



Consultation paper on proposal with respect to *pro-rata* and *pari-passu* rights of investors of Alternative Investment Funds (AIFs)

Objective:

To seek comments and inputs from stakeholders and public on the proposal to provide clarity in SEBI (Alternative Investment Funds) Regulations, 2012, regarding maintaining *pro-rata* and *pari-passu* rights of investors of AIFs.

Background:

1. As per SEBI (Alternative Investment Funds) Regulations, 2012 ('AIF Regulations'), AIF is a privately pooled investment vehicle, which collects funds from investors, for investing it in accordance with a defined investment policy for the benefit of its investors.
2. In recent past, AIF industry's request for permitting issuance of separate class of units for making co-investment along with investments of AIFs, was not acceded to and co-investment by investors was facilitated through portfolio management route. The industry's request for issuance of co-investment class of units was not acceded to, based on the principle that AIF is a pooled investment vehicle, where the investors have rights in each investment of the AIF in the ratio of their contribution in the AIF, i.e., on a *pro-rata* basis. The approved Board Memorandum providing detailed agenda in this regard, is given [here](#) for reference.
3. To elaborate on the same, as an investment vehicle, AIF pools money (in the form of commitment) from investors towards the corpus of the AIF. Upon identification of investment opportunity, it calls for funds to be drawn down from investors in the ratio of their commitment to the scheme/AIF and makes investment, resulting into *pro-rata* contribution/rights (in the ratio of their commitment to the scheme) of each contributing investor in each investment of the scheme.
4. While the above principle is not explicitly stated in AIF Regulations, 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 the AIF structure.
5. It may be noted, based on industry request, to help the AIF industry in negotiation for fund raising from investors, vide SEBI circular no. CIR/IMD/DF/14/2014 dated June 19, 2014, the following was specified:

'With respect to investment by the sponsor/manager in the AIF, the sharing of loss by the sponsor/manager shall not be less than pro-rata to their holding in the AIF vis-à-vis other unit holders'.

Thus, sponsor/manager of an AIF may share loss higher than their *pro-rata* holding *vis-à-vis* other investors. The aforesaid provision allows only sponsor/manager to have greater skin in the game by accepting losses more than their *pro-rata* holding and does not provide for

differential distribution/sharing of loss among investors. This indicates the regulatory intent to maintain *pro-rata* rights of investors in investments, including distribution of investment proceeds.

Issues identified:

6. It was observed that certain schemes of AIFs have adopted a distribution waterfall in such a manner that one class of investors ('Junior class/tranche'), other than sponsor/manager, share loss more than *pro-rata* to their holding in the AIF *vis-à-vis* other classes of investors/unit holders ('Senior class/tranche'), since the latter has priority in distribution of proceeds over former (**'priority distribution model'**, also referred to as *PD model* from hereon). In case of loss scenario, the Senior class investors may be compensated for the loss out of the residual capital of the Junior class investors. Similarly, in case of profit scenario, distribution is first made to Senior class investors till their hurdle rate is met, and the remaining amount, if any, is distributed to Junior class investors. In both the scenarios, the *pro-rata* return of capital to all investors is affected.
7. It was also brought to SEBI's attention that, AIFs with PD model may be structured to take advantage of regulatory arbitrage with respect to compliance with other regulatory requirements. It was given to understand that such structuring may be established with the intent to facilitate probable ever-greening of loans extended by certain regulated lenders, in the following manner:
 - 7.1. The regulated lender which intends to remove loans given to certain companies (which may be in default or expected to default in near future) from its books/loan portfolio, subscribes to the junior class units of an AIF/scheme set up for this purpose.
 - 7.2. The AIF also on-boards other willing investor(s) who prefer to subscribe to Senior class of units to get protection on their investment, to the extent of securing priority of return over Junior class investors.
 - 7.3. The expected loss on the loan portfolio at the time of structuring (haircut) appears to be used to determine the size of investment by the regulated lender in the AIF, as a Junior class investor. The investor(s) of the Senior class invest to the extent of perceived fair market value of the assets acquired by AIF from the regulated lender.
 - 7.4. The AIF invests in NCDs of the borrower companies with the understanding that funds so received by them shall be used to repay the loans extended to them by the regulated lender.
 - 7.5. The loan portfolio is replaced in the books of the regulated lender, with the amount repaid by the borrower investee company and investment in units (junior class) of AIF.
 - 7.6. It is pertinent to note that the regulated lender's investment in AIF units, which appear to represent the haircut in the loan portfolio, may be shown in its books of accounts at value at par with Senior class units. This may facilitate the regulated lender in avoiding the classification, provisioning and other applicable compliance requirements with respect to the loans in or expected to be in default. Further, the probable loss in loan repayment, if any, may reflect as loss in investment in AIF, in future.

7.7. In this arrangement, the recognition of deteriorating creditworthiness of the investee company may also get deferred.

8. Further, considering that AIFs/schemes with PD model are intended to cater to different set of investors with different risk appetite with the same pool of underlying investments, the said structure has significant scope for conflict of interest issues.
9. In this context, it is pertinent to mention that one of the key factors contributing to the global financial crisis of 2008 was the practice of tranching, which was a part of the creation and distribution of collateralized debt obligations (CDOs). Different tranches were created within the CDOs, with different levels of risk and potential return. Thus, investors could opt for the tranche suitable to their risk appetite and invest accordingly. However, tranching, along with other factors, resulted in various issues. The complexity of the CDOs with tranches and the lack of transparency made it difficult for investors to accurately assess the risks involved with such instrument. Many such investors had invested large amounts in CDOs with tranches, without fully comprehending the potential risk/downside. Subsequently, when the crisis hit and value of CDOs plummeted, many investors alleged mis-selling with respect to CDOs with tranches, which lead to various litigations relating to investor grievances.
10. Thus, tranching as a concept, has in-built structural vulnerability and a high potential for mis-selling, especially with respect to returns accruing to junior tranches and has contributed to financial crisis in past.
11. After consideration of the aforesaid issues, it is viewed that the PD model, being structurally vulnerable, is prone to misuse and is not in line with the regulatory intent of AIF being a pooled investment vehicle.

Consultation with stakeholders:

12. Considering the above, an agenda was placed in meeting of Alternative Investment Policy Advisory Committee ('AIPAC') of SEBI held on November 22, 2022, to explicitly provide in AIF Regulations that *pro-rata* rights of investors shall be maintained in investments (including distributions) of the AIFs, so that structures having PD model are not allowed. After deliberation, AIPAC recommended that a Working Group may be formed to address regulatory concerns and suggest safeguards in the matter pertaining to priority distribution among investors. SEBI informed the committee that a stand has been taken to not allow priority distribution/tranching among investors/unit-holders, which may be reviewed upon receipt of recommendations from aforesaid working group, if considered appropriate.
13. Accordingly, vide SEBI circular dated November 23, 2022, schemes of AIFs which have adopted aforesaid priority distribution model were directed to not accept any fresh commitment or make investment in a new investee company, till a view is taken by SEBI in this regard.

14. Subsequently, during the constitution of the Working Group, SEBI expressed the view that AIF is a pooled investment vehicle and allowing priority in distribution among investors would affect the *pro-rata* rights of investors of AIFs, in investments, including distributions. With this context, the terms of reference of the Working Group to provide its recommendations, are as under:
- Measures to prevent regulatory arbitrage/misuse of PD model in AIFs such as ever greening of non-performing assets by regulated lenders.
 - Concerns which regulators may have in allowing investment by regulated entities in AIFs having priority in distribution among investors.
 - Safeguards to address the aforesaid misuse/concerns.
 - Any other input which may require regulatory consideration.
15. The Working Group recommended that the PD model should not be entirely prohibited but instead, checks and balances should be evaluated to mitigate the risk of any misuse and the PD model should be prohibited only in the limited cases where such measures are found insufficient to prevent the misuse. It recommended that the PD model may be permitted where both the following conditions are satisfied:
- 15.1. The AIF has been set up by acquisition of assets or refinancing of assets of an unrelated third party, and;
- 15.2. None of the Limited Partners, directly or indirectly, are associates or group entities of the parties from whom assets are being acquired or being refinanced at all times, provided however, that the contributor of the assets may be permitted to hold up to 10% of the AIF units.
16. The Working Group also suggested that, while cases falling outside the above permissible situations mentioned in para 15 above may create a potential for regulatory arbitrage, it may be logical to permit cases where the contributor of the assets, directly or indirectly, holds more than 10% of the AIF units and the contributor confirms that the valuation of the AIF units in its books would continue at the value after provisioning 'as if' the assets which were contributed to the AIF continued to be held by the contributor. The contributor of the assets may be required to obtain a certificate from their statutory auditors confirming the provisioning on the 'as if' basis.
17. A brief summary of the recommendations of the Working Group and SEBI's views on the same are, as under:

S.No.	Recommendations of the Working Group	SEBI's views
Advantages of PD model -		
(i)	Units with differential returns attract multiple investor groups having different return and risk appetites. This widens the overall investor base for AIFs thereby increasing the overall	AIF Regulations provide flexibility to launch multiple schemes under the same AIF registration, which may have different strategies to attract investor groups of different risk appetite, while also



S.No.	Recommendations of the Working Group	SEBI's views
	capital accessible by AIFs in general, including foreign inflows.	investing in the same investment portfolio.
(ii)	This model could lower the systemic risk by creating additional liquidity in the refinancing space, leading to the consequential advantages.	AIF Regulations allow AIFs to invest in debt securities and the use of funds received by the investee company is at its discretion, including for refinancing outstanding loans of investee companies, even in case of investment by AIFs without adopting PD model.
(iii)	The RBI guidelines on securitisation of standard assets as well as the discussion paper on Securitisation of Stressed Assets Framework prescribes certain minimum investment by the originator of debt, to ensure that the originator continues to have 'skin in the game' and continues its participation in the underlying debt portfolio alongside the investors in the securitisation platform. Issuance of differential AIF units gives flexibility to the AIF Managers and/or the AIF investors to commercially negotiate the proportion and other terms regarding participation, if any, by the original lender. The participation of the original lender increases the confidence of other parties for investing in the AIF.	AIF is a pooled investment vehicle set up with the objective of generating return for investors unlike ARCs/Securitisation Trusts which act to provide resolution of specific portfolio of standard/stressed assets, wherein the ARCs/Securitisation Trusts by structure requires higher skin in the game from the original lender, including by way of 'first loss right'. Thus, it may not be appropriate to compare adopting PD model in AIFs with that of securitisation of standard/stressed assets.
(iv)	A model akin to the PD model is prevalent globally and has also been permitted by Regulators - the case of Pass-Through Certificates issued by securitisation trusts and security receipts issued by Asset Reconstruction Companies pursuant to a scheme are examples.	Though Working Group has referred to global precedence, no specific example of global jurisdictions which permit PD model in funds has been provided. Even if some jurisdictions do not explicitly prohibit PD model, it is essential to ensure that the registered entity/intermediary is not being misused to take advantage of any regulatory arbitrage, more so since SEBI registers the fund itself. Reference is drawn to role of CDS with tranching, in



S.No.	Recommendations of the Working Group	SEBI's views
		global financial crisis of 2008 as mentioned in Para 9 above. As regards ARCs and securitisation trust, comparison of AIFs to the same may not be appropriate for reasons as provided at para (iii) of this table.
(v)	The threshold for investment in AIFs of INR 1 crore lays down a presumption that investors investing in AIFs would be fairly sophisticated.	The issue is not just from the perspective of investor protection but also about regulatory arbitrage on compliance with other applicable regulatory requirements such as asset classification and provisioning, and structural vulnerability which arises from issues relating to valuation of assets and masking of true asset quality.
(vi)	The level of disclosure and documentation provide investors complete transparency in how the PD model would be administered before they agree to sign up to it.	
(vii)	There were some positive instances where this model was being adopted – one example mentioned was of a State Government proposing to take up a junior tranche in a renewable energy project to sweeten the economics for investors	Generally, Government or such related entities provide contribution to an AIF it sets up, in the form of sponsor or by setting up a sponsor. As stated, sponsor/manager are permitted to bear loss more than their <i>pro-rata</i> holding in the fund.
Safeguards prescribed -		
(viii)	Misuse or arbitrage could arise in cases of conflict of interest or where parties are not independent of each other. An unrelated party transaction creates a natural hedge against any attempt at arbitrage or bypassing the regulatory intent.	Entities may circumvent the proposed requirement of parties involved being independent of each other, either by layering the investor entities investing in AIFs or the investee companies of the AIF or by intermediation with third parties. Thus, the proposed safeguard may not necessarily address the concerns relating to ever greening stressed assets or conflict of interest issues.
(ix)	Certain guiding principles/ valuation methodology be laid down to ensure adherence to an internationally accepted basis of valuation of assets at the time of the transfer, which would help to mitigate any potential for arbitrage at the time of the	The Working Group has acknowledged that the valuation methodology could create a window for potential arbitrage. Concerns related to valuation become multi-fold with respect to units of AIFs with PD model and underlying stressed assets, even after taking into

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	contribution. It is suggested that the valuation be supported by a valuation report of an independent registered valuer reflecting the value arrived at based on the above methodology.	consideration the safeguards proposed by the Working Group.

18. To summarise, the merits in permitting the PD model, as it may cater to investors of different risk appetite within the same scheme structure, have been deliberated at length. However, it is evident that such a structure with differential distribution has inherent conflict of interest issues and is highly prone to misuse, by benefitting from regulatory arbitrage. The safeguards proposed by the working group do not appear to address the concerns relating to PD model.
19. Further, while the Working Group has acknowledged the issue of valuation and provided its recommendations, concerns with respect to valuation of differentiated units and underlying assets still remains, which forms the basis for not permitting PD model.
20. The Code of conduct prescribed for AIFs specifies that an AIF shall be operated and managed in the interest of all investors and not only in the interest of the sponsor, manager, directors or partners of the sponsor and manager or a select class of investors. AIFs with differential distribution waterfall, may serve the interest of only select investors or sponsor/manager and thus, has inherent structural vulnerabilities. Further, AIFs with PD model provide significant scope for mis-selling to investors.
21. Considering the above, AIFs with priority distribution model may be misused to mask true asset quality, which may lead to ever-greening of bad/doubtful assets. It may therefore not be prudent to permit AIFs to adopt PD model. The cost of permitting PD model outweighs benefits of the same.
22. The recommendations of the aforesaid Working Group on 'Priority Distribution among investors of AIFs' were circulated to members of AIPAC prior to meeting held on May 10, 2023. In the said meeting, SEBI informed the committee regarding the recommendations of the Working Group and that the same did not adequately address the primary concerns surrounding valuation of the assets of AIFs and therefore, it was decided not to accede to the recommendations of the working group.
23. Considering the above, it is necessary to explicitly prohibit adopting of differential distribution model by AIFs and any such practice providing differential rights to investors which affects the pooling requirement of the investment vehicle. Accordingly, clarity may be provided in AIF Regulations regarding maintaining *pro-rata* rights of investors in investments (including distributions of proceeds) of the AIF.

Pari-passu rights of investors of an AIF:

24. While it is being considered to provide clarity regarding *pro-rata* rights of investors in investments of AIFs, the aspect of economic parity between investors of AIFs is also critical. In this regard, it has been observed from the examination of Private Placement Memorandum ('PPMs') submitted by AIFs that the industry adopts different practices which provide differential benefits/rights to certain investors over others. Few such terms on which differential rights are being provided by AIFs, generally through side letters, are as under:

- (i) Drawdown timeline
- (ii) Hurdle rate of return/performance linked fee
- (iii) Transfer rights
- (iv) Information rights
- (v) Compensatory contribution for investors on-boarded in subsequent closing (not including catch up contribution for maintaining *pro-rata* rights of investors)
- (vi) Co-investment rights etc.

While these 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.

25. AIF Regulations do not specifically state the terms on which differential rights may be provided. Instead, it is mandated to disclose to investors, the terms on which differential rights may be provided. SEBI circular dated February 05, 2020, prescribes [template](#) for PPM providing certain minimum level of information in a simple and comparable format, which is to be adopted by AIFs. As per the template PPM, under the term 'Classes of units', AIFs are mandated to disclose economic and special rights attached to additional classes of units issued by the Fund/Scheme.

26. Similarly, under the section 'Side letters', to the extent the Manager intends to offer favourable/preferential terms by entering into side letters with certain investors, AIFs are required to provide list of commercial terms and non-commercial terms on which differential rights may be offered. Further, it is stated that differential rights shall not be offered on the following terms:

- (i) Preferential exit from Fund/Scheme
- (ii) Contribution to Indemnification
- (iii) Giveback
- (iv) Drawdown (except as per the provision for 'excuse and exclusion')

It may be observed from the above mentioned list of terms that the same is intended to ensure that economic rights of other investors are not affected by issuance of side letters on different terms to select investors, i.e., rights of all the investors in the scheme are *pari-passu* with respect to economic terms.

27. It is pertinent to mention that, in both the aforesaid terms 'Classes of units' and 'Side letters', AIFs are also mandated to explicitly disclose that special rights attached to such classes of units issued by the Fund/Scheme or terms of side letters shall not have any adverse impact on the economic rights or any other rights of other investors.
28. Thus, currently only disclosure based norms have been specified for ensuring that economic rights of investors are not affected by any differential rights provided to certain investors. While flexibility is provided to AIFs to have multiple classes of units or enter into side letters to provide differential rights to investors in order to market AIFs as an attractive investment option, it is essential to ensure that economic rights of all investors are *pari-passu* except where such rights are bilaterally agreed between the investors and manager and have no effect on economic rights of other investors.
29. It is pertinent to mention that the Report on 'Elements of international regulatory standards on fees and expenses of investment funds' published by the technical committee of the International Organization of Securities Commissions in November 2004, also discusses issue pertaining to fair treatment of investors in investment funds. The report, while analysing fee structure in funds having multiple class of units, has prescribed that the existence of different share classes should not result in a breach of equality of investors who invest or have invested in the same share class and that no advantage should be provided to a share class that would result in a prejudice to another share class or to the fund.
30. Further, reference is drawn to Alternative Investment Fund Managers Directive 2011 (2011/61/EU), legal act of the European Union on the financial regulation of hedge funds, private equity, real estate funds, and other "Alternative Investment Fund Managers" (AIFMs) in the European Union. Article 23 of Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012, specifies the following with respect to fair treatment of investors in the AIF:
- (i) The AIFM shall ensure that its decision-making procedures and its organisational structure, ensure fair treatment of investors.
 - (ii) Any preferential treatment accorded by an AIFM to one or more investors shall not result in an overall material disadvantage to other investors.
31. Considering that fair treatment of investors is a core and inherent principle for a pooled investment vehicle, as also evident from global references given above, it is essential to expressly provide that AIFs shall not provide any differential treatment to investors which affects economic rights of other investors. Therefore, it is necessary to explicitly provide for fair treatment of all investors as a principle under the AIF Regulations, from the perspective of investor protection.
32. In order to retain flexibility to AIFs to provide certain differential rights which are bilaterally agreed between the investors and manager and have no effect on economic rights of other

investors, terms such as hurdle rate of return, performance linked fee, and management fee may be excluded from the aforesaid requirement.

Proposal:

33. With respect to *pro-rata* rights of investors, the following is being proposed:

33.1. *The rights of each investor shall be maintained*

- a) *pro-rata to their commitment to the scheme, in each investment of the scheme, while making investment, and;*
- b) *pro-rata to investment made in the investee company, while distributing the proceeds of the investment.*

Provided that the manager may charge performance linked fee as per the terms of contribution agreement with each investor.

33.2. While manager/sponsor may continue to have differential distribution to bear loss more than their *pro-rata* holding, the same is subject to the condition that the amount invested by the AIF in the investee company shall not be utilized directly or indirectly to repay any pending obligations to the manager/sponsor or their associates.

33.3. 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 investment in a new investee company.

34. With respect to *pari-passu* rights of investors, the following is proposed:

34.1. *All investors of the AIF/scheme shall be treated equally with respect to economic rights of the investors i.e., no differential rights shall be provided to investors of AIF/scheme which would affect economic rights of other investors.*

34.2. *The aforesaid provision shall not apply in case of differential rights provided on terms with respect to hurdle rate of return, performance linked fee/additional return and management fees.*

35. Public Comments:

35.1. Public comments are invited for the proposal given above. The comments / suggestions may be provided in MS Excel file as per the format given below:

Name of the person/ entity proposing comments:	
Name of the organization (if applicable):	
Contact details:	
Category: whether market intermediary/ participant (mention type/ category) or public (investor,	



investee company, academician, law firm, consultant etc.)	
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Sr. No.	Para. no. of the consultation paper	Extract from the consultation paper	Comments / Suggestions	Rationale

35.2. Kindly mention the subject of the communication as, “*Comments on Consultation paper on proposal with respect to pro-rata and pari-passu rights of investors of Alternative Investment Funds (AIFs)*”.

35.3. Comments as per aforesaid format may be sent to the following, latest by June 04, 2023, in any of the following manner:

(i) Preferably by email to afdconsultation@sebi.gov.in, with a copy to Ms Padma Bharathi S, Manager (padmab@sebi.gov.in)

(ii) By post to:

Shri Sanjay Singh Bhati,
Deputy General Manager,
Alternative Investment Fund and Foreign Portfolio Investors Department,
Securities and Exchange Board of India,
SEBI Bhavan, C4-A, G-Block, Bandra Kurla Complex,
Bandra (East), Mumbai - 400051

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