DEREGULATION AND INVESTOR PROTECTION: A CRITICAL ANALYSIS OF GOVERNANCE CHALLENGES IN INDIA'S NEW AIF REGIME FOR ACCREDITED INVESTORS

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ABSTRACT

Alternative Investment Funds (AIFs) have become an important source of private capital in India, making their governance framework crucial for investor confidence and market stability. In 2025, SEBI introduced Accredited Investors Only funds, based on the assumption that accredited investors are financially sophisticated and capable of protecting their own interests. While this reform aims to improve flexibility and ease of doing business, it also raises serious questions about governance and investor protection. Existing discussions on AI-Only funds largely focus on their benefits and regulatory ease, leaving a vacuum with respect to governance risks. This paper addresses this gap by examining three key vulnerabilities introduced by the 2025 amendments: the transfer of trustee responsibilities to fund managers, leading to reduced independent oversight, the requirement of unanimous investor consent for converting existing AIFs into AI-Only funds, and the relaxation of pari passu treatment by allowing differential rights subject to an unclear ‘not detrimental’ standard. The paper concludes that excessive reliance on investor sophistication, combined with vague regulatory standards and broad managerial discretion, can weaken transparency, fairness, and accountability in AI-Only funds. The paper argues for targeted regulatory reforms, including clearer standards, balanced consent thresholds, and procedural safeguards, to ensure that flexibility does not come at the cost of sound governance.

I. INTRODUCTION

In India's evolving financial landscape, Alternative Investment Funds ('**AIFs'**) have become increasingly popular as a mode of pooled investment among high-net-worth investors, financial institutions, and corporates. As of September 2025, AIFs in India have raised funds worth over INR 6364 billion and made investments worth INR 6119 billion.[1] AIFs are private investment vehicles that pool investments from investors through private placement and invest such capital in line with their objectives.

They are regulated by the Securities and Exchange Board of India ('**SEBI**') under the SEBI (Alternative Investment Funds) Regulations, 2012 ('**AIF Regulations**')[2]. The regulatory architecture governing AIFs has been designed to balance two equally important imperatives *firstly*, facilitating capital investment and *secondly*, ensuring investor protection through a robust governance model.

On November 18, 2025, SEBI notified the SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2025 ('**Amendment**'), followed by a circular dated December 8, 2025.[3] With this amendment, SEBI has recognized a new category of AIF schemes – Accredited Investors only fund ('**AI-only fund**') for "Accredited Investors." AI only fund includes the Large Value Fund for Accredited Investors ('**LVF Fund**').

SEBI had introduced the Accredited Investor framework by amending the AIF Regulations in 2021, laying down the criteria for determining 'sophisticated investors.' AI-only funds will be subjected to a lighter level of regulatory oversight, which, as per SEBI's Consultation Paper dated August 8, 2025 ('**Consultation Paper**') based on the presumption that accredited investors, in light of their better financial understanding and capacity, sophistication, and higher risk-taking ability, will be able to independently and adequately conduct due diligence required while investing.[4]

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[1] SEBI| Data Relating to Activities of Alternative Investment Funds (AIFs)<https://www.sebi.gov.in/statistics/1392982252002.html>.

[2] The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012.

[3] Securities and Exchange Board of India, 'Circular of Modalities for migration to AI only schemes and relaxations to Large Value Funds for Accredited Investors under SEBI (Alternative Investment Funds) Regulations, 2012 Circular- HO/19/34/11(5)2025-AFD-POD1/I/188/2025.

[4] Securities and Exchange Board of India, 'Consultation paper on introduction of separate type of AIF scheme for only Accredited Investors (SEBI Consultation paper) (08 August 2025).

While this regulatory ease shows market maturity and aligns with SEBI's objective of improving ease of doing business and ensuring investment flexibility, it also raises critical questions about the adequacy of governance safeguards. With investments in AIFs being on a significant rise, the contemporary relevance of addressing such issues cannot be overstated. This paper addresses three such critical governance vulnerabilities introduced by the Amendment: *First,* the transfer of responsibilities and obligations of trustees to the manager in AI-only funds leading to erosion of independent oversight; *Second,* the unanimous investor consent mandate for conversion of existing AIFs into AI-only funds creating the unanimity trap; and *Third*, the relaxation of pari passu treatment of investors by permitting differential rights in AI-only schemes, with the condition of these rights not being 'detrimental' to other investors.

Existing literature and comments have majorly focused on the advantages of AI-only funds, ignoring these critical questions related to governance implications. Against this backdrop, this paper adopts a doctrinal and analytical approach to critically analyse the underlying amendments. The discussion proceeds in the following manner: Part II provides a regulatory and structural overview of AIFs in India; Part III examines the manager-trustee conflation and erosion of independent oversight; Part III analyses the requirement of 100% investor consent for scheme conversion; Part IV is based on relaxation in pari passu treatment of investors; Part V presents recommendations for regulatory reforms to address shortcomings in the AI-only fund scheme, following by the conclusion.

II. ALTERNATIVE INVESTMENT FUNDS IN INDIA: REGULATORY & STRUCTURAL OVERVIEW

A. Legislative Framework

AIFs are a distinct class of pooled investment vehicles, beyond the traditional Mutual Funds and Collective Investment Schemes ('CIS'). AIFs are regulated by India's securities and commodity markets watchdog – Securities and Exchange Board of India. They are governed by the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012[5] ('AIF Regulations') and circulars issued thereunder from time to time. The AIF

[5] Supra note 2.

Regulations have also been amended multiple times as the capital markets' landscape continues to evolve.

Regulation 2(1)(b) defines AIFs as a privately pooled investment vehicle established or incorporated in India as a trust/company/limited liability partnership ('LLP')/body corporate, collecting funds from Indian as well as foreign investors, for investing them in accordance with a defined policy, for the benefit of such investors.[6] As stated above, AIF's do not include funds which are covered under the SEBI (Mutual Funds) Regulations, 1996, SEBI (Collective Investment Schemes) Regulations, 1999, or any other SEBI Regulations related to fund management activities.[7] Further, AIFs also do not include family trusts, ESOP Trusts, employee welfare or gratuity trusts, holding companies etc.[8]

AIFs have been classified under 3 different categories, with different investment criteria, fee and regulations. An AIF may be registered by obtaining a certificate of registration[9] under one of the 3 categories and such category can be changed by applying to SEBI only if no investments have been made by it under the original category.[10]

As per Regulation 3(4), Category I AIFs invest in start-ups, early stage ventures, social ventures, small and medium-sized enterprises ('SMEs'), infrastructure, or sectors and areas considered by the government as socially or economically desirable.[11] They include venture capital ('VC') funds, SME funds, infrastructure funds, etc. Category II AIFs are those which do not fall in Category I or III and which do not undertake leverage or borrowing, expect to meet daily operational requirements and as permitted by the AIF Regulations.[12] This includes real estate funds, private equity ('PE') funds etc.[13] Category III AIFs employ diverse or complex trading strategies and may employ leverage, which includes investments in listed and unlisted entities.[14] Various hedge funds and private investment in public equity (PIPE) funds are registered under Category III.

[6] The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 2(1)(b).
[7] The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg (2)(1)(b)(ii).
[8] The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, Proviso to reg 2(1)(b).
[9] The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 3(1).
[10] Securities and Exchange Board of India, 'Circular of Application for change in category of the Alternative Investment Fund, 2013, No. CIR/IMD/DF/12/2013.
[11] The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 3(4)(a).
[12] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 3(4)(b).
[13] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, FAQs.
[14] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 3(4)(c).

AIFs under Category I and II are close ended, having fixed tenures.[15] They also must have a minimum tenure of three years.[16] Category III AIFs may be open or close ended.[17] Except angel funds, which can have a maximum of 200 investors, no AIF shall have more than 1000 investors.[18] AIFs may raise funds for their corpus from accredited investors only via private placements, and are not permitted to make invitation to the public at large for subscribing their units. An investor is required to invest at least one crore rupees in an AIF while employees or directors of the AIF or its manager shall invest at least twenty-five lakh rupees.[19]

The AIF Regulations also require the sponsor or manager to have a continuing interest in the AIF. Under Category I and II, such interest shall be at least 2.5% of the corpus or five crore rupees, whichever is lesser, and for Category III, it shall be at least 5% or ten crore rupees, whichever is lesser. For angel funds, it shall be 2.5% or fifty lakh rupees.[20]

For each financial year, an AIF's manager is required to prepare a compliance test report ('CTR') on compliance with the AIF Regulations and circulars thereunder. Where the AIF is established as a trust, the CTR shall be submitted to the sponsor and trustee within 30 days from the end of the financial year.[21]

B. Structural Framework of an AIF

An AIF may be established in any of the following forms:

i. A trust, established under the Indian Trust Act, 1882;

ii. A company, established under the Companies Act, 2013;

iii. LLP, established under the LLP Act, 2008;

iv. Body corporate [22]

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[15] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 13(1).
[16] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 13(2).
[17] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 13(3).
[18] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 10(f).
[19] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 10(c).
[20] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 10(d).
[21] Securities and Exchange Board of India, 'Circular of Guidelines on disclosures, reporting and clarifications under AIF Regulation' Circular- CIR/IMD/DF/14/2014.
[22] Supra note 3.

Trusts are the most preferred mode of AIFs due operational flexibility as well as lower administrative and compliance requirements. However, a trust does not have a separate legal personality.[23]

The person(s) setting up the AIF, including promoter (in case of a company) and partner (in case of a limited liability partnership) is called the sponsor.[24] The manager is a person/entity appointed by an AIF to manage its investments.[25] The sponsor himself may also be the manager. The sponsor and manager shall be fit and proper persons, based on the criteria provided by the SEBI (Intermediaries) Regulations, 2008.[26] The manager, registered with SEBI under Regulation 4(g),[27] serves as the investment advisor and portfolio manager. He makes investment decisions, monitors portfolio and manages exists.

An investor provides an AIF with capital, which it invests in listed and/or unlisted entities and securities, as per its objectives. The investor later enjoys returns from these investments. There is a fiduciary relationship between the investors and the sponsor/manager of the AIF as the decisions taken by the manager are on behalf of the investors.[28]

An AIF's governing body comprises of board of trustees where the AIF is established as a trust, board of directors ('BoD') in case of a company, or designated partners in case of an LLP, as the case may be. Trustees supervise fund operations, approve transactions, and ensure adhere to the investment mandate, as provided in the Private Placement Memorandum ('PPM'). Similarly, the BoD oversees appointment of the manager, approval of investment policies, review of portfolio performance, adhere to the Companies Act, 2013 and other regulations, etc. In case of an LLP, designated partners are often responsible of management and compliance.

Under Regulation 20(7),[29] an Investment Committee may be constituted by the manager, which approves the AIF's decisions and ensures compliance with policies and procedures. The committee may comprise of internal members and external investors.

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[23] Bharathan, Sai Krishna and Rao, Ganesh (2017) "Alternative Investment Funds in India: Unlocking Sophisticated Investment," *National Law School Business Law Review*: Vol. 3: Iss. 1, Article 3.
[24] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 2(1)(w).
[25] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 2(1)(q).
[26] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 4(f).
[27] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 4(g).
[28] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, Fourth Schedule reg 20(1) and 20(9).
[29] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 20(7).

Another important part of an AIF's structure is the Custodian, who has been authorized under the SEBI (Custodian) Regulations, 1996.[30] Appointed by the sponsor or manager,[31] he provides SEBI with periodic reports about the AIF's investments which are under his custody. Furthermore, the Manager also appoints a Compliance Officer, who ensures compliance with legal requirements and directives issues by SEBI.[32] In case of any non-compliance, the compliance officer is required to independently report to the SEBI, as soon as possible, and maximum within sever working days.[33]

This governance structure reflects international best practices, drawing from United Kingdom's Financial Conduct Authority (FCA) and European Union's Alternative Investment Fund Managers Directive (AIFMD), ensures a system of checks and balances.

With the 2025 Amendment to the AIF Regulations, SEBI has introduced a new class of AIF Schemes for Accredited Investors. AI-only fund is a category of AIFs in which each investor (except the sponsor, manager and employees or directors) qualifies as an accredited investor.

III. EROSION OF INDEPENDENT OVERSIGHT: MANAGER PERFORMING TRUSTEE'S OBLIGATIONS

With the 2025 Amendment to the AIF Regulations, SEBI has introduced a new class of AIF Schemes for Accredited Investors. AI-only fund is a category of AIFs in which each investor (except the sponsor, manager and employees or directors) qualifies as an accredited investor.

The 2025 Amendment has inserted Regulation 20(24) which reads:

"*(24) The responsibilities and obligations of a trustee of an Alternative Investment Fund specified under these regulations shall, in case of an Accredited Investors only fund, be carried out by the manager of the Accredited Investors only fund.*"[34]

This means that in an AI-only fund, the manager will be carrying out all responsibilities which were assigned to the trustee under the standard AIF structural framework. Thus, both decision

[30] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 2(b)
[31] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 20(11).
[32] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 20(17).
[33] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 20(19).
[34] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 3(V) (as amended in 2025).

making and oversight authority now vests with the Manager. In its consultation paper, SEBI stated that the responsibilities were casted on trustee primarily from an investor protection stand point. In case of AI only schemes, such responsibilities under AIF Regulations may be fulfilled by the manager itself.[35] This creates four critical vulnerabilities in governance of AI-only funds: -

A. Functional Conflation and Erosion of Oversight

Under Regulation 20(2), the manager and either the trustee, BoD or designated partners, as the case may be, are jointly responsible for ensuring compliance by the AIF with the Code of Conduct.[36] The manager and trustee also approve the policies and procedures of the AIF.[37] By vesting the trustee's responsibilities and obligations entirely with the manager, regulation 20(24) creates a functional conflation. The implications become particularly stark in a situation where the AI-only AIF is set up as a trust and the sponsor himself acts as the manager. In such a situation, a single entity or person exercises complete authority over sponsorship, investment decision-making, and supervision, eliminating independent oversight. Even where the sponsor himself is not the manager, the sponsor's power to appoint the manager significantly dilutes functional independence.

This undermines the system of checks and balances within the AIF framework, as discussed previously, marking a departure from the regulatory separation between investment and portfolio management functions and supervisory monitoring, a safeguard meant to and ensure legal compliance and accountability.

B. The Heightened Risk of Self-Dealing

Handing over the responsibilities of a trustee to the manager of an AI-only fund also gives rise to concerned regarding self-dealing. Self-dealing refers to a person in a position of trust using their role for their personal gain, instead of acting in the best interests of those they work for.[38] The agency theory states that there is often a conflict of interest between the principal

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[35] Securities and Exchange Board of India, 'Consultation paper on introduction of separate type of AIF scheme for only Accredited Investors (SEBI Consultation paper) (08 August 2025).
[36] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 20(2).
[37] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 20(3)
[38] "Self-Dealing" (*LII / Legal Information Institute*) <https://www.law.cornell.edu/wex/self-dealing> accessed 31 December 2025.

(investors) and the agent (manager), on whom they rely for undertaking financial decisions.[39]

Where supervisory monitoring is absent, the possibilities of corruption increase as managers may be bribed by investees. There is also a risk of unscrutinized related-party transactions in violation of regulation 21.[40] This concern is compounded by the fact that the independent valuer is also appointed by the AIF itself,[41] which being under managerial influence, the risk of valuation manipulation increases as ex ante safeguards reduce.

C. Over-Reliance of Investor Sophistication for Internal Governance

The introduction of AI -only funds and the underlying amendment is based on the rationale that accredit investors are 'sophisticated investors' having higher risk appetite. This sophistication presumes that accredited investors can monitor managerial conduct independently.[42]

While regulatory relaxation can be understood, SEBI appears to have overly relied on accredited investors, substituting the monitoring function performed by trustees in pooled investments. Higher risk appetite, however, does not definitely ensure granular oversight over managerial actions. Even though the regulations have measures for transparency and reporting, information flow remains on the manager's discretion.

D. Ambiguity in application

The underlying amendment also leaves an ambiguity as to whether it is only the responsibilities of the trustee which shall solely rest with the manager, or the transfer extends to the BoD where the AIF is established as a company, and designated partners, where the AI-only Fund is established as an LLP, as the case may be.

While it is true that an overarching majority of AIFs have been set up as trusts, there is no bar to setting up an AI-only fund as a company or LLP, and thus they cannot be ignored. Furthermore, this leaves an inconsistency with the AIF Regulations which uses the term

[39] Linder S and Foss NJ, "Agency Theory" [2013] SSRN Electronic Journal https://doi.org/10.2139/ssrn.2255895 accessed 30 December 2025.
[40] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 21.
[41] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 23(2).
[42] Supra note 32.

"*trustee or the trustee company or the Board of Directors or designated partners of the AIF, as the case maybe*."

One of the most significant governance challenges introduced by SEBI's framework arises

IV. THE UNANIMITY TRAP IN AIF CONVERSIONS

One of the most significant governance challenges introduced by SEBI's framework arises from the requirement of unanimous investor consent for the conversion of an existing AIF scheme into an AI-Only scheme or LVF structure. Existing AIFs are now permitted to migrate into AI-Only or LVF structures however, such migration is not automatic. SEBI's circular dated 8 December 2025 clarified that only eligible AIFs or schemes may undertake such conversion, subject to compliance with the newly prescribed modalities and the prior approval of all investors and satisfaction of all eligibility conditions[43], thereby ensuring investor protection and alignment with revised risk–return expectations.[44]

The consent requirement operates less as a protective safeguard and more as a veto within fund governance. By making conversion contingent upon unanimous investor approval, the framework introduces a classic holdout problem, thus, enabling individual investors to obstruct the decision-making process irrespective of the collective interest.[45] Unanimity rules creates a significant barrier since opposition from even one investor including a smaller accredited entity, is sufficient to prevent the conversion. [46]

Unanimity requirements, while ex ante protective, are widely recognised as inefficient in collective decision-making process. Mancur Olson in *The Logic of Collective Action* Olson's theory of collective action and subsequent transaction cost economics literature demonstrated that when consent thresholds are absolute, individual actors are incentivised to withhold approval to extract private benefits disproportionate to their stake. [47] From the perspective of a

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[43] Securities and Exchange Board of India, 'Circular of Modalities for migration to AI only schemes and relaxations to Large Value Funds for Accredited Investors under SEBI (Alternative Investment Funds) Regulations, 2012 Circular- HO/19/34/11(5)2025-AFD-POD1/I/188/2025.

[44] Taxmann, "SEBI Allows AIFs to Launch or Convert to AI-Only and LVF Schemes" <https://www.taxmann.com/post/blog/sebi-allows-aifs-to-launch-or-convert-to-ai-only-and-lvf-schemes>

[45] XiaoboYu, "A General Theory of Holdouts" (Job Market Paper, 2023).

[46] Nluo C, "SEBI's New Vision for Large Value Funds: Rethinking Investor Safegaurds" (*CCL, NLUO*, October 12, 2025) accessed 30 December 2025.

[47] Mancur Olson, *The Logic of Collective Action* (Harvard University Press, 1965); Oliver E. Williamson, *The Economic Institutions of Capitalism* (Free Press, 1985).

dissenting unitholder, refusal has little to no risk, the status quo remains intact, but the act of dissent can generate significant negotiating power. As a result, a conversion that is beneficial for the investor body as a whole may be derailed by one investor whose rational response is to withhold consent, giving rise to a ‘unanimity trap’.

The problem is further exacerbated by the heterogeneity of AIF investors, which often include domestic and foreign investors with divergent regulatory obligations, tax considerations, and investment horizons and therefore, achieving unanimous consensus in such a setting becomes structurally improbable.

When contrasted with foreign jurisdictions, in countries such as United States and the United Kingdom, amendments to fund governance typically require supermajority approval, with unanimous consent reserved only for changes that directly affect the core economic rights of the investors. These jurisdictions recognise that unanimity is neither practical nor desirable in sophisticated investment environments.

The unanimity requirement further creates perverse incentives for informal or opaque bargaining. Faced with the risk of conversion failure, fund managers may seek to negotiate arrangements with dissenting investors, potentially through side letters or preferential exits. This significantly undermines SEBI’s regulatory concern with information asymmetry and differential treatment among investors. Rather than enhancing investor protection, the unanimity rule may thus increase governance uncertainty and lead to unequal treatment of the investors.

V. DIFFERENTIAL RIGHTS AND THE DILUTION OF PARI PASSU PROTECTION

The concept of pari passu is rooted in the maxim ‘aequitas est quasi aequalitas’ which establishes that fairness arises from equitable treatment[48]. Historically, this principle has functioned as a safeguard in governance of pooled investment vehicles which mandates that investors within the same scheme must stand on an equal footing with respect to priority, sequencing, and enjoyment of their rights, particularly in relation to distributions and

[48] Nayak P ACS and others, “Legal Analysis of the Pari Passu Principle in Distribution of Assets to the Creditor under the Insolvency and Bankruptcy Code, 2016” (2025).

governance participation.

The 2025 reforms however show a significant departure from this approach as SEBI has proposed a more flexible framework that permits departures from strict pari passu treatment. Regulation 20(22) of the SEBI AIF Regulations, 2012 sets out general obligations of AIFs, including the requirement that all investors in a scheme be treated fairly and must comply with the *pari-passu* principle safeguarding the rights of other investors of an AIF equitably.[49] To ensure operational flexibility, the proposal also introduces targeted relaxations, including allowing government owned entities and multilateral institutions, alongside sponsors and managers, to subscribe to junior tranches, and exempting LVF from compliance with these requirements.

Under the amended framework, AI-Only schemes are permitted to grant differential rights to certain investors, provided that such rights are 'not detrimental' to other investors. It permits deviations from strict pari passu treatment subject to four safeguards:

I. Such rights must not impose inter-investor liability

II. Non-monetary or non-commercial rights must not confer decision-making control except for investment committee members

III. Differential rights must not alter or dilute the contractual rights of other investors

IV. All such rights must be transparently disclosed in the Private Placement Memorandum (PPM), including eligibility criteria.[50]

A. Expansion of Permissible Deviations from Pari Passu Treatment

Previously, departures from strict pari passu equality were narrowly confined and only Large Value Funds (LVFs) were permitted to grant differential rights to strategic investors on the basis of investor sophistication and relative bargaining parity.[51] Angel Funds were exempted

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[49] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 20(22).

[50] Sharma V, "Pro-Rata and Pari-Passu Rights: Regulating the Differential Rights for AIF Investors | India Corporate Law" (*India Corporate Law*, March 5, 2025) <https://corporate.cyrilamarchandblogs.com/2025/03/pro-rata-and-pari-passu-rights-regulating-the-differential-rights-for-aif-investors/#:~:text=Regulation%2020(22)%20of%20the,AIF/scheme%20of%20the%20AIF.> accessed 30 December 2025.

[51] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, Proviso 2, reg 20(22).

from pro-rata participation requirements under Regulation 20(21) due to their distinctive opt-in structure, which renders pooled proportional participation impractical.[52] These exemptions were limited and accompanied by enhanced disclosure and investor acknowledgements.

The 2025 regulatory reforms, however, mark a significant departure from this approach as SEBI has now extended the exemption from the pari passu requirement under Regulation 20(22) to all AI-Only funds.[53] Under the amended framework, managers are permitted to extend differential economic and governance rights provided such differential treatment is 'not detrimental' to other investors.[7] This reflects SEBI's broader policy shift toward contractual flexibility and reduced regulatory rigidity.

B. Lack of Clarity in Assessing Investor Detriment

The SEBI framework does not define what constitutes 'detriment' to other investors. Neither the AIF Regulations nor any subsequent circulars have specified whether detriment is to be assessed narrowly in economic terms or more broadly to include governance disadvantages, imbalances in access to information, or reduced participation in decision-making. This gap is significant when contrasted with SEBI's detailed approach to pro-rata participation under Regulation 20(21), where permissible structures, exceptions, and operational safeguards have been clearly laid down.

SEBI's circular dated December 13 has operationalised the 2024 amendments, and limited the scope of differential rights by establishing that such rights must not impose liabilities on other investors, must not alter their financial position, and must not confer impermissible decision-making influence beyond Regulation 20(7).[54] Although these conditions narrow the extent of permissible deviations, they do not resolve the core ambiguity as to what exactly amounts to detriment as a right can comply with each formal requirement and yet materially disadvantage other investors.

C. Determination of Detrimentality

The ambiguity surrounding the definition of "detriment" is further exacerbated by the lack of

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[52] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 20(21).
[53] Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg 20(22).
[54] Securities and Exchange Board of India, 'Circular of Pro-rata and pari-passu rights of investors of AIFs' Circular- SEBI/HO/AFD/AFD-POD-1/P/CIR/2024/175.

clarity as to who bears the responsibility for determining whether a particular differential right is detrimental or non-detrimental. Usually, The obligation to ensure that an AIF complies with all regulatory provisions rests primarily with its manager who is responsible for ensuring adherence to the AIF's internal policies and procedures. Given that the manager is appointed by the AIF and in some cases, the sponsor itself assumes the role of the manager [55] the Regulations, have effectively left the determination to the managerial discretion. Furthermore, the Regulations do not specify whether detriment is to be evaluated ex ante i.e at the time the differential right is granted, or ex post based on its actual impact on other investors nor do they prescribe any procedural safeguards to ensure independent review, fairness opinions, or investor ratification mechanisms.

While the amendment aims to promote flexibility, the absence of clear definitions and safeguards creates uncertainty and risks unequal treatment, thereby highlighting the need for clearer regulatory guidance and effective oversight mechanisms.

V. RECOMMENDATIONS AND REFORM PROPOSALS

In the previous sections, we examined three vulnerabilities in the AI-only fund governance framework. These create compounding risks which undermine investor protection. The following proposals aim to safeguard regulatory checks, structured governance and informational transparency.

1) **Transfer of responsibilities to be made voluntary**: In its consultation paper, SEBI had stated that the responsibilities of the trustee may be fulfilled by the trustee itself, subject to the terms of the agreement between the Trustee and the Manager and the fund documents.[56] However, this agreement between the manager and trustee was not mentioned in the amendment. Further, the term "may be fulfilled" was also replaced by "be carried out." It is suggested that such a transfer of responsibilities to the manager must be kept voluntary and based on agreement between the parties.

2) **SEBI-appointed Independent Valuer and Compliance Officer**: The transfer of

[55] Taxmann, "Private Capital Ecosystem in AIFs – Concept and Essentials" https://www.taxmann.com/post/blog/private-capital-ecosystem-in-aifs accessed 30 December 2025.

[56] Securities and Exchange Board of India, 'Board Memorandum for bringing clarity on the roles and responsibilities of Trustees and Board of Asset Management Companies of Mutual Funds and amendment to SEBI (Mutual Funds) Regulations, 1996.

responsibilities solely to the manager of the AIF, even if voluntary, along with the valuer being appointed by the AIF itself, increases of risk of non-compliance as well as self-dealing. This can be curbed by SEBI's appointment of an external individual who is not directly remunerated by any member of an AIF, but by SEBI directly. He shall be made responsible for monitoring compliance, auditing expense allocations, reviewing differential treatment arrangements, and reporting violations.

3) **Clarifying the scope and applicability of AI-only funds and Regulation 20(24)**: The authors propose issuance of clarification by SEBI regarding whether AI-only funds can be set up as companies and LLPs, and the application of Regulation 20(24) on such funds not set up as trusts.

4) **Post-Implementation Review of AI-only fund performance**: SEBI may monitor conversion uptake rates, complaints received from investors, actions regarding regulatory enforcement, and market developments to assess the performance of the AI-only funds in the market. Based on these findings, targeted amendments may be introduced to address deficiencies and improve governance.

5) **Replace Unanimity with Supermajority Consent for Conversion :** SEBI can reconsider the requirement of unanimous investor consent for conversion of existing AIF schemes into AI-Only or LVF structures. Given the heterogeneous nature of AIF investors, unanimity often creates a holdout problem. A supermajority threshold, coupled with enhanced disclosures and structured exit options for dissenting investors, would strike a better balance between investor protection and governance efficiency.

6) **Discourage Holdout Behaviour and Informal Side Arrangements**: unanimity requirement incentivises strategic dissent and informal negotiations for extracting private benefits. SEBI can address this by adopting voting thresholds that reduce veto power and by mandating transparent, scheme-wide disclosures of any differential arrangements, thereby reinforcing its objectives of transparency and equal treatment.

7) **Clarify the Scope of Permissible Deviations from Pari Passu Treatment**: While the 2025 reforms promote contractual flexibility by relaxing strict pari passu requirements, the absence of a clear definition of "detriment" creates uncertainty. SEBI may issue guidance clarifying the economic and governance dimensions of detriment to ensure consistent

application and prevent unequal treatment. Furthermore, To mitigate risks SEBI can introduce independent fairness reviews, ex ante approvals, or third-party assessments before permitting differential economic or governance rights within AI-Only funds.

8) **Strengthen Disclosure and Investor Ratification Mechanisms**: Enhanced disclosures in the PPM, along with mechanisms for investor acknowledgment or ratification of differential treatment, can further protect investor interests. These measures would ensure that operational flexibility is exercised transparently and does not undermine fairness or equitable treatment.

Overall, these recommendations aim to balance flexibility with investor protection. While lighter regulation encourages efficiency, unclear rules and excessive leads to uncertainty and weakens governance. Clear standards, better disclosures, and practical consent thresholds can reduce risks and ensure that operational freedom does not come at the cost of fairness, transparency, and accountability.

VI. CONCLUSION

SEBI's 2025 reforms mark an important shift in India's AIF regulatory framework by introducing AI-only schemes built on the assumption that accredited investors can adequately protect their own interests. While this approach promotes flexibility and ease of doing business, it also alters long-standing safeguards that were designed to ensure transparency, accountability, and fair treatment within pooled investment structures.

The shift of trustee responsibilities to fund managers concentrates supervisory and decision-making powers in a single entity thus, weakening independent oversight and increasing exposure to conflicts of interest. Similarly, the requirement of unanimous investor consent for conversion of existing AIF schemes, though framed as a protective measure, creates inefficiencies by enabling holdout behaviour and informal negotiations that undermine transparency. Furthermore, the relaxation of the pari passu principle through the allowance of differential rights, without clearly defining what constitutes 'detriment,' introduces legal uncertainty and leaves critical determinations to managerial discretion.

The paper concludes that targeted reforms can address these concerns without reversing the benefits of deregulation. Making the transfer of trustee functions voluntary, introducing independent SEBI-appointed oversight, replacing unanimity with supermajority consent, clarifying the scope of AI-only rules, and defining the contours of permissible deviations from pari passu treatment would strengthen governance while preserving operational freedom.

The core proposition that excessive reliance on investor sophistication, combined with vague regulatory standards and concentrated managerial authority, can weaken investor protection stands proved. In the way forward, the effectiveness of AI-only funds will depend on SEBI's ability to recalibrate the framework to ensure that regulatory flexibility coexists with fairness, transparency, and accountability. A balanced approach will not only protect investors but also reinforce long-term confidence in India's alternative investment ecosystem.