

**SIDE LETTERS IN ALTERNATIVE INVESTMENT FUNDS:
TRANSPARENCY, PREFERENTIAL RIGHTS, AND
REGULATORY CHALLENGES UNDER THE INDIAN
SECURITIES LAW FRAMEWORK**

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Abstract

This paper examines the legal and regulatory implications of side letter arrangements in Alternative Investment Funds (AIFs) under the Indian securities law framework. Side letters, being private agreements between fund managers and select investors, grant preferential economic, informational, or governance rights that are not uniformly available to all investors. While commercially justified in many circumstances, such arrangements create concerns regarding transparency, information asymmetry, and fiduciary accountability. The paper analyses the SEBI (Alternative Investment Funds) Regulations, 2012 and identifies regulatory gaps arising from the absence of explicit statutory provisions governing differential investor treatment. It further evaluates SEBI's disclosure-based regulatory approach and highlights enforcement challenges resulting from the confidential nature of side letters. Through a comparative analysis of regulatory practices in the United States and the European Union, the paper argues that enhanced disclosure and fiduciary scrutiny, rather than outright prohibition, constitute a more effective regulatory response. The study concludes that India requires a calibrated framework that balances contractual flexibility with investor protection to preserve fairness and market integrity in the AIF ecosystem.

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INTRODUCTION

The Indian capital market has observed a remarkable transformation over the last decade, marked by the fast growth of privately pooled investment vehicles operating outside the traditional mutual fund framework. Between these, Alternative Investment Funds (AIFs) have emerged as a crucial channel for mobilizing the capital into the sectors such as private equity, venture capital, real estate, hedge strategies, and distressed assets. Recognizing the need to regulate this evolving segment while allowing flexibility for innovation, the Securities and Exchange Board of India (SEBI) introduced the SEBI (Alternative Investment Funds) Regulations, 2012, thereby providing a formal regulatory structure to the alternative investment industry in India.¹

As the AIF sector has developed, fund managers increasingly engage with institutional and high-net-worth investors who possess substantial bargaining power during fund formation and capital commitment stages. This dynamic has given rise to the heavy use of side letters private contractual arrangements entered into between an AIF (or its manager) and select investors, granting them certain rights that are not uniformly available to all investors in the fund.² These rights may range from fee concessions and enhanced disclosure obligations to preferential liquidity options and regulatory or tax-related assurances. While side letters are many times justified on commercial grounds, their expansion raises serious concerns regarding transparency, investor equality, and fiduciary responsibility.

The central regulatory challenge posed by side letters lies in their inherently private and confidential nature. Unlike the fund's primary constitutional documents such as the private placement memorandum (PPM) or limited partnership agreement side letters are typically not disclosed to the entire investor base.³ This selective disclosure creates

¹ Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, No. LAD-NRO/GN/2012-13/04 (India).

² Andrew J. Donohue & Daniel M. Gallagher, Side Letters and Preferential Treatment in Private Funds, 8 Cap. Mkts. L.J. 289, 291–93 (2013).

³ Wulf A. Kaal, Private Fund Transparency and Investor Protection, 19 Fordham J. Corp. & Fin. L. 149, 172–75 (2014).

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information asymmetry among investors who have committed capital to the same fund but operate under materially different contractual conditions. Such asymmetry sits uneasily with SEBI's broader mandate of investor protection and fair dealing in the securities market.⁴

From a legal perspective, side letters occupy a grey area under Indian securities law. The SEBI (AIF) Regulations, 2012 do not explicitly prohibit side letters, nor do they comprehensively regulate the scope or enforceability of preferential rights granted through them.⁵ Instead, the regulatory framework relies heavily on disclosure-based norms and fiduciary obligations imposed on fund managers. However, the absence of clear statutory guidance has resulted in inconsistent market practices and uncertainty regarding the permissible limits of differential treatment among investors.

Recent regulatory developments indicate that SEBI has begun to acknowledge the risks associated with undisclosed preferential arrangements in AIFs. Through consultation papers and circulars, the regulator has emphasize the need for transparency in side letter arrangements, particularly where such arrangements may materially impact other investors in the fund.⁶ Even with these efforts, significant enforcement and compliance challenges remain, especially given the private and reflect nature of side letters.

Against this background, this paper examines the legal and regulatory implications of side letters in AIFs under the Indian securities law structure. It seeks to review whether existing regulations sufficiently address concerns of transparency and investor protection, and whether preferential rights granted through side letters undermine the fiduciary duties owed by fund managers to the investor collective. By situating the Indian position within a comparative international context, the paper argues for a more structured regulatory approach that balances contractual freedom with the core principles of fairness and market integrity

CONCEPTUALFRAMEWORK: UNDERSTANDING SIDE LETTERS IN AIFS

⁴ Securities and Exchange Board of India Act, 1992, No. 15 of 1992, § 11 (India).

⁵ Generally SEBI (Alternative Investment Funds) Regulations, 2012 (India) (not containing any express provision governing side letters).

⁶ Securities and Exchange Board of India, Consultation Paper on Review of Regulatory Framework for Alternative Investment Funds (Jan. 18, 2023).

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Side letters are a well-established characteristic of private fund structures globally, yet their legal character remains complex due to their contractual, confidential, and investor-specific nature. In the context of Alternative Investment Funds (AIFs), a side letter may be described as a bilateral agreement entered into between the fund or its manager and a particular investor, which modifies, supplements, or clarifies certain rights and obligations otherwise contained in the fund's primary constitutional documents.⁷ Unlike the private placement memorandum (PPM) or limited partnership agreement, which apply uniformly to all investors, side letters operate selectively and are enforceable only between the contracting parties.

At a conceptual level, side letters derive their validity from the principle of contractual freedom. AIFs primarily provide to specific investors, such as institutional investors, private equity funds, sovereign wealth funds, and high-net-worth individuals, who are presumed to possess the bargaining power and expertise necessary to negotiate custom the contractual terms.⁸ Consequently, side letters are often defended as a commercially efficient mechanism that enables fund managers to secure anchor investors, close funds within stipulated timelines, and hold regulatory or tax-specific constraints faced by certain investors.

Side letters typically grant a wide range of preferential rights, which can be largely classified into economic, informational, and governance-related categories. Economic preferences may include management fees discount, carried interest reductions, or priority distributions.⁹ Informational rights often involve enhanced or more frequent disclosures, access to portfolio-level data, or advance notice of material events. Governance-related rights may include participation in advisory committees, consent rights over key decisions, or veto powers in limited circumstances. While these arrangements may appear safe when viewed in isolation, their collective impact can significantly alter the risk-return profile of different investors within the same fund.

⁷ Phoebe A. Wilkinson, *Side Letters in Private Equity Funds: Contractual Flexibility or Regulatory Loophole?*, 45 J. Corp. L. 623, 626–28 (2020).

⁸ Securities and Exchange Board of India, *Concept Paper on Alternative Investment Funds* 6–7 (2011).

⁹ Andrew M. Berman, *Fee Arrangements and Preferential Treatment in Private Investment Funds*, 12 Bus. L. Brief 45, 48–50 (2016).

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A particularly significant feature of side letters is the inclusion of Most Favoured Nation (MFN) clauses. MFN provisions typically allow an investor to select into more favourable terms granted to other investors, subject to certain thresholds or exclusions.¹⁰ Although MFN clauses are many times acted as a tool to mitigate inequality, they may, in practice, reinforce complexity and opacity, as investors remain unaware of the full universe of side letter arrangements unless disclosures are made in a comprehensive and timely manner.

From a legal point of view, side letters raise important questions regarding their relationship with the fund's core documents. In most private fund structures, the governing documents expressly permit side letters, provided they do not materially prejudice other investors or violate applicable law.¹¹ However, determining what constitutes "material prejudice" is inherently subjective and context-specific. In the absence of clear regulatory benchmarks, fund managers are often left to rely on internal compliance assessments, thereby increasing the risk of inconsistent standards and potential conflicts of interest.

In the Indian AIF context, this ambiguity is further compounded by the absence of an explicit statutory definition or regulatory framework governing side letters. While SEBI mandates extensive disclosures in the PPM, side letters being private contracts are not subject to mandatory filing or approval.¹² This regulatory silence has allowed side letters to evolve organically, shaped more by market practice than by legal oversight. As a result, their usage varies significantly across fund categories, investor profiles, and fund managers.

Understanding the conceptual foundations of side letters is therefore essential to evaluating their suitability with the principles of transparency, fairness, and fiduciary responsibility rooted in the Indian securities regulation. Without such a framework, side letters risk becoming instruments that privilege contractual sophistication over

¹⁰ European Securities and Markets Authority, Guidelines on Sound Remuneration Policies under the AIFMD ¶¶ 186–89 (2013).

¹¹ William A. Birdthistle, The Fortunes and Foibles of Exchange-Traded Funds, 2012 Wis. L. Rev. -69, 101–03.

¹² Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg. 11 (India).

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collective investor protection, thereby undermining the integrity of the AIF regime as a whole.

LEGAL AND REGULATORY FRAMEWORK GOVERNING AIFS IN INDIA

The regulation of Alternative Investment Funds in India reflects a purposeful regulatory choice to strike a balance between investor protection and market flexibility. Before the 2012, privately pooled investment vehicles such as private equity and venture capital funds operated in a fragmented regulatory environment, many time structured through trust or company forms with limited sector-specific oversight. This changed with the introduction of the SEBI (Alternative Investment Funds) Regulations, 2012, which combined the regulatory framework for such fund and sought to bring greater transparency and accountability to the alternative investment space.¹³

The AIF Regulations classify funds into three categories based on their investment objectives and by observed risk profile. Category I AIFs include socially or economically desirable funds such as venture capital funds, infrastructure funds, and social venture funds, which may receive certain regulatory incentives. Category II AIFs, which form the largest segment, include private equity funds and debt funds that do not undertake leverage other than for limited operational purposes. Category III AIFs include hedge funds and other funds that employ complex trading strategies and leverage to generate short-term returns.¹⁴ This categorisation is relevant to the discussion on side letters, as the nature and extent of preferential rights many times depending on the category of the fund and the specific types of its investor base.

A central feature of the AIF regulatory regime is its reliance on disclosure rather than substantive merit-based regulation. SEBI mandates that AIFs raise funds only through private placement and requires detailed disclosures to investors through the private placement memorandum (PPM).¹⁵ The PPM is intended to serve as the primary document informing investors of the fund's investment strategy, fee structure, risk factors, governance mechanisms, and conflicts of interest. However, while the PPM

¹³ Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, No. LAD-NRO/GN/2012-13/04 (India).

¹⁴ Id. reg. 3(4).

¹⁵ Id. reg. 11.

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must disclose all material terms applicable to investors generally, it does not necessarily capture investor-specific arrangements negotiated through side letters.

The AIF Regulations impose fiduciary-like obligations on fund managers and sponsors, particularly in relation to conflicts of interest and fair treatment of investors. Regulation 20 requires AIF managers to act in the best interests of investors and to ensure that conflicts are identified, mitigated, and disclosed.¹⁶ This provision implicitly assumes a standard of equitable treatment among investors, even though it stops short of mandating identical contractual rights. The absence of an express prohibition on differential treatment has allowed side letters to coexist with the fiduciary framework, albeit in a legally ambiguous manner.

In addition to the AIF Regulations, SEBI derives its authority to regulate side letter practices indirectly from its broader statutory mandate under the SEBI Act, 1992. Section 11 of the Act empowers SEBI to take measures necessary to protect the interests of investors and to regulate the securities market.¹⁷ This expansive mandate has been used by SEBI to issue circulars and guidelines addressing emerging market practices, including preferential arrangements that may affect investor protection. However, the lack of specific statutory language addressing side letters limits the predictability and enforceability of such interventions.

Recent regulatory initiatives suggest a gradual shift towards greater scrutiny of side letter arrangements. SEBI has introduced standardised PPM templates and enhanced disclosure requirements for AIFs, including disclosures relating to differential rights granted to certain investors.¹⁸ While these measures represent an important step towards transparency, they rely heavily on self-reporting by fund managers and do not establish clear substantive limits on the nature of preferential rights that may be granted.

Overall, the Indian regulatory framework governing AIFs adopts a principles-based approach that prioritises disclosure and fiduciary responsibility over prescriptive regulation. While this approach offers flexibility and accommodates commercial

¹⁶ Id. reg. 20.

¹⁷ Securities and Exchange Board of India Act, 1992, No. 15 of 1992, § 11 (India).

¹⁸ Securities and Exchange Board of India, Circular No. SEBI/HO/AFD/AFD-PoD-1/P/CIR/2022/157 (Nov. 23, 2022).

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realities, it also creates regulatory blind spots, particularly in relation to private contractual arrangements such as side letters. The resulting tension between contractual freedom and collective investor protection lies at the heart of the legal challenges examined in this paper.

TRANSPARENCY AND PREFERENTIAL RIGHTS: LEGAL CONCERNS

Transparency forms the cornerstone of modern securities regulation, particularly in regimes that rely on disclosure rather than merit-based supervision. Within the Alternative Investment Fund (AIF) framework, transparency is intended to ensure that investors are able to make informed decisions and that fund managers remain accountable for conflicts of interest. The increasing use of side letters, however, poses a direct challenge to these objectives by creating differentiated rights and obligations that are not uniformly disclosed to all investors.¹⁹

One of the primary legal concerns arising from side letters is the problem of information asymmetry. When select investors receive enhanced disclosure rights such as access to portfolio-level information, early notice of exits, or regulatory communications, other investors in the same fund may be placed at a structural disadvantage.²⁰ This asymmetry is particularly troubling in closed-ended AIF structures, where investors lack exit flexibility and must rely heavily on periodic disclosures to monitor fund performance. While sophisticated investors may be presumed to tolerate some degree of inequality, Indian securities law does not endorse a regulatory model that permits material informational advantages to remain undisclosed.

Preferential economic rights granted through side letters raise a separate but related concern. Fee rebates, priority distributions, or downside protection mechanisms may significantly alter the risk-return calculus among investors within the same fund.²¹ Although SEBI regulations do not require identical economic treatment, such

¹⁹ Wulf A. Kaal, *Private Fund Transparency and Investor Protection*, 19 *Fordham J. Corp. & Fin. L.* 149, 160–64 (2014).

²⁰ Andrew J. Donohue & Daniel M. Gallagher, *Side Letters and Preferential Treatment in Private Funds*, 8 *Cap. Mkts. L.J.* 289, 295–97 (2013).

²¹ Andrew M. Berman, *Fee Arrangements and Preferential Treatment in Private Investment Funds*, 12 *Bus. L. Brief* 45, 51–53 (2016).

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arrangements may indirectly prejudice non-favoured investors by shifting costs or risks onto the broader investor pool. In the absence of transparent disclosure, investors may be unable to assess whether their interests are being diluted through private contractual arrangements negotiated by others.

These concerns are closely linked to the fiduciary obligations owed by AIF managers and sponsors. Regulation 20 of the AIF Regulations obliges managers to act in the best interests of investors and to manage conflicts of interest fairly.²² Granting preferential rights to certain investors particularly where those investors exert significant influence over fund governance, may place managers in a position where their duty to the investor collective conflicts with commercial incentives to accommodate large or early investors. This tension becomes more pronounced when side letters remain confidential, as the absence of disclosure impedes effective accountability.

The principle of equitable treatment, while not explicitly codified in the AIF Regulations, is implicit in SEBI's broader investor protection mandate. Indian securities jurisprudence has consistently emphasize fairness and non-discrimination as guiding principles of market regulation.²³ Side letters that materially alter investor rights without adequate disclosure risk undermining this normative foundation. Even where side letters are commercially justified, their legitimacy depends on whether they are implemented in a manner consistent with transparency and informed consent.

Another significant legal concern relates to enforceability and regulatory oversight. Side letters, being private contracts, are typically governed by general principles of contract law rather than securities regulation. This raises questions about SEBI's ability to monitor, investigate, or sanction practices that may fall within the letter of contractual freedom but violate the spirit of securities regulation.²⁴ The confidential nature of side letters further complicates enforcement, as regulators often rely on self-disclosures or whistleblower complaints to identify problematic arrangements.

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

²³ Sahara India Real Estate Corp. Ltd. v. SEBI, (2013) 1 SCC 1 (India).

²⁴ Securities and Exchange Board of India Act, 1992, No. 15 of 1992, § 11 (India).

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Taken together, these issues reveal a structural tension within the Indian AIF framework. While side letters serve legitimate commercial purposes, their unchecked use risks eroding transparency, exacerbating conflicts of interest, and weakening investor confidence. Addressing these concerns does not necessarily require prohibiting side letters altogether; rather, it calls for clearer regulatory standards that define the permissible scope of preferential rights and mandate disclosures sufficient to preserve the integrity of the AIF regime.

SEBI'S REGULATORY RESPONSE AND ENFORCEMENT CHALLENGES

SEBI's approach to regulating side letters in Alternative Investment Funds reflects a gradual and reactive regulatory strategy rather than a comprehensive, ex ante framework. For much of the initial decade following the introduction of the AIF Regulations in 2012, side letters remained largely outside the regulator's direct focus. This regulatory restraint was rooted in SEBI's assumption that AIF investors are sufficiently sophisticated to protect their own interests and that market discipline, rather than prescriptive regulation, would curb abusive practices.²⁵ However, as the AIF industry expanded in size and complexity, concerns surrounding undisclosed preferential arrangements began to attract closer regulatory scrutiny.

In recent years, SEBI has attempted to address these concerns primarily through enhanced disclosure norms rather than substantive prohibitions. A significant step in this direction was the introduction of standardised Private Placement Memorandum (PPM) templates for AIFs, which require fund managers to disclose the existence of any differential or preferential rights granted to certain investors.²⁶ These disclosures are intended to ensure that investors are at least aware of the presence of side letter arrangements, even if the precise contractual terms remain confidential. This approach aligns with SEBI's broader philosophy of disclosure-based regulation, which seeks to empower investors without unduly constraining contractual freedom.

SEBI has further reinforced this approach through consultation papers that explicitly acknowledge the risks posed by side letters. In its 2023 consultation paper on the

²⁵ Securities and Exchange Board of India, Concept Paper on Alternative Investment Funds 8–9 (2011).

²⁶ Securities and Exchange Board of India, Circular No. SEBI/HO/AFD/AFD-PoD-1/P/CIR/2022/157 (Nov. 23, 2022).

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review of the AIF regulatory framework, SEBI noted that preferential treatment through side letters may result in unfair advantages and undermine investor confidence if not adequately disclosed.²⁷ The paper proposed greater transparency around such arrangements, particularly where they could materially affect the rights or interests of other investors. Although these proposals indicate a heightened regulatory awareness, their implementation remains dependent on industry compliance rather than direct regulatory supervision.

Despite these initiatives, enforcement challenges continue to limit the effectiveness of SEBI's response. Side letters are inherently private agreements, often protected by confidentiality clauses that restrict disclosure beyond a narrow group of parties. As a result, SEBI's ability to detect non-compliant or abusive arrangements is constrained unless fund managers voluntarily disclose such arrangements or investors raise grievances.²⁸ This reliance on self-reporting creates enforcement asymmetries, as smaller or less influential investors may lack the information or incentives necessary to challenge preferential treatment.

Another enforcement difficulty arises from the absence of clear substantive standards governing permissible differential treatment. While SEBI requires disclosure of preferential rights, it has not articulated definitive criteria for determining when such rights cross the threshold into unfair or prejudicial conduct.²⁹ This ambiguity complicates enforcement actions, as regulatory intervention must often rely on broad principles of investor protection and fiduciary duty rather than precise statutory violations. Consequently, fund managers may comply formally with disclosure requirements while continuing practices that raise substantive fairness concerns.

Moreover, SEBI's enforcement toolkit is better suited to addressing public market violations than private contractual arrangements embedded within alternative investment structures. Investigating side letters requires detailed examination of fund

²⁷ Securities and Exchange Board of India, Consultation Paper on Review of Regulatory Framework for Alternative Investment Funds 14–16 (Jan. 18, 2023).

²⁸ Wulf A. Kaal, Private Fund Transparency and Investor Protection, 19 *Fordham J. Corp. & Fin. L.* 149, 182–85 (2014).

²⁹ Andrew J. Donohue & Daniel M. Gallagher, Side Letters and Preferential Treatment in Private Funds, 8 *Cap. Mkts. L.J.* 289, 302–04 (2013).

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documentation, investor communications, and internal compliance processes, all of which are resource-intensive and legally sensitive.³⁰ These practical limitations further weaken the deterrent effect of regulatory oversight.

In sum, SEBI's regulatory response to side letters in AIFs reflects an incremental effort to enhance transparency without fundamentally restructuring the contractual dynamics of private funds. While recent disclosure-focused measures represent an important step forward, persistent enforcement challenges and regulatory ambiguity continue to undermine their effectiveness. Without clearer standards and stronger supervisory mechanisms, SEBI's ability to reconcile contractual flexibility with investor protection in the context of side letters remains limited.

COMPARATIVE ANALYSIS: INTERNATIONAL REGULATORY APPROACHES

A comparative examination of international regulatory practices reveals that side letters are not unique to the Indian alternative investment landscape. Jurisdictions with mature private fund markets have long grappled with the tension between contractual flexibility and investor protection, and their regulatory responses offer valuable insights for the Indian context. In particular, the approaches adopted in the United States and the European Union demonstrate a gradual shift from regulatory indifference to enhanced disclosure and fiduciary accountability.

A. United States In the United States, side letters are a common feature of private funds, particularly in private equity and hedge fund structures. The regulatory treatment of side letters is shaped largely by the fiduciary obligations imposed on investment advisers under the Investment Advisers Act of 1940. Rather than prohibiting preferential arrangements outright, U.S. regulators focus on whether such arrangements are adequately disclosed and whether they are consistent with the adviser's fiduciary duty of loyalty to all investors.³¹

³⁰ Securities and Exchange Board of India Act, 1992, No. 15 of 1992, § 11 (India).

³¹ Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (2022).

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The U.S. Securities and Exchange Commission (SEC) has repeatedly emphasised that granting preferential rights to certain investors is not inherently unlawful. However, failure to disclose material preferential treatment, especially where it affects liquidity, redemption rights, or access to information, may constitute a breach of fiduciary duty or a misleading omission.³² Enforcement actions in the U.S. have often centred on scenarios where side letters created hidden conflicts of interest or materially disadvantaged other investors without their informed consent.

Recent regulatory reforms further underscore this disclosure-centric approach. The SEC's private fund adviser reforms seek to enhance transparency around preferential treatment by requiring advisers to disclose material economic and governance arrangements granted to certain investors.³³ While these reforms stop short of banning side letters, they impose greater compliance obligations and reinforce the principle that investor sophistication does not negate the need for transparency.

B. European Union The European Union adopts a comparatively more structured approach through the Alternative Investment Fund Managers Directive (AIFMD). The AIFMD imposes explicit obligations on fund managers to ensure fair treatment of investors and to disclose any preferential treatment granted through side letters.³⁴ Article 12 of the Directive requires managers to act honestly, fairly, and with due skill, care, and diligence, while Article 23 mandates disclosure of material arrangements that could result in preferential treatment.

Under the AIFMD framework, fund managers must disclose the existence and nature of side letter arrangements to prospective investors before they invest, even if the precise contractual terms are not shared in full.³⁵ This approach reflects a regulatory recognition that unequal treatment may be commercially justified but must be accompanied by informed consent and transparency. Supervisory authorities in the EU

³² U.S. Securities and Exchange Commission, In the Matter of Blackstone Management Partners L.L.C., Investment Advisers Act Release No. 4219 (Oct. 7, 2015).

³³ U.S. Securities and Exchange Commission, Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Investment Advisers Act Release No. 6240 (Aug. 23, 2023).

³⁴ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers, art. 12, 2011 O.J. (L 174) 1.

³⁵ Id. art. 23.

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also possess stronger investigative powers to review fund documentation and assess compliance, thereby enhancing enforcement effectiveness.

C. Lessons for India The comparative experience of the United States and the European Union highlights several lessons for the Indian regulatory framework. First, both jurisdictions accept the commercial reality of side letters but subject them to heightened disclosure and fiduciary scrutiny. Second, regulatory effectiveness depends not merely on disclosure obligations but also on clear standards for assessing materiality and investor prejudice. Third, enforcement capacity plays a critical role in ensuring that transparency requirements translate into substantive investor protection.

For India, these approaches suggest that a calibrated regulatory response, one that mandates meaningful disclosure of preferential rights while reinforcing fiduciary accountability, may be preferable to either complete regulatory abstention or rigid prohibition. Adapting these international practices to the Indian AIF ecosystem could help address existing transparency deficits without undermining the flexibility that underpins private fund investments.

POLICY ANALYSIS AND NEED FOR REFORM

The preceding analysis demonstrates that while side letters serve legitimate commercial objectives within the Alternative Investment Fund (AIF) ecosystem, their unregulated or under-regulated use poses systemic risks to transparency, investor protection, and regulatory credibility. The policy challenge for Indian securities regulation is not to eliminate side letters altogether, but to ensure that their operation remains consistent with the foundational principles of fairness, disclosure, and fiduciary accountability.

A central policy concern lies in the overreliance on investor sophistication as a justification for regulatory restraint. While AIF investors are undoubtedly more sophisticated than retail market participants, sophistication does not equate to perfect information or bargaining parity.³⁶ Smaller institutional investors, family offices, and first-time participants may lack the leverage necessary to negotiate comparable terms or to demand full disclosure of existing preferential arrangements. A regulatory

³⁶ Wulf A. Kaal, Private Fund Transparency and Investor Protection, 19 Fordham J. Corp. & Fin. L. 149, 165–67 (2014).

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framework that assumes homogeneity among AIF investors risks entrenching structural inequalities within the fund.

Another critical issue is the ambiguity surrounding the permissible scope of preferential rights. Current SEBI regulations do not articulate clear thresholds for determining when differential treatment becomes unfair or materially prejudicial.³⁷ As a result, compliance is often reduced to a formalistic disclosure exercise rather than a substantive assessment of investor impact. From a policy perspective, this ambiguity undermines predictability and weakens deterrence, as fund managers may remain uncertain about the regulatory consequences of aggressive side letter practices.

Reform efforts should therefore prioritise enhanced disclosure standards coupled with clearer fiduciary benchmarks. One potential approach is to mandate categorical disclosure of the types of preferential rights granted through side letters, such as fee concessions, liquidity preferences, or information advantages, without necessarily requiring full disclosure of commercial terms.³⁸ This would allow investors to assess relative positioning within the fund while preserving a degree of contractual confidentiality. Additionally, SEBI could require explicit investor acknowledgment of such disclosures, reinforcing the principle of informed consent.

Strengthening fiduciary accountability is equally important. SEBI may consider issuing interpretative guidance clarifying that fiduciary duties under Regulation 20 extend to evaluating the cumulative impact of side letters on the investor collective.³⁹ Such guidance would shift the focus from procedural disclosure to substantive fairness and encourage fund managers to internalise the broader consequences of preferential arrangements. Over time, this could foster a compliance culture that prioritises investor trust alongside commercial efficiency.

Finally, regulatory reform must be supported by improved supervisory and enforcement capacity. Enhanced reporting mechanisms, periodic compliance audits, and targeted

³⁷ Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (India).

³⁸ Securities and Exchange Board of India, Consultation Paper on Review of Regulatory Framework for Alternative Investment Funds 18–20 (Jan. 18, 2023).

³⁹ Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg. 20 (India).

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inspections could enable SEBI to better monitor side letter practices without imposing disproportionate compliance costs.⁴⁰ These measures would also signal regulatory seriousness and deter opportunistic behaviour that exploits contractual opacity.

In sum, the need for reform in the regulation of side letters arises not from their existence, but from the risks they pose when left unchecked. A calibrated policy response, one that harmonises contractual freedom with transparency and fiduciary responsibility, would strengthen the integrity of India's AIF regime and align it more closely with global best practices.

CONCLUSION

The growing prevalence of side letters in Alternative Investment Funds reflects the evolving commercial realities of private capital markets, where flexibility and bespoke arrangements are often essential to fund formation and investor participation. In the Indian context, side letters have emerged as a pragmatic tool for accommodating the diverse regulatory, tax, and commercial requirements of sophisticated investors. However, their increasing use has also exposed structural weaknesses in the existing regulatory framework governing AIFs.

This paper has demonstrated that while Indian securities law does not expressly prohibit side letters, their operation raises serious concerns relating to transparency, information asymmetry, and fiduciary accountability. The reliance on disclosure-based regulation, coupled with the absence of clear substantive standards, has allowed preferential arrangements to develop largely beyond effective regulatory scrutiny. As a result, similarly placed investors within the same fund may be subject to materially different rights and risks, often without adequate awareness or informed consent.

Comparative analysis with the United States and the European Union illustrates that mature jurisdictions have moved towards greater regulatory engagement with side letters, not by banning them, but by subjecting them to enhanced disclosure and fiduciary oversight. These approaches recognise that contractual freedom in private

⁴⁰ Securities and Exchange Board of India Act, 1992, No. 15 of 1992, § 11 (India).

funds must coexist with baseline standards of fairness and investor protection. India's regulatory response, though evolving, remains incomplete in this regard.

The paper argues that meaningful reform lies in recalibrating the balance between flexibility and protection. Clearer disclosure obligations, strengthened fiduciary guidance, and improved supervisory capacity can collectively address the risks posed by side letters without undermining the efficiency of the AIF market. Ultimately, the legitimacy of side letters depends not on their contractual sophistication, but on whether they operate within a framework that preserves transparency, trust, and market integrity.

As India's alternative investment industry continues to expand and attract global capital, the regulation of side letters will play a critical role in shaping investor confidence and regulatory credibility. A principled and proportionate approach to reform will ensure that side letters remain instruments of commercial accommodation rather than sources of systemic inequity within the AIF ecosystem.

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