GNLU CENTRE FOR LAW & ECONOMICS

Policy Recommendations

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Comments to the Securities and Exchange Board of India (SEBI) on the Consultation Paper on the Draft Circular 'Clarifications and Specific Modalities with Respect to Maintaining Pro-rata Rights of Investors of Alternative Investment Funds (AIF)'

Comments on behalf of the Policy Inputs Research Group, GNLU Centre for Law & Economics

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I. INTRODUCTION

On the 7th of November, 2025, the Securities Exchange Board of India ("**SEBI**") published a Draft Circular for Public Comments titled 'Clarifications and Specific Modalities with Respect to Maintaining Pro-rata Rights of Investors of Alternate Investment Funds.'

This draft has been put out by SEBI to "provide clarity on certain operational aspects and specific modalities with respect to maintaining pro-rata rights of investors of AIFs" based on feedback from the industry since the 2024 amendment of the SEBI (Alternative Investment Funds) Regulations, 2012, and its December 2024 circular, which prescribed certain exemptions regarding the maintenance of AIF investors' pro rata rights.

Active engagement with the latest Indian policy developments through the interdisciplinary lens of law and economics has always been one of the GNLU Center for Law and Economics' key goals. In view of the same, the centre has formed a working group to analyse this draft circular, which has submitted the following observations.

II. GENERAL COMMENTS

Alternate Investment Funds ("**AIFs**") are privately pooled investment vehicles that collect capital from sophisticated investors and invest in accordance with a defined investment policy. AIFs are governed by the SEBI (Alternative Investment Funds) Regulations 2012 ("**AIF Regulations**"). Under Regulation 3(4) of the AIF Regulations, three categories of funds can be registered: Category I, Category II, and Category III.

Category I AIFs invest in start-ups, early-stage ventures, social ventures, SMEs, infrastructure, or other sectors considered socially or economically desirable by the government. Category II AIFs are those that don’t fall into Category I or Category III and only borrow for day-to-day operational requirements. Category III AIFs, considered the riskiest category of AIFs, are those AIFs that use complex trading strategies, including leveraging through listed or unlisted investments.

SEBI amended the AIF Regulations in November 2024 through a circular to mandate pro rata rights (rights proportionate to their investment) and pari passu rights (equal rights for all investors of the same class). The AIF Regulations, however, did not allow for exemptions for certain situations, such as investor defaults or subscription to junior units by managers or sponsors. AIFs were not allowed to use priority distribution models, which created a waterfall between senior and junior investors, resulting in junior investors only getting the residue of the senior’s share, which violated the pari passu principle, as investors with the same commitment percentage did not get the same returns in this model, unless it is for exceptional categories like managers and government entities who take up larger risks. Under this model, AIFs were no longer permitted to accept fresh commitments and investments.

The circular additionally stated that the Standard Setting Forum for AIFs would create a positive list of permissible differential rights by January 15, 2025. It also declared that existing AIFs are to report non-compliant differential rights to SEBI by February 28, 2025

This circular had a few shortcomings. One such major shortcoming was the lack of a clear timeline for existing AIFs built on priority distribution models regarding their restructuring or phasing out. Additionally, there was concern that the winding down of existing priority model-based AIFs might result in breach of contractual obligations between fund managers and investors. Further, the circular did not provide a clear set of criteria for determining when differential rights would affect other investors’ interests, leaving room for subjective interpretation and potential confusion.

To address these issues, SEBI has published the latest draft for public comment, which seeks to close gaps in the previous notification. One key feature is the clarification regarding the operationality of pro-rate rights through two key methods: total and undrawn commitment. It also solved the transition-period conundrum faced by existing AIFs by allowing them to continue their existing schemes, thereby resolving the retrospective winding-down problem they were facing while enabling them to honor their contractual obligations. The circular also provided clarity with regard to the functioning of category III AIFs, which cannot use drawdowns by setting concentration limits to prevent disproportionate stakes.

III. SPECIFIC COMMENTS

Sl. No.	Proposal	Summary	Comments/ Suggestions	Rationale
1.	**Proposal No. 1: Drawdown Methodology - Commitment may be construed as 'commitment' or 'undrawn commitment' for drawing down capital from investors for investment**	Commitment referred to in Regulation 20(21) of AIF Regulations would include commitment or undrawn commitment for pro rata capital drawn down investments from investors and distribution of proceeds for an AIF. Therefore, the procedures and schedules have to be disclosed to enhance transparency, in line with the requirements for closed-ended AIF schemes.	The proposal is supported because it clarifies the operation of the pro-rata rights. However, some suggested changes to enhance this regulation are as follows: 1. It should be mandated to disclose the procedure through which the pro-rata rights have been allocated and the time-weighted pro-rata has been calculated through a systematic template in Private Placement Memorandums ("**PPMs**"). 2. It must be mandated that the drawdown	Systematic disclosure and methodological reporting are essential as transparency remains a significant limitation in private markets. Research shows that information asymmetry in private capital funds is a major risk factor for investors, particularly relating to capital call timing, liquidity forecasting, and allocation fairness. Hence, full disclosure of information and regulation of managers are required to ensure that all the investors have a thorough understanding of the allocation methodology and real-time metrics. It would also provide a platform for investors to monitor

			schedules be reported, and any kind of deviation be explained to the investor advisory boards. 3. The undrawn commitment status should be required to be disclosed regularly through a digital PPM portal to enhance transparency.	their exposure, reducing information asymmetry and strengthening governance. In reality, the investors encompass different classes, fee structures, and timing of capital calls. When drawing down capital, there is a world of difference between a drawdown based on total ‘commitment’ and one based on ‘undrawn commitment’. This illustrates that without clarity, an investor whose commitment has already been called for most of it might be disadvantaged compared to an investor whose commitment remains largely undrawn. By making undrawn commitments acceptable, it allows fund managers to unjustly prevent the penalisation of investors who still have uncalled

				commitments, behind a facade of maintaining fairness across investors.
2.	**Proposal No. 2: Conditions and disclosure requirements regarding the adoption of a drawdown methodology**	This proposal mandates upfront disclosure in the PPM of the basis of calculating pro-rata rights, which cannot be changed during the scheme's tenure. If an investor is excluded from a specific investment, the unutilised portion of their commitment cannot be used for future investments. Additionally, it mandates that no investor should exceed concentration limits under Regulation 15(c) as a result of the drawdown methodology.	The above proposal is supported because it improves the predictability, fairness, and transparency of capital allocation. However, it is recommended that the PPM should include a clear illustrative disclosure.	Investors often struggle to understand the practical impact of allocation rules. Investors and fund managers may interpret matters differently in the absence of concrete examples, leading to disagreements. Precise illustrative disclosure must therefore be included in the PPM to reduce subjectivity and clarify expectations. This would help reduce information asymmetry between investors and fund managers and allow them to rationally make the choices best suited to them.
3.	**Proposal 3: Applicability of the drawdown**	1. Existing AIF schemes that follow a	Existing schemes following other methodologies for	The mandate to comply with either of the two drawdown methodologies

	methodology on existing AIF schemes	drawdown based on either commitment or undrawn commitment shall continue with it until the end of their tenure. 2. If the existing schemes are following any other methodology for drawing down or accepting money for making an investment, the schemes must align their drawdown methodology with either of the above by issuing drawdown notices after the issuance of this circular for	drawing down or accepting money for making an investment, must disclose explicitly to the investors the alignment with either of the two drawdown technologies. Further, it should be considered as a "material change".	is to ensure that all the investors of the AIF schemes are treated equally and are given shares in proportion to their contribution. The investors have the option of not continuing with their contributions after the passing of the circular and any consequent breach of minimum investment requirement based on corpus or investable funds, would not be regarded as non-compliance. Here, the investors are given an option to continue and their consequent breach is not treated as non-compliance. Had this not been a material change, the investors would not have been given an option to discontinue their contributions and their

		making an investment. 3. Such alignment of the drawdown methodology shall be disclosed explicitly to the investors and shall not be construed as a "material change". The investors in such schemes of AIFs shall have the option to continue contributing to investments made by the AIF after the issuance of this circular. In case they opt not to, any subsequent breach of the provisions of the AIF Regulations with respect to		consequent breach would have been regarded as non-compliance. Giving the investors the choice to continue or discontinue their investments after the issuance of the circular takes the 'Rational Consumer Theory' into account, as it allows the investors to make a rational decision of continuing or discontinuing.

		minimum investment requirements or limits based on corpus or investable funds may not be considered non-compliance in this regard.		
4.	**Proposal 4: Drawdown and distribution in open-ended schemes of Category III AIFs.**	1. In open-ended schemes of Category III AIFs, investors may invest in the scheme any amount at any time at their discretion, subject to Clause 4.7 of SEBI Master Circular for AIFs dated May 07, 2024. Drawdown on a pro-rata basis may not be applicable here.	This proposal is economically sound.	Open-ended schemes are already transparent. Here, an investor's profit or loss is directly linked to the NAV. NAV is the per-unit value for a particular mutual fund. With the increase or decrease in NAV, the investors gain profits or suffer losses, which is the same for everyone who invested the same amount of money. The proposal simply reinforces this transparency. Unlisted securities are securities that are not listed in the public market

		2. Open-ended schemes of Category III AIFs shall issue and redeem units at Net Asset Value ("**NAV**"), and other proceeds, if any, shall be distributed pro rata to units held by the investors. 3. However, if an open-ended scheme of Category III AIF has invested or is proposing to invest primarily in unlisted securities, then the conditions specified for maintaining pro-rata rights of investors in close-ended schemes of AIFs		and not traded on the stock exchanges. As these are privately traded, the procedure is not transparent. To ensure transparency, the conditions applicable to close-ended schemes must be applied, mandating compliance with either drawdown methodology. This proposal takes into consideration information asymmetry, which leads to adverse selection. Information asymmetry occurs when the parties do not have complete, identical information. In adverse selection, one party takes advantage of the extra information known to benefit more, which is something fund managers can do by exploiting the information asymmetry of investors and creating things such

		shall be complied with.		as differential pricing and hidden fees. This also reduces monitoring costs that investors would otherwise have had to bear to determine whether they are on the winning or losing end of the deal.
5.	**Proposal 5: Applicability to the distribution of existing investments made by AIFs.**	1. The rights of the investors of the scheme issued prior to the amendment shall be dealt with in the manner specified by SEBI, when it is neither pro-rata nor exempted. 2. Prior to the SEBI circular dated December 13, 2024, AIF schemes that have adopted the priority model and do not fall	The decision by SEBI allowing old investments to follow their original waterfalls is a step toward preserving contractual expectations, enhancing predictability in the system, and avoiding disputes. With regard to this, the following suggestions are made: 1. Clarify what constitutes 'new investments' to avoid ambiguity, since ambiguity raises transaction costs and discourages	First, the prospective banning would work as an incentive to encourage convergence to fairer structure without disturbing the investments. Secondly, the preservation of pre-existing distribution models would help in avoiding the costs of negotiation which occur as per the Kaldor Hicks efficiency model. Further, clear rules about follow ons would reduce transaction costs of disputes and negotiations.

		under para 5 of the said order are directed not to accept any fresh commitment nor make an investment in a new investee company. 3. The distribution of proceeds from investments made prior to December 13, 2024, would be as per the terms of the distribution waterfall as disclosed in the PPM or any other document.	efficient capital deployment. 2. A list should be provided for safe actions that can be taken with respect to the existing investments, such as bridge funding, restructuring investment, etc., which will preserve the allocative efficiency by preventing underinvestment due to regulatory uncertainty. 3. Provisions should allow for limited flexibility where the investors can consent unanimously. This would internalise externalities and	Applying the Coase Theorem, the allowance of unanimous investor consent would enable private bargaining to achieve efficient outcomes in form of distributions. To avoid the double trust dilemma, regulator should not alter the rights retroactively.

			ensure efficient outcomes without harming investor rights.	
6.	**Proposal 6: Proposal related to carried interest and other clarity**	The pro rata rights would not apply to the extent returns or profits on an investment are shared by the investor with the manager or sponsor, or the employees/ directors/ partners of the manager of the AIF. The AIF's commitment must be considered and recorded in Indian National Rupee ("**INR**") for calculating the corpus of the scheme. This amount would form the basis for determining the drawdown, pro rata to the investor's commitment or undrawn commitment.	This provision, which allows interest to be distributed outside the pro rata model in certain circumstances, maintains the industry-standard incentive structures. The following suggestions are made: 1. Clarification is needed to ascertain whether this exemption applies only to carried interest or to co-investment carry, fee waivers, deal-by-deal carry, etc., as well, in order to reduce ambiguity and compliance risk. 2. There should be guidance with respect to the	Carried interest works as an incentive for performance, thereby protecting it supports efficient behavior. Standardization in INR reduces the transaction costs of calculation and audit processes by simplifying it. As per risk allocation to the least cost avoider, FOREX risk should be allocated to the party best able to hedge it. Clarifying catch-up/carry nuances prevents unnecessary renegotiation or disputes.

			conversion date and method for foreign investors, such as whether to use the RBI reference rate on the signing date or on the drawdown date to avoid uncertainty and administrative friction. 3. FOREX can create externalities and risks. To prevent this, there needs to be disclosure of the FOREX risk allocation.	