Pro-rata and Pari-passu rights of investors of AIFs

December 13, 2024

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BEACON RESEARCH
www.beacontrustee.co.in | research@beacontrustee.co.in | +91 84518 44276

Key Points of the SEBI Circular

The Securities and Exchange Board of India (SEBI) has made amendments to the Alternative Investment Funds (AIF) Regulations with the notification of the Securities and Exchange Board of India (Alternative Investment Funds) (Fifth Amendment) Regulations, 2024, on November 18, 2024. These amendments are designed to refine investor rights in AIF schemes, aiming to maintain a balance between equity and flexibility in terms of investment distributions.

1. Pro-Rata Rights for Investors in AIF Schemes

As per the updated Regulation 20(21), investors in AIF schemes must have pro-rata rights in relation to their commitment to each investment and in the distribution of proceeds from those investments. This ensures that each investor's share of the proceeds remains proportional to their investment. SEBI has, however, provided exceptions: if an investor is excused or excluded from a particular investment or defaults on their contribution, their pro-rata rights may not apply for that investment. Additionally, returns shared with the manager or sponsor, such as carried interest or additional returns, are exempt from the pro-rata requirement. This allows for a more flexible distribution framework.

2. Flexibility for Different Risk Profiles

The amendment introduces flexibility for investors with varying risk profiles. It allows entities to accept returns below their pro-rata share or bear losses exceeding their pro-rata share. This flexibility is specifically intended for large institutional investors, including multilateral and bilateral development financial institutions, state industrial development corporations, and entities controlled by the government. These investors can take on junior or subordinate units within an AIF. This provision ensures that high-risk investments can attract specific institutional players, enhancing the capital flow to sectors such as infrastructure and real estate.

3. Impact on Existing AIF Schemes

For existing AIF schemes, those with a priority distribution model (involving senior and junior/subordinate classes of units) must halt fresh commitments or investments until SEBI issues further directions .If any AIF schemes violate the investment limits as per the updated regulations, such breaches will not be considered non-compliance, as long as they are included in the 'Compliance Test Report' prepared by the AIF manager. This provision aims to mitigate operational disruptions and ensure smooth compliance.

4. Pari-Passu Rights of Investors

Under Regulation 20(22), SEBI has reiterated that investors in AIF schemes generally enjoy pari-passu rights, meaning equal rights in all respects. However, the amendment allows for differential rights for certain investors, as long as they do not infringe on the rights of other investors. These rights must be disclosed clearly in the Private Placement Memorandum (PPM), with no investor holding veto power unless they are part of a defined committee.

5. Disclosure Requirements for Differential Rights

For schemes that filed PPMs post-March 1, 2020, the AIF manager is required to report any differential rights that do not comply with the SEBI guidelines by February 28, 2025. If these differential rights negatively affect other investors, they must be discontinued. These measures are expected to impact approximately 5-8% of all active AIFs, particularly in cases where investments are structured with different investor classes. Additionally, Large Value Funds (LVFs) catering to accredited investors may be exempt from maintaining pari-passu rights, provided they disclose such terms in the PPM and obtain the investor's acknowledgment The differential rights shall be provided only in accordance with the implementation standards formulated by SFA.LVFs typically comprise about 10-12% of the AIF industry, and this provision is expected to foster greater capital inflows from high-net-worth individuals and institutional investors.

Impact of the Circular

The amendments introduced by SEBI are designed to foster transparency and fairness in the AIF space while also offering flexibility for varying investor risk profiles. These changes aim to encourage more investment from large institutions, which already make up over 40% of the total capital deployed in AIFs in India. The updated regulations are effective immediately, and AIFs are expected to comply with these changes by 2025. These reforms are expected to help expand the AIF market, which has seen a 15-20% growth over the past three years, by attracting more institutional investors into sectors like infrastructure, real estate, and sustainable development.