

Investment Funds: Monthly Digest

December 10, 2021

NEW SEBI RULES FOR AIF LPS TO CO-INVEST

In an attempt to regulate offering of co-investment opportunities to investors (or LPs) of Alternative Investment Funds ("AIFs"), the Securities and Exchange Board of India ("SEBI") has recently introduced amendments¹ to the SEBI (Alternative Investment Funds) Regulations, 2012 (the "AIF Regulations")² and SEBI (Portfolio Managers) Regulations, 2020 ("PMS Regulations")³ on November 9, 2021 (referred to as the "Amendment Regulations").

These amendments come, in light of SEBI's recent request to AIF managers to provide details on co-investments made by various AIF LPs from April 1, 2019 to March 31, 2021.⁴

In February 2020,⁵ SEBI had released a template for the Private Placement Memorandum ("PPM") for AIFs to ensure and establish minimum disclosure standards for disclosures to be made under a PPM. The template PPM provided disclosure obligations in relation to co-investment opportunities, such as the eligibility criteria for participating in the co-investment, whether such opportunity was being offered to certain LPs and whether any fees / commission is being charged by the IM/affiliates for offering such co-investment opportunities.

The Amendment Regulations provide a stricter framework than was expected by the industry. The original ask of the industry was to allow co-investments by AIF investors through the AIF itself.⁶ A similar construct was allowed for AIFs in International Financial Services Centres ("IFSC") by the IFSC Authority in December 2020, i.e. AIFs set up in IFSC are permitted to co-invest in a portfolio company through a segregated portfolio by issuing a separate class of units subject to the compliance conditions.⁷ However, SEBI seems to have taken a view that allowing co-invest through the AIF itself would breach the pooling concept of AIFs.⁸

This edition of the Monthly Digest endeavours to analyse the concept of co-investments in the context of fund formation, and discuss the potential impact of the Amendment Regulations.

THE CO-INVESTMENT STRUCTURE

By the very nature of AIFs being blind pool investment vehicles, the AIF LPs do not enjoy the freedom over selection of deals to be made by the AIF, and the same is entirely at the discretion of the AIF manager.

However, in some situations the investment being considered by the AIF manager for the AIF may have some bandwidth for additional capital taking into consideration the maximum amount to be invested by the AIF. In such cases, AIF managers may offer such excess opportunity to the AIF investors to consider 'co-investing' in the deal alongside the AIF.

Often, the buck stops here, i.e. at the AIF manager informing the AIF LPs about the deal opportunity, and the LPs make their own investment decision. In such cases, ordinarily the investors get to play a more active role in the deal selection and portfolio construction process. The AIF manager does not charge any fees or commission in such cases because it only makes a disclosure to AIF LPs about certain investee entities of AIFs requiring more capital in a given round. Sometimes this helps AIF managers to close a relevant deal for the AIF, because co-investors provide an investee entity the required capital for completing the round in which the AIF is investing (given that the AIF has concentration limits).

In some situations, LPs may require the AIF manager's services for such deals, in lieu of fees and therefore engage the AIF manager for such services. In this case, the AIF manager is undertaking a responsibility for such investors.

THE AMENDMENT REGULATIONS AND ANALYSIS

The AIF industry, in an attempt of getting flexibility of facilitating co-investments through fund structures, made a representation⁹ to SEBI, seeking an amendment to the AIF Regulations to allow co-investment by issuing a separate class of units under the fund structure.

While the proposal to allow co-investment within the AIF structure was not approved, SEBI introduced the Amendment Regulations to define and regulate Co-Investment.

The definition of Co-investment introduced under the AIF Regulations by the Amendment Regulations is wider than necessary. As currently defined, it would even include situations where the AIF investors make investments in investee entities of the AIF on their own, without any offer or advice from the AIF Manager, or where the AIF manager offers certain investment opportunities to the AIF investors (typically the uninvested portion of an investee entity after considering the AIF's investment) on a good faith basis in the interest of relationship building rather than as an investment advice or service without charging a fee.

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The definition is relevant as the governing provisions in the Amendment Regulations go on to require terms of investment and exit of such co-investments to be identical to that of the AIF. The issue is that not all such co-investments (as explained above) are in the AIF manager's control to ensure that the terms are identical with that of the AIF.

The definition also suggests that it is an obligation on the AIF investors to make such co-investments only through co-investment portfolio managers ("CPMs") licensed in such manner under the PMS Regulations. Once the definition is amended as above, the obligation to ensure compliance should be on the AIF manager or the CPM rather than the investors.

The AIF Regulations also now prohibit the AIF manager to provide investment advice to any investors other than clients of CPMs. As per the SEBI Memorandum, SEBI has introduced this restriction to ensure that investors who are not AIF LPs do not co-invest alongside the AIF on terms more favourable than those offered to the AIF. While the concern is valid, rather than completely prohibiting AIF managers from being engaged for such services, SEBI should require AIF managers to ensure that any such co-investment by third party investors is also on terms identical to that of the AIF. As currently drafted, the restriction also prohibits any B2B arrangements. For example, an Indian entity which is also an AIF manager could provide investment advice to an offshore fund manager prior to the Amendment Regulations but now seems to be prohibited.

CONCLUDING REMARKS

The Amendment Regulations introduced by SEBI have not been received well by the AIF industry, as the Amendment Regulations, while not considering the representation made by such stakeholders, instead provides for increased regulatory compliances, in a framework which originated as light-touch but is increasingly becoming compliance intensive.

The Amendment Regulations seem to increase the compliance burden on the AIF managers as they would now have to register as portfolio managers with SEBI in order to offer co-investment opportunities to the AIF's investors, in addition to the existing compliance requirements as AIF managers.

This increases the management cost of providing co-investment, which may disincentivise the IMs to provide such right to the investors of the AIF, and in turn impact LP sentiment while allocating to AIFs.

In the International arena, the general practice is to allow co-investment through separate vehicles¹⁰ or by issuing separate classes under the fund's structure¹¹. Furthermore, countries such as United Kingdom, U.S.A, Luxembourg and Singapore prescribe regulations in order to align the interest of the respective limited partners of the co-investment vehicle with that of the main fund. Generally, the same is implemented by the respective general partners by providing for tag-along and drag-along rights in the co-investment agreement with the respective limited partners.¹² Generally, there is no requirement for the general partners/sponsors of a fund to undergo any specific registration in order to facilitate co-investments.¹³

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You can direct your queries or comments to the authors

¹ SEBI (Alternative Investment Funds) (Fifth Amendment) Regulations, 2021 and Securities and Exchange Board of India (Portfolio Managers) (Fourth Amendment) Regulations, 2021

² https://www.sebi.gov.in/legal/regulations/nov-2021/securities-and-exchange-board-of-india-alternative-investment-funds-fifth-amendment-regulations-2021_53830.html

³ https://www.sebi.gov.in/legal/regulations/nov-2021/securities-and-exchange-board-of-india-portfolio-managers-fourth-amendment-regulations-2021_53857.html

⁴ <https://www.vccircle.com/indian-aifs-limited-partners-wary-of-sebi-request-for-co-investment-information>

⁵ SEBI/HO/IMD/DF6/CIR/P/2020/24

⁶ Available at < <https://www.sebi.gov.in/sebiweb/about/AboutAction.do?doBoardMeeting=yes>>

⁷ F. No. 81/IFSCA/AIFs/2020-2021

⁸ Available at < <https://www.sebi.gov.in/sebiweb/about/AboutAction.do?doBoardMeeting=yes>>

⁹ <https://www.sebi.gov.in/sebiweb/about/AboutAction.do?doBoardMeeting=yes#>

¹⁰ Luxembourg allows co-investment vehicles in the form of Joint Ventures and Club-deal Vehicles. See T. Alabaster & G. Faleiro, If it "looks" like a fund, if it "sounds" like a fund... - An Analysis of the Definition of an AIF, Exemptions and Consequences in the Non-Traditional Alternative Investment Space, JurisNews – Investment Management, Vol. 2 - N° 4/2014; Peter-Jan Smet & Sebastiaan Hooghiemstra, "Co-Investment Vehicles" under the AIFM Law: Is your Vehicle an AIF?, Juris News, https://www.nautadutilh.com/sites/nautadutilh.com/files/inline-files/Co-Investment%20Vehicles%20under%20the%20AIFM%20Law%20-%20Is%20your%20Vehicle%20an%20AIF_0.pdf

¹¹ Co-investments, Standards Board for Alternative Investments, <https://cdn.wide-area.com/acuris/files/private-equity-law-report/documents/2019-12-14-Toolbox-Governance-Co-investments-FINAL.pdf>

¹² <https://www.sebi.gov.in/sebiweb/about/AboutAction.do?doBoardMeeting=yes#>

¹³ Co-investments, Standards Board for Alternative Investments, <https://cdn.wide-area.com/acuris/files/private-equity-law-report/documents/2019-12-14-Toolbox-Governance-Co-investments-FINAL.pdf>

¹⁴ <https://www.sebi.gov.in/sebiweb/about/AboutAction.do?doBoardMeeting=yes#>

¹² Helen Kim, Negotiating Co-Investments: Unique Features and Considerations in Co-Investment Vehicle Documents, Private Equity Law Report, [https://www.pelawreport.com/10645711/negotiating-co-](https://www.pelawreport.com/10645711/negotiating-co-investments-unique-features-and-considerations-in-co-investment-vehicle-documents-part-two-of-two.html)

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[https://www.mondaq.com/uk/fund-management-reits/836104/behind-the-co-investment-curtain-current-](https://www.mondaq.com/uk/fund-management-reits/836104/behind-the-co-investment-curtain-current-market-terms-revealed)

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¹³ [https://www.pelawreport.com/2955956/regulatory-risks-and-important-tax-considerations-in-pe-](https://www.pelawreport.com/2955956/regulatory-risks-and-important-tax-considerations-in-pe-coand8209investments-parttwo-oftwo.html)

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