

Consultation paper on providing flexibility to AIFs to offer Co-Investment opportunities to investors within the AIF structure under SEBI (Alternative Investment Funds) Regulations, 2012

Objective

1. To enable AIFs to offer co-investment opportunities in unlisted securities through Co-Investment Vehicle (“CIV”) as a separate scheme of Alternative Investment Fund (“AIF”) launched specifically for making a co-investment under SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”).
2. Removing the prohibition on Investment Managers of AIFs to provide advisory services in listed securities

Background

3. Co-investment, in AIF industry parlance, refers to offering of the investment opportunity to the investors of AIF for additional investment in unlisted securities of an investee company, where the AIF is also making or has made investment. Such investment opportunities are offered to investors who meet certain objective criteria such as size of minimum commitment, strategic value of the investor, etc.
4. SEBI had received representations from the AIF industry during FY 2020-21 requesting to allow co-investment facility within the AIF structure by issuing separate class of units to the co-investors, highlighting, *inter alia*, the following constraints faced by Category I and II AIFs (who invest primarily in unlisted securities), while offering co-investment outside the fund structure—
 - 4.1. Subsequent to the notification of SEBI (Portfolio Managers) Regulations, 2020 (“PMS Regulations”) on January 16, 2020, discretionary Portfolio Managers cannot invest funds of their clients in unlisted securities and the Portfolio Managers offering non-discretionary or advisory services can invest or advise investment in unlisted securities only up to 25% of the assets under management of the clients. As co-investment is generally made in unlisted securities, the portfolio management route earlier followed by Managers became restrictive for such co-investment.
 - 4.2. Further, as per PMS Regulations, the clients have the option for early termination of the portfolio management contract/agreement as well as for the early withdrawal of funds and securities, thereby allowing the investor to exit from an investment before the expiry of the tenure of the contract. The Manager offering co-investment is expected to align the interests of co-investors with those of the AIF so that the interests of investors of the AIF are not adversely affected by the co-investment. If the co-investor makes an early exit/divestment from the investment, such decision may not align the interests of the investors of the AIF with that of the co-investor. This may adversely affect the interests of investors of the AIF.
 - 4.3. Apart from the portfolio management route, the Manager can advise co-investment through investment advisory route. However, the same does not enable the Manager to

maintain alignment of interests of the investors of the AIF with that of the co-investor, since the co-investor has the discretion to take investment management decisions, including exit from investment and the Manager only provides advice to the co-investor.

- 4.4. In view of the above, AIF industry represented to allow co-investment within the AIF structure by issuing separate class of units to the co-investors.
5. Taking into account the recommendations of Alternative Investment Policy Advisory Committee (hereinafter referred to as “AIPAC” or “the Committee”) and internal deliberations, the proposal to allow co-investment within the AIF structure by issuing separate class of units to the co-investors was not acceded to, considering the following:
 - 5.1. AIF is a pooled investment vehicle, where the rights of the investors in investments of and distributions of the returns from a scheme of an AIF are pro-rata to their commitment in the scheme.
 - 5.2. Pooling of funds is an essential characteristic of an AIF, which provides the AIF a distinct identity from its investors and hence should not be compromised.

However, it was also viewed that to facilitate the Managers to manage the co-investment of their investors in unlisted securities outside the AIF framework, amendment to the PMS Regulations to enable co-investment through portfolio management route, merits consideration. Accordingly, AIF Regulations and PMS Regulations were amended in December 2021 to facilitate the co-investments, which is applicable presently.

Issues in the existing framework for co-investment highlighted by Working Group on Ease of Doing Business by AIFs:

6. SEBI set up a Working Group to review compliance requirements under AIF Regulations and provide recommendations with the objective to simplify AIF Regulations, to provide ease of doing business and to reduce cost of compliance to AIF industry. Hereinafter the said working group is referred as “EoDB WG”.
7. In respect of extant Co-Investment framework, EoDB WG highlighted the following issues in the current regulatory regime for co-investments:
 - 7.1. Seeking an additional SEBI registration as Portfolio Manager is not only an added cost to the Manager but also poses hindrance in offering co-investment rights to the investors due to the conditionality contained under the PMS Regulations. It also affects competitiveness of the domestic Investment Managers as their competitors (global PE funds scouting India deals) are not subject to any constraints on co-investments and can thus easily acquire large stakes in Indian companies or participate in large ticket size deals.
 - 7.2. Portfolio companies are sensitive to both the investor profile and the number of investors directly participating on their cap table. Investors on the other hand, seek such participation without the burden of undertaking compliances arising out of such investment. The documentation becomes cumbersome with multiple co-investors and

causes delays in timely closing of transactions and in some instances loss of opportunity to participate due to the delays involved as each co-investor will follow its own process of closure of documentation.

- 7.3. The current regime restricts advising on listed securities in the co-investment context or to advise other funds that are operating alongside the AIF on a parallel investment model basis. WG has recommended allowing managers of AIFs to advise investors on listed securities in the co-investment context and to advise other funds that are operating alongside the main AIF on a parallel investment model basis.
- 7.4. Extant framework under the PMS Regulations requires terms of exit and timing of exit to be identical to such terms applicable to exit of the main fund. However, each co-investor may have its own internal guidelines on exit timeline and thus prefers to have the right to choose not to exit.
- 7.5. The current framework has an expansive definition of co-investment that also potentially captures situations where an investor of the AIF is directly approached by the portfolio company or where the Investment Manager is not charging any fees or economics for its specific services.
- 7.6. As per the extant regulatory framework, co-investment services can be provided only to investors of such funds where the Sponsor is same and is being managed by the Co-investment Portfolio Manager - this impedes the ability of Investment Managers to connect investors with appropriate investment opportunity.

Recommendations of the EoDB Working Group

8. To address the afore mentioned issues, EoDB WG recommended replacing the extant framework for co-investments through the PMS Regulations with an alternative through the AIF Regulations.
9. For this purpose, the EoDB WG compared three models: (a) current framework of making parallel investment directly by the investor into the portfolio company through PMS route (Model A), (b) Issuance of a separate Class of Units within the fund to track co-investments (Model B), and (c) creation of a separate Co-Investment Vehicle ("CIV") tagged to a fund to enable co-investments (Model C). After deliberations, EoDB WG recommended adopting Model C i.e. permitting co-investment through a CIV model, along with the following suggestions:
 - 9.1. CIVs to be allowed to be registered as Category I or Category II AIF (i.e. the same category as the main AIF is registered),
 - 9.2. A shelf PPM of the CIV to be annexed to the PPM of the main AIF at the time seeking registration of the main AIF. The shelf PPM of the CIV to set out in details the following: (a) principles / parameters on which the investors of the main AIF will be offered co-investment right e.g. on basis of quantum of capital commitment to the main AIF. The co-investment policy of the investment manager to be made available for inspection by

prospective investors prior to on-boarding in the main AIF and (b) only Accredited Investors will be offered co-investment opportunities.

- 9.3. The Investment Manager shall seek registration of the CIV at the time of the first co-investment deal by filing the shelf PPM with SEBI and the same shall be deemed approved if no queries from SEBI within 30 days of such filing. CIV to be given a separate registration number so as to ensure a separate PAN can be obtained for tax purposes.
- 9.4. Tenure of CIV to be co-terminus with the main AIF.
- 9.5. Quarterly filing of the CIV shall be made as per extant format subject to exemptions conferred.
- 9.6. CIVs to be exempted from the following requirements under the AIF Regulations:
 - (a) Diversification norms per investee company not to be applicable to a CIV, since a CIV may end up making only a single co-investment with the main AIF. Hence, CIVs to be exempted from conditions set out under Regulations 15, 16 and 17 of the AIF Regulations.
 - (b) Investment Manager should be permitted to set up a single CIV for all co-investments in relation to each main AIF. However, if SEBI is of the view that this will impede severely the pro rata construct set out in the November circular, then SEBI may consider allowing one CIV per co-investment with no restrictions as to the number of CIVs that could co-invest alongside the main AIF
 - (c) no separate sponsor commitment should be required for a CIV since the sponsor would have made its commitment to the main AIF,
 - (d) minimum tenure of 3 (three) years to not be applicable to a CIV.

Issues for consideration and proposals:

10. Co-Investment through separate Co-Investment Vehicle within AIF framework

- 10.1. Pooling of funds is an essential characteristic of an AIF, where the rights of the investors in investments and distributions of the investment returns of a scheme of an AIF are pro-rata to their commitment in the scheme. To maintain the said characteristic of pooled investment vehicle, any co-investment by an investor of the fund, is currently not allowed within the AIF structure and are facilitated through PMS framework.
- 10.2. However, in view of the recommendations of the EoDB WG, issues pertaining to maintaining pro-rata rights of the investors may be addressed by allowing AIFs to launch a separate CIV (scheme) for each co-investment in unlisted securities of the investee companies and relaxing the investment concentration norms under AIF Regulations, so that 100% of the investable fund of the CIV scheme are invested in a single investee company.

- 10.3. This would also address the issues being faced by the AIF industry with respect to obtaining additional SEBI registration as Portfolio Manager and with respect to multiple shareholders in the cap table of the investee company as stated in para 7.1 and 7.2 above respectively.
- 10.4. There is also a view that the issue pertaining to investee company having to deal with multiple investors may be addressed by executing Power of Attorney (“PoA”) by the co-investors that may empower the Co-Investment Portfolio Manager to take all the decisions on behalf of co-investors in a investee company (such as voting, administrative procedures, etc.). However, operational efficiency and effectiveness of the same is not known presently.
- 10.5. Taking into account the suggestions of EoDB WG and internal deliberations, it is proposed to allow managers of AIFs to offer co-investment opportunities to investors of AIFs through CIV model with the following conditions:
- 10.5.1. CIV shall be a scheme of the AIF (Category I or Category II) which shall facilitate co-investment of investors of any of the schemes of the AIF, in unlisted securities of investee companies of AIF
 - 10.5.2. A shelf PPM for CIV scheme shall be filed with SEBI at the time of registration of AIF, if AIF intends to provide co-investment facility to its investors. Existing AIFs can also file the shelf PPM with SEBI for this purpose.
 - 10.5.3. A separate CIV scheme shall be launched for each co-investment in an investee company under intimation to SEBI, in accordance with the shelf PPM for CIV scheme filed with SEBI. Each CIV scheme shall have separate bank account, demat account and PAN.
 - 10.5.4. Co-investment through CIV scheme shall be offered only to Accredited Investors.
 - 10.5.5. CIV scheme shall be exempted from the following requirements:
 - a. Investment diversification norms
 - b. Manager / Sponsor investment commitment
 - c. Minimum tenure of the scheme of an AIF
 - 10.5.6. CIV scheme shall be subject to implementation standards formulated by Standard Setting Forum of AIF, to ensure that the investments by CIV scheme are made for *bona-fide* purposes and that the flexibility extended in this regard is not misused.

Proposals for consideration:

Proposal 1.	Do you agree with the proposal to allow managers of AIFs to offer co-investment opportunities to investors of AIFs by way of launching a separate CIV scheme?
Proposal 2.	Do you agree with the construct of CIV scheme as proposed in para 10.5 above?
Proposal 3.	Whether to discontinue the current framework of offering co-investment through PMS route, if proposal 1 is implemented?

11. Reviewing condition of co-terminus exit of co-investors

- 11.1. The requirement of co-terminus exit for co-investors was stipulated to address the concerns relating to conflict of interest between manager, investors of AIF and co-investors, which may arise if the terms of co-investments are more favourable to co-investors than that offered to investment by the AIF.
- 11.2. It is felt that objective of this mandate is to mitigate conflict of interest concerns between manager, investors of AIF and co-investors and therefore the terms of Co-investment, including the timing of exit, are appropriate to be identical.
- 11.3. AIF Industry also advocated in past to have control over the exit of co-investor to protect the interest of investors of AIFs, as a rationale in support of their request to allow co-investment within AIF structure by issuing separate class of units. EoDB WG has also recommended that the tenure of CIV to be co-terminus with the main AIF.

Proposal for consideration:

Proposal 4.	Do you agree that the terms of co-investment by a scheme of AIF and CIV scheme, including the timing of exit, to be identical?
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12. Relaxing the conditions attached to advisory services by the manager of AIF

- 12.1. Regulation 20(15) of AIF Regulations, states that *“the manager shall not provide advisory services to any investor other than the clients of co-investment portfolio manager as specified in PMS Regulations, for investment in securities of investee companies where the AIF managed by it makes investment.”* The phrase *“for investment in securities of investee companies where the AIF managed by it makes investment”* does not differentiate between listed or unlisted securities; consequently, the manager of AIFs presently cannot provide advisory services to investors other than co-investors on listed securities where the AIF managed by it has made investment.
- 12.2. In this context, EoDB WG highlighted that the current regime restricts advising on listed securities in the co-investment context or to advise on co-investment opportunities in portfolio of other AIFs. This regulatory constraint poses operational and compliance

challenges. Accordingly, EoDB WG recommended to allow Managers of AIFs to advise on listed securities in the co-investment context.

- 12.3. Upon internal deliberations, it is viewed that there may not be similar concerns of conflict of interest between manager and investors of AIFs in providing advisory services on listed securities to investors, irrespective of their AIFs have invested in such listed securities or not. The investment in listed securities can be bought and sold by the AIF or investors on the stock exchanges at the prevailing market price. However, there may be conflict of interest concerns, similar to those in investment in unlisted securities, in allowing managers of AIFs to provide advisory services on listed securities that are thinly traded or not traded, in case their AIFs have invested in such listed securities.
- 12.4. Accordingly, it is viewed that in respect of investment in listed securities of investee companies, manager of AIF may provide advisory to any investors, irrespective of whether the AIFs managed by it has made investment in such listed securities or not.

Proposal for consideration:

<i>Proposal 5.</i>	Do you agree with the view that there are no conflict of interest concerns in allowing managers of AIFs to provide advisory services on listed securities irrespective of whether the AIFs managed by them have made investments in such listed securities or not?
<i>Proposal 6.</i>	Do you agree with the view that there may be conflict of interest concerns, similar to those in investment in unlisted securities, in allowing managers of AIFs to provide advisory services on listed securities that are thinly traded or not traded, in case their AIFs have invested in such listed securities?

Public comments

13. Considering the implications of the aforementioned matter on the market participants, public comments are invited on the proposals 1 to 6 as given above. The comments / suggestions shall be submitted on or before May 30, 2025, via online web-based form through the following link:
<https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes>
14. In case of any technical issue in submitting your comment through web based public comments form, you may contact Mr. Dinesh Ghusinga, Assistant General Manager at dineshg@sebi.gov.in or afdconsultation@sebi.gov.in with the subject of the email as, “Providing flexibility to AIFs to offer Co-Investment opportunities to investors within the AIF structure under AIF Regulations”.

Issued on: May 09, 2025
