

Exploring SEBI's Co- Investment Vehicle (CIV) proposal



SEBI has proposed to replace the existing co-investment portfolio manager (“**CPM**”) license route for facilitating co-investments alongside the main Category I or II Alternative Investment Fund (“**AIF**”) with a new co-investment vehicle (“**CIV**”) route as a separate scheme of the main Category I or II AIF. See the last page for a comparative table between CPM and CIV.

Benefits of SEBI’s proposed Co-Investment Vehicle

Obvious

- **Time and Cost Efficiency:** Reduces regulatory burden of obtaining a separate license improving time and cost efficiencies as it allows immediate launch of CIV simply under intimation route to SEBI.
- **Portfolio Company:** The cap table of the portfolio company will be lean.

Less obvious (and subject to further regulatory clarity)

- **New Potential Structures:** Foreign investors may co-invest in securities which they could not do directly under the current CPM structure due to foreign exchange restrictions.
- **GP Economics:** GPs may be able to structure their economics for co-investments in a more tax efficient manner if the GP has a negotiating advantage at all. Carry could be deal-specific.
- **Deal litigation management:** If a deal results in shareholder litigation, then instead of each co-investor being a party to the dispute, the CIV will be party to the litigation.
- **Governance benefits:** Co-investors can collectively hold the fund manager accountable as investors in the CIV. Smaller co-investing LPs may benefit from the governance strategies of bigger co-investing LPs as co-LPs in a single CIV rather than separately managed accounts (“**SMAs**”) through the CPM structure. However, there are governance issues also being created by CIV which are discussed in the next section.



Shortcomings of CIV & Case to allow CIVs and CPM to co-exist

- **CIV limits types of co-investors:** Universe of co-investors shrinks from all LPs to only those who are Accredited Investors in CIV. This should be reversed because the risks of being an LP in a single-asset fund, or worse a single-asset fund-of-one are not considerably more than being subject to a SMA structure. Further, CPM should be expanded to allow co-investments to be offered to third party co-investors, though it may affect the cap table issue.
- **Multi-scheme AIF vs single-scheme AIF problems:** Investors across all AIFs under common management and sponsorship were permitted to be co-investors under CPM, but the CIV proposal limits it to schemes of a single AIF. Many AIFs follow separate AIF for each fund rather than doing multi-scheme AIFs. Also, such existing single scheme AIFs may not be able to switch to a multi-scheme AIF due to PAN and other operational issues. It is unclear how LLP or company AIFs can do multiple schemes.
- **Governance issues:** Governance complexities arise due to a pooling structure being created. Which decisions of the main AIF should be adopted by default by the CIV (e.g. removal of manager) and which ones should be kept distinct (e.g. annual valuation instead of bi-annual) because holding ratios and LPs will not be identical in CIV? The GP may owe a fiduciary duty to the CIV as a whole, unlike in a CPM structure where it could manage each co-investor separately.
- **Follow-ons:** Each follow-on round will require a new CIV because ratios of original co-investors may not be the same for follow-on. This is also assuming that the AIF is also doing that follow-on, because otherwise it would not even be a co-investment to qualify for a CIV. There is no regulatory avenue to facilitate that by the GP (SMA for unlisted investments), similar to no avenue being available for managing third-party co-investments, keeping Indian GPs in a losing battle against global counterparts.
- **Portfolio rights:** If a co-investor was investing a majority stake in a company under the CPM route, it would be able to independently negotiate with the CPM its board nominee.
- **Limited co-investment:** If an AIF only has one large investor which does co-investments, and the manager already holds a CPM, CIV is not adding any value because the cap table of the company would have two separate shareholders in either case.



Best Practices for GPs to prepare Co-Investment Policies

- **No guaranteed co-investments:** If a GP guarantees co-investments to potential co-investors, it may indicate that the GP does not intend to maximize deal flow for the main fund and will always create some room for co-investment as a side activity. This could be seen as the primary fiduciary obligation to the fund being compromised. Instead, GPs should always clarify that any co-investment rights will be contingent on a co-investment opportunity arising in the good faith judgment of the GP, after concluding that the main fund cannot or should not take up the entire deal opportunity.
- **Types of co-investment rights, lemons problem:** GPs may, depending on the make of the LPs, agree to different forms of co-investment rights. The policy should be enabling. It could take the form of a waterfall where Class A Investors get the first right to assess co-investments due to their size or strategic importance and then the unutilized portion gets offered to others. It could also take the form of pay to play considerations. LPs may worry about lemons problem while negotiating co-investment provisions with emerging GPs where such GPs may in turn diligence the LP's capabilities (such as appropriate personnel) to fully appreciate a deal.
- **Resources of the GP and timelines for achieving co-investment:** One of the considerations for LPs to consider co-investment opportunities is to differentiate themselves. By securing co-investment rights, they're trying to access unique deals or better terms that they would otherwise not get. This helps them offer something distinctive compared to other investors or funds. However, practically this may involve a lot of time being spent by personnel of the LP with that of the GP assessing each co-investment opportunity in great detail, making it a learning exercise. Accordingly, GPs may consider specifying the exact process and timelines to be followed for LPs to efficiently remit their contribution towards the co-investment.
- **Appropriate representations from LPs:** The risk appetite of the LP may not always be commensurate with the kind of co-investment exposure that it is looking to elect. However, it is not the duty of the GP to make that assessment for the LP. Accordingly, sufficient undertakings should be put in place in the co-investment documentation with the co-investing LPs about them having done their own independent assessment of the deal and governance aspects (e.g. removal of manager from the fund could also lead to removal of manager from the CIV).
- **Expense Allocation:** To always be appropriately, fairly and proportionately allocated between the main fund and the CIV.



Enclosed: Annexures for additional reading

- 1) First principles of co-investment
- 2) Existing law vs proposed law

First Principles of Co-Investment : Global Perspective

- **Meaning:** A co-investment opportunity arises when the main fund is unable to take up the entire deal opportunity available to it and there is excess to be offered to others by the fund manager (“**GP**”).
- **Rationale:** Reasons could be legal, contractual or commercial (investment judgment), but the main fund should not be shortchanged.
- **Co-investors:** Excess opportunities may be offered to investors (or “**LPs**”) of the main fund and / or to others (there could also be sponsor or manager or employee co-investment).
- **Structures:** Co-investment could be done by co-investors through (i) co-investment vehicles (“**CIVs**”) where they are pooled or (ii) directly or (iii) through separately managed accounts or (iv) a combination thereof applied for different co-investors variably / bespoke.
- **GP Economics:** Depending on power dynamics and other facts and circumstances, the GP may be able to negotiate a fees and / or carry on co-investment being offered and managed by it, although it is usually lower than whatever is being charged to the main fund.
- **Governance:** Co-investments can create conflicts of interest between the main fund, co-investors, and the GP, particularly around deal and expense allocation, deal and exit terms, access to information, and alignment of incentives.



CPM vs CIV

Parameter	Existing Law	Proposed Law
Definition	<p>Any investment made by the fund manager, sponsor or any LP of a Category I Alternative Investment Fund (“AIF”) and Category II AIF in companies where such AIF makes investments.</p> <p>Third-party co-investors kept out.</p>	<p>Instead of any LP of the AIF, to be offered only to LPs who are Accredited Investors (“AI”) (active accreditation required to be obtained from a recognized agency on the basis of financial criteria).</p> <p>Also only AI-LPs of multiple schemes within the same AIF, ignoring single AIF structures.</p>
License / Route	<p>AIF manager to obtain a separate co-investment Portfolio Manager license (“CPM”) under the SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”) and SEBI (Portfolio Managers) Regulations 2020 (“PMS Regulations”) to facilitate co-investment by LPs of the Category I or II AIF as SMA.</p>	<p>CPM route to be replaced with a co-investment vehicle (“CIV”) to be launched as a separate scheme of a Category I or Category II AIF. CIVs will be either single-asset funds or single-asset fund-of-one.</p>
Permissible Investment	Unlisted securities.	
Terms of investment	Not more favorable to the co-investors than the AIF.	Open to consultation though SEBI is leaning towards status-quo.
Terms and timing of exit		



About the Authors



Nandini Pathak

Partner | Investment Funds and Asset Management
Bombay Law Chambers

E-mail: nandini@bombaylawchambers.com
[LinkedIn](#)



Sanyukta Srivastav

Senior Associate | Investment Funds and Asset Management
Bombay Law Chambers

E-mail: sanyukta.srivastav@bombaylawchambers.com
[LinkedIn](#)

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