor is permitted to exit the investment prior to the AIF exiting the same. This becomes slightly more complicated when the investee company's shares get listed, since the co-investment regime does not factor or deal with this situation. From a practical standpoint, GPs prefer transferring the holdings of the Co-Investors at the same time when the AIF transfers its holdings.

- ***Are there any specific considerations that an AIF should keep in mind?***
 - Terms: While the co-investment route does not permit more favourable terms on the Co-Investors' investment, the contrary (i.e. Co-Investors getting inferior terms) is not restricted. This may be an important consideration to be borne in mind when transactions (i) are a mix of primary and secondary investments (where secondary transactions are generally at a discounted valuation), or (ii) include a combination of equity shares and preferred stock.
 - POA: The POA that custodians and portfolio managers take are usually relevant for listed transactions and the powers set out in the POA are generally relevant for listed stock. It may be prudent to ensure an appropriate POA for unlisted / private deals, including powers for amendment of agreements, providing consent for shorter notice for board or shareholders meeting, etc.

- Discretion to offer co-investments: There is no regulatory restriction on which LP can be offered a co-investment opportunity. However, to avoid regular disagreements, it is preferable to have objective thresholds (such as commitment) over which such co-investments shall be offered as a rule, while keeping some discretion with the manager. This ensures that the GP does not need to offer the co-invest opportunity to each LP, while ensuring that if exceptions need to be made, the same can be undertaken.
- Information and visibility: As opposed to commitment to the AIF under the AIF regime (where the LPs have adequate information rights), or investment under the PMS route (where the portfolio manager and the clients have similar information due to the listed status of the investee companies), CIPM covers an entirely different set of investments, where LPs may not have direct information rights at the investee company level. Addressing this may be appropriate from both the LP's perspective, as well as from the GP's perspective.
- 'PAC': Considering that the investment by the AIF and the co-investors are structured and implemented collectively, along with the POA construct, the possibility of the Fund and the co-investors being 'persons acting in concert' are considerable and merely providing for the same not to be persons acting in concert may not be sufficient should the investee company get listed.

With public markets in India dampening and private deals and M&A activity already set to see significant increase in volumes, it is expected that the co-investment route (permitting PE and VC funds to do larger deals) shall play a significant role.